FT.com FINANCIAL TIMES

University funds take a course in liquidity

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Published: October 16 2009 03:00 | Last updated: October 16 2009 03:00

Harvard is cutting back on hot breakfasts. Princeton is not letting its students use the campus printers as much. Stanford students will have to wait for their student union to be renovated.

Some of the most prestigious and richest universities in the world are facing steep budget cuts after a year of crushing losses for their endowments. And it represents quite a turnround. For years, universities such as Harvard and Yale were the envy of the investment world because it seemed they had hit on a formula that consistently produced better returns. This was because they had moved aggressively and early into alternative assets, such as private equity, real estate and "real assets" such as timber, with less reliance on equities and bonds.

The strategy delivered explosive growth and gave the schools more money to expand departments and fund research.

But the financial crisis has brought huge losses for some endowments and posed the question: are alternative assets still the best bet for superior returns, or has the experiment failed?

"Many endowments are reassessing their investment strategies, having learnt the hard way that liquidity really matters given the need to disburse funds on a regular basis," says Hazel McNeilage, executive director at Principal Global Investors. "Many of them followed Yale and Harvard into very large allocations into illiquid alternative investments, which have proved challenging in terms of both liquidity and returns. They are now reassessing this model."

Endowments, led by David Swensen at Yale, pioneered new investing styles, trailblazing the path that many others followed - out of the traditional mix of stocks and bonds to so-called "alternatives." The "Swensen model" earned cult status and envious returns. The Yale endowment raised its value by more than 10 times to $23bn between 1988 and 2008.

The crisis inflicted particularly acute pain on the endowments that embraced this model. The median fall for large endowments in the fiscal year to June 30 was 17 per cent, according to Wilshire Associates, an investment consultancy. The performance of the top schools was much worse. The Yale endowment dropped 25 per cent, Harvard 27 per cent and Stanford 26 per cent.

The declines have brought budget cuts, lay-offs, scrapped expansion plans and several public bond sales. But many schools have preserved financial aid for less well off students.

The Yale model hinges on the idea of diversification, using an array of different investments to insulate against a rough stint in any one, and looking beyond the publicly traded markets at areas where there may be less visibility, but a greater chance of finding mispriced assets. Some borrowed against the portfolio, creating a negative cash position.

"The big problems came in not knowing how assets would correlate and not knowing how illiquid these assets would become," says Chris Bittman, a partner at Perella Weinberg Partners who was hired this year from the University of Colorado endowment to run Perella's Agility business, which now manages the endowment. Endowments were squeezed when every asset, except those with government backing, converged in a precipitous decline late last year.

Some were forced to sell their liquid assets at the bottom to meet the needs of the university or capital calls on their investments. Some money was locked up in hedge funds with limits on withdrawals. Some argue that Yale and other early adopters had the advantage of buying into illiquid areas early before the mispricings were exploited by the masses.

The University of Pennsylvania suffered a relatively modest decline of 16 per cent for the year. When Kristin Gilbertson was hired in 2004 to manage the endowment, then $4bn, she decided to slowly increase the amount invested in "alternatives" and remained cautious in early 2008, keeping a 15 per cent allocation to ultra-safe US Treasuries. She also kept a significant portfolio of stocks, tilted to blue chips, which are among the most liquid and widely studied investments. They outperformed over the last year, as did Treasuries. "We needed to walk before we could run," Ms Gilbertson says.

"The idea was to diversify, but to do it slowly, given where valuations were at the time."

Harvard has since reduced its uncalled capital commitments to raise liquidity, while hiring new managers to bring more control of the endowment in-house. The aim is to increase flexibility to react the next time a downturn hits. Stanford has put up to $1bn of its portfolio, including private equity and real estate, on the block.

Still, few in the industry expect a wholesale shift in strategy back to traditional public markets - nor do they advocate it.

"It is more about liquidity than strategy," says Stewart Massey, a partner at Massey Quick, which manages endowments. "Time horizons have been compressed over the last six months. Endowments are theoretically perpetual pools of capital, but market conditions made it difficult for the investment community and CIOs to think about perpetuity in the context of what was going on around them."

Harvard has said that during the past 10 years, its strategy has added $18bn in value over what it would have earned by employing a simple 60:40 stock bond portfolio.

Mr Bittman adds: "There are a lot of institutional investors that would take that Yale model performance in the last 10 years in exchange for one difficult year."

The recent market rally has given endowments breathing room. But managers and advisers believe their boards will not allow them to be as aggressive with leverage or in running down cash in future. And, even if it tempers performance in good times, most endowments are likely to be more conservative and maintain larger holdings of investments that can be readily sold the next time liquidity runs dry.

Ms Gilbertson says the allocation to Treasury bonds "was an insurance policy. When we needed it, it was there for us".

Additional reporting by Aline van Duyn

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