

THE Smartest GUYS IN THE ROOM

Josh Lerner tells us why endowments at top private schools and universities in the U.S. do so much better than the rest.

BY CAROLINE CAKEBREAD

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League schools have been taking top marks when it comes to investment returns. So concludes Josh Lerner, the Jacob H. Schiff Professor of Investment Banking at Harvard Business School. In his paper, “Secrets of the Academy: The Drivers of University Endowment Success,” Lerner and his co-authors, Antoinette Schoar and Jialan Wang, find that 5% of university endowments have outperformed the largest defined benefit pension funds in the U.S. for the past ten years. And they have outperformed all other endowments by 3% a year on average—in 2000, that number jumped to 14%. The trend surprised Lerner and his colleagues—even though Yale University’s endowment regularly outperforms its peers, he didn’t expect to see such dramatic results. Here, he answers our questions about where the returns are coming from and what it means for plan sponsors. He also shares his insights into the future of private equity in the wake of the liquidity crisis.

Can you give us an overview of what you found through your study?

Endowments have been remarkably successful, particularly those of larger and more elite schools. When we looked at why they’ve been so successful, we found that, by and large, it was not a function of the asset allocation per se. If you looked at the returns they would have generated had they had the average return from each asset class they invested in, there would not have been much difference across endowments or much outperformance. Rather,

success is related to asset allocation but in a more subtle way—the outperformance is taking place in only a few asset classes, more specifically those that are more difficult to value. For example, areas like private equity and real estate have a lot of outperformance, whereas areas like stocks and bonds have very little.

What seems to be taking place is not so much about the average returns of these asset classes, but that the endowments are specializing in areas where things are really opaque, where it’s hard to figure out what’s going on. So they seem to be generating particularly good returns in those areas presumably because they are particularly skilful and selecting good managers in these complicated and hard-to-figure-out asset classes.

Why do you think this is?

This reflects several things. First there is an element of experience: clearly this is a game where doing this stuff for a long time helps. Endowments have been investing in many of these alternative asset classes for a long time, particularly the more established and larger universities. Second, the features associated with many of these endowments, such as a long time horizon and the ability to dig deeply into these areas more deliberately—all of these qualities seem conducive to good investment decisions.

You mention that outperformance happens in assets that are difficult to value. Are the benchmarks inaccurate or does it reflect more effective use of them?

Benchmarking illiquid alternative assets is difficult, because it is challenging to discern the extent to which they are correlated with the market. As a result, there is a danger that we will conclude that investors outperform the market, when instead they are only investing in riskier assets.

Despite this caveat, the effects are so large that it is hard to attribute them to differences in risk. For instance, in private equity, funds in which endowments invested between 1993 and 2001 had greater returns of about 10% per annum. Nor do many conventional measures (e.g., the probability of the fund losing money) suggest that the funds chosen by the endowments were noticeably riskier. Thus, there appears to be a significant difference in performance.

Summary:

The article looks at trends in college and university endowment returns and investments at 1,300 schools in the United States between 1992 and 2005. It was published in *The Journal of Economic Perspectives* – Volume 22, Number 3, Summer 2008.

Key findings:

- Endowments experienced a median growth rate of 7.4% per year and median return of 6.9%.
- The top 20 endowments grew more than 9% annually on a real basis between 1992 and 2005.
- As of 2007, the two largest endowments, belonging to Harvard and Yale, have grown to \$35 billion and \$22 billion in size, respectively.
- The Ivy League Schools outperformed other endowments by 3% per year.
- The top endowments posted impressive returns in 2005, averaging a net real return of 12.3%, compared to 4.4% posted by Standard & Poor's 500 index in the same year.
- 5% of college and university endowments exceeded the top percentile return for corporate pension funds between 1996 and 2005.
- Yale University experienced an annualized return of 16.2% between 2000 and 2008.
- Ivy outperformance comes from real estate and other alternative investments.

What prompted you to study the returns of endowments?

It's been an area where there has been enduring interest—there have been a lot of institutions that have looked at the success of endowments and tried to emulate them, for example sovereign wealth funds. These investors would love to have the same kind of success in their investments or at least be better able to understand what endowments are doing so they can emulate their practices.

Were you surprised by the results?

There are aspects of the results that were surprising, particularly the magnitude of the effect. When we looked at the difference between endowments and other investors, the outperformance was more dramatic and stark than we anticipated. The overall results were not shocking—but nonetheless it was the size of the difference that caught our imagination.

Should pension funds and plan sponsors be copying what these top endowments are doing?

I think there is a mixed message. Certainly there are attractive elements to what endowments have done. On the other hand, with the benefit of hindsight due to the market downturn, some endowments went too far in a few cases in their pursuit of illiquid assets. That limited their flexibility. But I do think there are a lot of things they have done that would be worth emulating by pension funds.

Is there a governance angle to all this? Are the top schools more likely to have the top minds on the investment committee?

One of the things you sometimes see in public pension funds—particularly where politicians and political appointees are involved—is a whole set of motivations that aren't purely about maximizing returns. While promoting economic development might be desirable, we have seen scandals in U.S. states where public institutions were apparently making investment decisions based on connections rather than the best interests of the people whose money was being invested.

So what lessons should plan sponsors take away from your research?

They can learn to pay attention to the decision-making process—both in terms of cultivating a long-term

view and a more contemplative approach to analyzing successful and unsuccessful decisions. Taking more time to understand why it is they did the right or wrong thing. Pension funds could look more closely at the role of investment committees and try to encourage continuity of staff and to get people who are more experienced is important. Certainly the revolving door phenomenon can be detrimental.

In the wake of the financial crisis, how do you think these endowments are doing?

Institutional investors worldwide have suffered substantial losses—endowments are no exception. The question will be whether endowments went too far in terms of pursuing illiquidity. It's clear that one of the costs of illiquid investments is that cash is very difficult to access when you need it. If you have all your money tied up in illiquid stuff it's tremendously costly to sell. One thing that might come out of this is a reassessment of some of the extremes in pursuit of illiquidity.

You have spent a lot of time studying private equity—how has the liquidity crisis changed the game in your view?

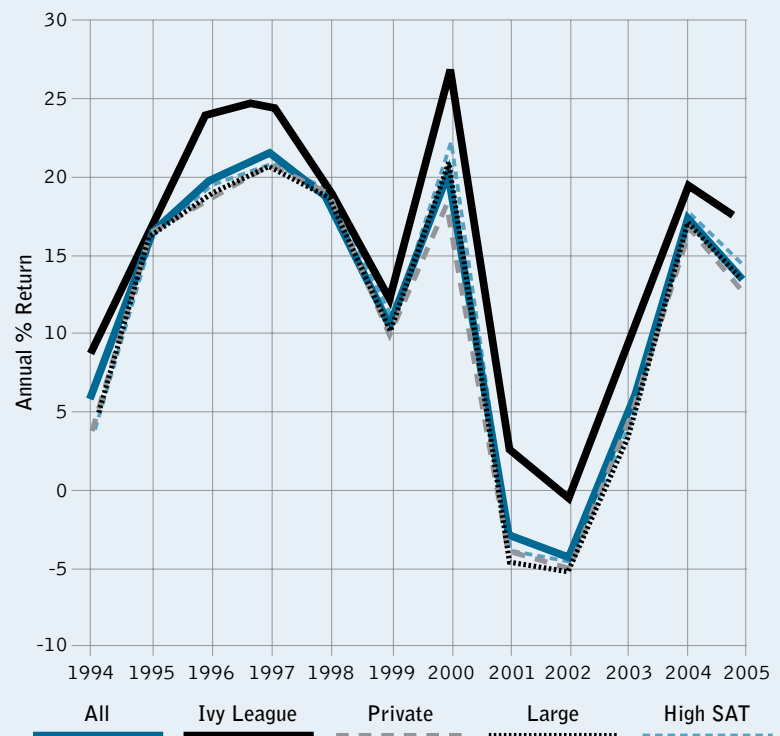
Private equity has always been a cyclical business. It has tended to have booms and busts. Is this simply another cycle or is the magnitude of what has happened in the last couple of years going to dramatically change the game? I think that's an open issue—I would not be surprised to see broader changes in this area as a result.

What types of changes are you referring to?

The emergence of the mega group has dominated private equity over the past few years. I think we're going to see that trend reversed. During the boom period the largest players did well and could get money quickly because they were more readily able to access leverage on cheap terms. But clearly what worked well during an upturn won't serve them during a downturn. It's natural to speculate about whether we're going to see a more back to basics emphasis, with institutions selecting groups that have relatively narrow, clearly defined strategies that may be better able to take advantage of market conditions.

Endowments and foundations are struggling in the financial crisis—what are they doing to survive? And could they be in danger of making decisions that could damage them for the long term?

EXCESS RETURNS BY SCHOOL TYPE



Source: Lerner, Schoar and Wang [2008]

Decisions are being made that are very painful. If you look at a number of big universities, they are selling big chunks of their private equity portfolios at substantial discounts. Obviously that's a very tough process and it ends up hobbling returns not just in the short run but in the long run as well. I think you can raise questions as to whether people will overreact to this—one can imagine people throwing the baby out with the bathwater and becoming so risk-averse they are unwilling to take any kind of chances. They could be paralyzed by the possibility of some other great crash taking place and then miss attractive opportunities. There's a balancing act.

Accounting standards are being altered to deal with the pricing of illiquid assets. What do you think of this type of shift?

It sounds great in theory to say "fair value" but what does that really mean and how do you really think about the true underlying value of a private equity portfolio? These things are traded on a really irregular basis and in markets like today's you have a few severely depressed sellers selling at extreme discounts. It's not really clear that this is the best indicator. ■