Charles Skorina & Company

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Special report – Should smaller endowments and foundations manage their own money?

The Zen of In-sourcing: Can small institutional funds resist the out-sourcers? Should they even try?

What is the sound of one small institution managing its own money? It's not very loud, apparently, compared to the racket from all the people who want to do it for them.

Should smaller tax-exempt funds just give up managing their own portfolios and succumb to the siren song of outsourcing? I think the answer is: Not necessarily.

In a previous letter I presented mini-case-histories of two smallish college endowments which recently chose to outsource.

In this special issue, I look at the other side: some small funds which have eschewed outsourcing, and are doing just fine, thank you very much. Reports from the field suggest that resistance to outsourcing may not be futile at all.

Further below: we gather some wisdom from **Jack Rich**, CIO at *Abilene Christian University*; and, for you left-brainers, some statistics — my take on how many institutions are in this "small investor" category.

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Seeking enlightenment among the insourcers:

Wesleyan University's endowment currently stands just north of our arbitrary $500 million cutoff for "small" funds, but CIO **Anne Martin** made some relevant observations when she spoke to aiCIO magazine back in June. She says that smaller funds can benefit from the same internal management discipline as big one.

"Build a diversified portfolio, pick great managers, approach asset allocation and rebalancing in a disciplined manner, and maintain a long-term horizon."

She emphasizes that "[small funds] can be more concentrated with a smaller number of high-conviction managers. We don't need to go to the 10th name on our private equity list, and we can get into terrific funds

because we only need a small allocation."

She cautions, however, that smaller institutional funds are more vulnerable in some respects. For instance, they must be especially vigilant about maintaining liquidity, since they don't have the same borrowing power as big institutions.

See: http://ai-cio.com//channel/ASSET_ALLOCATION/Interrogation__Anne_Martin_Thinks_Liquidity_Is_Key.htm

Jack Rich, the CIO at *Abilene Christian University* in Texas (with $300 mil AUM), told me in a recent interview that even a one percent positive variance over a benchmark 70/30 return can generate several million dollars in excess returns; enough to support an investment office with money left over.

[See my interview with Mr. Rich below]

I spoke to a senior investment professional at a prominent San Francisco Bay area cultural institution who champions in-house management for smaller funds. He said:

"No external manager will have the total picture or insights into the institution and their unique needs. You can't do that unless someone is on the inside. Also, there are many managers that consultants don't cover, but I can find them and give us an edge.

Engaged and active investment committees have good ideas and access to managers. We can custom tailor our portfolio and remain flexible.

If I can add just fifty basis points, my salary is justified. Fifty basis points on $200 mil can buy you an office and director of investments and still have additional earnings for the endowment."

My alma mater outperforms:

I can add the example of my own high school, *Culver Military Academy* in Indiana (now known as Culver Academies) to the list of small funds who successfully manage their own money. Culver has no CIO, but runs its endowment with a troika consisting of school president **John Buxton**; investment committee chair **Jeffrey Adams**; and consultant **Brian Hunter**, CEO of *Strategic Capital Allocation Group* in Boston.

Ironically, Mr. Adams is president of *Balentine*, an Atlanta-based investment manager which competes in the outsourcing market, although they don't do business with Culver.

They have backup from the rest of board and the investment committee, which includes financial heavyweights like **Peter Fasseas**, chair of *Metropolitan Bank Group*, and **Paul Gignilliat**, a Senior VP at *UBS Financial Services*.

Culver has a rather amazing 75% allocation to alternatives, a full spectrum including event-driven strategies, long-short domestic and international strategies, global macro, managed futures, sovereign debt, credit strategies, distressed private equity, and royalty funds.

But, as Mr. Buxton pointed out in an interview, "the issue is not the percentage of alternative investments but the selection of managers who manage risk creatively and successfully in a volatile market place and the strategic placement of those managers in a portfolio."

In 2008/2009 many institutions discovered that their alternatives weren't alternative enough, but Culver seems to have achieved good non-correlation with conventional assets. They lost only 12.9% in FY2009 compared to the *NACUBO* average of -19%. They also avoided managers with lock-ups and gating provisions and faced no liquidity problems during the crisis.

Culver earned about 14.5% in FY2010, compared to the NACUBO average of 11.9% for their peers. So they've outperformed in both down and up markets. And it's been noticed. They were named Small Nonprofit of the Year by *Foundation and Endowment Money Management Magazine*.

<u>A conversation with Jack Rich of Abilene Christian University:</u>

Jack Rich started thinking about the benefits of a full-time chief investment officer for *ACU* when the Texas school's endowment was a mere $70 mil AUM, and he was still the chief financial officer. He and his colleagues continually studied the matter and when the endowment finally grew to $200 million, they decided it was time to pull the trigger and create a full-time CIO position. In 2005, Mr. Rich moved into the CIO job himself, handing off his CFO duties.

Over the past decade, ACU's endowment grew from $147 million to $262 million, earning an average investment return of 8.9%. That's one of the highest among all U.S. endowments, and puts ACU in a dead tie with **Dr. David Swensen's** famous team at *Yale*. Like Yale (and Culver – see above), ACU is heavily tilted toward alternative assets, which make up about 70% of their portfolio.

Mr. Rich has been a thought-leader among his peers, and received the Rodney H. Adams Award from the *National Association of College and University Business Officers (NACUBO)* in July. He has worked for ACU, his undergrad alma mater, since 1991. He was previously president and COO of *Morton Companies* in San Antonio and also did stints at *InterFirst State Bank* of San Antonio and *Arthur Anderson* & Co in Dallas. He earned his BBA in 1976, then an MBA from *University of Texas* in 1980. He also holds a CPA credential.

Given the burgeoning number of outsourcing firms competing for business among smaller funds, it's particularly interesting to hear why he thinks ACU should stick with their current structure.

He made several good points when I spoke with him a few weeks ago.

Skorina: Jack, what prompted the school to believe that running a $200 million dollar endowment (as it then was) with an in-house CIO was the right way to go?

Rich: Charles, we felt that if we could earn just one percent more than a benchmark 70/30 stocks/bonds portfolio, it would justify setting up an investment office and a full-time CIO. On a $200 million dollar portfolio, a one percent increase is two million dollars which more than covers our costs. I'm simplifying a little, of course — we worked through a lot of options and what-ifs – but that's what it came down to.

Skorina: Performance counts, but the world is full of people who will promise you better performance. There must have been other factors you considered.

Rich: Sure. One big one is the just the ability to manage the portfolio in our own interests. For example, we currently have thirty percent of the portfolio in hedged vehicles, with significant emphasis on global macro managers and managers with a sharp eye on tail risk. And we are only twenty-two percent long public

market equities and six percent in public market fixed income. I doubt we could get exactly that allocation if we relied on an outsourcer.

Also, due to our various long-time investments in oil and gas here in Texas, we have built up some expertise in that field and feel comfortable making investments in this area. The school has significant royalty income from our O & G holdings and, by the way, we feel these investments are an excellent diversifier and tail-risk hedge. We are currently at a fifteen percent of portfolio allocation in this asset class and would like to move to twenty percent when we see attractive opportunities.

Skorina: Jack, you've now had five years experience with this structure, what other pros and cons have emerged?

Rich: On the plus side, we feel that if we are willing to study and hustle and knock on doors, we will have a good chance of finding some excellent managers, even if we are not that big.

Skorina: How about the pricing you get from those managers?

Rich: We can't count that as a plus for us, Charles. We're not big enough to get much leverage. But we do feel we can get just as much quality as bigger funds, and that's even more important.

Skorina: What else works for you?

Rich: Speed. In this climate of uncertainty we want to be able to move quickly if an opportunity presents itself or something goes wrong. We know what we can do and we can do it fast.

Skorina: So, would you conclude that everyone at your size should use your model?

Rich: No, I would not go that far. The relationship I have with the board and the way the board itself functions is crucial. The board has to have a high level of trust and confidence in the investment staff to function well; and vice-versa.

Not all boards have the time or personnel to make it work the way we do. If that's the case, then outsourcing might make more sense.

Skorina: I really appreciate your comments Jack; always good speaking with you.

Rich: The same here, Charles.

Footnote: Jack wrote an excellent article about how an investment office can work productively with their board. "All Oars in the Water" appeared in the March, 2011 issue of NACUBO's Business Officer magazine.

You can read it here:

http://www.nacubo.org/Business_Officer_Magazine/Magazine_Archives/March_2011/All_Oars_in_the_Water.html

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Revisiting the numbers:

As a crude rule-of-thumb, we can say that most tax-exempt funds over $1 billion AUM use professionally-

staffed in-house investment offices; whereas, most funds under $500 million do not. The $500 million-to-$1 billion bracket is a transition zone, where we can find both models.

Those sub-$500 million funds typically rely upon a volunteer investment committee and an outside consultant to steer their portfolio and oversee external managers. A few also have a professional CIO or designated investment person on staff, although these are far less common when you get much below $400 million.

If we take $200 million as pretty much the absolute lower limit for in-house management (there are a few exceptions), even with a non-CIO model, then how big is the $200 million to $500 million AUM pie for U.S. tax-exempts?

As I have noted elsewhere (See: www.charlesskorina.com **Chief Investment Officers – supply and demand**), I believe there are about 1,072 such portfolios (excluding 800 corporate pensions which, historically, are almost all outsourced to money management firms or insurance companies). I estimate that only about 10 percent of these have a CIO or equivalent, so 90 percent have a pure committee-and-consultant model. Outsourcing is beginning to penetrate this group, but it's still a new idea for most and that penetration is not very large – yet.

Tax-exempt institutional funds between $200 and $500 million AUM (Charles A. Skorina & Co estimates)

Endowments: 124

Foundations: 157

Health systems: 245

Misc other: 217

Subtotal: 743

Public pensions: 150

Subtotal: 893

Union pensions: 179

Total: 1,072

There is plenty of evidence to support the case for in-house investment management at endowments and foundations; even for those under $500 million. A savvy chief investment officer can earn good returns, brief the board in real time, and react quickly to market events. And, as **Leonard Raley**, the president and CEO of the *University System of Maryland Foundation*, pointed out to me recently, "a well managed in-house investment operation is tied directly to an institution's ability to raise philanthropic funds as well as donor confidence."

Some boards see the investment management function as integral to the institution's purpose and feel comfortable being closely involved in the process. And others don't.

For those that do, excellent investment talent is available, particularly in this tough job market. For those that don't, my special report on outsourcing lists at least forty-two outsourcers willing to shoulder the burden.

[See: www.charlesskorina.com **Special CIO (chief investment officer) Outsourcing Edition, The Skorina Letter No. 28**]

Whether a small institution insources, outsources, or uses some hybrid form to manage their investments is up to the board. What can't be outsourced is the board's responsibility to understand their specific needs and capabilities and find a structure that works for them.

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