The Endowment Syndrome: Why Elite Funds Are Falling Behind

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Abstract

Elite endowments with heavy allocations to alternative investments are underperforming, losing ground to simple index strategies. High costs, increased competition, and outdated perceptions of superiority are taking a toll. Is it time for a reset?

Endowments with large allocations to alternative investments have underperformed comparable indexed strategies. The average return among the Ivy League schools since the Global Financial Crisis of 2008 was 8.3% per year. An indexed benchmark comprising 85% stocks and 15% bonds, the characteristic allocation of the Ivies, achieved 9.8% per year for the same 16-year period. The annualized difference, or alpha, is -1.5% per year. That adds up to a cumulative opportunity cost of 20% vis-à-vis indexing. That is a big chunk of potential wealth gone missing.[1]

"Endowments in the Casino: Even the Whales Lose at the Alts Table" (Ennis 2024), shows that alternative investments, such as private equity, real estate, and hedge funds, account for the full margin of underperformance of large endowments.

Why do some endowments continue to rely heavily on what has proven to be a losing proposition? Endowment managers with large allocations to alternative investments suffer from what I call the Endowment Syndrome. Its symptoms include: (1) denial of competitive conditions, (2) willful blindness to cost, and (3) vanity.

Competitive Conditions

Alternative investment markets were comparatively small and inchoate when David Swensen (Yale) and Jack Meyer (Harvard) worked their magic in the 1990s and early 2000s. Since then, many trillions of dollars have poured into alternative investments, increasing aggregate assets under management more than tenfold. More than 10,000 alternative asset managers now vie for a piece of the action and compete with one another for the best deals. Market structure has advanced accordingly. In short, private market investing is vastly more competitive than it was way back when. Large endowment managers, however, mostly operate as if nothing has changed. They are in denial of the reality of their markets.

[1] I corrected 2022-2024 fund returns for distortions caused by lags in reported NAVs. I did this by using regression statistics for the prior 13 years combined with market returns for the final three. (The corrected returns were actually 45 bps per year greater than the reported series.) I created the benchmark by regressing the Ivy League average return series on three market indexes. The indexes and their approximate weights are Russell 3000 stocks (75%), MSCI ACWI Ex-US (10%), and Bloomberg US Aggregate bonds (15%). The benchmark is based on returns for 2009-2021.

Cost
Recent studies offer an increasingly clear picture of the cost of alternative investing. Private equity has an *annual* cost of at least 6% of asset value. Non-core real estate runs 4% to 5% per year. Hedge fund managers take 3% to 4% annually.[2] I estimate that large endowments, with 60%-plus in alts, incur a total operating cost of at least 3% per year.

Now hear this: *A 3% expense ratio for a diversified portfolio operating in competitive markets is an impossible burden.* Endowments, which don't report their costs and don't even discuss them as far as I can tell, seem to operate in see-no-evil mode when it comes to cost.

Vanity
There exists a notion that the managers of the assets of higher education are exceptional. A dozen or so schools cultivated the idea that their investment offices were elite, like the institutions themselves. Others drafted on the leaders, happy to be drawn into a special class of investment pros. Not long ago, a veteran observer of institutional investing averred:

> Endowment funds have long been thought to be the best-managed asset pools in the institutional investment world, employing the most capable people and allocating assets to managers, conventional and alternative, who can and do truly focus on the long run.
>
> Endowments seem particularly well suited to [beating the market]. They pay well, attracting talented and stable staffs. They exist in close proximity to business schools and economics departments, many with Nobel Prize-winning faculty. Managers from all over the world call on them, regarding them as supremely desirable clients.[3]

That is heady stuff. No wonder many endowment managers believe it is incumbent upon them --either by legacy or lore -- to be exceptional investors, or at least to act like they are. Eventually, though, the illusion of superiority will give way to the reality that competition and cost are the dominant forces. [4]

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[2] See Ben-David et al. (2020), Bollinger and Pagliari (2019), Lim (2024), and Phalippou and Gottschalg (2009).
[3] See Siegel (2021).
[4] My research consistently shows that large endowments achieve lower risk-adjusted returns than public pension funds, which spend much less on active investment management, and alternative investments, in particular. See Ennis (2022).

The Awakening

The awakening may come from higher up, when trustees conclude the status quo is untenable.[5] That would be an unfortunate denouement for endowment managers. It could result in job loss and damaged reputations. But it doesn't have to play out that way.

Instead, endowment managers can begin to gracefully work their way out of this dilemma. They could, without fanfare, set up an indexed investment account with a stock-bond allocation of, say, 85%-15%. They could then funnel cash from gift additions, account liquidations, and distributions to the indexed account as institutional cash flow needs permit. At some point, they could declare a *pragmatic* approach to asset allocation, whereby they periodically adjust their asset allocation in favor of whichever strategy -- active or passive -- performs best.

Or, as Senator James E. Watson of Indiana was fond of saying, "If you can't lick 'em, jine 'em." To which, I would add, "And do it as quietly as you please."

[5] I estimate that Harvard pays its money managers more than it takes in in tuition, with nothing to show for it.

References

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