The Enduring Futility of the Endowment Model
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by Larry Swedroe

Investors have no chance of adding alpha by pursuing an “endowment” model. New research shows that even the most sophisticated institutions do worse when they increase exposure to alternative asset classes.

Educational institutions hold hundreds of billions of dollars in endowment funds. The outstanding performance of the Yale endowment fund, managed by legendary investor David Swensen, led many endowments to try to replicate its performance by increasing their exposures to alternative investments, such as private equity, private real estate and hedge funds. Today, the endowments of large educational institutions have allocations to these alternatives of almost 60%.

Unfortunately, the research from the 2013 study, Do (Some) University Endowments Earn Alpha?, the 2018 study, Investment Returns and Distribution Policies of Non-Profit Endowment Funds the 2020 study "Institutional Investment Strategy and Manager Choice: A Critique, and the 2020 study, A Better Approach to Systematic Outperformance? 58 Years of Endowment Performance, show that factor models explain virtually all of the variation in performance of endowments, and that despite taking on more risks in the form of often opaque and illiquid investments (such as hedge funds, venture capital and private equity), there has been no evidence that the average endowment is able to deliver alpha relative to public stock/bond benchmarks.

In fact, they have generally underperformed appropriate risk-adjusted benchmarks.

Richard Ennis contributes to the literature on the performance of university endowments with his June 2020 study, “Endowment Performance.” He analyzed the performance of 43 of the largest individual endowments over the 11 fiscal years ending June 30, 2019. Following is a summary of his findings:

- None of the 43 endowments outperformed with statistical significance, while one in four underperformed with statistical significance.
- Alternative asset classes have failed to deliver diversification benefits and have had an adverse effect on endowment performance.
- Risk-adjusted performance of endowments is consistent across six cohorts of fund size – there was no evidence of larger funds doing better than smaller ones after adjusting for risk. Risk-adjusted returns (alphas) for the various cohorts fell within a range of -1.1% to -1.8%, with t-statistics of -2.7 to -4.9.
- The benchmarks fit the returns well, with r-squared values of 0.99 and small standard error terms of 0.8% to 1.5%.
- Pronounced underperformance was evident across the range of both equity exposure and diversification.
- The underperformance was generally associated with endowments’ holdings of alternative investments and with the high, unrecovered costs – the risk-adjusted return of public pension funds decreases sharply as alternative investment exposure increases.

Ennis’ findings led him to conclude: “Endowment funds have underperformed passive investment by a significant margin during the study period, no matter how one slices the data.” He added: “Given prevailing diversification patterns and costs of 1 to 2% of assets, it is likely that the great majority of endowment funds will continue to underperform in the years ahead.”
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