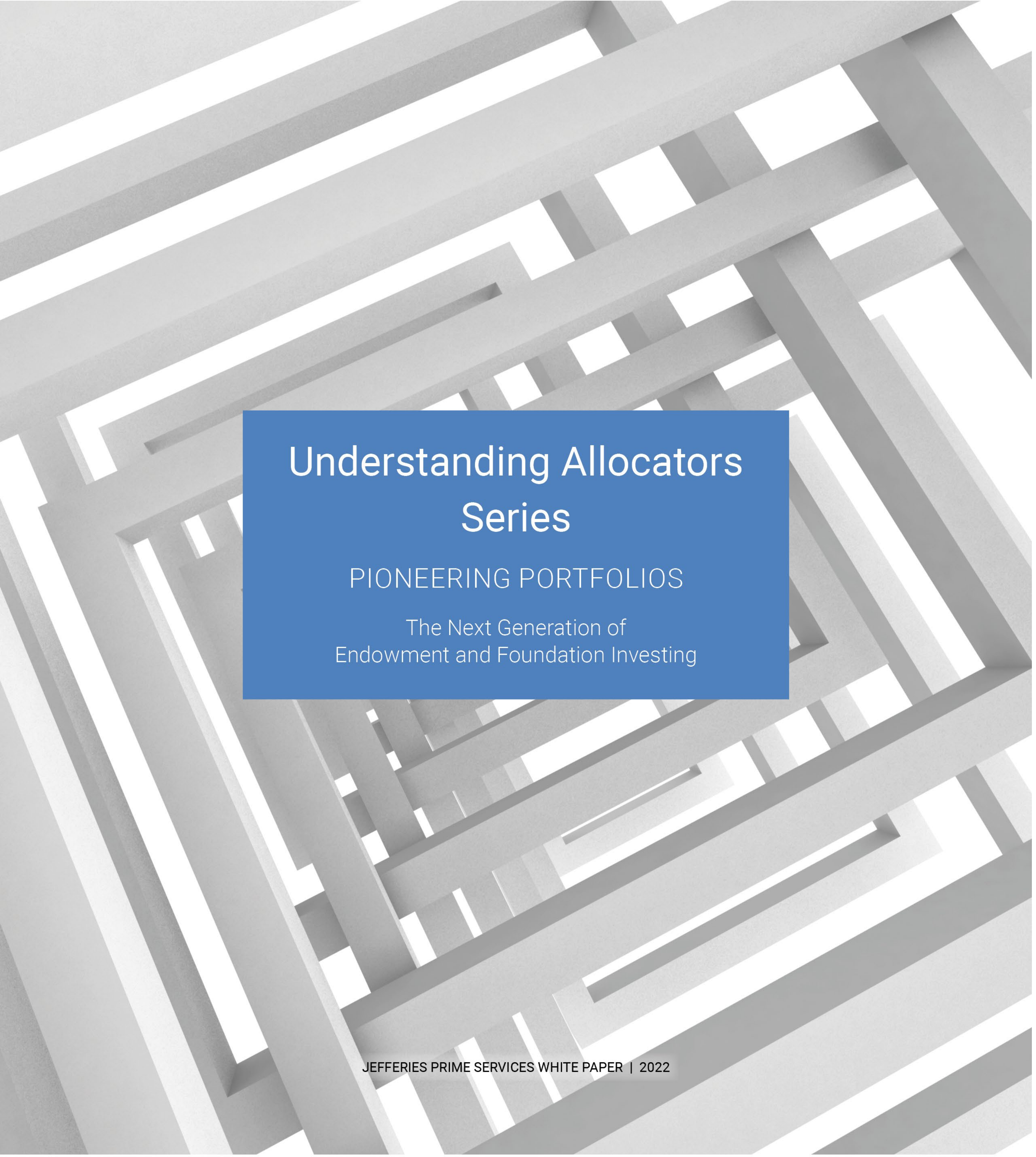


Understanding Allocators Series

PIONEERING PORTFOLIOS

The Next Generation of
Endowment and Foundation Investing

JEFFERIES PRIME SERVICES WHITE PAPER | 2022

Jefferies

Investing for a Cause

MISSION DRIVEN AND NON-PROFIT INVESTING

Endowments and foundations (E&Fs) are some of the most sought-after GP partners – not only are they focused on bettering communities around them through education and access to healthcare or other causes, but they also tend to have long duration capital. While many GPs think about both verticals similarly, there is nuance to each institution's investment objectives, portfolio construction, and structural preferences and needs.

In *Pioneering Portfolio Management*, David Swensen, the late CIO of Yale's endowment, posited what became a framework for most endowments, suggesting that long-term investors should bucket their portfolios in roughly 5 asset classes with larger allocations to alternative assets, so as to earn illiquidity premiums and exploit the inefficiencies found in illiquid markets and avoid asset classes with low expected returns such as fixed income and commodities[1]. Overtime, many foundations also adopted this structure given the shared inevitable time horizon and tax-exempt status.

Given the growing complexity of the markets and liquidity needs of institutional investors, endowments and foundations are becoming less focused on asset classes and are instead thinking more holistically about the market environment, the short- and near-term investment objectives and funding needs of the organization regardless of investable product type. Many institutions are thinking more carefully about the opportunity cost of returns, liquidity, and volatility at the organizational level and are pressing out on the risk curve in order to achieve return targets. Endowments and foundations are now having to ask themselves the question – was the illiquidity worth it?

While many GPs approach endowments and foundations similarly because of their duration of capital, portfolio construction, and 5% spend rate targets, these institutions' needs can be vastly different. While Jefferies sees the benefit in partnering with a diverse array of allocators, Pioneering Portfolios explores the investment objectives and preferences of the endowment and foundation verticals, the changing and variant portfolio construction models, and the structural differences between these frequently compared investor types.

Jefferies interviewed 40 endowments and foundations to better understand the variation across these allocator verticals. All institutions interviewed were over $1bn in AUM and about 66% of the respondents were endowments while on 34% were foundations. Respondents ranged from $1.2bn to $20bn in AUM with a median of $3.3bn.[2] Allocations to GPs ranged from $5mm to $300mm but the median respondent size was between $20mm and $50mm.[3] Most noted smaller ticket sizing when allocating to private equity and venture capital given the duration of the commitment and recent frequency of re-ups.

The Next Generation of Pioneering Portfolios builds on Construction Zone where we explored the purpose of alternatives and where they fit into institutional portfolios and focuses more deeply on how Swenson's "endowment style portfolio construction", which we will refer to as the asset class-based model that was adopted by institutional investors of the 1990s is changing to a more risk-based model of the 2020s. In addition, this piece should help managers better understand where it can fit into an endowment or a foundation's portfolio based on its strategy and investment objectives. Lastly, this piece will offer valuable insights for allocators to better understand how endowments and foundations differ in investment objectives and structural needs, how to think about product correlation and portfolio construction in order to achieve investment goals over specific time periods.

THE INVESTMENT A, B, CS OF E&FS

WHAT ARE ENDOWMENTS? FOUNDATIONS?

An endowment is a pool of capital donated to a university that can be used for various programs to move the mission of the organization forward. The goal of an endowment is to fund the needs of an institution – principal capital raised and donated remains intact, while investment income is available for immediate funding projects, scholarships, or general use to keep a nonprofit company operating efficiently. Structurally, endowments can also include pension assets for employees, hospital system assets and have specific pools of capital designated for a specific use by the donor, which allows for the pools of capital to be invested and hopefully ensure that operational needs are covered in perpetuity.

Structural Similarities Between E&Fs		
	Endowment	**Foundation**
Spend Rate	5% + CPI or HEPI	5%
Portfolio Construction	Asset or Risk Based Models	
Time Horizon	1, 3, 5 and 10 year	
Donations	Active	Minimal to None

Like endowments, foundations have investment portfolios that are gifted to fund the operating budget and needs of the organization and support charitable activities by making grants for scientific, educational, cultural, religious, or other charitable purposes. Both E&Fs tend to have a 5% spend rate annually (and a 7-8% nominal return target when incorporating inflation to maintain purchasing power). In an inflationary environment like today, the institutions' investment objectives can dramatically increase causing the investment team to shift asset allocations, re-underwrite the portfolio, and potentially increase their risk appetite to hit those new return targets.

While foundations are often primarily engaged in grantmaking activities, some may engage in their own direct charitable activities or programs. Additionally, foundations generally (and all interviewed) were established with a pool of capital and do not currently take donations, whereas most endowments can have more frequent fundraising initiatives.

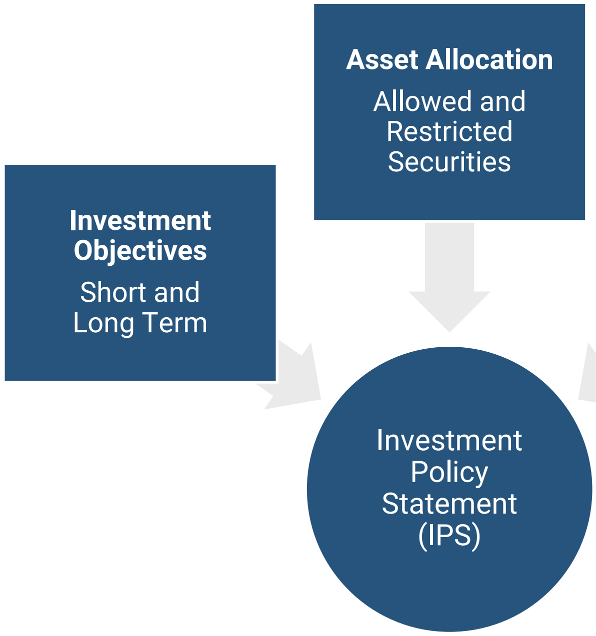
WHAT'S IN AN INVESTMENT POLICY STATEMENT?

Most university endowments and many foundations are established to last in perpetuity and must maintain purchasing power; therefore, when created, these investment offices try to create an investment policy statement (IPS) with investment objectives and annual spending limits. An IPS is a document that outlines the key elements of an institutions short and long-term investment objectives, spending policy, asset allocation guidelines, and overview of the roles and responsibilities of the fiduciaries and stakeholders.

Institutions typically create investment objectives based on **absolute** and **relative** return metrics.

- **Absolute Returns**: These absolute return targets are defined based on short- and long-term metrics while relative returns are typically based on benchmarks selected in the IPS and measured on rolling 1-, 3- and 5-year basis. Most institutions must make eligible charitable expenditures that equal or exceed approximately 5% of the value of its endowment in order to maintain the institution's tax-exempt status. As such, at a minimum, many E&Fs have absolute return target around 5%.

- ***Relative Returns:*** Many endowments and foundations have annual (short term), and 10-year (long term) investment objectives that vary: it can be as simple as a flat percentage or more complex including the flat spend rate plus inflation, which tends to be 5% + CPI or HEPI. For the institutions that have an investment objective that includes a spend rate plus inflation, 67% used CPI. Of the 21% that used Higher Education Price Index (HEPI), all were endowments.[4]



The most varied statistics around the investment objectives of endowments and foundations stems from the percentage of the operating budget used to fund the organization and cost of the investment office and program. **Almost 60% of respondents from the investment office were not sure what percentage of endowment or foundation was used to fund the operating budget of the organization.**[5] Of the 40% that did, it ranged from "minimal" or 0% to almost 95%.[6] The larger the percentage of the operating budget, the higher the institution's return target. In addition, **the expense ratio of operating the investment office ranged dramatically from as low as 9 basis points (bps) to as high as 50bps with the median being around 20bps.**[7]

	Investment Objective	Spend Rate	% Of Operating Budget	Expense Ratio (bps)
Median	7.0%	5.0%	20.0%	20
Low	5.0%	4.0%	0.0%	9
High	10.0%	5.5%	95.0%	50

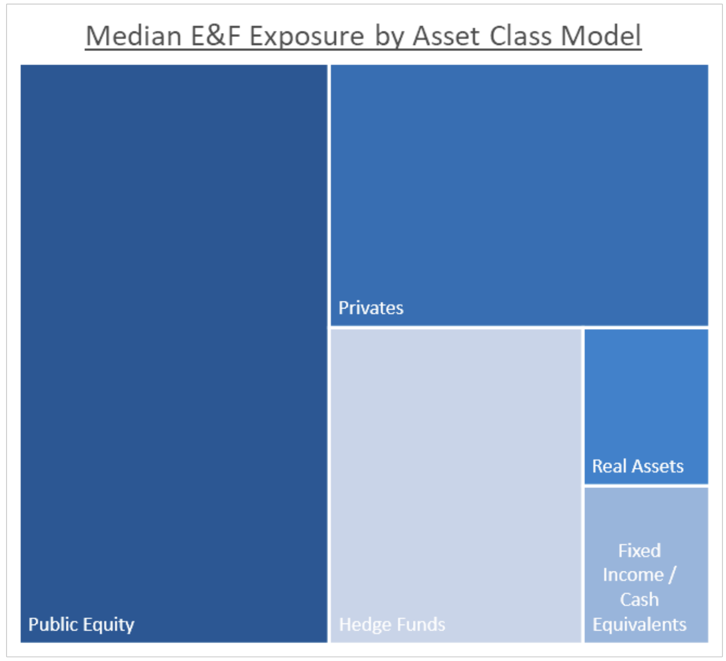
INSTITUTIONAL ENGAGEMENT WITH THE NON-INVESTMENT TEAM

Endowments are made up of thousands of sub-endowment accounts from donors who get to decide what initiative they want to fund unless generally allocated. Moreover, different departments within an organization have different investment objectives and requirements (ex. A specified endowment, operating pool of capital, hospital needs or pension pools of capital within an endowment).

Not only does the dynamic among the investment team, committee and board vary vastly, but the investment offices relationship with other lines of business and functions within the institution can vary greatly as well. For example, many CIOs at endowments or foundations sit on different institutional committees like fund raising committees, grantmaking teams and other strategic planning boards. While the primary way the investment office engaged with the institution is through regular engagement with the planning and finance team to better understand cash flows and grant needs, almost 70% of those surveyed noted limited to no engagement with other functions across the institution. It may seem obvious that groups need to understand what each is doing to achieve the shared goal and yet there is still limited communication.

ASSET BASED VS. RISK BASED PORTFOLIO CONSTRUCTION MODELS

In the late 1990s, many endowments and foundations adopted the “endowment model”, a portfolio construction model developed by the late Yale CIO, David Swenson. This investment philosophy is centered around a portfolio construction structure that incorporates alternative assets into a traditional equity and fixed income portfolio so as to earn illiquidity premiums and exploit the inefficiencies found in illiquid markets to achieve desired returns.[8] These portfolios are broken down into 5 primary buckets including: public equity (domestic, international, global), hedge funds, privates (venture, growth equity, private equity and private credit), real assets (real estate and natural resources) and fixed income / cash equivalents.

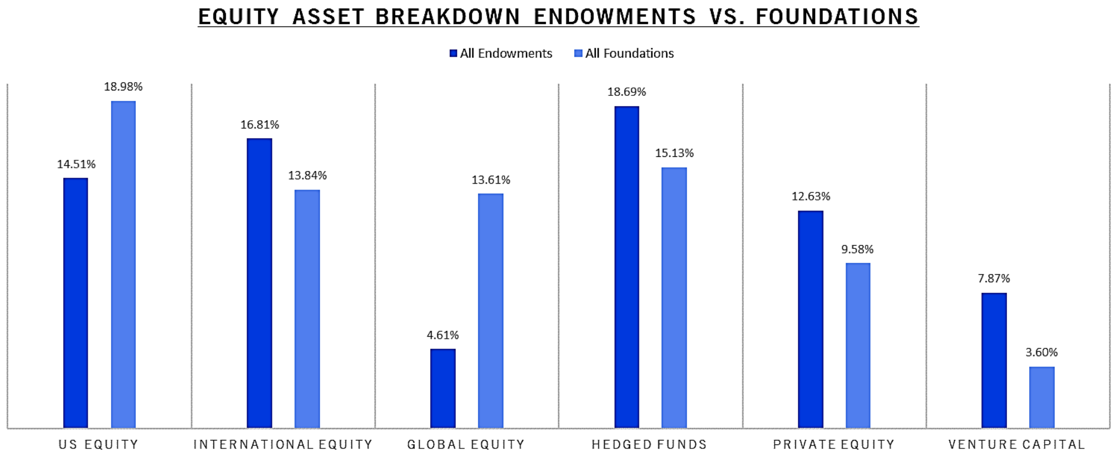


As such most of these asset classes can be further bucketed into marketable and non-marketable asset classes that each institution managed by respective investment professionals within these institutions. Within marketable securities there tends to be an allocation to public equities (split fairly evenly between domestic and international equities), fixed income and cash equivalents and then hedge funds. Within non-marketable securities there is a swath of private focused products ranging from early-stage venture capital and growth equity to late-stage private equity and private credit in addition to real assets and natural resources.

Based on the 2021 National Association of College and University Business Officers (NACUBO) data, most institutions have about 75% allocation to equities, 11% allocation to fixed income securities and 14% allocation to real estate and real assets.[9] Taking a closer look within underlying equity assets, endowments tend to have a higher allocation to international equities and alternatives broadly while foundations tend to tilt more towards global and US equities and are fairly underweight venture capital.[10] More specifically, endowments over $1bn in AUM have more of a tilt to alternatives and global equities compared to domestic or internationally delineated public equity exposure.[11]

Given the performance success of this model and because endowments and foundations both tend to have long term investable time horizons and can afford to take more risk for higher returns and less liquidity, most adopted this alternatives heavy, asset focused investment stye. Moreover, because the FED has kept rates at low levels in order for institutions (and people) to borrow at lower levels, there has also been an increase in stock prices driven up by the increase of money supply and by the fact that stocks have been far more lucrative investments than bonds.[12]

Given the perceived increased correlation across asset classes and products over the 10-year bull market, some institutions have started to restructure how they think about portfolio construction, moving from an asset-based model of portfolio construction to a more risk-based model. For example, instead of having a dedicated hedge fund or absolute return bucket, a long/short hedge fund would be competing for capital against long only equity products and private equity products.



While the line items in the portfolios have not changed dramatically, how E&Fs categorize the underlying managers has. **Most of the change to portfolio construction has occurred in asset allocation, manager sizing and portfolio and risk management; not the underlying managers in the portfolio.** Institutions that implement this style of investing typically institute three buckets which include equity, credit and "uncorrelated / other" which tends to include niche strategies, real assets, and other investments that are uncorrelated to equity and credit markets. These portfolios also tend to be more focused on benchmarking as part of asset allocation and portfolio construction discussions, usually using either the MSCI World or SP 500 as an equity benchmark and the Barclays Agg for credit.

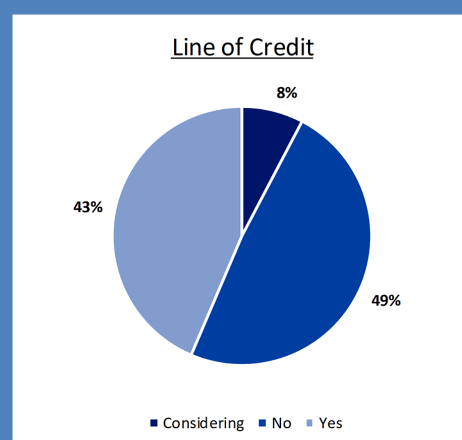
There is no right way to structure a portfolio but given the more volatile market movements, institutions are seeking new ways to innovate and achieve their desired annualized return targets. Endowments and foundations tend to use one of these two portfolio construction models (asset based or risk based), but endowments tend to have greater capacity for risk given their time horizon and lower operating budget.[13]

PERFORMANCE

LINE OF CREDIT

A line of credit is a flexible loan that establishes a pre-set borrowing limit that can be drawn on repeatedly. Many universities have lines of credit but the endowment itself did not. For those allocators that leveraged a line of credit, when calling on capital, it is used for costs associated with the spend rate (grants, charitable programs etc…) and not for capital calls or direct investments. While most banks offer these credit facilities, most endowments and foundations noted Northern Trust, JP Morgan, Silicon Valley Bank and to a less extent Stifel and Keybank as primary partners.

About 43% of all respondents have a line of credit and post-COVID another 8% are in the process of onboarding or thinking about opening one. For those respondents with a line of credit, the size ranged from $20mm to a couple hundred million with most ranging between $20mm to $50mm or to cover 1 year of spending needs. For those respondents that did not have a line of credit, most institutions had one, but the investment office could not call on it.



While many institutions interviewed did not have a line of credit, over the course of 2020, more investment offices began conversations about adding credit facility during COVID to fund obligations. Some endowments that do not use lines of credit will still have means to lever up their hedge fund portfolio through their portable alpha programs, which consist of ACWI swaps, cash funded hedge funds, as well as hedge funds turned into a total return SWAPs.

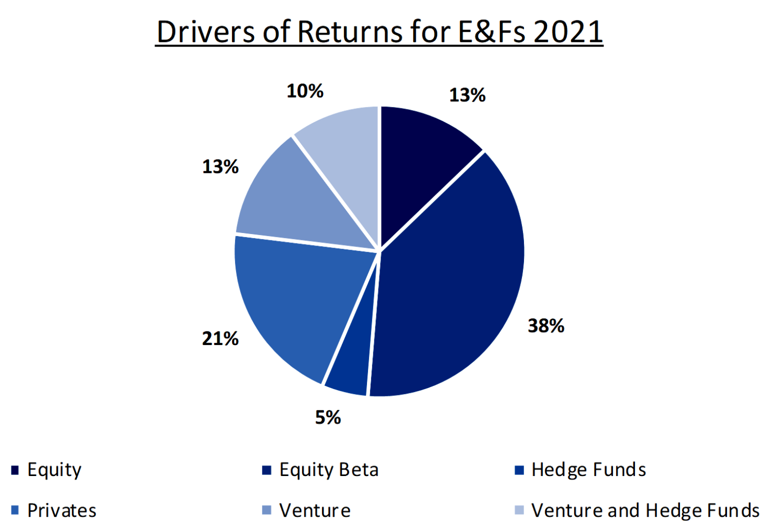
REPORTING AND PEER COMPARISONS

Once an institution has its IPS statement and portfolio construction models set, investments begin, and performance is generated. Most endowments report fiscal year returns in June (which aligns with the school year) while most foundations report in December on a calendar year. There were a couple of outliers that reported in July or August (mostly from endowments on a quarter system).

Mission driven institutions are often heavily focused on peer performance. While peer performance can help an organization generate ideas and learn from best practices, each institution should be focused on achieving the investment objectives of the organization. About 64% of institutions surveyed formally compare its performance to peers and another 15% do so informally.[14] When comparing, most E&Fs compared themselves to other endowments and foundations with >$1bn in AUM (regardless of their own size) and more specifically to the Cambridge Index which incorporates endowments and foundations with over $1bn in AUM.[15]

VENTURE CAPITAL AND PRIVATE EQUITY HAVE HELPED DRIVE ENDOWMENT AND FOUNDATION RETURNS

Most institutional investment returns have been driven by the beta of private equity and venture portfolios as well as public equities. While part of this is due to performance and growth of private investments, mark-to-market reporting has had a bigger impact on reported performance than ever before. **LPs have found themselves in a breach of allocation policy as illiquid portfolios are not adjusted downward after public portfolio has had a sell off.**[16] Moreover, private marks are usually on a 3-6 quarter delay, so many portfolios today remain unmarked or are still being marked flat to slightly up. In the near term, E&Fs are left with no options except to sell their private portfolios in the secondary market or change their strategic allocations. Longer term, E&Fs can write smaller tickets to smooth the curve of private commitments and valuation fluctuations.



In addition, many endowments and foundations noted the positive alpha attribution from hedge funds. While absolute returns have not been able to compete with other asset classes like venture capital and private equity in terms of absolute performance, many endowments and foundations were incredibly pleased with the alpha generation and capital protection from their hedge fund portfolios over the past year. **Hedge funds did what they were supposed to do!**

Not only has performance been driven by the private equity and venture portfolios, but capital continues to flow into those same products. Given the H1 2022 sell off, public equity markets are starting to look cheaper, while later stage private equity funds tend to still look frothy. While the public market correction is also causing a slowdown in late-stage deal activity[17], allocators are still interested in allocating to venture capital as many feel that there has been a market correction in some of the earlier stage valuations unlike that of late-stage private equity.

DOES AN INSTITUTION'S SIZE AFFECT PERFORMANCE?

Most endowments are united in their purpose of providing support to their institution in perpetuity, but their resources and access to blue-chip managers vary widely by institution. In 2021, the average annual net return of E&Fs was 30.6%, a sharp increase from 2020's 1.8% and even 2019's 5.3%.[18] The largest endowments were the highest-performing cohort, with an average return of 37.3%, while schools with the smallest endowments were the weakest, with an average return of 23.9%.[19] The larger the institution and ticket size and the longer the program has been around, the more likely the institution could access the top decile managers and develop its venture and private equity program overtime, which primarily drove returns this year.

Benefitting from their scale, mega endowments (defined as institutions with a median of about $8.8bn in AUM), have tended to top their E&F peers on the performance league tables. Endowments without significant investments in private equity or venture capital still did well in fiscal 2021.[20] However, the biggest dispersion stemmed from the size of the endowment – while most endowments in this study were larger than $1bn in AUM, NEPC's 2021 data elucidated the dispersion of performance based on size of endowment. Endowments of over $1 billion generated an average net investment return of 14.2%, while those with endowments under $25 million saw an average return of 10.8%.[21]

BENCHMARKING

Benchmarking is a tool that allows allocators to better understand and assess a manager's performance attribution and correlation to other managers in the portfolio. It also helps the investment professionals think about the additional value a manager brings to the portfolio or consider whether an investment could be made more passively to achieve a similar return outcome. While benchmarking is not a perfect tool, it can be a useful one – in helping investment professionals measure manager selection (active management) and peer performance.

What do we benchmark? Endowments and foundations can benchmark each manager, an asset class, product, or risk type, and even an entire portfolio.

Why do we benchmark? Benchmarking can demonstrate how a return target is achieved and what value the manager or an employee's manager selection can add to the portfolio in question. It is not about the absolute number but how one measures and achieves that investment objective.

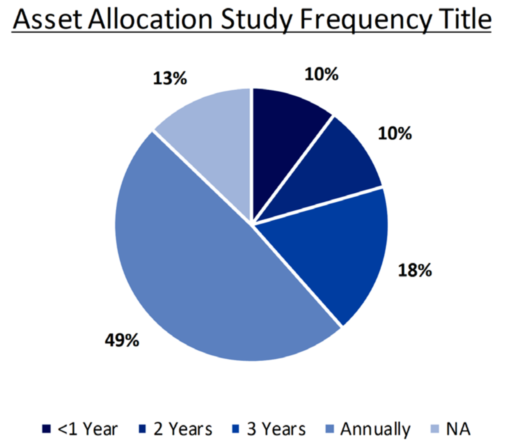
Considerations: Benchmarking can drive what an institution invests in, so it is important to select benchmarks carefully and be intellectually honest as to whether a benchmark is still a fit (due to style drift of the manager or changes in underlying benchmark exposures). Endowments and foundations should spend more time thinking about the benchmarks being used at the manager and portfolio levels and how frequently those benchmarks should be assessed during asset allocation studies and portfolio reviews.

Institutional Portfolio Construction

ASSET ALLOCATION AND INVESTMENT PROCESS

Once an IPS and portfolio construction model has been decided upon, maintenance is still required. While most institutions noted that the role of the investment team was to review asset allocation informally and regularly, about 49% formally reviewed asset allocation targets on an annual basis and another 30% assessed this every 2-3 years.[22] All institutions that assessed asset allocation formally more frequently than annually were foundations, which further demonstrates the more consistent need for and emphasis on short term returns given annual funding needs. Only 12% of institutions interviewed did not have formal asset allocations studies; all of whom were endowments.[23]

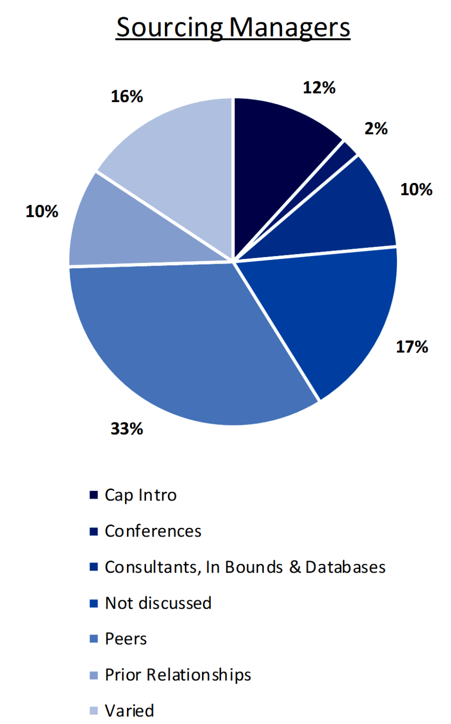
When making asset allocation and portfolio level decisions, over 50% of the time, the person in charge of these studies were usually a member of the investment team, the entire team, or the investment committee.[24] When it was a specific member, it could be the CIO, Head of Risk, or an appointed member of the investment team. When making bottom up, manager specific decisions, it was almost exclusively the CIO with a formality of approval from the investment committee.[25]



TECHNOLOGY

Like many business today, endowment and foundations leverage technology to improve daily, quarterly, and annual processes whether communication internally or reporting externally. There are four primary functions where technology improves investment team efficiency: 1) CRM and team communication, 2) portfolio management, 3) performance aggregation and analytics and 4) market data.

There are a variety of communication tools like Bloomberg, Teams, and Zoom that are used between team members as well as CRM systems like OneNote, Dynamo, Backstop and Bipsync to allow for shared notes and material aggregation. Most institutions leverage external service providers for portfolio and risk management like Addepar, Solovis[26], a NASDAQ solution that helps manage multi-asset class portfolios, or Burgiss[27] (formerly Caissa), which provides a data-driven approach to portfolio management, performance, and risks. There are many other third-party information providers like Factset, Preqin and Pitchbook or performance aggregators like Evestment and Morningstar or consultants with large databases like Cambridge's indices, Albourne's Moat Space or Mercer's GIMD that also help these institutions assess peers, benchmark, and manage their portfolio exposures.



MANAGER SOURCING AND DILIGENCE

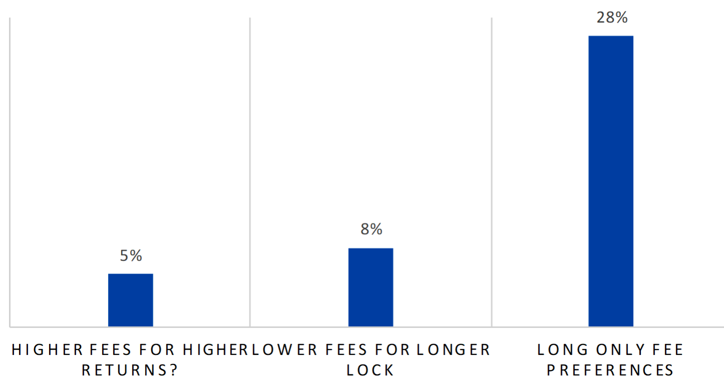
Like most allocators, endowments and foundations source managers and complete investment due diligence (IDD) and operational due diligence (ODD) before an investment is made. However, manager research teams within the endowment and foundation space seem to leverage their personal networks and peers more than any other vertical. While there is limited data as to whether universities are over indexed to alumni, the alumni network can add value as many financially successful alumni end up being money managers or have access to a unique network of other thoughtful money managers; however, the alumni network can be detractive when alumni over-influence the CIO and investment committee with too much input or similar industry ideas.

While there are situations when an investment committee can veto an investment, it is rare, in part, due to discretion of the CIO and trust of the investment team by the investment committee, but also due to the active dialogue between the investment team and the investment committee throughout the process. **There should be no surprises during the formal vote!**

FEES AND TERMS

Part of the manager sourcing and diligence process is understanding the alignment of GP fees and terms with relevant return and liquidity needs of the organization. Most allocators noted that they assess each manager's fees and terms based on the GP's strategy and alpha generation capabilities. While most allocators were willing to pay a higher premium for higher returns or lock up capital longer in exchange for lower fees, all groups paid attention to alpha share and illiquidity premiums.[28] Similarly, almost all E&Fs are willing to pay a premium for higher returning products as they are focused on the net returns of the product.[29] Moreover, most E&Fs are willing to lock up their capital for lower fees (assuming it is a way to generate higher net returns) as most think of hedge fund investments as being at least 1 year anyway.[30] Much of E&F reporting and compensation time horizon tends to be between 1-3 years as well.

FEE AND LIQUIDITY PREFERENCES

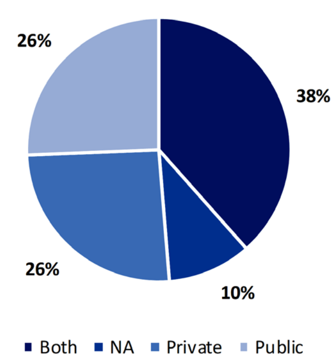


For those institutions that teeter between the product based and risk capital-based investment models, there were more long biased equity long short products invested in the long only portfolio. When making these investments, institutions focused on identifying managers that are producing alpha consistently, are better aligned through lower fees, crystallization of incentive fees over 3-to-5-year hurdles, and an index hurdle. Endowments and foundations are looking for managers that can add alpha and overall value compared to the portfolio compared to the benchmark. If the manager (and the institution's portfolio) cannot beat passive indices, both the GP and the investment team should re-underwrite the value the manager is providing. **Is the purpose of the manager hedging? Should the institution not be actively investing at all?**

EMERGING MANAGERS

E&Fs have a bifurcated view about investing in emerging managers across product types. About 53% of institutions self-attested that they were active emerging manager investors, meaning the institution made an investment within the last year[31], to a first-time private fund or a new hedge fund business that had less than one year of track record. While no respondents had formalized emerging manager programs / farm teams, some E&Fs voiced a preference to invest in emerging managers on the private side because the institution could not get access to the top decile performers and would prefer to take a shot on a newer launch and business rather than invest a "second tier" manager. However, other E&Fs prefer public emerging managers as there is less long-term risk and one can redeem and correct a bad or unforeseen decision due to performance, style drift or business risk. With publics, if an investment team is "wrong", the institution can redeem and course correct more easily; however, with a private commitment, the institution could be stuck in a bad relationship for over 10 years or be forced to sell their GP stake.

Emerging Manager Investment Preferences



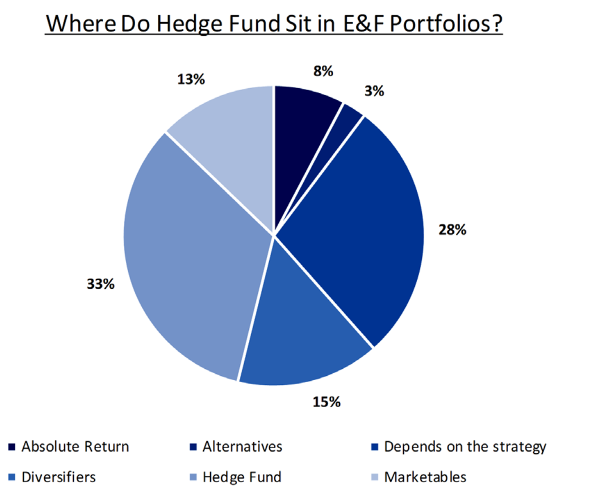
Jefferies

FUND OF HEDGE FUNDS

In part due to the additional layer of fees, most endowments and foundations over $1bn in AUM do not actively invest in funds of hedge funds. 59% of institutions interviewed had fund of fund exposure to private focused products.[32] Where there was exposure it was usually a on the private side and specifically a venture capital fund of fund or a product that was Asia dedicated. Institutions reported being happier to pay a premium on these fund of funds with a niche focus or that required expertise the investment team did not have internally. These investments offered the institution a way to get comfortable with a new asset class or geographic exposure that would be harder to assess with the current resources the institution had due to a lack of network, access, or knowledge of the space. As such, a number of these investments are legacy positions that would roll off in the next 5 to 10 years as the investment team would go direct.

HEDGE FUNDS

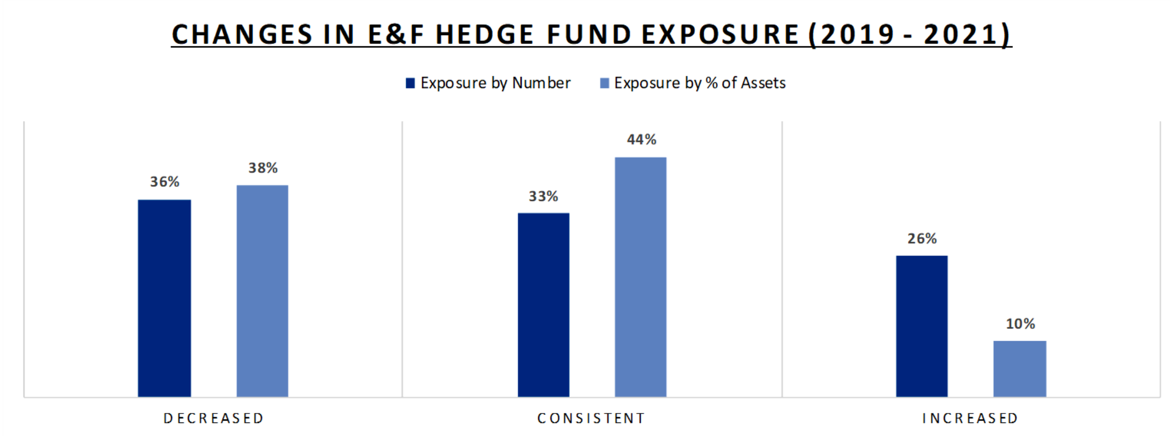
Endowments and foundations were fairly bullish on hedge funds regardless of the portfolio construction model. Whether in a hedge fund dedicated bucket or leveraged as a volatility dampener, all institutions interviewed had exposure to and see the value of investing in hedge funds. **About 33% of respondents would place hedge funds in a hedge fund dedicated bucket and another 13% in the marketables category – all of these institutions leveraged the asset-based model to investing.** For those that leverage more risk-based models, there was more variety in where hedge funds were placed. About 28% of respondents noted that it depends on the strategy, meaning long short equity funds, long only equity funds or managers that produced equity like returns would fall into the equity bucket while equity market neutral, multi-strategy and relative value diversifiers were categorized into the credit or uncorrelated buckets.[33] Many of non-equity strategies were also labeled with "absolute return" or "diversifiers" category.



Regardless of the portfolio construction model, the purpose of hedge funds varied and depended on the bucket. If an equity-oriented strategy, the purpose was for absolute outperformance and success was usually measured over a benchmark. If the strategy was non-equity like, the purpose of the hedge fund was about diversifying return streams, capital protection and volatility dampening.

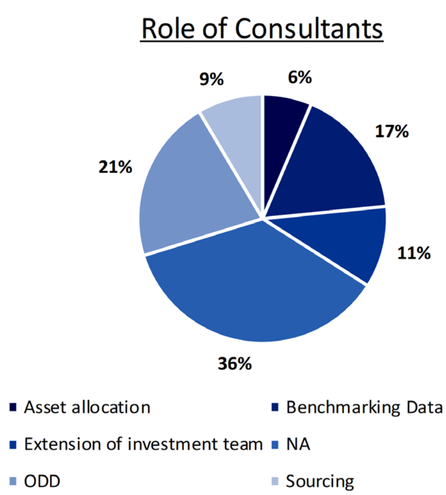
When benchmarking hedge funds, most institutions also noted that the type of benchmark depended on the strategy – usually the MSCI World or SP 500 for equity-oriented managers and the Barclays Agg or Cash + 300bps for diversifying hedge fund strategies. For institutions that leveraged the product focused model, there was consistency in the benchmark – almost all institutions leveraged the HFRI Fund of Hedge Fund Weight Index.

Within institutional portfolios, the median number of hedge fund managers (regardless of categorization), was about 12.5.[34] Some portfolios had as few as 2 hedge funds and other as many as 30 managers. Over the last three years, endowments and foundations have added more hedge fund line items to the portfolio and rotated capital from relationships they have had for 10+ years but noted that they have and plan to keep the overall percentage of hedge fund assets the same or slightly decreased it as an overall percentage.[35] Endowments and foundations noted that they were more willing to make farm team allocation or toe hold positions as they build conviction in new manager relationship after a period of portfolio consolidation from 2010 to 2019.[36]



TEAMWORK MAKES THE DREAM WORK

INVESTMENT TEAM STRUCTURE, OUTSOURCING AND CONSULTANTS



While it is important to understand the IPS and an organization's investment objective, manager sourcing and diligence processes require human capital and personnel to function efficiently. Most $1bn endowments and foundations have about 8 to 10 members on the investment team across the investment and operational teams.[37] While there are typically more investment dedicated individuals than the operational due diligence team, some investments offices were small as 3 total employees and others are as large as 30.[38] On the smaller side, most teams have a CIO, someone senior or midlevel (at least 8 years of experience) and a junior (<5 years of experience).

Retaining and building talent pipelines was important to institutions whether it be for talent recruitment or furthering the mission of institution (ex. Education or financial literacy). While only 20% of respondents had a formal analyst program, over 53% of institutions had summer internship programs.[39]

Even if an organization had a sizeable investment team, many allocators across verticals will hire a consultant to act as an extension of its sourcing and diligence efforts and endowments and foundation are no exception. About 56% of respondents leveraged a consultant, but all were in an advisory capacity.[40] Of those interviewed, the most common consultant firm used was Cambridge (33%) and then Albourne (15%).[41]

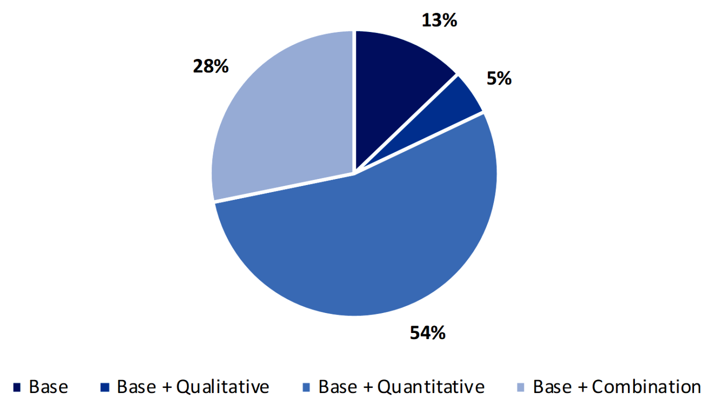
Some institutions have considered the benefits of exclusively leveraging a consultant and have cut their investment office justifying this choice by noting that the consultant driven portfolio outperforms a 75% ACWI / 25% Agg or 60/40 portfolio and is cheaper than the expense ratio of operating the investment office. These E&Fs typically have less than $1bn in AUM will typically have two C-level individuals across either CEO, COO / president, CFO / controller roles in addition to a consultant or outsource CIO at the helm.

Many allocators noted that investment teams would outsource some functions, primarily administrative and legal functions as well as background checks; however, about 36% of those interviewed also outsourced their operational due diligence (ODD) function or had members of the investment due diligence also execute ODD.[42] For those that outsourced this function, most leveraged the consultant hired (which is most cases were also used for sourcing).

SALARY AND COMPENSATION STRUCTURES

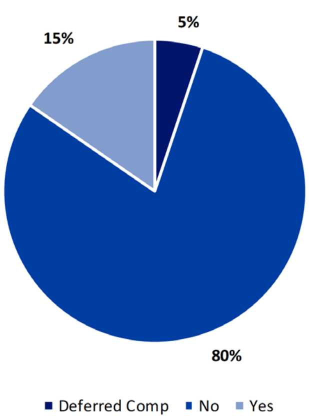
One tool for employee recruiting and retention is compensation. Over 50% of E&F allocator compensation is based on an annual salary and bonus that is dependent on some combination of qualitative and or quantitative metrics.[43] About 12% of respondents were compensated only on a base salary without any bonus and another 5% were discretionary bonuses without any portfolio performance focused metrics.[44] Some employees noted that as an individual gained more seniority, the mix of the employee bonus inputs changes as well, applying more quantitative and performance-based metrics. Non-financial benefits or flexibility like "work from home", vacation days, gym memberships, corporate perks or parental leave extensions were mentioned when discussing compensation packages.

E&F Employee Compensation Metrics



When quantitative metrics were used, it was usually fairly formulaic and based on the outperformance of the absolute returns in the form of a policy benchmark or relative performance of peer portfolios (usually Cambridge's endowments and foundation greater than $1bn in AUM index on a 3-year rolling basis).[45] When assessed based on performance it was rarely focused on alpha and more so focused on absolute outperformance over a stated investment objective or benchmark.

Salary & Incentives: Can employees co-invest?

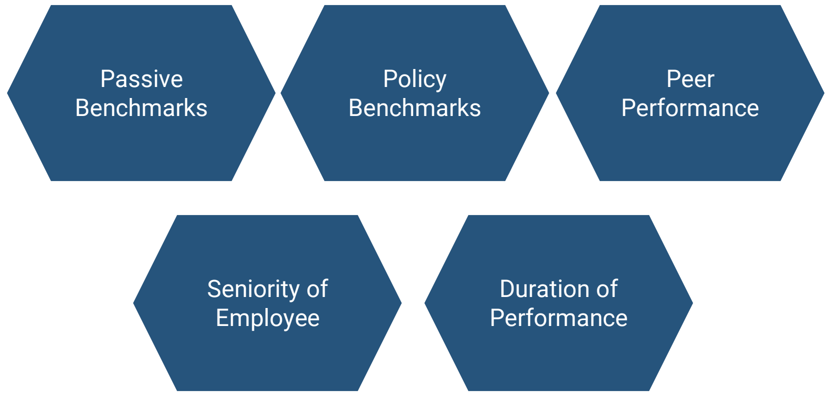


Unlike family offices that tend to have co-investment perks, almost 80% of all employees surveyed noted that the investment team could not invest in the endowment pool or co-investment along-side one of the managers or deals in the portfolio.[46] When pushed, only 10% of those respondents noted a formal policy in place.[47] About 15% of those surveyed noted that they were allowed to coinvest but either a disclosure policy existed for an investment greater than 5% of the company or there was some sort of a restricted list that is shared with the investment committee.[48] The investment needed to be pre-cleared when it was a private investment or a single stock equity.

It is arguable that there is a disconnect between employees' compensation structure and an organization's investment objective duration. For example, there is a J Curve on building and investing in a privates focused investment fund – performance is usually negative to flat in early years as capital is called and deployed, and performance does not impact the portfolio (and the institution) until 3 to 5 years later as harvesting begins and yet employees are paid annually. If we look at 10-year bull market and the run-on venture and private equity performance, employees that are compensated in part due to portfolio performance have been incentivized to make investments in higher returning products with less liquidity even if it is not in the best fiduciary interests of the institution, which might have a lower risk tolerance and higher near-term liquidity needs.

Jefferies

The challenge is that the investment objectives of most endowments and foundations are measured over the long term or even in perpetuity whereas an employee's compensation is assessed at least annually. Some toggles that could be incorporated into the compensation structure include thinking more about how a portfolio outperforms passive and policy benchmarks, and peer performance in addition to the seniority of the employee across a variety of time periods.



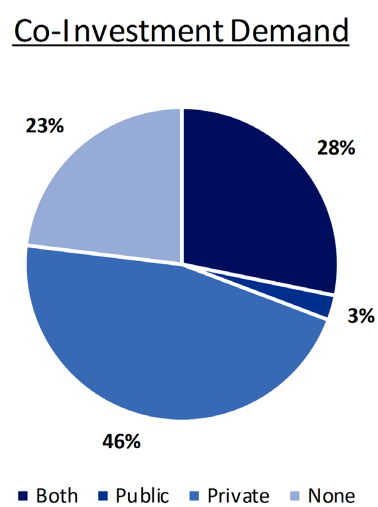
While there is no perfect solution to incentivization and alignment of employee compensation, there must be other ways to better align the current mismatch between the performance and duration of the institution's portfolio and maybe consider an employees' tenure whether through deferred compensation, better aligning personal and portfolio performance over variety of durations or peer groups, or even adding additional grant giving, lifestyle or non-cash perks into compensation packages.

THEMES OF TODAY

Organizations need to align compensation to attract and retain talent because human capital is the engine that fuels investment decisions and there are a lot of investable products to choose from. Some of the more topical offerings today include co-investments, blockchain technology and cryptocurrencies as well as ESG and DEI focused products.

CO-INVESTMENTS AND ANCILLARY PRODUCTS

Many endowments and foundations are active co-investors. About 75% of all respondents noted that they will co-invest alongside a manger.[49] Most of the time these investment are made with their current external managers, but sometimes new relationships are forged with an interesting opportunity.[50] Most institutions appeared to prefer private investments over public co-investment opportunities, citing the ability to gain access to higher conviction manager ideas and blend down overall fees with a manager.



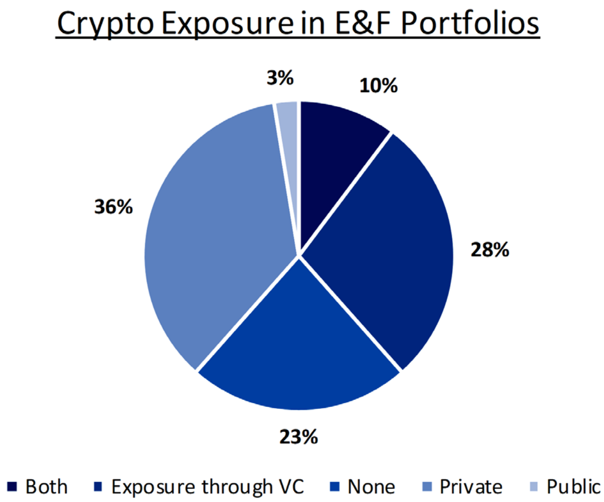
Many allocators wanted to leverage the manager relationships they had to assess coinvestments but did not have a systematic approach to assessing them. For all investors, assessing co-investment opportunities can be time consuming. Many institutions noted that investment due diligence can take "90% of their time to make a 5-10% investment", which begs the question – is it worth it?

Many respondents felt that lower fees on the co-investment will offset the adverse selection of doing the work and efficiently triaging an exponential number of opportunities that come across their desk from pre-vetted sources.

Not only has there been an uptick in allocations to co-investment opportunities, but there has been more demand and willingness to invest in a GP's ancillary products. About 64% of respondents have investments with multiple products from a single GP relationship.[51] While some E&Fs noted that new products and opportunities can distract a manager from what the GP is currently doing, create style drift, and enhance pressures that aren't beneficial to the reason the E&F originally invested, many institutions see the creation of new products and adaptation to the new market environment as the reason why it made the investment in that manager in the first place. Moreover, E&Fs noted that they are buying the manager's network, platform, and foresight into the next opportunity and not just a product.

DIGITAL ASSETS

Many endowments and foundations are also dipping their toes into digital assets and blockchain oriented technology investments. Many see these products as uncorrelated instruments that should be designated as their own asset class (until Q2 2022 when they sold off with stocks and the rest of growth teach and the equity market). For more details on Digital Assets and Institutional Flows, please see The Library of COINgress.



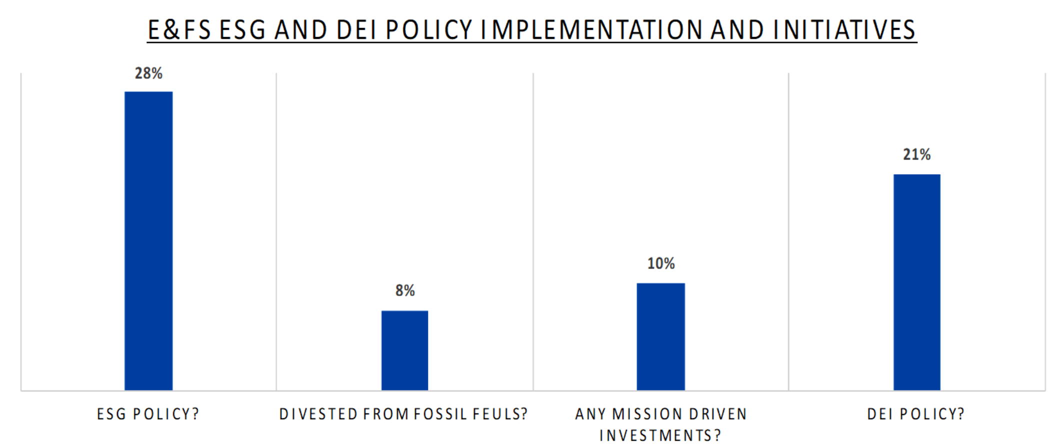
While most organizations have not made dedicated allocations to publicly traded cryptocurrency funds, when there is exposure or interest in investing directly into the space, there is more interest on the private side. Unlike token or currency valuations, it is easier to understand the value of the infrastructure and technology associated with the blockchain.

While many institutions are open to digital asset investments, 23% of E&Fs will accept donation or tuition payments via cryptocurrency.[52] When asked about the donation policy, many institutions noted that the institution would likely open up an account on an exchange and immediately liquidate that investment.

While there are a few exceptions like the University of Pennsylvania[53], many institutions will accept donations, but won't accept it as a means of tuition payment. None of the interviewed endowments or foundations have accepted tuition and minimal have accepted donations either because due to lack of infrastructure or that no one has donated. However, about 50% of E&Fs have direct product exposure to digital assets.[54]

ESG & DEI

While many endowments have student populations that voice concerns about the environment or foundations that have mission driven causes focused on social issues, many of these institutions have not formalized these values within their investment policy. Only 28% of all institutions surveys have a formal ESG policy at the investment level and only 8% of them have formally divested fossil fuel investments.[55] From the social perspective, only 21% have formal DEI policies and only 10% of them have mission driven investments.[56]



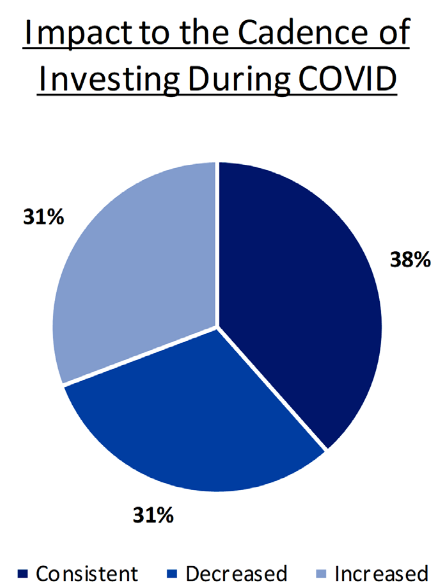
Some groups have made commitments to targeting a certain percentage of their portfolio will be women or minority owned or a certain level of carbon neutrality by a certain date. The biggest challenge is while these public commitments are steps in the right direction, there is limited consistency on how to measure diversity and ownership. For example, is diversity a focus on gender, religion, race, or sexuality? Is it about diversity of experience, socioeconomic status and up-bringing or network? Is it about ones' investable universe or the improvements made within a company's environmental impact, social diversity, and governance? Is it majority or minority ownership? Is diversity only based on risk taking or overall ownership in a business? Does it need to be a majority or minority ownership at that?)

While this research is primarily focused on US endowments and foundations, the few European institutions interviewed made it clear by implementing ESG and DEI metrics into their investment process and portfolios. The European governing agencies have incentivized these institutions to create clear markers and measure success. In the meantime, the institutions themselves are trying to find ways to move the needle. For example, IADEI was founded by a consortium of asset owners, primarily endowments and foundations, that seeks to drive diversity, equity, and inclusion within institutional investment teams and portfolios and across the investment management industry.[57] Until there are consistent ways to measure these milestones and therefore incentivize better alignment in decision making, there will limit ways to fully make an impact.

FROM 2020 AND BEYOND

COVID FALL OUT AND THE FUTURE OF "WORK FROM HOME"

While there are a variety of thematic investable ideas that keep E&F investment teams busy, nothing impacted these institutions (and world) more severely than the COVID-19 pandemic. When COVID hit in Q1 2020, at first, many endowments and foundations were concerned about the needs of their institutions and needed to rethink how they were structured and what funding needs would be needed moving forward. For endowments, there were concerns about tuition, revenues from student housing and the ability to pay its faculty and maintain the institution. Moreover, some endowments have hospital systems that are huge funding sources for the organization – without elective surgeries, large sources of revenues were lost that normally went towards the operating budget.

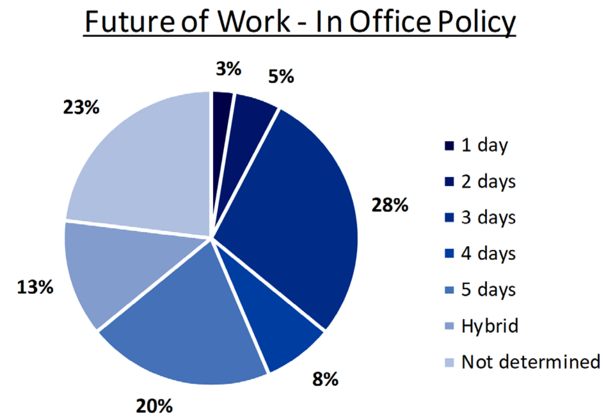


Beyond the 5% spend rate needed for both endowments and foundations to maintain their tax-exempt status, foundations needed to give more away in grants and charitable programs due to the needs of their target affected populations. A number of foundations noted that the investment team spent more time speaking with the finance and treasury department at this time since COVID to better understand how much volatility a grant program could withstand. Moreover, the team continues to think about whether the organization should have a more flexible grant budget that can dial up or down in a given each year.

Over the past 2 years, these organizations spent the time to re-assess investments, optimize financing and liquidity needs of the institution and now feel like they are now operating more efficiently as their budgets decreased and their portfolios were optimized (due to less travel, lower expenses, and even more productive employees). By H2 2022, 69% of institutions noted that the cadence of investing increased or remained consistent and only 31% noted a decrease in initial activity.[58]

While there was an increase in investments, it was usually due to the increase in asset raising from private funds. Private funds are coming to market every 1-2 years compared to every 3-5 years in the past so allocators do not want to overcommit or get overexposed to a certain manager or vintage and so are starting to write smaller checks given the increased frequency.

Some additional COVID directed changes are in the work from home approach and policy. Over 56% of teams are coming in some sort of a hybrid while 20% are coming in 5 days a week. [59] The remaining teams still have not determined the course of action but are generally operating in some hybrid or exclusively work from home structure. Most teams are coming in 3 days a week with usually 1 day where the entire team is in (most folks are typically Tuesday, Wednesday and Thursday). **Who knows where the future of work and investing will take us!**



TAKEAWAYS

WHERE DOES INSTITUTIONAL INVESTING GO FROM HERE?

After 30 years of one primary asset allocation model and the emergence of a more volatile and inflationary market, it is time for the industry and the institutional investors within it to modernize and adapt. Portfolios have to adjust its asset allocation, construction and product selection in order to achieve these higher return targets and maintain purchasing power. Like most industries, institutional investing must innovate!

CONTACTS

Julia Dworkin
jdworkin@jefferies.com
+1 (212) 708.2732
SVP, Capital Intelligence Team

Leor Shapiro
lshapiro@jefferies.com
+1 (212) 336.6267
MD, Head of Capital Intelligence Team

Shannon Murphy
shannon.murphy@jefferies.com
+1 (212) 336.1139
MD, Prime Services Strategic Content

IMPORTANT DISCLAIMER

THIS MESSAGE CONTAINS INSUFFICIENT INFORMATION TO MAKE AN INVESTMENT DECISION.

This is not a product of Jefferies' Research Department, and it should not be regarded as research or a research report. This material is a product of Jefferies Equity Sales and Trading department. Unless otherwise specifically stated, any views or opinions expressed herein are solely those of the individual author and may differ from the views and opinions expressed by the Firm's Research Department or other departments or divisions of the Firm and its affiliates. Jefferies may trade or make markets for its own account on a principal basis in the securities referenced in this communication. Jefferies may engage in securities transactions that are inconsistent with this communication and may have long or short positions in such securities.

The information and any opinions contained herein are as of the date of this material and the Firm does not undertake any obligation to update them. All market prices, data and other information are not warranted as to the completeness or accuracy and are subject to change without notice. In preparing this material, the Firm has relied on information provided by third parties and has not independently verified such information. Past performance is not indicative of future results, and no representation or warranty, express or implied, is made regarding future performance. The Firm is not a registered investment adviser and is not providing investment advice through this material. This material does not consider individual client circumstances, objectives, or needs and is not intended as a recommendation to particular clients. Securities, financial instruments, products, or strategies mentioned in this material may not be suitable for all investors. Jefferies does not provide tax advice. As such, any information contained in Equity Sales and Trading department communications relating to tax matters were neither written nor intended by Jefferies to be used for tax reporting purposes. Recipients should seek tax advice based on their particular circumstances from an independent tax advisor. In reaching a determination as to the appropriateness of any proposed transaction or strategy, clients should undertake a thorough independent review of the legal, regulatory, credit, accounting, and economic consequences of such transaction in relation to their particular circumstances and make their own independent decisions.

© 2022 Jefferies LLC

---

[1] *Pioneering Portfolio Management: An Unconventional Approach to Institutional Investment* by David Swensen
[2] Jefferies Endowment and Foundation Survey 2022
[3] Jefferies Endowment and Foundation Survey 2022
[4] Jefferies Endowment and Foundation Survey 2022
[5] Jefferies Endowment and Foundation Survey 2022
[6] Jefferies Endowment and Foundation Survey 2022
[7] Jefferies Endowment and Foundation Survey 2022
[8] *Pioneering Portfolio Management: An Unconventional Approach to Institutional Investment* by David Swensen
[9] 2021 NACUBO Data: https://www.nacubo.org/Research/2021/NACUBO-TIAA-Study-of-Endowments
[10] 2021 NACUBO Data: https://www.nacubo.org/Research/2021/NACUBO-TIAA-Study-of-Endowments
[11] 2021 NACUBO Data: https://www.nacubo.org/Research/2021/NACUBO-TIAA-Study-of-Endowments
[12] CNBC: *How Interest Rates Impact your portfolio* https://www.cnbc.com/select/how-interest-rate-increase-impacts-your-portfolio/
[13] Jefferies Endowment and Foundation Survey 2022
[14] Jefferies Endowment and Foundation Survey 2022
[15] Jefferies Endowment and Foundation Survey 2022
[16] *Venture Capital Journal*: https://www.venturecapitaljournal.com/lps-and-gps-wrestle-with-how-and-when-to-mark-down-portfolios/
[17] Wellington: *How the public market correction is affecting the late-stage private equity market* https://blog.wellington.com/market-correction-late-stage-private-equity/
[18] 2021 NACUBO Data: https://www.nacubo.org/Research/2021/NACUBO-TIAA-Study-of-Endowments
[19] 2021 NACUBO Data: https://www.nacubo.org/Research/2021/NACUBO-TIAA-Study-of-Endowments
[20] https://www.insidehighered.com/news/2021/10/01/wealthy-colleges-see-double-digit-returns-fiscal-2021
[21] 2021 NACUBO Data: https://www.nacubo.org/Research/2021/NACUBO-TIAA-Study-of-Endowments
[22] Jefferies Endowment and Foundation Survey 2022
[23] Jefferies Endowment and Foundation Survey 2022
[24] Jefferies Endowment and Foundation Survey 2022
[25] Jefferies Endowment and Foundation Survey 2022
[26] Solovis was acquired by the NASDAQ in March 2020 https://www.solovis.com/news/nasdaq-acquires-institutional-investment-fintech-firm-solovis/
[27] Burgiss acquired Caissa October 2021: https://www.burgiss.com/news/2021/10/6/burgiss-and-caissallc-complete-merger
[28] Jefferies Endowment and Foundation Survey 2022
[29] Jefferies Endowment and Foundation Survey 2022
[30] Jefferies Endowment and Foundation Survey 2022
[31] Jefferies Endowment and Foundation Survey 2022
[32] Jefferies Endowment and Foundation Survey 2022
[33] Jefferies Endowment and Foundation Survey 2022
[34] Jefferies Endowment and Foundation Survey 2022
[35] Jefferies Endowment and Foundation Survey 2022
[36] Jefferies Endowment and Foundation Survey 2022
[37] Jefferies Endowment and Foundation Survey 2022

[38] Jefferies Endowment and Foundation Survey 2022
[39] Jefferies Endowment and Foundation Survey 2022
[40] Jefferies Endowment and Foundation Survey 2022
[41] Jefferies Endowment and Foundation Survey 2022
[42] Jefferies Endowment and Foundation Survey 2022
[43] Jefferies Endowment and Foundation Survey 2022
[44] Jefferies Endowment and Foundation Survey 2022
[45] Jefferies Endowment and Foundation Survey 2022
[46] Jefferies Endowment and Foundation Survey 2022
[47] Jefferies Endowment and Foundation Survey 2022
[48] Jefferies Endowment and Foundation Survey 2022
[49] Jefferies Endowment and Foundation Survey 2022
[50] Jefferies Endowment and Foundation Survey 2022
[51] This can mean an investment in a hedge fund manager's long short equity and long only product or an asset manager's hedge fund and private equity product etc…
[52] Jefferies Endowment and Foundation Survey 2022
[53] NBC: https://www.nbcphiladelphia.com/news/business/university-of-pennsylvania-cryptocurrency/3018458/#:~:text=The%20University%20of%20Pennsylvania%20will,currency%2C%20reports%20the%20Philadelphia%20Business
[54] Jefferies Endowment and Foundation Survey 2022
[55] Almost all endowments respondents specifically noted that they would not actively try to make future fossil fuel investments (all things equal), but there was no formal policy and no formal divestment of the current portfolio exposure.
[56] For example, if an endowment is focused on funding education needs of the institution, only 10% of them have made ed-tech investments. Similarly, if a foundation is focused on curing Alzheimer's only 10% of those investments were directed in the healthcare arena (almost none were directly for the mission itself).
[57] IADEI: https://iadei.org/
[58] Jefferies Endowment and Foundation Survey 2022
[59] Jefferies Endowment and Foundation Survey 2022