Portfolio Management for Institutional Investors

Managing Institutional Investor Portfolios (Part 2)

- Foundations
- Endowments

Foundations: Independent

- **Description**: Single donor, private or family
- **Purpose**: Makes grants to charities, educational institutions, religious purposes, etc.
- **Source of funds**: Typically an individual or family or group
- Annual **spending requirements**: **5% of average market value of assets** during preceding year (excluding investment management fees)

Foundations: Company Sponsored

- **Description**: Legally independent grant making institution closely tied to sponsoring organization
- **Purpose**: Makes grants to charities, educational institutions, etc., however, interests can be aligned with the sponsoring company
- **Source of funds**: Corporate sponsor
- Annual **spending requirements**: **5% of average market value of assets** during preceding year (excluding investment management fees)

Foundations: Operating

- **Description and purpose**: Established for the sole purpose of funding an organization (e.g., museum, zoo, etc.) or funding research
- **Source of funds**: Typically an individual or family but can be a group—same as independent
- Annual **spending requirements**: At least **85% of dividends plus interest income** (may also be required to spend 3.33% of assets)

Foundations: Community

- **Description**: Publicly sponsored grant-awarding organization
- **Purpose**: Fund social, educational, religious, and other purposes
- **Source of funds**: General public and large donors
- Annual **spending requirements**: **None**

Foundations: Return Objective

- **Typical return objective:** Preserve **real** value of the portfolio and meet distribution (**spending)** targets.
  - Maintain **intergenerational neutrality.**
    - Maintaining real value allows the real value of distributions to be maintained.
    - Meaning that nominal value after distributions must increase at the rate of inflation over the long term.

Foundations: Return Objective

- Management costs are 30 basis points.
- The distribution target is 5%.
- The relevant inflation rate is 2%.

$$\underbrace{(1.003)(1.05)(1.02)}_{\text{compounded}} - 1 = 0.0742 = 7.42\%$$

Compound vs. Arithmetic Return

- The discrepancy between approaches widens:
  - Over longer time periods
  - The higher the spending and inflation rates
- Past exam answers generally show **compounded as the preferred approach for institutions**.
  - Foundations and endowments are often perpetual and exposed to path dependency.
  - Arithmetic as an alternative answer

Foundations: Spending Rules

- **Simple rule**: Spend x% of beginning market value
  - Volatile market value leads to volatile distribution
- **Smoothing rules** are intended to reduce the volatility of distributions. For example:
  - Spend x% of the average of last 3 years market value
  - Base next distribution on past distribution amount, increased for inflation

Foundations: Risk Tolerance

- A perpetual time horizon, flexible spending requirements, and need to maintain purchasing power may allow for very aggressive risk.
  - If deemed appropriate by the board of the foundation
- Risk tolerance is reduced by (1) recipients who depend heavily on the distributions and (2) lack of smoothing rules.
- With no contractual liabilities, an asset only management is appropriate.

Foundations: Time Horizon and Taxes

- **Time horizon** is usually **perpetual**.
  - Watch for exceptions such as a spend down provision requiring distribution of all assets by a specified date.
- **Taxes**: Generally **tax exempt**
  - Watch for special cases such as **UBIT** (unrelated business income tax) imposed on certain specifically-designated assets.

Foundations: Liquidity

- Anticipated and unanticipated needs for cash in excess of contributions received
- Smoothing techniques make liquidity needs more predictable.
- Cash equivalent liquidity needs are usually low.
  - Some foundations choose to hold some fraction of the annual spending need as a reserve.

Foundations: Legal and Regulatory

- Generally less regulated compared to other institution types
- Varies by country and type of foundation
  - Generally the Uniform Management of Institutional Funds Act (UMIFA) in the United States
    - A prudent investor standard, which is less strict than a prudent expert
    - Assumes care of an ordinary business person

Foundations: Unique

Varies and case specific:

- **Concentrated holdings**, restrictions on sale, or prohibited investments
- **Socially responsible investing**
- Board of director biases and opinions
- Inadequate resources for due diligence on complex investments

Endowments: Return Objective

- True endowments are, by definition, perpetual and restricted in their spending.
  - Principal must be maintained
- More generally, an endowment is a long-term portfolio designed to support social purposes (e.g., support for universities, colleges, or hospitals).
  - Maintaining perpetual purchasing power is key.
  - Distributions must be sustainable and reliable.

Endowments: Return Objective

- **Total return** should cover spending goals, inflation, and management fees over the long run.
- The form of return is not significant:
  - Income
  - Realized gains
  - Unrealized gains

Endowments: Spending Rules

- **Simple rule**: Spend x% of beginning market value
- **Rolling average:** Spend x% of the average of last 3 years market value
- **Geometric rule:**
  - Y% of spending set as x% of the average of last 3 years market value
  - 1 – Y% set as past distribution amount adjusted for inflation

Endowments: Risk Tolerance

- Typically high due to perpetual time horizon
- Risk tolerance is reduced by:
  - Lack of smoothing rules to dampen distribution volatility
  - Distribution receivers who are heavily dependent on the distributions
  - Directors who are focused on short-term market volatility

Endowments: Time Horizon and Taxes

- **Time horizon** is usually **perpetual.**
  - Watch for exceptions, such as a requirement to fund large onetime projects at a specific date.
- **Taxes**: generally tax exempt
  - Watch for special cases such as **UBIT** (unrelated business income tax) imposed on certain specifically-designated assets or other specifically-disclosed taxes.

Endowments: Liquidity and Legal/Regulatory

- **Liquidity** needs are generally limited.
  - Watch for specified cash outlay needs or specified reserves.
  - Perpetual nature may allow the use of illiquid assets.
- **Legal/Regulatory**: similar to foundations
  - Varied and relatively less regulated compared to other institutions

Endowments: Unique

- SRI – ethical investing concerns
- BOD biases and opinions
- Inadequate resources for due diligence on complex investments