Endowment Sweepstakes: How Tiny Houghton College Beat Harvard

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Common Sense

By JAMES B. STEWART

The hotly competitive returns of college endowment performance are out, and the results have again shaken the higher education elite down to their Ivy League roots: The smallest endowments — those with total assets under $25 million — outperformed their billion-dollar-plus rivals for the second year.

The National Association of College and University Business Officers, known as Nacubo, and the Commonfund Institute last week released the latest results, which are, for most schools, far more important than whether they advance to the N.C.A.A. Final Four.

The 2016 fiscal year, which ended June 30, wasn't an especially good year for anybody. But the smallest endowments outperformed the billion-plus group, losing 1 percent, on average, compared with a 1.9 percent decline for the biggest endowments.

Results were even worse for endowments of $500 million to $1 billion, which lost on average 2.2 percent.

Falling behind by nearly a full percentage point has a huge impact on giant endowments like Harvard's, which stood at $35.7 billion at the end of the fiscal year. Harvard said its investments declined by 2 percent, and its endowment total dropped by $2 billion because of the investment losses and spending. Harvard is now shaking up its endowment management.

Yale did much better than many of its peers, gaining 3.4 percent. But that still lagged the 4 percent return over the same period for the Standard & Poor's 500-stock index and wasn't enough to offset spending. Yale's total endowment dropped by $200 million, to $25.4 billion.

Compare the results with those of Houghton College, a liberal arts institution affiliated with the Wesleyan Church in the Genesee Valley in western New York. Houghton has just over a thousand students and an endowment of $46.4 million.

Houghton emerged in the top quartile of all endowments, according to Nacubo, with a return of 11.85 percent for the year ended Sept. 30. (Houghton uses a different fiscal year.) For the calendar year, the results were also impressive, at 7.54 percent. Houghton has been able to lower its spending rate — the amount it withdraws each year to fund operations — to an enviable 4.5 percent, and may be able to lower it further, to 4 percent.

How did tiny Houghton do it?

The answer is pretty simple: Houghton got out of hedge funds and all alternative investments a year and a half ago, and moved the entire portfolio to a mix of low-cost index funds and mutual funds at the fund giant Vanguard.

Houghton's endowment is now invested in a simple mix of 76 percent in stocks, evenly divided between United States and foreign, and 24 percent in fixed income, according to Vincent Morris, who joined Houghton last year as its vice president for finance after a stint in risk management at the insurance broker Arthur J. Gallagher. Roughly half the endowment is in low-cost index funds, and the rest is in actively managed mutual funds.

Houghton's investment committee met this week, and is likely to move even further from active management, Mr. Morris said. "I went to the University of Chicago, where I sat in a lot of investment classes," he told me. He learned how difficult it was for active managers to outperform market averages, “especially year after year,” he said, adding, “I’m a big believer in passive investment.”

As for hedge funds and other high-cost alternatives, “the whole two-and-20 model” — in which investors typically pay 2 percent of assets under management and 20 percent of any gains — “is ridiculous,” Mr. Morris said. “The cost structure is outrageous. As they say on Wall Street, ‘Where are the customers’ yachts?’ I’m not going to play that game.”

Houghton’s experience with hedge funds predates Mr. Morris’s arrival on campus, but their performance was “mediocre at best,” he said, adding, “The investment committee and I are on the same page about moving to less active management and lower costs.”

As Houghton’s experience suggests, the past year’s disparity in results between the large and small endowments can almost entirely be explained by the differing allocations to alternative investments, especially hedge funds.

According to the association’s survey, endowments larger than $1 billion had 58 percent of their assets in alternative strategies on average, with 20 percent in hedge funds and 12 percent in private equity.

The smallest endowments — those of less than $25 million — had just 10 percent in alternatives, with 6 percent in hedge funds and a mere 1 percent in private equity.

Stung by overexposure to the troubled pharmaceutical company Valeant International, and taken by surprise by Britain’s decision to leave the European Union, hedge funds, on average, lagged far behind both the S.&P. 500 and fixed-income returns in fiscal 2016.

As a result, the performance of a simple low-cost mix of stocks and bonds, much like the portfolio Houghton assembled, has streaked past the more complex portfolios laden with hedge funds and other alternative investments.

Vanguard said a simple mix of index funds with 70 percent in equities and 30 percent in fixed-income assets delivered an annualized return of 7.1 percent over the past five years, and 6.1 percent over the past 10. For a mix of 60 percent stocks and 40 percent bonds, the returns were 6.7 percent for five years and 6.1 percent for 10.

By comparison, the annualized returns for the billion-plus endowments were 6.1 percent for five years and 5.7 percent for 10.

Hedge funds, however, have successfully marketed themselves as offering higher risk-adjusted rates of return, in part because they supposedly minimize losses in down years. But according to Vanguard's calculations, its simple, low-cost model portfolios have provided higher returns even after adjusting for risk in eight of the past 11 years.

Most investors "would have been much better off in a low-cost, broadly diversified portfolio than in these other complex vehicles," Christopher Philips, head of Vanguard Institutional Advisory Services, said.

Harvard reported its hedge fund portfolio lost 1.2 percent for the 2016 fiscal year. The university said it had 14 percent of its assets in "absolute return" strategies — meant to ensure that the return is always positive, rather than pegged to a benchmark — a category that includes hedge funds.

Nonetheless, in a report written by the previous chief executive of Harvard Management Company, which oversees the university's endowment, Harvard said that "we continue to believe that partnering with best-in-class managers will lead to attractive risk-adjusted returns."

Why Harvard would harbor such a belief after years of hedge fund underperformance remains a mystery to some.

“Supposedly the big endowments have access to better managers,” Mr. Morris said. “I may be more cynical, but I’m not sure I buy that. How do you know who the better managers are? I’m not convinced that any manager can outperform” over the long-term horizons of most endowments.

Mr. Philips of Vanguard agreed. “The ultimate challenge is picking the hedge fund managers,” he said. “There are so many, you end up seeing the same distribution of returns that you see in mutual funds except there are twice as many hedge funds.”

No major college endowment has publicly turned its back on hedge funds, as the California Public Employees’ Retirement System did in the world of pension funds in 2014. But endowment managers are closely watching to see if Harvard changes its approach now that it has brought in a new chief executive, N. P. Narvekar, who had a successful run managing Columbia University’s $9 billion endowment.

Mr. Narvekar has already shaken up the endowment’s management, saying Harvard will lay off roughly half its 230 employees by the end of the next fiscal year, including all of its internal hedge fund managers. He promised to outsource more of the endowment’s investment decisions.

Even so, no one expects Harvard — or any other major endowment — to ditch hedge funds anytime soon. Hope springs eternal, and the allure of potentially higher returns is paradoxically more potent the lower the actual returns are.

“If I put myself in the shoes of an endowment manager, I can sympathize,” Mr. Philips said. “You have to keep ahead of inflation and contribute to the operating budget at a time when return expectations are muted. So you feel compelled to reach for hedge funds or private equity in the hope you’ll outperform.”

While Vanguard hasn’t seen any stampede out of hedge funds and other alternatives among college endowments, “those hopes are starting to come up against reality,” Mr. Philips said.