

TIAA-CREF institute

## **TRENDS AND ISSUES**

### HIGHLIGHTS OF 2004 NACUBO ENDOWMENT STUDY

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# TRENDS AND ISSUES

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## EXECUTIVE SUMMARY

Traditional U.S. and international equities performed well and domestic bonds performed poorly in fiscal 2004, thus rewarding college and university endowments with large allocations to the former and small allocations to the latter. Overall, institutions participating in the 2004 NACUBO Endowment Study experienced average returns of 15.1%, a welcomed result after three very difficult years. Other highlights of the study, which is administered by TIAA-CREF on behalf of NACUBO, include:

- Six of the top-10 performing institutions in 2004 had endowments of less than \$100 million. Over long-term periods, however, large endowments with more than \$1 billion tend to perform better than small endowments.
- Endowments continue to invest larger percentages in alternative investments. Of the \$267 billion assets in the study, \$68 billion were invested in alternatives, led by hedge funds, \$39.2 billion; private equity, \$9.3 billion; and venture capital, \$8.3 billion.
- The trend of endowments turning to external managers continues. From 2000 to 2004, the percentage of overall endowment assets managed internally has declined from 17.5% to 11%.
- The average spending rate declined slightly in fiscal 2004, from 5.1% to 5.0%, following four years of increasing rates.

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## INTRODUCTION

In the closely watched arena of endowment management, the institutions commonly considered top performers are Ivy League and other elite, sizable universities. But for any particular year, a number of smaller and less familiar names can populate the list of top performers. Such was the result of the NACUBO Endowment Study (NES) for fiscal 2004, when six of the top-10 performers were endowments with less than \$100 million. The 2004 study reveals the continuation of a number of trends-- such as greater allocations to alternative investments and increased reliance on external money managers—as well as a reversal in the direction of spending rates and shifts within certain asset classes.

A total of 741 institutions, both public and independent, participated in the 2004 study, representing \$267 billion. NACUBO believes that its study captures at least 90% of higher education endowment assets, since essentially all of the largest 250 U.S. endowments participate. The study in various forms has been conducted since 1971 and provides information on many aspects of endowment management, including performance, asset allocation, operational practices, and spending rates. For the past five years, TIAA-CREF has administered the study and compiled the results on behalf of NACUBO. The table below provides information on the 2004 study participants.

	<b>Public</b>	<b>Independent</b>	<b>All</b>
<b>Participants</b>	227	514	741
<b>Avg. Student Enrollment</b>	21,051	3,701	8,984
<b>% of All Students</b>	72%	28%	100%
<b>% of Endow \$</b>	28%	72%	100%
<b>Endow \$ per Student</b>	\$15,833	\$100,929	\$40,218

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In the study, institutions are grouped by the size of their endowments. As shown below, Group 1 consists of 47 institutions, each having more than \$1 billion in endowment assets. Group 1 represents only 6% of participants in the study, but 61% of assets. In contrast, Group 6 represents 19% of participants but only 1% of assets.

### Groups by Endowment Size

Group	Endowment Size	# Inst.	% Inst.	% All \$	\$/student
1	>\$1 billion	47	6%	61%	\$124,178
2	\$501 million-\$1 billion	50	7%	14%	\$41,268
3	\$101 million-\$500 million	224	30%	19%	\$22,160
4	\$51 million-\$100 million	124	17%	3%	\$12,375
5	\$26 million-\$50 million	157	21%	2%	\$7,932
6	<\$25 million	139	19%	1%	\$2,726
<b>Total</b>	<b>\$267 billion</b>	<b>741</b>	<b>100%</b>	<b>100%</b>	<b>\$40,218</b>

### PERFORMANCE REVIEW

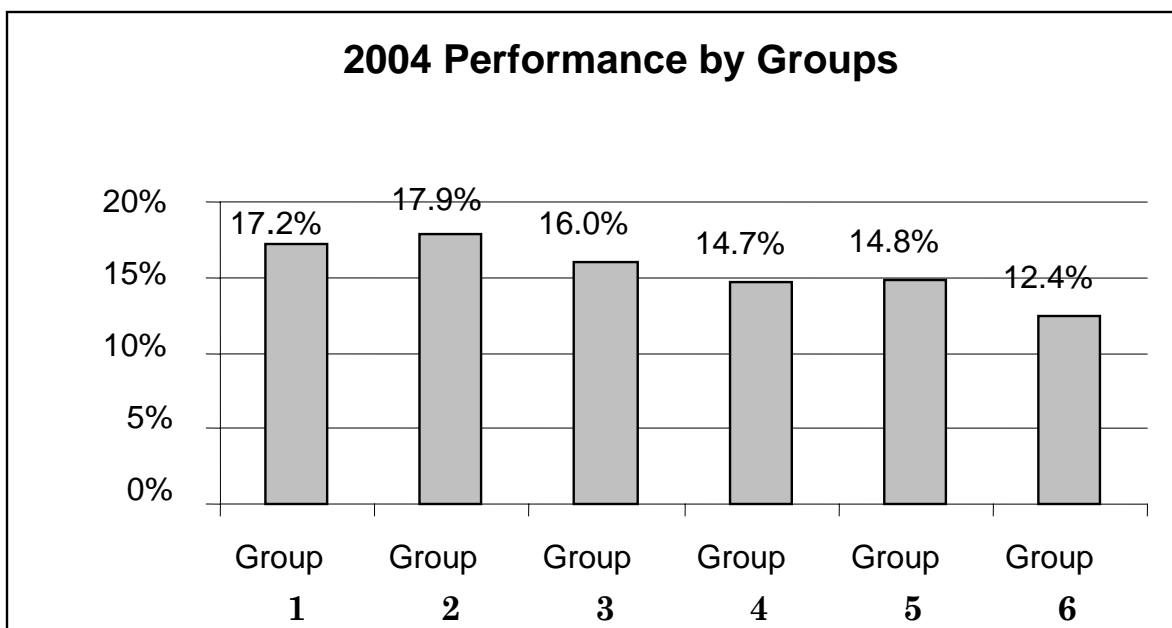
After a rough 3-year stretch, college and university endowments experienced buoyant returns in fiscal 2004, fueled by strong equity performance both here and abroad. In general, institutions with high allocations to publicly traded equities and low allocations to fixed income came out on top. The equal-weighted return of fiscal 2004 participants was 15.1%, the highest since 1998, and the dollar-weighted return was 17.4%, which reveals the tendency of larger endowments to outperform smaller endowments. Larger endowments generally have larger and more sophisticated investment staffs and greater allocations to alternative investments.

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The top performers in any given year may vary significantly, which tends to reflect stronger market performance in the asset classes they over-weight and weaker market performance in asset classes they under-weight, relative to average allocations. In fiscal 2004, equities greatly outperformed fixed-income, so that institutions with large equity-type allocations and minimal fixed-income allocations generally fared the best. Over the 12 months ended June 30, 2004, the Russell 3000 Index (representing about 98% of the U.S. equity market) returned 20.5% and the Lehman Brothers Aggregate Bond Index returned only .3%. Within equities, small-cap stocks and international stocks posted stellar returns of 33.4% (Russell 2000 Index) and 32.4% (MSCI EAFE Index), respectively. A number of small asset segments-- such as timber, energy, and certain other natural resources-- also had outsized returns.

In fiscal 2004, Group 2 endowments with \$500 million to \$1 billion in assets chalked up the highest returns, 17.9%, enhanced in part by their above-average allocation to small-cap equities. The graph below shows the fiscal 2004 performance by the six groups.



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Below, data from the top-10 performers are averaged and compared with averages of all participants in the 2004 study. As shown, the top performers in fiscal 2004 had considerably higher allocations to equities (both U.S. and international), 69.9%, compared to the equal-weighted average of all participants, 59.9%. Conversely, the top performers had considerably lower allocations to fixed income (both U.S. and international), 15.1%, than the average endowment, 22.1%.

### Comparison of Top-10 Performers and Average Participant in 2004 Study

	2004 Endow Assets (\$mil)	Fiscal 2004 Returns %	U.S. Public Equity Allocation	Non-U.S Public Equity Allocation	Fixed Income Allocation
Average of Top 10 Performers	258	24.1%	55.4%	14.5%	15.1%
Average of All Participants, Equal Weighted	361	15.1%	48.9%	11.0%	22.1%

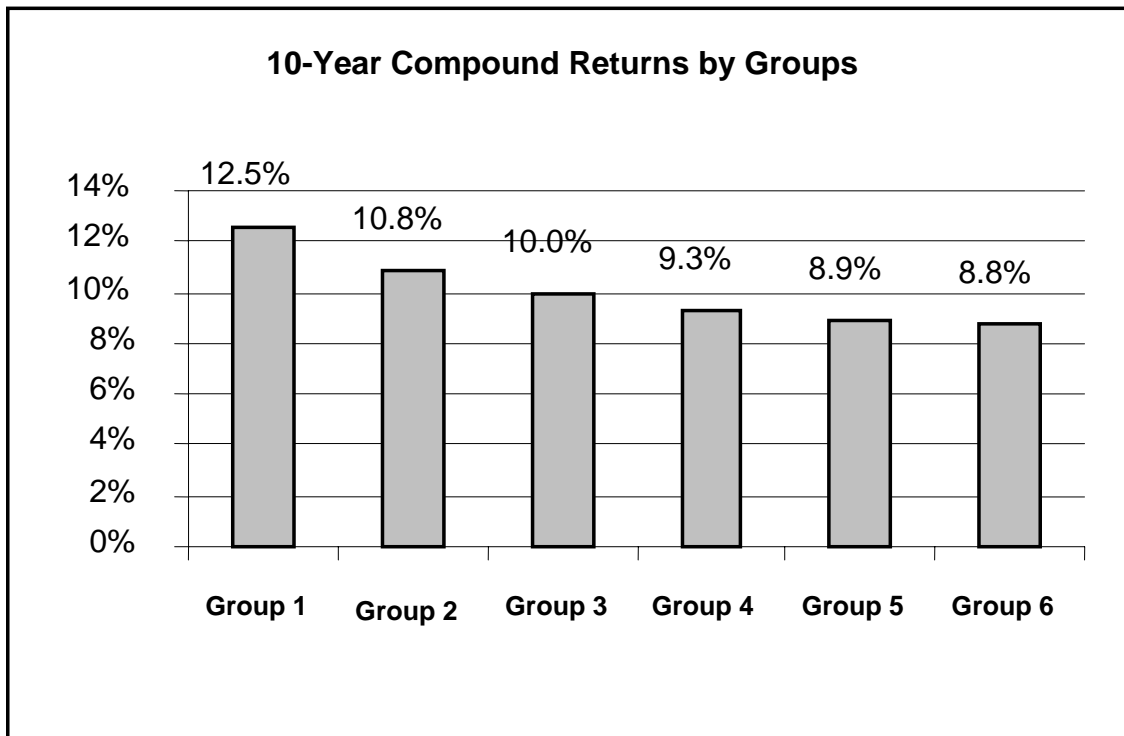
Just one year earlier, in fiscal 2003, the 10.4% average return of fixed-income investments greatly outpaced U.S. equity returns, .8%, as measured by the Russell 3000. Not surprisingly, the list of top-10 performers was composed of completely different institutions in fiscal 2003 and fiscal 2004. In fiscal 2003, most of the top achievers had above-average allocations to fixed-income or to cash.

Of course, asset allocations aren't the entire story. Different managers within the same classes can have dramatically different returns, so that even if an institution has a winning asset allocation its performance may lag due to under-achieving managers. And vice versa. The happiest scenario, undoubtedly, is to have a winning asset allocation and managers who beat their benchmarks.

In each of the past three years, at least five of the top-10 performing endowments had assets of less than \$100 million, so fiscal 2004 was not unusual in that regard. What is unusual about the fiscal 2004 winning lineup, however, is that it does not include a single endowment with \$1 billion or more in assets. Large endowments, nevertheless, maintained their domination of longer-term superior returns, as reported in the 10-year annualized results.

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### ASSET ALLOCATION REVIEW

As always, the 2004 study revealed substantial differences in asset allocations between the very large endowments and the numerous smaller endowments. Dollar-weighted asset allocations indicate the overall allocations of the total \$267 billion in the study, thus giving more weight to institutions with larger endowments. Equal-weighted allocations are a simple average of all 741 institutions' allocations to each asset class. The following table shows the difference between the two methods, as well as the average allocation of the largest 47 institutions with endowments greater than \$1 billion. In general, larger endowments have considerably higher allocations to alternative investments--and smaller allocations to conventional equities and fixed income--than smaller endowments. Within fixed-income securities, larger endowments invest a greater percentage in Treasuries-- including Treasury Inflation-Protected Securities (TIPS)-- whereas smaller endowments invest a larger proportion in corporate bonds.

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### Endowment Asset Allocations in Fiscal 2004

Asset Class	Equal-Weighted Asset Allocations	Dollar-Weighted Asset Allocations	Largest Endowments' Asset Allocations (>\$1 billion)
Equity (U.S. and non-U.S. publicly traded)	59.9%	50.9%	46.3%
Fixed-Income (U.S. and non-U.S.)	22.1%	17.2%	15.2%
Real Estate (public and private)	2.8%	4.0%	4.0%
Hedge Funds	7.3%	14.7%	20.2%
Private Equity	1.3%	3.5%	4.9%
Venture Capital	0.8%	3.1%	3.5%
Natural Resources	0.6%	3.0%	2.6%
Cash	3.7%	2.6%	2.7%
Other	1.6%	1.1%	0.7%

### ALTERNATIVE ASSET CLASSES

A continuing trend in fiscal 2004 was that of greater average allocations to alternative investments. Over the past 10 years, the average endowment's allocation to alternative investments—combining hedge funds, private equity, venture capital and natural resources—has grown from 2.7% to 10.0%, calculated on an equal-weighted basis. On a dollar-weighted basis, the allocation to alternative investments is much greater, reflecting the fact that larger endowments invest more heavily in them. As of June 2004, alternative assets held by all participating institutions totaled \$68 billion, or 25% of all investment pool assets, as follows:

Hedge Funds:	\$39.2 bil
Private Equity:	9.3 bil
Venture Capital	8.3 bil
Timber:	3.5 bil
Private Real Es.	3.0 bil
Oil & Gas:	2.7 bil
Commodities:	1.9 bil

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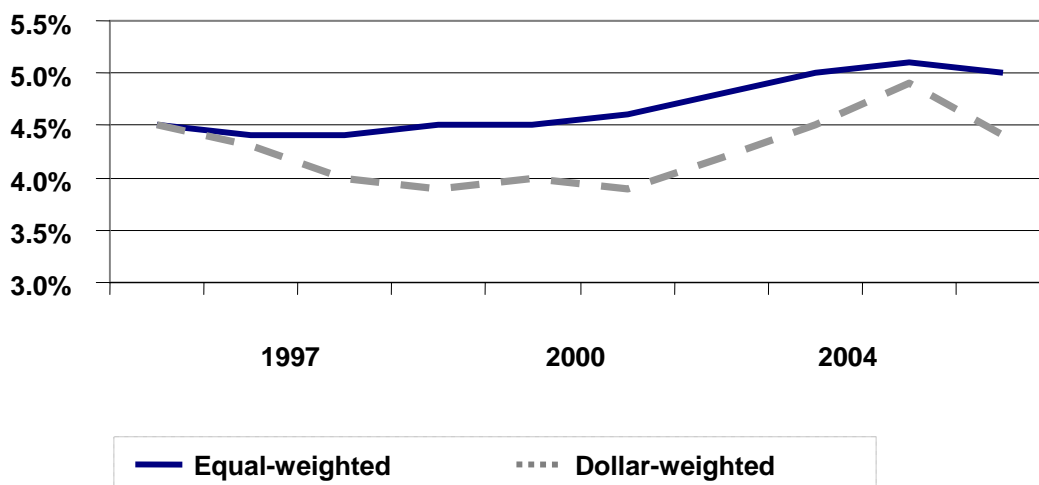
In Group 1, those institutions with more than \$1 billion, alternative assets made up 31.2% of endowment portfolios at the end of fiscal 2004, up only slightly from 30.7% in 2000. Over the four years, however, the composition of the alternative assets in Group 1 has changed significantly. Allocations to hedge funds in Group 1 have jumped from 9.5% to 20.2% of total portfolio value, and allocations to venture capital have dwindled from 12.6% to 3.5%. About one-fourth of hedge fund dollars continue to be allocated to long/short strategies. In fiscal 2004, allocations to absolute return strategies dropped to 11.1% of hedge fund dollars, from 23.1% in fiscal 2003. Several other strategies---such as global macro and distressed securities---increased somewhat in fiscal 2004.

### MANAGEMENT PRACTICES

The NACUBO Endowment Study reveals that from fiscal 2000 to fiscal 2004, the percentage of overall endowment assets managed internally has declined from 17.5% to 11%. The category of endowments with assets of more than \$1 billion still manages the biggest percentage of assets internally, 16.7%, although the level has dropped significantly from 30.6% in fiscal 2000.

After four years of increasing spending rates, caused largely by market-induced drops in endowment values, fiscal 2004 registered a slight decline from 5.1% to 5.0%, calculated on an equal-weighted basis. Throughout the late 1990s, the spending rate had remained essentially level at 4.4% or 4.5%.

**College and University Endowment Spending Rates, 1995-2004**



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An interesting trend occurring in spending rules is that the largest endowments—those with more than \$1 billion in assets—have increasingly shifted toward a policy of reconsidering the spending rate each year, rather than abiding by a pre-specified rate. In fiscal 2004, 16% of the largest endowments reported that they reconsider the spending rate each year, up from 6% in fiscal 2000. Considering all participants, more than 80% continue to spend a pre-specified percentage of a moving average of market values. The most common method is to spend 5% of the recent three-year average of endowment values.

### SUMMARY

After three very challenging investment years, endowments enjoyed strong returns in fiscal 2004, led by traditional equities, both domestic and international. As a result of portfolio appreciation, spending rates declined slightly in fiscal 2004 and the average endowment per student at participating colleges and universities increased to approximately \$40,000, compared to about \$35,000 in fiscal 2003. Public institutions face continuing uncertainties about the level of state appropriations, and both public and private institutions alike are looking to their endowments to help cover the ever-rising costs of providing higher education.

For more information about the 2004 NACUBO Endowment Study, please go the NACUBO web site link, <http://www.nacubo.org/x2321.xml>. Another issue of *Trends and Issues* will be devoted to coverage of the 2005 NACUBO Endowment Forum, <http://www.tiaa-crefinstitute.org/Publications/trends/latest.htm>.