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2005 NACUBO Endowment Forum:
Managers Find Pickings Quite Slim

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EXECUTIVE SUMMARY

Investment managers at the 2005 NACUBO Endowment Forum appeared grateful for the strong equity returns in fiscal 2004, but expressed little hope for a continuation of stellar performance going forward. Pundits said that U.S. equities are hindered by the large federal budget deficit, the large foreign trade deficit, and the low savings rate. U.S. fixed-income investments also may come under pressure if the economy transitions into a period of higher inflation. In general, speakers at the forum recommended broad diversification of investments and an overall lowering of risk exposure. Among the asset classes mentioned with above-average prospects: emerging markets and timber.

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Note: A similar version of this article previously was posted on NACUBO’s website, www.nacubo.org.

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INTRODUCTION

A notable lack of excitement about most investment opportunities might be the best way to summarize the 2005 NACUBO Endowment Management Forum. That's not to say that the speakers were unexciting—quite the opposite was true of such market pundits as Barton Biggs, Ben Inker, Abby Joseph Cohen, and Cliff Asness. But when the asset class garnering the most excitement is timber, it's fairly evident that professional investors are looking harder than usual for places to put their money.

Overall, participants at the January 26-28 conference agreed that the major challenges facing the U.S. economy are the federal budget deficit, the foreign trade deficit, and the low savings rate. However, given the strong gains in Gross Domestic Product (GDP) and productivity, most participants also agreed that the U.S. economy is continuing to improve following the 2001 recession, and that there is no imminent threat of overheating.

As for investment advice emanating from the forum, entitled, "Achieving Investment Success in a Low Return Environment," most discussants focused on reducing risks rather than seeking high returns. In other words, 'achieving success' in today's market environment means avoiding big mistakes.

MEASURED OPTIMISM

Amidst a lineup of speakers who generally were less than lukewarm about the prospects for U.S. equities, Barton Biggs and Abby Joseph Cohen stood out as having relatively optimistic views. Biggs, managing partner of Traxis Partners LLC, predicted annualized domestic equity returns of 8%-9% over the next 3-5 years. Cohen, chief U.S. portfolio strategist and partner with Goldman Sachs & Company, stated her firm's outlook that the S&P 500 "fair valuation" at yearend 2005 would be 1325, providing a return of about 10-11%.

Characterizing the U.S. economy as in "good condition," Cohen, formerly a Federal Reserve economist, said that trend productivity growth continues to look very good by historical standards and that, in her opinion, "everything else is commentary." While conceding that the federal budget deficit of more than \$400 billion is a concern, she noted that as a proportion of GDP it is still considerably less than the 6% level reached during the Reagan administration and is comparable to the percentage of many other countries. However, she cautioned that further growth in the budget deficit could become worrisome. The U.S. foreign trade deficit, while huge,

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is largely a reflection of the disequilibrium of economic growth around the world, said Cohen, adding that many foreign countries such as those in Europe aren't capable of importing like the U.S. because their economies aren't growing as fast. Unlike the situation in many other countries, the U.S. economy has benefited from both monetary and fiscal stimuli.

Cohen presented Goldman Sachs' "model portfolio breakdown" for the S&P 500, which revealed a preference for stocks that benefit from ongoing economic expansion. The biggest deviation from the market benchmark was for Information Technology, in which Goldman Sachs suggests an 18% weighting compared to the current market weighting of 15.4%, a relative overweight of about 17%. Cohen said the firm also is enthusiastic about industrials and consumer discretionary services stocks—such as dining, travel and media—as consumers are expected to shift their spending from big-ticket items such as new homes and cars. Another attractive area is healthcare, she added.

“MORE PAIN TO COME”

While Cohen said she does not believe U.S. equities are overvalued given the low-inflation and high-productivity environment, Ben Inker, director of asset allocation at GMO LLC, on the other hand, presented a foreboding prediction of “more pain to come.” Inker's thesis rests on the premise that most asset classes are considerably overvalued and that investors are faced with an inevitable principle of capitalism: reversion to the mean. Pessimistic about the outlook for U.S. equities overall, Inker said that small-cap and value-oriented domestic equities are particularly overpriced, following an extended period of superior performance.

For six different asset classes, Inker first presented what he referred to as “real returns at equilibrium prices,” which he described as annualized real returns (net of inflation) that most consultants would project over the long term when starting at fair prices. He then showed the required drop in value if the asset classes were to return immediately to fair value, after which they could expect to provide equilibrium returns. Lastly, Inker showed the annualized returns one could expect over the next seven years if the return to equilibrium pricing occurred more gradually. As shown in the table below, the annualized returns over seven years would range from -2.4% for U.S. small-cap stocks to 6.2% for emerging equities.

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Equilibrium Returns vs. GMO Forecasts

Asset Class	Real Returns at Equilibrium Prices	Immediate Gain/Loss to Reach Fair Value	Expected Ann'l Real Return to Reach Fair Value in 7 Years
U.S. Large Caps	5.7%	-37%	-1.5%
U.S. Small Caps	6.7%	-44%	-2.4%
Int'l Large Caps	5.7%	-15%	3.1%
Int'l Small Caps	6.2%	-16%	3.0%
Emerging Equities	6.7%	-2.0%	6.2%
U.S. Bonds	3.0%	-8.0%	1.5%

GMO's return projections for each asset class are based on expectations from four components of return: 1) expected change in price/earnings ratios; 2) expected change in profit margins; 3) real per-share sales growth; and 4) dividend yield. Built into the firm's estimate of -1.5% annualized returns for the S&P 500 (U.S. Large Caps), for example, are negative contributions from compression of price/earnings ratios and profit margins, and positive contributions from sales growth and dividend yield. Inker said his outlook for U.S. equities is so negative that he has a net short position in his personal account. He added that he's not in danger of firing himself for taking such an unconventional approach in his own account, but that endowment investment officers would be taking on considerable career risk by doing so.

With the risk/return curve lower and flatter than normal, Inker recommended that investors move their "optimal portfolio" down the curve to a lower risk level to "decrease the risk of doing really badly." He said that in today's market it may not be possible for endowments to earn enough on a real-return basis to cover their 5-6% spending rate with conventional allocations to U.S. equities.

The only asset class for which Inker expressed overt enthusiasm was timber, which he applauded for its diversification benefits, its strong historical returns, and its attractive yield. In addition, timber provides much greater visibility of returns than most other asset classes since its returns are tied to biological growth. "If you know what you paid and how fast the trees are

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going to grow, you know almost everything you need,” claimed Inker. If the data are right about timber, he added, “you’ve got to own some.” Commodities also provide strong diversification benefits, he added, but they tend to have considerably greater volatility than timber.

Strategists who compared domestic and international equities generally said they believe prospects are better abroad than at home. Biggs said he thinks that the U.S. dollar will continue to decline, thus providing currency-effect returns on international investments of 200-300 basis points above the domestic-currency returns. He particularly likes certain international real estate markets such as Japan where, in his view, office properties are very undervalued. As for emerging markets, Biggs thinks they will outperform most other asset classes until they reach a bubble and burst. Even Inker, who believes international equities are overvalued, said they offer better potential than domestic equities.

FIXED INCOME

For the most part, the investment gurus indicated that fixed-income allocations should be pared back, and particularly in the corporate and high-yield sectors where spreads have narrowed significantly as credit quality has improved in recent quarters. As articulated by Dan Fuss, vice chairman of the board at Loomis, Sayles & Company, the U.S. is in a transition from a period of quite low interest rates that bottomed in June 2003 to a period of higher rates. “How long it will last and how high rates will go is unknown,” he said. Even Treasury Inflation Protected Securities (TIPS) may come under pressure as the Treasury releases sizable new issues, he added, but “long-term, they’ll (TIPS) do great.”

ALTERNATIVE ASSET CLASSES

Similar to other NACUBO Endowment Management Forums in recent years, discussions about alternative asset classes took center stage for extended periods. A couple of speakers suggested that the nomenclature of “alternative” is no longer accurate since many of these asset classes are now sufficiently common to be considered traditional. Several participants also noted that there are so many different strategies falling under the hedge fund umbrella that it should no longer be considered a distinct asset class. One speaker referred to hedge funds simply as a form of asset allocation and another called them merely “a compensation scheme.”

Regardless of nomenclature, multiple speakers expressed their views that the investment areas of private equity---both buyouts and venture capital—and hedge funds have become too crowded, thus diminishing return potential. Biggs warned that most private equity firms under-perform

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the S&P 500 and that risk levels have escalated as junk bonds increasingly are being issued as part of exit strategies. “I’m convinced that private equity is the next bubble and that returns over the next five years will be disappointing,” he said.

Louis Morrell, vice president of investments and treasurer of Wake Forest University, and William Spitz, vice chancellor for investment and treasurer of Vanderbilt University, emphasized that it’s critical to invest with top managers in the areas of private equity and hedge funds since there is enormous disparity between top-quartile and bottom-quartile performers. When interviewing potential managers, Spitz stressed the importance of finding out if they have a competitive edge. “It’s who you hire that really matters,” he said. “With alternatives, you’ve got to have the right managers –with strong track records and risk management processes--or you’re better off not getting into them.” Morrell said he reviews carefully the managers that the leading endowments invest in, as provided in the annual NACUBO Endowment Study, especially when considering new alternative investments.

Inker suggested a “modest proposal” for investing in hedge funds starting with a base case of no hedge funds and then deciding how much of the portfolio to dedicate to your manager selection capabilities. “None is not an unreasonable answer, nor is 90%,” he said. While a mediocre hedge fund is “just wasting space in your portfolio,” Inker added that “you don’t need to find top-quartile performers---55 or 60 percentile performers will do.”

Although several participants expressed skepticism about hedge funds, and particularly because of their high fees, Cliff Asness, managing and founding principal of AQR Capital Management, said he believes hedge funds are “the future of active management.” Asness described two broad categories of hedge fund strategies: 1) investment skill or “alpha” turned into an investable diversifying asset; and 2) a set of non-traditional arbitrage strategies that either provide liquidity or take a risk for which they are paid a premium. To undertake these strategies, hedge funds use the tools of leverage, derivatives, and short-selling, which generally aren’t available in traditional investments. Asness stated his view as follows: “Hedge funds are here to stay. It’s very possible that the model for the future will be index funds plus hedge funds.” However, he acknowledged that hedge funds need to “grow up” in certain aspects and overcome some “dark sides” before this future can be reached.

WORDS OF ADVICE

Verne Sedlacek, president and CEO of Commonfund, spoke of the possibility that the U.S. may be re-entering a higher-inflation environment and of the value of reallocating some portions of

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endowment portfolios into asset classes that perform relatively better in such an environment. He discussed the advantages of taking 20% of a traditional portfolio and dividing it among commodities, private real estate, energy and TIPS. That kind of diversification costs very little in lost returns if inflation remains low, but provides valuable relative returns if we enter into a “real-return environment.”

Sedlacek also recommended that endowment officers reconsider their overall levels of liquidity and suggested that they likely are unnecessarily high, given endowments’ long-term investment horizons. He referred to studies indicating positive correlations between low-liquidity investments and above-average returns.

Andrew Golden, president of Princeton University Investment Company, said he recommends categorizing investment decisions into horizon buckets. Alluding to “The Serenity Prayer” often quoted in self-improvement programs, Golden asked to be granted “the wisdom to differentiate the secular and the cyclical; and the strength and courage to act accordingly.”

Inker, in addition to urging investment caution, also recommended restraint in endowment spending. “Enjoy the money (from recent endowment gains), but do not assume the good times are here to stay,” he said. “If it is possible to reduce the payout percentage, do it.”

Lest investors were unconvinced about the merits of timber investing, Spitz provided the following arguments based on evidence from the 1987-2004 investing period:

- **Diversification.** Timber’s correlation with the S&P 500 was only .06.
- **Volatility Reduction.** Timber’s annualized standard deviation was only 8.9%, compared to 16.6% for the S&P 500.
- **Return Enhancement.** Timber’s annualized return was 14.9%, compared to 11.6% for the S&P 500.
- **Inflation Protection.** During rising inflation, timber provided positive returns compared to negative returns for the S&P 500 and Treasury bonds.

Of course, past performance provides no guarantee of future performance, and Spitz cautioned that, despite his enthusiasm, a sizable number of professional timber management firms have entered the market in recent years and that the increasing institutionalism of the industry could dampen returns in the future.