# Endowment Management: The Benefits of Active Investing

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Alpha plays an important role in helping endowments meet their return targets and manage portfolio risk. Research suggests that alpha exists in the long run but is cyclical in the short run, and that today we may be in a favorable part of the cycle for active management.

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The question of active versus passive investing is once again challenging fiduciaries of investment capital. During the recent equity bull market, many active managers have failed to outperform passive indexes, while flows out of active managers and into passive vehicles have increased dramatically. As a result, many investment committees are re-examining the role of active managers relative to passive strategies.

Active management rests on the belief that alpha (idiosyncratic and uncorrelated outperformance) can be generated. Empirical evidence demonstrates that alpha generation exists and that it plays a meaningful role in the risk/return profiles of portfolios. However, alpha generation is clearly cyclical. We believe this is a particularly opportune time for active management.

This paper is not meant to be a comprehensive review of active and passive investing; rather, we present the philosophy underpinning active management and show how it can benefit investors.

## Alpha Exists in the Long Run

We start by reviewing (**Figure 1**) the 10-year annualized performance of a subset of endowments with assets over $1 billion that report to the National Association of College and University Business Officers (NACUBO). These large endowments tend to be professionally managed, diversified across asset classes, and heavily invested in active managers. As noted in the table, they have handily outperformed the two most prevalent passive equity/fixed income benchmarks over the long term.

**Figure 1: Long-Term Alpha of Endowment-Style Investing**

| | Trailing 10-Year Annual Returns | |
|---|---|---|
| Portfolio | As of FY 2016 | As of FY 2015 |
| 70% MSCI ACWI/30% Bloomberg Barclays US Aggregate Bond | 4.9% | 6.2% |
| 60% MSCI ACWI/40% Bloomberg Barclays US Aggregate Bond | 5.1 | 6.1 |
| Endowments > $1 billion in AUM (NACUBO) | 5.7 | 7.2 |

These data show that endowment-style investing has historically delivered meaningful alpha over time. We believe that a significant portion of this alpha generation came from investing in active managers that are exceptionally skilled in security selection, although we acknowledge that other factors such as diversification benefits and the illiquidity premium no doubt played a role. Still, we use these endowment data as evidence of the existence of alpha over purely liquid, indexed investment strategies. When compounded over time, this outperformance leads to substantial portfolio growth compared to passive approaches.

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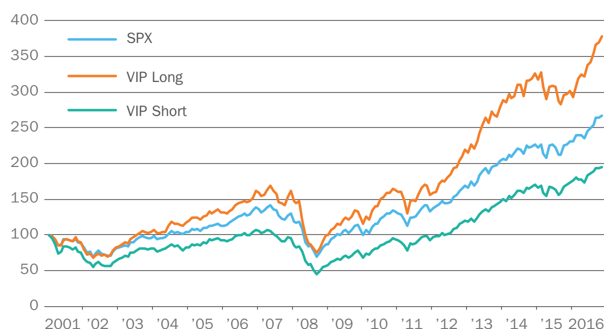
In order to isolate the equity side of the story, we look beyond the NACUBO portfolio level data to the long-term performance of stock pickers as defined by the Goldman Sachs Hedge Fund VIP lists.[1] In **Figure 2 (left)**, we see that the most prevalent long (short) positions of hedge fund managers have meaningfully outperformed (underperformed) the S&P 500 index over a 15-year period. This finding suggests that high quality active managers doing extensive company research can identify both undervalued and overvalued securities over long periods of time.

**Figure 2: Long-Term Alpha of Hedge Fund Managers**

**GS Hedge Fund VIP vs. S&P 500**




**GS Hedge Fund VIP Long—SPX**

When we chart the rolling two-year performance of the hedge fund VIP longs minus the S&P 500 index (**Figure 2, right**), we can observe the overall trend of outperformance. Just as with many other factors relating to the business cycle, active management underperforms in short-term periods. While the last few years have been one of the worst periods of underperformance for active managers, we believe this trend will revert to the mean as it has before.

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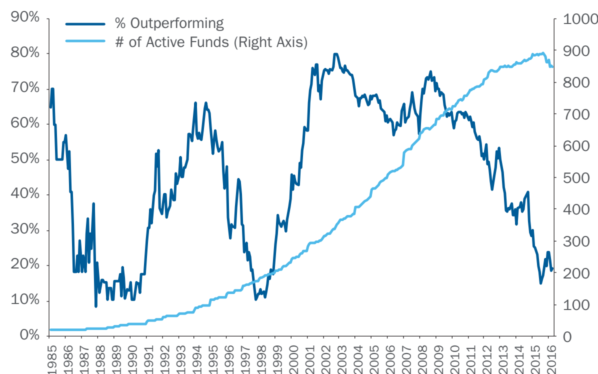
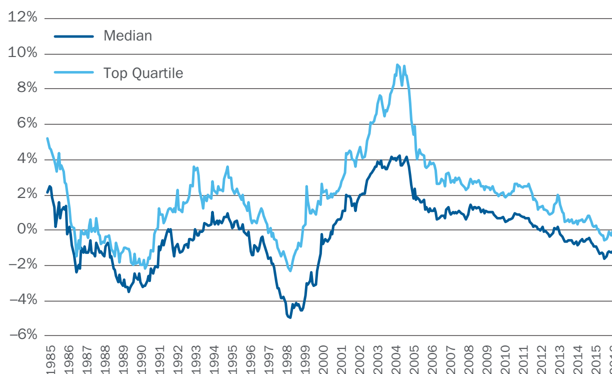
We then compiled databases of active managers and compared them with their benchmarks to identify trends across different investment universes,[2] starting with U.S. managers. Active U.S. large cap managers have most meaningfully lagged their benchmark over the past few years (**Figure 3, left**). The chart displays the cyclicality that has existed in this peer group since 1985, and provides context for today's situation, perhaps suggesting that we are at an inflection point. We also observe that the majority of managers in this universe have not routinely provided compelling excess returns over the S&P 500 index.

**Figure 3: Performance of Active Managers in the U.S. Large Cap Universe**

**Percentage of U.S. Large Cap Active Funds Outperforming S&P 500 (5-Year Rolling Basis)**




**U.S. Large Cap Active Funds Rolling 5-Year Annual Excess Return vs. S&P 500**




One hypothesis often cited in favor of passive approaches is that the steady growth in the number of active managers has crowded the space and reduced the investment opportunity set. One can see the steady growth in managers in **Figure 3 (left)**, although the number has recently turned down slightly.

We believe this chart underscores two key points about manager selection:

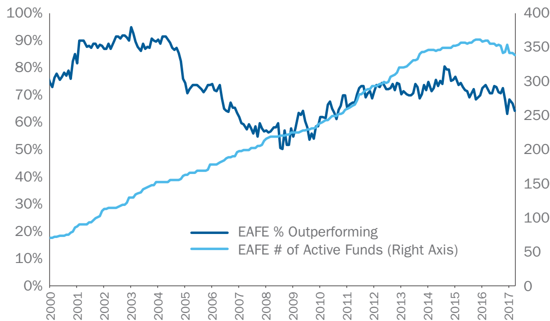
1. Even at the lowest points, at least 10% of the universe outperformed.
2. While a dedicated staff of research experts is required to find these managers, it is possible, as there are a larger number of funds in the top percentiles.

In **Figure 3 (right)**, using the same data, we group excess returns into quartiles to observe the importance of manager selection. We find a meaningful spread between top-quartile managers and median managers. Interestingly, even the top-quartile managers experienced short-term periods of underperformance (see the periods in which the top-quartile line dips below the 0% horizontal line).

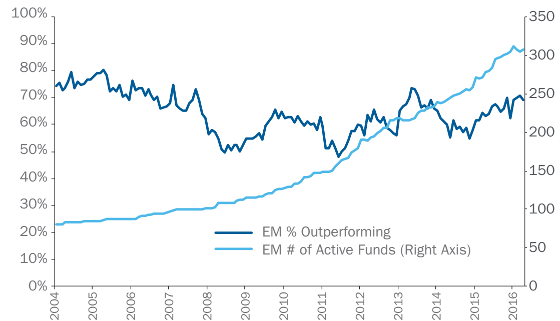
The underperformance of U.S. large cap managers is the most cited evidence in favor of passive investing. It is important, however, not to generalize these results to all active managers, across all investment universes. When we look across geographies, we find less efficient markets that provide potentially more attractive environments for alpha generation. Indeed, active equity managers in international and emerging markets have demonstrated a sustained ability to outpace their benchmarks (**Figure 4**). In these markets, because return generating opportunities are often within smaller capitalization stocks, it is particularly important to invest with active managers who can manage the related liquidity issues.

**Figure 4: Performance of Active Managers in EAFE and Emerging Markets**

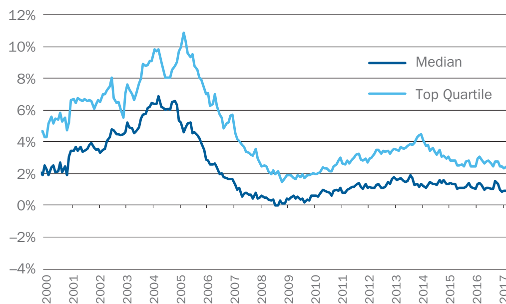
**Percentage of EAFE Active Fund Outperforming MSCI EAFE Index on a 5-Year Rolling Basis**



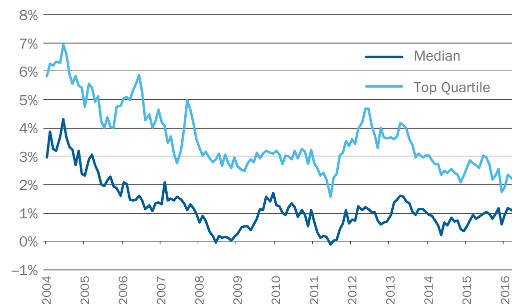

**Percentage of EM Active Funds Outperforming MSCI EM Index on a 5-Year Rolling Basis**




**EAFE Active Funds Rolling 5-Year Annual Excess Return vs. MSCI EAFE Index**




**Emerging Markets Active Fund Rolling 5-Year Annual Excess Return vs. MSCI Emerging Markets Index**



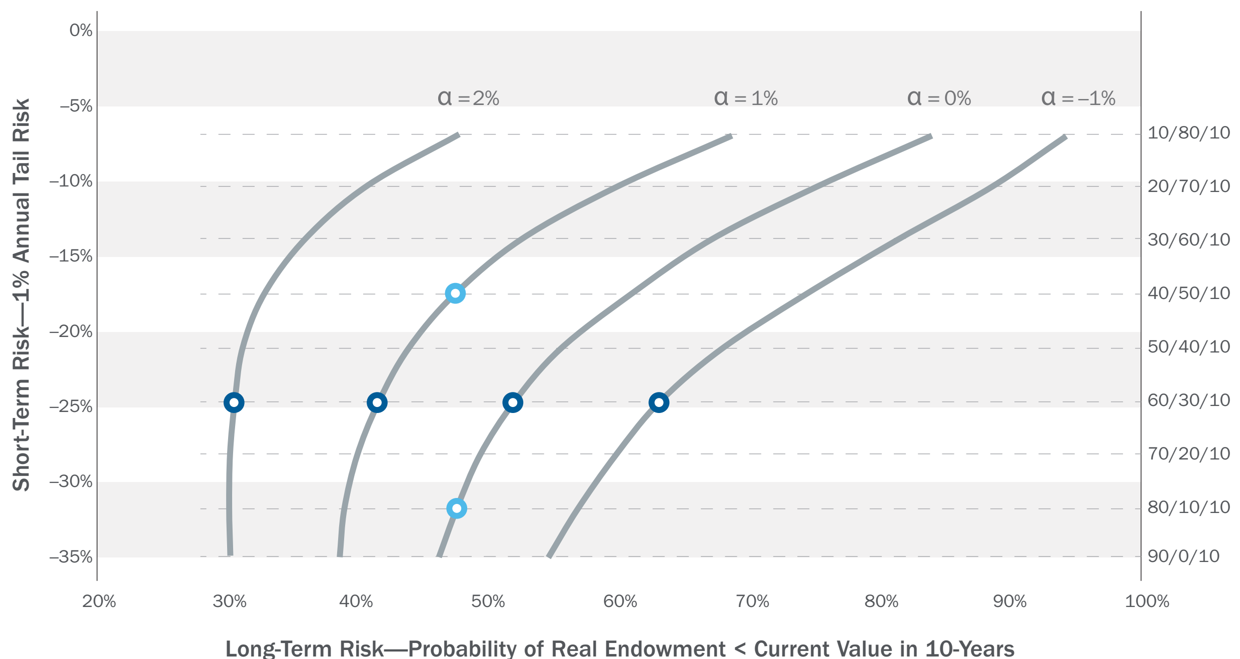

It is clear from looking at the quartile returns that even the median manager has routinely outperformed the benchmark; the top-quartile managers have done so by a meaningful margin. Although these data provide a compelling counterpoint to the U.S. large cap chart, a trend of return compression exists within these markets, albeit to a lesser degree. Perhaps the growth in the number of active funds in these asset classes is also gradually making international markets more efficient. Regardless, the data show that the top half of the active manager universe in these markets has delivered steady excess returns. We believe that investors with the skill to pick top managers will continue to enjoy outperformance.

## Alpha Is Important

There is strong evidence not only that alpha exists, but also that it plays a key role in achieving one's long-term objectives. Alpha is an idiosyncratic, uncorrelated return driver that is extremely important for achieving an endowment's target return, while keeping market/systematic risk at a desired level. Specifically, it allows a portfolio to take on less market risk to achieve its target rate of return. This is critical for endowment portfolios that have a dual mandate of achieving a high real rate of return while avoiding large drawdowns that might disrupt the institution's spending and thus its operations.

Our previous research based on Monte Carlo simulations illustrates the important role of alpha (**Figure 5**). We looked at typical policy portfolios across different equity/fixed income/real asset weightings. Despite having similar long-term risk profiles (i.e., the probability of losing real value in the long term), the 40% equity/50% fixed income/10% real asset portfolio, with 1% alpha, has much less annual drawdown risk than the 80% equity/10% fixed income/10% real asset portfolio with 0% alpha. This is because the former portfolio relies on consistent alpha contributions to returns compared with the latter portfolio, which relies on a higher allocation to risk assets, such as equity, which are much more volatile.

**Figure 5: Risk Trade-Off for Different Alpha Levels**



Adding alpha through active management significantly reduces long-term risk, while keeping short-term drawdowns at the desired level. In a typical policy portfolio of 60% equities/30% fixed income/10% real assets, the probability of losing real value in the long term is reduced by more than 10% for every 1% increase in alpha, while maintaining the same short-term drawdown risk profile.

It is important to remember the idiosyncratic and uncorrelated nature of alpha, which serves as both an absolute return driver and a risk mitigation tool. Sacrificing alpha in the pursuit of higher beta will introduce more market risk into the portfolio and might cause unintended structural impairment over the short and long run.

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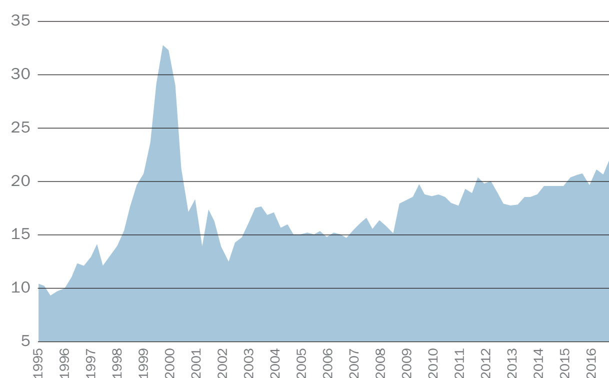
## Indexed Exposure Can Be Problematic

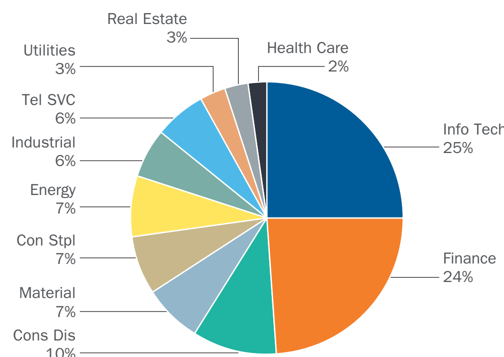
Passive vehicles provide unconstrained beta exposure that can present problems in certain environments. Investing in an index fund can be viewed as a de facto momentum strategy, as increased capital flows inflate the index in which it is invested. When the index is market capitalization based, for investors, it means buying increasingly expensive companies and sectors, thereby participating in both bubbles (and eventually market corrections). A prominent example of this phenomenon is the evolving weight of the information technology sector within the S&P 500 index (**Figure 6, left**). The index's exposure to the sector peaked at almost a third before the tech bubble burst in 2001, which led to rapid value destruction. It took years for these portfolios to regain their value.

**Figure 6: Examples of the Impact of Market-Cap Weighting on Passive Indexes**

**S&P 500 Information Technology Sector Weight**




**MSCI Emerging Markets Sector Exposures**




While passive investing is an effective way to capture market upside, it is equally effective at capturing the full downside. The drawback of market capitalization weightings is also observed with the MSCI Emerging Markets index (**Figure 6, right**). The index is overweight large cap state-owned companies in low growth sectors, and as such, does not reflect the expansive opportunity and diversification benefits of investing in emerging markets. As market capitalization-weighted indexes tend to be backward looking (biased toward those companies that have done well in the past), they are at a particular structural disadvantage in quickly evolving, diversified areas like emerging markets. The benefit of active investing in emerging markets is that investors can place capital in specific sectors and companies that stand to gain the most from local economic developments (such as consumer-oriented companies and healthcare).

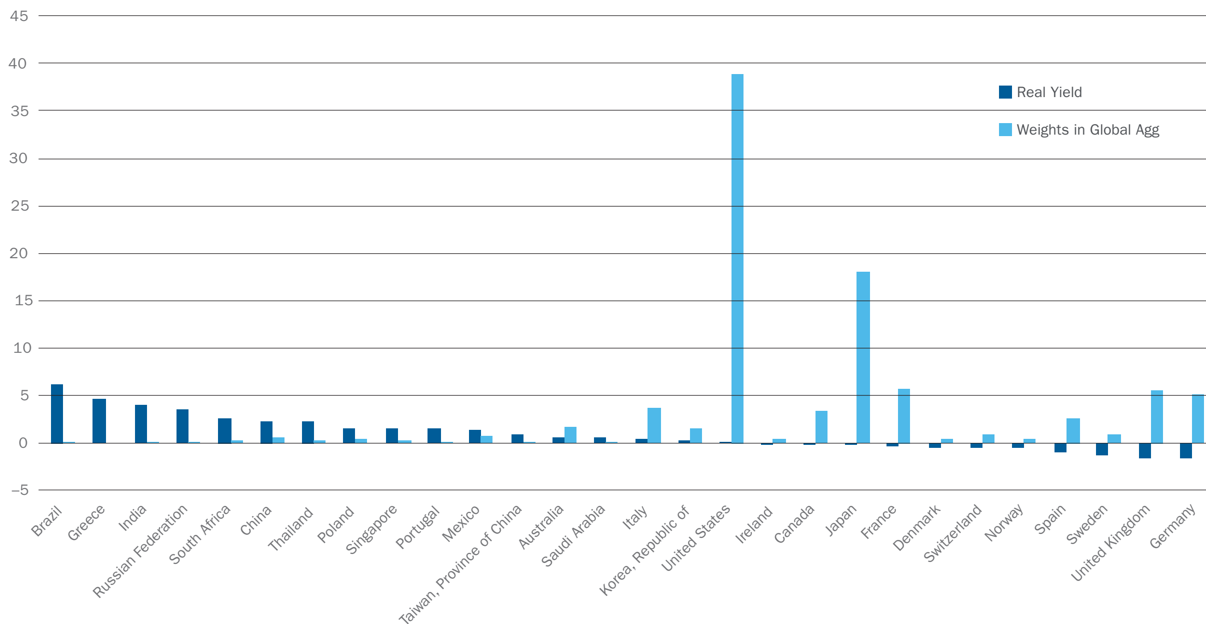
Active management also has the advantage over passive approaches of providing rational limits to company, sector, and industry-level concentrations. This extra layer of analysis and prudence can provide compelling downside risk mitigation benefits in certain environments without a loss of return generation capabilities.

Active versus passive is most often debated in terms of equities, but fixed income is also attracting a growing number of passive investors. There are, however, structural complications with passive fixed income investing. Currently, many global fixed income indexes have considerable exposures to countries employing zero and negative interest rate policies (“ZIRP” and “NIRP”).

Looking at the Bloomberg Barclays Global Aggregate Bond index (**Figure 7**), we see that weighting by market capitalization means that the more a country is in debt, the higher its weight is in the index. This is a counterintuitive way of constructing an investment portfolio. It is particularly difficult to invest this way in today’s quantitative easing (QE) dominated market environment, in which the largest issuers of debt embrace ZIRP and NIRP. An active fixed income management approach allows for underweighting exposures to issuing countries following ZIRP and NIRP, and selectively overweighting countries that have more manageable levels of debt and potentially higher real yields. We believe this is a more rational investment approach and one that reduces portfolio risk over time.

**Figure 7: Bloomberg Barclays Global Aggregate Real Yield vs. Market Capitalization Weights**

**Real Yields vs. Market Cap Weights**



## Why Active Management Now

As we have demonstrated, alpha generated from active management is typically cyclical, and many of the charts in this paper indicate that we might now be exiting from a low point in the cycle. Qualitatively, we believe that the market factors that have posed challenges for active management recently are dissipating and that we might now be entering a compelling part of the cycle for alpha generation. A few factors drive this outlook:

1. **Divergent central bank policies and economic outlooks.** At a high level, we believe that we are returning to an environment that is less macro/QE-driven, in which idiosyncratic stock characteristics will drive returns in the U.S. and internationally.

2. **Interest rate normalization and increasing dispersion between individual stocks and sectors.** As interest rates continue to rise and the availability of cheap leverage begins to abate, we anticipate more dispersion between the performance of good and bad companies. A return to a more normalized interest rate and monetary environment tends to be advantageous for active managers seeking fundamentally stronger companies that can outperform the benchmark (in contrast to the index which would have exposure to both good and bad companies).

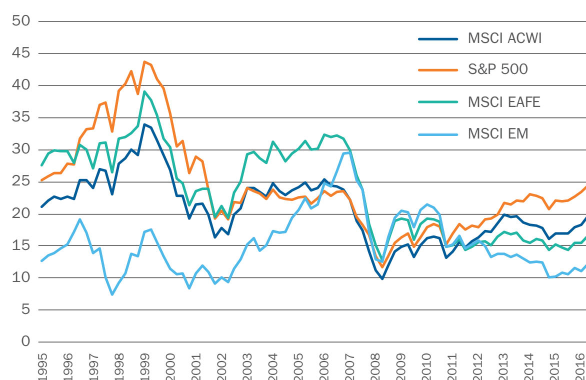
3. **Massive inflows into passive products.** These large inflows have helped push up equity market valuations to rich territory for index participants. While it is difficult to predict the sustainability of these valuations, being nimble and a little off-the-run at this point in the market cycle seems like a prudent way to uncover undervalued securities and potentially protect capital in the event that flows reverse. We believe there are attractive long-term investment opportunities in companies that are not included in the index or have small weightings in the index.

We believe the market factors that posed difficulty for active management over the most recent period are dissipating and that we are now in a particularly compelling part of the cycle for alpha generation.

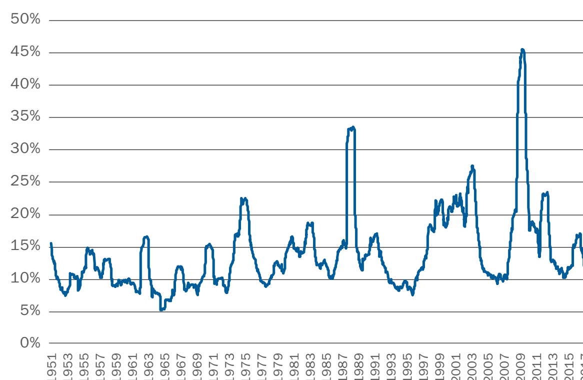
4. **Rich equity valuations.** As discussed, large inflows into passive strategies have helped inflate equity market valuations in general. CAPE ratios (**Figure 8, left**) show high valuations for the U.S. versus MSCI EAFE and MSCI EM, which reinforces the importance of owning a global portfolio. As we have discussed, active managers have had more success outperforming indexes in developed and emerging markets than in the U.S.

**Figure 8: Current Market Environment**

Global Cyclically-Adjusted Price/Earnings (Cape Ratio)




S&P 500 Rolling 1-Year Volatility




5. **Extremely low equity volatility.** Domestic equity volatility has been at historical lows during this market run-up. We expect volatility to follow its mean-reverting trend (**Figure 8, right**) and increase in the future. Increased volatility will provide active managers with opportunities to both increase exposure to high conviction holdings and minimize downside risk.

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## A Note on When to Invest Passively

It is important to note that passive investments can play a role in portfolios and that the investment solution need not be binary—either all passive or all active. Passive instruments can be used in a variety of important ways. We typically incorporate small passive investments to facilitate liquidity, to maintain geographic exposure when rotating in and out of managers, and to gain exposure to assets where we have not yet found a compelling active manager. In these ways, we believe certain passive investments can serve as beneficial short-term vehicles.

Also, institutions without a full-time staff or partner with demonstrated manager selection skill might be better served allocating a meaningful portion of their capital to passive indexes, as long as they understand the potential risks and rewards. Because a considerable spread in performance exists in all universes of active managers, third- and fourth-quartile performing managers can potentially do more harm to portfolio growth than index funds.

When allocating to passive investments, important active portfolio construction decisions still need to be made, including which indexes to invest in (across geographies, market capitalizations, sectors, etc.), the timing of market entry, when to rebalance, how to adjust the portfolio during sector bubbles, among other issues. The simple but crucial point is that active decision-making and monitoring are required regardless of whether a portfolio is invested entirely in active managers, entirely in passive indexes, or in a combination of the two.

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## Conclusion

We caution investors from overreacting to recent market dynamics and turning away from active management that has provided excess returns to endowments over the long term. We believe an endowment can meaningfully outperform passive benchmarks and, as importantly, reduce portfolio risk over time by investing with high quality active managers. However, doing so requires strong manager selection capabilities. We believe those institutions with access to teams that have the expertise and the resources to select high performing active managers will benefit the most in the long run.

Endowments with a perpetual time horizon, high risk tolerance, and low liquidity needs are particularly well suited to use active managers. Highly successful active managers typically:

1. Tend to own concentrated portfolios with high tracking error relative to the benchmark.
2. Focus on longer time horizons than their more benchmark-hugging "active" counterparts (i.e., closet indexers).

Not only do these characteristics correspond well with the average endowment's risk appetite, but they are also the key components required for long-term success. Said another way, active management across most asset classes is one way endowments can capitalize on their unique risk tolerance, liquidity profile, and time horizon to create excess returns. Active management has been critical to the success of many endowments in the past, and we believe it is particularly important in the current market environment.

Endnotes

[1] The GS HF VIP Long list equal weights the top 50 securities that most often appear on the 13F filing among the top 10 holdings of hedge funds and other institutional investors. The GS HF Short list is an equal-weighted basket that consists of the 50 S&P 500 constituents with the highest total dollar value of short interest outstanding.

[2] The eVestments database is the most extensive data source for hedge funds at this point in time. It includes both mutual funds and hedge fund managers. In an attempt to reduce survivorship bias, we include both live and closed down funds within the historical data. Performance is net of fees.

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