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Billions Squandered

Grant makers are coming up short by relying on active money managers and exotic financial instruments, new data shows.

By Marc Gunther



NATHAN HACKETT FOR THE CHRONICLE

Foundations rely on investment returns from their endowments to fund their grants. So how are their endowments performing? Not well, according to a new database that for the first time enables foundations to benchmark themselves against their peers — and other investment options.

Nearly three out of four U.S. foundations underperformed the global markets for stocks and bonds during the five-year period ending in 2016, according to Foundation Financial Research, the

company that compiled the database.

Foundations manage about \$850 billion in assets. Those that fail to match market returns are missing the opportunity to earn billions of dollars each year.

"A little bit better performance could mean a lot more money for foundations to give away," says John Seitz, a former Wall Street analyst who started Foundation Financial Research.

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The New York-based startup has spent three years building its database, which is by far the most comprehensive repository of foundation endowment performance.

Most foundations don't disclose their investment returns, so Seitz and his team had to collect data from a mountain of publicly available Internal Revenue Service filings. The database includes all 40,000 foundations with endowments over \$1 million, representing 97 percent of foundation assets, the company says. The data in this article is drawn from a subset of 14,000 foundations with fiscal years ending in December to provide consistent comparisons, but the trends hold true industrywide.

Their findings are striking. The median annual return for the five-year period ended in December 2016 was 7.7 percent. That falls well below the 9.04 percent annual return that those foundations would have earned had they simply invested in low-cost, passive, global index funds composed of 70 percent stocks and 30 percent bonds from Vanguard, the investment firm that pioneered passive investing. Index funds provide broad market exposure at low cost.

Performance among the foundations varied widely. The best-managed endowments did fine: Those in the top-performing quartile outdid the passive indexes, earning at least 9.3 percent annually. But at the opposite end of the curve, managers in the bottom quartile earned less than 6.3 percent annually.

Small changes in investment returns can make a big difference. For a foundation with assets of \$100 million, each percentage point of gain or loss in its investment returns is worth \$1 million — the equivalent of 20 percent of its grant-making budget if the foundation, like many, gives away 5 percent of its endowment per year.

The investment returns take into account the costs of hiring outside investment managers, but they do not include the salaries of the investment professionals who work for the foundations, which can be considerable. Chief investment officers at big foundations are often paid more than the foundation presidents or CEOs.

Foundation Endowment Performance

Annualized returns for the 5-year period ending December 2016.

Passive index funds	9.04%
25th percentile	9.30%
Median	7.70%
75th percentile	6.30%

'Culture of Complacency'

Of all the activities that America's foundations engage in, the performance of their endowments is arguably the least scrutinized. The Foundation Financial Research database makes clear that foundations as a group have lately failed to achieve market-beating returns, while spending vast sums on high-cost investment products and advice from Wall Street money managers. This holds true over the one-year, three-year, and five-year periods ending in 2016, the latest period for which comprehensive data is available.

Jeffrey Hooke, a former investment banker and a lecturer at the Carey Business School at Johns Hopkins who has studied endowments, says very few foundation investment officers have the skills to consistently outperform the market or to pick outside managers who can.

"If you're not beating the [passive] index by a significant amount, you ought to be cutting all your expenses and just go into the index," he says.

The trouble is, without transparent, independent, and objective benchmarks, foundation trustees have to rely on their own investment advisers to tell them how they are doing.

"The larger issue," Seitz says, "is that foundations haven't been getting objective performance data." The result, he asserts, is a "culture of complacency" that his company aims to shake up.

Leaders and Laggards

Seitz aims to sell his data to investment professionals, who can use it to pitch their services to foundations that are underperforming. Foundation trustees get free access to the data and reports, enabling them to compare their foundation with its peers.

Of the biggest grant makers, the top performers during the five years ending in December 2016 included the Charles Stewart Mott Foundation (10.6 percent average annualized return), the David and Lucile Packard Foundation (10.1 percent), and the William and Flora Hewlett Foundation (9.8 percent).

The laggards included the Robert W. Woodruff Foundation (6.6 percent), the Margaret A. Cargill Foundation (7.0 percent), the John Templeton Foundation (7.0 percent), and the John D. and Catherine T. MacArthur Foundation (7.2 percent), Foundation Financial Research estimates. They all fell below the median performance of all foundations and well below the performance of the Vanguard 70/30 portfolio, which consists of a mix of diversified index funds designed to provide exposure to global equity and fixed-income markets.

The Woodruff Foundation, which was the beneficiary of the estate of Robert W. Woodruff, who led the Coca-Cola Company for more than 60 years, suffered because more than 80 percent of its endowment is held in Coca-Cola stock, which lagged the market during the five-year period.

The Cargill Foundation, similarly, was concentrated in a single company stock, Mosaic, which it received in 2009 from the estate of its benefactor, Margaret A. Cargill. It gradually sold off those shares from 2011 to 2016, while its other holdings during that period were weighted toward lower-returning, fixed-income investments to balance the risk created by its concentration in Mosaic.

MacArthur's subpar performance from 2011 to 2016 was an anomaly, the foundation says, and the data backs that up. Over the 10-year period ending in 2016, MacArthur's \$6.9 billion endowment outperformed the passive indexes as well as its own customized benchmarks, says Andrew Solomon, managing director for communications.

"Our portfolio returns have exceeded relevant benchmarks against which we measure our performance over one-, three-, five-, and 10-year periods," he said. MacArthur does not disclose the benchmarks against which its investment office is evaluated, saying its asset allocation is confidential investment information.

MEASURING SUCCESS

Too many foundations let money managers devise their own performance benchmarks, allowing them to set a low bar for success, says John Seitz, founder of Foundation Financial Research.

The incentive compensation paid to investment officers for meeting those goals can be considerable — sometimes bigger than their annual salaries.

Seitz points to the example of the Duke Endowment with assets that stood at \$3.7 billion at the end of 2017. Its goal was 3.5 percent annual growth over the 10 years ending in 2016.

"Whoever was setting the benchmark at Duke gave themselves a very low hurdle," says Seitz.

The private foundation's endowment easily surpassed its benchmark, returning 6.4 percent.

The benchmark is set annually by the board of Dumac, an investment organization formerly known as the Duke Management Company.

According to Neal Triplett, Dumac's president, customized benchmarks make more sense than a one-size-fits-all approach. "I don't think it necessarily makes sense for all foundations to have the same benchmark because [performance] is very dependent on your risk tolerance and asset allocation," he says.

The foundation paid Dumac \$4.3 million in compensation in 2016.

By contrast, the Carnegie Corporation of New York, which is about the same size as the Duke Endowment, set for itself a much tougher benchmark of 5.8 percent for the same period — and surpassed it, returning 8.3 percent.

Chris Philips, head of institutional advisory services at Vanguard, said that almost any endowment manager can be above average if allowed to set his or her own benchmarks. "You can compare yourself to whatever you want," he says.

MacArthur also argues that comparing its endowment returns with those of thousands of other foundations overlooks the fact that different grant makers have different strategies, objectives, and tolerance for risk. While low-cost index investing may be suitable for some foundations, MacArthur said in an emailed statement: "We believe that for MacArthur, an actively managed, globally diversified portfolio that combines public and private asset classes results in strong risk-adjusted returns over the long term."

Like MacArthur, Templeton relies on outside investment advisers to manage its endowment. Karen Miller, the foundation's chief financial and operating officer, said by email: "We recognize that there will be periods when it is difficult to outperform a passive index, but we have remained committed to our investment strategy and, in 2017, the returns were very strong." She also noted that Templeton had positive returns during the five years when it trailed its peers.

The poor performance of most foundation endowments will come as no surprise to some prominent investors who have argued for years that active investment managers, as a group, underperform market indexes because they charge higher fees and engage in more frequent trading, which adds to costs. That group includes Warren Buffett, the chief executive of Berkshire Hathaway; David

Swensen, the longtime chief investment officer at Yale University; and Charles Ellis, who began his career at the Rockefeller Foundation and founded Greenwich Associates, a financial-industry consulting firm.

In his 2017 letter to investors in Berkshire Hathaway, Buffett wrote: "When trillions of dollars are managed by Wall Streeters charging high fees, it will usually be the managers who reap outsized profits, not the clients. Both large and small investors should stick with low-cost index funds."

Going Low Cost

A small but growing number of foundation endowment managers have taken Buffett's advice. Some 42 percent of respondents to a 2017 survey of foundations and endowments by NEPC, a Boston-based investment consultancy, said they had increased their use of passive management during the previous three years.

From 2011 to 2017, Vanguard, the index-investing giant, saw the number of clients in its nonprofit investment-management business grow from 1,655 to 2,865 — numbers that still represent only a small fraction of America's foundations.

Meanwhile, big foundations have taken an entirely different tack, plowing more of their endowments into an IRS-defined category called "other investments," which includes hedge funds, private-equity funds, venture capital, and real assets, like commodities and real estate.

Jeffrey Hooke and Ken Yook, who also teaches finance at Johns Hopkins, looked at the performance of 56 large private foundations during the 10-year period ending in 2015 and found that, as a group, they "substantially cut their allocations to publicly traded stocks and bonds in favor of illiquid alternatives that supposedly offered higher returns and lower volatility."

Unfortunately for the foundations, hedge funds suffered a decade of underperformance after the 2008 financial crisis, and private-equity returns have trended downward as more money has flowed into those asset categories.

Defending Active Management

Global investment firms like Cambridge Associates, which builds customized portfolios for institutions including foundations, continue to advocate for a fully diversified approach that includes active stock managers, hedge funds, and private equity. In a study published last year, Cambridge found that since 1990, portfolios that included hedge funds and private-equity funds outperformed a simple 70/30 stock-bond portfolio except for two periods: 1995 to 99 and 2009 to 2016.

The firm said: "We continue to find investments in private equity and hedge funds that we believe have an ability to add value to portfolios over the long term."

AQR Capital, a hedge fund with foundation clients, published its own study recently that found that "active management has paid off especially well for large institutional investors" in the long term. It acknowledged that "recent years have been especially bad for active equity managers in the United States, but at least part of this is environmental and thus should not be extrapolated into the future."

Foundation Financial Research takes no position on the active versus passive debate, and it won't offer investment advice. Instead, Seitz aspires to provide foundations with independent research so they can make their own informed judgments about how to invest. Smaller and midsize foundations, in particular, can benefit from a reliable way to assess their investment performance. "They've been operating in the dark," he says.

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