The endowment and foundation sector is at the forefront of innovation in the investment industry. Industry players are accelerating their move into alternatives to drive performance and diversification in an era of low interest rates. At the same time, they’re updating their existing technology to support more sophisticated investment strategies.

A State Street survey of 170 endowment and foundation funds, conducted by the Economist Intelligence Unit, reveals how the industry is evolving. It shows how industry leaders are taking a more proactive approach to investing so they can prosper in an increasingly challenging environment.

INVEST TO PERFORM

Our research suggests that many endowments and foundations are now broadening their portfolios and also pursuing a risk premium. For example, more than half (52 percent) of funds expect to ramp up their risk appetite over the next three years, as the search for returns intensifies.

Investment allocations are shifting accordingly. Three-fifths of endowments and foundations in the survey (62 percent) see increased investment opportunities for their institutions in emerging markets, with 18 percent believing there will be a strong increase in these opportunities. While some endowments were early advocates of greater diversification and higher allocations to some alternative assets, alternatives are becoming an even more important piece of their future strategy. Thirty-eight percent expect to increase their existing allocation to infrastructure, while 26 percent plan to increase their allocation to private equity, and another 20 percent plan to invest there for the first time.

This shift into alternatives comes against the backdrop of preliminary data from the 2014 NACUBO-Commonfund Study of Endowments (NCSE). The NCSE shows that over the last 10 years, US college endowment funds have seen an average return of 7.1 percent. This is below their average long-term growth target of 7.4 percent. However, annual returns

---

need to hit about 9 percent for endowments to grow, once their typical yearly spend is factored in.

The preliminary results of the NCSE also found that larger, better-diversified endowments have outperformed their smaller, equity-heavy peers for the first time since 2012. The large funds, with $1 billion or more, returned 16.8 percent, outperforming the overall average of endowments at 15.8 percent. This stronger performance is largely attributed to a continued shift from public equities and fixed income into alternatives. The NCSE also shows allocations into alternative assets increasing from 53 to 58 percent overall, and schools with $1 billion or more increasing their alternatives allocations from 58 to 65 percent.

Diversification brings clear benefits — but this trend is challenging existing operating models in the industry. Only 11 percent of our survey respondents report strong confidence they have the operational infrastructure in place to accommodate such changes to their portfolio. “These entities are looking for technology that can give them a view into all their alternative asset classes — hedge funds, private equity and real estate — in a user-friendly portal, but to date that need hasn’t been fully met,” says Chris Sadler, State Street vice president, Asset Owner Servicing.

DEFINING A NEW RELATIONSHIP WITH ASSET MANAGERS

As endowment and foundation funds seek to take a more hands-on approach to investment management, they are looking for asset managers who can deliver solutions that are aligned with their long-term investment objectives and can offer a competitive edge.

Our survey shows that improving due diligence in manager selection remains top of mind for institutional investors in this sector. Fifty-six percent say conducting due diligence post-hire to ensure managers are meeting their expectations is a challenge, while 51 percent say due diligence is a challenge when hiring new managers too. “We’re looking for asset managers who have some kind of edge, but you need to do the due diligence,” says the chief operating officer of a US university endowment fund with more than $2 billion in assets. “It’s not enough to look at a manager’s track record — how much of that track record comes down to market conditions, and how much is attributable to skill?”

Along with other institutional investors such as pension funds and insurance companies, endowments and foundations are searching for greater transparency from external managers around performance and risk. Almost half (46 percent) of those in our survey say they struggle to obtain a complete picture of risk-adjusted performance from their managers.

Funds in the endowment and foundation sector are increasingly looking at the advantages of in-house management, partly to provide them with greater visibility of risk and to reduce costs. Nearly one-third (32 percent) say they’re planning to increase the proportion of their assets managed in-house. Sadler agrees, “Some endowments and foundations are starting to manage more assets internally, such as futures, swaps and swaptions.”

A MORE HANDS-ON APPROACH TO GOVERNANCE

Endowments and foundations will not only need to be more proactive in how they manage investment performance in the future, but also in how they handle governance.
Executive Summary

A Hands-on Future for Endowment and Foundation Funds

Regulatory pressure continues to intensify. According to Rebecca Schechter, State Street senior vice president, Asset Owner Servicing, “While the endowment and foundation sector has felt increased regulatory scrutiny, this is expected to continue apace.”

Internal governance structures are also being reviewed. More than half (56 percent) of global respondents believe their increasingly sophisticated portfolios will require a change in their trustees. “A board may have one trustee saying, ‘Give me a synopsis with pie charts that gets to the heart of the matter,’ and another saying, ‘I need to drill down into the data that supports the synopsis to form a better understanding of our situation,” says Martin Sullivan, State Street head of Asset Owner Solutions.

To get ahead of the market, endowments in particular are getting far more granular on risk. “Investment committees and boards are becoming more hands on, and their level of sophistication is growing,” says Schechter. “As a result, investment teams are consuming data daily and pushing harder for daily updates around risk exposures.”

As they seek to satisfy greater reporting requirements from regulators and their boards, endowment funds’ IT infrastructure is a vital success factor. In our survey, 41 percent of endowments and foundations

<table>
<thead>
<tr>
<th>Areas prioritized for improvement over next three years</th>
<th>High priority</th>
<th>Medium priority</th>
<th>Low priority</th>
</tr>
</thead>
<tbody>
<tr>
<td>Regulatory compliance</td>
<td>58%</td>
<td>33%</td>
<td>9%</td>
</tr>
<tr>
<td>Overall governance</td>
<td>44%</td>
<td>45%</td>
<td>11%</td>
</tr>
<tr>
<td>Data management</td>
<td>41%</td>
<td>36%</td>
<td>24%</td>
</tr>
<tr>
<td>Contingency planning</td>
<td>31%</td>
<td>49%</td>
<td>20%</td>
</tr>
<tr>
<td>Cybersecurity</td>
<td>25%</td>
<td>30%</td>
<td>45%</td>
</tr>
</tbody>
</table>

Source: State Street 2014 Asset Owner Survey, conducted by the Economist Intelligence Unit (170 respondents from endowments and foundations)

DARING TO BE DIFFERENT

Endowments and foundations are highly competitive with one another, and they’re often willing to take a different approach to other institutional investors.

The largest university endowments in the US are competitive, and the freedom given to their chief investment officers (CIO) often puts them in a unique position.

“The CIOs of the largest endowments are leaders in the industry. They’re willing to take a different approach,” says Sadler. “Some managers are dramatically increasing their number of separately managed accounts. They’re hiring a lot of different managers, giving each of them small amounts to invest.” This approach, however, creates infrastructure support needs, as some of these managers are effectively very tiny shops.

At the same time, university endowments can tap into vast internal expertise and have the ability to invest for the longer term, both of which bring advantages. “Some of the major universities are willing to work with new technology solutions and software companies to enhance their solution,” notes Sadler. “They’re also willing to do things in-house as they feel they have access to more expertise than may be available externally.”

RESPONSIBLE CHOICES

Among foundations in particular, there’s also a growing emphasis on pursuing sustainable and responsible investment approaches in the post-crisis environment. The idea that investment strategies across assets can help to achieve positive societal outcomes and deliver targeted financial returns is gaining greater traction in the sector. As an example of this trend, in 2012, the US SIF Foundation identified 95 foundations in the US that applied some form of environmental, social and corporate governance (ESG) criteria to assets — collectively totaling $60.3 billion.

cite better data management as a high priority. They also recognize that a broader perspective on risk management is needed, encompassing contingency planning such as disaster recovery and business continuity, and emerging cybersecurity threats. One quarter of our survey respondents say cyber security is now a high priority.

LOOKING TO THE FUTURE
As they respond to changes in both their external and internal environment, endowments and foundations will increase the complexity of their portfolios by deepening their reliance upon alternatives and moving into new markets. At the same time, they’re under pressure to deliver more granular risk and performance reporting to increasingly knowledgeable and specialist investment committees and board members.

Many of the larger endowments already possess the investment know-how to thrive in this hyper-competitive marketplace. However, they’ll need to develop specialist talent, advanced technology and new governance frameworks to help them navigate the new terrain that lies ahead.

ABOUT THE RESEARCH
On behalf of State Street, the Economist Intelligence Unit conducted a global survey of institutional asset owners during July and August of 2014. The survey garnered 170 responses from endowment and foundation executives globally, spanning public and private institutions.