The Marriage of Passive and Active Investment Strategies

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In many cases, combinations are much more powerful than individual circumstances. Think hot dogs and mustard, Abbott and Costello, peanut butter and jelly. Investing is not much different. When the power of two schools of investment management—active and passive—are combined in the Core-Satellite approach to portfolio management, the end result tends to be better. Many of the largest pension plans and endowments use a form of the Core-Satellite approach in their portfolio management, and it may be just the right approach for your foundation in today's markets.

Many investors may think passive investment management or "indexing" is optimal for foundations and endowments, especially over the past few years. After all, passive management matches an underlying market index, such as the S&P 500; is fully diversified; and is associated with low fees and expenses. But it is important to take into account the significance—especially over the long term—of generating *alpha,* or returns above that of the market that are associated with active management.

Whereas indexing does make a lot of sense in many asset classes and for many investors, it is not a panacea for today's foundation investors. For that matter, neither are active strategies. Today's foundation and endowment investors—in a bit of a pickle, addressed below—need a new playbook that offers a combination of approaches.

Enter the Core-Satellite approach to portfolio management—a marriage of passive and active strategies. In this approach, the portfolio's core consists of passive investments that track major market indices. Additional positions, known as satellites, are added to the portfolio in the form of actively managed investments. This approach can be implemented in a variety of ways.

Let's explore why a combined strategy may be right for your foundation.

Today's Investment Pickle

In today's markets, foundations and endowments are finding it very difficult to make the returns they need to maintain their giving. Carry-forwards notwithstanding, a typical private foundation must distribute 5% of its corpus each year in grants and qualifying distributions, so that means it must earn at least 5% just to maintain its corpus. But what about growth? What about hedging inflation? To meet these needs, let's add another 2%–3% for an earnings goal of 7%–8% annually.

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In a "normal" economic environment (read: not the financial repression of the past 6-plus years), a private foundation's investment committee might suggest holding 40% or so of assets in fixed income, with average returns on this sleeve around 4%–5%. Let's say the balance are held in equities, with a near 9% average rate of return on this sleeve. In this "normal" environment, a foundation can reach its earnings goal.

But that was then. Today, fixed income returns, in a balanced, conservative portfolio, are earning returns less than 2%, which puts a considerable drag on the portfolio. In fact, the math is sobering: Given a 40% fixed income and 60% equity portfolio, the equity portion would have to achieve a near 12% annual return, which is above the 25-year average.

Either today's investment committee simply hopes the equity sleeve returns a good deal more than it has over the past 25 years, which might lead to taking on more risks in the form of more volatile, speculative equity investments, or it increases the portfolio's allocation to equities substantially. In both cases, the foundation's portfolio adopts an increased risk profile.

So what is a foundation's investment committee to do? How can it steward its portfolio—among its greatest assets—to produce the returns necessary for the charitable donations that many are counting on? It can alter the foundation's spending policy, of course, but that doesn't help the nonprofits that rely on the gifts, nor does it remove the required 5% floor. There has to be a better way.

One option: the Swenson Model, named for David Swenson, CIO of Yale University's endowment, who, over the past 25-plus years, has reduced the university's public equity and fixed income exposure and substantially increased its private equity and alternative exposure. Is this the secret sauce? The silver bullet needed for investment committees to meet their long-term goals?

Developing an endowment portfolio is no slam dunk these days. Investment committees need a robust solution set.

The thinking goes that foundations and endowments with longer time horizons can withstand the illiquidity of alternative investment vehicles (e.g., lock ups, capital calls) and, as such, can gain an advantage (alpha) over time. Whereas that might very well be true, questions do remain:

- Was the outperformance size dependent? In other words, do the largest portfolios outperform the smallest ones?
- Is it worth the expense? Netting out costs, how do these returns fare compared to a low-cost liquid balanced fund?
- Have the vast majority of gains been to the first movers (those that adopt the strategy early on)?
- Does a combination Core-Satellite portfolio (with alternatives as satellites) serve to optimize outcomes and minimize risks?

Despite a substantial increase in exposure to alternatives among endowments of all sizes over the past 10 years, only the largest endowments have seen a substantial increase in annualized returns. For example, since 2004, the exposure to alternatives increased from 5% to 18% for the smallest endowments, from 15% to 36% for medium-sized endowments, and from 30% to nearly 60% for the largest endowments—but only the largest endowments witnessed an outsized leap in average annual returns. So begs the question, Why have the largest endowments outperformed so strongly in the alternative sector?

The largest endowments have key advantages over their smaller brethren: investment expertise, the power to reduce the expenses associated with alternative strategies, and a "first mover" advantage with direct access to the best strategies before they reach capacity.

Then there is the price of alternative strategies. They don't come cheaply—at least not to the smaller endowments. Costs, of course, matter—although this tenet is often forgotten during bull markets—and, if one compares the average annual returns of the smallest (and mid-sized) endowments to a low-cost actively managed balanced fund, the low-cost fund wins out over most time periods during the past 25 years.

What's an Investor To Do?

So what's the answer you may ask? Low-cost passive strategies? Active strategies that are not too expensive? Or alternative solutions where even the smallest endowments can gain access? I side on "all the above."

In the end, developing an endowment portfolio is no slam dunk these days. Investment committees and their financial advisors need to embrace a more robust solution set—complete with a portfolio of index funds for the largest sectors where indexing makes the most sense, active strategies where opportunities to exploit mispricing are more significant, and alternative strategies where costs are not prohibitive and the implementation is not easily replicated in traditional solutions (e.g., global infrastructure, global real estate, market neutral, private equity).

The Core-Satellite solution allows for such a portfolio—meeting the needs of an investment committee without incurring huge expenses.

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