"AN INVESTMENT PHILOSOPHY FOR A COLLEGE ENDOWMENT FUND"

Speech given by Mr. Bosworth M. Todd, Jr.,
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I am pleased to have this opportunity to discuss with you college officials the problems of investing money today in college endowment funds. This is quite a challenging subject.

Today I want to talk with you about four subjects:

1) Why is there pressure on endowment funds for better performance?
2) What is an effective investment strategy for an endowment fund?
3) Should endowment funds spend part of their capital gains?
4) Finally, how can the smaller endowment fund obtain better results?

I. THE PRESSURE FOR PERFORMANCE

Mc George Bundy, President of the Ford Foundation, started the whole controversy in 1967 when he said:

"It is far from clear that trustees have reason to be proud of their performance in making money for their colleges. We recognize the risks of unconventional investing, but the true test of performance in the handling of money is the record of achievement, not the opinion of the respectable. We have the preliminary impression that over the long run caution has cost our colleges and universities much more than imprudence of excessive risk taking. The capital portfolios of American Colleges and universities are now estimated at $12 billion dollars, at market value. If their current average annual performance, counting both interest and capital appreciation, could be improved by only 1% of capital a year, the increased return to our colleges and universities would be $120 million dollars a year, more than twice the current budget of the Ford Foundation for education and research."

Bundy's bombshell has forced colleges to take a new look at their endowment fund policy. Twenty years of bond losses and twenty years of stock gains are behind us. Bond yields have risen from 3% to 8%, therefore bond prices have fallen sharply.

Historically bonds have dominated college funds. Although the Dow Jones Average, which is a sampling of the price of thirty blue chip stocks, has quadrupled over the past twenty years, it is no higher now than five years ago. The more meaningful New York Composite Average, a weighted average of all big board stocks, is up 15% over the past five years. Traditionally endowment funds have been concentrated in the slow-growth, basic-industry type stocks which comprise the bulk of the Dow Jones Industrials. This is the problem, hence Bundy's blast.

The increasing diversity, stability, and growth of our postwar economy, along with a continued inflation, created an environment which made obsolete many aspects of traditional investment philosophy. The postwar period began with a widespread distrust of the permanence of corporate earnings after World War II, but as the economy continued to roll along without serious readjustment, (the much-feared postwar depression never came) this cautious attitude gave way to an acceptance of common stocks as reasonable investments which would provide the investor with an average annual gain of 9 or 10%, including income. For example, the Merrill Lynch sponsored study at the University of Chicago revealed that over the past forty years a random selection of common stocks produced a 9% average return. The Performance Era, which began in the early 60's, holds that much greater stock gains than 9% can be achieved by more aggressive management.

Until the Performance Era, much of the investment thinking was an inheritance of and reaction to the experience of the 30's. Investment managers sought to avoid risk, avoid volatility, avoid turnover, and to a greater extent, even to avoid decision making. It was a period that gave more weight to safety than to growth.

Gradually, starting in the 50's, and picking up steam in the 60's, performance took over, and investors increasingly asked, "How much money can I make?", rather than, "How can I protect my principal?"

1) Trends toward Seeking Professional Advice

So what has been the result? Many endowment fund managers are seeking professional help. In the fall of 1967 Yale University established a Boston investment counsel company to manager its $500 million endowment. In the spring of 1968 Amherst College, Colorado College, and Scripps College contracted for the services of John Bristol & Co., an investment counselor in New York that already handles Princeton University, Howard University, and a half dozen others.

Stanford University in the spring of 1968 made arrangements for investment counseling with the Fund America group.

Roland Grimm, who heads the investment counseling firm which managers Yale's money, is quoted as saying, "Too many colleges have had back-burner treatment of their investments. They deserve better than that. If they are to get first class treatment they must have professional managers who can watch the market from day to day, not meet once a month and make investment decisions."

2) College Expenses Rising Four Times Faster Than Average

Over the past ten years college expense budgets have grown 14% a year, about four times faster than the cost of living index, while public schools, such as U. of K., have been able to offset costs by increased legislative appropriations. Private schools which have 80% of endowment investment funds in this country, have had to boost tuitions to extremely high levels. Mr. Kirk, former President of Columbia, said that financial troubles are threatening the entire existence of private universities; hence the growing pressure on college trustees to improve investment results.

For most schools endowment income is a very small part of the budget. By rough estimate, the investment of endowment funds earns $400-$500 million a year, which is only about 5% of the budgets of the endowed institutions - mostly private, but some public. Thus, even good investment results can only reduce, not close, the money gap. In 1964, the latest figures compiled by the U. S. Office of Education, public and private institutions of higher learning spent close to $8 billion for education and general operations. For the private schools, more than a third of their revenues came from tuition, and equal share from government aid. For public institutions their principal source is state, federal and local funds.

3) Most Endowment Funds Are Small

The Office of Education reported that there were 458 private and 71 public universities and liberal arts colleges with endowments of $500,000 or more, of which only 180 had $5 million or more. In other words, a few institutions have most of the money. The endowments of the private schools were almost six times as much as those of the public institutions.

A recent Boston Fund study shows that 70 leading college endowment funds on the average had nearly 58% of their total value in common stocks. The common stock ratio ranged from 80% to 39%. These 70 funds earned between 3% and 5.2% on their money.

II. <u>EFFECTIVE INVESTMENT STRATEGY</u>

What is an effective investment strategy for a college endowment fund? First, we should state a few basic assumptions which underlie our investment philosophy:

A. The world we operate in is one where governments of the industrialized powers have rejected economic stagnation in favor of growth, even if it means accepting steady inflation, as it invariably does. (Later on we'll look at the experience of the British investor since World War I.)

B. Inflation, as it continues, means higher prices all around, including those for industrial goods, so that capital needs increase out of proportion to normal economic growth.

C. The steadily higher wage rates demanded as an offset to inflation cause managements to turn increasingly to more sophisticated automation machinery, which also applies capital pressures.

D. Inflation causes central banks to maintain higher money rate structures than they would like to, but political objectives make them stop short of tightening money enough to stop inflation because that would mean an unacceptable level of unemployment.

E. These basic economic trends are not helped by the world's political situation, which features lasting mistrust between West and East and therefore large defense budgets (unproductive and inflationary) on both sides. While hoping for a lasting accommodation some day, we assume for now continued high levels of defense spending in the U. S., Vietnam War or no.

No matter what your objectives or situation is, you must achieve at least two basic goals. You must:

--- Participate fully in the economic growth around you, because otherwise you will fall back - there is no neutral ground.

--- Overcome whatever rate of inflation exists at the time you are committing assets to the securities markets.

Meeting both these criteria means that you will preserve your purchasing power, and to the extent that you exceed these goals, you will enhance it. We use the phrase "purchasing power" rather than "income" because static capital with gradually rising income from it is not enough in an inflationary environment.

You must constantly search for securities which will offer long-term appreciation of principal. When your search succeeds, the resultant capital growth improves your income over the long term.

Therefore we think investment policy of a college endowment fund should recognize 1) that the trend of operating expenses will continue to rise faster than the cost of living generally and also faster than your endowment income, 2) the endowment income in relation to the total budget is continuously diluted so alternate sources of revenues are having to be relied upon, and 3) any

attempt to maximize endowment income would be futile and shortsighted as it would entail a high risk of loss in purchasing power.

1) Choice of Securities - Stocks

Inasmuch as common stocks are the only securities which provide gradually rising income during periods of economic growth, such investments should constitute the most suitable vehicle for implementing your endowment fund's investment objective. As increases in dividends are generally a function of rising earnings, stock prices should reflect over a period of time the prosperity of their issuers by appreciating in value.

An economy which offers the reasonable expectation of future growth, in which the fear of depression has been moderated, is one in which the concept of "risk" takes on new meaning.

In a sense the big, so called "blue chip" companies can be considered alternatives to bonds - General Motors, Standard Oil of New Jersey, American Telephone. It can be objected that these stocks are volatile, but a counter argument is provided by an inspection of bond price charts over a period of years.

And dividends and capital values of such stocks gradually rise over the years, neither of which is true for straight bond issues.

The primary objective of stock investment, usually not fulfilled by the type cited above, is growth at a pace well in excess of the general economy. There are some particular categories which best reflect the sort of economy we live in and they deserve emphasis. The rate of innovation is unusually high in the U. S. and you should capitalize on it, though risks are somewhat above normal. A research-driven industrial structure like this one calls for use of 1) technological leaders, and 2) smaller firms which utilize research "fall-out" to pioneer new techniques in product improvement and efficiency. Companies in the first category are easy to identify, hard to evaluate in terms of proper price earnings ratios. Those in the second require more work, but offer commensurate rewards for correct choices.

Investment opportunities also arise in well-established groups of companies as structural shifts take place in our economy, either in response to social trends, changes in allocation of government spending, or other influences. There develop too, from time to time, large "air pockets" which hopefully can be avoided by major switches into better-situated groups. As the spotlight of investment attention moves from one area to the next, major profit potential is created, and the companies involved often have large stock capitalizations which permit purchases in desirable size.

Another investment device is the purchase of overlooked "sick" companies, invariably larger ones, which are turnaround candidates based usually on new management. While there is little downside risk in these, there is the danger of your patience wearing thin as

time stretches out before the better earnings appear. Turning a large, demoralized company around is harder than it looks, and for every Chrysler success, one can point to an Allied Chemical failure (at least so far, though investors are still hoping).

Asset plays, such as in oil, sulphur or silver, are always attractive to us because there is hardly any theoretical upside limit to such stocks. They are well worth attention, provided the source of information is expert, with first-hand rather than hearsay knowledge. Shifts in the world's strategic geopolitical balance can be of great importance, as witness the impact of northern Canada oil discoveries in the face of Middle East tax pressures and increased Russian penetration there.

In general, we try to be very selective among the multibillion dollar companies, and only use them when a persuasive case can be made that earnings progress will be above average for more than a year ahead. Some very large companies seem to subordiante stockholders' interests to those of customers, employees, or even the government: they seem at times to be run as public philanthropies.

Selectivity is the key to performance. It's a mistake to pay undue attention to the short run trend of the general market. For example, the Dow Jones Industrial Averages, as mentioned earlier, have been flat for the past five years. IBM, on the other hand, has gone from 150 to 300 during this period, while duPont has dropped in half. Polaroid, for example, benefiting from new product introduction, has increased its earnings and market price five-fold during the past five years.

Proportions of assets devoted to different areas will change as conditions do. Diversification should be allowed to take care of itself, i. e. let the attractiveness of various areas determine how the money flows and do not attempt to allocate an arbitrary 5% here, 10% there. And if unusual success is attained in one investment sector, bringing the proportion in it to 25%, for example, we do not arbitrarily chop it back because it looks "too big", but let the fundamentals determine where the sales are to be made, just as they do the purchases. Adherence to fixed rules about proportions means that the best choices are penalized, the second-best rewarded (by being left alone.)

The selection of equities should emphasize a number of considerations, including the five following:

1. Stability and growth in income, requisities which are met generally in equities with a consistent, non-cyclical record of earnings growth. As profits grow, increases in dividends generally follow.

2. Most of the following yardsticks should be found in each of the situations to be included in the endowment fund:

- Secular growth of sales and earnings (as opposed to cyclical growth);
- Product innovation (thus creation of new markets);
- Industry leadership;
- Line of products enjoying wide consumers' acceptance;
- Homogenity of ultimate markets (no excessive diversification);
- No overcapacity problem;
- Sustained or improving profit margins;
- Ability to reinvest at high rate of return on invested capital;
- Reasonable depth of management;
- Low labor factor;
- Sound financial situation;
- Sound research;
- Little or no foreign competition;
- Participation in the growth of the population and of disposable income at home and abroad.

3. Quality of investments should not be quaged primarily by the size of companies, the "respectability" of their name, or by marketability factors. Industry leadership, management excellence, and future prospects are more meaningful factors for sharing in the growth of up and coming industries, as well as in established fields and companies.

4. The following areas of investment should be favored for their long term, non-cyclical prospects:

- Labor saving devices to offset rising wages;
- More leisure and travel resulting from a shorter work week, longer paid vacations, and from increasing discretionary income;
- The surge in population;
- Extension of the human life;

- Services;

- Increasing needs for energy.

We agree with Godfrey Howard, head of investment research at my parent company, The Boston Company, who talks about the obsolescence of size. It is very difficult, he says, for a company with $1 billion in sales to grow 10% a year on a sustained basis It is much easier for smaller companies to show above average growth. Furthermore, according to a report issued in 1967 by the Commerce Department, they came to a startling conclusion about the relation of company size to technological advance. Their findings are quoted as follows: "These studies were unusually consistent in indicating that independent inventors in small technologically based companies are responsible for a remarkable percentage of the important inventions and innovations of this century". Technology is the driving force of our economy. Three industries which did not even exist in 1945, computers, jet aircraft, and television, accounted for $13 billion of our Gross National Product in 1965.

There is now an acceleration of history, and the risk takers are in a stronger position than they used to be. The final third of the 20th century is no time to be playing it safe. Research and development expenditures will continue to grow. Herman Kahn, in his new book, "The Year 2000", thinks such expenditures will reach 10% of Gross National Product by the end of this century.

2) Choice of Securities - Bonds

Looking at the senior end of the investment spectrum, we have a variety of bonds available, many of which are unsuitable for the aggressive investor, except in periods like right now. For the endowment fund, however, bonds can prove useful if they are properly appraised for what they are rather than what investors would like them to be. If one is willing to regard bonds as dynamic instruments (not in the sense of growth, but in the sense of volatile price movements) and not be unduly swayed by the absolute level of interest rates at any moment, one can perhaps use them successfully.

Major swings in our economy usually carry certain implications for bonds and to the extent that they recur, bond investment policy is facilitated. The likelihood is, however, that future economic fluctuations may be less severe and this, coupled with worldwide capital shortages, may mean interest rates will stay unevenly in a high range without any marked shift downward. Such a possibility, along with the increasingly disadvantageous fixed-income characteristic of bonds, tends to limit their usefulness. They should be used, but not dominate the portfolio.

Funds committed to bonds as such should be invested in the following, with each serving a different purpose:

A. Convertible debentures or preferred shares of publicly held companies, thus readily marketable, offer a long term call on the common stock. Priority should be accorded to such securities whenever available at/or near par inasmuch as their market downside risk is limited to whatever price they would command as straight bonds or preferred stocks under prevailing money market conditions; conversely their upside potential may be substantial, as it is geared to the market action of the common stock.

B. High yielding debentures, either convertible or accompanied by warrant, acquired under an investment letter, thus not marketable until duly registered, should be considered whenever 1) their asset and interest coverage justify the risk inherent in a "lockup" situation, and 2) possibilities of capital gains can be reasonably well ascertained. The aggregate amount of such securities, however, should be limited to a definite percentage of the endowment fund's assets to be set by the investment committee.

C. Subordinated, thus unrated, high yielding debentures cannot be ignored when they can be considered money good. Such junior debentures of relatively new pipeline companies constitute a case in point, as their asset and interest coverages, thus their credit standing generally improve continuously after the breakeven point in profits has been attained.

D. High grade long term bonds and straight preferred shares, contrary to accepted beliefs, are actually more speculative than conservative investments. Namely they represent a speculation on the trend of money rates. The "AAA" American Telephone 4 3/8% bonds, offered at par a few years ago, are now selling at 75, a decline of 25% since issuance. Such bonds are desirable holdings only after interest rates have risen sharply. They are not particularly attractive investments as they provide no protection against the secular decline of the pruchasing power of the dollar.

E. Short term securities should always be held as a reserve for contingencies or for buying opportunities in equities. The proportion of short term securities in terms of total assets is likely to vary in direct relation with the ratio of equity investments.

3) Additional Thoughts on Strategy

The endowment fund's portfolio ought to be diversified. Over-diversification, however, ought to be avoided as it constitutes merely a dilution of investment judgment. The investment committee should, therefore, set standards for the size of individual holdings which in any event should not be lower than a specified dollar amount.

Promising unlisted securities should not be by-passed on account of the engrained prejudices in many circles against the Over-the-Counter market. More stringent and complete disclosure to the SEC imposed since 1965 and improvements in quotation methods should alleviate any objection to investing in unlisted securities.

Furthermore, an increasing number of such companies are making the trek to the official exchanges.

The type of stocks is a more pertinent question than what percentage of the fund is in stocks.

Don't be frightened by the low yield on growth stocks. The effect on next year's school budget is too small to hurt in contrast to the long run benefit.

Consider periodic profit taking in low yielding stocks which have risen sharply in price. Reinvestment in higher yielding securities can increase income substantially in any given year.

You should think about hiring professional investment counsel to manage your fund. Although the fee is based on market value of the fund, the fee seldom exceeds 5% of the income, except on very small funds.

If you manage your own fund be sure you make effective use of Wall Street analysts. Add up the commissions you spend in a given year. Generally it is an impressive figure, and it can buy good investment research in Wall Street.

Consider carving out a "funny money" account from the reserves formed by profit taking in your account. It was through such a device that the University of Rochester made an astute investment in Haloid, Xerox's predecessor, when the price of the stock was equivalent to 25¢ a share. Their nominal investment is now worth $80 million.

4) The British Experience Encourages Stock Investment

Because of our concern about inflation, Vietnam, and occasional anxiety over our balance of payments, it is interesting to look at the experience of the British investor, where these problems have been prominent for the past fifty years.

In connection with the British experience, a word of cheer for shareholders may be in order. Britain, in the period of the last fifty years, has had three Labor Governments, which devalued three times, and was in a major war (which seems to have been lost, because of its cost, although everybody thought it was won). During this period Britain also lost her Empire and her industrial and trade supremacy.

Certain studies have been made of the performance of British common stocks during this period. A study by a well-known London stock exchange firm indicates that in the period from the beginning of 1919 to the beginning of 1968 an index of representative common stocks advanced from 100 to 978.7 or 5% a year. During this period the cost of living index increased by 250%, or 2% a year, and a dividend index increased by about seven times, or 4% annual growth. Thus, taking the period as a whole, the holder of equities came out reasonably well, although certainly adjustments must be made for higher taxes, the imposition of a capital gains tax, etc. In this period

the holder of British Perpetual 2 1/2% bonds saw the price decline from 100 to 60, and the purchasing value decline from 100 to under 24.

III. SHOULD ENDOWMENT FUNDS SPEND THEIR CAPITAL GAINS?

The most fundamental controversy under way now is over the question of what "endowment income" really is. Should a university use only the interest, dividends or other current earnings on its investments? Or may it prudently spend out of capital too? Classical truth says that dipping into capital is evil. Modern theory - nurtured by the aforementioned pressing need for money - says that at least some of the gains in market value of an investment can be used along with the yield of the investment.

For example, the University of Rochester might reasonably spend some of what it has giained on the skyrocketing price of its Xerox holdings, in addition to the Xerox dividends which it spent already, but Mr. Tripp is against it. "Some people seem to think that if you take a bit of the ammunition away the aggressive battle can go on."

John Bristol says that "If you've done the right kind of thing in you fund you don't have to invade capital".

Yale has started doing it, to the extent of a specified small amount of its gains each year, but its latest Treasurer's report says rather defensively that this was only done as "the last resort".

Harvard in its new pamphlet explaining its finances explained that so far it has "resisted this temptation".

The University of Chicago's treasurer, Richard Burrage, says, "We worried about our endowment income for some time, and we studied a lot of schemes". His university adopted a double standard eighteen months ago.

That portion of the University of Chicago's funds whose principal cannot, by terms of the gift, be touched are being invested for growth. To the extent that the dividends on the growth money are less than that of high grade bonds, the difference is being made up by dipping into the growth capital gains realized.

Several years ago the Ford Foundation began a many-faceted study of the problems of investing endowment money. Recently the first aspect of this study, its legal portion, has appeared. It deals with the subject of encroachment. The prevailing trustees' view is that they are not free to spend gains. How this view affects their investment policy became clear in the Ford study. Of the 300 largest institutions of higher learning in the U. S. , 186 answered the questionnaire. Eighty-five percent said that their choice of investments was influenced to some extent by a desire for high current dividend and interest income, and 11% said that their choice is greatly influenced by this desire. Conversely, 67% said that a low current dividend sometimes dissuaded them from investments with

"unusually attractive long term growth prospects", and 8% said a low current yield was usually enough to block such a investment altogether.

The Ford Foundation study concludes that there are no legal reasons why endowment funds cannot spend their capital gains. If fund managers take this conclusion to heart it could profoundly influence their own investment policies and those of other charitable institutions, and by so doing could affect markets for all investors. The study says that the earnings of endowment funds dropped from 25% of total college budgets in 1900 to only 5% in the late 50's. They claim that the portfolios of many endowment funds have been far too heavily ladened with fixed income securities to resist the relentless erosion of inflation.

The report suggests that endowment managers are overly conservative and some have insisted that their only duty is to safequard, the original dollar value of funds entrusted to their care. But, instead of safequarding the legacy of tomorrow's students, such managers, the report goes on to say, have sacrificed it to fiscal conservatism. Many endowment fund managers are well aware that it is not necessarily prudent to ignore possibilities for long term growth in formulating policy, but too often the desperate need for funds to meet current expense has lead the manager, contrary to his best judgment, to forego investments with favorable growth prospects if they have a low current yield.

It has been suggested that it would be far wiser to take capital gains as well as dividends and interest into account in investing for the highest overall return consistent with the safety and preservation of the funds invested. If the current return is insufficient for the institution's needs, the difference between that return and what it would have been under a more restrictive policy can be made up by the use of a prudent portion of capital gains. This is the heart of the concept.

This suggestion has repeatedly been met with the response that as a matter of law capital gains on endowment funds may not be expended, because the principal of endowment funds must be maintained intact in perpetuity and capital gains are part of principal. The Ford study came to the conclusion that there is no substantial authority under existing law to support the widely held view that the realized gains of endowment funds of educational institutions must be treated as principal. No case has been found which holds that such an institution does not have the legal right to determine for itself whether to retain all such gains or to expend a prudent part. The study suggests that there is no reason why the law should deny educational institutions that flexibility.

The report goes on to say that there are those who argue that if the law does not in fact bar the spending of gains, the gates will open wide and all our educational endowment funds will drain away. Such an argument is necessarily premised on the assumption that our colleges are directed by irresponsible men who await only the opportunity to dissipate funds committed to their care. The authors

believe that assumption is illfounded.

The Museum of Modern Art in New York, for example, now appropriates each year a fixed percentage (usually based on the average market value of their funds over the past several years, without regard to dividends and interest received. Yale, Cornell, and University of Chicago follow a similar procedure now.

Proponents of the new formula argue that they are effective in preventing irresponsible dissipation of funds, while more accurately reflecting present day investment realities, and that in addition they free investment managers to select securities without undue emphasis on their current yeild.

The subject is a controversial one. Harvard, Princeton, and the University of Rochester are against it. The answer is not clear cut. I think the concept will become much more popular once the court lays down some guidelines similar to the prudent man rule.

IV. MANAGING SMALLER ENDOWMENT FUNDS

What can the small college do about the management of its endowment fund?

There is no single right answer as to how your fund should be managed. Each of you should examine your strengths and weaknesses and decide for yourself how it should be done. It does not necessarily mean that you should manage it yourself. It may mean that you should farm it out to a bank or an investment counselor. Naturally, I have a biased view as to which is best. The important thing is that you should have peace of mind and confidence in the investment. plan and you should be able to be enthusiastic about it with your alumni when soliciting gifts. A good record with your investments can do wonders in attracting larger gifts from your donors.

Don't overlook the help of successful and experienced alumni not necessarily a broker whose main interest may be in commissions from the treasurer's office.

Avoid decisions made by large committees which meet infrequently. Committees can oftentimes be a help but not in the area of selecting individual stocks.

You might invite a good investment man to be a trustee of your college then get him to become chairman of the investment committee. Then select some docile trustees to serve as rubber stamp members of his committee. I would think a lot of people around the age of 50 would be glad to help you.