

THE SIGNIFICANCE OF REAL ESTATE IN UNIVERSITY ENDOWMENT FUND PORTFOLIOS

Professor Graeme Newell

School of Business, Western Sydney University

ABSTRACT

University endowment funds have a key role in providing opportunities for universities beyond their normal budgets (eg: student scholarships, additional professorships etc). In many cases, these university endowment funds are significant pools of assets; eg: Harvard (\$39 B), Yale (\$30 B), Stanford (\$28 B) and Princeton (\$26 B) in the US, Oxford (£7 B) and Cambridge (£6 B) in the UK and Sydney University (A\$2.5 B) in Australia. This often sees separate investment management organizations established to manage these assets. The significance of these university endowment funds to university operational budgets highlights the importance of the portfolio asset mix of these endowment fund portfolios; this includes real estate. This sees a range of alternate asset classes (eg: private equity, hedge funds, venture capital) as key assets in many university endowment fund portfolios. This paper examines the operation of university endowment funds and the role of real estate in the portfolios of the leading university endowment funds globally. With university endowment funds taking on increased importance in Asia, a range of critical strategic issues are assessed for these university endowment fund portfolios; particularly in the context of the current COVID-19 crisis.

Keywords: *University endowment funds, philanthropy, asset allocation, real estate, alternate assets, COVID-19*

1. INTRODUCTION

University endowment funds are a pool of philanthropy and donations to universities that are a critical source of university income to supplement their normal operating budgets to fund student scholarships and additional professorships etc. Leading university endowment funds include Harvard (\$39 B), Yale (\$30 B), Stanford (\$28 B) and Princeton (\$26 B) in the US, and Oxford (£7 B) and Cambridge (£6 B) in the UK. The effective investment of these funds is of crucial importance, as they are multi-generational funds to support ongoing university activities.

This paper will explore the significance and operation of university endowment funds globally; including their asset allocation strategies and the role of real estate in their portfolios. Their increasing importance in universities in Asia will also be discussed. The impact of COVID-19 on these university endowment funds will also be highlighted.

2. SIGNIFICANCE OF UNIVERSITY ENDOWMENT FUNDS

2.1 Significance

University endowment funds are an important income source to universities to fund a range of activities, including student scholarships and professorships. They are the aggregation of the many donations and philanthropy to the university; eg: Harvard has over 13,000 such donations in the Harvard University Endowment Fund. In most cases, these donations are for a specified university function.

The extent of these university endowment funds depends on the philanthropic “culture” of the country. While many countries have a strong philanthropic culture for donating to the arts, social issues, medical research, environmental causes and religious causes, some countries also see significant donations to universities. This is particularly the case in the US amongst the private universities, such as Harvard, Yale, Stanford, Princeton and MIT.

These university endowment funds have a key role in providing an extra income source to the normal operating budget of universities to support activities such as student scholarships and additional professorships. In many cases, they provide one of the main income sources in the university budget; eg: Harvard (35%) and Yale (32%); often being the major income source to the university.

An essential element of these university endowment funds is capital preservation where the capital can not be eroded. This is to meet the donors’ requirements that the funds be used to support future generations of students, not just the current generation of students. This sees the income stream from the endowment fund coming from the investing of this capital; hence asset allocation becomes a critical issue for these endowment funds. Real estate is one of the assets that figures prominently in many of these asset allocations for endowment funds.

The assets under management (AUM) for these endowment funds often sees separate investment management companies established to manage the assets, being separate to the normal university finances. Typically, once the AUM exceeds \$1 billion a separate investment management group is established for more effective asset management. There is a strong governance structure established, involving a Board of Trustees, Investment Committee and professional investment team at the operating investment management level. The spend rate is typically 4-5%; but this needs to be from the generated income stream, not by eroding the endowment fund's capital.

This sees endowment funds operating at three strategic levels; fund-raising, spending and investment. COVID-19 has had a clear impact on these university endowment funds; impacting AUM and income returns on these assets.

2.2 Fund-raising Strategy

Typically, donors indicate specific conditions for how their donation can be used. This includes funding student scholarships and additional professors. Given the importance of these endowment funds to university budgets, most universities have increased their focus on employing high-quality fund-raising teams to increase the AUM of these university endowment funds. Donors want their donations to be used to support future generations of students; hence they are seen as long-term investment funds and supporting inter-generational equity. The endowment donation can not be withdrawn, but can be made in a series of staged payments.

2.3 Spending Strategy

To meet these donor-specific goals of supporting specific activities, the spend rate is typically 4-5% pa. This highlights the asset allocation in the portfolio and asset returns needed; as these activities are funded off earnings, not capital erosion. So to meet the requirements of a spend rate of 5%, expected returns on the portfolio would typically need to be 5% (for spend rate) + 2% (for impact of inflation on asset value) +1% (for re-investment); giving an overall expected portfolio return of at least 8% pa to meet these requirements.

2.4 Investment Strategy

University endowment funds use sophisticated investment management strategies, including professional teams and rigorous risk management procedures. This sees the Board of Trustees overseeing management and asset allocation, the Investment Committee making the strategic investment decisions, and the professional investment management team delivering the strategy. For example, the Yale Endowment Fund have 30 professional staff in their investment management team. As they are long-term investors, liquidity is not a critical issue in their asset allocation decisions; as such, the asset allocation in the endowment fund is typically a mix of liquid and illiquid assets.

The level of AUM in the endowment fund is critical in impacting the asset allocation; particularly in terms of diversification and number of asset classes used. Typically, this sees external fund managers used; eg: with AUM of over \$1 billion, over 100 external asset managers would be required by the endowment fund; for AUM less than \$250 million, around 25 external asset managers would be required.

Recent years have seen a strategic shift in the asset classes used; eg: using the “Yale model”. This has seen a shift from the traditional domestic stocks and bonds portfolio to an international portfolio including alternate assets such as private equity, hedge funds, venture capital, real estate and natural resources. This sees a larger number of asset classes and higher allocations to these alternate assets used today to deliver this investment performance. ESG concerns have also taken on increased importance in recent years; particularly concerning the divesting of fossil fuel stocks in the fund’s portfolio. Subsequent sections of this presentation will examine the asset allocation of specific leading university endowment funds to highlight their asset allocation strategies.

3. PREVIOUS RESEARCH

Compared to the level of research on pension funds, the level of research on university endowment funds is limited. Key issues such as performance, asset allocation strategies, manager selection, decision-making, success factors and asset management have been assessed in various finance journals. No previous research has specifically assessed real estate in their portfolios. Industry reports have also been produced (eg: CFA, Sutton Trust, NACUBO), as well as books involving specific university endowment fund portfolio strategies (eg: Yale, Oxford).

4. US UNIVERSITY ENDOWMENT FUNDS

The major university endowment funds are in the US; particularly in the US private universities. The National Association of College and University Business Offices (NACUBO) produce an annual survey of over 770 US university endowment funds to produce a snapshot of this sector. The leading US university endowment funds are Harvard (\$39.4 B), University of Texas* (\$30.9 B), Yale (\$30.3 B), Stanford (\$27.7 B), Princeton (\$26.1 B), MIT (\$17.6 B), Pennsylvania (\$14.6 B), Texas A&M (\$13.5 B), Michigan (\$12.4 B) and University of California* (\$11.8 B), where University of Texas and University of California represent multi-university systems.

This sees over \$650 Billion in US university endowment funds in 2019, with 5 university endowment funds having in excess of \$25 B, 13 having in excess of \$10 B and 111 having in excess of \$1 B. In 2019, over \$23 B was the annual spend to support university budgets; being a spend rate of 4.5% of AUM to support student financial aid (49%), professors (11%), campus facilities (7%) and academic programs (17%). This accounted for 6.6% of university operating budgets; although this varied considerably across universities. 2019 endowment fund performance was 5.3%, with 5-year performance being 5.2% pa, 10-year performance being 8.4% pa and 25-year performance being 7.9% pa.

Those endowment funds with more significant AUM were able to access more asset classes, a wider range of fund managers and a greater depth of investment for more effective asset allocations. In particular, the average asset allocation was:

- Stocks: 35.2%; comprising US stocks (14.1%) and non-US stocks (21.1%)
- Fixed income: 11.7%
- Private equity/managed alternates: 39.0%; comprising private equity (12.3%), managed alternates (19.1%) and venture capital (7.6%)
- Real assets: 12.3%; comprising real estate (5.9%), mining/energy (4.4%), agriculture/timberland (0.6%)
- Cash: 1.7%.

4.1 Yale University Endowment Fund

The Yale University Endowment Fund is a leading US university endowment fund and highlights many of the issues captured in this presentation; particularly the role of real estate in the endowment fund's portfolio.

The Yale endowment fund is #3 in the US, having \$30.3 B in AUM; managed via a separate investment management company. 2019 saw \$1.4 B allocated to the Yale operating budget; seeing a spend rate of 4.6%. This saw the Yale endowment fund contribute 32% of Yale's operating budget; being the largest contribution to Yale's operating budget. 82% of these endowment funds are for specific purposes; eg: professors (24%), scholarships (18%) and special purpose (28%); only 18% of the Yale endowment fund donations are unrestricted in their role. 2019 performance by the Yale Endowment Fund was 5.7%, with 11.1% pa over the last 10 years, 11.4% pa over the last 20 years and 12.6% pa over the last 30 years. The "Yale model" is seen as the classic university endowment fund model, particularly relating to the asset allocation mix. The Yale endowment fund has grown from \$1 B to over \$30 B over the last 35 years, comprising original donations, new donations and asset growth.

The 2019 Yale endowment fund asset allocation is US stocks (2.7%), foreign stocks (13.7%), bonds/cash (8.4%), leveraged buy-outs (15.9%), venture capital (21.1%), real estate (10.1%), natural resources (4.9%) and absolute return (23.2%). This sees 73% of AUM allocated to the alternate assets. Importantly, real estate makes up over 10% of the portfolio of the Yale endowment fund.

Other leading US university endowment funds also see significant levels of real estate in their portfolios. This includes Harvard, Stanford, Princeton and MIT.

5. UK UNIVERSITY ENDOWMENT FUNDS

The UK university endowment funds are dominated by Cambridge (£6.9 B) and Oxford (£6.1 B); comprising 81% of the total £16.1 B in UK university endowment funds. Other leading UK university endowment funds include Edinburgh (£460 M), Kings (£258 M), Manchester (£238 M) and Glasgow (£202 M). This sees only Cambridge and Oxford having in excess of £1 B in their endowment funds. The annual spend is approximately £650 M from these UK endowment funds.

5.1 Oxford University Endowment Fund

The Oxford University Endowment Fund is #2 in the UK, having £4.1 B in AUM; being managed via a separate investment management company and representing 40 major investors. The 2019 spend rate was 4.25%, seeing over £781 M distributed for university operations since 2009. The Oxford endowment fund had delivered 8.1% pa over the last 3 years, 9.6% pa over the last 5 years and 9.2% pa over the last 10 years. The asset allocation comprises public equity (53%), private equity (23%), real estate (8%), credit (8%) and cash/bonds (8%); seeing less diversification across the asset classes compared to the Yale Endowment Fund. Importantly, real estate accounts for 8% of the Oxford endowment fund portfolio.

6. AUSTRALIAN UNIVERSITY ENDOWMENT FUNDS

The Australian university endowment funds account for over A\$15 B in AUM. Leading university endowment funds include Sydney (A\$2.5 B), Monash (A\$2.5 B), UNSW (A\$2.5 B), ANU (A\$1.4 B) and Melbourne (A\$1.3B), with 5 endowment funds having in excess of A\$1 B in AUM. This sees an annual spend of approximately A\$600M to support a range of university activities.

6.1 Sydney University Endowment Fund

The Sydney University Endowment Fund is #1 in Australia, having A\$2.5 B in AUM and being managed as a separate investment management company. The 2019 spend rate was 4.5%, seeing over A\$110 M generated to support university activities. 2019 performance saw a return of 12.0%, with 9.2% pa delivered over the last 5 years.

The asset allocation was stocks (35%), private equity (25%), debt (24%), derivatives (4%), real estate (1%), infrastructure (6%) and cash (2%). Whilst real estate only accounts for 1% of the endowment fund AUM, other real estate assets including commercial property, farmland and student housing investments are used to support the core teaching and learning functions and are managed internally.

7. ASIAN UNIVERSITY ENDOWMENT FUNDS

Endowment funds in many of the leading Asian universities will take on increased importance going forward. This includes universities in Malaysia (eg: University of Malaya), China (eg: Tsinghua University, Peking University), Hong Kong (eg: University of Hong Kong), Singapore (eg: NUS), Japan (eg: University of Tokyo) and South Korea (eg: Seoul National University). These university endowment funds will be essential income streams to support crucial university activities for future generations of students; particularly in the quest for increased global rankings.

8. REAL ESTATE INVESTMENT STRATEGIES IN UNIVERSITY ENDOWMENT FUNDS

University endowment funds use a range of real estate investment strategies. These are largely influenced by their AUM and experience in real estate investing, and include:

- 1: direct real estate
- 2: separate accounts
- 3: JV/club deals
- 4: non-listed real estate funds
- 5: REITs/ listed real estate securities
- 6: real estate fund of funds.

Clearly, the larger university endowment funds have more flexibility in their depth of investing in real estate and accessing high quality real estate fund managers. Typical levels seen for real estate in the major university endowment funds are 5-10%; although some leading university endowment funds have higher levels of real estate in their asset allocation; often being those that have higher exposure to the alternate asset classes in their asset allocation. These levels of real estate in endowment funds tend to be marginally higher than that seen in pension funds.

9. UNIVERSITY ENDOWMENT FUNDS AND COVID-19

Universities have been significantly impacted by the global COVID-19 crisis with income short-falls; particularly relating to reduced intakes of international students. The obvious question is can these university endowment funds be used to cover these income short-falls? It is important to recognise that these university endowment funds are not “rainy day” funds; but have a specific focus to meet strategic long-term goals for current students and future generations of students via activities such as student scholarships. This sees the vast majority of these university endowment funds as being fixed in how they can be expended. As such, these university endowment funds can not generally be used to offset the impact of COVID-19.

Possible options for universities that impact on their university endowment funds in terms of dealing with COVID-19 income shortfalls are:

- 1: increase the spend rate
- 2: deploy flexible mandate endowment funds

- 3: sell-off real estate
- 4: fund student scholarships first
- 5: use previous discretionary funds
- 6: change focus of current-use funds
- 7: deploy unspent endowment funds.

10. IMPLICATIONS

University endowment funds have taken on increased importance in recent years globally as an important additional source of income for universities to fund essential activities such as student scholarships etc. Often using separate investment management companies, they employ sophisticated investment strategies. This sees the asset allocation process as fundamentally important for income generation in delivering the investment returns needed to support these activities. This has seen many of the leading university endowment funds increase their exposure to the alternate assets such as private equity, hedge funds, venture capital and derivatives. Importantly, real estate is seen as an important asset class in many university endowment funds as an effective asset class to help university endowment funds deliver the necessary returns to achieve their long-terms goals in supporting the current generation and future generations of university students.

REFERENCES

NACUBO (2020) 2019 NACUBO-TIAA Study of Endowments. NACUBO-TIAA.

Specific details of 2019 activities of the various university endowment funds discussed in this paper were obtained from their respective websites.