How Have Independent School Endowments Evolved Over the Past Decade?

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"Are we doing the most we can with our endowment?" This is a question we are increasingly hearing from independent schools. Whereas a decade ago the endowment was seen as "set it and forget it," more schools view endowment growth as crucial to their financial health. The mentality has fundamentally shifted from capital preservation to capital growth. Let's explore how independent school endowments have evolved and what is behind the shift in investment approach.

Endowment Trends: 2013 to 2022

Over the last decade, independent schools shifted their endowments to have a much more growth-oriented asset mix. Since 2013, the percentage of total equity assets has increased from 60% to 70%. The shift into equities was entirely sourced from hedge funds, which decreased from 21% to 11%. Fixed income was unchanged at 19%[1]

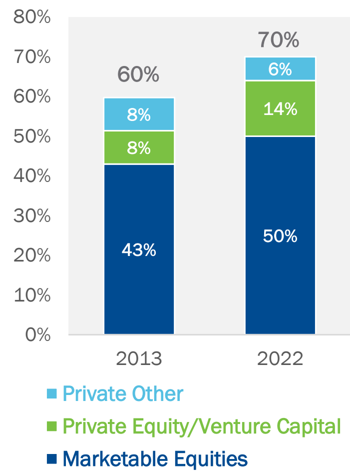
There are several conclusions to be drawn from these shifts:

The Risk/Return Calculus Has Changed

Independent schools are more focused than ever on returns, and they are willing to take on more equity risk to earn them. Historically, they were most comfortable investing in a traditional portfolio of 60% equity/40% fixed income ("60/40"), Today the "70/30" portfolio seems to be the new norm.

Within equities, there is notably more comfort with private equity compared to a decade ago. As shown in the chart on the right, the increase in equities was split relatively evenly between public equity and private equity/venture capital. Schools are recognizing the powerful advantage the endowment's perpetual time horizon provides in compounding capital. They are more comfortable locking up capital to potentially earn higher returns in private markets.

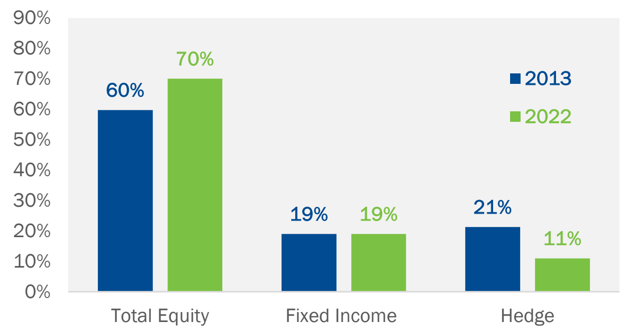
Components of Equity Allocation
2013 vs. 2022



Source: Commonfund Study of Independent Schools from 2013 and 2022.

At Hirtle Callaghan we have seen a similar change in independent schools' risk tolerance and appetite for private equity. For our more selective independent schools, we are seeing an even greater shift to 75% or 80% equity exposure with PE targets of 15% or more.

Independent School Asset Allocation
2013 vs. 2022



Source: Commonfund Study of Independent Schools from 2013 and 2022

Schools Still Favor Bonds for Stability

Independent schools kept their fixed income allocation static over the past 10 years. With interest rates falling to historical lows, bonds offered very little yield – and in fact at times had negative real yields; long-term bond holders were not being well compensated. Despite the challenging environment for bonds, they have continued to be perceived as providing ballast and liquidity to the portfolio.

Goodbye Hedge Funds

Hedge funds, on the other hand, were punished for delivering lackluster returns while investors continued to pay high fees and sacrifice liquidity. For the 10 years ending June 2022, hedge funds returned 3.7% annualized while U.S. equities returned 12.7%.[2] While hedge fund returns outpaced bonds, the higher fees and lack of liquidity made investors less likely to stay the course. Hirtle Callaghan made a similar decision. In 2021, we stopped investing in actively managed hedge funds because we felt we were not being adequately compensated after fees. We also concluded we could get similar diversification benefits in less expensive ways.

[1]Data is from the 2013 and 2022 Commonfund Studies of Independent Schools.
[2]Hedge fund return data is for the HFRI Fund of Funds Composite and U.S. equity return data is for the S&P 500 Index for the 10 years ending June 30, 2022.

What Caused the Endowment Shift?

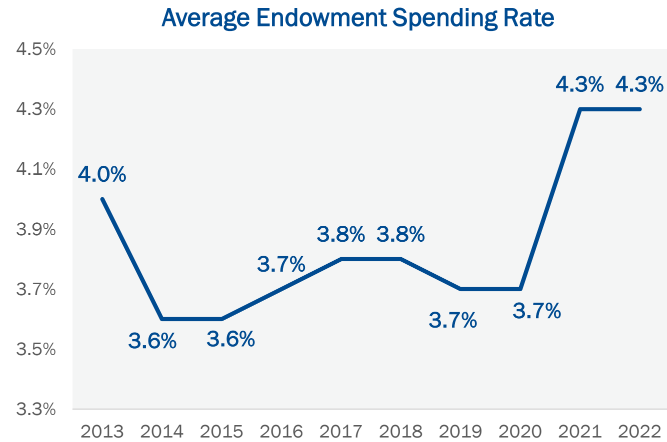
Fundamentally, schools need their endowments to achieve more today than they did previously. Historically, most independent schools were strong financially and did not need to rely on endowment income to fund operations. As a result, the endowment was treated more like a reserve fund than a source of growth capital. More recently, we have seen a greater focus on future sustainability, which is placing a bigger onus on the endowment to be a source of growth rather than just a source of stability. Three factors are contributing to the emphasis on endowment growth.

Independent schools are increasing their spending from the endowment. Prior to 2021, independent schools had an effective endowment spending rate below 4%. Post-COVID, the average spending rate increased to 4.3%.

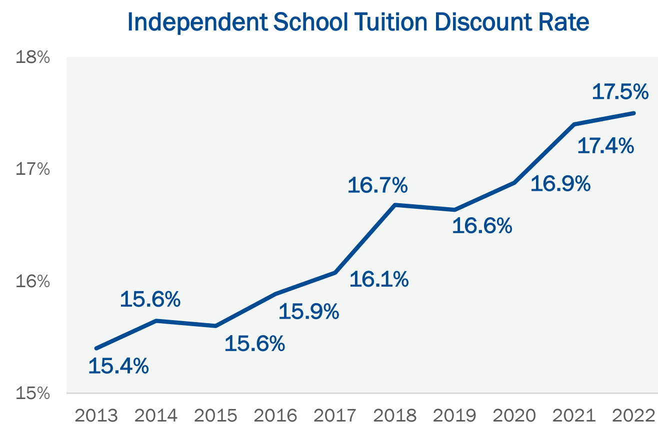
Schools are giving out more financial aid. Over the past decade, the tuition discount rate has increased from 15.4% to 17.5%. Based on the latest available data, 18% of independent school financial aid is funded by endowment and gifts. The trajectory of financial aid has been cited as a significant driver of the need for higher endowment returns.

More schools are embarking on campaigns specifically for endowment. In the prior decade, the emphasis was on raising funds for capital projects, but today the emphasis is on sustainability. In 2022 average endowment gifts reached an all-time high of $2.4 million, up from $1.5 million a decade earlier. Donors giving to endowment want to see that their capital is invested wisely, adding to pressure to get the endowment's investment strategy right.

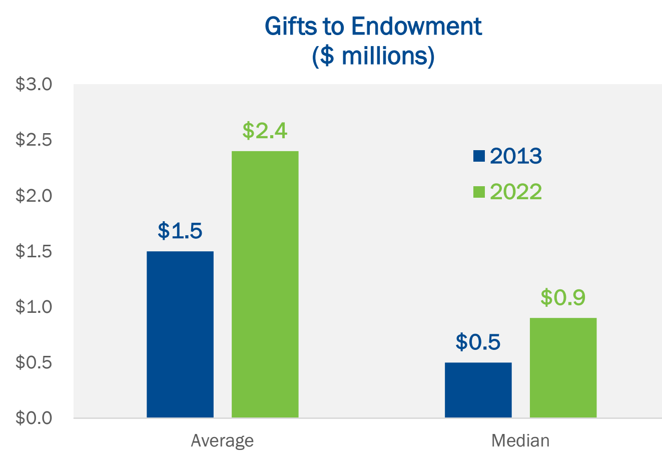
As schools reimagine a larger role for the endowment, they are realigning their investment programs to aim for higher returns. For most schools with whom we work, the shift in equity exposure is being taken not as a result of any immediate financial need, but out of concern for the pressure a rising discount rate and increased endowment spending have on the future financial strength of their school.



Source: Commonfund Study of Independent Schools



Source: National Association of Independent Schools



Source: Commonfund Study of Independent Schools

What Can Schools Glean from Endowment Trends?

As a best practice we recommend schools go through an in-depth endowment planning exercise every three years at a minimum. Keeping in mind the above trends, boards should take a step back to understand whether their endowment is being invested to achieve what they need over the long term. The "right" endowment strategy is different for each school; there is no one-size-fits-all approach. The portfolio of the past may not be the best one to meet today's needs. Schools should start by asking "what do we need this endowment to achieve?" For schools still living with a traditional 60/40 portfolio, it is worth questioning whether the endowment is positioned to deliver enough return for the school.

Based on the current trends, we recommend schools ask the following:

1) Is the current level of equity providing sufficient endowment growth? If not, what is the right level?

2) What level of investment risk is the school able to bear based on its financial profile? Key financial drivers include operating margin, debt structure, reserve levels, cash management and fundraising.

3) Is the endowment spending rate sustainable?

4) Is the current level of liquidity prudent for the endowment? What level of illiquidity can the endowment bear without impacting the school's financial health?

5) What role should time horizon play in how you invest the endowment?

These are questions we ask our independent school clients. As an outsourced endowment manager, we focus on alignment between a school's investment program and its financial goals. We strongly encourage boardroom discussion about whether your endowment is best positioned to meet your school's long-term objectives and therefore thrive. Your investment program does not need to change overnight; the dramatic shifts we highlighted in this paper took place over the course of a decade. Even small changes in your asset allocation can pay large dividends for your school over the long term.

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John is a Director and Endowment Specialist with Hirtle Callaghan. He has over 35 years of nonprofit experience. John works closely with nonprofits to design customized investment programs that are fully aligned with their goals and risk tolerance. He also helps them tackle key strategic issues, including spending policy, liquidity policy, debt ratios and covenants, capital campaigns, operating reserves and governance. Prior to joining Hirtle Callaghan, he was the Chief Financial Officer and Treasurer of Bryn Mawr College.

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