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“Wisdom and fortune combating together,
If that the former may dare but what it can,
No chance may shake it.”
- *Shakespeare, Antony and Cleopatra*

THE DEATH OF THE ENDOWMENT MODEL: INTELLEGEN T DIVERSIFICATION TAKES CENTER STAGE

The global marketplace nearly collapsed in 2008, and the world has barely begun to come to terms with the next incarnation of economic reality. It is no secret that markets move in cycles, and forward-thinking investors need to apply time-tested disciplines to a new context, returning to the fundamentals that create sustainable strategies. To move forward with confidence, however, we must articulate and appreciate the larger lessons of our recent failures.

The ability to shed the mistakes of the past requires parting with bad habits. In this last cycle, one of the primary contributors to what ultimately became an historic era of capital destruction was the perversion and misapplication of diversification theory. Institutions and individuals alike built their portfolios not on the sensible risk-control concept originally born as the endowment model (technically termed the “policy portfolio”), but on what evolved into mass-produced product that distorted key concepts and turned what were once uncorrelated investments into a melting pot of correlated downturns.

The result is that in the modern market, the endowment model in its current form should be placed into proverbial cold storage. Advancing to a more sensible and sustainable investment strategy means putting faith back into the dirty work: only heavy due diligence and intelligent diversification can ensure that risk and return remain aligned.

The endowment adoption

With the publication of *Portfolio Selection* in 1959, Harry Markowitz first formalized the quantifying of risk, return, and correlation among disparate asset classes that we recognize today as modern portfolio theory. His models show the clear benefits of diversification across a range of asset classes and recognize that variance is an important measure of economic risk.

His seminal insight - one which contributed to his winning of the Nobel Prize - was that diversification could reduce risk, *but not eliminate it*. While Markowitz believed that an entire portfolio's risk could be less than the sum of its individual positions, he correctly recognized that underlying securities, even in appropriately diversified portfolios, do carry risk.

But investors, hungry for outsized returns and yields, warped Markowitz's work to justify a mutation of diversification principles. Famously, we remember how in recent years investment banks created - and pensions and endowments bought - securitized mortgage instruments that relied wholly on an over-simplified theory of diversification and ignored the individual security risks within each portfolio. With an unemployment rate hovering at 10%, soft consumer confidence, and low growth, we are still paying a brutal price for this conveniently profitable oversight.

What observers may not recognize is how dramatically the investment landscape has morphed over the last two decades to embrace the widening of exposures into higher-risk instruments for all investors. Seeking outsized returns within the perceived protective armor of a diversification strategy, a broad swath of the marketplace adopted its own iteration of the endowment model.

Understandably, investors today are attracted to the endowment model by the remarkably consistent and powerful historic returns generated over the last two decades by early adopters. But when considering past performance it is critically important to consider the context in which those gains were made: during that same timeframe, we experienced pervasive and dramatic declines in global interest rates that played a profound role in the rate of return enjoyed by many investors.

In addition, we have witnessed one of the largest and most coordinated expansions of credit in history. Combined with the emergence of developing economies, that created a well-documented "global savings glut." It is no wonder then that endowment models were heavily skewed toward private equity, venture, and other high-return vehicles, or that they delivered extraordinary returns over this period. Floods of liquidity provided exits for all manner of investments, and dropping interest rates made refinancing continuously profitable while improving discount model valuations across the board.

The 2008 Lessons Most Investors Ignore

After markets recovered from lows in 2009, most finger-wagging pundits explained that the primary lesson learned in 2008 was that wide diversification was the only way to preserve capital. And yet, those who diversified core fixed-income holdings into high yield funds, mortgage-backed securities, and multi-alpha hedge fund products were skewered. Those who built out wide exposures in real estate, financial products, private equity, and venture certainly were hurt more than those with more focused investment portfolios.

That difficult year taught us that with money flows come correlations. Low interest rates, automated trading processes, and vast inflows of capital into popular investments resulted in many endowments (and individuals) carrying the same allocations and risk profiles. The correlations – modeled to be minimal – became massive. Even the long-short hedge funds that promised equity-like returns with uncorrelated risk found themselves at the center of the market swoon.

Asset classes that were reasonably uncorrelated in 2000 had become very highly correlated by 2006, as more and more investors adopted the model.ⁱⁱ With so many managers and committees following the conventional wisdom, they found themselves shopping for the very same diversification opportunities. As a result, by 2006 many asset classes were nearly perfectly correlated to the S&P 500.

5-Year Correlations of Selected Asset Classes to the S&P 500 ⁱ		
	2/28/2000	2/28/2006
T-Bills	34%	-58%
Long-term Treasuries	37%	-54%
Goldman Sachs Commodity Index	-14%	33%
Russell 2000	62%	94%
MSCI EAFE®	32%	96%
Hedge Funds	35%	96%

Sticking with the basics

With the advance of the endowment model, due diligence took a distant back seat to the unrealistic promise of total protection through ever-widening diversification. The historic magnitude of the resulting market implosion taught investors, once again, that there is a fine line between diversification and exposure. As investors saw the values of their portfolios plummet, they learned the hard way that risk cannot be imagined away.

Those who remain committed to the fundamentals of intelligent diversification (outlined in the 2009 Reynders, McVeigh paper, *Finding Safety in Intelligent Diversification: Maintaining the Marriage Between Risk and Investment Quality*ⁱⁱⁱ) likely had their feet under them even as the global markets dropped into turmoil. Intelligent diversification recognizes that valuation and underlying quality are critical components in the selection of assets within a portfolio.

Intelligent diversification understands that correlations are not static and that managers cannot find safety by filling the same buckets that other managers are filling. It confirms that liquidity has a value, and it allows a manager to step aside when the risks within an asset class are too great or when a lack of transparency creates concern.

Focusing on the minute details of investments is the fundamental, essential work that safeguards investors from risk. Portfolio strength is developed on themes, opportunities in the marketplace, diversification, and, as we are once again discovering, underlying quality. Ensuring a full understanding of the composition of and rationale behind each investment requires investigating elements such as:

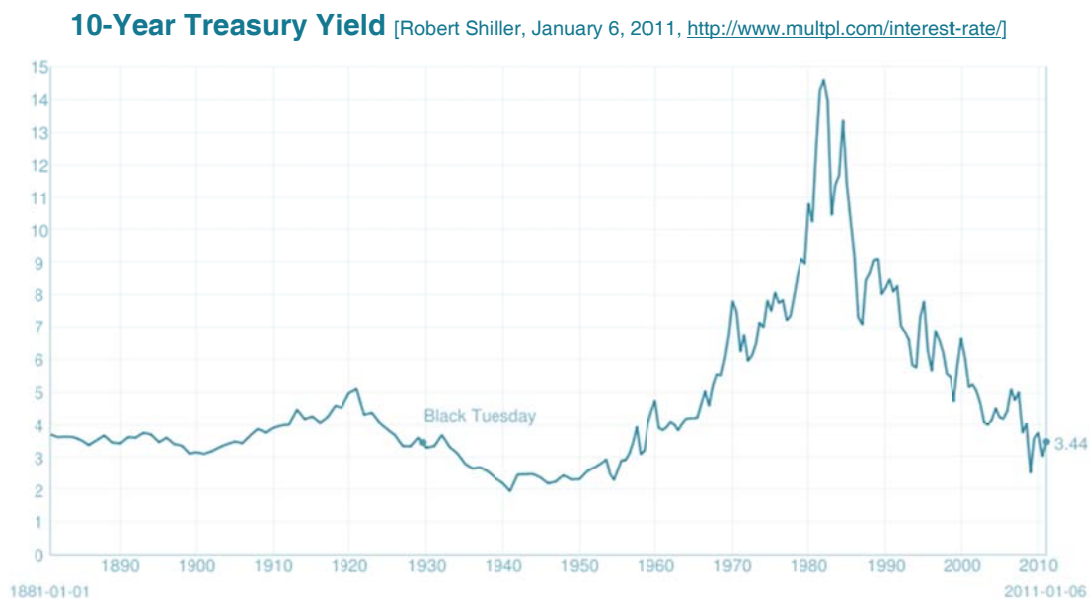
- **Disruption opportunities.** Economies are made up of shifting plates of industry, and those who identify undervalued areas poised for significant momentum – and individual companies that are positioned to benefit – will see enduring upside that thrives when the general investing population weakens.
- **Quality of Demand.** Stability and sustainability of demand are critical factors that drive opportunities. Investors must also understand the value of functional demand as it relates to supply. In the last decade,

as an example, the demand for commodities as investment products brought many outside buyers into the commodities markets, driving prices well above the rational price suggested by the functional supply and demand fundamentals in the global economy. This mispricing left investors vulnerable.

- **Debt/asset ratios.** A low debt/asset ratio is a fundamental sign of a strong balance sheet, and in a deleveraging environment (such as that of 2009) it is a critical component to sustainability. There is a true competitive advantage to having actual liquidity at hand; it provides management with the flexibility to keep their options open, to pursue opportunities that may benefit shareholders, and to grow market share when overleveraged competitors are weakened by a lack of accessible capital.
- **Dividend growth.** Management that gives back to its investors with consistent increases in dividend returns demonstrates a long term commitment to the enterprise, and invites shareholders to remain dedicated.

Looking Ahead

Never has it been more important for investors to return to these fundamental building blocks, because the era of easy credit is likely over. As it was during the Great Depression and World War II, the yield on a 10-year Treasury is again at emergency lows. Following these two challenging times in our nation's history, interest rates moved up dramatically for thirty years. Whether it comes from the debasing of currency, or from an acceleration of inflation, or simply from normalization, interest rates are likely to increase in the coming years.

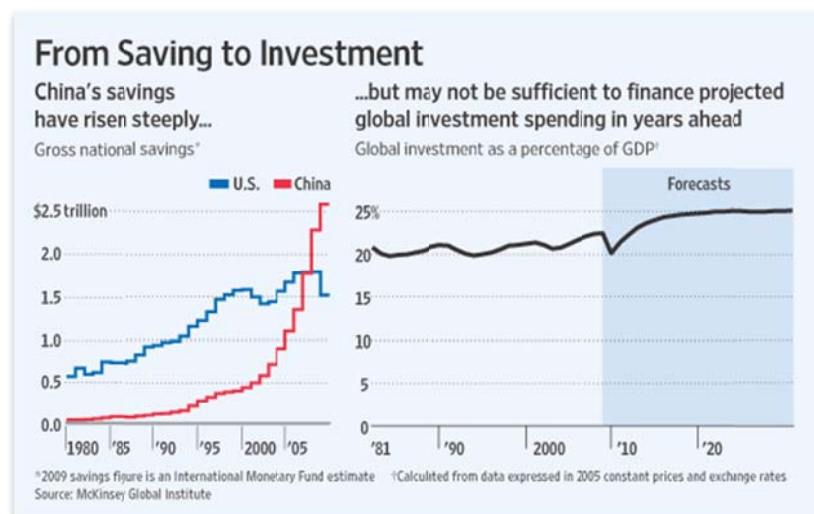


In a recent report entitled “Farewell to Cheap Capital,” the McKinsey Global Institute argues that interest rate increases may be structurally hard-coded into the future global economy. In the paper, McKinsey warns that businesses, banks, consumers, and investors will “all have to adapt to a world in which capital is more costly and less plentiful, and where over half of the world’s savings and investment occurs in the emerging markets,”^{iv} particularly in China.

China’s savings have been prodigious over the last two decades, and as these savings have been invested around the world they have exerted extraordinary negative pressure on interest rates. As their economy

grows and becomes more consumer based, however, a surge in business capital spending is likely in China and in other emerging economies.

As they build themselves up, savings in these economies will be more directed toward internal investments.



McKinsey projects global investment – which amounted to slightly more than 22% of world output before the financial crisis – could reach nearly 25% by the end of this decade. As capital flows turn inward in China and other emerging economies there will be less available for investments in developed nations.

Without significant savings advances in the developed world, the savings glut could easily become a savings dearth. Should

that happen, interest rates would rise substantially around the world. Higher rates would make leveraged investments less attractive, and could lower returns on both traditional and alternative investments.

With these shifts looming, the path for investors is likely to be substantially different from the terrain we have traveled in our recent U.S. history. The risks that presented themselves through an era of easy credit will not be the risks we face over a long period of tightening, recovery, and reconstruction. Growth themes that can blossom and advance through this more difficult environment may prove to be particularly powerful, but with the significant headwinds of de-leveraging and rising interest rates, there will be fewer winning investment opportunities.

As the world anticipates the next wave of growth, investors must recalibrate their approach to recognize the significant change in landscape that is coming. Wide exposure across a range of higher-risk assets may well hurt investors more than it helps them. With that in mind, the time is right to begin examining strategy and considering risk allocation.

Intelligent diversification and investment quality should never again be separated. That slope, we know, is a slippery one.

About the Authors

Charlton Reynders, III, Chairman and CEO of Reynders, McVeigh Capital Management, has more than 15 years of experience in investment management and social venture investing. His passion for forward-thinking investment strategy rooted in fundamentals has provided a guidepost for his success to date.

In addition to his leadership in the traditional investment management world, Chat has structured and funded public/private partnerships that have brought more than \$150 million in revenues to leading cultural institutions around the world – projects that have won numerous awards. In this vein, he has for decades produced socially-oriented IMAX films including *Dolphins*, which was produced in conjunction with the National Wildlife Federation and garnered an Academy Award nomination in 2000, and *Coral Reef Adventure*, which received the largest grant in the history of the Informal Science Division of the National Science Foundation. He currently sits on the Advisory Boards of Project Adventure and the MacGillivray Freeman Educational Foundation.

Patrick McVeigh, President and Chief Investment Officer of Reynders, McVeigh Capital Management, is widely recognized as a pioneer in bringing traditional investment management together with socially progressive investing. He was one of three original employees at Trillium Asset Management; his research was key to asset growth from startup to \$700 million.

A voice of reason and leadership within the socially responsible investing realm, Patrick has served as Managing Editor of *Investing for a Better World*, authored numerous articles on ethics and ecology, and contributed chapters to *The Social Investment Almanac* (New York: Henry Holt, 1992) and *Working Capital: The Power of Labor's Pensions* (Cornell University Press, 2001).

Since 1995, Patrick has been project manager for a series of groundbreaking studies conducted by the Social Investment Forum, tracking the growth of socially responsible investing and its implications in the investment markets. He also served on the boards of SEED: The Haitian Community Loan Fund, directing approximately \$1 million to peasant cooperatives in Haiti to create businesses; the Social Investment Forum; and the San Jose Food Co-operative.

Endnotes

ⁱ Spring 2006 Strategy Update, Richard Bernstein, Merrill Lynch

ⁱⁱ Spring 2006 Strategy Update, Richard Bernstein, Merrill Lynch

ⁱⁱⁱ Finding Safety in Intelligent Diversification, Chat Reynders and Patrick McVeigh, 2009,

http://www.reyndersmcveighresearch.com/index_files/Finding%20Safety%20in%20Intelligent%20Diversification.pdf

^{iv} Farewell to cheap capital? The implications of long-term shifts in global investment and saving, McKinsey Global Institute, December 2010, http://www.mckinsey.com/mgi/publications/farewell_cheap_capital/pdfs/MGI_Farewell_to_cheap_capital_full_report.pdf