

Diversification beyond traditional domestic stock and bond funds is necessary to achieve optimal return/risk performance.



Conclusions

ENDOWMENT MANAGERS and fiduciaries should draw at least three conclusions from the information and analysis presented in this issue.

First, diversification beyond traditional domestic stock and bond funds is necessary to achieve optimal return/risk performance. Even if you disagree with the outlooks for individual assets presented here, domestic stocks and bonds are not sufficient for the best portfolio performance. If you don't look any further than these categories, you will not be serving your organization's mission as it deserves.

Consider the traditional 65/35 asset allocation. Endowment and foundation assets that are allocated according to the traditional formula of 65% in domestic equities and 35% in domestic bonds are likely to produce poor returns on both an absolute and a risk-adjusted basis. According to our outlook, the expected return for the traditional allocation is 8.3% with a 14.3% standard deviation! Figure C.1 shows how far this return/risk point is from the efficient frontiers for both narrowly and broadly diversified portfolios constructed according to the rules as described in the section on the optimally risky portfolio but excluding venture capital. The traditional allocation provides too little return for the risk and too much risk for the return. (For the traditional allocation we allocate 40% to large-cap stocks, 25% to small-cap stocks, 20% to corporate bonds, 10% to intermediate-term government bonds, and 5% to long-term government bonds).

The second conclusion is that average portfolio returns are likely to be less than 10% per year over the next three to five years, and are unlikely to exceed 12% per year even with the assumption of substantial risk. Institutions and organizations whose spending policies are much in excess of 4% per year, therefore, may see limited growth in their endowed assets without additional contributions.

Third, prudent asset allocation requires knowing your risk tolerance. Although one can argue that all permanent endowments should have similar risk tolerances because they are perpetual, the fact is that permanently endowed institutions face different financial and mission challenges, and these different challenges affect their risk tolerances. But how do you measure your risk tolerance? How do you decide where you should be situated on the efficient frontier? Not by the individual opinions of members of your finance or investment committee! Institutional risk tolerances should be determined in a systematic fashion that takes into account the near- and long-term resources and needs of the institution. It should be a process that yields a quantitative measure not just a vague sense of what is and is not acceptable. We take up this topic in the next issue.

EFFICIENT FRONTIERS COMPARED TO TRADITIONAL 65/35 ALLOCATION

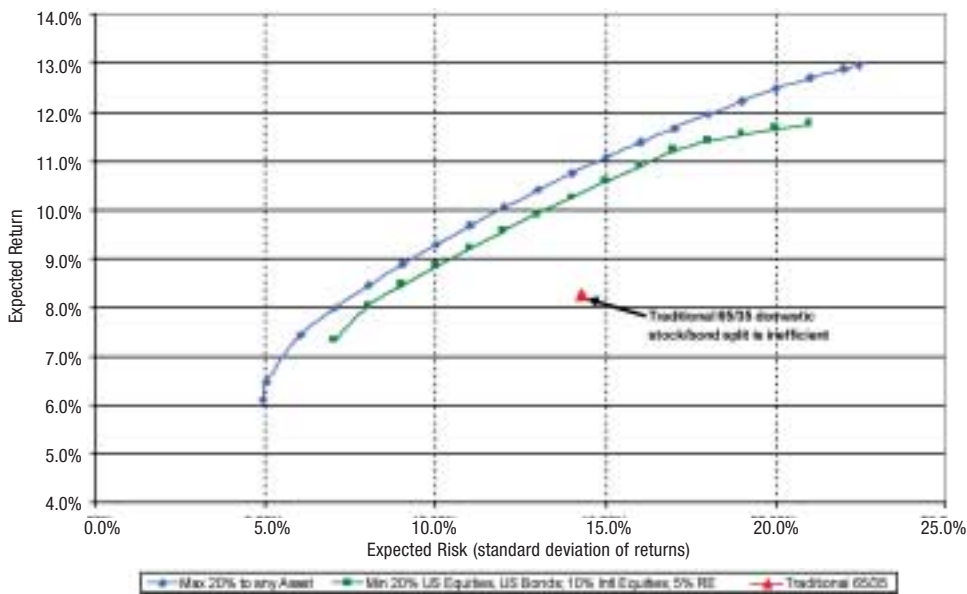


Figure C.1: Comparison of Expected Return/Risk for Traditional 65/35 Asset Allocation to Efficient Frontiers for Narrowly and Broadly Diversified Portfolios

Source: Advisor calculations