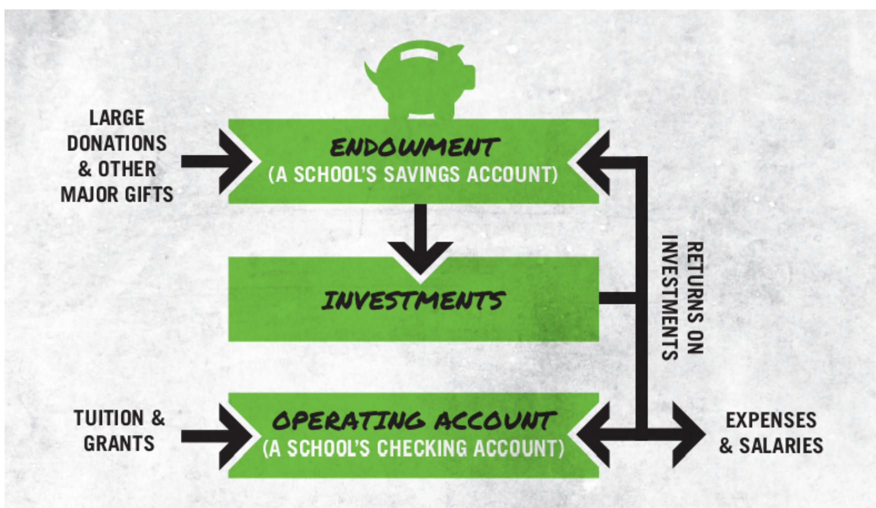
RESPONSIBLE ENDOWMENTS COALITION

Endowment 101: A Play in Three Parts

Part I: What is an endowment?

Most schools have two pots of money: a **general operating account** and an **endowment.** To understand the difference between these two pots of money, it is useful to think of your university as a person with two different bank accounts: a checking account and a savings account.

You likely use your checking account on a regular basis, to cover normal expenses such as food, clothing, and transportation. Similarly, your university uses its operating account to run the daily operations of the university: to pay its faculty and staff, to fund the dining system, and to keep its grounds in good condition. While your checking account is likely built up through paychecks you deposit, a school's operating account is built up through tuition payments.



The endowment, on the other hand, is analogous to your personal savings account. You probably do not withdraw money from your savings account on a daily basis. Savings accounts are often built up slowly and the money in them is generally intended for long-term use such as paying for college or a mortgage on a house.

Because you do not withdraw money from your savings account frequently, the money in your savings account accumulates **interest** over time.The endowment is built up slowly through donations from alumni and other supporters of the institution. This is called the **principal**.

The principal is not used for day-to-day affairs. Rather, just as your savings account earns interest, the principal is invested and generates **returns**. Most of these returns circulate back into the endowment, though a small portion of them is transferred to the operating account.

Generally, colleges and universities spend around **5%** of these returns. The size of the endowment varies substantially from school to school. More established and bigger universities generally have larger endowments. Even though the size of the endowment doesn't necessarily impact the day-to-day affairs of the school, administrators often see the endowment as a proxy for the prestige of the school. The size of the endowment often plays a large part in influential rankings, such as the *US News* and *World Report.*

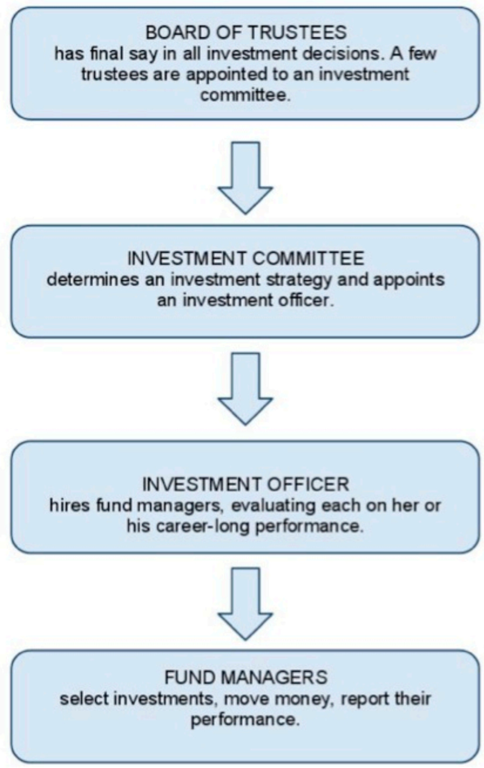
Part II: Who Controls the Endowment?

Understanding who controls your school's endowment is often difficult. It can often seem as if there are multiple layers of control, making it difficult to find one target with decision-making power.

It is very important, however, to find the **one person** with the ultimate power over your endowment. It is much easier to place pressure on one person than it is on a group of people.

While the exact control structure of the endowment varies from school to school, the **Chief Investment Officer** (sometimes called the Vice Chancellor of Finance or the Executive Vice President) is often the person who makes decisions about the endowment.

The Board of Trustees is a group of influential alumni, many of whom have backgrounds in higher education and/or finance. They are not paid for their work, but they are held accountable by their **fiduciary responsibility** to the college. This means that they are legally bound to act in the best interest of the college, though this can mean different things for different trustees.



There is often a subcommittee of the board, called the **investment committee**. They decide on a long-term investment strategy for the endowment, though not specific investments. Whether or not your ultimate target is a trustee, you can often leverage control over an influential member of the investment committee to have them place pressure on your target for you.

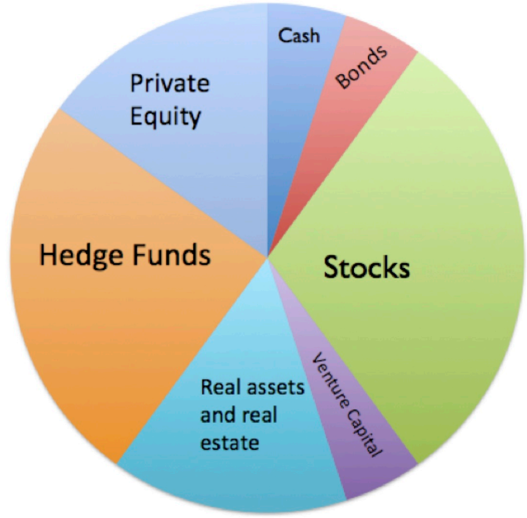
The board of trustees hires an **investment officer**. The investment officer takes the broad investment strategy of the board and makes decisions on individual investments. Often, the investment officer outsources the actual management of the endowment to various private firms.

However, this means that ***the investment officer has the most direct and immediate control over the actual investment of your school's endowment***.

The investment officer is paid and is often more accessible to students than trustees, because they generally works on campus.

The balance of power between the board and the investment officer differs among schools depending on a number of factors, including whether your school is public or private, its size, and the power of alumni. It is crucial to single out one target. You can use other trustees and/or your CIO as secondary targets to help you place more pressure on your ultimate target.

Part III: How is the Endowment Invested?



Endowments are generally invested in a range of **asset classes** in order to minimize investment risk and maximize investment returns. In the same way that many students apply to “safety schools” and “reach schools,” hoping for the best but hedging with the rest, universities hold different kinds of assets in case one asset or group of assets underperforms.

Colleges and universities are experts at what is called “diversifying risk.” When a school diversifies risk, it puts money in a variety of different asset classes, each with a different amount of risk attached to them. Institutions hire fund managers as specialists to pick the best bets. Though the risk profile of any particular fund manager may be relatively narrow, together the endowment is spread across many different financial instruments to achieve a mix of assets.

Typically, greater potential returns come with more risk, whereas low returns can be achieved with very low risk. Treasury bonds, for example, are backed by government assurances and are therefore a very safe investment, but their low risk comes at a price: a very low return.

The way your endowment is invested shapes how you ask your school to engage in responsible investing. The investment profile of your endowment can therefore determine what sort of campaign will be most successful on your campus. Though there are many different asset classes, it is important to note that your campaign will probably target only one specific sector of the endowment to start with. For example, if you are working on shareholder advocacy, you may only be interested in stocks. If you are working on community investment, you may only be interested in cash or bonds.

Asset Classes:

Cash: Schools keep cash in both the endowment and the operating account. The cash in the endowment is kept there for liquidity and emergency situations. It is typically a very small percentage of the endowment, because keeping cash in a bank does not produce high returns.

Bonds: Money lenders profit by lending money and getting it back with interest. When you buy a bond, you are lending money, and you are going to profit by having the bond paid back with interest. How risky they are depends on who is issuing the bond, but they are generally lower risk.

Bonds can be issued by companies, governments, banks or even non-profits. Bonds can have a fixed or variable rate of return, no matter who issues them. Some, however, are more secure than others depending on who is backing them, so they are rated by risk, and bonds that are more risky pay higher rates. (You may have heard of bond ratings like AAA, BBB, etc.) Other factors, like changes in interest rates, also contribute to the risk of bonds. Similar to a mutual fund for stocks, you can also buy funds that bring together lots of different bonds.

Stocks: Corporations need money to grow, and many medium and large firms get it by issuing stock. Because they let the general public buy a bit of their company, stocks are sometimes called public equity, and when a company's stock is first sold it's called an "Initial Public Offering." Shareholders have limited ownership rights, and stand last in line to be paid, but once all suppliers, taxes, employees, and debts have been paid, shareholders often receive a dividend, or a portion of the firm's profit. Investors profit from the distribution of these dividends, and also increases in share price.
The returns on an investment come through the appreciation of a share price or through the dividend paid to the shareholders. As a company becomes more profitable, each share becomes more valuable, and hence investors make money (or lose money if the value goes down).

Assets and Real Estate: Real assets are things that you can touch, be it timber, gold, buildings, or land.

Mutual Funds: A mutual fund is simply a collection of stocks and bonds. A mutual fund manager mingles money from various people and companies and invests them in a mixture of stocks and bonds, thereby diversifying risk. Any person or company can invest in a mutual fund.

Private Equity: Every company begins as a private organization owned by one or a few investors. To grow, these companies need more capital. One way to get more capital is to sell stock, but for some firms the burdens of listing on the public stock market are undesirable (sometimes they don't want to hold meetings that activists like us would attend). Private equity firms provide an alternative by purchasing companies outright. Though there are exceptions, most private equity firms have a small group of investors and tend to be relatively secretive.

This is partially by design. Private equity firms share a characteristic with the companies that they acquire: they want to avoid the regulatory burden of public listing. Firms can avoid regulation by keeping their investor pool small. However, the private equity boom seems to have peaked.

Some private equity firms have made enemies in the labor community by laying off workers and drastically changing the benefit structures of acquired firms. Depending on the strategy, private equity can be very high risk.

Venture Capital: A commonly used term, this is actually a sub-category of private equity and means investing in new companies or "startups" that have high growth potential. New companies fail all the time, so venture capitalists bet on the few hoping at least one will be a winner.

Hedge Funds: Hedge funds are very similar to mutual funds, though they are more exclusive and subject to less regulation, making them riskier but potentially more profitable. Furthermore, they usually require a larger investment than mutual funds and are comprised of a bigger mix of assets.
Hedge funds tie with private equity for the most contentious asset class; both have very little transparency about how they operate. While hedge funds are not secretive by definition, they are highly secretive in practice.

These funds are only open to a class of "accredited" investors, either institutions or high net worth individuals (over $1 million). They vary, but can be more risky than mainstream investment vehicles as they aim to get the highest returns. Managers focus on gaining the highest returns possible, and charge a pretty penny to do it—management fees may be as much as 50% of all profits.