Endowment Trends in Higher Education

Q&A | April 2024

To gain a better understanding of recent trends and topics being discussed around endowment management in the higher education space, we conducted the following Q&A session with Floyd Simpson III, CFA, CAIA, CFP and Mallory Sampson, CFP. Floyd is a portfolio strategist in PFM Asset Management's (PFMAM) OCIO Portfolio Strategies Group. Mallory serves as a director on PFMAM's investment advisory team and is responsible for managing a number of the firm's institutional OCIO relationships.

How would you describe the current state of the higher education industry?

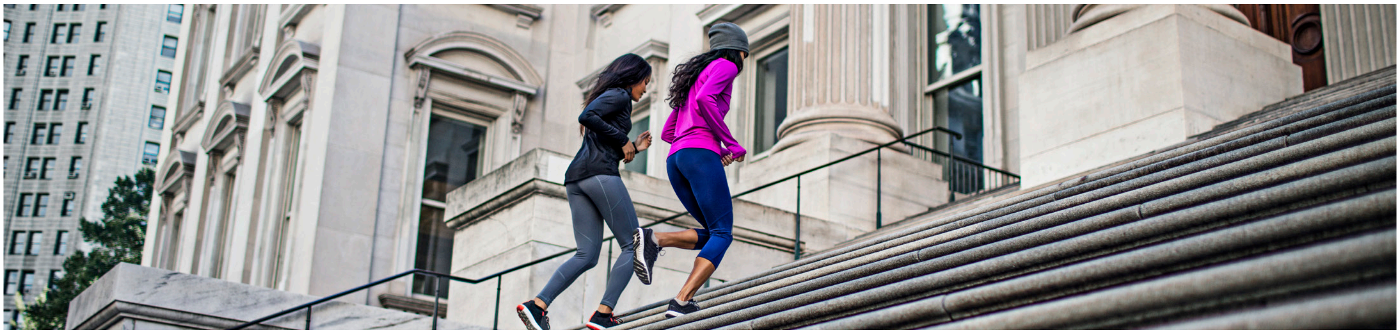
Simpson: I would describe higher education to be in a state of flux. There are several reasons for this:

Declining Enrollment: The industry has continued to face a trend of declining enrollment. One of the causes of this trend is structural, and that is the fact that population demographics have resulted in fewer aggregate college-aged students graduating from high school and matriculating to college. Other reasons for the continued decline include the rising cost of attending college. Additionally, we continue to see college-aged students electing to attend technical colleges or seek alternative certifications. This dynamic has created a host of operational challenges for colleges and universities of all sizes. For example, how does an institution make certain that they have the right infrastructure in place (e.g., buildings and classrooms) if enrollment is tenuous?

Increased Competition: Institutions once competed almost solely through differentiated academic programming and on-campus student experiences. However, advancements in technology have enabled institutions to broaden the programs they offer, enter new geographic markets, and attract a wider base of potential students. This access has created a competitive environment for colleges and universities that require them to continuously evolve and invest in their respective institutions. While many have been successful in responding to this endeavor, we have seen some colleges and universities need to close, while others have sought to consolidate operations, or in the case of some public institutions, employ the use of shared services.

Operating Costs: Colleges and universities have historically faced higher inflationary pressures related to their operations as compared to other industries. Faculty and employee salaries and benefits generally comprise a meaningful allocation of the operating budget of institutions, which has been further influenced against the backdrop of needing to retain tenured faculty while labor markets remain tight. Additionally, other factors such as investment in technology, the student experience, and more importantly, student safety, have further impacted the operating budgets of institutions.

In light of the above, and in consideration of the long-term trends of the industry, it is imperative that institutions think strategically and intentionally as to how they want to position themselves in the years to come, and what investments are required to get them there.



How have colleges/universities evolved with respect to their view on endowments?

Sampson: Historically, colleges and universities have leaned on their endowments as a strategic asset to support their institutions, most commonly for scholarships. In fact, based on the 2023 NACUBO-Commonfund Study of Endowments (NCSE), 47.7% of participating institutions' distributions were allocated to student financial aid.[1] While we don't anticipate this changing, we increasingly see a desire for institutions to have the endowment support operations in a greater way — partly given the current state of the industry as was articulated in the prior question.

It should be noted that the evolving view of looking at the endowment as a strategic asset has also led to changes in investment committee and staff composition. The core competencies and subject matter expertise of these individuals have increasingly turned to disciplines that surround endowment management, finance, investment and governance. The goal is to construct investment committees and staff who have complementary experiences to enable endowment growth through a combination of prudent investing, alumni engagement, and development.

What role do alternative investments play or what role might they play within an endowment strategy?

Sampson: Alternative investments, inclusive to hedge funds and private investments, have historically had a place in the conversation around a comprehensive endowment investment strategy. The perpetual time horizon of these portfolios allows for them to consider these types of strategies — private equity in particular. Additionally, investment return requirements may necessitate a strategic allocation to alternatives given their higher return expectations over the long-term as compared to their public market counterparts. In fact, the average fiscal year 2023 annual effective spending rate for participating institutions in the NCSE was 4.7%.[1] When we factor in long-term inflation expectations and other administrative costs, the hurdle rate for endowments may exceed 8%. When considering PFMAM's 2024 Capital Market Assumptions, the only way to achieve this investment return over the long-term requires the inclusivity of alternative investments.[2]

Critically, unlike public market investments, investing in alternative strategies requires an understanding of the risks and considerations associated with them — primarily around investment risk, underlying fees, illiquidity, and the importance of access. Anecdotally, we are having more frequent discussions with the institutions we serve around the strategic inclusion of alternatives. As an OCIO, we employ an "education first" approach to the conversations. In doing so, we seek to understand each client's need and specific situation prior to any recommendation.

Interest rates have risen in recent years. Does fixed income present an opportunity for endowment portfolios?

Simpson: Absolutely. The improved return expectation for fixed income as an asset class compared to just a few years ago makes it a far more attractive investment opportunity for endowments, particularly for those that are reaching for yield and looking to exceed a rising hurdle rate. Additionally, some may argue that with fixed income "back," endowments are able to seek more aggressive investments as part of their return-seeking allocations. That said, endowments must continue to employ a disciplined risk management process.

Inflation has been a big concern over the last few years. How should a college or university think about this when developing their long-term investment return goals?

Sampson: Given the perpetual horizon of endowments, it is imperative that inflation be considered when building an investment strategy to allow for intergenerational equity. Similar to how we think about building a strategic asset allocation for these portfolios, inflation should be viewed through a long-term lens.

1 https://www.nacubo.org/Research/2023/NACUBO-Commonfund-Study-of-Endowments.

2 Our 2024 Capital Market Assumptions are available upon request.

To be clear, short-term spikes in the consumer price index (CPI) can be concerning, but inflation has historically ebbed and flowed over time. In our view, endowments would be better served by thinking about longer-term trends, and average inflation rates over time. At PFMAM, we assume long-term inflation to be 2.5%. The recent spike of inflation may offer tactical investment opportunities for endowment portfolios in the near-term, but it does not warrant a shift to an endowment's overarching strategy.

Are there any final thoughts you'd offer to a trustee, investment committee member or college/university leadership?

Simpson: The environment of higher education is evolving quickly. We encourage clients to embrace the change and to properly adapt in ways that make sense for their institution. Lastly, lean on your strengths as an organization, talents as a team, and rely on the expertise of the advisors who support your efforts. This is imperative as every institution experiences a distinct journey—taking them from where they are today, to where they want to be. Again, PFM Asset Management stands ready and willing to assist should you have further questions.

To learn more or discuss in greater detail, please contact us:

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