The Endowment Model and the Philanthropic Taxable Investor

Background

In spite of David Swenson's advice (in essence, "Do not try this at home!")[1] and the capital market difficulties of the last three years that have brought its use into question, the endowment model continues to be promoted by some as an optimal asset allocation solution for ultra high net worth individuals. To a large extent this rests on the assumption that, given far more wealth than these individuals could ever consume, their investment time horizon is practically as long as an endowment's. Others have correctly focused on the need to factor in taxes to determine the extent to which the endowment model may be appropriate for a taxable investor.[2] This paper also addresses the need to consider the dynamic management of multiple personal objectives which require liquidity and transferability of appreciated assets to optimize tax efficiencies associated with charitable giving. These circumstances favor a more liquid, tax-managed allocation.

The Endowment Model - An Example

Broadly defined, the endowment model seeks higher investment returns over long periods of time on a more consistent basis by allocating significant portions of a portfolio to non-public, illiquid markets. Typically fixed income allocations are minimized in favor of market neutral hedge funds. In addition, long-only equity allocations are supplanted by private equity, venture capital and real asset investments. Yale University's endowment fund's well publicized approach (and, until the second half of 2008, stunning returns) is a classic example. Its most recently published target asset allocation and expected returns[3] were:

Asset Class	Target Allocation	Expected Real Return	Volatility (3)	Nominal Return (4)	Portfolio Contribution (5)
Absolute Return	19.0%	5.25%	15.0%	8.25%	1.57%
Domestic Equity	7.0%	6.0%	20.0%	9.0%	0.63%
Fixed Income	4.0%	2.0%	10.0%	5.0%	0.20%
Foreign Equity	9.0%	6.0%	20.0%	9.0%	0.57%
(incl. Emerging	up to 2.5%)	7.0%	22.5%	10.0%	0.27%
Private Equity	33.0%	10.5 %	27.7%	13.5%	4.46%
Real Assets	28.0%	6.0%	15.5%	9.0%	2.52%
				Portfolio Weighted Return	**10.21%**

(1) Swenson, David. "Unconventional Success: A Fundamental Approach to Personal Investment", Free Press, 2005, citing taxes, time horizon and limited access to the talent available to Yale.

(2) See e.g. Greycourt & Co., Inc. "White Paper No. 9 - Managing Investment Related Taxes", self published, September 2001 and Jones, Henry & Skeean, Will. "The Endowment Investment Approach: Should Wealthy Taxable Investors Replicate the Strategy?", Advisor Perspectives, Nominal returns assume 3% inflation.

(3) The Yale Endowment 2010 Yale University, New Haven: Yale UP, June 2011.

(4) Nominal returns assume 3% inflation.

(5) Assumes 25% to 50% of the Foreign Equity is Emerging Markets. Totals may not sum due to rounding.

Thanks to assumed equity-like returns from absolute return strategies with lower volatility than public equities and the benefits of broad diversification among uncorrelated asset classes, the potential for double digit returns with lower overall portfolio risk argues strongly for the use of this model for private investors, albeit with an 80% allocation to illiquid asset classes. This of course assumes such an investor has well in excess of $100 million in order to properly diversify and meet the steep minimums demanded by many of the non-public investment opportunities.

The Impact of Taxes

Taxes are one factor that the taxable investor must consider, especially in light of recent increases in state and local taxes and the prospect of rising federal rates. The potential tax impact on the Yale allocation for high net worth individuals may be:

After Tax Returns to a Taxable Investor in a High-tax State (6)

Asset Class	Nominal Return	After Tax 2011 (7)	Portfolio Contribution	After Tax 2013 (7,8)	Portfolio Contribution
Absolute Return	8.25%	5.01%	0.95%	4.37%	0.83%
Domestic Equity	9.0%	6.75%	0.47%	6.05%	0.42%
Fixed Income	5.0%	3.75%	0.15%	3.75%	0.15%
Foreign Equity	9.0%	6.76%	0.43%	6.06%	0.38%
(incl. Emerging)	10.0%	7.15%	0.19%	6.37%	0.17%
Private Equity	13.5%	10.32%	3.41%	9.26%	3.06%
Real Assets	9.0%	6.88%	1.93%	6.17%	1.73%
		Total	**7.53%**	**Total**	**6.74%**

The Competing Goals and Liquidity Needs of the Wealthy

Taxes aside, ultra high net worth investors tend to have complex finances with sometimes competing objectives. Personal income tax management, tax efficient philanthropy and wealth transfer goals must be flexibly balanced with cash flow needs and availability. In tough economic times, philanthropic investors may be challenged to meet their charitable goals - while at the same time, their favorite charities can ill afford reduced contributions.

For many high net worth individuals, cash flow from a closely held business, a concentrated stock portfolio or intellectual property can be unpredictable. This is particularly the case in stressful economic times. For example, the recent credit crisis has resulted in companies seeking to retain funds - some privately held businesses are hoarding cash rather than distributing it to family shareholders and a number of public companies have cut dividends.

Simultaneously, depressed valuations and historically low interest rates have motivated many wealthy families to transfer cash-generating assets to GRATs and other wealth transfer vehicles - devices in which they part with the cash flow from the investment but retain the annual cost of income taxes on that cash flow.

If the high net worth investor wants to minimize the impact of these factors on philanthropic activities, they must resort to unexpected partial liquidations of investments, placing significant pressure on portfolio management if only a minority of the assets held are easily liquidated.

(6) *This table assumes a 12.6% state and local income tax rate, dropping to 10.6% in 2013.*

(7) *After-tax returns assume:*
Absolute Return generates 80% short-term capital gains (STCG) and interest and 20% long-term capital gains (LTCG) and qualified dividends (QD).
Fixed Income generates tax exempt income at 75% of the assumed Treasury return.
Domestic Equity generates a 2.4% QD and 10% of the remaining return is STCG, 90% LTCG.
Foreign Equity generates a 2.9% QD (1.6% for Emerging Markets) with 10% of the remaining return as STCG, 90% LTCG.
Private Equity and Real Assets are 100% LTCG.

(8) *After-Tax returns in 2013 assume a return to a marginal 39.6% federal rate on ordinary income, 20% on long-term capital gains and qualified dividends, the 3.8% Hospital Insurance tax and a return to the 3% "Clawback" on itemized deductions.*

Appropriate Assets for Philanthropic Funding

If liquidity is constrained due to reduced distributions or wealth transfer strategies, there may be a need to fund charitable foundations and/or other publicly supported organizations (including donor advised charitable funds) with property other than cash. One of the most powerful tools available to philanthropists is the ability to contribute qualified appreciated securities (held for more than one year) to their private foundations or other charitable organizations resulting in a charitable deduction equal to the fair market value (FMV) on the date of contribution while not being subject to tax on any portion of the unrealized appreciation. In general, qualified appreciated securities are stock in a corporation that is capital gain property and for which market quotations are readily available on an established securities market on the day of the contribution.

In the endowment model shown earlier, 80% of the portfolio is in non-public investments, which are less suitable for distribution in kind. Contributing non-public interests in hedge funds and/or private equity typically requires the recipient to be a "qualified purchaser". Many private foundations may not have the requisite $25 million of investable assets to meet that standard. Most donor advised charitable funds will not accept any of the illiquid assets in the model above under their current rules, unless an acceptable near-term exit strategy exists.

Even if permitted, such contributions to the family foundation lessen the potential tax benefits for the philanthropist. Under current law, the amount of the deduction allowed for a gift of a partnership interest in a hedge fund or private equity fund to a private non-operating foundation is limited to the lesser of the taxpayer's cost basis or the FMV on the date of the contribution.

In addition to the deduction limitations, the gift of domestic hedge fund interests and many private equity and real asset interests to private foundations can carry other costs related to inherent tax implications. There are requirements for independent appraisals and the unrelated business income tax (UBIT) may apply. Generally this would strongly motivate the foundation to liquidate such a holding as early as possible. However the foundation could then face the issues we have seen recently of lock-ups, "gates" and potential distributions of illiquid assets in separate accounts.

A Reasonable Alternative

Increasing the public market portion of the taxable investor's asset allocation can be accomplished with modest impact. Consider the following model with 75% in readily marketable holdings:

The Tax Managed Target Allocation

Asset Class	Target Allocation	Expected Real Return	Volatility	Nominal Return [4]	Portfolio Contribution [5]
Absolute Return	10.0%	5.25%	15.0%	8.25%	0.83%
Domestic Equity	40.0%	6.0%	20.0%	9.0%	3.60%
Fixed Income	20.0%	2.0%	10.0%	5.0%	1.00%
Foreign Equity	15.0%	6.0%	20.0%	9.0%	0.68%
(incl. Emerging	up to 7.5%)	7.0%	22.5%	10.0%	0.75%
Private Equity	10.0%	10.5%	27.7%	13.5%	1.35%
Real Assets	5.0%	6.0%	15.5%	9.0%	0.45%
				Portfolio Weighted Return	**8.65%**

At first blush, this would appear to cost the philanthropic investor about 156 basis points in total return. However, by tax managing a large portion of the domestic equity through continual tax loss harvesting and donating significant portions of appreciated long-term capital gain securities from both the domestic and foreign equity allocations to meet philanthropic goals[9], the after-tax returns can actually equal or exceed those of the endowment model.

Generating short-term capital losses of 10% per year on the domestic equity portfolio could offset 37% of the assumed short-term gains on the absolute return allocation, effectively increasing that component's after-tax return by 105 basis points. Donating most of the long-term capital gains from the equity portfolios to charitable vehicles could similarly enhance their after-tax returns.

After Tax Returns of the Tax Managed Allocation

Asset Class	Nominal Return	After Tax 2011 (7,10)	Portfolio Contribution	After Tax 2013 (7,8,10)	Portfolio Contribution
Absolute Return	8.25%	6.06%	0.61%	5.60%	0.56%
Domestic Equity	9.0%	8.28%	3.31%	8.04%	3.22%
Fixed Income	5.0%	3.75%	0.75%	3.75%	0.75%
Foreign Equity	9.0%	7.48%	0.56%	7.01%	0.53%
(incl. Emerging)	10.0%	7.74%	0.58%	7.16%	0.54%
Private Equity	13.5%	10.32%	1.03%	9.26%	0.93%
Real Assets	9.0%	6.88%	0.34%	6.17%	0.31%
		Total	**7.19%**	**Total**	**6.82%**

A drop of 55% in the allocation to the illiquid asset classes that have offered important diversification benefits is significant. However, a recent study of the impact of a 40% difference between 2003 and 2007 (good years for alternatives) suggested that there was almost no difference in overall volatility and 94% of such a portfolio's return was explained by the performance of domestic equities [11].

Conclusion

The ultra high net worth philanthropist faces competing goals in an unpredictable world. Meeting significant charitable goals efficiently creates a disproportionate need for the characteristics inherent in liquid, public securities. Increasing the allocation to liquid asset classes from 20% to 75% on a tax managed basis can generate comparable returns to the endowment model after taxes while maintaining the flexibility needed to handle cash flow interruptions and the relentless pace of change in markets, tax regimens and personal goals.

For additional information on this topic, please contact Jon Persson or Susan Sofronas at 212.583.6001

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(9) For further insights into this "tax alpha", see Longmeier, Geoff and Wotherspoon, Gordon. "The Value of Tax Efficient Investments", The Journal of Wealth Management, Summer 2006.
(10) The Domestic Equity return assumes a 2.4% QD and the remaining return taxed 10% as a short-term capital loss and 10% LTCG with the remaining unrealized LTCG contributed to charitable entities. The Foreign and Emerging Markets return assume the recognized LTCG will drop to 40% due to more limited charitable contributions of appreciated securities from those accounts.
(11) Martin Leibowitz's study as reported in "We now know why investing like Yale isn't easy", The Financial Times, October 28, 2008.

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