The Arts Outperform, Hospitals Lag: Nonprofit Returns Vary by Sector

By Aziza Kasumov June 2, 2020

The network of nonprofit endowments in the U.S. is vast and incredibly heterogenous, but organizations don't just differ by the causes they support. Endowments in certain sectors are also more likely to out- or underperform peers of similar size focusing on other issues, researchers at the Massachusetts Institute of Technology (MIT) and the **University of Illinois at Urbana-Champaign** (UIUC) found.

Nonprofits supporting the arts, for instance, outperformed similar-sized peers from other sectors on average annual net investment returns by 0.88% when weighted by value, and by 0.35% when equally weighted. For the latter, researchers weighted all return datapoints of similar-sized peer institutions equally, whereas the value-calculation took the asset size into consideration, effectively giving more weight to the largest institutions among similar-sized group comparisons.

Institutions supporting public and societal benefit, and those supporting the environment, also had higher size-adjusted, average annual returns. Hospitals, health-focused nonprofits, and those supporting international causes had among the worst returns, both in absolute and in a size-adjusted relative returns compared to other sectors.

"It's a significant finding," says **Egor Matveyev**, a visiting assistant professor of finance at MIT's **Sloan School of Management**, and one of the researchers for the study. "Why is it that, on average, when you compare to your same-sized peers, … an arts organization can earn a higher return, and you as a health care [organization] or hospital can't?"

Together with **Andrew W. Lo**, also from Sloan, and **Stefan Zeume**, of UIUC, Matveyev collected tax return data from more than 300,000 nonprofits in the U.S. from 2009 to 2017 for the analysis, which was published in April. As of 2017, close to 35,000 of those nonprofits had endowment funds, totaling $800 billion in assets under management.

For their study, the researchers also looked at nonprofit characteristics that were associated positively with strong returns across the board, regardless of sector. The analysis showed that lower investment management fees, higher-paid executives, lower

Bad Health?

Across nonprofit sectors, the endowments of health and hospital groups are among the worst performers, even on a size-adjusted basis.

Nonprofit sector	Number of orgs with endowments	Total endowment assets in sector (in billions)	Net annual investment return	Size-adjusted outperformance (value-weighted)	Size-adjusted outperformance (equally weighted)
Higher education	1,229	$252.9	6.83%	-0.35%	0.08%
Education	5,284	$21.0	5.26%	0.52%	0.09%
Arts	3,934	$10.1	5.15%	0.88%	0.37%
Public & societal benefit	3,418	$13.4	5.03%	0.76%	0.21%
Environment	1,586	$5.3	4.89%	0.87%	0.27%
Other	4,640	$16.5	4.79%	1.58%	-0.36%
Human services	8,037	$3.5	4.75%	0.70%	0.16%
Religion	773	$3.3	4.46%	0.58%	-0.03%
Mutual benefit	50	$5.8	4.36%	0.05%	-0.38%
Health	4,141	$6.8	4.28%	0.01%	-0.48%
International	467	$20.3	4.25%	0.01%	-0.53%
Hospitals	1,218	$37.7	4.09%	-1.11%	-1.21%

Note: Data collected between 2009 and 2017
Source: "The Risk, Reward, and Asset Allocation of Nonprofit Endowment Funds," by Andrew W. Lo, MIT; Egor Matveyev, MIT; Stefan Zeume, UIUC; April 2020

discretionary spending, and good governance were positively associated with strong returns. Having a dedicated CIO, however, was not associated with outperformance; neither was that CIO's compensation.

The researchers were careful to note that the findings don't say whether bad relative performers such as hospital endowments have better governance or not. Matveyev added that it's also not clear from the research whether it's good governance that is actually causing the better returns because correlation doesn't mean causation.

Consultants working with hospital clients note that asset allocation decisions, and how integrated endowment funds are in the financial workings of an organization, could be at the heart of the comparatively lower returns.

Hospitals, for instance, have a lower risk tolerance than more traditional private foundations, says **Eric Ralph**, a senior consultant at **Highland Associates**. "How does that transfer into returns and allocations? You have less equities in the allocation, that's both public and private allocations," he says. Between 2009 and 2017, portfolios with relatively smaller equity positions would have had lower returns because of the bull market, Ralph says.

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Ralph also notes that hospitals often have less assets in illiquid instruments – which tend to produce higher returns – because these institutions frequently issue debt and could thus have restrictions on accessibility of capital imposed by rating agencies. He adds that since the beginning of the coronavirus crisis, which

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sent some hospitals and health care systems sliding into financial crisis mode, the additional liquidity some organizations have through their endowment funds could be helpful in bridging revenue shortfalls.

The crisis potentially strengthened another one of the trends outlined in the MIT study: Good governance being positively associated with higher returns.

"Good governance means that when you hit the crisis, you can deal with the threats and capture the opportunities," says **Rich Nuzum**, president of Mercer's wealth business. The investment consulting giant recently outlined governance guidelines for investors during a crisis, including a regular review of liquidity needs, assessing asset allocation boundaries, stakeholder needs, and opportunistic investments.

MIT and UIUC researchers measured good governance by the presence of independent boards, less discretionary spending on travel and the likes, and the ratio of overall executive pay going to the CEO – all aspects that can be calculated based on tax returns. Mercer's governance recommendations, on the other hand, focus more on the investment program's oversight specifically.

But Nuzum says strong guidelines in place within the program itself would've positioned asset owners to capture higher returns now, too.

Organizations with good governance, for instance, would've set a bucket of their assets aside throughout the bull market to tap into opportunistic investments during the market meltdown, as well as having ensured access to dry powder, Nuzum says. In addition, the vast majority of asset owners who stuck largely to their asset allocation guidelines and rebalanced accordingly "would be better off than if they hadn't," Nuzum adds.

Going forward, good governance might become even more important.

"We should know by now that crises are going to happen more frequently than statistical models predict, and they're opportunities," says Nuzum.

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