Institutional Investor

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What Drives Outperformance at Endowments & Foundations

Size matters — but having a dedicated CIO doesn't, academic research shows.

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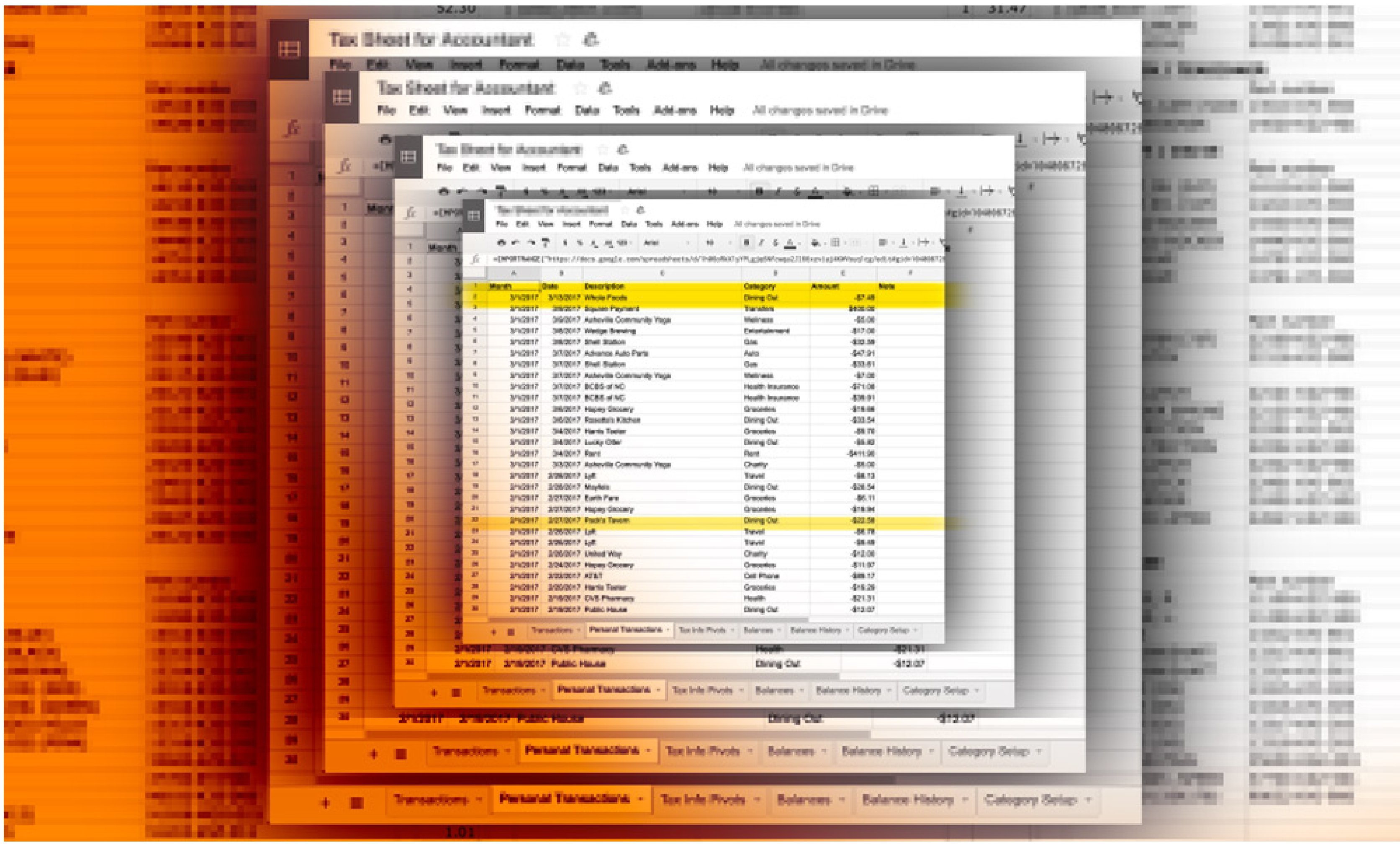

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How important is it for endowments to have a chief investment officer? Not very, according to new research from the Massachusetts Institute of Technology and University of Illinois.

The study, which examined characteristics linked to higher returns at nonprofit endowment funds, found no "systematic evidence" that funds with dedicated CIOs perform any better than endowments without dedicated CIOs. Furthermore, compensation for CIOs was found unrelated to returns, according to authors Andrew Lo and Egor Matveyev of MIT and Stefan Zeume, a business school professor at the University of Illinois at Urbana-Champaign.

What does matter then? According to the study: Size. The authors found that endowment funds larger than $100 million on average delivered net annual returns of 7.6 percent, while the average sub-$1 million fund earned 3.8 percent annually. This discrepancy was mostly, if not entirely, driven by asset allocation decisions: Larger endowments and foundations tend to invest more in riskier, higher-returning assets.

While size could explain a lot of the disparity in investment returns among nonprofits — including the tendency of university endowments to outperform — it was not the only factor driving performance, the researchers found.

Using data compiled from tax forms filed by U.S. nonprofits between 2009 and 2017, the trio determined that other characteristics including expenses and governance structures might also impact investment outcomes.

For example, independent boards were linked to higher returns, while higher administrative and travel expenses were associated with worse performance. “Higher administrative expenses in the nonprofit sector is usually interpreted as an indication of wasteful spending,” the authors noted.

Even though CIO pay didn’t appear to impact investment performance, compensation for nonprofit CEOs, officers, and directors all had a “strong,” positive correlation with endowment returns, according to the study. “A more highly compensated CEO may indicate greater centralization of the decision-making process at the organization,” the authors suggested.

Nonprofits that managed investments internally tended to perform slightly worse than organizations that hired external managers. However, the benefits of using external advisors varied depending on how expensive they were: A one percent increase in fees resulted in a 0.17 percent decline in net returns, according to the study.

Even controlling for size, the authors found that certain categories of nonprofits tended to be better at investing endowment funds than others. Health care and hospital funds, for example, were the worst performing on average. The best performers, meanwhile, were foundations focused on the arts, the environment, and human services.

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