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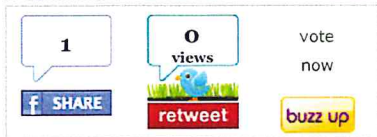
The Financial Crisis Is Not Over Yet for America's Top Colleges and Universities

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We may have financial regulation pending, and we may have stopped the death spiral in the markets, but the aftermath of the 2008 crisis has left many institutions on which America's intellectual capital depends at high risk. Here's why.

For the last 30 years, long-term investment pools have been seeking ways to diversify the volatility in their equity and fixed income portfolios without sacrificing return, the last so-called free lunch. Unfortunately, diversifying portfolio risk has proved far from simple. Financial assets are leashed to each other like dogs to their owners, and the leash that ties together all financial assets

is money. Once that money leash is attached to an asset in the form of a price at which the asset is bought or sold, whatever happens to one asset has a way of affecting all other assets. In short, they become correlated. These correlations are not stable. They change with the state of the world, and they are even less predictable with assets that are illiquid.

Over the last 10 years and more, US university endowments, encouraged by the exceptionally stable and attractive returns achieved by the likes of Yale and Harvard, have increasingly loaded their portfolios with illiquid assets. Like bees to nectar, they were attracted by the sweetness of high returns with low apparent volatility. It seemed easy to buy the argument that private equity

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firms were generally more efficacious investors than institutional asset managers that invested in public companies. They could be more innovative, more prone to restructuring weak management teams and to shedding unproductive operations. They could re-align their product lines without the tyranny of regularly increasing quarterly earnings and without the threat of dismantling their longer-term objectives by short-sighted hostile takeovers, and they could use leverage to boost returns without having to deal with dividend demands or earnings volatility. Once the private firms were configured for sustainably high growth rates, they could go public and realize an attractive exit multiple for investors.

What was there not to like about this free lunch of high returns and low mark-to-market price volatility? As it turns out, plenty. Allocations to less liquid investments in private equities, venture capital, timberland, real estate, natural resources, hedge funds and many other illiquid ventures started at 10% of total assets two decades ago and with the success of the "endowment model" rose to much more than 50% of total assets in many cases. Worse still, to maintain the allocation at such a high level of assets, commitments to new funds, which took a number of years to be called, reached a number as high as the already disbursed amounts -- sometimes higher. It was a form of leverage not even remotely perceived as leverage, because there was no loan document involved. But in a way, endowments were "borrowing" against current illiquid allocations to commit to future callable allocations.

Lost in this perfect synchronicity of endowment group behavior were voices of reason, pointing to the risks in the model, should extreme illiquidity events hit capital markets. Lost was an understanding that 1% or 5% probability events cannot be forecast. If they could, they would not be such low probability events. They strike like lightning, many times without the ex-ante benefit of distant thunder. Lost was the understanding that commitments to any portfolio model assume the ability to rebalance the mix of assets under extreme circumstances. Lost too was the fact that asset-owners can become hostage to the amount of assets that can be called away by strangers to their needs, in this case the private partnerships to which funding promises have been made. This is not very different from being hostage to the call of a loan when one can least afford to pay it.

Some of us saw this risk clearly and, against the grain, decided to stop short of joining the chorus line of diversification into illiquid assets past the point of prudence. We also stopped short of quieting the noise of volatility in the portfolio at the price of losing management flexibility. Liquid assets are noisy, but the noisiness allows you to buy them back at cheaper prices after markets collapse. Protecting a portfolio is not just tempering downside volatility; it is also having enough flexibility to re-invest in cheap assets to benefit when prices return to more normal levels. You cannot do that with illiquid assets, regardless of their nature or the ex-ante attractiveness of their returns; you cannot double down on a good illiquid asset after a fall in price.

It is easy to understand why, when competing for highest honors in the performance race, endowments stretched their illiquidity beyond sustainable levels and chose not to heed dissenting voices. Out of step dancers get taken out of the show. And there were not many dissenting voices, and the few were rarely heard amid the clamor of the pack. Now we know better, but at what cost? The future of US private, world-class education is at risk, unless colleges and universities -- trapped in the quicksand of commitments they seem unlikely to meet -- find a constructive escape without destroying significant value in the remaining portfolio.

One Way Forward: Partnership Commitments Re-scheduled Before It is Too Late

One way forward is clear. Illiquid private pools that have a call on endowment funds unable to meet their obligations without significant risks to the functioning of the sponsoring institution, should sit down with these loyal clients to find a way to restructure these commitments, before it is too late and real and irreparable damage is done to endowment finance. The problem cannot be fixed by endowments' blanket liquidation of marketable assets to meet private partnerships capital calls, resulting in even more illiquidity in their portfolios.

The problem needs to be addressed by well-reasoned negotiations, even if they involve a negotiated closing of some partnerships and launching new ones to be financed by those players with liquidity to fund them. There will be some losses, as the institutions in question will have to pay for the policies they adopted, and those who managed their liquidity well will expect, and merit, consideration. Managers of private partnerships with callable capital at their disposal might agree to rise above the immediate objective of banking on their rights for capital calls. We hope -- and expect -- that they will do that. The time to engage in those reasoned conversations is now, when there is renewed liquidity and appetite for risk-taking among investors. If we wait for another liquidity crisis to strike it will be too late, and the American taxpayer will rightly bridle at any rescue of elite colleges and universities, when they truly should have known better.



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