

Part 2: How Smaller and Mid-Size Endowments Can Benefit from the Endowment Model

In part of one of this two-part series, we discussed the basics of the endowment model and how large endowments and foundations have used that strategy to generate returns that have the potential to outpace inflation over the longer-term by maintaining allocations to alternative asset classes.

In this piece we will discuss how small endowments might think about using alternatives within their portfolios and talk more about how those entities might be well-served by enlisting the services of an outsourced chief investment officer (OCIO) firm.

Framework for smaller and mid-size clients to access the endowment model

Smaller and medium-sized endowments have tried to overcome inherent challenges by building in-house expertise or by using outside consultants, and by adding more public equity to compensate for lack of access to private capital managers. However, we believe there are better ways to achieve the benefits of the endowment model.

Due to the large dispersions of private capital returns, even private capital strategies in the second performance quartile historically do well compared to public benchmarks. The primary objective for smaller endowments should be to do better than average private capital benchmarks, which historically provided better performance than average public benchmarks. They can achieve this not by chasing top-tier funds, but by considering both first- and second-quartile performance funds with consistent outperformance. The objective is to access the beta of the private capital asset class, with alpha above the median private capital benchmark return. In other words, second quartile funds are expected to achieve above average private asset class returns and higher than average public benchmarks.

Another way to access quality private capital is through a fund of funds structure. In this case, the endowment

must consider a second layer of fees being charged by that fund, although the overall performance of a quality fund of funds with long-term track records and long-term relationships with top-tier funds could mitigate higher fees. Top-tier funds like this structure because they have access to a larger invested pool of capital, a faster decision process, and they forego individual (smaller) client servicing and reporting.

Benefits of working with an OCIO firm

Yet another way for smaller endowments to access top-tier funds is to hire an OCIO firm that has a history of working with alternative and private capital managers.

There are many potential benefits to working with a quality OCIO firm, but one important aspect is access to top-tier private capital managers. A recent study by Cerulli (*Cerulli Associates 2024 OCIO Providers Study*) cited that one of the top three reasons endowments and foundations liked the OCIO model is because it allows for greater access to alternative investments. Working with an OCIO allows smaller endowments to access top private strategies because an experienced OCIO firm has often built long-term relationships with private capital managers and allocated significant amounts of capital over time to these managers. Private capital managers generally look at an OCIO as one client and thus aggregate at the asset level. The benefits of this are lower minimums and lower fees, even though an OCIO has many potentially smaller clients.

Customized Portfolio

Another aspect that an experienced OCIO firm should provide is a customized build out of allocation to private capital. This is important for several reasons. Similar to public equity and debt allocations, the private capital portfolio should incorporate the endowment's needs for liquidity, return, and risk. In short,



an OCIO firm should provide a Strategic Alternatives Asset Allocation and build out a customized long-term cash flow plan for capital calls and distributions.

For example, some endowments may tolerate higher risk as they require higher return, which may lead to a higher allocation to private equity and venture capital. Other endowments may prefer private equity secondaries strategies which combine private equity returns with earlier distributions. Other endowments may prefer stability of returns to fulfill an endowment's mission, which would lead to a higher allocation to diversifying strategies. Yet other endowments may prefer higher and earlier income generation which would lead to higher private debt allocations while others may be focused on inflation protection which would lead to higher allocation to inflation sensitive real assets.

Bottom Line

The endowment model is an approach to portfolio management for endowments and foundations that has long been utilized by the largest university endowments, but there are fewer barriers to entry today for smaller endowments and foundations, particularly when working with a skilled OCIO firm. OCIO providers can bring access, experience and resources that provide the benefits of alternative investments to smaller portfolios in a scalable manner. Experienced OCIO firms can also provide access to private capital strategies, a customized portfolio and robust risk management.

For questions about this report, please reach out to your relationship manager.

Glossary of Private Capital Alternative Investments Definitions

Asset Class	Definition	Strategies
Private Equity	Investment in common stock, preferred stock, and (in some cases) debt securities of firms that are not publicly traded.	• Buyout • Venture Capital • Growth • Special Situations • Secondaries • Co-Investments • Multi-Strategy Fund of Funds
Private Debt/Credit	Loans to companies and individuals by entities other than banks.	• Senior Direct Lending • Mezzanine Direct Lending • Venture Debt • Asset-Backed Debt • Distressed/Special Situations • BDCs
Real Assets	Tangible or 'real assets' that have an inherent value as a result of their physical attributes – metals, commodities, real estate, land.	• Private Real Estate • Listed Real Estate • Private Infrastructure • Listed Infrastructure • MLPs • Commodities • Farmland • Timberland

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