The Vindication of a Boring Strategy

NYU, mocked for conservative investments in the '90s, shines in a down market

By JOHN L. PULLEY

It wasn't long ago that higher education's financial scorekeepers had all but written off New York University. The institution's endowment was dowdy, detractors concluded, its management hopelessly stuck in the past.

It was the 1990s, a golden era for college endowments. But as others marched to prosperity, NYU's portfolio was out of step. Critics carped that the endowment was buckling beneath a burden of boring bonds.

The world has changed since then. In the more difficult investment environment of the past few years, NYU continues to post positive, if modest, returns -- an accomplishment few institutions can claim.

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By going slow and shunning the passing lane, NYU has largely avoided many of the worrisome financial dilemmas that have befallen colleges jolted by erratic endowment performance.

"Some of them are regretting not being so diversified now," Mr. Lew says. "They became dependent on the income being thrown off by those endowments, [and] schools are finding that they have to change their budgets."

Indeed, as the economy remains stuck in neutral and equities...
markets have been unable to pull out of the tank, market valuations of college endowments continue to fall. Scrambling to fill the breach, colleges are trimming staff, forgoing raises, increasing tuition, paring programs, and cutting classes. Some are drawing more heavily on their endowments, further decreasing their values. Even relatively wealthy institutions like Oberlin and Dartmouth Colleges have had to tighten up.

"Investment pools with higher equity allocations have suffered more because of these exposures," says Todd E. Petzel, executive vice president and chief investment officer of Commonfund Group, which manages $27-billion on behalf of college and university endowments and other nonprofit organizations. Looking ahead to the round of meetings of colleges' boards of trustees this fall, he predicts "a lot of hard conversations on these topics in the next six to eight weeks."

Amid the hand-wringing, NYU reports that both its balance sheet and its $1.1-billion endowment are bearing up well.

We're not in any kind of financial distress," Mr. Lew says.

The rehabilitation of NYU's endowment performance, from pitiable to envious, is on one level a testament to contrarian thinking. The endowment managers' refusal to go with the flow, and the resultant success, is a microcosm of the university's iconoclasm. And NYU has used its financial successes to pay for a series of ambitious improvements that have transformed it from a good commuter college to a respected university that attracts students from all over the country.

Timing, of course, is everything, and it has been said that every investment strategy, like every stopped clock, is right some of the time. Skeptics, then, will no doubt attribute NYU's recent success with a bond-heavy portfolio to dumb luck. And even if the endowment is performing relatively well now, they add, what about the potential profits that were lost while NYU stood on the sidelines watching the bull market run past?

"They were very poorly served for a long time by a portfolio that was largely in bonds," says Richard E. Anderson, a senior fellow at the National Association of College and University Business Officers. "They were taking risks with the endowment. If inflation had taken off, their bond portfolio would have shrunk."

The university's recent performance also calls into question the endowment world's cult of numbers, which rate investment styles on annual returns, regardless of potential long-term impacts. Now some people are pondering whether higher
returns are always worth the volatility that typically accompanies them. What, some are asking, is the value of consistency?

**Safe and Boring**

In New York City, the handicapping of financial acumen is a pastime, and in 1997, almost everyone looked like a genius.

The typical endowment that year posted a return of 20.3 percent. Some did much better, propelled by profits from venture capital, esoteric hedge-fund strategies, and large-cap stocks, particularly in the technology sector. During the height of the bull market, Duke University and the University of Notre Dame had one-year investment returns of 58 percent. Risks of future downturns were often not prime considerations.

In those heady days, NYU's progress was simply solid, steady, and safe. During the five-year period from 1993 through 1997, for example, NYU's average annual rate of return was 8 percent, compared with almost 14 percent for the typical college endowment. The institution was assailed for its aversion to equities and its fondness for fixed-income investments.

"NYU missed the epic bull market in stocks of the '80s and '90s [and] squandered hundreds of millions of dollars in lost opportunity," harrumphed Roger Lowenstein in the *Wall Street Journal*'s "Intrinsic Value" column.

The Motley Fool investment service pilloried the university as "a classic example of how even well-regarded professional investors can produce lousy results."

NYU shrugged off the criticism, saying circumstances dictated that it invest conservatively, officials say. The institution had been on the brink of financial collapse twice in the 1970s, and fiduciary responsibility demanded protection of the endowment, administrators say.

The first crisis came in 1973. Until then, New York University had succeeded as a commuter college. But when the City University of New York liberalized its admissions policy, many of Gotham's subway students abandoned NYU for CUNY. Unable to make its payroll, NYU cut staff, closed its engineering school, and sold the university's Bronx campus to CUNY.

Liquidating that asset, though, was no panacea for its financial woes. By 1977, the institution was in trouble again. This time, it sidestepped disaster by selling the university-owned Mueller
pasta company for $115-million.

Having survived two close calls, the university's leadership eventually determined that it must reposition itself in the higher-education marketplace. Nudged from its niche as a solid commuter college, NYU decided to go upscale, to transform itself into an elite institution that would draw top students from all over the country. The challenge, as summarized by former President L. Jay Oliva, who stepped down last year, was to "grow or die."

Traditionally, the road to higher education's top tier is built on a bedrock of ever-larger endowments. The correlation between institutional prestige and wealth is apparent. New York University, however, settled on a road less traveled: It would raise and spend money by the vault-full, plowing comparatively little into its endowment.

**Raising and Spending**

Plan in hand, NYU became the first university to unveil a $1-billion capital campaign, in 1985. Defying convention again, the institution announced that the fund-raising drive would continue for 15 years, much longer than the typical campaign. The university reached its goal five years ahead of schedule, and then completed a second billion-dollar campaign in 2000. True to its stated intentions, the administration spent 85 percent of the billions it raised.

NYU acquired and refurbished scores of properties in one of the most expensive real-estate markets in the country, transforming a collection of buildings in Greenwich Village into an identifiable urban campus. Student housing quadrupled to 12,000 units. The institution also spent lavishly to lure prestigious professors to New York from top institutions, including the dean of social sciences, George W. Downs Jr., from Princeton University, and Ned Block, who came from the Massachusetts Institute of Technology, where he served as chairman of the philosophy program.

With relatively little new money flowing into the endowment, NYU adopted an investment policy that at its core had one overarching goal: preserve the reserve. At a time when the institution was taking many chances, its leaders were happy to trade potential investment gains to protect its nest egg. As recently as 1992, the university invested 89 percent of endowment assets in fixed-income investments, and 11 percent in equities.

By 1997, the allocation had become slightly less conservative: 74 percent fixed income; 18 percent equities; and 8 percent
alternatives, like hedge funds. By comparison, other college endowments that year allocated an average of 25.6 percent of assets to fixed-income assets.

Some viewed the loosening of the portfolio as too little, too late. By then, the calls for change were coming not just from the media but also from inside the university. Leonard Stern, a wealthy real-estate developer, had resigned from the Board of Trustees in 1996, reportedly over his dissatisfaction with the endowment's performance. Baying also was heard from New York University's well-regarded law school, where two of the city's firebrand mayors, Ed Koch and Rudolph W. Giuliani, learned their legal chops. The school pulled its share of the endowment from the common pool.

"The toughest part of the job of being a trustee is listening to your other alumni as they tell you that you could be doing it better," Mr. Petzel said.

The criticism tends to be loudest when an endowment's investment style diverges from the standard set by other institutions. It's not easy being different. An insidious, underlying presumption of higher-education finance is that there is a single, best way to manage all endowments.

"I couldn't disagree with a hypothesis more than that," Mr. Petzel says. "People often ask me: What is Commonfund's recommendation for asset allocation? It's a completely inappropriate question until we know an institution's spending rate, risk tolerance. ... There are literally scores of factors you must consider before you can come up with an appropriate investment policy."

**Shifting Power**

In order to better assess and respond to those myriad factors, NYU in 1997 created an investment committee and empowered it to fully manage investment policy. A prior committee had been toothless, and most of the investment decisions had been made by the Board of Trustees' Finance Committee.

NYU recruited Michael H. Steinhardt to lead the new investment committee, which included a number of Wall Street heavyweights. Maurice Maertens, who had recently taken early retirement, was recruited to be the endowment's first chief investment officer. During more than two decades at Ford Motor Company, Mr. Maertens had built his reputation as a top-shelf institutional money manager.

With the new team in place, the committee formulated new
goals for investing the endowment: 50 percent equities; 25 percent alternatives; and 25 percent fixed income.

Not exactly out there, but a departure nonetheless. No one accused the committee of radicalism.

"We went from an extremely conservative position to a relatively conservative position," says Mr. Steinhardt of the new investment targets.

NYU had committed to acquiring more equities, but with markets at all-time highs and heading higher, there were few bargains to be had. The investment committee, disinclined to quickly execute its new strategy, opted to "feather in" more equities over a period of years, says Harold Read, NYU's vice president for finance and its chief financial officer.

As of July, this incremental approach had yielded a portfolio of 36 percent equities and 38 percent fixed-income assets. The portfolio's allocation to alternative investments, like hedge funds, has risen to 26 percent, more than triple the portfolio's share in 1997.

The alternative investments fall into three basic categories: absolute return, arbitrage, and convertible securities. The committee has largely avoided investments in physical assets such as real estate or commodities, and has only negligible investment in private equity, the hot sector of a few years ago.

During the 2002 fiscal year, as the Standard & Poor's stock index plunged 18 percent, NYU's alternative investments posted overall returns of 5.4 percent. The bonds outperformed equities, as well. Bottom line: NYU's endowment has increased its exposure to equities -- many purchased at hoped-for bargain prices -- positioning itself to take advantage of the market's likely rebound, while continuing to earn positive returns, and avoiding erratic swings in the value of its endowment.

Had the university capitulated in 1997 to calls for loading up on equities, the results certainly would have been less favorable, as it would have been purchasing near the top of the market before it tumbled.

"One of the important things is not to radically change your strategy," Mr. Lew says.

"You don't want to be riding the wrong end of both markets ... or responding to every twist and turn of the market."

And even though some at NYU feel that the institution was
"unfairly hammered" for its investment philosophy in the 1990s, no one is smug about the recent success.

"I don't think most of the board members seek vindication at all," Mr. Steinhardt says. "They felt comfortable that they did the right thing before and that we are continuing to do the right thing."

Well, perhaps there is a hint of vindication.

"We feel," says Mr. Lew, "that the performance of the last three years validates the university's investment strategy."
Going Against the Grain

During the market boom of the '90s, the investment performance of New York University's endowment lagged the higher-education average. NYU managers came under fire for allocating a large portion of the portfolio to fixed-income investments, such as bonds. More recently, equities markets have faltered, and NYU has outperformed the field. Its endowment is currently valued at $1.12 billion.

**Annual rates of return**

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**Endowments' 2002 asset allocations**

- **New York University**
  - Alternative investments: 26%
  - Fixed income: 38%
  - Equities: 36%

- **Higher-education average**
  - Alternative investments: 15%
  - Fixed income: 28%
  - Equities: 57%

Sources: New York University; National Association of College and University Business Officers; Commonfund Group

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