ASSET ALLOCATION

Derivatives Strategies for Endowment and Foundation Portfolios: The Manager Perspective

January 1, 1996

Many endowment and foundation funds automatically maintain a mix of 60% stocks and 40% bonds, and numerous researchers will tell them they are wrong. Charts of the cumulative value of $1 invested in various portfolios from 1926 through 1993 show a dollar growing to $800 if invested in equities, $40 if invested in bonds and $330 if invested in the 60/40 mix. The obvious conclusion from such evidence is that long-term investors should invest only in stocks.

That conclusion is precisely the notion that this presentation attempts to dispel. If a foundation or endowment decides to take on additional risk, there are better ways to achieve higher returns than a 100% equity portfolio. I argue that long-term investors who are willing to bear the risk of a 100% equity portfolio can do better with a diversified portfolio while keeping their risk the same.

For example, assuming that the 20% volatility of an all-stocks portfolio is acceptable to an investor, the issue is how that investor can come up with an alternative portfolio that has the same volatility as an all-equity portfolio but provides higher returns. One solution is that, instead of putting all of the money in a very volatile asset, such as equities, the investor puts all of the money in a diversified portfolio-say, 60% stocks and 40% bonds — and then borrows funds to buy more of this diversified portfolio.

eliminate the risk of experiencing investment losses.

The information in this paper may contain projections or other forward-looking statements regarding future events, targets, forecasts or expectations regarding the strategies described herein, and is only current as of the date indicated. There is no assurance that such events or targets will be achieved, and may be significantly different from that shown here. The information in this document, including statements concerning financial market trends, is based on current market conditions, which will fluctuate and may be superseded by subsequent market events or for other reasons.