



ASSET ALLOCATION

Derivatives Strategies for Endowment and Foundation Portfolios: The Manager Perspective

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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.

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