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Portfolio Management

Institution Driven Investing: A new model

By John Michaelson

Despite signs the U.S. economy is coming back, this remains a perilous time for investors. The world is still in recovery from a credit crash. Trillion-dollar federal deficits and near-zero interest rates are producing massive distortions in the market. Europe continues to wobble, and the global center of financial gravity is shifting.

In a world marked by so many unknowns and potential pitfalls, institutional and pension fund managers need a new way to look at investing — one that starts with the characteristics of the institution and then works up from there.

This new strategy is called Institution Driven Investing because it is based on a risk-and-needs assessment specific to each institution. This assessment, in turn, is reflected in every investment in the portfolio: Each one is judged in terms of its impact on the institution — not just the potential returns it might produce but equally important, the potential losses. Based on those potential losses, boundaries are drawn and never crossed because doing so might compromise the institution's financial integrity.

This doesn't rule out investments that involve risk, even considerable risk. But the strategy assures that the totality of risk does not compromise the mission of the pension fund or institution.

An IDI-based portfolio is not static, however — it is constantly evolving. Markets constantly change, so the selection of the best assets in the market that do not exceed risk requirements must change, too. Institutions also evolve over time, and these changes likewise must be reflected in the investment strategy.

Does Institution Driven Investing work in the real world? Yes. The model is an educational institution, the Cooper Union in New York City that, like so many other such institutions and pension funds, depends heavily on revenues from its portfolio. In Cooper Union's case, investment income provides 60% of the school's revenues.

After the recession of the early 2000s, Cooper Union, which provides full scholarships to all its 1,000 students, faced a financial crisis. The endowment had been invested in traditional assets and was greatly diminished by the market declines.

A reconstituted investment committee decided to rethink the approach to managing the endowment. We looked at all the sources of Cooper Union's revenues, including investment returns, gifts, fees and government grants. We found most sources of income were market-correlated and fluctuated considerably with the economy. We also looked at expenses and found that most were fixed, or varied only over a considerable period of time.

This mismatch between revenues and expenses convinced us that our first priority was to stabilize income and avoid future losses. We concluded that unhedged investments in stocks and bonds, real estate, natural resources, private equity, venture capital and directional hedge funds did not fit the risk profile of the institution since they increased the correlation with markets already inherent in all the other revenue sources.

Instead, we focused on achieving a constant cash flow from investment assets. Rather than seeking out the maximum returns available, we chose investments that were both steady and relatively uncorrelated to markets, or we took much of the correlation out of assets through hedging.

The 2008-'09 meltdown proved the soundness of this approach. The value of the endowment fell by only 8% and cash flow was maintained. The school recently opened a $150 million academic building designed by the renowned architect Thom Mayne and has renovated several other buildings. The tradition of full scholarship may not endure because of mounting academic costs. But if it ends, it will not be because of a failure of the investment strategy.

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In the interest of full disclosure, part of Cooper Union's financial health is the income from its most valuable asset, the land underneath the Chrysler Building in midtown Manhattan. In 2006, we renegotiated the lease to lock in a steady and large progression of rent increases rather than risk exposure to market-based resets. We also raised $100 million by leasing other land the school owns on a cash-in-advance basis. We were lucky in our timing because these deals were cut during the peak of the New York real estate market.

But that is precisely the point. We locked the school into long-term leases because our strategy was to ensure the stability of income rather than letting it fluctuate with the market. The decision was a direct product of our risk-avoidance strategy — we were not going to gamble on high returns from a bull market when it meant risking losses in a bear market. Few other institutions took advantage of the opportunities that the real estate boom of 2005-'08 offered. Cooper Union did because it assessed risk differently.

Institution Driven Investing requires that each institution make judgments based on its specific situation — there is no one-size-fits-all model. But for pension funds and other institutions that depend on portfolio income, it is a strategy that avoids devastating losses, ensures a steady, safe return on investments, and protects and preserves the institution's core mission. ■

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