CASE MODEL

THE INITIAL INVESTMENT ALLOCATION

After conducting a comprehensive fundraising program, the Hoowa Medical Center received initial gifts of $50 million to establish an endowment. Its status as the community's only trauma center and neonatal intensive care unit causes it to provide substantial amounts of unreimbursed care every year. This phenomenon, together with the declining reimbursements and an estimated 6% increase in operating costs, leaves the Center with a budgeted cash shortfall of $4 million next fiscal year. Although the new endowment's funds are available to cover such operating shortfalls, the donors also expect their gifts to provide perpetual support for a leading-edge medical institution.

Bill, the Center's treasurer, has been appointed to supervise the day-to-day operations of the endowment. One of his initial successes was convincing his investment committee to retain a consultant who specializes in managing endowment investments. The consultant has recommended a portfolio that is expected to generate long-term investment returns of approximately 10%. The allocation reflects the consultant's belief that endowments should generally have long-term investment horizons. This belief results in an allocation that has a significant equity bias. Achieving the anticipated long-term rate of returns would allow the endowment to transfer sufficient funds to the operating accounts to cover the next year's anticipated deficit. However, this portfolio allocation carries risk of principal loss as well as risk that the returns will be positive but somewhat less than anticipated. In fact, Bill's analysis suggests that the allocation could easily generate a return ranging from a 5% loss to a 25% gain over the following year.

Although the committee authorized Bill to hire the consultant, he knows that he will have some difficulty selling the allocation recommendation to his committee members. In particular, he has two polarizing committee members around whom other committee members tend to organize into factions. John, a wealthy benefactor whose substantial inheritances allow him to support pet causes such as the Center, believes that a more conservative allocation that allows the endowment to preserve principal is the wisest course. Although such a portfolio would likely generate a lower long-term return, John believes that this approach more closely represents the donors' goal that the endowment provide a reliable and lasting source of support to the Center. For this committee faction, Bill hopes to use MVO to illustrate the ability of diversification to minimize overall portfolio risk while simultaneously increasing returns. He also plans to share the results of the MCS stress testing he performed suggesting that the alternative allocation desired by these "conservative" members of his committee would likely cause the endowment to run out of money within 20 to 25 years.

Another polarizing figure on Bill's committee is Marcie, an entrepreneur who took enormous risks but succeeded in taking her software company public in a transaction that netted her millions. She and other like-minded committee members enthusiastically subscribe to the "long-term" mantra and believe that the endowment can afford the 8% payout ratio necessary to fund next year's projected deficit. Marcie believes that the excess of the anticipated long-term rate of return over the next year's operating deficit still provides some cushion against temporary market declines. Bill is certain that Marcie will focus on the upside performance potential. Marcie will also argue that, in any event, additional alternative investments could be used as necessary to increase the portfolio's long-term rate of return. Bill has prepared a comparative analysis of payout policies illustrating the potential impact of portfolio fluctuations on the sustainability of future payout levels. Bill is also concerned that Marcie and her supporters may not fully understand some of the trade-offs inherent in certain of the alternative investment vehicles to which they desire to increase the allocated funds.

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KEY ISSUES:

1) Given the factors described in the case study (anticipated long-term investment return, anticipated inflation rate, and operating deficit) how should Bill recommend compromise with respect to maximum sustainable payout rates?
2) How should Bill incorporate the following items into his risk management strategy?
    a. educating the committee regarding types of risk affecting individual investments, classes, and the entire portfolio;
    b. measuring risk and volatility;
    c. provisions for periodic portfolio rebalancing;
    d. using tactical asset allocation; and,
    e. developing and implementing a contingency plan.
3) What additional steps should Bill take to form a group consensus regarding the appropriate level of endowment investment risk?
4) What additional elements should Bill add to his presentation to target the concerns of the "conservative" and "aggressive" committee members, respectively?