

## Clare's Endowment

Clare College is a tax-exempt charity which since its foundation has benefited from the generosity of many donors. Over the years the resulting endowment has grown to its current value of around £65 million. The income from this is available to support the work of the College, and in particular to reduce the cost of a Cambridge education to Clare undergraduates to well below that which would have to apply if the endowment were not available to help. It is the College's aim to ensure that no potential undergraduate who reaches the academic standards needed for entry should be deterred from applying or entering the College by the fear that the costs of their education will be more than they can reasonably afford. [For details see [www.clare.cam.ac.uk/admissions](http://www.clare.cam.ac.uk/admissions).]

Our ability to achieve this aim is dependent on the continuing generosity of our alumni and other donors, and on the successful management of the existing endowment.

### Investment Philosophy and Long Term Asset Allocation

The College looks upon itself as a perpetuity. It therefore aims to preserve and if possible to improve the real value of the College's endowment and the income from it. We consider that the natural investments for the College to hold are titles to real assets, such as shares and property, since these assets should, by definition, preserve their real value over time. There is the added advantage that there is abundant evidence that over the long term, shares not only provide protection against the ravages of inflation, but also provide a higher return than other financial assets such as bonds or cash on deposit.

While there is lots of good quality data on the long term return from shares, similar data on the returns from property are not available over the very long term. It is not possible therefore to make a carefully reasoned decision about the correct allocation of assets between property and shares. There is, however, reason to assume that the long term returns on these assets will tend to be similar; and there is a clear benefit in holding both, since neither their capital values nor income streams (rent and dividends respectively) move together over medium term periods of five to ten years. A portfolio that contains both shares and property is thus less risky than one exclusively invested in either. We have set a long term target allocation for the endowment of 80% to shares and 20% to property.

A similar approach to risk reduction has led us to invest both in UK shares and in those of other countries, as dividend and capital values in different stock markets do not rise and fall in unison. We have chosen a target equity allocation with the following geographical spread:

North America	30
UK	25
Europe ex UK	15
Japan	15
Asia-Pacific ex Japan	3
Emerging markets	12
	100%

For historical reasons the current allocation is more heavily weighted towards the UK than is the target. The intention is to move towards the target allocation over the next few years. However, even the target allocation over-weights the UK, compared with the relative size of the UK stock market. This is because exchange rates can vary greatly, not only in nominal but also in real terms, over periods lasting for many years. A rise in the real value of sterling could place a strain on the value of our income from the non-UK components of the endowment. Accordingly we target a higher allocation to UK assets, and a lower allocation to non-UK assets, than relative market capitalization might suggest.

The foreign currency risk for equities is not hedged unless there is a specific tactical case for doing so. Over the long-term emerging market countries tend to have rises in real exchange rates and therefore hedging their currencies back to Sterling is not sensible. The exchange rate fluctuations in respect of developed equity markets is impossible to predict with any degree of assurance in the medium term, and therefore it is not sensible in general terms to hedge the currency risk since there is a cost in doing so. All cash is held in Sterling unless there is a specific tactical case to do otherwise.

## **Investment Strategy**

It used to be thought that the returns from stock markets followed a “random walk”. However, it is now generally agreed that returns show long term negative serial correlation. This has two important consequences. First it means that after a prolonged period of high returns, subsequent returns are likely to be poor; and secondly that it is possible to make approximate judgments about when stock markets become over or under-priced relative to underlying value.

Stock market returns were high on average in the 1980s and 1990s. By the late 1990s share prices had increased to levels which were far higher than their underlying value, and shares remained overpriced (with fluctuations) until 2008. We therefore decided to make a temporary change to our asset allocation, reducing our exposure to shares to under half of the long run target level, and holding bonds and cash as explicit protection against the risk of a decline in share prices. With the benefit of hindsight, we would have done better to have sold all our shares rather than just half. However, we are very aware that there are important limits to the extent to which market returns can be predicted, and this restrained our actions.

We waited for stock markets to fall back to being fairly valued before reinvesting. We currently estimate that fair value for the US market is at 850 on the S&P 500 Index. In November 2008 we started to reinvest at the rate of £1 million in each month that the S&P 500 Index is below 1100. We will reinvest all the cash and bonds when the S&P 500 Index reaches 800. We recognize that markets tend to move from overvaluation to undervaluation, and do not stop falling just because they have become fairly valued. We have no way of judging when markets reach their nadir and do not think that we should take risks in trying to do so.

## **Inflation-linked Borrowing: the 2048 Fund**

In October 2008, after careful analysis, the College took out a £15 million inflation-linked loan for 40 years. The initial coupon is 1.09% per year and will rise in line with the UK Retail Price Index, as will the principal which the College will repay in 2048. To guard against any period of very high inflation over the next 40 years, the College’s liabilities are capped so they will not increase by more than 7% in any year.

The money is being invested in an international spread of equities, the 2048 Fund, in the expectation that the return will be substantially greater than the cost of the loan. Past returns on equities have been around 6% p.a. after allowing for inflation.

The timing of this borrowing was propitious: real (i.e. inflation-linked) interest rates were exceptionally low in October 2008, so the College has locked into a very low interest cost. At the same time, the equity market collapse in 2009 meant that the College was able to invest at a time when shares were not overpriced. Unless there is a world economic calamity, the College should have a very positive return.

Consideration was given to the option of a conventional loan but the College concluded that it had a higher degree of risk. With the inflation-linked loan, the College is matching a real liability with real assets (equities). Also, the initial interest cost is far lower than it would be on a conventional loan. The lower cost minimises the adverse impact of negative serial correlation on the returns from the equities in the 2048 Fund.

The lower initial interest cost also means that the College has effective use of the funds for longer (the loan has a longer duration), which gives the power of compound interest more time to work its magic. For the same reason, the assets in the 2048 Fund will be “ring-fenced” until the loan is repaid.

The loan of £15 million with Santander is secured on £23 million of the College’s external student properties. The inflation swap (i.e. the liability for the inflation element) is with HSBC and is secured on the £15 million investment portfolio, which is being invested in global equity tracker funds managed by HSBC. The College has the option to close-out the deal at any time. If there is a shortfall in 2048 on the investments compared with the inflation liability, HSBC can ask the College for the difference.

By January 2012 £9 million had been invested, and it is intended to continue to invest £1 million in each month when the S&P 500 Index is below 1100. If the S&P 500 Index falls to 800 the College will invest all the cash holdings.

If the investments in the 2048 Fund were to achieve a real return of 4% per year - which is below the average historical return from equity markets - over the life of the loan, the College would end up with a very substantial additional endowment.

### Current Asset Allocation

The asset allocation as at 31 December 2011 was still weighted strongly towards cash and fixed interest holdings, as follows:

	Endowment	2048 Fund
Quoted Equities	59%	67%
Private Equity	2%	-
Property in the UK	18%	-
Fixed Interest	4%	-
Cash	17%	33%
Total	100%	100%

### Endowment Drawdown

At the heart of the College’s financial strategy is the “spending rule” which provides the fiscal discipline for the endowment, setting a compromise between two competing objectives. The first objective is to release a substantial level of income to cover operational expenditure in a stable stream, since large fluctuations are difficult to accommodate in the College’s activities. The second objective is to protect the value of the endowment assets against inflation. The College’s spending rule attempts to meet these two objectives by using a long term spending rate of between 4.0% and 4.5% of the endowment portfolio, with an annual drawdown increasing by 3.5% p.a.

## **Investment Management**

The College's Investment Committee makes the asset allocation decisions both for the main endowment and for the 2048 Fund. For the property part of the portfolio, we take external advice on individual properties (our current adviser is Bidwells). For the equity part of the portfolio we use "index-tracker" funds, rather than make any decisions regarding individual shares (our current supplier for the main endowment is State Street Global Advisers). Our decision to use tracker funds in the markets in which we currently invest is based on the evidence. This indicates that while some "active" fund managers naturally enough have above average performance over particular periods, the number that do so consistently over more than one period is not more than what would be expected if fund managers' performance was random. There is therefore no good evidence that active fund managers can be selected on a rational basis. On the other hand, it is clear that active management incurs higher management and dealing costs than the passive alternative.

Alternative investments, such as hedge funds and commodities, have been considered by the Investment Committee. We are, however, yet to be convinced that such investments will lead to improvements in our performance, particularly after allowing for the various costs involved.

In 2011 the College wrote a £1m put option on the S&P 500 Index for three months, with a strike price of 1125, to reflect the fact that the College did not intend to reinvest in the Index until it had fallen to 1100. This was a profitable decision which will be repeated when the market conditions are next favourable.

## **Ethical considerations**

The College's holdings are in index-tracker funds, and as a result the College has a wide range of indirect holdings in companies listed on the world's stock markets. In view of this, we believe that the best approach to ethical investment considerations is to engage with those companies which may be falling short of their social responsibilities.

College members (particularly students, but including Fellows and staff) are encouraged to monitor the ethical standards of listed companies and to draw to the Bursar's attention the evidence of instances where companies may be falling short. The Master will then write to the chairman of the relevant company expressing the College's view.

## **Management Costs**

Good investment performance requires not only a sound philosophy with consistent execution, but low costs. Members of the Investment Committee are happy to provide their services without cost to the College, and as noted above fund management costs are kept to a minimum by the use of indexed funds. The total costs amount to about 0.2% per year of the value of the funds.

## **Final Word**

Our investment philosophy and strategy are, we believe, rationally based on the information currently available about the behaviour of financial markets. We believe that rationality provides the most likely route to success, but the future is uncertain and this cannot be guaranteed.