W&L's Endowment: Making a Difference Every Day
by Lindsey Nair

Washington and Lee's endowment supports so many vital aspects of life at the university that increasing it was a main goal of the recently concluded capital campaign. Of the total $542.5 million raised during Honor Our Past, Build Our Future, secured gifts and commitments to the endowment accounted for 61 percent. Furthermore, W&L's ranking in endowment per student increased from 38 to 25 among all American colleges and universities.

Outside of Lexington, questions about large university endowments resurfaced this year on Capitol Hill, with two congressional committees asking colleges and universities for information about how they manage their endowments and spend endowment funds. The 56 schools queried, including W&L, all have endowments larger than $1 billion.

The letter from the Senate Committee on Finance and the House Committee on Ways and Means cites double-digit returns on endowment investments in 2014, questions tuition increases in light of these earnings, and notes that both committees are interested in how colleges and universities use their endowments to carry out educational and charitable purposes. Congressional hearings on large university endowments are scheduled to take place this fall.

Washington and Lee, with an endowment valued at more than $1.4 billion, responded with a 64-page document that answers the specific questions and provides additional information about university policies and codes of ethics. The full response, including a letter from President Ken Ruscio '76 and a preamble by Steve McAllister, W&L's treasurer and vice president for finance, can be viewed in full on our website (https://www.wlu.edu/treasurers-office/about-the-treasurers-office/messages-from-the-treasurer/congressional-endowment-inquiry).

In early August, McAllister discussed the endowment in depth. To watch videos of the entire interview, please visit https://www.wlu.edu/support/funding-priorities/endowment/endowment-qanda-with-university-treasurer.

Q: What is the purpose of the endowment, and how does it work?

An endowment is a collection of many individual funds, with their own specific purposes, intended to be a perpetual source of capital to support the university in fulfilling its mission. The Washington and Lee endowment is comprised of 1,300 individual endowments and 46 trusts held externally for the university's benefit. These funds have been established over the many years of the institution from alumni, parents and friends of the university who care about the strength and quality of W&L.

The purpose of each endowment is established through a set of conversations with the donor to ensure that it reflects the donor's interests and intent. For the last several years, we have used endowment agreements to memorialize the context and purpose of each new endowment. The funds are invested in a manner that generates both yield and, over the long term, capital appreciation. Through a set of policies established by the university, the endowments allocate a portion of their underlying value each year to support each individual endowment's underlying purpose.

The objective for the endowment is twofold: to provide ongoing annual support towards the university's mission and to preserve the purchasing power of the endowment to ensure support of future generations of students. To be clear, the endowment is not a bank account that can be tapped for any institutional need at a whim, but an intricate set of individual accounts that support various specific purposes across the university that should provide consistent and reliable support for the rest of the institution's life.

Q: What shapes the economics and finances of the university, and how is that related to the need for endowment?

When one looks at the financing of private higher education, there are really three sources of support: tuition and fees, gifts and grants, and endowment. As has been widely reported in the press, private higher education is or may have reached the point where fee increases generate little or no increase in revenues for institutions. This is supported by the most recent NACUBO (National Association of College and University Business Officers) tuition-discounting study, which revealed that in higher education, 90 percent of students receive some form of institutional aid.

If, as an institution, you want to grow programs or offerings — or better yet, invest in additional ways to engage and provide robust experiences that students can benefit from and gain valuable experience and insight to assist them after college — gifts and endowment support take on even greater significance. That is certainly true at W&L. Here at the university, we have seen philanthropy overtake tuition over the last decade as the largest source of revenues. In 2007, net student fees accounted for 53 percent of revenues while philanthropy represented 39 percent. This past year, net student fees represented 47 percent, while philanthropy topped 48 percent.

Q: How does Washington and Lee's endowment compare to those of our peers?

There is one fundamental difference: The university's endowment benefits greatly from external trusts, which represent more than $400 million of the $1.4-plus-billion total endowment value. Our peers simply do not have the number or magnitude of these trusts that W&L benefits from. It is a structural difference that I will talk more about later.

Otherwise, I think that W&L's endowment compares favorably with those of our peers. I often think endowments are measured in two ways: sheer aggregate size and endowment per student. I think the latter is typically the more appropriate way, as it effectively normalizes the value to something that is more meaningful — in essence, how much endowment is available to support any student at the university. This is not an area in which we have always been strong relative to peers, but it is one in which we have seen great strides over the last 10 years. Since 2007, the endowment at W&L has climbed from the 44th highest in the nation (at $466,299 per student) into the top 25 at $651,294 of endowment per student.

Having said that, we are in a tier of institutions that fall outside what I call the uber-wealthy — institutions where this measure is well in excess of $1 million per student. I think it is safe to say that the larger the endowment per student an institution has, the greater the levels of offerings in curricular and co-curricular activities that can be made to students. These opportunities do translate into greater success in graduate school and early career opportunities coming out of college. It is one of the reasons that this past campaign focused in part on expansion of curricular offerings and student engagement, both in and out of the classroom.

The other measure that I noted, aggregate endowment size, is also important. Annually, colleges and universities participate in a study of endowments. One of the outcomes of the studies is that the larger endowments ($1 billion-plus) tend to generate higher returns over the long run than smaller endowments. In the most recent study, larger endowments ($1 billion-plus) outperformed the next grouping ($500 million to $1 billion) by 50 basis points over the past 10 years. And if you extend this out over the last 20 years, the gap widens to nearly 1.1 percent per year of greater performance. If you think about it, a billion-dollar endowment would generate an additional $220 million over the last two decades from this performance gap. With a 5 percent payout rate, that translates into $11 million more per year that can be invested in student aid and academic programs and experiences.

Q: How is the investment strategy for endowments different from other forms of investing?

There is a dichotomy in terms of the purpose of the endowment that leads to a fairly unique approach to investment allocation. On one hand, the endowment is intended to last forever while preserving purchasing power. Based on the history of investment markets, this leads the investment approach to be through broad-based equity instruments such as domestic and international stocks. Yet because spending or allocation is made each year, minimizing downward volatility in the underlying value of the endowment is important to ensure that the allocation stream is fairly predictable from year to year.

The most common approach for addressing this challenge is through a diversified asset allocation strategy. This is certainly the approach that we have taken at W&L. I should note that this is where the size of the endowment plays a major factor, as it allows for greater diversification, especially into less liquid investment vehicles such as private equity, real assets and absolute return, where being able to invest directly with the best managers has proven to yield greater returns with lesser volatility. Most investment mandates have only one objective — either a time objective or an income-generation objective. This unlimited time horizon with the need to deliver predictable, and, over time, growing allocations, makes the endowment model somewhat unique.

Q: Who invests or manages our endowment, what is their record, and to whom are they accountable?

In 2007, following an extensive review and study of our practices, the Investment Committee made the recommendation — and the Board of Trustees approved it — to engage Makena Capital Management to provide broad oversight and management of the endowment. They directly manage about 70 percent of the funds that the university controls, and they help us oversee the long-lived limited partnerships that we have, along with liquid investment pools that we have.

Makena is accountable to the Investment Committee (a committee of the Board of Trustees) and the Board of Trustees. Overall, their performance record has been strong, with them being a top quartile performer over the one-, three- and five-year periods. We don't have a 10-year track record with them, but we are looking forward to getting that.

Q: External trusts account for almost 30 percent of the total endowment value. What are these, and how are they structured to benefit the university?

External trusts are established with the goal of providing a level of distribution of income or payout to the university, but they are managed through entirely different boards, and the university does not have access or control of the underlying funds and investments. Washington and Lee benefits from 46 such trusts at the current time. They range in size from roughly $100,000 to the largest at over $400 million.

Typically when we discuss these trusts, we focus on the largest one, the Lettie Pate Evans Restricted Fund. This trust was established in the 1940s and funded upon her death in 1953. Washington and Lee is a 15 percent beneficiary of the income generated by the fund, which is primarily invested in Coca-Cola stock. In this past year, the fund provided more than $12.5 million to the university in support of our operations.

The university has no say in the investment or payout formulas of these funds, but they provide a substantial allocation to our revenue base, and since the majority are structured for perpetuity, they act very much like endowments. I can't overstate their importance to what we are able to do at the university.

Q: Do schools like W&L assume too much risk through diverse investments?

This is a very good question and a complex one to answer. I think it is important to remember that one of the goals of the endowment is to provide equal purchasing power over time — this is often referred to as providing intergenerational equity. To accomplish that while spending or allocating each year somewhere between 4 and 5 percent of the underlying value, an institution needs to generate equity-like returns over the long term.

One way that can be done is to invest in marketable equities and accept the volatility of those markets. That would mean in 2008–09, you would accept a drop in the endowment value by roughly 50 percent. The other approach is to utilize marketable equities in a portion of the portfolio but also include alternative asset classes such as private equity, venture capital, absolute return, real estate and natural resources.

The challenge with investing in these asset classes is that there is far greater dispersion of returns among managers. As such, generating median returns in these asset classes does little to help the risk-return profile. It is imperative that you invest with those managers that can deliver in the top quartile on a consistent basis to be able to generate the needed returns. This is one of the key reasons that we hired Makena. Because of their size and relationships with managers, they are able to access the best managers across these asset classes, and they have been able to outperform the benchmarks during the one-, three- and five-year periods while also being at two-thirds' the volatility. You can never take risk out of the equation, but I think what we've done is we've tried to manage the question of risk and volatility with what we need to accomplish over the long term with the endowment.

Q: What are the ways in which endowment gifts might be restricted? In other words, how much of our endowment is flexible?

For the internally controlled endowment at the university, over three quarters of the endowment is restricted, with nearly one half of that amount restricted to student financial aid and scholarships. Other major areas of restriction include professorships, individual departmental support, student research, faculty research and scholarship, equipment and library acquisitions, and facility maintenance and upkeep endowments. So when you actually look at the list of these restrictions, they are very integral to who we are as a university and very integral to the programs that we provide at the university.

Having said that, approximately 25 percent of the endowment is unrestricted, although designated by the Board of Trustees as funds that should act as endowment. In some cases, the board has placed programmatic restrictions on these funds to guide their use. The board could adjust these uses over time, and could elect to draw down the principal if they deemed [it] appropriate; however, in doing so, it would negatively impact the programs and services that we view as mission critical, so in some respects, I don't view any part of the endowment as flexible, but view it in its entirety as dollars that help to ensure that we can meet our mission over time.

Q: Who or what determines the spending rate for our endowment, and why can't we spend more than a small percentage each year?

The Board of Trustees established many years ago a spending policy for the endowment that allows spending to be increased by inflation plus 1 percent from year to year. This amount is tested against a 5 percent market-value cap, which, if hit, governs the allocation in a year. At the time this approach was adopted, we had two significant endowment funds that had considerably higher spending rates.

In the early 2000s, we were able to merge those two funds into the regular spending pool so that over the last 10 to 12 years, our spending rate has been between 4 and 5 percent per year. Studies have shown that based on historic returns, a spending rate in excess of 5 percent will erode the purchasing power of an endowment over time. Since one of the major principles of endowments is to preserve intergenerational equity, it simply is not prudent to allocate greater than a 5-percent payout over time, and that is what governed the development of the policy.

Overall, I believe it is a sound policy, as it limits endowment payout growth in extremely strong markets but buffers against payout reductions in low-growth or negative-return environments, much as we have experienced over the last couple of years.

Q: If someone is considering a donation, are they better off donating to an institution with a large endowment or to one with a small endowment? Why?

You ask some tough questions. I don't believe such a decision should be based on the size of endowment. My own philosophy is that an individual should contribute to those organizations that they feel make a difference. As such, I think the key for a donor is to make a fully informed decision.

When I look at the impact that the endowment has had at W&L in terms of recruiting the very best students, providing a depth and breadth of curriculum that is unusual in the liberal arts environment, supporting a forward-thinking pedagogy, and providing the myriad opportunities for students to participate in funded research, internships, study abroad and service-learning activities, to name a few, I see how W&L can and does provide each student a transformative experience. I may be biased, but it is hard for me to identify many other higher-ed institutions that can deliver such a rich set of opportunities to its students, and as a result, I see how endowments make a difference every day at W&L.

Q: How much of our endowment is directed to the Law School?

Just under $100 million of the endowment is restricted in its support of the Law School. In and of itself, the Law School would be viewed as having a strong financial foundation based on its endowment.

Q: What is the role of endowment in moderating tuition increases?

The answer to this question has three parts. First, and probably the most obvious, is endowment support of student financial aid. These endowments allow us to provide grants and scholarships, which reduce the cost of attendance for a student to come to W&L. Roughly one half of our financial aid budget is underwritten through endowment support.

The second part is that, to the extent that we have endowments that support the general operations of the university (and this is especially true of the Lettie Pate Evans Trust), those dollars substitute for dollars that we would otherwise need from students and parents to underwrite programs.

Third, and this one is a bit more challenging to articulate, is that it creates opportunities that otherwise would never get funded. These are opportunities in terms of student research or study abroad opportunities that you would never be able to generate through student fees. One other thing I think is important to note is that every student, whether they are paying the full tuition, room and board or not, is receiving at least a subsidy from the university of $20,000 a year. This comes from the fact that our educational costs and services that we provide actually exceed the cost of tuition, room and board. Our goal is to try to create a richer experience for students that translates into success for them, and allows them to be placed in the best graduate programs to get good jobs coming out of colleges. This all plays into how we do that.

The policy question of how best to set tuition is, in my opinion, one of the most difficult to answer, and one that we will be deliberating as we begin to develop the next strategic plan.

Q: When it comes to university endowments, is there such a thing as big enough?

I cannot identify an institution in our peer set that has reached that level of endowment, and certainly we have not at W&L. When I look at our financial picture, we still underwrite half of our financial aid with unrestricted revenues, and still must be need-aware on the final decisions of a small subset of admission decisions. We have needs to allow us to continue the strong programs that have been funded by gifts and grants for the Spring Term and summer research programs for our students. We have been challenged in how best to expand interdisciplinary offerings without negatively impacting the underlying disciplines that these programs draw from. What I think is important for us as an institution is to ensure that as we work to fundraise for new endowments, those endowments fit within the strategic objectives of the university and fit within our long-term mission as an institution. We had great success with this approach in the last campaign, and I see no reason that this approach will not be successful in the future.

Q: How much would be enough for W&L to consider going tuition-free, or is that even a goal that should be considered?

The notion of higher education being tuition-free is getting a fair amount of airplay during this election season, but the discussion has focused solely on sticker price with no discussion about what is a quality education. It is a rather disappointing narrative.

But let's play along for a moment and think about what would be needed if W&L wanted to go that route. To make up for the $60 million annually that we receive in net tuition, we would have to essentially double the endowment size today. Even if we concluded it was desirable, I think that it is highly unlikely that we could achieve such a target in the near term to make it a reality. Instead, I think our focus needs to remain on how we can continue to grow the endowment to support student financial aid, so that we can recruit classes that are more representative of today's society and fund the difference between a family's ability to pay and our costs.

Today, we have the W&L promise, which guarantees any family with an income of $75,000 or less that we will provide them a grant of at least tuition. We will need to find ways to expand this to a growing set of families in the coming years, but I don't see us abandoning tuition as a source of revenue in the near to mid-term future. I also think that we need to continue to look to endowment support to find ways to provide the creative and innovative educational approach that has made W&L distinctive, much as we did over the last campaign and strategic plan. If our focus is to become tuition-free, then I think it would come at the expense of continued quality improvement of our programs.

Q: Is there anything you'd like to add that we have not already talked about?

If there is one thing that I would add, it would be an acknowledgement of the dedication of the Board of Trustees and, in particular, the Investment Committee, in the management and oversight of the endowment over the years. I have been fortunate to have a front-row seat to that committee for over 20 years now, and even as the membership and leadership have changed, the focus has been and continues to be on how best to structure the endowment portfolio for the university's long-term best interest. These are talented people, many of whom have extensive and strong track records in fields of investment management, and yet when they come together, it is never about their success as individuals. Instead, it is about the university's success. They ask tough questions and focus attention on the appropriate policy questions. It has been a pleasure to work in such an environment.