Study: Colleges suffer when endowment values wane

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University investment decisions can deepen job losses and other financial cuts when market collapses carve into budget-supporting endowment funds, a new study by the National Bureau of Economic Research found.

Researchers say the findings show that universities need to re-evaluate investment portfolios and policies to cushion the blow when market downturns wither endowments, a growing economic engine for colleges over the last two decades.

"A secretary at Harvard probably had no idea her employment could be tied to how the school's endowment was invested, but that actually turned out to be the case," said University of Illinois finance professor Scott Weisbenner, a co-author of the study.

Many endowments scale back payments to universities more than their own policies dictate when asset values tumble, according to the study, which examined endowments at more than 200 doctoral universities from 1988 to 2008. That, in turn, further shrinks resources available to fund university operations.

Universities typically have policies that set annual payout rates based on a fixed percentage of average fund values over the last three to five years, said Jeffrey R. Brown, a U. of I. finance professor and co-author of the study.

But while university endowments follow their policy when strong market performance increases asset values, he said, many scale back payouts beyond what their guidelines suggest the market suffers large declines.

"That means the university budget takes a double hit because not only are asset values declining but they're spending a smaller fraction of the endowment than their own rules say they should," Brown said.

He says the move is puzzling because it defies the mission of endowments, which are designed to provide steady financial support for universities and are larger than annual budgets at most of the schools included in the study.

"It's consistent with the view held by some that rather than trying to preserve a steady stream of income to support the university, endowment mangers may be trying to preserve the size of the endowment for other reasons, such as the prestige of having a large endowment," Brown said.

Other findings include:

- Universities with large endowment declines cut faculty, support staff and maintenance workers, but not administrators. "We found no effect on the number of administrators - none whatsoever," Brown said. "It's statistically no different than zero."
- Schools made larger cuts to faculty and staff when endowment investment portfolios included riskier, less liquid assets such as hedge funds, private equity and venture capital.
- Universities sought to capitalize when their endowments weathered downturns while their peers took a hit, and hired more

tenured and tenure-track faculty the following year. "Universities don't let a crisis to their peers go to waste," Weisbenner said.

- When endowment values rise, universities with highly selective admissions standards reward tenure-system faculty with pay increases, while less-selective schools boost financial aid for students and give raises to lecturer and adjunct faculty.

"It matches the mission of these two different types of universities," Weisbenner said. "The more selective universities can get top students without financial aid, and are competing for the top research faculty. Less-selective schools won't get the research stars, so they try to get better students."

Brown says the study analyzed endowment data from the technology bubble collapse that sank financial markets in 2001-02, but not from the current economic crisis.

"We have anecdotal and survey data that indicates the current situation is consistent with what we found earlier," he said. "But I would want to wait for data to see if everything we found is going to be mirrored exactly in the current environment."

Brown and Weisbenner hope the findings encourage universities to incorporate appropriate risk-management strategies when making portfolio decisions.

"You can't count on having an up market all of the time," Weisbenner said. "High-reward investment strategies can have a real impact on universities during down markets, including fewer professors and support staff being hired or more being let go."

Brown says the current economic crisis highlights the need for caution, with endowment values declining at the same time that government support and donations sank because of the recession.

"It's not enough to just think about what can go wrong," he said. "You also have to think about the fact that when something goes wrong with the endowment, it is likely to come at a time when it's particularly bad for something to go wrong."

The paper, "Why I Lost My Secretary: The Effect of Endowment Shocks on University Operations," was co-written by finance professors Stephen G. Dimmock of Michigan State University and Jun-Koo Kang of Nanyang Technological University.

Provided by University of Illinois at Urbana-Champaign

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