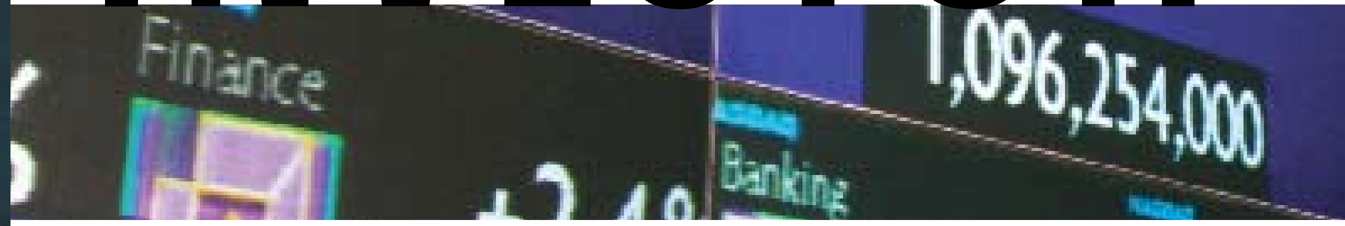
PATIENT INVESTOR



Vice President for Investments Tom Kannam leads Wesleyan's disciplined approach to portfolio management that has made its endowment a top performer.

BY WILLIAM HOLDER '75

PHOTOGRAPHY BY BILL BURKHART

In the winter of 1997, with the stock market booming, Wesleyan's Board of Trustees adopted a new investment policy that recognized the need for a full-time investment professional on staff if the institution's portfolio were to achieve superior results in the highly competitive world of investment management.

Behind this desire lay an unsettling fact. Despite two decades during which Wesleyan's endowment neither underperformed nor outperformed comparable college and university endowments, Wesleyan had fallen well behind most of its academic peers in endowment size, both on a total and per student basis. Some top liberal arts colleges, benefiting from outstanding portfolio returns plus successful fundraising, were rapidly putting more distance between themselves and Wesleyan in this important measure. President Douglas Bennet '59 responded by setting endowment performance as a top priority of his new administration.

Wesleyan turned to Tom Kannam, a 33-year-old Dartmouth alumnus and graduate of the Tuck School

IN THE PAST FISCAL YEAR, WESLEYAN ACHIEVED AN ENDOWMENT RETURN OF 15 PERCENT, WHICH NOT ONLY RANKED AS TOP QUARTILE PERFORMANCE, BUT ALSO MET A NEW GOAL: PERFORMANCE IN THE TOP FIVE OF LIBERAL ARTS COLLEGES.

of Business, who saw an institution ready for change. Kannam had helped to manage the pension investments for Exxon until the oil giant asked him to assume an operating role at a chemical company. He chose instead to take the number-two post in investment management at Dartmouth, which provided him an opportunity to learn the latest in portfolio management techniques at a multibillion-dollar enterprise.

One of the key challenges facing Wesleyan was to take better advantage of alternative investments, which unlike traditional stocks and bonds, often require committing capital for significant lengths of time. The principal proponents of the board's new policy, Board Chair Emeritus Alan Dachs '70 and Trustee Emeritus Robert McKelvey '59, recognized that the right investments could provide the high returns Wesleyan needed to achieve its goal of performance in the top quartile of college and university portfolios. Kannam brought expertise in this area to Wesleyan.

Most other universities with large endowments were also building their in-house staff. All were realizing, says Kannam, that, "If you can generate an extra one or two percent on a huge pool of assets, you can go a long way toward helping an institution address its priorities."

Kannam, who has since become vice president for investments, assumed responsibility for a storied endowment that in an earlier era had powered Wesleyan to the top rank of liberal arts colleges. Some of this history is well known to older graduates: the sale in 1965 of American Education Publications (including *My Weekly Reader*) for 400,000 shares of Xerox stock; Wesleyan's meteoric rise to wealth as one of the best endowed (per capita) colleges in the country; the rapid growth of faculty size, partly to accommodate the doubling of the student body that accompanied coeducation; and an ambitious building program highlighted by construction of Hall-Atwater and the Science Center in the late 1960s and the Center for the Arts shortly thereafter. In 1968, *World Almanac* listed Wesleyan among "Selected Colleges with Major Endowment Funds" with a value of $88 million. Brown University had only $57 million.

The dreams of Wesleyan's planners in that era ran smack into the punishing decade of the '70s. Equity markets plunged into a trough that saw little relief as the years wore on, energy costs soared, and high inflation eroded the purchasing power of endowments nationwide. The need to pay off large construction projects forced Wesleyan to draw down its endowment at an alarming rate. The university responded with retrenchment in its operating budget and a sizeable increase in the number of students to raise revenue.

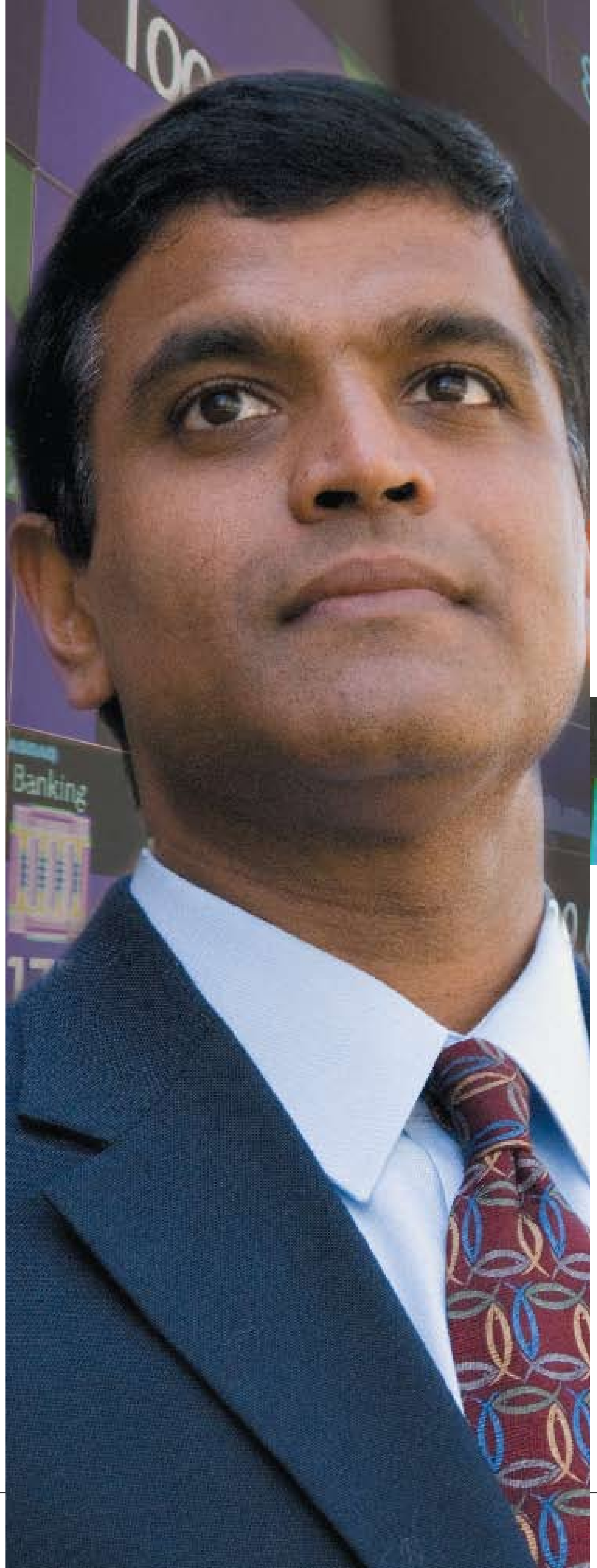
Less well known is the subsequent course of Wesleyan's endowment. In 1981, its market value stood at $135 million. Wesleyan had lost its advantage over peers, but had not fallen behind.

"There is a myth afloat," says Chair of the Board Jim Dresser '63, "that Wesleyan's historical endowment returns were below average. This simply isn't true. Compared to our peers over the past 25 years, our returns have been in the middle of the pack. In 1997, we set a goal of achieving returns in the top quartile of all schools with equal or larger endowments. For the latest five- and three-year periods we have hit our first-quartile target."

During the historical period, Wesleyan's rate of spending from the endowment fell within a range considered to be prudent (though higher than some peers), and the size of the student body leveled off at about 2,750 in the early 1990s. So why did the endowment-per-student ratio fall to dead last among academic peers?

The largest contributor by far was inadequate gifts to the endowment and therefore less compounding of endowment value. Although Wesleyan finished the Campaign for Liberal Learning in 1987 with approximately $67 million in gifts (its first successful capital campaign), the university didn't begin to raise significant new funds again until late in the '90s—unlike competitors. During 1984–2004, Wesleyan raised $105 million in gifts to the endowment. The more successful competitor institutions raised roughly three times that amount, and the most successful one raised $359 million. Strong equity markets compounded the disparity to such a degree that by 2005 seven liberal arts colleges—Williams, Grinnell, Wellesley, Pomona, Swarthmore, Amherst, and Smith—had endowments topping $1 billion. Wesleyan's was approximately $565 million. Wesleyan's more recent strong fundraising results could not erase the advantage competitors had attained.

At a conference held in April of 2002 at Harvard, Kannam first met David Swensen (parent '09), who had become legendary in investment circles for leading Yale's endowment on a meteoric rise from $1 billion in 1985 to more than $15 billion in 2005, achieving the best investment returns in higher education. The two subsequently continued their conversation at other conferences, and in 2004 Swensen agreed to start meeting in New Haven with Kannam, who was assessing "best practices" in university endowment management at the suggestion of the former chair of Wesleyan's Portfolio Subcommittee, Trustee Emeritus Robert Patricelli '61.

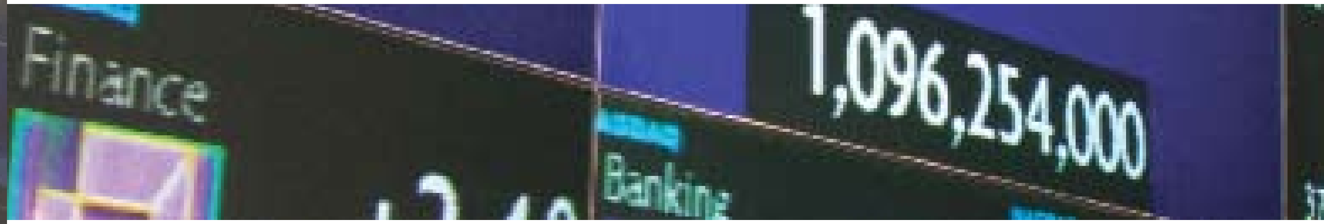


Swensen generously shared his staff, analyses, and computer models. In 2005, Swensen accepted an invitation to join Wesleyan's Board of Trustees.

In his book, *Pioneering Portfolio Management* (2000), Swensen warns that "active management strategies demand uninstitutional behavior from institutions, creating a paradox that few can unravel. Establishing and maintaining an unconventional investment profile requires acceptance of uncomfortably idiosyncratic portfolios, which frequently appear downright imprudent in the eyes of conventional wisdom."

Swensen led Yale's endowment away from publicly traded investments toward alternative investments: private-equity funds (ownership of private companies), venture capital funds that seed start-ups, and hedge funds in which managers use tactics such as short-selling and arbitrage that are unavailable to mutual-fund managers.

Swensen's success has made the unconventional more common. According to a survey conducted by



the *Chronicle of Higher Education* and the *Chronicle of Philanthropy*, 10 percent of the assets in 210 endowments are invested in hedge funds. A key component of success is rigorous screening of active managers. It is no exaggeration to say that success is predicated on investing with the right managers.

That's why Kannam's desk is piled high with files about investment managers—ones that Wesleyan currently invests with and ones under consideration for future investments. Most of them are managers of alternative investments, which Kannam argues are particularly well suited for the long-term horizon of university endowments.

"You can capture what is called the illiquidity premium by investing your assets for longer periods of time in high-return strategies," he says. "That was one of the areas that was missing at Wesleyan, and I had experience with these types of investments. They require a lot of due diligence, monitoring, and analysis.

"One of the best things you can do is identify talented people early in their careers and grow with them over time," he says. Accomplishing this is difficult, in part because capital is plentiful and top managers have their pick of investment partners. "With a lot of these managers," he observes, "if you are not there at the beginning, you're shut out."

Universities possess a strategic advantage in this arena because endowments are perceived as desirable, patient investors that occupy a moral high ground by doing good in society.

In a world of fluid markets, Wesleyan's Portfolio Subcommittee is a critical asset. Its 15 alumni are experienced, active participants in financial markets, whom Kannam characterizes as nimble, able to seize opportunities quickly.

Wall Street veteran Frank Sica '73, a current trustee, is chair of the committee, which has recently changed its role to give Kannam more of a leadership position, while retaining oversight responsibilities and serving as a sounding board. "We help him shape the overall portfolio," Sica says. "We help him review asset allocation decisions and asset managers.

"Tom has vastly increased the analytical approach of the processes used to measure performance," Sica says. "He has certainly grown in the experience he brings to analyzing specific asset classes and managers. Under Tom, we've achieved top quartile performance."

Alternative investments have been a key element in Wesleyan's portfolio strategy. With the tactical ability to sell short and trade in a variety of instruments, managers of alternative investment funds have greater flexibility than traditional managers.

"These managers can participate in worldwide financial markets in a more eclectic way than people who simply buy and hold assets," says Sica.

The strategy of using alternative investments has paid off. In the bear market of 2000–2002, a diversified pool of 15 hedge funds that had the ability to sell short and take other defensive positions helped Wesleyan preserve capital. In the past fiscal year, Wesleyan achieved an endowment return of 15 percent, which not only ranked as top quartile performance, but also met a new goal set by President Bennet: performance in the top five of the 20 highest rated liberal arts colleges in the annual *U.S. News & World Report* ranking.

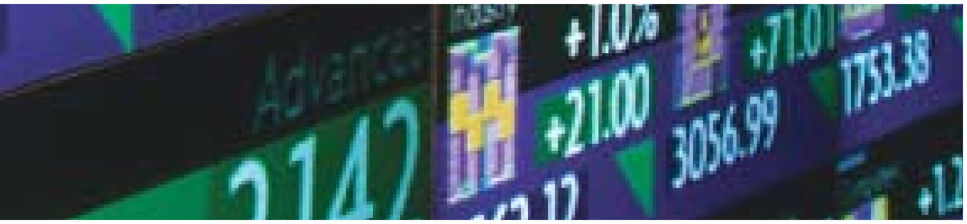
The flip side of an excellent endowment return is tight discipline on spending from the endowment. Wesleyan's policy has called for the endowment draw not to exceed 5.5 percent of the 12-quarter trailing market average. But the university deliberately relaxed that policy during the past four years to take strategic advantage of its debt capacity and historically low long-term interest rates. Special draws of approximately 1.9 percent supported an ambitious Campus Master Plan and an expanded fundraising effort. The administration and Board undertook this initiative out of a belief that it was vital to the university's success in a highly competitive marketplace. At the same time, trustees realized the high rate of spending from the endowment was not prudent if sustained.

At their November meeting, trustees endorsed an administration proposal to return the endowment draw, including debt service, to a 5.5 percent maximum within five years. The administration and Board considered a timetable as short as one year but concluded that the cuts required to meet that schedule would unnecessarily, and counterproductively, signal an atmosphere of crisis that does not exist.

"While we will be faced with difficult decisions about the budget, we are acting from a position of overall financial strength," says President Bennet. "I am confident that we have the financial discipline and support to strengthen Wesleyan for the long term."

Whether a 5.5 percent spending rate will be sufficiently low to protect the university's competitive posture remains to be seen. According to the *Wall Street Journal*, Amherst, Grinnell, and Pomona are spending at a rate of 4 percent or less. Differential spending rates will make it all the harder for Wesleyan to close the endowment gap with competitors over time. The *Journal* also reported that some institutions with the largest endowments, notably Harvard at $26 billion, have come under scrutiny from critics who say low rates of endowment spending amount to hoarding of assets that could be used, for example, to reduce tuition.

Regardless of whether Wesleyan can close the total or endowment-per-student gap with competitors, adding gifts to the endowment is a top priority for the university. The success of the Wesleyan campaign in raising $281 million has dramatically underscored both the ability and willingness of alumni and parents to support the university. The campaign raised $75 million in direct contributions to the endowment; the rest went to new faculty positions, financial aid, facilities, annual operating support, and other projects. Wesleyan is on track to bring in more cash from gifts than ever before—well over $30 million—in the first year *after* the campaign. That is triple the rate before the campaign. Based on an analysis of Wesleyan's fundraising capacity in light of results achieved by 50 top colleges and universities, Vice President for University Relations Barbara-Jan Wilson contends that Wesleyan can raise substantially more.



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"We plan to invest in our fundraising operation with the expectation that the investment will be repaid many times over," she says. "Wesleyan alumni and parents want the university to continue offering the very best liberal arts education, and they are generously contributing toward that goal."

Findings from an analytical consulting firm further buttress the belief that Wesleyan can raise more money and increase gifts to the endowment, according to Dresser.

"Last summer we asked our fundraising consultant, the CORE Group, to undertake a socioeconomic analysis of 40,000 alumni from Wesleyan and nine of its peers. The results show what we always suspected: the wealth profile of Wesleyan grads is near the mean. Despite this similarity, our average gift is significantly below our peers. This gap is pure opportunity.

"We still have the youngest alumni body of our peers, but our alumni are moving into what fundraising consultants like to call 'peak earning years.' Our alumni who graduated from 1973 to 1986 are the second wealthiest of the 10 schools in the CORE Group study."

Wilson credits the CORE study with affirming that Wesleyan has every reason to be optimistic about the future of fundraising for projects such as the planned University Museum and a new science facility—two projects that alone will cost more than $100 million. The study does not, however, provide a strategy for raising this money. Leadership for that task falls to the board's newly created Development Committee, chaired by Dachs, which is considering how to approach Wesleyan's next major fundraising effort.

Meanwhile, Wilson is putting heavy emphasis on Wesleyan's annual fundraising effort, renamed the Wesleyan Fund. It has been established as the primary means of giving to Wesleyan and will include large projects such as gifts to the Suzanne Lemberg Usdan University Center, now under construction. Wilson notes that gifts to the Fund benefit the endowment directly by diminishing Wesleyan's need to draw on its endowment.

Wesleyan must raise significant sums on an ongoing basis to meet the Board's goal of adding substantially to the endowment through gifts every year. Last fiscal year Wesleyan added 2 percent of endowment value (roughly $11 million) in gifts to the endowment, and that percentage is slated to rise incrementally over the life of the strategic plan adopted by the board last May.

By addressing the three legs of endowment market value—investment performance, spending, and gifts—Wesleyan has taken crucial steps toward increasing the probability of healthy endowment growth in an uncertain world. Nevertheless, administrators and trustees are keenly aware that the university lacks the financial resources of many of its peers. To remain competitive Wesleyan will need highly efficient management, ambitious fundraising, and a continued presence in the top quartile of university portfolios.

Do you have an opinion about this topic? Please write us at letters@wesleyan.edu.