CASE STUDY
PORTFOLIO MANAGEMENT:
Institutional Investor

Portfolio Management
for Financial Advisors

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Description

The Help for Students Foundation (HFS) exists to provide full scholarships to U.S. universities for gifted high school graduates who otherwise would be denied access to higher education.

Additional facts concerning the organization are:

- Per-student full scholarship costs, which have been rising rapidly for many years, were $30,000 this year and are expected to grow at least 5% annually for the indefinite future.
- The market value of HFS' investment assets is $300 milion, allocated as:
  - 35% to long-maturity U.S Treasury bonds;
  - 10% to a diversified portfolio of corporate bond issues;
  - 10% to U.S. bank certificates of deposit (CDs)
  - 45% to large-capitalization, income-oriented U.S. stock

Description

- HFS's entire annual administrative costs are paid for by donations received from supporters.
- An amount equal to 5% of the year-end market value of HFS's investment portfolio must be spent annually to preserve the foundation's existing tax-exempt status under U.S. law.

The IPS governing Trustee actions is unchanged since its adoption in the early 1960s and reads as follows:

„The Foundation's purpose is to provide university educations for as many deserving individuals as possible for as long as possible. Accordingly, investment emphasis should be on the production of income and the minimization of market risk. As all expenses are in U.S. dollars, only domestic securities should be owned. It is the Trustees' duty to preserve and protect HFS' assets while maximizing its grant-making ability and maintaining its tax-exempt status."

Description

After a long period in which board membership was unchanged, new and younger trustees are now replacing retiring older members. As a result, many aspects of HFS' operations are under review, including the principles and guidelines that have shaped investment decision-making in the past.

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Questions

a) **Identify** four shortcomings of the existing HFS IPS, and **explain** why these policy aspects should be reviewed.

b) Create a new IPS for HFS. In your response, be specific and complete with respect to objectives and constraints.

c) Using the policy created in Part b), revise HFS' exiting asset allocation and **justify** the resulting asset mix. You must choose from the following asset classes in constructing your response.

Asset Classes	***Expected Total Return***
Cash Equivalents	4%
Medium- and long-term government bonds	8%
Real estate	9%
Large- and small-cap U.S equities	11%
International (EAFE) equities	13%

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Answers

a)

SAMPLE ANSWER

There are many deficiencies in the existing policy. Any four of the following, with a brief explanation of why it is deficient, would form an acceptable answer.

- The return objective's emphasis on income is inconsistent with a long time horizon and the need to grow with inflation
- Minimizing risk is also inappropriate for the same reason as above
- Time horizon is not addressed
- Liquidity is not addressed
- Legal issues are not addressed
- Unique needs and circumstances are not addressed
- Restricting the portfolio to only domestic securities is not consistent with maximizing return for the appropriate level of risk, given the diversification benefits of international assets.

Answers

b)

SAMPLE ANSWER

- RETURN – generate a 10% nominal total return, which consists of a real rate of return of 5% plus expected inflation of 5%
- RISK – moderate of slightly above average given a long time horizon and need for inflation protection
- TIME HORIZON – perpetual
- TAXES – none, as long as 5% per year is distributed from the foundation.
- LEGAL – foundations are normally subject to UMIFA
- LIQUIDITY – none specifically needed as long as the 5% yearly distribution is met. This can come from income and supplemented by asset sales as needed.
- UNIQUE CIRCUMSTANCES – none in particular. Administrative costs are covered from other sources.

Answers

c)

SAMPLE ANSWER

Given the risk and return objectives, an allocation of **60% to equity** investments and **40% to bonds** is more appropriate than the current asset mix. Cash equvalents should be minimal as their long-term returns are low and liquidity is not an issue for the endowment.

Considering its expected returns and diversification benefits, real estate could be substituted for some of the bonds. Likewise, international equity could be substituted for some of the equity.

An appropriate target allocation would be:

Cash equivalents	*0%*
U.S. governent bonds	*30%*
Real estate	*10%*
U.S. equity	*50%*
EAFE	*10%*

Answers

c)

This target allocation produces an expected annual return of 10.1% (=.30*8% + 0.10*9% + 0.50*11% + 0.10*13%) which exceeds the nominal return objective of 10%

! NOTE !

Shifting any of the allocations 5% or so should not affect the quality of the answer. Deductions would occur for emphasizing cash equivalents, weighting bonds and real estate more heavily than equity, or failing to use real estate or international equity to improve the efficiency frontier

THANK YOU!