The Atlantic Philanthropies is the largest foundation in history to spend down its endowment. Philip Coates, its chief finance and investment officer, spoke to Philanthropy Management about the challenges of tailoring its investment strategy accordingly.

Achieving closure: the investment challenge

The Atlantic Philanthropies plans to shut its doors by 2020. The task of overseeing and aligning finances, investments and budgets during Atlantic's final phase of grant making falls to its chief finance and investment officer Philip Coates. He is also responsible for implementing the foundation's investment policy, including the selection of investment managers. In addition to his role at Atlantic, Coates currently chairs the Steering Committee of the European Foundation Financial and Investment Officers Group (EFFIO), a network of the European Foundation Centre. From 2007 to 2008, he was a member of the Advisory Council of the Initiative on Foundation and Endowment Asset Management at London Business School. Coates has been a vocal advocate of the benefits of hedge fund investment by foundations.

In terms of the asset classes in which it invests, are The Atlantic Philanthropies in any way atypical of limited life foundations as a group?

There are not many limited life foundations, and so there is not a typical asset allocation for such a foundation. Although Atlantic has been in existence since 1982, our limited life was not crystallised until around 2003. This meant we had a number of longer-term investments such as private equity in the portfolio when the limited life decision was taken. We took the view that these were good investments that we wanted to hold.

We also took the view that we had a sufficient time horizon to try and generate some decent investment returns, rather than just holding cash or government bonds while we paid the funds out. However, we did not have a long enough time horizon such that we could afford a significant drawdown. That is why we settled on hedge funds as a core component of our endowment, along with our existing longer-term investments.

We believe the right hedge funds can provide attractive returns, while also preserving capital better than many risky assets in more volatile markets. As a result, we have significant investments in so-called alternative assets, such as hedge funds and private equity, which are probably only suitable for larger funds that have the internal resources for proper due diligence and monitoring of such investments.

"We have significant investments in so-called alternative assets, such as hedge funds and private equity, which are probably only suitable for larger funds that have the internal resources for proper due diligence and monitoring."

To what extent are there existing investment products appropriate for a spend-out foundation?
I am not sure if there are specific products designed just for limited life foundations, but there are certainly many products that can be used by such foundations. Of course, not all limited life foundations are the same; in the same way that not all perpetual foundations are the same. The foundation itself needs to determine what its risk appetite is and how to best align its goals and its investments.

Once you've appointed an investment manager, do you look to place any constraints on their latitude to reflect the aims of the foundation itself?
We invest primarily in pooled vehicles where it is more difficult to place constraints on what the manager can invest in, so in practice we have not pursued this approach.

Apart from the restructuring required as a result of the decision to spend out, presumably with low volatility and predictability as priorities, what further changes to the investment strategy are anticipated as the spend-out deadline approaches? For example, to what extent does diversification change as the end-date approaches?
I would say we want to achieve attractive returns over our limited life while limiting the risk of a significant drawdown, rather than purely low volatility and predictability. As we approach our end-date we may well need to reduce risk further. We expect some natural risk reduction as our private equity self-liquidates over time, and when we get to the very last few years we will need to hold more cash. We will also need to see how the world changes and what opportunities or risks present themselves.

At Atlantic, the peak-to-trough loss during the 2007-2009 financial crisis was 16%. What were the practical implications of that for the foundation's grant making?
When we decided to be a limited life foundation, we made a forecast of what we expected the trajectory of the endowment to be. Strong returns leading up to the financial crisis meant we were significantly above that expected trajectory. The financial crisis brought us back to that expected trajectory. Fortunately, we held a meaningful amount of cash going into the crisis, which also helped.

Having said that, we still had a significant amount of outstanding grants. Liquidity became more of a concern as private equity distributions slowed, which meant we had to be more careful in forecasting our cash flows. The uncertainty generated by the crisis in the markets and the economy were, of course, all-important issues to consider across our various activities. In terms of the endowment, we did not change our strategy and felt that overall it worked as expected over the crisis.

Do you have any lessons for other foundations from your engagement with private equity?
We think both private equity and hedge funds are models that work well if you pick the right ones. The combination of management and performance fees is a high hurdle to overcome, and many such managers will not be successful. For the right managers though, the structure provides enormous flexibility and a strong alignment of interests – especially if the managers invest their own capital in the fund.

In terms of private equity, commitments to funds are for a very long time. So it is critical to do significant upfront due diligence before investing and to make sure the right structure and incentives are in place. We prefer private equity managers that will roll their sleeves up and work with companies to restructure them or help them grow, rather than those that make passive leveraged investments.

You've written that, "A qualitative and common sense understanding of how different managers' strategies work is often better than relying on quantitative analysis of a limited data series." What does that involve in practice?
There are many reasons why looking at a manager's time series of returns is not a good way to make investment decisions. The time series of returns should be viewed as one component of a wider overall analysis. Such time series are often too short to be statistically meaningful and are backward looking and historical in nature. They are a product of the particular environment that was in operation when those time series were produced. It is also unclear if the investment approach has changed over time or if the risk in the strategy has changed over time.

Long-Term Capital Management is the classic example of what looked like a great investment if you just looked at their return series, which then spectacularly blew up. This is somewhat akin to the flaws in using Value-at-Risk to manage risk. Although we do look at these time series, we find more value in understanding what it is that the manager is doing and then from experience and a comparative approach, getting a feel for how they might behave in different environments.

Before we invest, we spend a lot of time meeting managers and in general understanding what their different approaches are and how

"We prefer private equity managers that will roll their sleeves up and work with companies to restructure them or help them grow, rather than those that make passive leveraged investments."

they might perform in different environments. It is also very important to scrutinise the individuals involved, and the quality of the operational setup. We will only invest with managers and strategies that we can understand and explain.

As an example, we would have more comfort with an experienced long/short equity manager that does fundamental research on companies, maintains low leverage and exposure to the markets and maintains prudent diversification rather than a highly levered manager that uses a black-box statistical tool to trade rapidly in futures markets.

Has there ever been any serious divergence of opinion within the Investment Committee?

Differences of opinion are often a good thing in Investment Committees as they lead to high-quality discussions that inform good decision-making. We have been very lucky to have an outstanding Investment Committee, which has been very engaged in terms of shaping the overall investment policy and helping to steer Atlantic's endowment through various environments.

If you're spending out, is there a potential problem with outperforming investment return expectations?

I would say this would be a high-quality problem if it occurs. It would mean more funds available over the remaining limited life to go towards our charitable goals. We hope to adjust the amounts we expect to be able to give over the remaining years as our actual investment returns become clearer. Assessing the funds that will be available is not an easy task, however, especially if your endowment does carry some investment risk. **PM**

Richard Schwartz