

Investment Management **The Big Leagues**

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Most investors with portfolios in excess of \$1 million appropriately expect better options than those commonly available to the general public. However, very few of these investors can access the top shelf talent available to the multi-billion dollar endowments. Our founders and principals have significant, direct experience overseeing pools of capital which utilize the “Endowment Model” of investment management. Since this model has served sophisticated, multi-billion dollar investors extremely well over the decades, we maintain that applying the same principles will also serve the best interests and needs of our clients over the long term.

What is the “Endowment Model?”

Quite simply, the term “Endowment Model” refers to the process utilized by the larger college and university endowments in the investment of their portfolios. These institutions have performance records that make them worthy of emulation. Typically their investment practices have five common characteristics:

1. Stated Objectives – Investment practices and expectations are governed by approved written policies.
2. Accountability – Endowments have boards of trustees and investment committees which serve as fiduciaries and overseers. Stated objectives are measured, reviewed and updated when necessary.
3. Long Term Focus – Endowments are designed to last for perpetuity which allows them more flexibility with their investment options.
4. Broad Resources – The larger endowments maintain a staff of dedicated professionals with substantial resources to exercise continuous due diligence over the managed assets.
5. Reporting and Peer Review – The activities of endowments are widely publicized and often can be quite insightful. In particular, two of the most highly respected endowment reports are the NACUBO Endowment Study (consisting of 741 institutions as of the 2004 report) and the Commonfund Benchmark Study (comprised of 707 endowment funds in its 2005 survey).

Why did Diversified Trust adopt the Endowment Model approach?

Our clients are composed of three primary groups: (1) families and individuals, (2) foundations and endowments, and (3) retirement plans. While

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investment objectives and tax considerations vary among these three groups, common characteristics exist among all of them. Most of our clients have principal preservation as their primary goal followed closely by prudent growth. Some desire a level of current income, but growth through consistent long term capital appreciation tends to be the primary objective. These are the same goals of large endowments.

Who are these endowments?

The endowments in the above-mentioned NACUBO study are generally broken down into several categories including: (a) \$1 billion or more in assets, (b) \$100 - \$500 million, and (c) under \$25 million. The largest group includes endowments such as Harvard University with \$22.1 billion in assets. In addition, the list includes Emory University (\$4.5 billion), Duke University (\$3.3 billion), Vanderbilt University (\$2.3 billion), Johns Hopkins (\$2.0 billion), and Brown University (\$1.6 billion). These large endowments are viewed by most as being among the most sophisticated investors with access to the best investment options available.

How have endowment funds performed?

The NACUBO Study published the annualized returns of endowments through June 30, 2004 (the fiscal year-end for most endowments):

Endowment Size	1 Year	3 Years	5 Years	10 Years
\$1 billion and higher	17.2%	5.4%	7.5%	12.5%
\$100 million - \$500 million	16.0%	3.7%	3.9%	10.0%
Under \$25 million	12.4%	2.6%	2.4%	8.8%

What is important about these results?

There are a couple of interesting things that stand out. First, these results incorporate the volatility of investment markets over the past decade. During this period we experienced some of history's best markets (the late 1990's and also 2003), and some of the worst (the 3 year bear market of 2000-2002). As a result, the 10 year averages are a good representation of long term investment returns. The second and most important conclusion from this ta-

ble is that the returns of the largest endowments significantly exceeded those of the smaller endowments. Clearly, bigger consistently did better over this ten year period.

Why did the larger endowments consistently do better?

While most endowments generally have very similar objectives, the larger group clearly achieved better results. The reasons for this outperformance can be boiled down to four primary characteristics: (1) broad diversification within their asset allocation, (2) exposure to high quality alternative investments, (3) specialized investment managers, and (4) sophisticated due diligence and oversight. These four reasons are not difficult to recognize, but understanding the execution of these principles is often where real differentiation can be found.

How do the larger endowments achieve a broader and more diversified allocation?

As discussed earlier, endowments must make annual distributions to support the schools that sponsor them, but they must also focus on long term growth. To achieve these dual objectives, endowments are very focused on maintaining an appropriate risk/return relationship. The following chart from the 2004 NACUBO study shows the average allocation for endowments of various sizes:

Asset Class	Over \$1 billion	\$100million-\$500 million	Under \$25 million
Cash	2.7%	2.5%	5.0%
Fixed Income	15.2%	19.5%	27.2%
Public Equities	46.3%	59.1%	61.7%
Real Estate	4.0%	3.1%	1.3%
Hedge Funds	20.2%	10.0%	1.8%
Private Equity	8.3%	3.2%	0.2%
Natural Resources	2.6%	0.9%	0.0%
Other	<u>0.7%</u>	<u>1.7%</u>	<u>2.8%</u>
Total	100.0%	100.0%	100.0%

What does the term "Alternative Investments" mean?

The asset classes in the table above can generally be categorized as "traditional investments" and "alternative in-

vestments.” Traditional assets include cash, fixed income, public equities and real estate. These core asset classes are generally very liquid and have been used for many years by institutions and individual investors. On the other hand, alternative investments include hedge funds, private equity, and natural resources, which are sectors that have become mainstream investments and are used as “alternatives” to traditional assets.

Why should an investor consider maintaining exposure to alternative investments?

The most striking allocation difference between large and small endowments is the degree of exposure to alternative investments. On average, larger endowments have over 30% of their assets invested in alternative investments, while the smaller endowments have less than 5%. Empirical studies reveal that the use of alternatives is one of the primary reasons for the superior performance of the larger endowments. Alternative investments typically provide total return opportunities that are not directly related to traditional investment markets. Consequently, in many instances, a portfolio with an appropriate allocation to alternatives can achieve better results with lower volatility than a portfolio that is primarily dependent on stock and bond markets.

How do endowments actually execute their portfolio allocation decisions?

Even the largest endowment funds rarely manage their own portfolio assets. Instead they implement an overall asset allocation strategy and retain independent, specialized investment firms to manage designated pieces of their portfolios. According to the 2005 Commonfund Benchmark Study (which included 707 institutions), the average endowment uses 12 managers, and the Endowments with performance in the top decile maintain 16 managers on average. Unlike many individuals and small institutions who either manage their own assets or choose a handful of mutual funds or money managers, the best performing endowments generally employ a broad mix of specialized managers who are each focused on a particular area of expertise within the overall portfolio asset allocation.

Can large endowments hire better managers?

Most successful and highly regarded investment managers do not accept small clients. Generally, if they are not al-

ready closed to new investors, the best managers have client minimums of \$10 to \$50 million in order to establish a new relationship. Consequently, only very large investors have the resources necessary to retain the prudent number of these top firms necessary to construct a broadly diversified portfolio. Not only do the portfolio managers of the larger endowments require higher minimums, they have tended to produce better results. To cite a recent example, when examining three distinct groupings of endowments, the below table shows the different results of one year returns by asset class for the fiscal year ending June 30, 2004:

Asset Class	Over \$1 billion	\$100 million- \$500 million	Under \$25 million
Equity-U.S.	22.3%	22.3%	20.2%
Equity-International	31.0%	28.7%	25.6%
Real Estate (Public)	26.4%	21.1%	19.9%
Hedge Funds	11.9%	7.6%	6.0%
Private Equity	21.2%	10.8%	-19.6%

The spread between returns in the alternative asset classes (hedge funds and private equity) is much more pronounced than in the traditional assets area. This further explains the higher returns of large endowments. By allocating more to alternative investments and by retaining high quality managers, large endowments have a distinct performance advantage.

What level of oversight is typically maintained by the larger endowments?

Most large endowments maintain dedicated investment staffs, investment committees and boards of trustees that are responsible for the governance and oversight of these funds. For example, the endowments in the top performance quartile in the Commonfund study averaged 4.1 full-time members on their investment staffs and 8.9 members on their investment committees. The execution and oversight of their investment process is performed by a full-time staff of experienced professionals following clear guidelines.

What about fees?

Cost is an important consideration in the management of every portfolio. Some investors tend to focus on the cheapest manager and in doing so they may sacrifice qual-

ity. Alternative investments are more expensive to manage than traditional asset classes, and thus quality managers in this area typically command higher fees. In fact, the endowments surveyed in the Commonfund study that ranked in the top decile of performance had higher fees (average of 0.81% of assets) than the average fee for all endowments (0.71%). We believe it is important to manage fees while recognizing that a highly diversified portfolio may bear more cost than one that is more narrowly invested.

What about taxes?

How does the Endowment Model accommodate this concern for taxable investors? Since endowments are tax exempt organizations, they do not have to worry about income and capital gains taxes. However, that is an important consideration for many of our clients. Through direct interaction with the portfolio manager and by having the required resources to maintain trade by trade oversight, the Endowment Model can be administered in a very tax efficient manner.

How does Diversified Trust replicate the Endowment Model?

Our investment platform is designed to provide broad diversification among asset classes, investment styles, and also traditional and alternative investments. We employ highly specialized investment managers to manage our proprietary strategies. These firms fit the profile of managers utilized by large endowments. In addition, our thirteen Principals and Bill Spitz form our Investment Committee that exercises extensive due diligence and oversight of our managers and investment process. The following table outlines the strategies we offer:

Asset Class	# of Managers
Tax Exempt Fixed Income	1
Taxable Fixed Income	3
Large Cap U.S. Equity	3
Small/Mid Cap U.S. Equity	3
International Equity	2
Real Estate	1
Hedge Funds	Multiple
Private Equity	Multiple
Private Income	1

What determines successful investing?

It can be human nature to seek out potentially hot stocks or sectors of the market. However, all too frequently this imprudent practice has been a recipe for trouble. The Endowment Model may sacrifice the potential for a home run, but it also significantly reduces the risk of a strike out. Consistently, those who employ this model's approach and utilize quality investment managers have been successful investors over the long term. The Endowment Model utilized by the sophisticated, multi-billion dollar endowments has proven successful over the multitude of past investment cycles. While each of our clients has unique needs and objectives, we are convinced that following the basic, time-tested tenets of this investment approach will greatly enhance the potential for the successful achievement of long-term goals.

Disclosure

The primary purpose of our periodic newsletters is to answer broad questions on a given subject and invite you to ask more detailed questions. We hope the above summary has been useful, and we look forward to providing more information to you as the need arises. Please visit our website which provides greater insight to our organization.

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