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The Business of Investing at US Endowments and Foundations

Endowments and foundations plunged into alternative investing five to seven years ago, and are now working to sort out complex issues related to performance measurement, accounting and transparency in their investments. Custodians are the natural service providers to assist endowments and foundations with this challenge, although the trend towards using external managers has left endowments and foundations with insufficient assets at their custodians to pay for the services they require. This industry-wide issue reaches into technology, data management and the economics of the custody business. How endowments, foundations and their service providers meet the challenge of performance measurement in a time of scarce resources is an open question.

Executive Summary

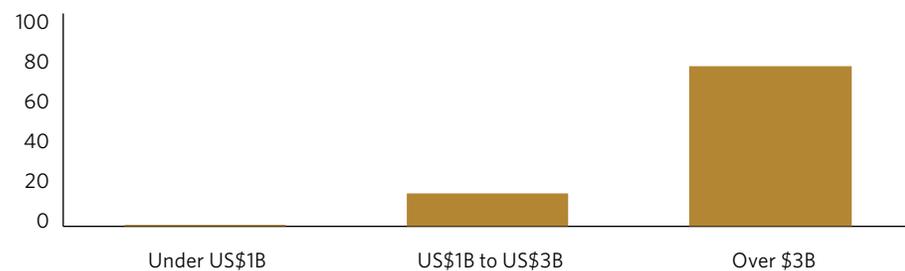
- The migration of endowment and foundation assets to alternative investments is largely complete: alternatives now comprise 54% of an average target asset allocation. Over the next two years, changes to asset allocation models will be adjustments around the edges or adding sub-allocations for macro hedge funds or emerging markets.
- Some endowments and foundations now consider cash as a standalone asset class or as a subset of Treasuries in an attempt to mitigate the subpar returns of a very low interest rate environment.
- Dodd-Frank is likely to push the majority of small OTC derivative users out of the marketplace. While some endowments and foundations may turn to managed futures and options, the majority appears content to trust their external asset managers to trade OTC derivatives on an individual portfolio basis.
- Operationally, endowments and foundations struggle with performance measurement and transparency for alternative investments. Nearly all endowments and foundations shadow their official performance reporting, and most would like more open data structures to amend and correct performance reports alongside custodian and consultant offerings.
- Endowments and foundations recognize that their cost pressures do not align with their technology, accounting and service needs, particularly for alternative investments. How to manage this challenge with custody providers, particularly when 80% to 100% of assets may sit with external managers in commingled accounts, is an immediate issue in today's market.

About This Study

This study, conducted in conjunction with Finadium, is based on a series of interviews with executives of US endowments and foundations conducted in September and October of 2011, and on a major survey of endowments and foundations conducted by BNY Mellon in June and July of 2011. In total, 305 endowments and foundations contributed data for this study, most of which provided baseline information on their satisfaction levels with various custodial services. The majority of responses to this study were electronic while a subset of organizations participated in a telephone or in-person interview.

Our telephone interviews covered US\$96.9 billion in assets across 15 endowments and foundations. Endowments comprised the lion's share of the assets under management we spoke with; these groups held \$90.7 billion. Assets were also heavily skewed towards the five largest organizations; these endowments held US\$80 billion, or 93% of the sample. The assets of the endowments and foundations we spoke with ranged from US\$500 million to over \$15 billion, with the majority managing between \$1 billion and \$3 billion (see Exhibit 1).

Exhibit 1: Assets under management of surveyed endowments and foundations (Percent)



Source: Finadium

Within these firms we spoke primarily with chief investment officers and senior operations executives. The individuals we spoke with had detailed knowledge about their funds' activities including their use of derivatives, performance measurement and custodial services. The funds included in our conversations came from throughout the US.

Between the electronic survey and our focus group interviews, we identified consistent patterns in the interests, behaviors and potential future actions of endowments and foundations today. This report presents our findings and suggests directions for future developments in the endowments and foundations industry.

Like other investment firms, endowments and foundations have worked to weather the storm of recent financial turmoil by diversifying assets and focusing on their long-term missions. This has been no easy feat; even stable investment structures and broad horizons could not save many organizations from losses between 2007 and 2009. Going forward however, assets have begun to grow again with endowments and foundations placing an emphasis on performance measurement, risk management and transparency.

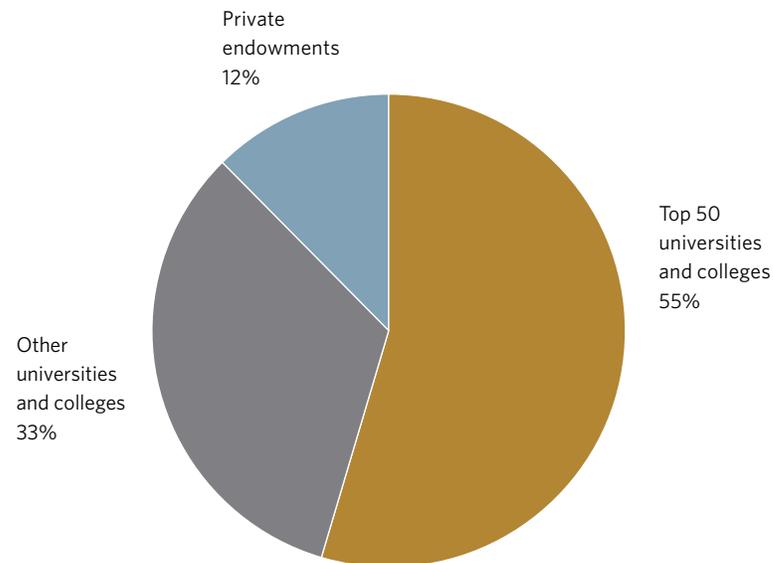
The Assets of Endowments and Foundations

The US endowment market currently controls an estimated US\$403 billion in assets, encompassing universities, colleges and private endowments (see Exhibit 2). Universities and colleges manage over US\$353 billion, or 88% percent of the total, according to a recent study by NACUBO and the Commonfund Institute. The top 50 endowments in the university market control 63% of educational assets with the remaining 815 managing just 37%. Another segment of the endowment market is not recorded by association surveys; this group is private and otherwise unaffiliated with a category such as universities. However, independent surveys including this study find that some large, non-educational organizations are classifying themselves as endowments. We estimate that these organizations control an additional \$50 billion in assets, or 12% of total US endowment assets.

For endowments, overall assets under management have grown over the last two years as a result of new contributions and returns on investment portfolios. Universities and colleges reported average growth of 19.8% from 2010 to 2011, according to NACUBO and the Commonfund Institute*, showing that this sector remains strong and will be vital for years into the future.

Exhibit 2: Assets under management at US endowments

Total = US\$403 billion



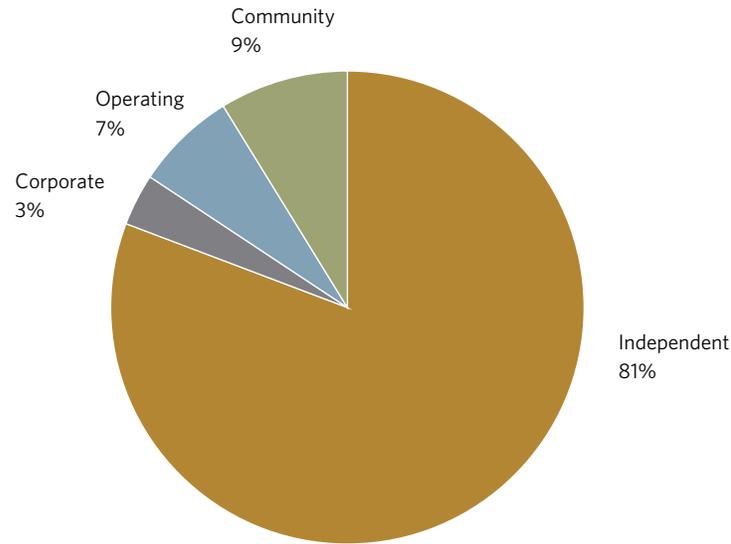
Source: NACUBO-Commonfund Institute.

The US foundation market is highly concentrated by both type of organization and the number of foundations that control the majority of assets, according to the Foundation Center. Of the US\$583.4 billion managed today by US foundations, 81% is in the hands of independent foundations (see Exhibit 3). These organizations were typically launched by a wealthy donor and give according to the mandates set out at their inception. Rates of giving are based on internal guidelines, with some foundations intending to last into perpetuity while others expecting to give away all of their assets within a fixed time period. Other types of US foundations include corporate, operating and community groups.

*2011 NACUBO - Commonfund Study of Endowments, available at http://www.nacubo.org/Research/NACUBO-Commonfund_Study_of_Endowments.html

Exhibit 3: Assets under management of US foundations by type of organization

Total = \$583.4 billion

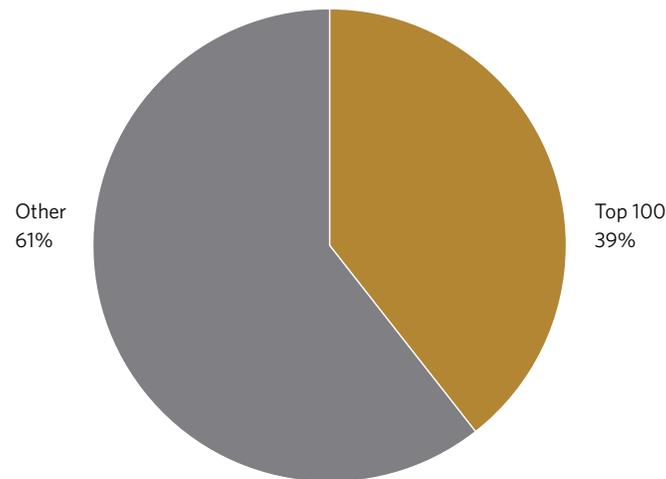


Source: Foundation Center

The top 100 US foundations control 39% of assets and represent just 0.1% of the 75,595 foundations currently active in the US today (see Exhibit 4). As a result of this concentration, the actions of the largest foundations drive giving and investment patterns for the remainder of the sector. The foundation market has seen less robust growth given its reliance on existing funds while endowments benefit from donor contributions, but the sector has begun to recover from losses of 17% from 2008 to 2009.

Exhibit 4: Concentration of assets under management of US foundations

Total = 75,595 US foundations



Source: Foundation Center

Asset Management, Alternatives and OTC Derivatives

While often categorized as one group, a more accurate representation of endowments and foundations may be to speak of one market with many niches and segmentations by needs and investment styles. Common trends do exist in investments and operations, but the behaviors of the largest, market leading institutions can be quite different than the actions of the smallest.

Most endowments and foundations describe themselves as “diversified” or “long-term,” but this self-definition carries a different type of meaning than when a pension plan would call itself diversified ten years ago. The diversification of endowments and foundations today extends into a myriad of assets classes that are so established that calling them alternatives appears to be a matter of historical convenience rather than anything truly alternative about them. These assets include hedge funds, private equity, timber, real estate, commodities and energy. While endowments and foundations appear comfortable with their investment options, tracking, reporting and managing these investments offers new complications for both investors and their services providers.

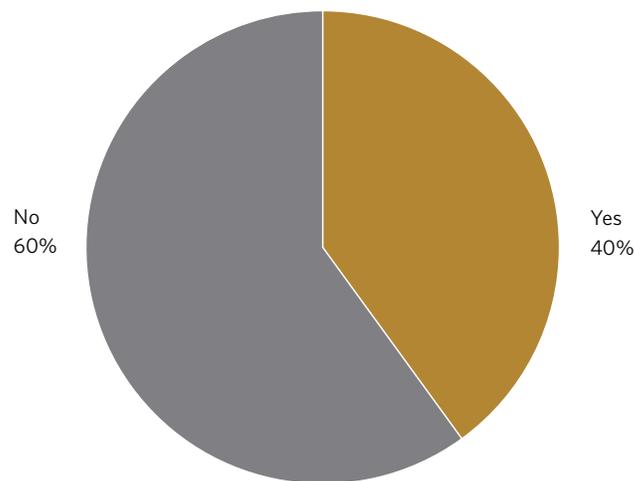
Asset Allocation and the Use of External Managers

For the most part, endowments and foundations use external asset managers for their investment activities; 60% of the executives we spoke with had no internal asset management activities at all, and most of the remaining 40% managed a small percentage of assets in-house (see Exhibit 5). The most popular reason for keeping asset management in-house was to capitalize on a core expertise, particularly when an organization’s initial creation was based on tangible assets in commodities or real estate.

“We used to have a much larger internal investment staff than we do now.”

—Operations Manager,
US foundation

Exhibit 5: Endowments and foundations managing assets in-house

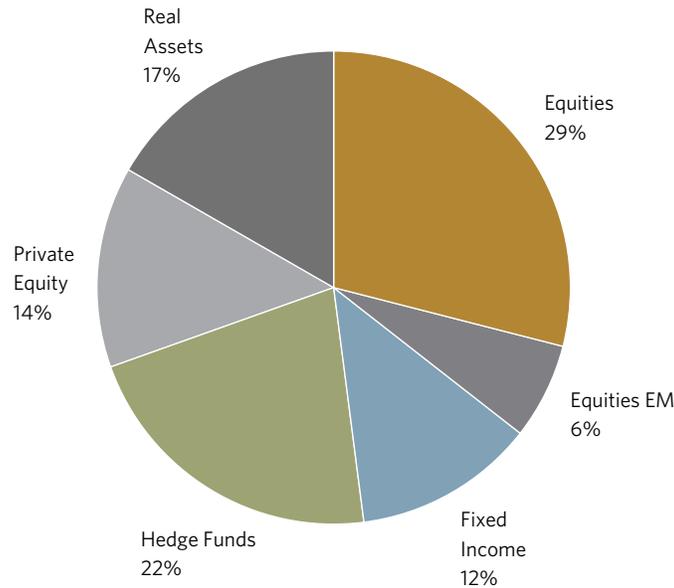


Source: Finadium

Endowments and foundations also retain control in some types of transitions between TIPS and Treasuries, for ETFs or in a few cases for marketable securities. With some large notable exceptions, internal management of assets appears to be on the decline. Executives appear comfortable with this decision so long as they maintain control over asset allocation and agreements with their asset managers.

The target asset allocation of endowments and foundations has extended fully into alternative assets. The average endowment or foundation now invests 22% of assets in hedge funds, with some of these allocations extending up to 35% (see Exhibit 6). This is a major shift away from the traditional long-only investment model that is still popular at many pension plans today. Real assets, including real estate, commodities and natural resources, account for another 17% of assets while private equity controls 14%. Together, these three asset classes make up 54%, or over half of the investment activities of endowments and foundations today.

Exhibit 6: Target asset allocations of endowments and foundations



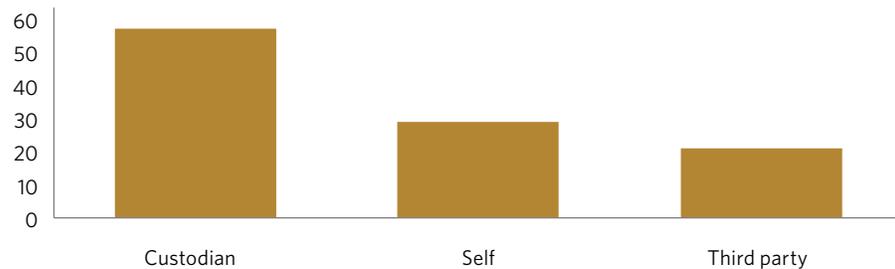
Source: Finadium

Endowments and foundations are not uniform in how they approach the internal classification of non-traditional investment types including alternative assets. Some organizations classify a long/short equity hedge fund within the equity asset allocation bucket while others put it in a separate hedge fund column. Likewise, private equity investments may be considered in a public/private equity category that includes long-only publicly traded securities. Emerging market investments can also overlap, with some endowments and foundations putting equities and fixed income into each relevant asset class while others are separating out emerging markets as its own group. In our data above we have separated out each group according to the information we received from executives and from institution websites.

Some endowments and foundations have begun to recognize cash as its own asset class. Typical allocations are 2% and are bundled into the fixed income category. Endowments and foundations may also make a sliding allocation of 0% to 10% that can be substituted with Treasuries or other liquid securities as needed. As interest rates remain at historic lows, executives recognize that their cash investments cannot simply be left in a money market mutual fund that may in some months charge the organization for cash management instead of providing an incremental return. Options for improving cash returns include putting the cash on the balance sheet of the custodian itself instead of in a money market fund, investing in repo or other products directly, or seeking out managers with different short-term investment styles that can produce a meaningful return in the current low interest rate environment.

Custodians are the most likely candidates to provide cash management services to their clients, although this should not be assumed as the only option. Currently, 57% of the executives we spoke with use their custodian for cash management either through a money market fund or by placing the cash on the custodian's own balance sheet (see Exhibit 7). The remainder either manages cash internally, which is particularly effective if the organization already runs a fixed income investment operation, or uses a third party. Third parties tend to be banks where the endowment or foundation is investing in CDs or other vanilla products.

Exhibit 7: Who provides cash management services to endowments and foundations (Percent)



Source: Finadium

Current target asset allocation models appear to be stable; endowments and foundations note that over the next two years they only expect to change their target asset allocations around the edges. For many organizations, the major changes came three or four years ago when institutions made the large scale decision to reduce their exposures to long-only, public investing in favor of long/short and private equity. The executives we spoke with appeared very comfortable with their current investment choices and have no desire to make further broad changes.

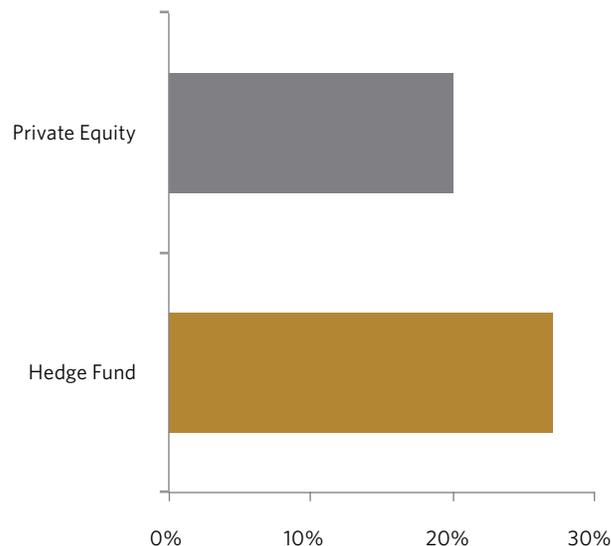
Going forward, expected changes to endowment and foundation portfolios were not uniform across the organizations we spoke with; there are no major investment trends on the horizon that would significantly alter the endowment and foundation landscape, and each organization saw its opportunities slightly differently than others. The small changes that endowments and foundations expect include further investments in emerging markets and in separating out specific types of hedge funds as their own sub-asset class. Global macro hedge funds in particular are likely to get their own categorization. Some executives also noted a greater interest in fixed income while others were heading in the opposite direction.

Investing in Alternatives

According to managers at endowments and foundations, the trend towards investing in alternatives, including hedge funds, private equity and real assets, began in earnest as early as 2002, and by 2007 most organizations had made the conscious decision to emphasize that part of their investment activities over traditional investment styles. Since 2007, the trend has been to refine which parts of alternatives make the most sense, whether to invest directly or through funds of funds, and how to manage those investments going forward.

Endowments and foundations have become predominately direct investors in hedge funds, private equity and real assets. This is a change from prior years when funds of funds were the major investment vehicle for hedge funds and speaks to the increasing sophistication of endowments and foundations in the alternatives market space. Endowments and foundations still report some funds of funds in their portfolios, but many of these are legacy and left over from previous rounds of investing. Only 27% of endowments and foundations cite a new and active use of funds of funds for their hedge funds investments, and 20% say that fund of funds are their primary investment vehicle for private equity (see Exhibit 8).

Exhibit 8: Endowments and foundations using funds of funds as their primary investment vehicle for alternative assets



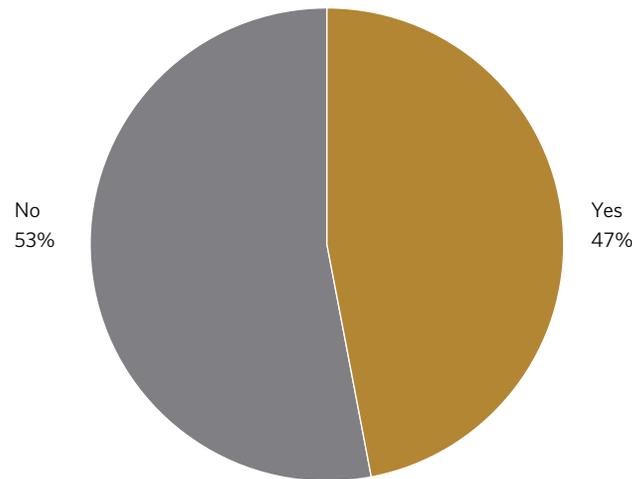
Source: Finadium

Endowments and foundations use a variety of benchmarks for their alternative investment activities. While most endowment and foundation investors have centered on Cambridge Associates for private equity and the National Council of Real Estate Investment Fiduciaries (NCREIF) for real estate, there does not yet appear to be a benchmark for hedge funds that is truly satisfying for endowment and foundation executives. Some endowments and foundations use the S&P 500 or Russell 3000 plus 2% or Treasury bills plus 5%. Others use the Hedge Fund Research indices (HFRI) but struggle to match up their own specific portfolios with the indices available.

OTC Derivatives and Dodd-Frank

Roughly half of the endowments and foundations we spoke with reported using over-the-counter (OTC) derivative contracts, but this simple statistic hides more complex dynamics in this market (see Exhibit 9). With very few exceptions, endowments and foundations noted that their use of OTC derivatives was small; OTC derivatives did not figure prominently in their portfolios or their investment activities. An overlapping group of managers also use managed futures as both an investment strategy and for hedging. Combining OTC derivatives and managed futures, the percent of endowments and foundations in this market space rises to 67%.

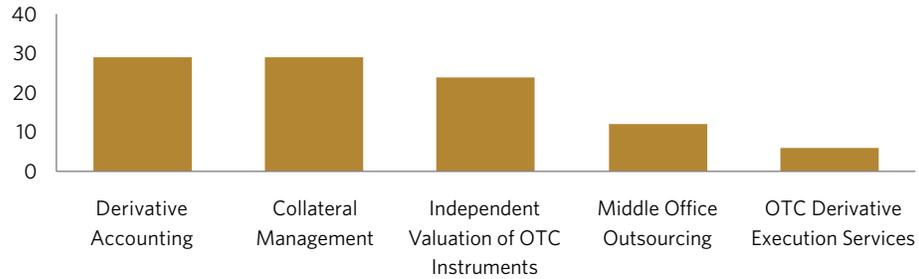
Exhibit 9: Endowments and foundations trading OTC derivatives



Source: Finadium

The more that an endowment or foundation has invested time, energy and resources in OTC derivatives trading, the more likely they were to consider outsourcing some or all parts of technology and operations. Our survey found that 29% of endowments and foundations have elected to outsource derivative accounting and collateral management activities to their custodian (see Exhibit 10). No other service providers were used for OTC derivative collateral management activities. Dodd-Frank represents a potentially large change to the business of endowments and foundations in OTC derivatives but it is still far enough away that it remains in the abstract. However, endowments and foundations are actively concerned that new requirements for registration of hedge funds as well as more reporting for trades means that their managers are not paying full attention to the investing side of their business. Executives also recognize there is nothing they can do in the short term to change the outcome.

Exhibit 10: Endowments and foundation use of outsourced derivative services (Percent)



Source: Finadium

“An A+ rated counterparty having to post margin with a lesser rated entity seems silly, but on the other hand some additional regulation doesn’t hurt.”

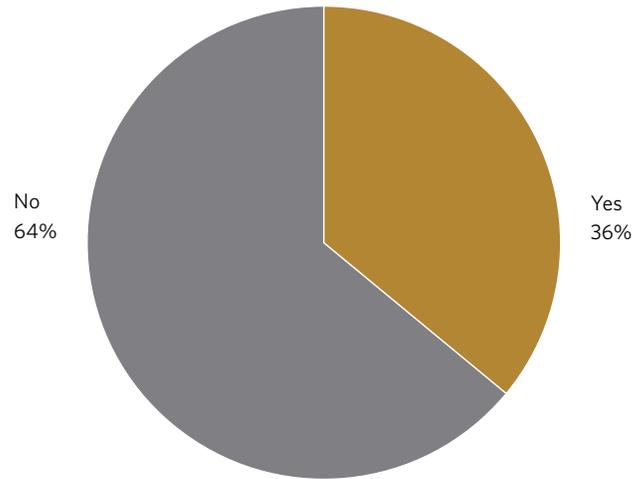
—Operations Executive,
US university

While theoretically the move from trading OTC derivatives on a bilateral basis to trading on exchanges is welcome, in practice it means greater costs for endowments and foundations through posting initial and variation margin. This is likely to take a large number of smaller players out of the market as they are simply not willing to post the additional margin required, although larger players with well established positions recognize that increased costs are part of doing business. Ironically, some managers planning to leave the OTC derivatives market said that they would fall back to listed options and futures. These products already require margin but perhaps are more understood and easy to track than today’s OTC derivative products. Other executives noted that they had not yet done the full margin calculations to understand their positions and would wait until there was more certainty before engaging in this exercise.

Portfolio Overlay Strategies

Portfolio overlay strategies are going through a cycle of use and disuse with endowments and foundations; only 36% of the organizations we spoke with reported employing such a strategy, and several of these were small organizations (see Exhibit 11). The organizations that have portfolio overlay programs appear to be committed to them and some are looking to expand their activities past foreign exchange and into macro risk. However, most of the 64% of endowments and foundations without a portfolio overlay strategy did not seem to mind; they put their greater faith in their external asset managers to generate the right performance. Only one manager thought to look into new options for portfolio overlay strategies going forward.

Exhibit 11: Endowments and foundations using portfolio overlay strategies

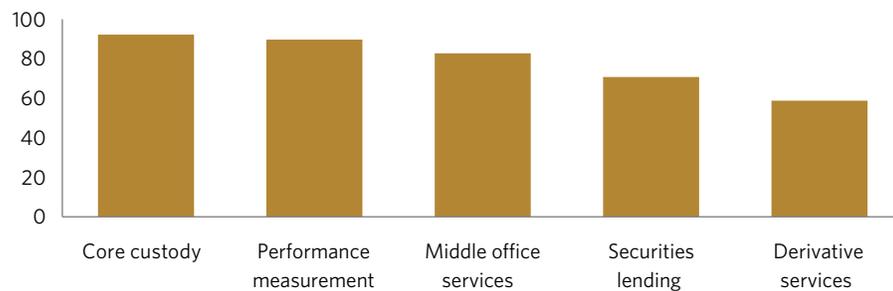


Source: Finadium

Challenges and Opportunities in Asset Servicing

Generally speaking, endowments and foundations report that they are satisfied or very satisfied with the services provided by their custodians. Core custody and performance measurement are viewed most positively, followed by middle office services, securities lending and derivative services (see Exhibit 12).

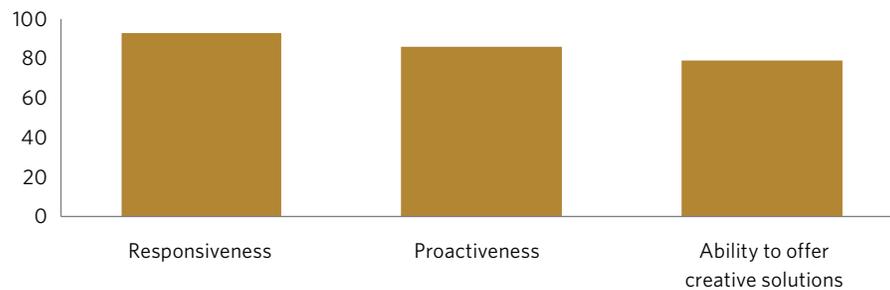
Exhibit 12: Endowments and foundations satisfaction with services provided by their custodian (Percent responding satisfied or very satisfied)



Source: Finadium

Endowments and foundations report overall satisfaction with their relationship managers, and are particularly pleased with their responsiveness in responding to requests and inquiries (see Exhibit 13). Responsiveness was also mentioned as the most important criterion for what makes a good custodian overall.

**Exhibit 13: Endowments and foundations satisfaction with their relationship managers
(Percent responding satisfied or very satisfied)**



Source: Finadium

Endowments and foundations begin to voice concerns with their custodians around performance measurement, new initiatives and accounting. In all three areas the issues come back to alternative assets: endowments and foundations are looking for better ways to get their reporting, documentation and accounting correct, and are frustrated when their custodians do not appear to understand the issues. In accounting particularly, turnover of personnel makes it difficult for endowments and foundations to have the same complex conversation with the right people on a regular basis.

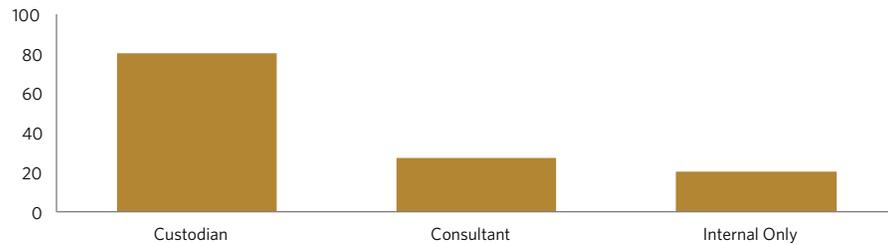
Performance Management, Data and Transparency

The more assets gravitate towards alternatives, the more difficult it is for endowments and foundations to track their performance the way that they have traditionally expected to. Managers of alternative assets will send reports once a month as opposed to a long-only, separately managed account where performance can be viewed on a daily basis with liquid asset classes. Further, new asset types require different buckets for accounting and performance analysis. Transitions in investment styles mean that endowments and foundations must either accept a different level of transparency and performance or look for new ways of tracking their assets.

When asked who currently provides performance measurement services, endowments and foundations gave a variety of answers. Custodians were the major provider, with 80% of endowments and foundations receiving a valued performance measurement report from these institutions (see Exhibit 14). Consultants were cited by 27% of the sample, with overlap among their client bases with custodians. Only 20% of the sample said that they proactively ran their own performance measurement figures although nearly all said that they shadowed their custodians or consultant's services to ensure accuracy.

Endowments and foundations would very much like their custodians to be the sole or primary provider of performance measurement services. By relying on one trusted counterparty, organizations can reduce the number of vendor touch points and facilitate data movements. However, endowments and foundations report that they cannot always find exactly what they are looking for among service providers, and that the number of custodians has dwindled leading to fewer choices from bundled custody and performance offerings.

Exhibit 14: Who provides performance measurement services to endowments and foundations (Percent)



Source: Finadium

Further, endowments and foundations believe that their custodians are working hard to solve the performance measurement problem correctly. When signing up for these services, endowments and foundations are told that specialists within the custodian will be overseeing asset reporting and making the determination on categorization, data structure and accuracy of data for multiple clients at the same time. Endowments and foundations note that this does not always happen to their satisfaction, and that coding an asset manager as a mutual fund may linger even though the manager is really providing a hedge fund or other type of account structure. Custodians in the alternatives reporting space are seen largely as providing hedge fund manager reports back to the investing organizations. Sometimes the data is taken from the endowment or foundation itself, which receives it from their alternative asset managers. These comments were heard repeatedly across endowments and foundations using a variety of custodians.

Even though they may not be getting exactly what they need from their custodians, endowments and foundations are still reluctant to turn to third parties for services. One concern is giving up internal operational controls, where an independent technology vendor may take over more of a process than the organization is really looking for. Another concern is being held hostage by data that cannot be transferred. Endowments and foundations are clearly comfortable with the ability of custodians to transfer their data; they see this on a daily basis. However, the same comfort does not necessarily exist with other outside parties.

Endowments and foundations report that getting accurate data and transparency for their alternative investments remains their most difficult, thus-far unsolvable dilemma. The issue could be resolved with enough human resources and technology but the effort is not seen as worth the end result. In this case, getting something 75% right at the current cost is better than 100% right at a much higher cost.

Executives are split on what exactly defines transparency but they know it when they see it. For some managers, being unable to understand why hedge fund investments have fared a certain way causes concern. This is less true regarding private equity; although statements may come late or may be stale on arrival, endowments and foundations say they understand what their private equity funds have invested in and are comfortable with their exposures.

Transparency for hedge funds is also seen as an issue that can affect investment decisions. If an endowment or foundation manager or their investment consultant is uneasy with the transparency provided, even though returns may look superlative on paper, that could be a reason to pass over the investment opportunity. This may be seen as an ongoing effect of recent hedge fund scandals or simply a sign of the times. Either way, hedge funds looking to hide their strategies from view should take notice.

Opinions on Outsourcing

The executives we spoke with about outsourcing the CIO function tend to not be supportive of this trend in the marketplace. Whether by virtue of their size or their strategic direction, all felt that outsourcing investments for their own organizations would not make sense although they could see how it might work for other organizations. Their primary concern was that investment outsourcing firms are putting endowments and foundations into asset allocation buckets in a cookie-cutter approach. This was viewed as unacceptable for organizations that believed that their own approaches to investing were substantially different than their peers.

Whether assets were managed internally or through third-party asset managers, executives said that endowments and foundations should always have the greatest possible control over their investment activities. Outsourcing the CIO function would mean placing that control in the hands of a third party. As well intentioned as that third party may be, they can never fully replicate having an internal CIO. Executives also mentioned that outsourcing the investment function requires an all or nothing approach. It could potentially be difficult to take back selected pieces in the future without disrupting the entire investment outsourcing relationship. A subset of the executives we spoke with expected a blowup to happen in the investment outsourcing field in the foreseeable future. This would end the notion that there is a fail proof way of managing investments cost-effectively and with minimal risk.

Another subset pointed out the strategic advantage to having an in-house investment function: the investment staff is critical to the fundraising and organizational process. Only in-house staff can meet with potential donors to discuss their options and to make them feel like true parts of the team. External volunteers are also more likely to support an in-house CIO as opposed to a more faceless organization that operates from the outside.

Endowments and foundations were uncertain about outsourcing operations functions for a variety of reasons. First and most importantly, the cost for fully outsourcing an internal team seemed prohibitively high: executives felt that they could perform all the needed functions in-house at a lower price. Second, similar to the investment function, there was a question about how to outsource only selected operational items to a third party while maintaining another portion internally. Third, managers voiced the opinion that they were unique in what they do. Although our research shows this to be perhaps less the case than managers may wish to believe, we do agree that there is still enough differentiation between organizations and how they operate from a philosophical perspective, that placing all endowments and foundations activity into a standardized outsourcing arrangement could cause disruptions.

“We’ve skipped over managers where transparency is an issue for either ourselves or our investment consultant.”

—CIO, US university

“Outsourcing operations would leave no one there to catch mistakes on statements, and those mistakes do happen. There are enough chances to create a problem that we would never give up total operational control.”

—Operations Executive,
US university

Instead of outsourcing operations entirely to an outside firm, managers instead are more comfortable outsourcing small pieces to their custodian or other service providers. For example, endowments and foundations have no trouble outsourcing derivatives collateral management when needed. This is a discreet service with the ultimate control remaining within the contracting organization. It is also a piece of operations that could be brought back in house if needed in the future. Further, internal operations staff still keeps an eye on statements and are able to catch occasional errors before they become a more serious issue.

Although personally skeptical, the managers we spoke with expect outsourcing for both investments and operations to continue. They think that there are enough small funds that cannot buy the expertise they need in-house to make outsourcing an attractive option. However, they also caution that the first big disaster will change the trend entirely. They themselves do not expect to get caught but worry for their peers and colleagues who have elected large-scale investment and operations outsourcing strategies.

Service Needs for the Future

Endowments and foundations expect to invest more in business applications going into the future: one way or another, the costs are unavoidable. Like mutual funds and other money managers, they recognize that building technology internally is not a productive use of resources. Instead, they will continue their role as technology integrators and large consumers of market data. The greatest areas for technology investments appear to be in asset allocation and performance measurement; both might suggest a replacement of consultants in favor of technology. However, there are no cost savings here; endowments and foundations see technology integration as an expensive proposition and wish that data transfer across applications would be easier. Some endowments and foundations noted that even with more technology they might keep their consultants for an independent opinion.

“Someone should crack the data integration code. Technology integration remains the full employment act for technology companies.”

—Operations Executive,
US university

Although technology drives the conversation about future service needs for endowments and foundations, managers are also concerned particularly about accounting for alternatives and new financial products. They worry that custodians do not necessarily have the adequate resources to manage diverse portfolios, particularly when there is a combination of human resources, technology, industry know-how and understanding required of the underlying investment strategies and structures. As one example, fixed income investment distributions for unusual products may be miscoded. In another case, private equity attributions may be miscalculated leading to the endowment or foundation making frequent corrections. These issues are system-wide and cut across custodians, technology and personnel.

Endowments and foundations have their own solutions for custodial improvement as well. The most popular idea we heard was for an open performance measurement platform that would allow clients to input and save data integrated with custodial reports. Clients would like to be able to make modifications to custodial reports and have those modifications fed back to central databases where the changes would persist into the future. The platform would allow customization and modification into the custodian’s own records. Executives want their custodians to maintain their record keeping but also want to skip the extra step of

providing verbal or email feedback to get errors corrected. Open data entry would be a short cut to solving that problem. From a technology perspective, endowments and foundations recognize that they may be asking for something close to the moon. However, this proactive idea would solve several key issues including keeping data all within the custodian, relying on one service provider and allowing users to customize reporting to fit their needs.

“Our custodian has to understand and educate their employees on accounting and performance measurement. CDS is a prime example of a new product that people were not ready for. There will be more products like that in the future.”

—Operations Executive,
private foundation

Endowments and foundations have just begun to think seriously about alternatives to their own or custodial reporting for their alternative assets. The logical competitor is a hedge fund administrator, thought to have all the common elements that an endowment or foundation requires for their reporting and the look-through to underlying holdings. In a few cases endowments and foundations have begun to speak with hedge fund administrators to see what performance measurement services are available. However, this is a very tentative step and not one that many endowments and foundations are keen to take; they may also find that fund administrators face the same technology and data management challenges that custodians do yet have fewer resources of scale to solve pressing problems.

The exploration of endowments and foundations into options for performance reporting is a critical development in the evolution of performance management. Custodians are the natural incumbents to provide the right performance products and services to their clients, and endowments and foundations wonder if hedge fund administrators might have better solutions or if the grass just appears greener on the other side of the fence. At the same time, the difficulties of recognizing the diversity of hedge fund investments, real assets, private equity, venture capital and other unusual, non-traditional classes means that it is often the investor alone who truly understands what bucket an investment should be in. It appears that giving the greatest control to endowment and foundation executives would be the best solution; the more open data structures that vendors can offer endowments and foundations, the happier both clients and service providers will be.

The Cost of Doing Business and the Custodial Relationship

“The custody feature is becoming less valuable than the reporting/analytical information aspect of the service we receive.”

—Financial Executive,
US university

As endowments and foundations deepen their commitment towards alternative assets, their relationships are changing with their custodians. Traditionally the custodial relationship was based on holding assets under management. Now, some funds have 80% to 100% of their assets managed by a third party asset manager with a separate prime broker, custodian or bank; this leaves the endowment’s or foundation’s contracted custodian as a holder of either a minority or no actual assets altogether. Instead, the role of the custodian becomes that of record-keeper and supplier of critical technologies such as performance measurement.

Endowments and foundations look naturally to their custodians to provide performance measurement technology and will happily be consumers. Custodians are valued for their technology investments and the attention they pay to the changing needs of endowments and foundations sector. At the same time, managers recognize that the fees they pay do not necessarily support the technology and services they want to receive. Managers recognize the mismatch between using custody to pay for other services and the amount they are actually paying.

While on the surface this changing role should pose no difficulty, the economics of the transaction become skewed when custodians are no longer holding meaningful endowment and foundation assets. The traditional custodian pricing model is based on assets under custody (AUC), and technology services have typically been provided as a free benefit based on that AUC figure. With the growth of assets that are not custodied but must be tracked by technology, this pricing model has become broken.

A desire for more or better services has pushed some endowments and foundations to thinking about the fees they pay for their asset services. Endowments and foundations report that their budgets are strained, particularly universities that are looking to maximize the value of their endowment for operational activities. At the same time, some executives recognize that in some cases paying the least amount possible is not worth it if the result is high turnover in key areas or lack of new product development for important services in the alternatives market. These organizations would be willing to consider higher fees if it meant better services in return.

Executives that support higher fees realize that this is not a popular option but also feel that the current services they are receiving are too frustrating to continue to put up with indefinitely. There are no immediate disasters on the horizon; simply that the increased focus of alternative investments in the endowment and foundation space means more time and effort spent on managing these portfolios. Ultimately, custodians and their clients will figure out the right mix of payment in services or endowments and foundations will gravitate towards third-party service providers for additional fees. Either way, endowments and foundations will wind up paying more for the services they receive.

“We are in an environment where we have maximized the costs or the environment is causing costs to become an issue. We are now sacrificing services to maintain our current costs.”

—Operations Executive,
US university

Executives were clear that they would not need any fewer services in two years than what they receive today. The expectation is that as investment structures become more complex, endowments and foundations will continue to require more services in investments, operations and technology. How these organizations will pay for new services without giving up old ones remains a question given the reticence of some endowments and foundations to spend money. However, it does appear that they will be faced with a real choice: either make investments or do without services that appear very important or critical in a changing environment.

The struggle going forward will be to find the right balance between what endowments and foundations are willing to pay and what custodians can realistically provide. Endowments and foundations could take on more as reported by their executives. They are operating today largely with bare-bones internal staff and could increase hiring to take on more responsibilities. At the same time, they also hope for more cost efficiencies from the broader services their custodians provide, but this is not always realistic. The real issue is that costs to custodians are increasing while endowments and foundations want them to do more. Creating solutions to this difficulty is the next evolution of the business of managing assets at endowments and foundations today.

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