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COST OF DIVESTMENT

QUESTIONS AND ANSWERS

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Who is responsible for the endowment?

The Investment Committee of the Board of Managers has investment responsibility for the endowment within investment guidelines and policies adopted and reviewed annually by the Board. Members of the Investment Committee are investment professionals.

What is the investment strategy of the endowment?

The objective of the endowment is to provide a sustainable level of support for Swarthmore College's annual operating budget while preserving the purchasing power of the endowment for the future. The success of the College's investment strategy depends on having a diversified mix of investments and hiring the best investment firms to manage specific portfolios of investments. As of June 30, 2012, over 100 firms managed the College's $1.5 billion endowment.

Why is diversification important?

Swarthmore's endowment is invested in many asset classes, as shown in Chart 1. An asset class is a type of investment, such as stocks of domestic companies. Diversification is important because some assets do well when others are performing poorly. Also, various assets have different risk characteristics. Diversification helps the College to achieve good returns with lower risk. Furthermore, within an asset class, the Investment Committee selects professional investment managers who employ different investment strategies, which also provides important diversification

How do investment managers invest our funds?

There are basically three ways an investment firm can invest—through an index fund, a separately managed portfolio, or a commingled fund. The simplest way is through an index fund. These funds essentially hold all the stocks in a specific universe. For example, a domestic stock index fund might hold all the stocks in the Standard & Poor's 500 Index. The performance of an index fund will replicate the universe and will do so for very low fees. Using index funds is called "passive" management and is a good low-cost strategy.

Institutions like Swarthmore, however, hope that they can identify and hire investment managers to put together customized portfolios that will outperform the basic index approach. This costs more so the performance must justify the higher fees. Under this "active" management, there are two approaches.

The first is for a firm to create a portfolio just for Swarthmore and to buy stocks just for Swarthmore; this is called a separately managed portfolio. The second way is for a firm to pool together all its clients' money into one large portfolio with each institution owning a *pro rata* share. This is called a commingled fund. An institution can have greater control over a separately managed portfolio, but fees tend to be higher. Commingled funds, because of their economies of scale, offer lower fees. Ultimately, an endowment seeks to invest where it gets the best return net of fees. Swarthmore has a relatively high performing endowment and does not use index funds. The endowment's assets are in a mix of separate accounts and commingled funds. Swarthmore has been able to consistently achieve returns higher than what index funds would have earned.

How much of Swarthmore's endowment structure could potentially be affected by divestment?

As Chart 1 shows, over 60% of Swarthmore's endowment could potentially be affected by divestment. This includes 5 domestic equity managers, 8 international equity managers, and 30 managers of alternative assets (e.g., hedge funds and other private investments). These firms currently have no divestment constraints and could possibly invest in fossil fuel companies.

What would happen if Swarthmore decided to divest?

If Swarthmore decided to divest, we would have to find replacements for all the commingled funds because an institution has no power to impose a constraint on a commingled fund. Swarthmore's commingled funds totaled $660 million at the end of the last fiscal year. Divestment would incur a very large cost.

Chart 2 shows that Swarthmore's domestic and international stocks have added 1.7% and 1.8% PER YEAR during the past ten years over and above index fund returns.

With divestment, an option would be to hire a firm (such as Aperio Group) to design customized index funds for the endowment. This group could put together portfolios of stocks designed to match desired indexes but without using the divested companies. The firm customizes this approach for an endowment's specific constraints.

If Swarthmore were to follow this approach, it would forego the 1.7% to 1.8% added return per year. This would amount to lost earnings each and every year. As Chart 2 shows, **the loss the first year would be $11.2 million, but by five years it would be a cumulative $73.1 million, and by ten years it would be $203.8 million.** It would be even greater if all the affected portfolios of the endowment were invested in this way.

What about the cost of divesting the endowment's separately managed funds?

It is likely that not all the endowment's separate account managers would agree to invest with constraints. Even if they did, a recent study* indicated we might expect a .4% annual cost. This would amount to over $5 million in the first 5 years and $15 million after ten years. When Swarthmore divested from stocks of companies doing business in South Africa over 20 years ago when the endowment was much smaller, it cost the College $2.2 million.

Could the College use all separately managed social investment funds?

We know that the index approach described above is possible. We do not know of any firms that have managed portfolios with a "sordid sixteen" constraint.

Are there other considerations with divestment?

Important considerations are whether divestment would have an impact and whether it might instead have unintended consequences. If Swarthmore were to divest, it could not participate in shareholder activism efforts, many of which have resulted in tangible progress. If engaged shareholders were replaced by shareholders without conscience on these issues, it would not deprive companies of capital, but would rather make it easier for them to maintain the *status quo*. Foreign ownership of domestic fossil fuel companies could also raise strategic geopolitical issues.

This is all very complex. What is the general conclusion?

Managing an endowment is very complex. Because the investment firms that manage funds for Swarthmore are among the best, our endowment has generated good returns over time. While determining a specific cost is not possible, a strong argument exists that a divested Swarthmore endowment would not continue to generate our historical level of outperformance and that divestment would entail a high cost for Swarthmore College accompanied by limited impact on the targeted companies or other unintended consequences.

*Timothy Adler and Mark Kritzman, "The Cost of Socially Responsible Investing", *Journal of Portfolio Management*, Fall 2008:52-56.

61% of Endowment Structure Could Potentially be Affected by Divestment

Asset Category	Target Allocation	Value 6/30/12	Composition	Possibly Includes Fossil Fuels
Domestic Equity (5)*	20%	$288	Separate portfolios **AND** commingled Funds	Yes
International Equity (8)	20%	$285	All commingled funds	Yes
Alternative Assets (30)	21%	$283	All commingled funds	Yes
Subtotal	61%	$856		
Private Equity	17%	$342	All commingled funds	No
Real Estate	7%	$68	All commingled funds	No
Bonds / Cash	15%	$234	Bonds and cash	No
	100%	$1.5 billion		

* Number of Managers

Chart 1

Cost Estimates

- Swarthmore's investment managers have consistently added return over indexes.
- If the College divested, all the commingled funds would have to be eliminated.
- Assume restructuring to move to customized index fund such as Aperio.
  Aperio creates index fund with customized screens.

- Swarthmore's domestic and international equities have outperformed indexes (net of fees) by:

	Average Annual	
	5-yr	***10-yr***
Domestic	3.0%	1.8%
International	2.5%	1.7%

- Cost of Divestment

Cumulative Cost After	Commingled Funds Only ($660 million @ 1.7%)	Comprehensive ($856 million @ 1.7%)
1 year	$11.2 million	$14.6 million
5 years	$73.1 million	$94.9 million
10 years	$203.8 million	$264.4 million

Chart 2