analysis

The crash reaches the universities

The global financial crisis threatens private and public university funding in the USA and Europe

You could call it the Billion Dollar Endowment Club: its members are those US universities—both private and public—that have at least US$1 billion in endowments from alumni, corporations and other investors. Over the past five years, the number of members in this exclusive club has doubled to 76 and, increasingly, these elite universities have come to rely on the returns from their endowments not as rainy-day funds, but as routine revenue streams. Head of the class was Harvard University (Cambridge, MA, USA) with a jaw-dropping US$36.9 billion in endowments as of June 2008 (Faust & Forst, 2008). Harvard's legendary fund managers, emulated and envied throughout US academia, seemed to defy the laws of gravity—and economics—as they built up the fund at a double-digit pace.

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That was BC; before the financial crash of September and October 2008 when the stock market fell, the subprime mortgage business imploded, oil prices soared, and investment banks and major insurers collapsed. In December 2008, the US Bureau of Labor Statistics acknowledged that the US economy had gone into recession and the financial disasters finally hit Harvard's hoard, which had contributed 35% of the university's operating budget. The endowment took an US$8 billion—or 22%—hit and Harvard began planning its future with endowment losses of up to 30%.

Drew Faust, Harvard's President, and Edward Forst, its Executive Vice-President, told university deans in a letter in December 2008, "[t]o put a loss of that size in historical context, over the last at least 40 years, Harvard's worst single-year endowment return was a negative 12.2 per cent in 1974, and at that time our endowment stood at less than US$1 [billion] and funded a much less significant proportion of university operations. Since that time, there have been only three years of negative performance, with returns ranging from minus 0.5 per cent to minus 3 per cent" (Faust & Forst, 2008). Harvard was not alone; a recent report by the financial services company TIAA-CREF (Charlotte, NC, USA) and the Commonfund Institute (Wilton, CT, USA), based on a voluntary survey of 435 institutions of higher education, estimated that universities lost, on average, 23% of their endowments in late 2008 (Zezima, 2009; Commonfund Institute, 2009).

Roger Kaufman, Professor of Economics at Smith College (Northampton, MA, USA), commented that the stock market itself was old hat for many universities and that the boom times came for endowments when they diversified their investments: "[w]e've seen an enormous growth of endowments, especially at the upper end," he said. "In the 70s and part of the 80s and the 90s, universities took their endowments and invested them in the stock market and the bond market. Then, the wealthiest universities, maybe ten or fifteen years ago, really diversified outside these areas. And so if you look at their portfolios now, they actually hold a very small percentage in stocks, especially US stocks, and a relatively small percentage in bonds. They own a lot of what we call alternative assets, which are hard assets. It could be real estate. It could be commodities. It could be hedge funds. It could be venture capital. It could be private equity." Kaufman said that the elite schools chose "exotic kinds of instruments which, they determined, improved the so-called efficiency frontier, namely: they can get higher expected returns without, at least until recently, assuming any perceived greater risk. As a result, some of these upper-end universities had enormous double-digit annual returns for the last five to ten years and their endowments grew very rapidly." However, exotic investments, especially commodities such as oil, agriculture or lumber, along with the stock market, also crashed in September and October, thus wiping out billions of the dollars held by the endowments.

The 2008 downturn was the worst since endowments became an important part of US university funding, and it caught the institutions and investors by surprise. "The universities are realizing that the downturn is probably going to be longer and deeper than anybody has anticipated. I think if you go back to late September, early October, when we first started to see the large drops in the market, I would imagine that people hoped there would be a fairly quick recovery after the election and things would turn around," commented Donald Heller, Director of the Center for the Study of Higher Education at Pennsylvania State University (University Park, PA, USA). "I think what's happened is it's pretty clear to everybody that the recession is going to be pretty long and pretty deep and the downturn in the market is going to be pretty long and pretty deep. And because of that, universities are realizing that it's going to be much harder for them to weather this

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and that's why you're starting to see some of the responses that are just coming down the pike now."

Harvard said it was "reconsidering the scale and pace of planned capital projects," including development of a new campus (Faust & Forst, 2008). Princeton, which ranked fourth in the Billion Dollar Endowment Club, with US$15.8 billion, BC, and which had the largest per capita endowment, plans to postpone major construction projects and to reduce pay raises. "We want to have the right equilibrium between resources and expenditures," Princeton Executive Vice-President Mark Burstein said in a statement (Arnsdorf, 2008). Top administrators at Stanford University (Stanford, CA, USA), third on the list last year with a US$17 billion endowment, took 10% pay cuts. Stanford Provost John Etchemendy told staff in a letter that the university might have to cut US$100 million from its general fund, including faculty and staff salaries, and daily operation costs over the next two years and that layoffs are "inevitable". "The ultimate cuts may not have to be this deep, but we would be irresponsible not to prepare for this eventuality," Etchemendy wrote.

"The wealthier schools are actually still in pretty good shape. Interestingly enough, the poorer schools didn't have much of an endowment to begin with and therefore didn't rely on endowment income very much for their own operating budget. So, some of them aren't in terrible shape as far as the endowment is concerned," Kaufman said. "As far as financial aid, that's a different story, but then the middle schools, they are a little bit concerned."

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Endowments are only part of the picture. In a letter to US President Barack Obama, the major public universities, the American Association of State Colleges and Universities, the American Council on Education, and other education associations, essentially followed the lead of the troubled US financial institutions and automobile industry, and asked for a bailout. A two-page advertisement in the New York Times and Washington Post, sponsored by the Carnegie Corporation (New York, NY, USA), said: "The current economic crisis poses a major challenge. […] Thirty-one of fifty states are underfunded for their 2009 budgets. As a result, states and municipalities are forced to cut workforces and spending, as well as investment in our institutions of higher education."

These organizations asked President Obama to devote US$40–45 billion to higher education facilities, to renovate classrooms and research facilities. This, they contended, would "provide the stimulus that will propel the nation forward in resolving the current economic crisis and lay the groundwork for international economic competitiveness and the well-being of American families into the future." The Association of American Universities has also recommended an injection of US$1.8 billion to "enable research universities to hire more young scientists and engineers for tenure-track faculty positions."

Yet, according to Heller, the enormous bailouts already paid to the banking and automobile industries could dry up federal funds for education and research. "With all the money put into this bailout nobody expects there's going to be much discretionary money available in the next year's budget. So that means there's probably going to be constraints on what's available for research." However, Kaufman noted that, "[i]t's also possible that funding from the federal government may increase depending upon what policies President Obama decides to implement," such as research into alternative energy sources or stem cells.

Still, universities are worried that their funding from government and charitable foundations could decline. Jeff Raikes, Chief Executive Officer of the Bill & Melinda Gates Foundation (Seattle, WA, USA), said: "[t]he financial crisis is affecting everyone. […] Non-profit groups rely on steady funding to carry out their work, but with an uncertain economy and a volatile stock market, funders are having an increasingly difficult time meeting their commitments." He said the foundation plans to increase its payout by 10% in 2009, which is less than it had planned.

> **…UK universities have been less affected by the economic crisis than US ones, as they depend less on endowments for income**

Others are more positive about their ability to weather the economic crisis. Avice Meehan, Vice-President for Communications and Public Affairs at the Howard Hughes Medical Institute (Chevy Chase, MD, USA), said: "[w]e take the long view. Despite the recent volatility in the markets, we fully expect to meet our current commitments to investigators, to our grantees."

In Europe, only the University of Oxford (UK) and the University of Cambridge (UK) can compete in the same endowment league as their US counterparts, in part because only the UK has a similar university funding model to the USA. Indeed, the UK Government suggested in a White Paper that "the way forward [for university funding] is through endowment" (Clark, 2003) as low endowment levels are believed to be hampering efforts by British universities to defend their position among the world's leading universities. However, Lee Elliot Major, Research Director at the Sutton Trust (London, UK), which released a report on university endowments (Sutton Trust, 2003), commented that UK universities have been less affected by the economic crisis than US ones, as they depend less on endowments for income. Nonetheless, he commented that UK institutions are envious of the wealth of some US institutions. "I think particularly given recent events, university administrations are going to be looking for a diverse range of income streams and that means still trying to grow your endowment, with a diverse investment strategy while ensuring that your state funding is healthy," he said.

Yet, according to an article in *The Guardian,* British universities will still suffer from the financial storm. "The universities of Cambridge and Oxford, whose endowments were valued at £907m and £680m respectively in July, are understood to be the biggest losers. Cambridge's fund plummeted £84m in the year up to July—before the credit crunch began to really bite—prompting fears that the worst is yet to come" (Lipsett & Curtis, 2008). Both were badly hit by the meltdown of the Icelandic economy. *The Guardian* reported: "Oxford is still waiting to find out if it will recover the £30m it had invested in Icelandic banks. Cambridge also had £11m in Iceland."

John Hood, the Vice-Chancellor of the University of Oxford, in his New Year message wrote: "[o]f course, the global financial situation has been highly volatile since the summer and that too is reflected in more recent University figures. These show a decline for the overall period from the end of July 2007 to the end of October 2008 of 14 per cent. It is worth noting in passing that the average UK equity market fall from its peak was in the order of 40 per cent. It is also worth reiterating that endowments count for less than five per cent of the University's total income."

Similarly, Alan Gilbert, President and Vice-Chancellor of the University of Manchester, UK, warned in a letter to members of the university: "We must now anticipate an era of extraordinary stringency in public outlays on higher education; an environment tougher, certainly, than anything universities have faced for the last quarter century" (Lipsett & Curtis, 2008).

The situation is different for many of the universities in mainland Europe, for whom endowments are a marginal funding stream, and which depend mainly on public financing. According to the European Union, 85% of national investment in higher education is provided through public funding, compared with 45% in the USA. Ernst-Ludwig Winnacker, Secretary General of the European Research Council (ERC; Brussels, Belgium), said that European universities have not been affected by the downturn. "Few of them have endowments and the endowments have probably been invested into funds, which are not very volatile."

Still, there are lingering concerns about funding in Europe. Winnacker, a biochemist and former president of the German Science Foundation (DFG; Berlin, Germany), commented that, "[i]t is not clear yet how the ministries that will probably be affected will distribute any reductions between their various institutions. This may or may not happen."

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Janez Potočnik, the European Commissioner for Science and Research (Brussels, Belgium) concurred that European institutions so far have avoided the crisis, but added that investment in research should be maintained. "There is no good reason to cut investment in R&D and education in these troubled times," he said. "Our response must not only be to stimulate short-term demand through fiscal and monetary stimuli. We need also to invest now in the research and technologies that will make us leaders in the low-carbon economy of the future. Now more than ever we need to make Europe the most dynamic knowledge-based economy. And knowledge is produced, among others, by universities."

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