

STRATEGIC INSIGHTS

An Institutional Perspective

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Recent Endowment Returns - Too Good to Last?

As always, the recently released NACUBO-Commonfund Study of Endowments provides noteworthy insights into the state of the markets and endowment investments. This edition of our Strategic Insights series sets out what we consider the most important messages conveyed in the data.

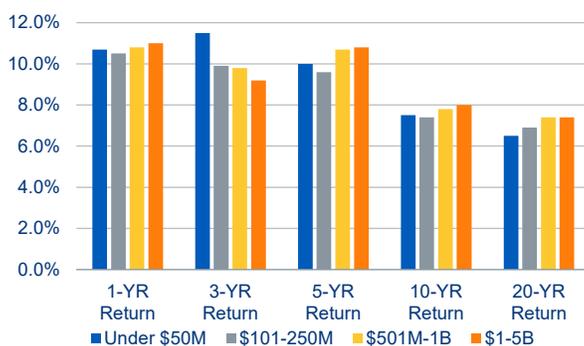
Recent Returns Have Been Outsized

Endowment returns over the past three years have been exceptionally high relative to longer term history. This strong performance largely reflects the surge in global equity markets whose annualized returns have exceeded 20% over the period. Also noteworthy, the longstanding advantage of large over smaller institutions vanished over the three-year period (Exhibit 1). While over longer horizons and the most recent one-year period large institutions have outperformed smaller endowments, thanks largely to the heavier allocation of large institutions to private equity, the pattern was reversed over the past three years of exceptionally strong public market returns. Over this period, large endowments have lagged their smaller counterparts.

Exhibit 1

Historical Returns by Endowment Size

Source: NACUBO. Returns in percent.



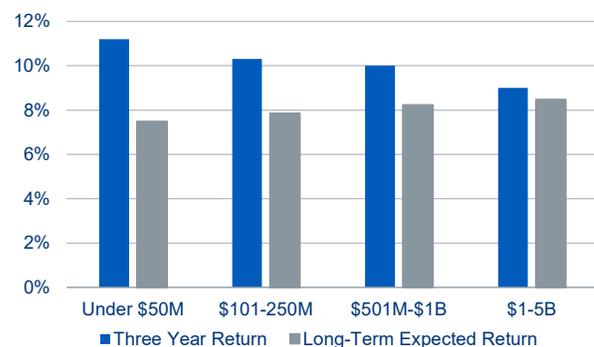
We draw two main conclusions from the data. First, the outsized returns of the recent three-year period cannot be relied upon to persist, especially considering the current near-record high valuation of global stock markets. Applying our capital market assumptions for the long-term performance of various asset classes, we estimate that the expected returns of endowment portfolios across size cohorts will be significantly

lower than the returns enjoyed over the past three years (Exhibit 2). It is important to take into consideration the potential for a reversion to more moderate return levels in the future given the increasing pressure on endowments to defray operating expenditure through higher spending rates. This likely reversion of asset market returns and valuations to more normal levels highlights the importance of enhancing and diversifying the sources of value added as a way to boost returns and increase portfolio resilience. While beta was king over the most recent three-year period, alpha will be increasingly important.

Exhibit 2

Recent vs. Expected Long-Term Endowment Returns

Sources: NACUBO and Strategic estimates.

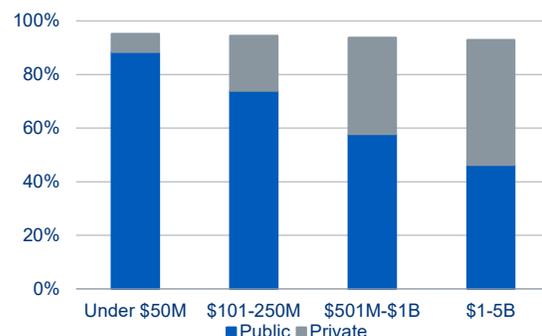


Second, the relative performance of assets ebbs and flows over time, underscoring the importance of diversifying portfolio allocations and avoiding piling on exposure to assets that have performed best in the past. We estimate that across size cohorts, public and private equity beta will account for over 90% of endowment portfolio volatility, highlighting the growth orientation of endowment portfolios and reinforcing the importance of diversification to enhance portfolio resilience (Exhibit 3).

Exhibit 3

Public and Private Equity Contribution to Volatility

Sources: NACUBO and Strategic estimates. Share of volatility public and private equity in percent of total portfolio volatility by size cohort.



The preponderance of equity beta risk in all endowment portfolios, including larger endowments with broad diversification across alternative asset classes, poses a major challenge to those seeking to build resilient portfolios. Diversification is in our view best enhanced by structuring portfolios to include a large number of independent sources of value added and risk exposures. This approach entails focusing on active security selection as the chief source of alpha across asset markets. Diversification can also be promoted by diversifying across types of active investment strategies and seeking out niche segments in equity and fixed income markets subject to idiosyncratic risk factors. Finally, we recommend allocations to hedge fund portfolios designed to generate a highly diversified stream of added value while minimizing market beta as a means of promoting portfolio diversification. This approach to hedge fund management is preferable to the high-octane approach that doubles down on market beta and thus misses an opportunity to increase diversification.

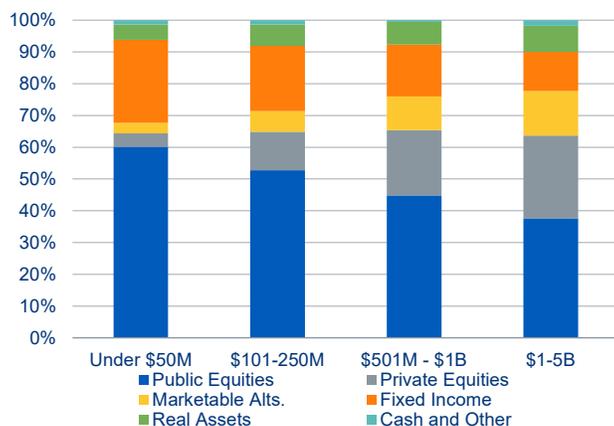
Endowment Size Drives Asset Allocation

The asset allocation of an endowment portfolio is closely related to the size of the portfolio (Exhibit 4). Smaller endowments tend to be heavily concentrated on publicly traded securities, notably equities and bonds, while larger endowments have significantly higher allocations to private equity. Size-related differences in asset allocation have been a persistent pattern in NACUBO data over many years and account for the bulk of the relative performance of small versus large endowments.

Exhibit 4

Asset Allocation Varies Significantly by Size

Source: NACUBO. Asset allocation in percent of total.



We do not believe in a cookie cutter, one-size-fits-all approach to asset allocation. In our view, the best allocation for an endowment is one that is best aligned with its return objectives, risk appetite, liquidity needs, and circumstances. Thus, in our view, seeking to emulate the past success of large endowments by adopting a very high allocation to private equity is potentially misguided.

However, the persistence of this asset allocation bias of large and small endowments does raise a key question. Do these disparate asset allocation habitats reflect the true preferences and circumstances of each size cohort? Or do they instead reflect the differing ability of endowment size cohorts to gain access to and manage private equity investments?

If larger allocations to private markets are constrained by a lack of access and administrative capacity, the solution is clear. An OCIO can resolve both of these impediments and design a portfolio for a small endowment that has the allocation to private markets that it prefers, rather than one limited by access and administrative capacity. The support of an OCIO can be especially beneficial given the costs and resource requirements of building the requisite internal capacity to manage multi-asset portfolios (see: [Strategic's Building Blocks and Costs of an Internal Investment Office.pdf](#)).

Allocation and Execution

Allocation opens opportunities. Execution produces results. The NACUBO study shows that scale, diversification, and governance resources matter. Larger endowments—those with greater access to private equity, venture capital, private credit, and real assets—tend to achieve stronger long-term returns and lower dispersion over extended horizons (10- and 15-year periods) compared to smaller pools. As discussed, an OCIO can help endowments of all sizes gain access to top-tier private market managers and undertake the administrative burdens that arise from such investments.

Allocation is not the whole story, however. Execution matters. Governance is key. While high private market exposure is associated with stronger long-term performance in the NACUBO data, success is not purely allocation driven. Nor, as evidenced by the relative performance of the past three years, is it guaranteed across all time horizons.

A disciplined investment approach, manager access, pacing discipline, rigorous controls and risk management are critical. The importance of good execution by a fully resourced and trusted fiduciary is a key factor favoring the use of an OCIO. Optimizing endowment and portfolio management and ensuring the alignment of the endowment's investments with its long run investment objectives and risk preferences is especially important given the funding pressures that endowments face and the recent increase in the need for special appropriations. These budgetary demands and the likely reversion of portfolio returns to more normal levels will pose major challenges to endowments in the coming years.

Many endowment investment committees operate with limited internal staffing, infrequent meeting schedules, and growing portfolio complexity—particularly in alternatives and private markets. An OCIO can be instrumental in helping endowments overcome these structural gaps.

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