

Gary Steinberg describes his approach to investing

The Wellcome Trust CIO discusses his efforts to support the generous funding policy of the Trust with Shanta Acharya and Elroy Dimson



The origins of the Wellcome Trust can be traced back to 19th century England. Two young American pharmacists, Henry Wellcome and Silas Mainville Burroughs, set up an innovative pharmaceutical company, known as Burroughs Wellcome and Co, in 1880.

After Silas Burroughs' untimely death in 1895, Henry Wellcome directed the growth of the company into an international network. In 1924, he consolidated all of the company's holdings under a corporate umbrella named the Wellcome Foundation Ltd. The Trust's charge was to devote all of its income to research into human and animal medicine for the benefit of mankind, and to support study of the history of medicine. Today the Trust is the largest biomedical charity in the world, spending approximately £400 million on research per year. Gary Steinberg joined the Trust as its chief investment officer in April 2000.

The Wellcome Trust is a permanently endowed foundation that does not receive donations from the public. Its success therefore largely depends on its investment activity. Recent investment policy has been to seek total return over the long term, in order to provide for real increases in the Trust's annual expenditure, while preserving the capital base. Now the challenge for the Trust is how best to sustain the real value of the assets and its grant-giving in perpetuity, or how best to secure intergenerational equity.

Gary Steinberg discusses issues related to investing the Trust's assets with Elroy Dimson and Shanta Acharya of London Business School.



London Business School (LBS): In investing for the future, what are your major objectives? Would you please comment on your Trust's spending policy, how it affects your asset allocation and what sort of return targets you aim for?

Gary Steinberg: Our spending policy is governed by two broad objectives. What we aim to do for The Wellcome Trust is to maximise our spending today, and at the same time maximise our ability to spend tomorrow, so that we can provide our current and future beneficiaries with adequate resources through time. Our challenge in asset allocation is to reconcile these two apparently conflicting objectives.

We believe that maximising our spending can best be achieved by investing in a range of assets that provide the highest return. Our asset allocation is based on the belief that equities are most likely to deliver the best returns over time.

Historically, equities have delivered 5% to 6% real returns annually. While these returns may differ from country to country, we believe that such returns are achievable in the long term. The Trust also has to bear in mind that what we spend today should not prejudice our future spending. We have targeted our current spending policy at 4% of the asset base, on the assumption that we will grow by 2% through time. The 4% is applied to a smoothed average asset base—a practice not uncommon among other foundations.

A spending policy of 4% of asset base is only a benchmark. At times in the scientific cycle, it may be good to be opportunistic in raising that threshold. In recent years, we have had a number of such opportunities. One example is the Human Genome Project - work that has been largely funded by the Wellcome Trust.

Then, there are times when we have spent below that level. It can be argued that when we spend above the threshold, on a sustained basis, we may be prejudicing one of our objectives, which is to maximise our future spending. In any case as the world's largest not-for-profit sponsor of biomedical research, our spending policy is somewhat determined not only by the financial environment in which we operate but by the scientific environment as well.



Gary Steinberg is chief investment officer at the Wellcome Trust, a UK-based endowed foundation with a mission to improve human health through scientific research. The value of the endowment is roughly £10 billion.

Prior to joining the Wellcome Trust in 2000, Gary Steinberg was chief executive of BP Investment Management, an operating subsidiary of the BP group, charged with managing the assets of the UK pension plan. During a 25-year career in investment management, he has managed a wide variety of investment funds ranging from mutual funds and pension funds to endowments.

Gary holds a business studies degree from the Polytechnic of Central London and a masters degree in finance from the University of Strathclyde.

when setting up any mechanism that will empower us to do so. The Wellcome Trust funds leading-edge research—some of this work is blue-sky and will yield nothing, and other projects may lead to some very exciting discoveries.

LBS: When you say your spending is linked to the scientific environment, is it correct to say that out of your current spending there will be some projects not purely aimed at alleviating suffering, but actually work towards creating products of value? In that case, if they are going to provide some future value-addition, is that argument powerful enough to justify higher spending?

Gary Steinberg: The Wellcome Trust's broad mission is to improve human health through funding scientific research, which can be achieved variously by decoding the Human Genome, or finding a vaccine against malaria or building a scientific research laboratory in Cambridge. The scope is very wide ranging, indeed. But we are a charity and as such, we do not expect to see any financial return from our grant making activity.

The pace of discovery in the scientific/medical area seems to have been accelerating in recent years. In all probability, this speeding up of the pace of discovery will bring enormous benefits both to human and animal health. It will also yield a greater range of opportunities for the Wellcome Trust's grant-making activities. The question you are asking me is how do we capture some of that benefit to enable us to increase our spending? We have to be careful as a charity

LBS: To what extent then is portfolio investment and project support connected within the Trust's overall policy-making?

Gary Steinberg: About five years ago, a company was set up as a subsidiary of the Trust called Catalyst Biomedica Ltd. This was essentially a technology transfer company that moved in behind the Trust's funding activities to offer support in financial, managerial and technological, project-related issues.

The company's secondary remit was to identify potential investment opportunities arising out of that role. Following a review, the tech-transfer activities and the investment activities have been essentially separated. The tech-transfer activity has been absorbed into the Trust, operates directly within its remit, and has become a separate division with very clearly defined objectives.

Through the tech-transfer review, if there is an investment opportunity, the terms of the grant with the researching body ensure that the investment department can choose to invest in that particular enterprise. So, there is a mechanism now to capture future financial benefit of some of the Trust-funded research.

All of these changes have only just occurred.

Thanks to the tech-transfer review, the investment department can choose to invest should there be an opportunity

**In recent years,
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So far, we've only had limited opportunities to use this mechanism. However, we expect to make eight to 10 such investments per year as a result. Within the context of the overall portfolio, this activity will remain relatively small.

We have always managed a direct portfolio that leverages our expertise in healthcare, scientific research. However, we have not been constrained to investing just in Trust fund scientists or spin-off companies, although we are always looking at projects funded by the Trust. Catalyst and its successor, for example, hold equity in many projects funded by the Trust.

LBS: Can you share your views on how investment policy changes reflect altered market conditions? When most people talk about strategy, they refer to long-term asset allocation, or more precisely, to certain percentages in equity, private equity, bonds or property. A more complete strategy, on the other hand, would tell you where you start from today and then how you would shift your assets, depending on how conditions alter.

Gary Steinberg: One aspect of this question is: if markets today were to start steaming ahead, and once we know that assets have appreciated considerably, how would we respond? Would we raise our level of risk, or capitalise on our gains, and lock in some profits and take fewer risks?

Something similar did happen here before I arrived, though I can't take the credit. As the markets rose through the second half of the 1990s, there was a substantial move out of equities. The team in charge at the time wanted to back a number of capital-intensive scientific projects and so it was decided to take profits out of the capital base. This came out of equities.

So, when I arrived, there was a lot of cash in the portfolio. It was the combination of high valuation in the equity market and the availability of a number of big scientific projects in the pipeline that resulted in such an outcome.

We did put some money back into the equity market when it fell in July 2002. We thought at that point that the yield on UK equities, which was comparable to the yield on UK 10-year government bonds, indicated that the market was expecting no growth in the economy over the next decade. We did not agree with this view and so wanted to take advantage of the mispricing. Unless you thought that deflation and a Japan-style collapse was what would be in store for the UK, then the market was not pricing these assets properly.

LBS: Can you tell us more about your asset-liability study and the creation of the policy portfolio? How often would such a study be commissioned?

Gary Steinberg: We last completed an asset-liability (A/L) study in 2001. We tend to do one every three years and will shortly do another. The changes recommended from the 2001 study had more to do with the mix of equities, particularly between domestic and overseas, rather than with the distribution between equities, bonds, property and other asset classes. A consultant has assisted us in this process. We have taken the view that we need to diversify and have been doing this for 20-odd years.

While interest in private equity among pension funds is on the rise, I argue that over the very long term we were moving in the opposite direction. Thirty years ago, we were 100% invested in the Wellcome Company, which was a private firm. So, we were 100% in private equity. We have effectively moved away from that position. In recent years, as a result of the A/L study, we have reduced our UK equity weighting considerably.

LBS: When you undertake an A/L study, do you commission a standard consulting report, or does the Trust have special client demands that it puts to its consultant?

Gary Steinberg: We think A/L studies are too dependent on historic data. So, you have to apply some kind of subjectivity to the output. We commission the research and have a look at it; if some things do not make sense to us, we then apply our own judgement in assessing the input data. Property returns, for example, are seemingly uncorrelated to other asset classes such as bonds, and so the optimiser might say you should have 20% in property.

That is also the case with alternative investments such as private equity that gain favour in optimisation models because of their low correlation. But, I cannot believe that private equity has anything but an equity-based correlation. So, some kind of subjectivity is required to tweak these models.

In terms of the portfolio's investment and risk control processes, we do most of the things we are supposed to do—in terms of researching the manager and how they are going to fit into our objectives and what that means for their tracking error, their willingness to take risk etc.

We crunch numbers through our risk model.

The Wellcome Trust portfolio (As at 1 October in %)					
	1999	2000	2001	2002	2003
Equities					
UK	49.7	45.7	46.5	31.8	34.4
Europe	9.5	10.3	8.4	11.0	12.8
North America	11.4	11.5	9.4	11.6	11.9
Japan	3.3	2.7	2.5	3.6	4.0
Far east	2.3	1.9	1.9	3.0	3.7
Australasia	0.7	0.7	0.8	0.8	1.0
Latin America	0.4	0.4	0.3	0.4	0.6
Other	1.3	1.7	1.2	2.0	2.4
Total equities	78.6	74.8	71.0	64.2	70.7
Fixed interest	4.4	2.3	4.5	5.6	2.4
Unquoted investments					
UK	0.6	0.9	1.1	1.7	1.9
Europe	0.1	0.2	0.5	0.7	1.1
North America	4.2	7.2	7.5	7.7	7.9
Other	0.7	1.6	1.9	2.1	3.3
Total unquoted	5.6	10.0	11.0	12.2	14.3
Property	7.1	5.7	7.2	10.7	9.1
Other	4.4	7.2	6.3	7.3	3.5
Total	100	100	100	100	100
Total (£ bn)	11.7	15.0	12.1	9.3	10.1

Source: The Wellcome Trust, Annual Reports and Accounts

LBS: Most people who use BARRA or other risk models use it for thinking about relative-to-benchmark risk rather than absolute risk. Do you find yourself thinking more about the failure to adhere to a benchmark or are you concentrating on total risk?

Gary Steinberg: It is pretty unsatisfactory to ask people to beat a benchmark and then find the benchmark goes down 25% and they beat the benchmark and we congratulate them for having done a good job. We have given some thought to how we might override that problem with perhaps giving a manager an absolute return benchmark, such as saying we need 5% to 6% real return over the next 10 years. But, most investment managers have a problem with that. Any investment manager accepting that mandate will say: "We can do this, but we can only do it over quite a long period."

Looking at the history of the investment management industry, which is a relatively new industry, absolute returns mandates had been totally discredited by the mid-1970s. Fund managers were claiming they could provide x% real returns over a longer investment horizon. But, in the end, they failed to deliver. Hence, the industry moved towards benchmarking and has ended up tying everybody to an index. So, now we are all slaves to our own benchmark.

We are also reviewing the philosophy behind

indexed or passive vehicles. They have done pretty well for the last 20-odd years. The question is will active managers deliver better returns over the next 20 years?

All of that has also made us look at absolute return strategies. The problem then is who is going to deliver those absolute returns? The vast majority of investment managers have failed to deliver superior relative returns. There are a few smart people in the industry, but the vast bulk of them are increasingly becoming asset gatherers. And it is difficult to see how they are going to deliver as they also work under constraints. The challenge for us is to identify the good managers.

LBS: Once you have done the asset allocation, do you take the currency exposure that comes with it? Do you, for example, have a currency overlay or hedge your currency exposure?

Gary Steinberg: If you look at a hedged benchmark and one that is not hedged, you see that the returns in the long term for both are the same. The expected return from the currency is zero. So, a currency hedge provides lower volatility. Through our financial framework, we use a formula that takes out some volatility. We haven't passively hedged our currency portfolio. We have however thought of active currency management to see if we can add alpha.



LBS: What is your view regarding the use of derivatives and hedge funds in your portfolio?

Gary Steinberg: We do use derivatives in order to move quickly and cost effectively to our desired position. We have a futures overlay position at the moment.

We have allocated 3% to 5% to hedge funds and are working on achieving that. The issue for us is how do we get there? We are taking advice on that at the moment. The first approach to hedge funds was done via a gatekeeper arrangement, where they selected funds on our behalf. The bottom line was performance. The second stage will be more direct.

LBS: What is the Trust's position on socially responsible investing (SRI)? What are the issues that concern you most?

Gary Steinberg: Apart from not investing in companies that have a substantial interest in tobacco, we don't have any other constraints in investing. We've taken the view that we do not want to exclude companies from our investment universe. We believe that all companies should behave responsibly and follow best practice in corporate governance. We have entrusted our managers ensure that this is indeed the case.

Voting is part of the investment process and we always vote our shares. We do ask managers to flag up any particular issues they may have with us. We belong to various groups such as the Responsible Investor Network, which are better able to deal with more difficult issues directly with the companies concerned. We do not have anyone internally reviewing SRI issues, but are at the point of appointing an external adviser to help us with governance and SRI issues.

LBS: What is your benchmark, if any, in terms of costs in managing your fund?

Gary Steinberg: There is information available on US foundations and their costs. Cambridge Associates have done quite a bit of work in this area and we use them as a guide. We have also used the WM Company in the past to benchmark fund management costs. Our costs are higher than a purely internally managed pension fund, but we are competitive versus institutions that use external managers.

We look at measures of cost such as the price impact of trading and analyse these on an annual basis. We are pretty rigorous in demanding performance-related fees. If the manager wants our account, then they have to

agree to it. We don't mind paying up for good performance, but dislike paying for sub-benchmark performance.

Managers are rarely forthcoming with information on the breakdown of their trading costs, although in our request for proposals we ask for that information. Managers' trading costs are closely monitored.

The main issue for us is how independent is our manager's research? We give most of our mandates to those managers who have invested in independent research.

LBS: Do you have a wish list of changes you would like to see that would enable you to do a better job?

Gary Steinberg: Our investment powers, originally set out in Sir Henry Wellcome's will, have been updated and embodied in our new constitution. We have pretty broad powers providing that we carry out the required level of due diligence and take appropriate advice.

All this is costly of course, which in a world of high returns, probably did not have much of an impact. In a low return environment, which in all probability we will be in for some time, high fees and management costs all eat into our return and thus our ability to pursue our mission. So, if I had to be granted one wish, it would be for a more realistic approach from advisers and managers in this low return environment. ■

Shanta Acharya began her investment management career with Morgan Stanley Asset Management in London after an academic career at Oxford and Harvard. She was subsequently a fund manager with Swiss Bank Corp and Baring Asset Management. She is currently associate director, Initiative on Foundation and Endowment Asset Management at London Business School. She is the author of Asset Management Equities Demystified (Wiley UK, 2002) and Investing in India (Macmillan, UK, 1998), as well as a regular contributor to Professional Investor. email: sacharya@london.edu

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