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Building the World's Best Investment Management

How to Build a World-Class Investment Program: Sam Gallo and Endowment of the Year winner, the University System of Maryland Foundation

Each year Institutional Investor Magazine hosts a Hedge Fund Industry Awards dinner. This year's gala was held on April 27th and celebrated superior portfolio construction and manager selection.

Among the notables, the event featured two outstanding investment heads we just happened to have recruited in the past.

Jon Glidden, director of pensions at Delta Airlines received II's Allocator Lifetime Achievement Award and Sam Gallo, chief investment officer at the University System of Maryland Foundation accepted II's endowment of the year honor.

Our warmest congratulations to both winners.

We managed to catch up with Mr. Gallo during a recent conference in Charleston, SC and asked him how he built an elite, award-winning investment program, what to look for in a successful CIO candidate, and what fresh challenges lay ahead.

The Endowment Elite, A conversation with Sam Gallo

Skorina: Sam, it was almost eleven years ago that I first called you about the University System of Maryland Foundation (USMF) CIO position and look where you are now.

First, you received an endowment of the year award from Institutional Investor, then you celebrated ten years as the university's chief investment officer. Congratulations!

You don't have the usual up-through-the-nonprofit-ranks background of a typical endowment CIO, would you take a moment to give us your highlights.

[*Note: The USMF consists of twenty-plus schools with combined total assets of about $2.2bn.]*

Gallo: Thank you for the kind words, Charles. Briefly. I began my career as a valuation modeler, pivoted to trader and portfolio manager, then moved to several investment and operational consulting roles, and finally on to my current position as an endowment CIO.

The last, of course, is thanks to your call so long ago.

Skorina: Your mission when you joined USMF in 2012 was to invest smartly for the future, build a team and investment strategy, and develop a commercially oriented white-glove client service model. Ten years later you receive the Endowment of the Year award from Institutional Investor.

Let's dive right in and ask the money question, how did you do it?

Gallo: That's a big one Charles and complex, but here goes. The key to success for any nonprofit fund begins with the Board and Investment Committee.

Boards want and expect a "world-class investment program." But to achieve this goal, they must be willing to provide the resources and governance structure to flourish.

What boards put into it, is what boards get out of it. It's that simple.

Think Profit Center

Skorina: Ok. But what does that mean? If a foundation, endowment, or pension fund wants an elite program, what does it take to build one?

Gallo: Let's start by talking about our golden rule, which is, all decisions are linked and have consequences, so think and plan ahead. Be smart, be strategic. It matters.

Boards and administrations trip up when they view their investment offices as cost-centers. We are not cost centers. We make money for our schools.

Investment offices should be viewed as what they really are, essential profit-generating business divisions of the larger institution.

These offices should be nurtured, resourced, and report directly to the CEO, just like any other critically important revenue generating division.

Six Signposts on the Road to Riches

Skorina: When you say that decisions are linked and have consequences, what are the most important lessons you have learned leading the USMF investment program?

Gallo: I'll give you six examples from my ten years as CIO.

[*For board members that would like a broader discussion, feel free to ping me, Sam Gallo, on my LinkedIn page, and we'll set up a time to chat.]*

First – get ready Charles, I'm about to pay you a compliment – world class investment programs start by recruiting the best talent available.

So, use a professional like yourself who can recruit experienced, balanced candidates that have a variety of skillsets. Focus on candidate quality.

Second, great programs pair strong investment committees with the CIO and investment staff.

I was fortunate to work with industry practitioners who were investment committee members including David Saunders at K2 Advisors, Bruce Richards from Marathon, Viju Joseph from Eton Park and George Weiss, Larry Boggs and others, all legendary investors, wealth creators and risk managers.

Third, great boards don't micromanage.

There is a negative correlation between board control over a portfolio and its performance. Bureaucratic and arbitrary restrictions on a CIO impose negative alpha on the portfolio.

In our case, after a few years, my board gave me full discretion on portfolio decisions.

That trust and flexibility led to positive alpha and 200-300 basis points of annualized outperformance to our policy benchmark on a three-year, five-year, and ten-year basis.

Fourth, you get what you pay for.

Top-ranked programs do not hire the cheapest CIOs or lowest OCIO bidder.

Whether it's internal staff or an outsourced firm, paying up for talent, skill, and experience increases the odds of generating alpha. You're not going to win the Kentucky Derby with a three-legged horse.

Fifth, strong manager and peer networks are vital to success.

Focus on building your networks. Hard to access managers wants an A+ list of limited partners. An investment team needs to be known and respected in the institutional community to get those "first-calls."

Lastly, there is a huge advantage to being centrally located.

I know we work in this hybrid world now but we gain an important edge by physically working within the flow of information and talent in NYC, DC, Chicago, Atlanta, or LA, for example.

Investment professionals do not want to be "out of sight, and out of mind" from managers and peers.

And don't forget recruiting. It's important to be in a major market for sourcing talent.

Top-Down, Bottom-Up Performance

Skorina: What's the difference between the Sam Gallo I recruited for the University of Maryland ten years ago and the Sam Gallo of today? How have you changed?

Gallo: Where to begin? When I started in 2012 at USMF, we constructed portfolios based upon the quantitative and qualitative features of the investment and how it fit into the broader portfolio.

We built robust strategic asset allocation models that segmented our assets by liquidity, tracking error, and other risk attributes.

This is still a big part of what our team does day-to-day, but I now see the importance of balancing this top-down risk framework with building strong bottom-up relationships with attractive, hard-to-access managers.

One of our competitive advantages starts by nurturing relationships with superior investors years before we invest in their funds.

Jon Hirtle (executive chairman of OCIO firm Hirtle Callaghan) made the same point in your last newsletter as he was describing the endowment model and why he sticks with it.

He said true alpha is generated by specialist managers who have an identifiable, authentic, repeatable edge. However, those managers are hard to access, and they seldom accept new investors, so the relationships matter.

I totally agree. For an endowment to maintain a repeatable edge, it must build collaborative partnerships with top managers and advisors. The expression, "you want to make a friend before you need a friend," is so true.

Managing Risk, Reaping Rewards

Skorina: We've talked in the past about the way you look at endowment construction and performance. You mentioned that you look at risk first and consider superior performance to be a byproduct or reward. What do you mean by that?

Gallo: Risk management is our first and central focus. I fundamentally believe that portfolio returns are a healthy byproduct of careful risk management.

We have nearly tripled our assets since my hire, outperforming our policy benchmark every year for the last ten years, and have produced top-decile risk-adjusted returns compared to 120+ peer institutions.

That last statement is critical. It means we outperformed our policy benchmark, but at a much lower risk level than our peers and the benchmark itself.

Put another way, ninety percent of the universe takes more risk than we do, yet we are producing consistent year-over-year benchmark-beating returns. We are risk managers, not return chasers.

Skorina: How do you build a risk-first portfolio?

Gallo: Gallo: Three ways. First, we construct our top-down asset allocation so that we have a high probability of avoiding 80% of most equity market losses.

Or, to put it another way, if the market loses 10%, we are usually only down 2%. We limit losses, while still participating in much of the upside move.

Second, we invest in managers that protect on the downside, while providing meaningful upside capture.

Third, we create a balanced book that has ample liquidity so we can be opportunistic buyers in times of crisis.

It's a triple-layered safety net of portfolio-level, manager-level, and liquidity risk protection, that when combined, is very powerful.

If you used the same statistical formula and investment risk philosophy, you would have a winning program.

How CIOs Spend Their Time

Skorina: Describe a typical work week as a CIO. How do you allocate your time?

Gallo: I'm glad you asked because I'm not certain that boards and administrations always understand what CIOs do. We don't just sit at a Bloomberg terminal fourteen hours a day.

First and foremost, CIOs set a strategic vision and keep everyone aligned with that vision. Or, speaking more poetically, we gracefully weave together all the threads that make up and tug at a portfolio.

Successful CIOs use their political savvy to negotiate buy-in with the board while keeping the investment team focused on research and manager selection, and not on politics and bureaucratic squabbles.

One forty-year CIO veteran once told me, "You may be the best investor in the world, but if you can't convince your board and team of the value of an investment, that great investment will never make it into the book, and if by chance it does, it certainly will not stay long."

However, to answer your question more precisely, I work with my team on the portfolio roughly forty to sixty percent of my time.

This includes watching markets and securities, reading whitepapers, viewing webinars and attending speeches on global macro assessments.

In addition, we model risk and, when necessary, tweak our asset allocation. We meet managers, assess performance, talk with peer investment teams, and attend conferences.

Also, I am on the road a lot. You are not doing your job effectively as a CIO if you just sit at a desk all day. You need to be out and about, hunting, learning, and networking.

Another twenty to thirty percent of my time is spent on operational matters.

This includes issues related to team administration and cash management, as well as performance, risk, and manager reporting, and working with our back-office and service providers to identify, understand, and correct issues that arise.

Politics and Diplomacy

The remaining twenty to thirty percent is allocated to the politics of the job. Keep in mind, the CIO is the senior-most and often the only ambassador for the investment program.

This political side includes educating investment committee members, the administration, and other internal committees.

And then there are client boards and their staff, fundraising professionals, and existing and prospective donors to educate on what we are doing, why we are doing it, and presenting the results.

I must also make time for special-interest individuals and groups that want to shape and direct our portfolio toward a social or political goal.

In those cases, I work with them to understand if and how we can satisfy their requests. Or more bluntly, divestment demands.

Tips and Traits: Recruiting Chief Investment Officers

Skorina: What are the most important attributes recruiters and boards should look for in a successful CIO candidate?

Gallo: I thought you might ask that question, Charles. Let me answer by first citing something you wrote last year, which I think applies to all CIO searches, and then I'll list the top attributes I would look for.

You were musing about how hard it is to build superior investment teams that endure and outperform for more than a generation. Then you mentioned the University of California Regents CIO search and the ideal qualities they looked for in a chief investment officer, along with a caveat. These qualities were:

Organizational skills: Someone with serious organizational skills, who could work effectively with a big institution like the UC system.

Personality: Someone with the personality to work constructively with all of those different constituents, from the board and president to student groups.

Investment skill: But he [Paul Wachter, former investment chair of the University of California Regents] added a caveat to number three.

Mr. Wachter said, "what you can't tell in an interview is how good of an investor someone is. If you look at their track record in their previous position, you're seeing the product of an entire team or institution."

That final point is important to remember because institutional investing is a team pursuit. Few endowment professionals do it alone.

As an aside, UC hired Jagdeep Bachher, who has been managing the Regent's endowments, pension fund, and a few billion in petty cash for eight years now. He has done a terrific job.

Keeping Mr. Wachter's comments in mind, here are my top five attributes to look for in a CIO candidate.

The first one in my book is experience. In particular, experience with market cycles, clients, boards, committees, and in managing teams.

I am not the same CIO I was ten years ago nor the trader and portfolio manager I was twenty years ago. Every experience has made me a better investor, risk manager, and team leader.

Second, a deep respect for strategic asset allocation and risk management.

Understanding how the asset classes fit together is a huge edge, as well as managing liquidity, tracking error, and operational risks.

Third, a profound and intense level of intellectual curiosity.

Look for someone who loves to learn and discover the next great idea or manager. But not just a great analyst, look for someone who motivates their teammates to feel the same way about this quest for knowledge and great investments.

Forth, a candidate should love working with, educating, and communicating with the board, staff, and outside groups.

There is a big political, or as I said before, ambassadorship, component to being CIO. If a candidate or CIO does not like this part of the job, it will show, and that person will not last long.

And fifth, a strong ability to collaborate.

Top CIOs draw out the best in people. We want the best version of our advisors and team to show up every day. So it's important to support them behind the scenes by removing obstacles that sometimes they are not even aware of, and open paths for their growth.

A quick shout out to my amazing team and advisors…they are awesome, and I have such profound respect for how great they are at their jobs.

Final Thoughts: Move, Learn, Grow

Skorina: Any final thoughts before we close?

Gallo: Charles, I remember your pitch when you first called me about this position.

You said it would be the best job I ever had, but that it would take a lot longer to get things done and would be far more complex than anything I had experienced as a trader or money manager.

And that has been absolutely true. There are just many more moving parts when you're helping to lead a big institution's investment program, and we are not just one institution but rather more than twenty combined organizations.

We are a private system foundation, one of only a handful in this country.

My past consulting work at Ennis Knupp (now Aon) was great because it taught me how to conduct due diligence and work with boards, but those positions did nothing to train me for managing capital and risk.

I needed to be a trader and portfolio manager in charge of daily risk management, which I did at Goldenberg, Hehmeyer, and Company.

I needed to run a business inside of a larger business, as I did at PwC. That is what I do now as CIO at USMF.

We are a revenue-generating business, an investment office profit-center, inside of a larger enterprise.

All these experiences were crucial pieces of education along my journey.

My career advice to your readers is simple, don't be content doing only one thing and one job. Don't ever feel comfortable. Seek out new roles and learn more skills. Keep growing!

Skorina: Thank you Sam.

Gallo: You're welcome. And thank you for staying in touch all these years and introducing me to such a wonderfully impactful job.

Editor's Note: edits and corrections are made as needed, so changes included here may not have appeared in all editions.