Global Financial Private Capital

A Bitter Rivalry

SYNOPSIS

- Yale University's endowment returns have crushed the competition over the last 25 years.
- Alternative investments are those that are not considered to be traditional investments such as stocks, bonds, and cash.
- Yale can attribute its stellar performance to its large allocation to alternative investments.

BRAGGING RIGHTS

The Ivy League comprises some of the most prestigious educational institutions in the world. Names like Harvard, Princeton, and Yale conjure up images of future world leaders studying relentlessly to achieve perfect marks.

This is a group of high achievers who are unfamiliar with the concept of "second place," and they fiercely compete to be the best at everything. To this cohort, it's either the gold medal or nothing at all, and this even extends to the performance of their school's endowment fund.

An endowment is critical to the financial stability of a university because the returns fill the gap between revenue (tuition, etc.) and spending (salaries, etc.). The more money the endowment generates each year, the more a school can pay to attract better professors, build state-of-the-art facilities, and support research endeavors.

Therefore, endowments are closely followed, but no two schools receive more attention than Harvard and Yale. This bitter rivalry is the investment equivalent of Ohio State and Michigan, Yankees and Redsox, or even Jimmy Connors and John McEnroe.

The table below compares the average annualized returns of Harvard, Yale, and other endowments to all active balanced mutual funds and an indexed 60% stock/40% bond portfolio.

Picking the right allocation explains 93% of long-term returns…

The returns clearly show that Yale's bragging rights over Harvard have been in full effect for decades. When compared to the rest of the competition, it's not even close. Yale's returns are so far above all others that it begs the question of how they have been able to do it.

AN ALTERNATIVE APPROACH

Any real estate agent will say that the three most important rules of real estate are (1) location, (2) location, and (3) location, because the neighborhood

	5 years	10 years	15 years	20 years	25 years
Yale University	3.3%	11.0%	11.8%	13.5%	13.2%
Harvard University	1.7	9.4	9.6	11.9	11.5
All endowments	3.8	6.8	5.6	7.7	8.4
All active balanced mutual funds	5.1	6.0	4.9	7.0	7.9
60% stock/40% bond benchmark	5.9	7.4	5.7	7.6	8.3

Notes: The average endowment and average active balanced mutual fund returns are all net of fees. The average return for all endowments is weighted by the number of endowments in each category. The 60% stock/40% bond benchmark represents the approximate average asset allocation of active balanced funds. It is composed of 42% U.S. stock market (Wilshire 5000 Total Market Index through April 22, 2005, and MSCI US Broad Market Index through June 30, 2013), 18% MSCI World Index ex USA, and 40% Barclays U.S. Aggregate Bond Index. Average active balanced mutual fund performance is measured for all existing funds at the start of each period; an equal-weighted average is calculated each year. For any funds that were subsequently merged or liquidated, we included their performance data up to the point of the merger or liquidation. See **Appendix A-1** for details on calculation of endowment returns.

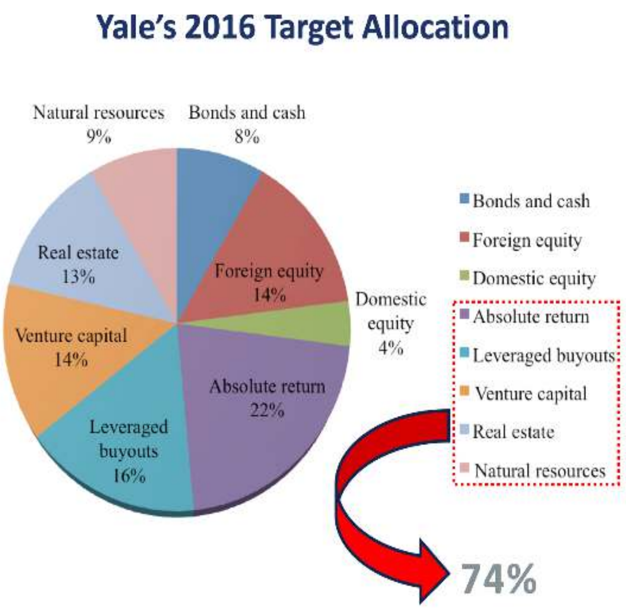
Past performance is not a guarantee of future results.

Sources: Vanguard calculations, using data from Morningstar, Inc., Yale Investments Office, Harvard Management Co., and National Association of College and University Business Officers (NACUBO).

determines most the value of a home. Buy a bad house in a great neighborhood, and you should still do ok.

Similarly, the three most important rules in investment management are (1) asset allocation, (2) asset allocation, and (3) asset allocation. Picking the right allocation explains 93% of long-term returns[1], and Yale has done a phenomenal job finding the best neighborhoods.

The chart shows the neighborhoods that Yale's endowment fund selected last year.



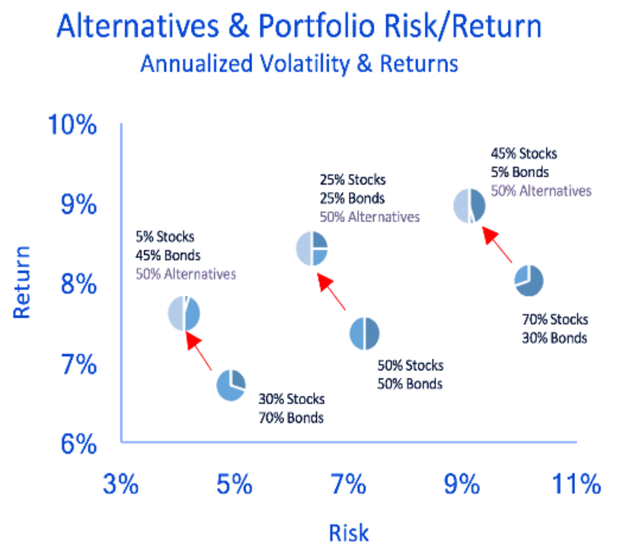
Source: Yale Daily News

Two striking conclusions are evident:

1. **Few Stocks & Bonds:** Yale's allocation to traditional asset classes is tiny. Only 18% is invested in stocks (4% domestic and 14% foreign) and 8% in bonds and cash.
2. **Lots of Others:** Asset classes not classified as either a stock or bond (red-dotted box) comprises 74% of the asset allocation.

Those other asset classes are commonly referred to as "alternative investments" because they are not considered to be equity or fixed income investments. Without question, these are the drivers of Yale's massive outperformance.

Now that drivers of Yale's returns have been identified, let's go under the hood to see why these asset classes have done so well. The chart below lists three different portfolios based on risk tolerance and compares the risk/return characteristics of each over the last 25 years.



Source: Bloomberg, Global Financial Private Capital analysis. Stocks represents the S&P 500 Total Return Index. Bonds represents the Barclays Aggregate Bond Index. Alternatives represents the HFRI FWI. Data spans 2Q1991 – 1Q2016.

The conservative portfolio consists of 30% stocks and 70% bonds, the moderate is a 50/50 split between the two, and the aggressive is 70% stocks and 30% bonds. As expected, the conservative portfolio has less risk than the aggressive one but also lower returns over time.

However, when each of these portfolios is adjusted to hold a 50% allocation to alternative investments, all three portfolios benefitted from higher returns and less risk (indicated by the three red arrows).

The reason why we see higher returns comes from the sophistication represented by these alternative strategies. These managers tend to fish in different ponds than traditional stock and bond managers, and their expertise often leads to (1) larger returns over time and (2) a smoother ride for investors.

Risk is lower because these asset classes are often less affected from what tends to drive stock prices down. This increased diversification creates tremendous benefits for those investors who prefer a smoother ride over time.

Simply put, Yale's large allocation to alternative investments is the reason why their returns have far surpassed its competition and the traditional 60/40 portfolio.

IMPLICATIONS FOR INVESTORS

Access to alternative investments has historically been restricted to institutions and ultra-high net worth investors. Fortunately, these barriers have started to fall, and individuals are now able to invest in these assets just as pension funds and endowments have for decades.

The big hurdle that remains for most individuals to invest in alternatives is perception. Thanks to the financial media, these investments carry a negative connotation as being riskier than traditional investments in stocks and bonds.

Arguably the most egregious of misconceptions is the hedge fund industry. These investment firms employ complex investment strategies to profit across the entire business cycle or mitigate specific risks. They are run by some of the best and brightest investment managers on the planet, and the table below shows that the industry returns far surpassed the S&P 500 from 1998 – 2012, with around half the annual volatility.

	RETURNS	VOLATILITY	SHARPE RATIO
HEDGE FUNDS	7.06%	7.42%	0.50
S&P 500	4.47%	16.24%	0.14

Source: PerTrac 1998 – 2012. Hedge Funds represented by the HFRI Fund Weighted Index.

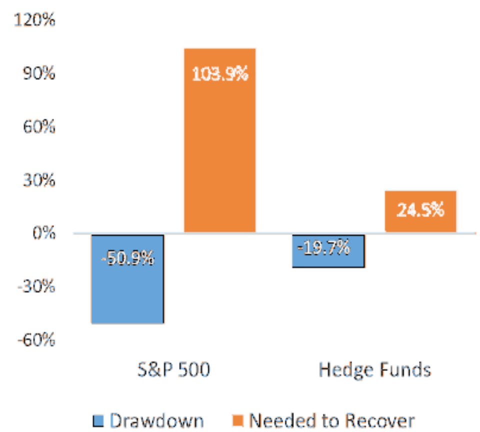
The Sharpe ratio in the far-right column is a measure of efficiency. It divides the excess return above risk-free investments by the annual volatility to measure how much return a manager is generating per unit of risk. A higher Sharpe ratio indicates a more efficient manager, and this hedge fund index delivered 3.6 times more efficient returns than the S&P 500 over this period.

However, since the financial crisis, the media has attacked the hedge fund industry over perceived lackluster returns, fee structures, and large bonuses paid to a select group of high-profile managers. It is as if we cannot go a week without hearing about how some hedge fund has closed or a pension fund fired another manager. The onslaught by the financial media has been relentless.

These stories do nothing but harm individual investors because they paint a picture of hedge funds being the Wild West of the investment world. Nothing could be further from the truth for three reasons:

1. **Smoother Ride**: Hedge funds aim to deliver more efficient returns, and in doing so tend to give investors a smoother ride over time. Less volatility leads to fewer sleepless nights.
2. **Talent:** Hedge funds often pay better than traditional asset managers because the strategies are more sophisticated and require the best talent. The intellectual brainpower in many of these firms rival NASA far more than the gunslingers at the O.K. Corral.
3. **The Name:** Hedge funds get their name because their goal almost always involves hedging some form of risk. Large institutions are not run by incompetent managers, and they would never pay the fees charged by hedge funds unless they were doing their job.

The chart below quantifies the importance of these characteristics by comparing the recovery rate needed to break even for a well-regarded hedge fund index during the financial crisis to the S&P 500.



Source: BlackRock, Informa Investment Solutions. Hedge Funds represented by the Credit Suisse Hedge Fund Index (DJCS)

Since the hedge fund index fell significantly less during the financial crisis, the amount needed to recover was a fraction what the S&P 500 needed to return to get back to even.

Add it all up and individual investors can learn a lot from watching what Yale and other top performing institutions are doing with their money. The level of responsibility that these endowments carry is tremendous, and the notion that some of the most experienced investors overseeing hundreds of billions in assets would gamble away the financial future of the universities they represent is hard to envision.

The bottom line is that Yale University has generated stellar returns over time because those who manage their endowment chose to fish in a different pond than most others, and it is time for investors of all risk tolerances to consider dipping their toes in this water.

Sincerely,

Mike Sorrentino, CFA
Chief Strategist,
Global Financial Private Capital
mikeonmarkets.com

[1] *Brinson, Hood and Beebower, "Determinants of Portfolio Performance" (1986, 1991)*