

# A LEAGUE OF THEIR OWN

Harvard and Yale have enjoyed stellar returns with their hard-to-copy investment strategies. Now, reports James B. Stewart, new products allow individuals to mimic the Ivy League playbook.





Photograph by Peter Casolino/Corbis

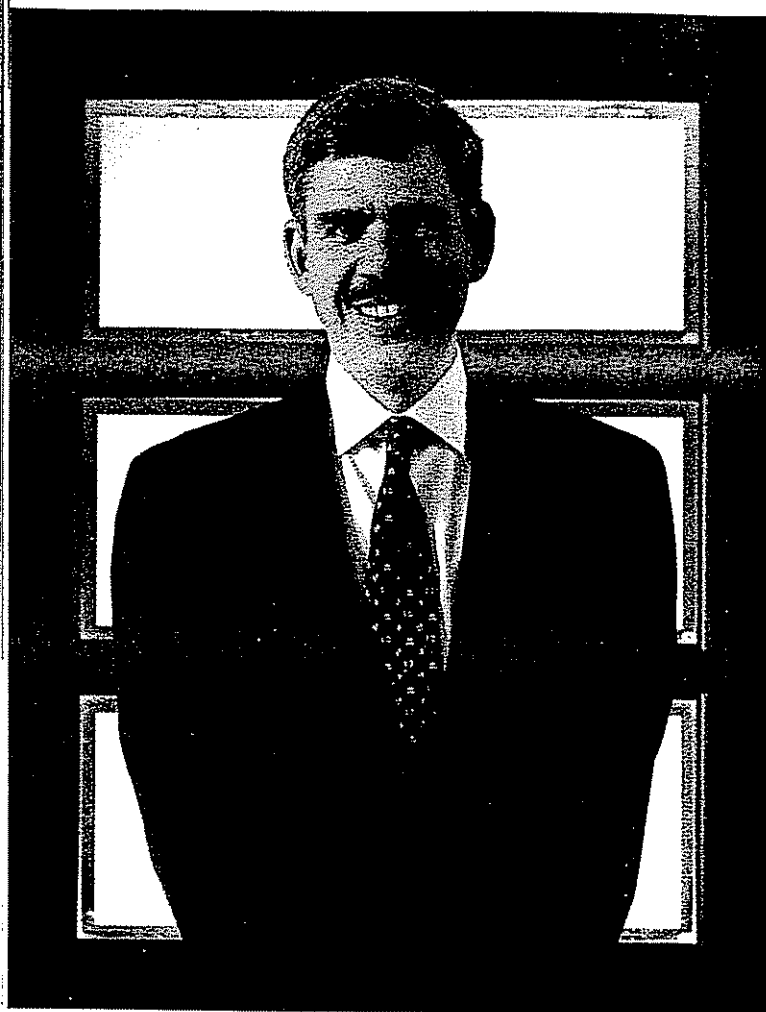
**I**N RECENT YEARS INVESTORS HAVE EYED burgeoning Ivy League endowments like high school seniors applying to Harvard and Yale with weak grade point averages, low SAT scores and no extracurricular activities: zero chance of getting in. Can you blame them for being envious? In the year that ended June 2006, Yale notched a 22.9 percent return for a gain of \$3.4 billion. Even more impressive is its consistency. Over the past 10 years, which included the market meltdown of 2000 to 2002, Yale has had annualized gains of 17.2 percent. Harvard, meanwhile, earned a 16.7 percent return in fiscal 2006 and boasts a 10-year average of over 15 percent. Of course, Harvard and Yale have long enjoyed formidable advantages, starting with immense wealth and prestige. Even other institutions, many with endowments in the billions of dollars, have been hard-pressed to keep up, let alone individual investors.

Surprisingly, that may be beginning to change. We've taken a close look at these endowments and at the new investment vehicles now available to the rest of us. Our conclusion: Even average investors can mimic Harvard or Yale in their portfolio, with access to some of the Ivy League's most exclusive and esoteric asset classes. We'll show you how and illustrate our method with a model portfolio. But first, a simple question. Should you?

No one argues that individual investors should slavishly copy the Harvard and Yale models, and not even very wealthy individuals have access to the kind of top-performing managers who work for Harvard and Yale, with their endowments of \$29 billion and \$18 billion, respectively. Still, the two fathers of the universities' successful investment policies, former Harvard endowment manager Jack Meyer and David Swensen at Yale, offer their qualified endorsement.

As Meyer puts it, "The most powerful tool an investor has working for him or her is diversification. True diversification allows you to build portfolios with higher returns for the same risk." While cautioning that it would be unrealistic for individual investors to match or outperform the major university endowments, Meyer, who now runs a Boston-based hedge fund whose charter investors include Harvard's endowment, endorses the goal of diversifying into a wide variety of asset classes. "Most individuals have never had true diversification," he says. "Coming close is an admirable goal."

Swensen agrees that diversification should be the



Mohamed El-Erian, who manages Harvard's endowment, says endowment strategies hold lessons for investors about asset allocation.

17 percent and 19 percent, respectively.

So where *do* they put their money? Yale and Harvard divide their endowments into seven broad asset classes: domestic stocks, foreign stocks, fixed income, absolute return, private equity, real assets and cash. Absolute return consists of assets that are expected to perform well in good and bad markets and aren't correlated to broad market averages. Most hedge funds fall into this category, including so-called long/short funds (which try to profit from both rising and falling markets), merger arbitrage and distressed securities. Private equity covers both buyout and venture-capital investments. Real assets are real estate, oil and gas, timber and other commodities. The percentages Harvard and Yale allocate to each category are shown in the charts on the opposite page.

Since both Harvard and Yale adjust their targets annually, their actual holdings often differ. Still, it's striking how aggressively they've moved into nontraditional categories. As of June 2006, real assets were the largest category at Yale, accounting for nearly 28 percent of the portfolio. At Harvard it was nearly 21 percent. Yale's allocation of 23 percent to absolute-return strategies was double its commitment to U.S. stocks.

As might be expected at big research universities, this aggressive move away from traditional assets was rooted in academic research suggesting that investors can earn a higher long-term rate of return with less risk by diversifying beyond the traditional mix of stocks and bonds. Economists James Tobin and Harry Markowitz each won a Nobel Prize for work they did on this topic while at Yale. Meyer, who ran Harvard's endowment for 15 years before leaving in 2005, and Yale's Swensen put those theories into practice.

Over the past decade, Harvard and Yale have turned in some of the best returns anywhere, but almost no one expects this level of performance to continue. Based on historical data, most asset classes are fully valued, if not overvalued. Yale expects a long-term annual return of about 6 percent, adjusted for inflation.

Still, if actual returns in certain asset classes turn out to be much better, Harvard and Yale are in a position to take advantage of them. Since they embarked on this strategy nearly

"bedrock" of every investor's portfolio. "Most investors, institutional and individual, are far less diversified than they should be," he says. "They're way overcommitted to U.S. stocks and marketable securities." In his 2005 book for individual investors, *Unconventional Success*, Swensen advocates much greater diversification than most investors have in their portfolios, even though he also questions their ability to match the returns of Harvard and Yale.

**I**F YOU HAVEN'T BEEN FOLLOWING THE IVIES' investment strategies over the years, you may be surprised by how Harvard and Yale allocate their endowment assets. Their portfolios are most likely radically different from yours, or from the models advocated by most financial planners, which are still heavily weighted toward traditional asset classes like stocks, bonds and cash.

Until about 20 years ago, Harvard's and Yale's portfolios looked like that too. Then, beginning in 1990, Yale, soon followed by Harvard, moved aggressively into new categories of investments. What's most striking about their portfolios today is how little they have invested in U.S. stocks and bonds, the mainstay of most individual portfolios. As of June 2006, Yale had less than 12 percent of its portfolio in U.S. stocks and a mere 4 percent in fixed income. At Harvard the portions were

## How They Do It

Economist James Tobin used to joke that he won his Nobel Prize in economics by saying, "Don't put all your eggs in one basket." Of course, it's not that simple, but putting the correct amount of eggs in each basket improves the overall expected rate of return while reducing risk. The endowments

of Harvard and Yale—whose target allocations are below—have been incredibly successful since adopting this approach. Both have average annual gains of more than 15 percent over the past decade, making them the envy of institutions both inside and outside academia. The key is to select

the right mix of investments. Although you are exposing your money to a number of risks, overall, your risk is reduced by coming up with the proper allocation among investments that don't move in the same direction. That way, you own both the zigs and the zags.



### HARVARD

- 12% Domestic equity
- 19% Foreign equity:
  - Emerging equity
  - Developed equity
- 13% Fixed income
- 31% Real assets:
  - Commodities
  - Inflation-indexed bonds
  - Real estate
- 13% Private equity
- 17% Absolute return

Note: Totals more than 100% because Harvard uses leverage to improve returns.



### YALE

- 12% Domestic equity
- 15% Foreign equity:
  - Emerging equity
  - Developed equity
- 4% Fixed income
- 27% Real assets:
  - Real estate
  - Oil & gas
  - Timberland
- 17% Private equity
- 25% Absolute return



SOURCE: 2006 ANNUAL REPORTS

## How You Can Do It

While Harvard and Yale still have built-in advantages, there are more opportunities than ever for small investors to play the game. SMARTMONEY's portfolio for individuals who want to invest like the Ivies follows their goal of diversifying across asset classes, though it's a bit lighter on private equity and absolute return.



#### SMARTMONEY MODEL

- 20% Domestic equity
- 25% Foreign equity:
  - 15% Emerging equity
  - 10% Developed equity
- 5% Fixed income
- 25% Real assets:
  - 10% Energy
  - 3% Metals
  - 2% Timberland
  - 10% Real estate
- 10% Private equity
- 15% Absolute return

#### SUGGESTED INVESTMENT

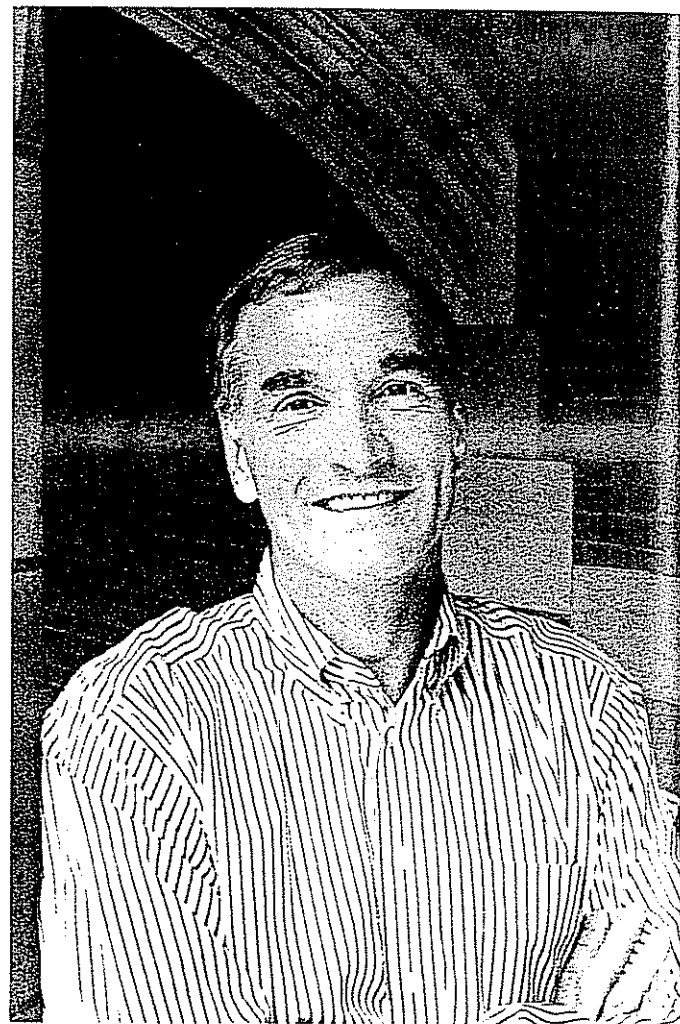
- DJ Wilshire Total Market ETF (TMW)
- T. Rowe Price Emerging Markets (PRMSX)
- iShares MSCI EAFE (EFA)
- Loomis Sayles Bond Fund (LSBRX)
- Guinness Atkinson Global Energy (GAGEX)
- SPDR S&P Metals & Mining (XME)
- Plum Creek Timber (PCL)
- Alpine US Real Estate Equity (EUEYX)
- PowerShares Private Equity ETF (PSP)
- Hussman Strategic Growth (HSGFX)

20 years ago, the premise of higher returns with lower risk seems to have been amply demonstrated. Both endowments avoided the severe hardship of U.S. markets after the dot-com implosion in 2000. Other asset categories helped compensate, such as hedge funds, which were able to benefit from a market decline, and private equity, real estate and commodities, which soared as interest rates dropped. Indeed, Yale's and Harvard's approach has been so successful that it is now being copied to varying degrees by nearly every major university and institutional endowment in the country. Swensen's 2000 book, *Pioneering Portfolio Management*, has been popular among endowment officers and helps account for the recent flood of money into hedge funds and private equity.

Of course, there are differences between venerable institutions with billions to invest and time horizons of perpetuity, and individuals whose resources and life spans are finite. Harvard's and Yale's superior performance is a function not just of wide diversification and a limitless time horizon, but also of the quality of their asset managers. Yale and Harvard are so large that they can select the best managers and provide the seed capital for top managers to launch new funds. Today the top hedge, private-equity and venture-capital funds are closed to new investors, and many others require enormous minimum investments or don't allow individual investors at all. Swensen says it's "ludicrous" to expect alternatives available to individual investors to replicate the results of top hedge funds and private-equity funds. Another consideration is taxes, since universities are tax-exempt.

**E**VEN SO, THERE'S NO REASON THAT THE theoretical underpinnings of Yale's and Harvard's investment philosophy shouldn't apply to individuals. The key is diversification, especially among assets that are noncorrelated. Harvard's current endowment manager, Mohamed El-Erian, agrees that individuals cannot hope to duplicate the quality of Harvard's asset managers. "It would be like advising my son or daughter to drop out of school to play basketball with the goal of becoming the next Michael Jordan." But he, too, says that endowment strategies hold lessons for individual investors, specifically, their asset allocations, their long-term perspective and their assessment of risk tolerance. "Individuals need to think in these terms as well, and have a clear, well-thought-out process where they think systematically in terms of risk and return, and how they're going to get there," he says.

In addition, investors accustomed to measuring themselves by traditional and widely quoted benchmarks like the Dow Jones Industrial Average and the Standard & Poor's 500 will



have to wean themselves off them, since U.S. stocks make up such a small portion of a portfolio this diversified. When U.S. stocks soar, or are the top-performing asset class, the portfolio will lag these indexes. The payoff comes in much lower volatility, especially in years like 2001 and 2002.

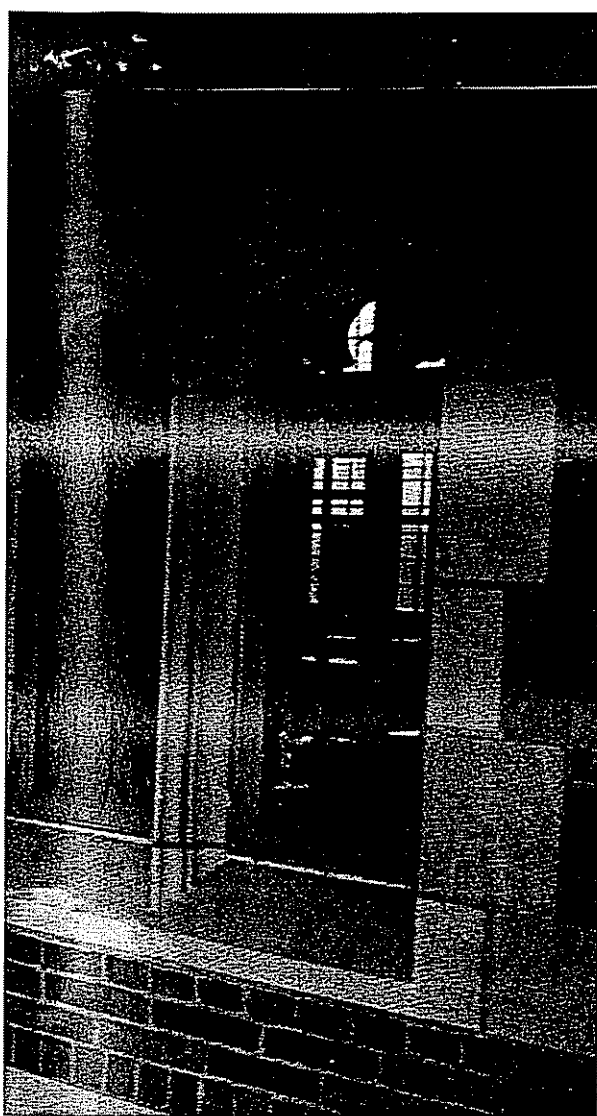
So you want an Ivy League portfolio, but you're not a billionaire. Where to begin?

**PRIVATE EQUITY:** The big challenges are the asset categories of absolute return and private equity, categories that have been closed to all but the wealthiest investors. One way in is to buy shares in a buyout company like Blackstone, which went public in June; Fortress Investment Group, which operates both hedge funds and private-equity funds; or Kohlberg Kravis Roberts, which has filed for an initial public offering. Since it's too early to tell how closely these public vehicles will track the returns of the funds themselves, an alternative is to buy shares of investment bank Goldman Sachs, which runs one of Wall Street's most successful private-equity operations. Goldman shares are up 325 percent since the company went public in 1999.

Another approach: PowerShares launched its Listed Private Equity Portfolio in October 2006. (So far it's up 10.5 percent.) In addition to the publicly traded buyout firms, it invests in institutions that finance buyouts, such as publicly held CapitalSource. While this risks weakening the correlation to private-equity returns, it provides greater diversification.

Photograph by Barbara Alper





David Swensen, Yale's endowment chief, says that most institutional and individual investors are "far less diversified than they should be."

Because the degree to which these choices actually correlate to private-equity returns is unproven, and many believe the recent outsize returns to private equity are destined to decline, we'd be more cautious in this category than Yale, more in line with Harvard's target of 13 percent. Our allocation: 10 percent.

**ABSOLUTE RETURN:** Numerous mutual funds and ETFs have recently been introduced that purport to offer the same advantage as long/short or market-neutral hedge funds, which is the ability to profit from both rising and falling stock markets. There are now 50 of these funds to choose from, double the number three years ago. Among the funds with the best performance records are Hussman Strategic Growth, Diamond Hill Long/Short and Highbridge Statistical Market Neutral. Most market-neutral funds use a combination of active management and proprietary computer programs to take long positions in stocks deemed undervalued and short positions in those deemed overvalued. Still, Swensen points out that

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few, if any, of these funds are truly market neutral. They have market exposure, though they offer some protection in a down market. Fees can be quite high for these mutual funds, though modest compared with most hedge funds.

Two other mutual funds offer the advantages of merger and arbitrage hedge funds: the Merger Fund and the Arbitrage Fund, with annualized five-year returns of 5.7 percent and 6 percent, respectively. More important, they have low volatility and little correlation to broad market averages. Because most of these funds are relatively new, and their ability to match hedge-fund returns still unproven, we'd also allocate a lower percentage than the major universities to the absolute-return category: 15 percent.

**REAL ASSETS:** While Harvard and Yale may have direct ownership of real assets—Harvard was at one time the largest institutional owner of timber in the world—individuals have a wide array of options that offer liquidity and diversification, including real estate investment trusts, mutual funds and limited partnerships in the major categories of real assets. Besides diversification, they offer the added benefit of inflation protection. We've included examples in our model portfolio, but readers should do their own research and might want to consider a mix of funds in each category.

**STOCKS AND BONDS:** Although international exposure is easily gained through ETFs and index funds, most endowment managers believe international markets remain inefficient compared with the U.S., especially emerging markets, and hence can benefit from active management. We've included the T. Rowe Price Emerging Markets Stock fund in our model portfolio, but there are many options. Finally, traditional U.S. equity and fixed income can be accommodated with ETFs and index funds, since even Harvard's and Yale's large-capitalization-equity and fixed-income managers have had trouble outperforming indexes.

Our version of the Ivy League portfolio comes close to Harvard's and Yale's diversification, but with smaller allocations to private-equity and absolute-return strategies, and larger investments in domestic and international stocks. This is simply one approach, and investors can devise variations that reflect their own goals and comfort levels with various asset classes.

Is this a radical departure from traditional asset-allocation models? Yes. Is it backed by impressive scholarly research? Yes. Will the model perform as well as the Harvard and Yale endowments over the past decade? That, of course, is the unanswerable question. But in a world of ever more efficient capital allocation and swift corrections, greater diversification seems more prudent than ever. 