Pioneering Portfolio Management

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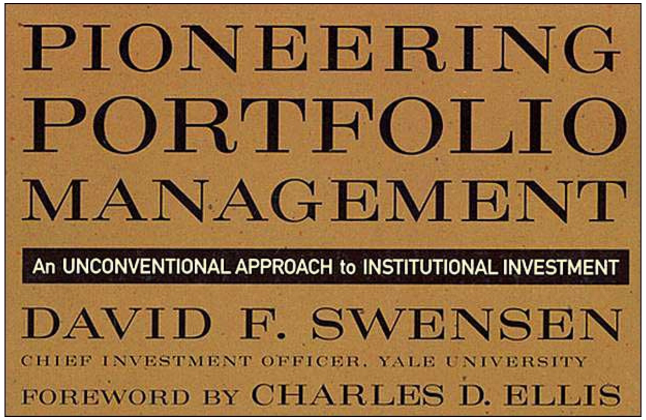
David Swensen manages the Yale University endowment fund worth US$18b at 2006. Since 1985, he has steered the fund to achieve a 16% pa return beating all other endowment funds. Indeed, the president of Harvard notes "we wish that David Swensen would find a new job"

This detailed book explains Swensen's investment philosophy and the unique considerations which apply to managing endowment funds. There are some interesting parallels that apply to managing your retirement funds, however, the perpetual nature of endowment fund investing and the scale/elite position that funds like Yale enjoy, means that your investment approach will differ.

Swensen's approach was considered pioneering for its multi-asset class investment model which favoured a higher overall allocation to growth assets, including to non-US equities, property[1] and alternative investments. The increased allocation to venture capital, leveraged buyout and hedge funds by Australian institutional funds (to ~ 5-10% total), can be traced in part to the Yale experience. *Note some have recently expressed concerns about the potential for too many funds "flooding" into these asset classes and the excessive fees sometimes extracted.*



David Swensen

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[1] US investors technically classify Real Estate (Property) as an Alternative Asset class, which we do not in Australia

About endowment funds

Endowment funds provide competitive advantage to institutions allowing greater independence, provide financial stability and fund educational excellence

- **Yale's fund contributed $280m or 20% of the University's annual budget in 2000**

Swensen points out a correlation between endowment size and institutional quality (and also age of institution) for US universities

- **Top Quartile Universities, as ranked by US News & World Report: Caltech, Duke, Harvard, MIT, Princeton, Stanford and Yale (ordered alphabetically) enjoy an average endowment size of US$4.5b (Year 2000) or $300k/student, vs. $2b/$1.5b/$0.7b for 2nd/3rd/4th Quartile universities**

Successfully managed endowments retain forever the ability to support an institution, their payout rising to provide education-inflation protected income

- **A tension exists between higher return / higher volatility investment outcomes sought to preserve purchasing power, with lower risk, more stable returns desired for operational budgeting**
- **Clear spending and investment policies are used to balance these tensions and also to avoid short-term tinkering by trustees**

Spending is not funded solely by yield (ie. interest, dividend, rent) "as it would only be a coincidence" that portfolio income would fund needs – some capital is divested to fund spending and to rebalance

There is a wide range of payout rates practiced amongst funds, from a low 1% to an unsustainable 10%. Yale's customary payout ratio is about 4.5%, adjusted via a multi-year smoothing approach

- **Even at that level, for 20 of 50 years from 1950-2000, the fund's value trailed the inflation adjusted purchasing power target**

New gifts play an important role growing endowments

- **Yale's fund is 3x larger today owing to new gifts since 1950**

"Serious", "successful" and "intelligent" investors …

Have a strong equity bias "since accepting the risk of owning equities rewards long-term investors with higher returns"

- **In June 1998, the average educational endowment fund had 28% of assets in low return bond/cash assets creating "significant opportunity cost"**

Diversify into assets that respond differently to market forces

Avoid timing markets

- **Overweighting cash / underweight growth assets, can lead to "permanent impairment of value" when missing subsequent rallies**

Rebalance portfolios "requiring strong stomach and staying power"

- **"the alternative of not rebalancing to policy targets causes portfolio managers to engage in peculiar trend-following market timing strategy"**

"Approach active management with skepticism"

- **In efficient markets, "investors fare far better with passively managed portfolios"**
- **Select top-quartile managers in private markets (eg. private equity, buyouts)**

Employ a value orientation which "provides a margin of safety"

Patiently accept some illiquidity, ie. include alternative investments

Large institutional endowment funds adopted a more diversified, higher growth asset allocation

	General College/Uni Mean	Large Institution Mean	Yale	Harvard	Princeton	Stanford
US equity	45%	27%	23%	36%	20%	30%
US fixed interest	22%	10%	13%	10%	10%	9%
Int'l equity	17%	21%	13%	29%	20%	23%
Private assets(1)	10%	28%	32%	25%	25%	30%
Other marketable assets(2)	6%	13%	20%	0%	25%	8%
Expected real return	5.0%	6.7%	7.2%	6.6%	6.7%	6.4%
Std. Dev'n	12.8%	12.6%	12.5%	13.8%	11.8%	12.4%

(1) "Real estate" (property), venture capital, leveraged buyouts
(2) incl. various absolute return, hedge funds (eg. merger arbitrage, long/short)

Expected return = f(% asset allocation, expected return by asset(3))
(3)US Equity 6%, US FI 2%, Int'l Eq 6%, Property 3%, VC/LBO 12%, Absolute Rtn 7% (real)

Source: Swensen, NACUBO 1997 Endowment study

More on Swensen's investment philosophy and concerns about agency issues

"Equity holdings form the core of institutional portfolios because owning a share of the profits generated by well run enterprises provides greater expected rewards than does staking a claim to debt service payments promised by the same corporations"

- "The principal justification for incurring expected opportunity cost by investing in bonds and real estate stems from diversification they provide"
- "Disingenuous [fixed interest] managers point to higher than benchmark returns as signs of management success, pocketing as fees the incremental returns generated by exposing clients assets to high levels of credit, call or foreign exchange risk"

"Venture capital and leveraged buyouts claim a place in institutional portfolios by promising returns in excess of marketable securities"

- "Burdened by extraordinary fees, investors face the difficult task of selecting top-decile funds to realize the promise of private investing"

Investors holding a composite portfolio of actively managed funds "run the risk that it resembles an index fund" while incurring high active costs

"Relying on research produced by investment banking wannabes provides a poor foundation for security selection. Cowardice leads to the extraordinary result that 90% of analyst stock recommendations fall in the positive and neutral categories"

"Investors increase the degree of coincidence of interests with fund managers by choosing to work with focused, independent firms"

- "Most fiduciaries pursue investment with 'name brand' money managers, reducing career risk by choosing easily recognized firms blessed by external consultants"

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