

Are Harvard and Yale Endowments Still Top of the Class?

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Harvard and Yale recently said that their endowments experienced sizeable losses for their most recent fiscal years ended June 2009. Harvard reported a 27 per cent loss for its most recent fiscal year. While Yale has not yet released its annual report, the university's president told alumni to expect a loss of around 30 per cent for the same period. As a point of comparison, the typical world-allocation fund in Morningstar's database fell almost 20 per cent from July 2008 through June 2009.

These results are noteworthy because Harvard's and Yale's endowments have produced results that have been the envy of the investment world. They also have been pioneering practitioners of what are now considered fundamental investment principles, such as diversifying among uncorrelated asset classes and developing a thoughtful long-term asset-allocation plan. Given the sterling reputations of these institutions, many thought that Harvard and Yale would fare much better than the competition amid last year's sell-off. Yet that clearly wasn't the case.

It's important not to make too much of this recent stumble. Last year's extreme market conditions humbled many talented managers, and every investor, even the most skillful ones, occasionally experiences a rough patch. However, the best investors also make a point of learning from their mistakes, and there are lessons to be taken from the endowments' recent underperformance.

Alternatives aren't a silver bullet

Academics theorized that the inclusion of noncorrelated assets in a portfolio would improve diversification and enhance risk-adjusted returns. But the investment managers at Harvard and Yale were among the first to put this theory to practice by including nontraditional assets, such as commodities, real estate, private equity, and hedge funds, in their endowment portfolios. This approach proved very successful for both universities. Indeed, it worked so well that many of their fellow institutions jumped on the alternatives bandwagon. Fund firms also got in on the act by launching a bevy of mutual funds and ETFs that offer exposure to asset classes and hedge fund strategies that were previously unavailable to retail investors, such as commodities, currencies, global real estate, and absolute return strategies.

However, last year confirmed that asset classes tend to correlate during market crises. In other words, when the market implodes, few investments can avoid the downdraft. Large allocations to alternative asset classes didn't protect Harvard's and Yale's endowments from the broad sell-off. Similarly, many retail alternative funds, some of which were advertised as effective diversifiers, failed to deliver on that promise.

Does that mean you shouldn't include alternatives in your portfolio? Not necessarily. A modest allocation to a commodity or real estate fund can improve diversification, but don't expect these investments to protect your portfolio from every unexpected turn in the market. Moreover, don't be drawn in by newfangled strategies with fetching back-tested results. The year 2008 proved just how challenging the real world can be.

Liquidity matters

Many alternative assets held by Harvard and Yale are not readily liquid, and that proved particularly problematic last year. Harvard singled out "aggressive commitments to illiquid asset classes" as one of

the factors behind its poor results last year. Private equity proved particularly insidious because not only are these investments difficult to sell, but they can demand additional investments, sometimes at inopportune times. That put private-equity investors in the position of selling their liquid positions at unattractive prices just to meet calls for capital. At the same time, some hedge funds were experiencing problems of their own and consequently limited their shareholders' ability to redeem their investments. This lack of liquidity squeezed many big investors, including university endowments.

Mutual fund investors escaped these problems because funds are required to provide their shareholders daily liquidity. That's a factor that many investors take for granted, but it was an invaluable attribute last year. Not only did it give fund investors the ability to sell when they wanted to, but the requirement keeps mutual funds out of the kinds of illiquid investments that caused major headaches for the investment managers at Harvard and Yale.

Asset allocation and time horizon must match

Endowment managers justified including large allocations to nonliquid assets because their time horizons were theoretically infinite. That should enable an endowment to ride out the occasional downturn without having to sell its investments at unfavorable prices.

But in recent years, time horizons for endowments have shortened. Their burgeoning coffers bred overconfidence on the part of administrators, who placed increasing demands on their endowments by relying on them to fund ongoing operations and massive expansion plans. Consequently, endowments became responsible for funding more near-term needs. That became a major problem amid last year's liquidity crunch.

Endowments are now smaller and their liquidity is limited. However, the universities' budgets have proved stubbornly inflexible, so unfortunately, administrators have been forced to slash costs.

The ambitious spending demands placed on endowments ultimately caused a mismatch between their asset allocations and their time horizon, which was no longer infinite. **Individuals, particularly retirees, can find themselves in similar straits if they don't take realistic account of short- and intermediate-term spending needs in constructing their portfolios.** Any money that you plan to spend over the next five years should be set aside in liquid and stable investments such as treasury bonds, CDs, and bond mutual funds. Also, it's smart to set aside emergency cash reserves to meet unexpected expenses.

Focus on the long term

Despite large losses last year, Harvard and Yale both hold enviable long-term track records. Harvard has earned annualized returns of 8.9 per cent over the past decade through June 2009, compared with 4.5 per cent for the average world-allocation fund. While we don't yet know Yale's results for fiscal 2009, its 10-year record as of June 2008 was well ahead of Harvard's and was the best among all university endowments. Its estimated 30 per cent loss for 2009, though painful, isn't large enough to derail its impressive long-term performance.

It would be a mistake to throw out an investment process that has produced these sorts of long-term results just because of one bad year. Still, last year serves as an important reminder of the limits of alternative investments and the value of liquidity.