



## Yale Endowment's 2007 Asset Allocation Targets: How Applicable Are They to Your Clients' Portfolios?

by Elaine Floyd, CFP®

Investors could do worse than to model David F. Swensen's asset allocation targets for the Yale Endowment. The fund earned 22.9% in fiscal year 2006, more than double the rate earned by the average institution. Since Swensen took over the fund in 1985, the Yale Endowment has soared to over \$18 billion from \$1 billion, generating an annual compound growth rate of 16.3%. According to its latest annual report, Yale's superior long-term record has resulted from "disciplined and diversified asset allocation policies, superior active management results, and strong capital market returns."

Asset allocation has been at the heart of Swensen's strategy from the beginning. When he took over the fund it was largely invested in traditional marketable securities. Over the years, in incremental shifts, he has gradually moved assets away from stocks and bonds and into a variety of alternative investments. The endowment's current asset allocation targets are as follows:

Absolute return	25.0%
Domestic equity	12.0
Fixed income	4.0
Foreign equity	15.0
Private equity	17.0
Real assets	27.0
Cash	0.0

If this allocation bears little resemblance to your clients' portfolios, it may be because Yale's prestige and sheer size give it the ability to go virtually anywhere. Also, the endowment's ultra-long time horizon, measured in centuries, allows it to invest in illiquid, slow-growing assets such as timber and oil exploration. Your clients' portfolios may have passed on to the next generation before some of Yale's investments pay off.

Still, there's a lot to learn from Swensen's style, the most significant being the fresh, common-sense approach he brings to asset analysis and his willingness to go against tradition. How many of the following statements from Swensen's 2000 book *Pioneering Portfolio Management: An Unconventional Approach to Institutional Investment* ring true for you?

- **On cash:** "For investors with short investment horizons, cash represents the riskless asset. [However], if investors operate with time horizons of several years, cash constitutes a risky asset. Holding-period returns become uncertain as investors roll over maturing cash instruments into new investments at then-market rates.
- **On corporate bonds:** "Structural issues render such bonds hopelessly flawed as an investment vehicle. Shareholder interests, with which company management



generally identifies, diverge so dramatically from the goals of bondholders that lenders to companies must expect to end up on the wrong side of nearly every conflict." Bondholders are motivated by the timely payment of interest and principal, while equity holders seek longer term growth, which may involve investment and risk-taking that is not aligned with the bondholders' incentives.

- **On private equity:** "To the extent that venture capitalists contribute to the process of bringing a company from an idea to a reality, generating tens of millions of dollars in revenues and employing hundreds of individuals, value creation occurs independent of market activity."

You will notice that over half of Yale's portfolio -- the 25% directed to absolute return strategies (which are how Swensen classifies hedge funds) and the 27% in real assets -- generate returns which are largely independent of market moves. The portfolio's absolute return investments -- defined as event-driven strategies and value-driven strategies -- returned 12.9% per year over the past ten years with essentially no correlation to the stock and bond markets. Real assets, including real estate, oil and gas, and timberland, provide high income, excellent portfolio diversification, and a hedge against unanticipated inflation, according to the annual report. Swensen acknowledges, however, that the illiquid nature of real assets combined with the expensive and time-consuming process of completing transactions create a high hurdle for casual investors.

It would be easy for advisors and clients to chalk off Yale's investment strategies as impossible for the average investor to implement. In fact, Swensen said as much in his second book, *Unconventional Success: A Fundamental Approach to Personal Investment*, in which he essentially told readers to stick with traditional asset classes and invest in index funds. But if outside-the-box thinking is what has led to Swensen's success, why can't you and your clients emulate that aspect of the master's approach, even if the actual investments Yale buys are out of reach?

Consider rethinking your clients' asset allocation plans to incorporate the following:

- **Private equity.** Clients who are unable or unwilling to play the venture capital game may already be participating in that most private of private equity: their own business. Or they may have the opportunity to invest in a friend's or family member's business. Either way, an allocation to private equity allows them to participate in the growth of a business independent of stock market trends. When analyzing your clients' asset allocation plans, consider expanding their portfolio to include ownership interests when they are involved in a privately-held business. Then see how the allocation stacks up against the other asset classes.
- **Real assets.** The same goes for real estate. Consider including your clients' real estate holdings -- investment property, vacation homes, even personal residence -- in the overall portfolio and assign the appropriate percentage allocation based on their value.



- **Absolute return.** In July 1990 Yale became the first institutional investor to pursue absolute return strategies as a distinct asset class. This begs the question: can a *strategy* be considered an *asset class*? Yale thinks so. Maybe you should broaden your thinking as well and look upon strategies -- whether executed via hedge funds or your own portfolio activities such as covered call writing -- as absolute return investments.
- **Corporate bonds.** Do you want to rethink your allocations to cash and corporate fixed income based on Yale's aversion to those asset classes? To be sure, these asset classes fulfill client objectives for income and liquidity. But if a client's main objective is growth, there may be little reason to allocate much of the portfolio to these asset classes.
- **Emerging markets.** Yale directs more than half of its foreign equity allocation to rapidly-growing emerging markets. How do your clients' allocations to emerging markets compare? As Swensen points out in his book, the United States was once an emerging market. For clients who can ignore the volatility of this asset class, shifting assets to the emerging markets of today could be smart long-term move. [Editor's note: In the Advisor Perspective's universe, 10.3% of marketable securities are in foreign markets. View Data [<http://advisorperspectives.com/reports/aa-domicile.php?univ=0>] Of this 10.3%, only 8.6% is invested in foreign emerging equities, with the bulk – 88.3% - in foreign developed equities. The remaining 3.1% is in foreign bonds.]

Perhaps the best lesson from Yale's iconoclastic approach to investing is its refusal to accept the conventional wisdom and its commitment to doing what is right for the fund, which, granted, may not be right for your clients. Still, examining the strategy and thinking of the Yale Endowment may remind us to break free of tradition and look at portfolio design in new and different ways.

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