

## University endowments

### The ivory trade

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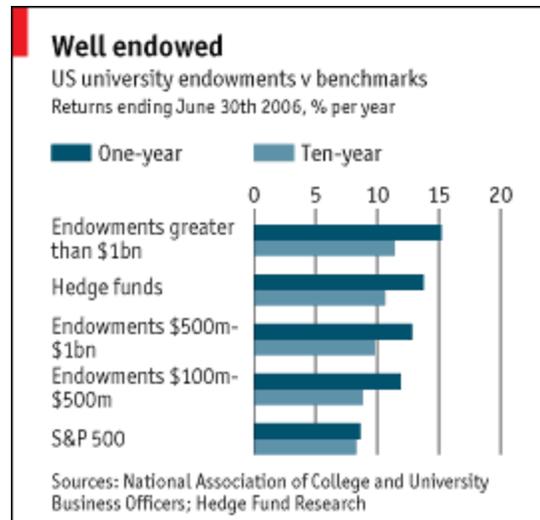
#### What makes America's colleges such clever investors?

AMERICA is the home of the efficient-market hypothesis, which says financial markets have become so keenly contested that it is impossible for investors to keep beating them. Yet the very universities that peddle this theory so confidently also gleefully undermine it by doing precisely that: over one year and over ten, their endowment funds beat the S&P 500 and hammer most other institutional investors, including pension funds.

The final figures for the most recent fiscal year will be out next week. But according to preliminary numbers from the National Association of College and University Business Officers (NACUBO) and TIAA-CREF, a financial-services group, university endowments made an average return of 10.7% in the year to June 30th 2006, net of fees and expenses.

The biggest endowments are big investors: between them, Harvard and Yale have some \$50 billion, around one-seventh of the total. They tend to do better than their smaller peers and pretty much everyone else. Indeed, these eggheads even beat the quants. Endowments larger than \$1 billion returned 15.2% on average last year, more than the main hedge-fund index (see chart). The best-performing endowment in 2005-06, which belonged to the Massachusetts Institute of Technology, gained a handsome 23%. That put it a whisker ahead of Yale's (22.9%), run for more than 20 years by David Swensen.

Endowment managers would no doubt like to claim this is all down to skill. But they do enjoy certain advantages over their rivals. In principle, their investment horizon lasts not weeks, months or years, but forever. Their capital is extremely patient. Each endowment has a single client—itself—that needs to extract only a small sum annually to keep the wheels of scholarship turning. Therefore, unlike pension funds, they do not have to fret about matching assets with liabilities. This means endowments can tolerate lots of volatility, which in turn allows them to make, and stick to, contrarian bets. They have been “incredibly gutsy” in going against the grain, says Will Wechsler of Greenwich Associates, a financial-services consultancy. Perhaps they can stay solvent longer than the market can stay irrational.



A second advantage is the university environment. “Whereas pension trustees are naturally risk-averse, universities are all about innovating, financially as well as intellectually,” says James Walsh, who runs Cornell’s \$5 billion endowment. Investment constraints are kept to a minimum. Alumni with Wall Street experience are encouraged not only to donate money but also to sit on investment committees. Many are happy to oblige. “This gives us access to minds we couldn’t otherwise afford,” says Mr Walsh. The brainpower on tap at the university itself is not always as useful. According to one former Harvard official, its endowment fund has done so well because it has avoided taking advice from the economics faculty.

Put these factors together, says Mohamed El-Erian, Harvard’s endowment chief, and you have a recipe for “thinking more boldly than the pack”. America’s endowments were among the first to look beyond the staid mix of domestic equities, bonds and cash. The idea they helped develop in the 1970s and 1980s—deemed eccentric at the time—was to break the portfolio into a mix of standard and “alternative” assets, as uncorrelated with each other as possible so as to spread risk. This strategy is sometimes referred to as “portable alpha”.

Their early moves into hedge funds, venture capital, private equity, property, distressed debt and the like brought outsized profits. Universities and foundations have also benefited from geographical diversification, especially into emerging markets. Foreign equity was their best-performing asset class last year, making 24.7% according to a survey by the Commonfund Institute, which manages pooled investments. Endowments have also revolutionised commodities. By making a killing in “hard” assets like timber in recent years, the universities have helped to turn them from industrial assets to financial ones in investors’ eyes. Harvard keeps three lumberjacks on its team, the joke goes.

### Sweating as they swot

Indeed, for university endowments to call all of these assets “alternative” is something of a misnomer. It is assets such as government bonds, once safely in the mainstream, that must fight for their place in university portfolios. Today the typical large endowment has 41% of its holdings in assets other than shares, bonds and cash, says NACUBO. In the past couple of decades, illiquid investments, which are less efficiently priced than liquid ones, have rewarded those brave enough to buy them. Thus big, bold endowments have thrived by resisting what John Maynard Keynes—a proponent of asset diversification—called the “fetish of liquidity”.

Will university endowments continue to defy the ivory-tower theorists? Don Fehrs, head of research at Evanston Capital Management, a hedge fund—and a former head of Cornell’s

endowment—thinks it is becoming harder for them to maintain their advantage because, predictably, copycat investors have piled into areas they once had largely to themselves.

The biggest endowments now employ dozens of bright sparks to look for promising new pastures. Some have even sent scouts to developing countries. Others are hoping to stay ahead by handing large sums to bright but untried managers. They are spending less time on broad asset allocation, and more on trying to pick winners within each class.

This is a trickier exercise, but they may have no choice. Simply putting 20% into hedge funds is no longer enough. The big test of their prowess will come when tax credit conditions tighten. John Griswold of Commonfund thinks that some investment committees, stuffed with alumni, may be starting to lose track of the risks their endowments are taking.

All endowments are finding it harder to hold on to their best people. Although a few high-fliers, such as Mr Swensen, are content to forgo the vast salaries they could earn at private firms—top endowment chiefs rarely get more than \$2m a year—many have been tempted away as portable alpha of a different kind.

Harvard, Stanford, Cornell and Duke have all lost their bosses over the past year and a half. After 15 years in the job, Harvard's Jack Meyer tired of the hostility students and professors showed towards his highly paid (and highly successful) managers. He quit and set up a hedge fund, taking more than 30 of his colleagues with him. Stanford's Michael McCaffery left after failing to persuade the university to let him manage private money alongside the endowment. These defections have left quite a few vacancies at the top.

Nevertheless, the endowment model continues to win plaudits—and to attract imitators abroad. As Japan loosens its investment rules, its university presidents are said to be looking very closely at the "Yale model". In Britain, Cambridge University has persuaded Mr Swensen to sit on the committee overseeing its £1.2 billion (\$2.35 billion) central endowment. Despite the resistance of otherworldly dons, it recently became the first British university to hire a City financier to run its fund. The university's vice-chancellor, Alison Richard, was previously provost of Yale, where she gained a "powerful understanding" of what a well run endowment can do. Profits trumping profs on the banks of the Cam: that really would be an investment coup.