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University Endowments Face a Hard Landing

By JAMES B. STEWART

For years, America's largest, richest and most prestigious universities have been the envy of investors. They churned out double-digit returns over the last two decades, even with steep losses during the financial crisis. Harvard's endowment today is over $30 billion and has generated annualized returns of 12.5 percent over the last 20 years.

Their investing success along with their vaunted academic reputations led many financial experts to conclude that Harvard and its peers at the pinnacle of higher education had solved an age-old conundrum: how to generate higher returns with lower risk.

An investment stampede ensued as other universities, giant pension funds and even individuals slavishly copied their strategy, which stressed diversification along with high-cost, often illiquid alternative investments like hedge funds, venture capital and private equity funds. Today, it's hard to find a college or university that stuck with the older and far simpler allocation between stocks and bonds. Hedge funds alone currently have what is estimated at over $2 trillion in assets, much of it from large institutions.

College and university endowment returns for the most recent fiscal year, which ended June 30, are starting to roll in. And in many cases, they warrant a grade of C at best, and in some cases, an F. Harvard reported a 0.05 percent loss and a drop in its endowment of over $1 billion in the same period, even as a simple Standard & Poor's 500-stock index fund gained about 5.5 percent. Harvard's endowment decline is more than the entire endowments of roughly 90 percent of all colleges and universities.

Even more startling, data compiled by the National Association of College and University Business Officers for the 2011 fiscal year (the most recent available) show that large, medium and small endowments all underperformed a simple mix of 60 percent stocks and 40 percent bonds over one-, three- and five-year periods. The 91 percent of endowments with less than $1 billion in assets underperformed in every time period since records have been maintained. Given the weak results being reported this year, that underperformance is likely to be even more pronounced when the fiscal year 2012 results are included.

The impact is significant. Universities depend on returns on their endowments to finance operations, pay faculty and administrative salaries, provide scholarships and pay for building projects. Harvard said it planned to spend $172 million this year on need-based

scholarships. Many colleges budget 4 to 6 percent of the endowment's value for current spending. At Harvard, funds from the endowment account for 35 percent of the university's annual budget.

"The compelling simplicity of a 60/40 strategy is very hard to beat," Timothy J. Keating, president of Keating Investments in Greenwood Village, Colo., and author of two reports on endowment performance, told me this week. "Many investors would be much better served with a simple 60/40 strategy, or at least a core where you have low-cost index funds. When you understand the role of transaction fees, it's a very high mountain to scale."

Those fees for so-called alternative investments can be enormous. Hedge fund and private equity fund managers typically keep 20 percent or more of the gains, which is known as carried interest, and a percentage of assets under management. Private equity, real estate and natural resources partnerships may also impose an array of transaction fees on top of performance fees. "The audacity of Wall Street at extracting fees never ceases to amaze me," Mr. Keating said.

Simon Lack, a founder of SL Advisors in Westfield, N.J., and a hedge fund insider — he allocated capital to hedge funds during his 23 years at JPMorgan Chase — caused a stir earlier this year with his book, "The Hedge Fund Mirage," in which he calculated that the hedge fund industry as a whole lost more money in one year (2008) than it had made in the previous 10 years. "If all the money that's ever been invested in hedge funds had been put in Treasury bills instead, the results would have been twice as good," he asserted. And he maintained that nearly all the hedge funds' gains had gone to hedge fund managers rather than clients.

"If you look at the data, hedge funds have underperformed a simple 60/40 stock/bond mix every year for the past 10 years," Mr. Lack told me this week. "They did well in the downturn of 2000-2. But that's when assets under management were less than half what they are now. There's no disputing that as assets have grown, performance has declined."

Not surprisingly, Mr. Lack's analysis has come under attack by a vast industry that depends on steering clients into alternative investments, among them the London-based Alternative Investment Management Association, a lobbying group that issued a detailed rebuttal. But Mr. Lack said he stood by his methodology, and pointed out that many of his critics had a financial stake in maintaining the status quo. Mr. Keating, who doesn't advise endowments or pension funds, said he agreed with Mr. Lack. "He's very controversial, but I found his analysis persuasive."

Among those raising questions about the Ivy League model and its heavy dependence on alternative investments is Vanguard, the giant mutual fund company that has long promoted a radically simpler approach based on low-cost index and mutual funds. "I feel

that there was endowment envy, or maybe emulation is a better word," Francis M. Kinniry Jr., a principal in Vanguard's Investment Strategy Group, told me this week. "Everybody wanted to look like the Yales and Harvards of the world. But they were early. They were doing these techniques in the mid-1990s and late 1990s when equities looked overvalued, and alternative strategies could capture market imperfections. That's no longer true. Those universities were forward-looking and deserve a lot of credit. But emulating that process three, five or seven years later is very problematic."

Even David Swensen, Yale's chief investment officer, who is widely viewed as the godfather of what has become known as the Yale model, has cautioned that few could expect to replicate Yale's results, because Yale had access to top managers whose doors were closed to all but a favored few. Mr. Kinniry agreed. "Because of their size and relationships, and the ability to commit to a continuing investment cycle, Harvard, Yale, M.I.T. and Notre Dame have unique access."

It's true that Harvard's and Yale's endowments, in contrast to most smaller endowments, have outperformed a simpler and more conventional mix of stocks and bonds, and a Harvard spokesman noted that over the last 10 years, Harvard's endowment had generated over $12 billion more than a 60/40 model would have.

But that may be hard to replicate in the future, even for the Harvards and Yales of the world, since even access to top managers is no guarantee of future performance. "They'll have to be very good at manager selection," Mr. Lack said, "because there's been very little return persistence. I looked at one-third of the hedge fund industry. Of those in top 40 percent of returns, only 7 percent stayed there throughout the period." A recent example is the billionaire hedge fund manager John Paulson, who after a spectacular bet against mortgage-backed securities in 2007 attracted millions from investors, but then suffered crushing losses last year. "He deserves credit, but he had one great trade and that was it," Mr. Lack said of Mr. Paulson. "He should have quit and done something else for a living."

In addition, the high annualized returns at Harvard, Yale and a few other universities largely depended on some superlative years that are now receding into the past. As a result, their average returns are dropping. Even the top endowments experienced severe double-digit declines during the financial crisis, when hedge funds failed to perform as expected and illiquid alternative investments left some major universities facing a cash bind. Yale recently reported a gain of 4.7 percent for the fiscal year that ended June 30. Princeton said its gain would similarly be less than 5 percent. Even those mediocre returns may be better than many smaller endowments, which, like Harvard, may be facing losses.

"If you look at the endowment world as a whole," Mr. Keating said, "they don't have access to the top quartile of managers. That

access is uniquely provided to a few of the best investors. So what does the median venture capital or private equity return look like? It's a horror show. It's been flat to even negative. The strong get stronger and the weak get stuck with non-top quartile managers and mediocre returns and high fees."