



Why It's Hard to Copy Harvard & Yale

Robert Huebscher

October 7, 2008

For advisors seeking to emulate the “endowment model” of asset allocation and expecting results similar to Harvard’s and Yale’s hefty returns, a new study, [*Secrets of the Academy: The Drivers of University Endowment Success*](#), may be humbling. The study, by Harvard Business School professor Josh Lerner and MIT professors Antoinette Schoar and Jialan Wang, documents the impressive returns of endowments. But the study also shows their performance advantage cannot be directly attributed to asset allocation or specifically to their use of alternative asset classes, such as private equity and hedge funds. Instead, endowments’ superior performance is more closely tied to factors that advisors will find much harder to emulate, such as endowment size and admissions selectivity.

The authors “suggest caution to investors seeking to reap similar rewards by copying the investment strategies of top endowments.” Even if this warning were insufficient, the authors cite recent dramatic events, such as Harvard Management’s \$350 million loss on Sowood Capital Management, and warn that the strategy of using alternative asset classes “that have worked so well for the endowments in the past two decades may not do so in the future.”

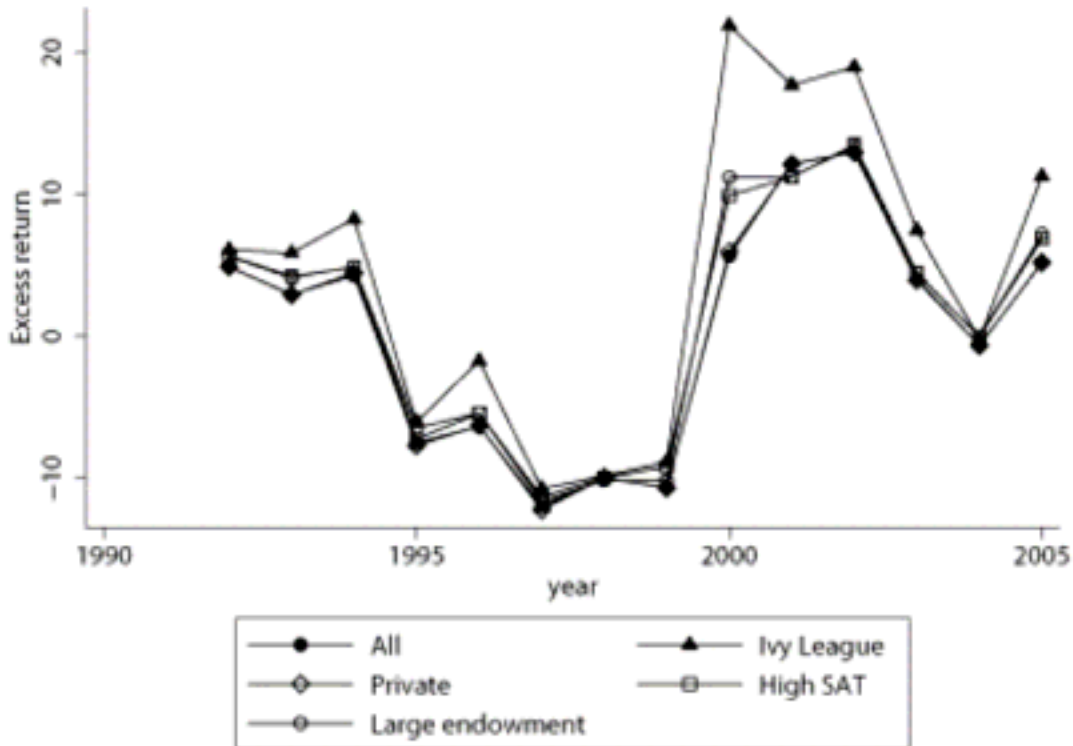
The study uses data from the National Association of College and University Business Officers (NACUBO), an organization of 2,500 public and private institutions. The data used was from 1992 to 2005, and it represents the performance of 1,300 schools. The authors cite a bias in the sample, in that participating universities are skewed to larger schools and include an overrepresentation of private institutions. But when the authors eliminated some schools to make their data set more representative of the broader universe of endowments, the results were qualitatively unchanged.

The study contains some interesting findings on the size and growth rate of endowments, but for our purposes we concentrate on the findings related to investment performance.

The authors provide the following data for returns across the endowments:

Excess returns by school type

(endowment return minus the Standard & Poor's 500 return in same year)



The authors highlight two points from this data:

- The eight Ivy League schools significantly outperformed the other schools (by approximately 3% per year), and the remaining schools performed essentially the same.
- Schools with large endowments and schools with students who scored high on the SATs (i.e., student bodies in the top quartile of SAT scores) outperformed the overall average by 1.3% per year.

Regarding the role of endowment size, the authors believe these schools are able to achieve economies of scale, for example by hiring professionals with expertise in various investment disciplines. SAT scores do not contribute to performance, but the authors suggest they may be a proxy for other factors, such as administrative skill, the wealth and connections of the alumni network, and



prestige of the “university brand,” all of which may enable these institutions to hire more skillful managers.

The study notes “remarkable persistence in the performance of endowments year after year.” This persistence is at the individual endowment level; individual schools that outperform continue to do so.

The Role of Asset Allocation

The authors looked at the role of asset allocation across five asset classes: equities, fixed income, real estate, alternative assets (hedge funds, private equity, venture capital, and commodities) and cash. Over the time period studied, there was a shift from equities and fixed income (declining from 83% to 73%), roughly offset by an increase in alternatives (from 11% to 21%). Allocations to alternatives are highest among the Ivy League schools, followed by the larger schools and those with high SAT scores. Yale is at the extreme, with an allocation at the end of 2006 of 69% of its funds in alternative assets.

The endowments with the highest performance in the study are those with the most aggressive allocation to alternative assets, which has led many institutions to emulate their approach. But the authors argue that such mimicry may not lead to comparable results in the future, as capital inflows to alternative strategies have diminished overall returns and made it harder to identify superior managers.

Endowment performance roughly tracked asset class benchmark performance from 1994-1999 but, starting in 2000, consistently outperformed benchmarks. The data are insufficient to pinpoint a reason, but most likely it is a combination of superior security selection and allocations to sub-classes like emerging markets, which outperformed during this period. Within the Ivy League schools, only 66% of the performance was explained by benchmark returns, versus 73% for the universe. These endowments are “doing more than just correctly timing by asset class,” the authors conclude.

Allocations to alternative assets are what set Yale, Harvard, and other top endowments apart. Performance within alternative assets varies widely, and the study shows that those endowments that were early to allocate to alternatives achieved better results. Latecomers to alternative assets found many of the top funds closed to new investors.

But success in alternative asset investing requires more than access to the right funds. The data show that performance varies significantly within alternative assets, so manager selection is crucial. Data for these asset classes is often hard to understand and interpret. Ivy League schools are benefiting from their extensive experience with alternatives in order to select superior managers.



The study shows that investment officers at top-performing endowments are more highly compensated, and the same holds true for investment officers at larger schools. It may be that superior performance is rewarded through compensation, or that schools with deeper pockets pay more handsomely. The data is inconclusive. But endowment managers across academia are generally paid far below their peers in the hedge fund industry.

Implications for Advisors

The authors note several questions which the study does not answer:

- The extent to which the organizational structure of endowment managers contributes to performance has not been studied. But the authors note that the top-performing endowments have boards that set broad policy decisions, are experienced, have worked together for many years, and have an academic and analytical orientation which fosters a culture of periodic self-assessment and evaluation.
- Whether the strategies pursued by the top endowments over the last 20 years will remain successful in the future is unclear. The authors believe these endowments benefited from an environment that was “kind” to investors, allowing them to pursue strategies that were uncorrelated to public equity markets. This success was made possible by organizational structures that permitted, or perhaps encouraged, unconventional strategies. Whether such strategies can still be identified in the future, and whether endowment boards will pursue them, is unclear.
- Lastly, and perhaps most pointedly, the authors warn of the dangers of imitation. As more capital follows an investment strategy, returns will diminish. In the past, there was significant lag from when top institutions began to pursue a strategy and when others followed suit. But top endowments are now much more closely scrutinized, dramatically compressing the time lag. Those hoping to imitate the decisions of top endowments going forward will face incredible competition.

Top endowments have been remarkably successful, but the authors say “much remains to be understood about the sources of their performance, whether they can continue to succeed, and whether the approaches of the successful endowment managers can be generalized to the broader investment community.”

We spoke with Lerner, who offered the following additional advice, specifically regarding the current market conditions: “I think taking a ‘contrarian’ point of view and not panicking are critical hallmarks of their success. Once again, being



cautious about liquid assets (which offer much less security than initially meets the eye) is also underscored.”

www.advisorperspectives.com

For a free subscription to the Advisor Perspectives newsletter, visit:

<http://www.advisorperspectives.com/subscribers/subscribe.php>