

Beyond the stock market:

Using the Strategies of Endowment Investing

If Harvard can do it, why can't I?

Recently, we've received inquiries from several clients who've noticed the returns being achieved by a number of prominent endowment funds such as those of Harvard, Yale, and Stanford. They're not necessarily unhappy with the results in their own portfolios, but they look with envy on the results of these school endowments. They want to know what strategies these investors use.

So just how do these funds achieve such consistently superior results?

Beyond the 60-40. Endowment funds have essentially infinite lives, requiring the long view in investing. Managers of these assets must ensure that their portfolios are positioned to provide positive, real returns (i.e., net of inflation) in enhancing the institution's annual cash flow, while also ensuring that enough is left to reinvest to support both future growth and meet the inflation protection goal. Finally, because higher returns necessarily involve higher risks, they need to design an asset class mix that reduces risk by investing in classes that provide true diversification. All in all, a very challenging proposition.

For many institutions, the prospective return stream from a traditional 60-40 mix of U.S. stocks and bonds simply cannot achieve these ends; thus, they have looked elsewhere. Endowment portfolios such as those of Harvard, Yale, and Stanford look very different from what most investors—even supposedly sophisticated ones—think of as being well diversified.

This table shows the critical difference:

Asset Class	Traditional	Modern	Endowment
U.S. Stocks	60%	35%	32%
U.S. Bonds	40%	25%	16%
Foreign		15%	17%
Alternatives		20%	32%
Cash			3%

The 60-40 column shows the traditional "bank trust department" asset mix that was viewed as prudent for many decades. Beginning in the 1970s and then increasingly in the 1980s (which we've labeled the Modern period), a few boldly creative firms began expanding into non-traditional asset classes, such as foreign stocks and bonds, real estate, and oil and gas holdings. By the 1990s, the most progressive investors, which included a very few pension funds as well as forward-looking endowments and family offices managing large resources, went way beyond this mix and expanded their holdings into what today are broadly termed "alternative assets" (sometimes but not accurately called hedge funds). This is the Endowment model.

Just what are these alternative assets?

They include natural resources and real estate holdings; an example is the industrial park and shopping center adjacent to the Stanford campus that were developed by Stanford beginning in the middle of the 20th century as part of its endowment. Alternatives have expanded to include a wide variety of unexpected, but promising, investment strategies, such as:

- Private equity, including venture capital
- A variety of long-short approaches
- Options arbitrage
- Statistical arbitrage
- Event-driven opportunities
- Distressed debt
- Managed futures
- Natural Resources such as timber
- Absolute return
- Market-neutral investment
- Using traditional assets in untraditional ways

If alternatives are so valuable, why aren't they widely available to individual investors at the retail level?

Several factors make these alternatives difficult for the average investor:

- **High minimum investment.** Most funds pursuing these strategies have very high minimum investments, ranging from \$250,000 to as high as \$10-\$25 million; in addition, some are completely closed to new investment.
- **SEC requirements.** Because these alternatives are viewed as "risky" by the SEC, an investor needs to be either "accredited" or "qualified"; a qualified person, for example, needs investment assets of \$5MM or more to be eligible.
- **No advertising.** The thousands of alternative funds available usually don't advertise, making it very difficult to get information about their strategies and performance.
- **High management fees.** Managers typically charge a 2% management fee and 20% of profits annually—some even more. In addition, many funds have been formed to invest in other funds, thus offering diversification, but these funds-of-funds typically charge an additional 1% management fee and 5%-10% of profits.

We have long been proponents of investment alternatives.

As far back as the 1970s, we invested regularly in real estate and oil and gas partnerships; in the 1980s, we added natural resources funds. Today, from our perspective, the good news for the average investor is that an increasing number of alternative-strategy funds are being targeted at the retail market—but they are, however, structured as SEC-registered funds imposing another layer of costs. Even in this situation, there are attractive funds available. We also believe that as the diversification advantages of this type of investment become better known to individual investors, their use will expand, and the funds will find ways to reduce costs.

If you are interested in learning more

about the endowment approach to investing, and what it can do for you, we recommend two books by David Swensen, the highly regarded manager of Yale's endowment:

Unconventional Success: A Fundamental Approach to Personal Investment

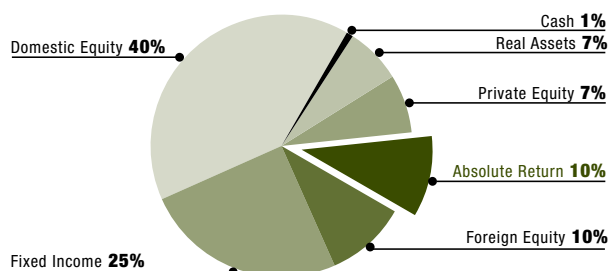
and *Pioneering Portfolio Management: An Unconventional Approach to Institutional Investment*

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