

University endowments show path to smart money

By Lyle Wolberg | President, Telemus Wealth Advisors, LLC
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Investing in today's volatile market can be frustrating for even the most experienced investors. The Standard & Poor's 500-stock index is trading near the 1,360 level, which it hit nine years ago in April 1999. If you factor in dividends and inflation in the returns over the past 10 years, the S&P rose an average of just over 1.5 percent on an annual basis.

Most stock market experts would agree that investors holding a broad range of stocks will outperform more conservative investments, such as fixed income, over a long-term investment time horizon. However, this rationale has not proven to be the case for stocks purchased in the late 1990s or early in 2000.

In fact, the S&P 500 has underperformed a number of investment vehicles, such as commodities, real estate investment trusts, gold and even treasury bonds.

Individual investor portfolios tend to perform even less successfully than the S&P 500. So the question becomes: What type of investment strategies can withstand the test of market volatility if a buy and hold stock strategy has proven to be less than effective?

One strategy that has proven to be extremely successful can be found in the way the large endowment funds such as Harvard, Yale and the University of Michigan are managed. Said David Swenson, chief investment officer for the Yale Endowment, "Establishing policy asset allocation targets represents the heart of the investment process, as no other aspect of portfolio management plays as great a role in determining a fund's ultimate performance."

Endowment funds such as Yale and Harvard seek to diversify across asset classes that are non-correlated to the general market. This means incorporating assets such as real estate, private equity, commodities and hedge funds to achieve those objectives. As a result, Yale and Harvard have returned 17.8 percent and 14.1 percent on average during the seven-year period from June 2000 - June



2006 compared to 1.2 percent on average for the S&P 500.

Utilizing alternative asset classes to diversify and reduce market risk is especially important in times of market downturns. While portfolios with alternatives may not always achieve positive returns, the downside risk is typically minimized.

Investors often mistakenly think they are diversified because they have multiple managers within a given asset class. In reality, the correlation of various investment styles within the class has actually increased over the last 25 years, meaning they move together. This effect cancels out the diversification strategy. In fact, the thought that investing in international stocks is a sufficient diversifier may not hold true. The correlation of a popular international index (MSCI EAFE) compared to the S&P 500 has risen dramatically in the last 20 years. The correlation increased from 0.583 during 1980-1989 to a correlation of 0.843 for 2000-2006.

At the end of the day, having many traditional equity managers gives an investor an assortment of styles, but little diversification.

For individual investors, investing like an endowment with alternative asset classes is not without its drawbacks. Barriers to investing according to this endowment strategy include: lack of liquidity due to lock-up periods, high minimums for entry, high taxes, and limited transparency. In other words, access is the main issue deterring affluent families and individuals from incorporating the endowment strategy.

But the access constraints are improving for the affluent. Hedge funds, private equity, real estate and emerging market access is becoming increasingly available in the form of Fund of Fund opportunities for families and individuals. These fund of funds incorporate Endowment-like strategies without many of the access issues.

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