FINANCIAL POST

PERSONAL FINANCE

Ultra-wealthy look to Ivy League endowment funds for investment lessons

Today's paltry interest rates on top of a decade of mediocre stock returns have prompted many wealthy families to search for more rewarding portfolio solutions. Some are turning to the trail blazing example of leading U.S. college endowment funds such as Yale's and Harvard's, which have been leaders in the quest for higher returning portfolios.

The returns of such endowments have been enviable. For the 20 years ended June 30, 2011, the Yale and Harvard Endowments earned annual average returns of 14.2% and 12.9% respectively. These numbers soundly trounce the 8.3% return of a portfolio comprised of 40% bond and 60% stocks, the asset mix of a traditional pension plan. It isn't only Yale and Harvard that excelled — the average large U.S. college endowment returned 10.7% annually. To put this into a Canadian context, equity-oriented, global balanced mutual funds here over the same period earned an unremarkable 5.6% per annum.

Why did endowments shoot ahead of other investors? Because they were pioneers in moving beyond the traditional staples of publicly traded bonds and stocks by shifting into alternative assets. By investing in real estate, commodities, timberland, energy, infrastructure, private equity and hedge funds, they were able to create a unique blend of diversification and growth. In fact, alternative assets now constitute the majority of endowment assets — a full 51% in 2011, whereas alternatives accounted for a meager 3% in 1992. These days, alternatives are "alternatives" in name only.

You only have to glance at the asset mix of college endowments to see how different it is from that of the typical investor. Fixed-income assets play a minor role, constituting only 10% of the average endowment portfolio. As noted in Yale's 2010 Endowment Report, it "is not particularly attracted to fixed-income assets, as they have the lowest historical and expected returns of the six asset classes that make up the Endowment."

Instead of bonds, many endowments have turned to hedge funds for diversification and a measure of downside protection. In fact, in 2011, 19% of endowment assets were invested in hedge funds.

It is the avid pursuit of growth that drives endowments' stellar returns. They currently allocate 65% of their capital to equities and real assets. Patiently hunting for higher long-term returns, they are major investors in private equity, either through funds or directly acquiring companies. They also look far afield for opportunities, and invest more in international equities than domestically. And their real asset investments go far beyond real estate to include infrastructure, commodities, timberland, farmland and energy.

Wealthy families are realizing that clipping coupons from a traditional portfolio of bonds and stocks won't cut the mustard in an era of miniscule interest rates and so-so stock valuations. Many have woken up to the fact they share the same challenges as college endowment funds — funding hefty and growing bills year in and year out while still wanting to build their wealth over the long-term.

It is, therefore, no surprise that a recent survey of ultra-wealthy families by the Institute for Private Investors found that 55% are increasing their investments in private companies. Close to half of the respondents are adding more real estate, commodities and global equities to their portfolios.

We've found that many of the wealthy families with whom we work are lengthening their investment horizons. With their children now in early adulthood, a truly multi-generational plan is warranted. In turn, a longer time horizon lends itself to a growth-oriented investment strategy that includes a significant global equity weighting as well as illiquid assets such a mortgage funds, direct real estate investment and private equity.

Of course, the pursuit of higher returns even in such a diversified fashion brings its share of risk. Major endowments suffered a 20.5% loss in the year ended June 30, 2009, while more aggressive funds such as Yale and Harvard, which plummeted 24.6% and 27.3% respectively, experienced even larger declines.

Many wealthy families figure that if that is the price of admission to "first in class" long-term returns, it is a cost they are prepared to pay.