



The Master Speaks
Insights from the genius behind Yale's endowment fund

In the world of investing, David Swensen is a bona fide rock star.

As chief investment officer at Yale University, Swensen's been at the top of the charts for two decades, producing hit after hit for the school's hefty endowment fund. Over his tenure he's averaged an astounding 16.1% annual return – a rate that multiplies \$1 million into \$18 million over twenty years. He achieved those results in market environments that ranged from the shock of Black Monday to the euphoria of the late 90's to the painful reality of the bursting Internet bubble.

Swensen shares his strategy on investing in his brilliant new book, *Unconventional Success: A Fundamental Approach to Personal Investing*. As the title suggests, he applies what he has learned from years as an institutional investor to the challenges of personal investing. It is really a must read for anyone who wants to better understand both the opportunities and pitfalls of investing personal or family wealth.

Simple ideas for complex markets

The following concepts capture much of Swensen's guidance. To his credit, he offers advice that can be implemented by any individual investor. None of it relies on proprietary information or tools.

- **Spread the wealth** – Swensen suggests allocating assets to six distinct asset classes: domestic equities, foreign developed market equities, emerging market equities, US Treasury bonds, U.S. Treasury Inflation-Protected Securities (TIPS), and real estate. This diversification plan allows a careful balance of risk and return, with specific allocations dependent on age, time horizon, appetite for risk and other factors. Swensen advocates an asset allocation heavy in US equities for one simple reason: over time, their value rises. He discourages any allocations to several non-core asset classes, such as corporate bonds, as they do not offer sufficient return potential to compensate for their inherent risk levels.
- **Be less active** – Trying to pick individual securities that will go up over time invites disappointing results. Swensen dismisses active selection of stocks, mutual funds and managers in favor of index funds that track broad bundles of securities or entire markets. Even real estate can be purchased this way, through indexes that track REITS. The empirical support for this strategy is overwhelming. Only 22% of actively managed mutual funds beat the Vanguard 500 Index Fund over a 20 year period spanning the 80's and 90's. After considering the impact of taxes, only 14% outperformed the index.



Paying a fund manager to pick securities is a cost to investors that, on average, yields inferior results.

- ***Be thrifty*** – The primary reason managers underperform their indices is fees. Sales loads, management fees and other more obscure costs may seem tiny, but they compound into huge shortfalls over time. Minimizing costs must be a focus of any serious investor. As brokerages earn much of their income through commissions on preferred families of mutual funds, this entire segment of the investment industry must be viewed with great caution.
- ***Stay in balance*** – Swensen presents data that demonstrates that very few investors make any effort to rebalance portfolios to maintain desired allocations to various asset classes. Most investors “set it and forget it,” yielding portfolios heavily skewed toward currently-popular asset classes that have grown in value, and underemphasizing out-of-favor classes that are likely to rebound in the long term. Failing to rebalance forfeits much of the value of asset allocation.
- ***Stay the course*** – For investors with long time horizons, one common behavior is even more dangerous than the failure to rebalance. That is totally abandoning asset classes that have declined in value. Our instincts may tell us to sell all foreign equities after a plunge in international markets, but doing so essentially guarantees that we sell low and buy back in at much higher costs after the inevitable rebound.
- ***Think after-tax*** – Most advertised investment returns are calculated as if taxes do not exist. Of course taxes have a tremendous impact on portfolio returns, and failure to consider tax implications at any stage of investment decision-making is careless.

A stacked deck

While his explanation of and empirical support for the above guidance are profoundly eloquent, Swensen did not invent any of the above rules. These are familiar and proven strategies for successful investment. Still, Swensen labels this approach to investing as “contrarian,” because so few investors actually follow these sensible and proven techniques.

As he explains, to follow the rules we must overcome powerful and pervasive influences. Some of these influences are internal, such as the temptation to follow the masses and throw money at the stock *du jour*, which is now overpriced. Or the urge to pursue alluring investments in areas where we have no particular knowledge, such as private equity or venture capital.

But most of the challenges to successful investment derive from the industry itself. Brokerages push highly-commissioned securities. Fund companies pay brokerages, asset managers and 401(k) plans to recommend their products. Private fund managers



skim 20% or more of profits, but take no extra share of losses. Bonds are structured with call options that severely limit the issues' upward value potential.

And there's more. Asset managers charge dearly for access to opaque algorithms and computer models that often yield no clear added value. The investment advisory complex, built to serve tax-exempt pension and endowment funds, largely ignores after-tax returns. Research firms offer ratings solely on rearview mirror historical performance, which encourages buying assets that are overvalued. And minute-by-minute analysis on CNBC and other outlets breeds a dangerous short-term mentality. Clearly, individual investors are playing with a deck stacked squarely against their interests.

Implications for wealthy families

Families with wealth of \$20 million or more face special challenges in the already difficult investment arena. They are flooded by offers of assistance from brokers, asset managers, private bankers and others, many of whom line their own pockets by advocating investment directions that may not be in the best interest of the families. Many families, not aware of the pitfalls, turn to the largest, most heavily advertised national firms, drawn by the perceived security of the name brands. As Swensen describes, these choices may greatly impair families in implementing the investment guidelines described above.

Choosing a trusted advisor to assist in wealth management and other financial matters is a critical decision. Wealthy families should look beyond the glossy ads to find advisors who:

- Provide low cost access to asset allocation guidance, coordinated tax planning and the other key components of Swensen-style investment
- Are uncompensated by fund companies and beholden to no one but the families they serve
- Share the long-term goals of families, eliminating the incentive to chase short-term performance
- Are inclined to recommend low cost, risk-appropriate, tax-efficient investment vehicles including index funds, ETFs and US Treasury bonds

The bottom line is simple: *Unconventional Success: A Fundamental Approach to Personal Investing* offers an eye-opening insiders view of the investment industry that yields important lessons for individual investors. Move it to the top of your reading list.

Steve Mott, Research Editor
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