

Top-tier performance linked to high alternatives allocation.(Endowments)

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CAMBRIDGE, Mass. - U.S. endowments with the largest allocations to alternative investments have the best overall returns, according to a new study.

Endowments with higher allocations to alternatives had higher excess returns over the S&P 500 than those with lower allocations. What's more, endowments with higher allocations to alternatives outperformed the top tier of corporate pension funds, according to the paper by Josh Lerner, professor at Harvard University, Jacob H. Schiff Professor of Investment Banking at Harvard Business School, and Antoinette Schoar, professor at the Sloan School of Management at the Massachusetts Institute of Technology, with Jialan Wang, an MIT graduate student.

Between 1993 and 2005, educational endowments shifted toward alternatives and away from equities and fixed income, the study noted. (The study included hedge funds and private equity in the definition of alternatives but excluded real estate.)

The combined average allocations to equities and fixed income fell to 73% in 2005 to from 83% in 1993, according to an analysis of data from the National Association of College and University Business Officers, Washington; the College Board, an association of educational institutions; and endowments' Internal Revenue Service filings.

Alternatives grew to 18% from 9% during the same period. The mean allocation to alternatives was 14%; the median allocation was 11%. This resulted in some endowments outperforming corporate pension funds during the period studied, Mr. Lerner said in an interview.

"If you look at 10 years of performance, over 5% of endowments returned more than the top 1% of corporate pension funds" with more than \$100 million in assets between 1995 and 2005, Mr. Lerner said.

Endowments with allocations to alternative investments above the median had higher returns, he said. School endowments with alternatives allocations above the median beat the S&P 500 by four percentage points compared with endowments holding below-median allocations, which beat the S&P 500 by 1.8 percentage points, the study showed.

Of the endowments, the so-called Ivy Plus schools had twice the average allocation to alternatives, 37%, than the overall sample of 18% in 2005. Those school endowments returned about 12 percentage points more than the S&P 500, compared with the average endowment's return of about seven percentage points above the S&P 500. (Schools in the Ivy Plus group are Brown University, California Institute of Technology, University of Chicago, Columbia University, Cornell University, Dartmouth College, Duke University, Harvard University, Massachusetts Institute of Technology, University of Pennsylvania, Princeton University, Stanford University and Yale University.)

Consistent outperformance

Ivy Plus endowments consistently outperformed the overall average by more than three percentage points per year and outperformed other endowments by up to 10 percentage points during the difficult years of 2000 and 2001, the study noted. In addition to higher allocations to alternatives, endowments at Ivy Plus schools had less correlation to the market and greater exposure to small stocks and growth stocks, the study stated.

Endowments with students that had high SAT scores returned more than schools with lower SAT scores, the paper noted. Even among endowments with high allocations to alternatives, the high-SAT-score school endowments outperformed schools with lower SAT scores; high SAT school endowments returned 4.2 percentage points more than

the S&P 500 compared with low SAT endowment return of 3.1 percentage points in excess of the S&P 500. Low SAT schools only modestly seem to benefit from increased allocations to alternatives.

Mr. Lerner said he thinks one reason for the difference in returns by SAT scores might be in the alumni attracted to the schools' endowment investment committees.

"High SAT schools may have more high-powered alumni base and have more connected people on their advisory committees," he theorized. "Also, if we think an important source of person-power is from the alumni, it may have access to higher caliber recruiting for the endowment office in light of the fact that endowments are paying non-market wages."

But, adding alternatives to the asset mix is not enough, Mr. Lerner cautioned.

Other pension funds, endowments and foundations will not necessarily be able to replicate these returns simply by shifting to more alternative investments.

"To conclude that more investments in alternatives will lead to higher returns is simplistic," the paper stated. "There are a considerable number of omitted variables that we are not measuring here, which may be impacting the results."

Ivy Plus schools were among the first institutional investors to use alternative investments, the paper pointed out. Experience can lead to better manager selection. In addition, Ivy Plus endowments have access to some of the best performing funds because they were investors in the earliest funds. "Many of the best private equity and hedge funds are essentially closed to new investors and have been so for many years," the paper stated.

CAPTION(S):

Josh Lerner cautioned that simply adding alternatives to the asset mix won't guarantee good performance.

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