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BARRON'S COVER

Crash Course

By ANDREW BARY

Many college endowments are learning that they can't make the grade by simply copying the work of star investors. Rethinking alternative assets.

THE GLOBAL BEAR MARKET HAS DEALT ONE OF THE BIGGEST BLOWS in decades to college and university endowments, prompting administrators across the country to cut budgets, freeze hiring and scale back ambitious building projects.

It's tough to gauge precisely the extent of the woes because most big universities haven't released information on their endowment returns since June 30, the traditional end of the academic fiscal year. Based on anecdotal evidence, however, and the turmoil in financial markets, the numbers aren't pretty.

Darren McCollester/Newsmakers; Vincent DeWitt/Sipa Press; Newscom
Endowment dollars have helped build impressive campuses at Harvard, top and right, and Princeton.

The president of Amherst, a Massachusetts liberal-arts college, recently said its endowment is off about 25% since June 30, when it totaled $1.7 billion. Maine's Colby College said its endowment has fallen by a similar amount since its peak a year ago. Wesleyan, in Middletown, Conn., is delaying the construction of a major science building and filling vacant positions only when necessary, to help cut $10 million to $15 million in expenses in the next few years. Cornell is freezing most hiring and delaying new projects.

The three super-rich Ivies -- Harvard, Yale and Princeton -- also are getting pinched, although few will cry for them. They've been trend-setters over the past decade, generating superlative returns from an asset-allocation mix that looks nothing like what individuals typically maintain. These schools are light on U.S. stocks and bonds, and heavy on illiquid assets, such as private-equity, real-estate and commodity holdings, and hedge funds.

Now these schools' endowment managers ought to be considering more investments in stocks and bonds, as alternative assets have offered too little diversification and liquidity while generating returns that indeed are correlated with the miserable ones now being turned in by the stock market.

With major U.S. stock indexes trading below their levels of a decade ago, and yields on corporate bonds at juicy levels, it could be time to switch back to conventional assets, which look inexpensive and cost less to buy.

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Reflecting the philosophy of David Swensen, its influential endowment director of the past 23 years, Yale has 70% of its endowment invested in three categories: hedge funds, private equity and "real" assets, including timber, real estate and oil- and-gas properties -- one of the most aggressive allocations among major endowments. Princeton similarly has 70% in hedge funds, private equity and real assets, while Harvard has 57% in those groups.

THE IVIES' RESULTS IN the past 10 years have been very impressive. Harvard's endowment was up an average of 13.8% annually, bringing it to $36.9 billion as of June 30, tops in the academic world. Yale's endowment grew at an average annual pace of 16.3% in the same span, to $22.9 billion, making it second to Harvard in size. Princeton's endowment rose at a 14.9% annual clip, to $16.4 billion. Stanford, in Palo Alto, Calif., also has shined; its endowment rose by 14.2% a year, to $20.4 billion.

These returns compare with the 6% yearly advance for the average institutional portfolio, and 3% for the S&P 500 over the same decade. Yale calculates it has added an extra $13 billion to its endowment, compared with how it would have done with the performance of the typical college endowment.

The growing endowment wealth has enabled the schools to upgrade their facilities, expand enrollment and boost financial aid for students. And a lot of less well-endowed schools have used the same investment strategies in an effort to catch up.

But times -- and markets -- change. Even if the markets resume rallying, the endowments of the Big Three Ivies could trail more conservative peers in the current fiscal year. Harvard, Yale and Princeton aren't saying anything specific about their returns. But on the basis of their reported asset allocations, we estimate each could be down 25% or more since June 30 if they were to assign realistic values to their illiquid investments.

Private equity, for instance, is a disaster, despite what optimists like Steve Schwarzman, the CEO of Blackstone Group (ticker: BX), assert. (See here.) There probably isn't much equity value in most of the leveraged buyouts completed during the bubble years of 2006 and 2007, owing to the weak economy, overleveraged balance sheets and declining values of comparable public companies.

What Are Better Alternatives?

Major college endowments have heavy investments in hedge funds, private equity and commodities. Given problems in those areas, maybe it's time for more emphasis on traditional stocks and bonds.

Asset	Yale	Harvard	Princeton	Stanford	Avg. Edu Endowment	Est. Return Since June 30†
Hedge Funds	23%	18%	26%	18%	20%	-20%
Domestic Equity	11	11	9	37**	26	-25
Fixed Income	4	11	3	10	13	-5
Foreign Equity	15	22	16	N.A.	22	-37
Private Equity	19	13	25	12	7	-50
Real Assets*	28	26	19	23	10	-35
Cash	0	-3	1	N.A.	2	

*Real estate, timber, oil and gas. **Domestic and foreign stocks. N.A.-not available. †-*Barron's* estimates.

Sources: School reports; Bloomberg

If this argument seems extreme, consider AP Alternative Assets and KKR Private Equity Investors, formed to invest in deals engineered by their sponsors, buyout specialists Apollo Management and Kohlberg, Kravis Roberts. The KKR vehicle wrote down the value of its assets by 15% in the third quarter. More important, shares of these companies, traded in Europe, fetch about 25% of the asset values assigned by their managers, indicating that investors don't

believe the valuations provided by Apollo and KKR.

With cash-strapped endowments and other institutional investors looking to sell some of their private-equity funds, an informal secondary market is developing. The going rate is said to be about 50% of stated investment values.

Commodities -- another favored asset class -- have plummeted more than 40% since June 30, with publicly traded oil-and-gas stocks off 50%. Real-estate investment trusts are down 35%. (The S&P 500 is off 28% in that span.)

Timberland prices rose to ridiculous levels this year despite weak markets for wood. The catalyst: what one Wall Street analyst called a "frenzy" of buying by endowments seeking to emulate Harvard, a longtime holder with a 9% allocation -- nearly as much as its 11% holding in U.S. stocks. In May, Chip Dillon, a former Citigroup forest-products analyst, wrote that timberland was selling at 20 to 30 times annual pretax cash flow. If the Ivies are carrying their timber at those levels, they'll have to make major downward adjustments. Emerging-market stocks, another Ivy favorite, also have been crushed, falling by 45% since June.

A key question all endowment chiefs should ask is: "How does the valuation of our illiquid investments compare with those of comparable public companies?"

Another question: "If private-equity funds are being sold at half of net asset value, should we keep ours at 100%?"

Swensen, the most influential investor in the nonprofit world, has argued that endowments, with a long time horizon, are ideally suited to buy illiquid investments where market inefficiencies can be best exploited. Low-return bonds should be kept to a minimum, in his view.

"The heavy allocation to nontraditional asset classes stems from their return potential and diversifying power," Yale wrote in its endowment report last year. "Yale 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."

YALE WAS BULLISH ON private equity as recently as the summer of 2007, just before the bottom fell out of that market. The endowment then raised its targeted private-equity allocation to 19% from 17%, citing "bottom-up opportunities, even in this heated market." Princeton has about a quarter of its endowment in private equity.

The Swensen approach may be too aggressive, particularly for endowments that need access to their money and have less skilled managers than Yale's. Endowments typically must disburse 5% of their value every year to support university operations.

One unpleasant twist: Private-equity firms are asking endowments and public pension funds to fork over cash committed, but not invested, when the markets were much stronger. The private-equity outfits are eager to recoup losses on bad leveraged buyouts by making new investments.

In a typical private-equity arrangement, a college would agree to invest a certain sum, say $10 million, with a firm like Blackstone or KKR, which would request the money only when suitable opportunities arose. Unfortunately, in a bad market like today's, distributions from already-made private-equity investments could dry up at the very time the private-equity firm is asking the college for some or all of the money it had pledged to make available for new private-equity investments. This mismatch can force the college to put, say, 18% of its endowment in private-equity holdings, even though it might have planned to invest no more than 10% at anytime.

The capital calls from private-equity firms are squeezing endowments and pension funds, including the giant California Public Employees Retirement System. Between spending needs and such capital calls, some endowments may have to liquidate 10% of their assets in the current fiscal year, one investor tells *Barron's*. No wonder endowments have been selling stocks, among their most liquid assets.

Straight A Returns

Straight-A Returns

Major endowments have bested the S&P 500 by a wide margin over the past decade. Can it continue?

Endowment	Size* (bil)	TOTAL RETURNS 1-Year	10-year
Harvard	$36.9	8.6%	13.8%
Yale	22.9	4.5	16.3
Stanford	20.4	6.2	14.2
Princeton	16.4	5.6	14.9
MIT	10.1	3.2	13.2
Michigan	7.6	6.4	13.2
U. Penn	6.3	-3.9	N.A.
Cornell	5.4	2.7	8.7
Dartmouth	3.6	0.5	12.1
S&P 500		-13.1%	2.9%

*As of June 30. N.A.–not available.

Sources: School reports; Bloomberg

Even Harvard appears to be facing this problem. The Wall Street Journal reported last week that the university was marketing about $1.5 billion in private-equity funds. That's stunning, considering it is an awful time to be selling such holdings. It's unknown whether Harvard found a buyer.

JEREMY GRANTHAM, THE HEAD of GMO, a large Boston investment firm, worries less about Yale than about the hundreds of Yale wannabes. "It's obvious to me that few of those emulating Yale have the resources of Yale and the talent of Yale to pick the right managers," he says. Yale, like most endowments, farms out the bulk of its assets to outside money managers.

The pressure to follow Yale was intense at other colleges, foundations and charities. "The charities have all these consultants, and they've been herding the buffalo in one direction, toward alternatives," says Thomas Kahn, president of Kahn Brothers, a New York investment firm. "The consultants say: 'Yale has alternatives. Harvard does. Look how well they've done. You've got to have 20% in hedge funds.' "

The hedge-fund talent pool isn't deep, and the Ivies have locked up some of the top managers. The blow-ups in the hedge-fund industry may cause a reassessment of this trend. Grantham believes that, given their high fees, hedge funds over all create little value for investors.

Endowment declines of 25% would hardly be disastrous for Harvard, Yale and Princeton, but such losses would matter mightily at smaller institutions.

That's why it may be time for most colleges and nonprofits, which can't afford to hire the very best talent, to move away from the pack and to rethink any heavy exposure to illiquid investments, especially when so many opportunities seem to beckon in global stock and bond markets.

As master investor Warren Buffett has noted, there's an inevitable trend in many pursuits, including money management: First come the innovators, then the imitators and, finally, the idiots. Or as Charles Darwin might put it: Those who don't evolve pay the price.

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