

# The death of the Yale Model?

## Alternative tales of investment returns



RIP the much-emulated, rarely replicated David Swensen © Bloomberg

Last month the National Association of College and University Business Officers reported that the average American endowment [returned 11.2 per cent last year](#). Huzzah! Trebles all round.

Unfortunately, this is slightly worse than what a [passive global 70/30 equity/bond portfolio](#) returned in 2024. OK, well maybe it was a weird year. Endowments and their racier asset mix must have done better in the long run, right? Nope.

Over the past decade, the \$874bn worth of endowments that report to NACUBO have averaged annual gains of 6.8 per cent. A global 70/30 has gained 6.83 per cent. And this is a generous comparison for endowments, given their far heavier US asset mix in a phenomenal decade for almost anything American. Over the past decade the Norwegian sovereign wealth

fund has returned 7.3 per cent, [and now costs just 4 basis points a year in management](#).

Apropos of nothing, [here](#) is a paper by investment consulting pioneer Richard Ennis predicting “the demise of alternative investments”. Or to put it in a more nuanced way, the inevitable decline of the alternatives-heavy “[Yale Model](#)” of institutional investing pioneered by the late David Swensen.

The abstract pulls zero punches:

Alternative investments, or alts, cost too much to be a fixture of institutional investing. A diverse portfolio of alts costs at least 3% to 4% of asset value, annually. Institutional expense ratios are 1% to 3% of asset value, depending on the extent of their alts allocation.

Alts bring extraordinary costs but ordinary returns — namely, those of the underlying equity and fixed income assets. Alts have had a significantly adverse impact on the performance of institutional investors since the Global Financial Crisis of 2008 (GFC). Private market real estate and hedge funds have been standout under-performers.

Agency problems and weak governance have helped sustain alts investing. CIOs and consultant-advisors, who develop and implement investment strategy, have an incentive to favor complex investment programs. They also design the benchmarks used to evaluate performance. Compounding the incentive problem, trustees often pay bonuses based on performance relative to these benchmarks. This is an obvious governance failure.

The undoing of the alts-heavy style of investing will not happen overnight. Institutional investors will gravitate to low-cost portfolios of stocks and bonds over 10 to 20 years.

Ennis's main concern has [long been](#) that about 35 per cent of US pension plans are currently invested in what he sees as illiquid, laughably expensive and, in reality, often mediocre alternative investments. The paper therefore primarily relies on the data he has for 50 large US public pension funds for the 16 years up to the end of June, 2024 as well as the less granular NACUBO reports.

But as he points out in the paper, a whopping 65 per cent of the average large US endowment fund is now invested in alternatives of some kind, as virtually all of them have sought to mimic Swensen's model at Yale.

Unfortunately, most investors have not been able to replicate Swensen's results, even when they copy his recipe of loads of assets — primarily private equity and venture capital, with a few big dashes of hedge funds and real estate to top it off.

Ennis estimates that the average endowment has underperformed even the average pension fund by 143 basis points a year over the period studied, once you've accounted for the differences in market exposures and risks. Pension plans have in turn markedly underperform a comparable public market benchmark, by 96 basis points a year over the 16 years.

Over the years those basis points add up:

This is a new-ish phenomenon, according to Ennis. Between 1994 and 2008 large endowments produced excess returns of 410 basis points a year thanks largely to their alternative investments, he calculates.

Ennis argues the stark shift from good to woeful results happened simply because results led to popularity, and popularity led to crowding. The outcome has been poorer returns but the same eye-watering fees.

The very investor enthusiasm that helped propel alts' returns pre-GFC began transforming the markets generating those returns. Many trillions of dollars poured into alts, which were relatively small, isolated areas of investment in the early days. Aggregate assets under management increased more than tenfold between 2000 and 2020. More than 10,000 managers now vie for a piece of the action and compete with one another for the best deals and trades. Market microstructure advanced accordingly. Private market investing is more competitive and efficient than it was way back when. Costs, though,

remain high — far too high to support much value-added investing.

The most controversial suggestion is that this will inevitably end in the demise of the Yale model of alts-heavy endowment management, citing the famous law articulated by the economist Herbert Stein: "If something cannot go on forever, it will stop." Here are 13 reasons proffered by Ennis for why the privates merry-go-round has to stop spinning.

1. Failing to meet stated investment goals. Since the GFC, public pensions have failed to meet their actuarial return requirement, which many say is their paramount goal. Endowments have not kept pace with typical stated inflation-based return objectives.
2. Realizing that their portfolio is worth half of what it would have been worth had they followed a simple indexing strategy. With underperformance of 2.4 percentage points per year since the GFC, large endowments are worth 70% of what they would have been worth had they followed an indexing strategy. If they continue to underperform at the same pace for the next 12 to 15 years, I estimate their value will be half that associated with a comparable index strategy. At some point the performance problem becomes too big to ignore.
3. Illiquidity: Universities, with tens of billions in endowment (e.g., Harvard), borrowing at unprecedented levels to support operations. Public pension plans (e.g., CalSTRS) borrowing against their portfolio to raise funds for the "flexibility" to rebalance their asset allocation. (It's not leverage; it's flexibility.) The heavy reliance on private assets is compromising institutions' normal operation, while increasing risk.
4. Trustees recognizing the agency issues at work and acting to redress them. Some diligent trustees will stop paying CIOs bonuses for beating benchmarks created by the CIOs and/or consultant-advisors. They will find other ways to compensate truly excellent performance.

Switching to index-based benchmarks would have a benign effect on practice.

5. Media reports of undergrad investment clubs with track records better than those of elite university investment offices.

6. The advent of an accounting requirement that public pension plans report their investment expenses fully and in detail, including carry. With that information, it would be easy to figure out what educational endowments are paying. This would come as news to most trustees, public and private, and make them uneasy.

7. CIOs acknowledging that leveraged private real estate equity and hedge funds have been really poor performers for a long time and dropping one or both.

8. With the advent of normal interest rates after years of the Fed's zero-interest-rate policy, substantial leverage of buyout investments coming into play in a way we have not seen since the GFC. News of a thousand bankruptcies among zombie corporations, many of them in buyout funds, would not be lost on trustees.

9. Enlightened trustees leaving their successors notes that say, *Put an end to this. I wish I had.*

10. College and university boards discovering that, like Harvard, they are spending more on money managers — for no benefit — than they collect in tuition.

11. Trustees discovering that secondary market pricing of private assets can be much lower than reported NAVs. Real estate and venture capital interests, for example, have been transacting at discounts of 25% or more of NAV in recent years.

12. Being sued for breach of fiduciary duty. Trustees serve on behalf of

others. Their duty is to be prudent and loyal to the beneficiary; there is no requirement to be clever or to attempt to maximize gain. Wasting assets is verboten. We live in a litigious world.

13. Taxpayer revolts. Taxpayers have about had it with public worker pensions as it is. Heightened awareness of investment waste might accelerate the transition to defined contribution plans for new employees.

Perhaps. Alphaville is a bit too cynical to think anything is going to change much, even in the decade that Ennis envisages. In finance, inertia can be a phenomenally powerful force.

For example, these days people get very excited about index funds eating up markets, but forget that we're still talking about a penetration of 10-30 per cent, (depending on the market) over a half a century after the invention of the index fund and crushingly compelling data on active management underperformance. Anyway, alternatives have found a brand new ~~mark~~ [market to woo](#).

### **Further reading:**

— [American endowments' complicated love affair with private equity](#)  
(FTAV)