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Learning from the investment leaders

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Affluent investors can learn a lot from top endowments and pension plans. Take the Yale and Harvard university endowments, for example. Within the institutional world, they are renowned as astute, long-term investment strategists. Their results speak volumes — their annual returns of 10.1% and 9.4%, respectively, over the decade ended June 30, 2011 far outstripped the 4.3% return of the traditional pension mix of 60% stocks and 40% bonds.

Many large pension plans and endowments have outperformed their benchmarks. In contrast, the returns of retail investors regularly lag the broad market indexes. There is no one “silver bullet” that accounts for the superior results of these institutions, but rather a common application of best practices in investing. Here are four pointers from their playbook.

First, set out your long-term strategy in writing and update it regularly. Whether it is the Yale and Harvard endowments, California’s gigantic $236-billion CalPERS pension fund or our own $152-billion Canada

Pension Plan fund, every institution sets out its long-term strategy in writing. Called an investment policy statement, this document encompasses objectives, time horizon, risk tolerance and performance benchmarks, as well as governance mechanisms and review and reporting requirements. Designed to provide structure and discipline, it is the battle plan in the war to gain returns and manage risk.

These strategies aren't carved in stone. Asset mixes evolve over time in response to the changing needs of the beneficiaries as well as developments in the capital markets. For example, the Harvard endowment's target allocation to emerging-market equities has grown from 5% of its portfolio in 2005 to 12% in 2012.

Second, diversify beyond domestic, investment-grade bonds and large-cap stocks, the vanilla mix that typifies so many portfolios. Fixed-income investment options include global, inflation-indexed and high-yield bonds as well as mortgages and distress debt. Equities encompass domestic, international and emerging markets as well as small-cap stocks. Yale's endowment, for example, focuses its U.S. equities in the stocks of inexpensive, small-capitalization companies.

Real estate and infrastructure, both long-term, cash-flow investments, are especially suited to meeting multi-decade funding needs. Commodities and natural resources have become increasingly popular. Ontario Teachers' Pension Plan has 5% of its net assets invested in commodities while the University of Texas endowment has 5% of its assets in gold bullion. Alternative investments including hedge funds and private-equity investments are also common. Yale and Harvard have target allocations of 17% and 16% of their portfolios, respectively, for hedge-fund and absolute-return strategies.

The explosion in the asset-class coverage of ETFs on top of growing hedge-fund availability is creating an opportunity for affluent investors to follow in the tracks of institutional leaders.

Third, focus on long-term real returns. Pension funding is about purchasing power capability, not nominal investment dollars. Similarly, endowments need to meet ever-escalating educational costs. Hence, institutions target real returns — those net of inflation. For example, the CPP fund has a minimum, long-term, real-return target of 4% annually. Yale has a target mix of assets designed to achieve a 6.2% annual real return.

The need for real returns results in target mixes weighted to a diversity of asset classes that provide equity-like returns. As the 2010 Yale Endowment Report states, "Serious investors recognize that the principles of diversification and equity orientation underlie successful long-term investment strategies."
Fourth, manage risk rigorously. Regular reviews of market, credit, counterparty, liquidity and concentration risk as well as independent assessment of managers keeps nasty surprises at a minimum.

In today's cacophony of endless investment ideas du jour and myopic market prognostications, the best practices of investment leaders are a blueprint for serious portfolio management.

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