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COMMON SENSE

Harvard's Endowment Offers An Education in Asset Allocation

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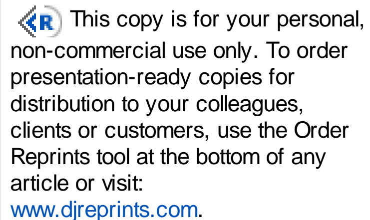
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It's back-to-school week, so let's do some homework by studying the success of Harvard University's endowment.

Harvard Management Co., which runs the endowment, generated a return of between 7% and 9% for fiscal 2008, according to people familiar with the returns and cited by The Wall Street Journal in August. That's consistent with an estimate of 9% for the first 10 months of the fiscal year, which ended June 30, reported the Harvard Crimson in July. Given that the S&P 500-stock index fell about 15% during the same 12-month period, and that Harvard's returns were well above the rate of inflation, I'd award that performance an "A."

How did Harvard do it? The key is diversification, and not just by investing in a variety of stocks and bonds. Harvard invests in 11 noncash asset classes, only one of which is U.S. stocks. Like Yale and other large endowments, it counts on one or more of those to shine even when others are weak, achieving better long-term results than could be attained with fewer asset classes. It looks as though Harvard's 33% allocation to real assets, which include commodities and real estate, salvaged performance in what was otherwise a treacherous year.

Individual investors can emulate the principles, if not the exact returns, of Harvard's approach. True, Harvard's vast wealth -- $38 billion as of April -- gives it access to the best managers, the most sought-after private-equity and hedge funds, natural-resource partnerships that are closed to most, and even the ability to eliminate middlemen and fees and buy direct. (At one time Harvard was even the world's largest owner of timberland.) But you too can achieve similar -- maybe even better -- results by embracing a variety of asset classes.

Like Harvard's, my results last year were strongly enhanced by the allocation I made to real assets, a result of more closely aligning my portfolio allocation with that of Harvard's and Yale's. That's why I recommended and bought stocks like **BHP Billiton**, Rio Tinto and Cia. Vale do Rio Doce, which are both commodity producers and foreign. As of June 30, the stocks were near their peaks after a spectacular multiyear run.

Harvard hasn't yet released the official results for fiscal 2008, but its 2008 asset-allocation strategy is on its Web site. Despite the subprime, real-estate and credit crises, Harvard is staying the course, with even larger commitments to foreign equities and commodities than in 2007. U.S. equities constitute 12% of the portfolio; developed foreign equities are 12% and emerging market equities are 10%. Total foreign equities account for 22% of the portfolio, up from 19% in 2007, compared with 12% domestic. Real assets, including commodities, are 33%, up from 31%. Fixed income dropped to 9% from 13%.

It's relatively easy for individual investors to duplicate these categories with individual stocks, sector mutual funds and exchange-traded funds. The good news is that for anyone trying to more closely align their portfolios with the Harvard model, foreign equities and real assets have recently sold off, making valuations far more attractive for anyone buying now. China stocks alone have lost about half their value year-to-date, and Russia and India are also experiencing significant corrections. Energy and commodities also have had a sharp selloff. A year ago, nearly all these asset classes seemed richly valued, if not overvalued; now bargains are showing up.

The hardest categories for individual investors to duplicate are private equity and hedge funds, which may be just as well, given their relatively weak recent performances. But in earlier years, they were critical to Harvard's success. A number of ETFs now approximate the returns of so-called long-short hedge funds by using quantitative strategies, without the exorbitant hedge-fund fees. Harvard allocates 11% of its portfolio to private equity and 18% to hedge funds.

Although I've been moving in the Harvard direction for some time, I still haven't gotten to as high a weighting in either foreign stocks or real assets. But the key is diversification. So far, it's benefited my portfolio just as it has Harvard's.

James B. Stewart, a columnist for SmartMoney magazine and SmartMoney.com, writes weekly about his personal investing strategy. Unlike Dow Jones reporters, he may have positions in the stocks he writes about. For his past columns, see: www.smartmoney.com/commonsense[1].

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