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Feb
24

Why Yale University Heavily Invests In Alternatives And Hedge Funds

Mike Furlong, Co-founder

Beside being a world-class university with a tiny 6.3% acceptance rate in 2014, Yale University also boasts one of the nation's largest endowments with ~$24 billion in assets under management, led by David F. Swensen, PhD. Under the stewardship of David F. Swensen, Yale university's endowment grew from $3.5 billion to $23.9 billion in the past couple of decades.

About 25 years ago, Yale became the first institutional investor and university endowment to define absolute return strategies as a distinct asset class, beginning with a 15% target allocation. Absolute return strategies is a code phrase for hedge funds, as hedge funds look to provide positive returns in both bull and bear markets.

Where did Yale look first for absolute return strategies? Tom Steyer's Farallon Asset Management, based right here in San Francisco. Tom Steyer received his bachelor's degree from Yale and worked at Morgan Stanley, the risk arbitrage department at Goldman Sachs under Bob Rubin, and at Hellman & Friedman in private equity before starting Farallon in January, 1986.

In 1987, Steyer approached David Swensen, Yale's CIO, to manage a portion of Yale's endowment for no fees in order to prove himself. After Farallon's initial success, other college endowments followed suit.

A PEAK INSIDE YALE'S ENDOWMENT ASSET ALLOCATION

Absolute return investments are expected to generate high, long-term returns by exploiting market inefficiencies. Here is an excerpt from the Yale Endowment Report, which finished 2013 with a 17.8% absolute return allocation, compared to a target absolute return allocation of 20%.

Endowment Highlights

	Fiscal Year				
	2013	2012	2011	2010	2009
Market Value (in millions)	$20,780.0	$19,344.6	$19,374.4	$16,652.1	$16,326.6
Return	12.5%	4.7%	21.9%	8.9%	-24.6%

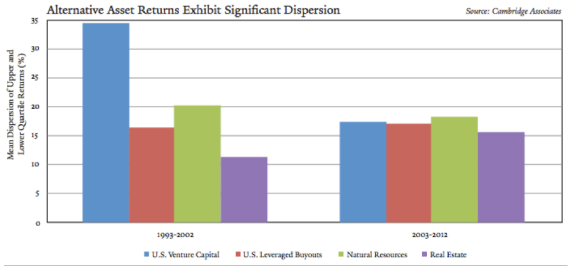
Spending (in millions)	$1,024.0	$994.2	$ 986.8	$ 1,108.4	$ 1,175.2
Operating Budget Revenues (in millions)	$2,968.6	$2,851.7	$2,734.2	$2,681.3	$2,559.8
Endowment Percentage	34.5%	34.9%	36.1%	41.3%	45.9%
Asset Allocation (as of June 30)					
Absolute Return	17.8%	14.5%	17.5%	21.0%	24.3%
Domestic Equity	5.9	5.8	6.7	7.0	7.5
Fixed Income	4.9	3.9	3.9	4.0	4.0
Foreign Equity	9.8	7.8	9.0	9.9	9.8
Natural Resources	7.9	8.3	8.7	8.8	11.5
Private Equity	32.0	35.3	35.1	30.3	24.3
Real Estate	20.2	21.7	20.2	18.7	20.6
Cash	1.6	2.7	-1.1	0.4	-1.9

"The Absolute Return portfolio is invested in two broad categories: event-driven strategies and value-driven strategies. Event-driven strategies rely on a very specific corporate event, such as a merger, spin-off, or bankruptcy restructuring, to achieve a target price. Value-driven strategies involve hedged positions in assets or securities with prices that diverge from their underlying economic value.

Today, the absolute return portfolio is targeted to be 20.0 percent of the Endowment, below the average educational institution's allocation of 24.4 percent to such strategies. Absolute return strategies are expected to generate a real return of 5.25 percent with risk of 12.5 percent. Unlike traditional marketable securities, absolute return investments have historically provided returns largely independent of overall market moves. Since its

1990 inception, the portfolio exceeded expectations, returning 11.2 percent per year with low correlation to domestic stock and bond markets.

Yale has consistently demonstrated its ability to identify high-quality active managers. For the twenty years ending June 30, 2013, 57 percent of Yale's outperformance relative to the median Cambridge Associates endowment was attributable to the value added by Yale's active managers. Over the past two decades, the Endowment returned a cumulative 1,152 percent relative to the Cambridge median of 402 percent, an outperformance of 5.1 percent per annum."



OTHER UNIVERSITIES FOLLOW YALE'S LEAD IN ALTERNATIVE INVESTING

Once Yale began investing in Absolute Return strategies and Alternative Investments to diversify their endowment, other educational

institutions follow suit.

Harvard, who runs the largest endowment with roughly $36 billion as of June, 2014 deepened its commitment to alternative investments in hedge funds, private equity and assets such as real estate. Their total exposure to private equity and hedge funds during fiscal 2015 rose to 34% of assets, up from 31% in 2014. For hedge fund allocation specifically, Harvard raised their exposure to 16% from 15%.

All large endowments and foundations thus far have a one-year median return of 16.69% for the year ending June 30, 2014 according to a report from Wilshire Trust Universe Comparison Service.

See below the Educational Institution Mean Asset Allocation compared to Yale University's asset allocation.

Asset Allocations

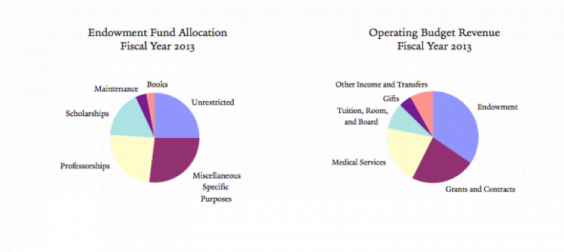
	Yale University	Educational Institution Mean
Absolute Return	17.8%	24.4%
Domestic Equity	5.9	20.1
Fixed Income	4.9	10.1
Foreign Equity	9.8	20.1
Natural Resources	7.9	8.3
Private Equity	32.0	9.5
Real Estate	20.2	4.2
Cash	1.6	3.2

Data as of June 30, 2013

ENDOWMENT SPENDING

Ever wonder what universities use

their massive endowment funds for, especially private schools with mind-boggling tuition rates? So did we. For Yale University, it looks like money is spent completely on causes that support the school, although "Miscellaneous Specific Purposes" and "Unrestricted" looks like a large chunk of the pie that might make people wonder.



Typically 4-6% of the endowment's assets are spent every year to fund operations or capital spending. Any excess earnings are typically reinvested to augment the endowment and to compensate for inflation and recessions in future years.

There's been large debate about why Universities don't spend more of their endowment on faculty and students. For example, it would require less than 1% of the endowments of Harvard and Yale to allow all students to attend tuition-free. Like many of us

individual investors, we often like to hoard our funds for a rainy day as the good times generally never last forever.

MANAGE RISK WITH ABSOLUTE RETURN STRATEGIES

As one's financial nest egg grows, it's important to manage risk because absolute losses are more painful and can be more difficult to make up. If you're 50 years old and 10 years away from retirement, your focus should probably be on capital preservation and growing your investments in a prudent manner that beats inflation, but doesn't swing for the fences.

University endowments allocate a much greater percentage of their portfolios to alternative investments because they have access. Whereas a private banker might allocate 10-15% in "liquid alternative" strategies for clients with less than $5 million in investable assets, multi-billion dollar university endowments are allocating 30%+. Endowment funds believe absolute return strategies provide a solid way to provide risk-adjusted returns to their respective universities.

Here is a recap of Yale's asset allocation targets for 2015 after returning 20.2% in 2014.

Yale University 2015 Asset Allocation

Private Equity:	31%
Absolute Return:	20%
Real Estate:	17%
Foreign Equity:	13%
Natural Resources:	8%
Domestic Equity:	6%
Bonds and Cash:	5%

At Sliced Investing, we are looking to give individual accredited investors more access to absolute return strategies by lowering the minimum investment to as low as $20,000. We believe that all investors should have access to these strategies and that they should not be limited to large institutions. Come sign up with Sliced Investing and explore our funds today.

93.7% of us might not be able to get into Yale, but with Sliced Investing we

> into Yale, but with Sliced Investing we can certainly invest like them!

Mike Furlong co-founded Sliced Investing with Akhil Lodha at the Bay Club in San Francisco while playing squash.

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