

The cover story on November 9<sup>th</sup> in Barron’s Magazine entitled “Crash Course” speaks to recent performance and allocation decisions of university endowment funds. After reading the article, we thought it was important to highlight the salient points, discuss our thoughts, and address some of the key decisions we, as investors and as a committee, have made.

- **Andrew Bary, the author of the Barron’s article asserts: “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.”**

One of the most unfriendly environments for fundamentally oriented investment strategies is a liquidity/solvency crisis. The current de-leveraging process has lasted longer than many expected and has created unprecedented volatility. While we are not happy with performance, we believe that marketable alternative investments continue to serve a very important role in portfolios. Below are the year-to-date returns (as of October 31<sup>st</sup>, 2008) for the equity hedge and fund of funds universe versus the traditional equity markets.

<i>Index</i>	<i>Return (%)</i>
HFRI Equity Hedge	-22.5
HFRI Fund of Funds	-18.7
S&P 500	-32.8
MSCI EAFE	-43.5

Although the results are well outside of our absolute return expectations, when compared to the traditional markets, the HFRI Equity Hedge and Fund-of-Funds indices have held up far better on a relative basis. Below we have included the 10 year annualized return, volatility (as measured by standard deviation) and Sharpe Ratio for these indices through October 31, 2008.

<i>Index</i>	<i>Annualized Return (%)</i>	<i>Standard Deviation (%)</i>	<i>Sharpe Ratio</i>
HFRI Equity Hedge	8.6	9.8	0.5122
HFRI Fund-of-Funds	6.0	6.2	0.4304
S&P 500	0.4	15.2	-0.1956
MSCI EAFE	2.0	16.4	-0.0803
LB Aggregated Bond	5.0	3.6	0.4582

Hedge fund strategies have produced risk-adjusted results that are more attractive than the traditional benchmarks over longer time periods. We believe the present dislocation has created some of the best investment opportunities for fund-of-fund and equity hedge strategies we have seen in years (and in some cases decades).

- **Bary highlights: “Emerging market stocks, another IVY favorite, also have been crushed, falling 45% since June 30<sup>th</sup>”**

While we think that there is a compelling long-term growth opportunity in the emerging markets, we acknowledge that this asset class can be extremely challenging and volatile. With the dramatic pull back in valuation metrics, and the likelihood that emerging markets may be the

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only asset class that realizes positive GDP growth next year, it is an extremely attractive asset class.

- *Bary emphasizes that “These schools are light on US stocks and bonds, and heavy on illiquid assets, such as private-equity, real-estate and commodity holdings, and hedge funds.”*

In our experience, timing the entry point for long-only commodity investments is critical given the volatility of the asset class. However, it does provide long-term uncorrelated return streams and a historical hedge against inflation.

- *“Yale was bullish on private equity up until the summer of 2007, just before the bottom fell out of the market.”*
- *Bary selectively points out that “ 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 value of comparable public companies.”*

According to Venture Economics, the performance of private equity as a whole outperformed the LBO vintage returns as well as public equities. The author fails to mention the success of the sector as a whole, and used only 2007 vintage year LBO returns to make his point.

**Venture Economics Vintage Year Performance (as of 6/30/2008)**

Year	All Private Equity Funds		Buyout Funds	
	Average	Median	Average	Median
2005	8.5%	6.8%	7.0%	7.2%
2006	-7.0%	-4.8%	-6.9%	-4.1%
2007	-19.0%	-21.6%	-25.0%	-21.8

We have steered clear of investments in venture capital and financially engineered transactions such as leveraged buyouts, but instead concentrated in the growth capital sector of the private equity market. As such, our performance has suffered much less than LBO’s and traditional long equities. Based on the current valuations and the lack of credit being offered by traditional lenders to companies, the opportunity set for growth capital private equity investing appears to be the best in over a decade. We are concentrating our efforts to identify managers that have the talent and infrastructure to capitalize on the events now unfolding in the credit markets. These managers are currently calling capital in private investment structures.

- *The author implies that the Ivy League schools may have it wrong, saying “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.”*

We infer he is suggesting an approach closer to the 60% stocks, 40% bond type allocation of yesteryear. Below is a comparison of this approach versus the returns of three major Ivy League institutions over the past 10 years as well as their allocations as of June 30, 2008.

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Endowment	Size (bil \$)	1-Year Return (%)	10-Year Return (%)
Harvard	36.9	8.6	13.8
Yale	22.9	4.5	16.3
Princeton	16.4	5.6	14.9
S&P 500	N/A	-13.1	2.9
60% S&P/40% LB Agg Bond	N/A	-5.25	4.3

Note: these endowments announce their results annually at their fiscal year-end (June 30<sup>th</sup>).

Asset Allocation	Harvard	Yale	Princeton
Hedge Funds	18%	23%	26%
Domestic Equity	11%	11%	9%
Fixed Income	11%	4%	3%
Foreign Equity	22%	15%	16%
Private Equity	13%	19%	25%
Real Assets	26%	28%	19%
Cash	-3%	0%	1%

Source: Bloomberg, School reports.

We are in the same camp with David Swenson, the Chief Investment Officer for the Yale University Endowment who states, “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.”

Additionally, the risk premium afforded private equity versus public equity has been quite sizable over the years averaging more than 600 basis points over public equities since 1995, according to Cambridge Associates and Standard & Poor’s. That would lead most investors to ask the following question, “If I don’t need a lot of liquidity why would I not invest in private equity versus public and capture the additional premium?”

***The Author concludes by saying, “Those that don’t evolve pay the price”***

The author’s suggestion that we evolve by going back to traditional allocations to stocks and bonds seems to be contradictory. A traditional 60/40 mix us stocks and bonds has failed to outperform the strategic allocations of the major endowments he reference over the past 10 years, producing a 4.3% return (period ending October 31<sup>st</sup>). Unfortunately, this return has failed to meet the two most important goals of most endowments and foundations: 1) maintain the purchasing power of the fund (exceed inflation + operational costs), and 2) grow capital (exceed spending policy).

In conclusion, we have a great deal of confidence in asset allocation decisions of a renowned academic and one of the top non-profit investors of our time, David Swenson, as well as the investment professionals at Harvard and Princeton. Traditional stock and bond mixes will have a difficult time supporting spending after inflation in the long run which, ironically, has been forecasted by Warren Buffet himself.