INVESTING

The Ivy League Model of Investing

Ivy League endowments have some of the best investing records in the country. Learn what advantages they use to beat the market average.

Though many people don't think of schools as investing powerhouses, some university endowments have an enviable legacy of successful investing. Institutions like Yale and Harvard have been so successful that people have begun to watch their endowment investments carefully. Using strategies with titles like "the Yale model" or "the Harvard approach," some investors even try to directly replicate the schools' high returns for themselves.

Investors should not get overly excited, however. Yale and Harvard have very special endowment programs that use a number of advantages the average investor simply does not have. Here are some of the factors that have made these endowments successful and how they compare to the opportunities of the individual investor.

Diversification

It is often said that diversification is the only "free lunch" in investing, and, unlike most of the tools large funds use, it is the one that all investors can make use of. Diversification is extremely important to a portfolio, even if it is only splitting exposure between a few different assets.

Diversification, for both investors and institutions, needs to take into account how investments behave in comparison with each other. One problem both educational institutions and investors have is the creation of "safer" portfolios by putting money into a variety of U.S. stocks and bonds. Even though U.S. companies are among the largest and most stable, using them exclusively makes a portfolio dangerously overexposed to the risk of an economic downturn in the United States.

Over the past 10 years, Yale's endowment has seen average annual returns of 10 percent. Harvard also has met with great success, posting average annual returns of about 8 percent during the same period.

Time Horizon

Investors who start investing early in life have a better chance of reaching their retirement goals than those who wait. The more time an investor has, the more risk (and potential growth) he or she can take on. Both Yale and Harvard are over 300 years old and are showing no signs of failure. They

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have a boundless time horizon, meaning their endowments can take on much riskier investments than what would be prudent for an individual. This desire to hold risk is one of the reasons endowments typically keep much more invested in equities than in bonds.

Available Investments

Not only do endowments have a timeline that favors risk, but their high net worth allows them to use investment vehicles many cannot. In order to protect investors with limited means, the government blocks some investments (like hedge funds) from individuals who have less than a million dollars or no experience with investing. Though investors can gain access to these investments through other funds, direct investment in these high-risk vehicles can help fuel an endowment's impressive returns.

Dedicated Research

Even if you have every investment option available and have an extremely long time horizon, your portfolio's annual success will still be dependent on your ability to pick successful investments. Skill is how Yale and Harvard differentiate themselves from other endowments. Both colleges have entire teams of professional investors analyzing stocks and specialized funds. They have both the talent and the resources to hunt down great investments and to beat the market in recognizing undervalued stocks.

Not surprisingly, individual investors do not have the time or experience to match Yale or Harvard in these categories. Stock analysis is tricky at best, and the average person can have an extremely difficult time predicting a company's prospects for future growth.

Tax-free

Tax-free exemption is by far the biggest advantage that endowments have over the everyday investor. With long-term investment taxed at 15 or 20 percent, a school's tax exemption makes a significant difference in returns each year and an enormous difference when compounded over several decades.

Taxes are what ultimately cause imitators of the "Yale model" and "Harvard method" to fall short of the actual endowments' success. Even if managers were able to carefully track and copy the schools perfectly, their returns would still fall short of the Ivy League's profits.

Harvard and Yale's investing methods prove that even great investing doesn't work for all investors. Some will find success in focusing on risky, high-yield assets, while others are better off using simple, low-fee index funds. But whether you invest like a university or save like a college student, being smart about your personalized strategy will be the key to success. ■