



current issue
issue archives

External Links

[University homepage](#)
[Admissions](#)
[Association of Yale Alumni](#)
[Athletics](#)
[Yale Daily News](#)
[Office of Public Affairs](#)
[School of Architecture](#)
[School of Art](#)
[Divinity School](#)
[School of Drama](#)
[Faculty of Engineering](#)
[School of Engineering & Applied Science](#)
[Graduate School](#)
[Law School](#)
[School of Management](#)
[School of Medicine](#)
[School of Music](#)
[School of Nursing](#)
[School of Public Health](#)

Send comments or suggestions to:
[Web editor](#)

The *Yale Alumni Magazine* is owned and operated by Yale Alumni Publications, Inc., a nonprofit corporation independent of Yale University. The content of the magazine is the responsibility of the editors and does not necessarily reflect the views of Yale or its officers.

[Comment on this article](#)
[Read comments](#)

David Swensen's Guide to Sleeping Soundly

Financial wisdom for troubled times -- plus strong opinions on the current crisis -- from Yale's in-house Warren Buffett

March/April 2009
by Marc Gunther '73

Marc Gunther '73, a contributing writer to *Fortune* magazine, blogs at marcgunther.com.

In just under a quarter-century as Yale's chief investment officer, David Swensen '80PhD has generated Bernard Madoff-like returns -- except that Swensen made his money honestly. Under his leadership, Yale's endowment has generated an astonishing 20 consecutive years of positive returns, from 1988 to 2008.

That streak will likely come to an abrupt end because of last fall's financial crisis. Yale had already lost \$5.9 billion this year as of December. But these losses should not tarnish Swensen's reputation as one of the world's great money managers. When Swensen, at the age of 31, left a well-paid job on Wall Street for Yale in 1985, the endowment was worth a little more than \$1 billion. Last June 30, it was worth \$22.9 billion. Today, it is worth about \$17 billion.

Perhaps the most striking evidence of Swensen's contribution to Yale is this: When he began managing the endowment, investment returns provided \$46 million in support, or about 10 percent of the university's operating budget. This year, the endowment is providing \$1.15 billion, which is nearly 45 percent of the budget.

The son and grandson of chemistry professors, Swensen earned his PhD from Yale in economics. He could have made much more money at an investment bank or a hedge fund, but he takes great pride in working to benefit Yale. His unorthodox approach to institutional investment, which has reshaped the way other large-scale endowments are managed, is described in a revised edition of his book, *Pioneering Portfolio Management* (Free Press, 2008). He is also the author of *Unconventional Success: A Fundamental Approach to Personal Investment* (Free Press, 2005), a much-praised guide to the markets for individual investors. President Obama has named Swensen to his new Economic Recovery Advisory Board, designed as an independent group of beyond-the-Beltway thinkers.

Swensen is soft-spoken yet passionate about his beliefs. In early February, we spoke about the endowment, the economy, how his investment principles could have saved Wall Street, and the most common mistakes made by individual investors.

Yale Alumni Magazine: Has it been a difficult time for you?

Swensen's Recipe for Investing

David Swensen has built Yale's exceptional endowment returns largely through categories of investments that aren't available to or aren't smart for an individual investor. (They include private equity, such as venture capital and buyout firms, and illiquid markets like timber. For more on Swensen's strategy, see "[Yale's \\$8 Billion Man](#)," July/August 2005.) He also relies on a highly trained staff and a phalanx of independent asset managers to evaluate potential investments.

If you don't have access to those resources, Swensen says, you shouldn't try to pick stocks, and you shouldn't pay anyone to do it for you. Instead, choose index funds. Then set your allocations and stay with them. When the value of your real estate holdings sinks below the allocation you set, buy enough to rebalance. When the value of your stocks exceeds your allocation (and it will again, one day), lock in the gains by selling enough to rebalance.

In his book *Unconventional Success: A Fundamental Approach to Personal Investment*, Swensen recommends the following allocations,

Related

[Yale's \\$8 Billion Man](#)
David Swensen can't tell you how to get rich quick. But he can tell you how not to get ripped off. (July/Aug 2005)

What Now?

What should the Obama administration do about the economy? Five economists and businesspeople offer their ideas. (Jan/Feb 2009)

Swensen: In some ways, yes. I absolutely love the idea of producing ever-increasing levels of support for Yale. Looking ahead to the next few years, that's not going to be in the cards. That's a difficult reality to deal with.

But in terms of the day-to-day work, managing through this economic and financial crisis is absolutely fascinating. It's exhausting, but fascinating.

Y: It may be fascinating to you, but it's discouraging for those of us who have watched our 401(k) values plummet. Given all the turmoil and uncertainty, what should individual investors do?

S: If an individual investor followed the program I outlined in *Unconventional Success* [see [box](#)], they probably did reasonably well, through the crisis, thus far. They'd have 15 percent of their assets in U.S. Treasury bonds. They'd have another 15 percent in U.S. Treasury inflation-protected securities. Those two asset classes have performed well.

Of course, the other 70 percent of assets are in equities, which have not done well. With all assets, I recommend that people invest in index funds because they're transparent, understandable, and low-cost. So, the equity holdings have gone down step-by-step with the declines in the market.

But I also recommend that investors rebalance. Rebalancing is even more important amidst these huge declines in the stock market because it presents a great opportunity. People can sell the Treasury securities that have appreciated dramatically to bring their allocation to the 15 percent target, and they can redeploy those funds into domestic equities and foreign equities and emerging market equities and real estate investment trusts, all of which are now much cheaper, and therefore have higher prospective returns.

I recommend that investors rebalance.

Y: Explain this idea of asset allocation, please.

S: Asset allocation is the tool that you use to determine the risk and return characteristics of your portfolio. It's overwhelmingly important in terms of the results you achieve. In fact, studies show that asset allocation is responsible for more than 100 percent of the positive returns generated by investors.

Y: How can that be?

S: It's because the other two factors, security selection and market timing, are a net negative. That's not surprising. They're what economists would call zero-sum games. If somebody wins by buying Microsoft, then there has to be a loser on the other side who sold Microsoft. If it were free to trade Microsoft, the amount by which the winner wins would equal the amount by which the loser loses. But it's not free. It costs money. It costs money in the form of market impact and commissions if you're trading for your own account, and it costs money in terms of paying fancy fees if you are relying upon an investment advisor or mutual fund to make these security-specific decisions. For the community as a whole, all those fees are a drag on returns.

That's why the most sensible approach is to come up with specific asset allocation targets that you can implement with low-cost, passively managed index funds and rebalance regularly. You'll end up beating the overwhelming majority of participants in the financial markets.

Y: So people should not be afraid of stocks now?

S: Not only should they not be afraid, they should be enthusiastic. One of the great ironies is that if you had talked

for individual investors who want a "well-diversified, equity-oriented portfolio":

30% Domestic stock funds

20% Real estate investment trusts

15% U.S. Treasury bonds

15% U.S. Treasury inflation-protected securities

15% Foreign developed-market stock funds (the EU, Japan, Australia, etc.)

5% Emerging-market stock funds (Brazil, Russia, India, China, Taiwan, Korea, and the rest of the developing world)

Today, Swensen says, economic conditions might call for a modest revision. He now recommends that investors have 15 percent of their assets in real estate investment trusts, and raise their investment in emerging-market stock funds to 10 percent.

Editors' note

No one, not even David Swensen, can know precisely what's best for your individual portfolio without having seen it. Therefore, please keep in mind that this article offers general information



[2009 Government Grants](#)

Billions of Government Grant Money is Available. Get Yours Now!

[GovernmentGrantsFinder.net](#)

[Asset Allocation](#)

Advanced Asset Allocation Software from Morningstar Principia

[global.morningstar.com/principia](#)

[Model Stock Portfolios](#)

Free and easy to follow stock trading strategy for 2009.

[www.stoxyfox.com](#)

[Asset Allocation Model](#)

Investment Portfolio.

Research is done for Independent Investor.

[www.ArborInvestmentPlanner.com](#)

[Invest with \\$100 or Less](#)

Buy Stocks for \$4. No Minimums. No Inactivity Fees. Start Today!

[www.ShareBuilder.com](#)

to the average investor 18 months ago, he or she would have thought it was a pretty good idea to buy stocks. In recent months, the same investors despair about their portfolio and are fearful about putting money into the equity market.

That's 180 degrees wrong. They should have been cautious 18 months ago, when prices were much higher than they are now. They should be enthusiastic today.

Y: That runs counter to human nature.

S: That's one of the really tricky things about the investment world. It's very different from a lot of things we deal with, day in and day out. If you talk to a businessman, a businessman is going to feed the winners and kill the losers. But in the investment world, when you've got a winner you should be suspicious about what's next. And if you've got a loser, you should be hopeful -- although not naively hopeful.

Y: You're asking people to be contrarians, which is hard. I assume that's one reason why you don't believe that most investors should be picking stocks.

S: That's absolutely right. There's no way that spending a few hours a week looking at individual securities is going to equip an investor to compete with the incredibly talented, highly qualified, extremely educated individuals who spend their entire professional careers trying to pick stocks. It's just not a fair fight. You know who's going to win before the bell rings.

The most important difference, in terms of categories of investors, is between those who can make high-quality active management decisions and those who can't. *Pioneering Portfolio*

Management is for those who have the ability to manage portfolios actively. *Unconventional Success* is a book for the overwhelming number of individual and institutional investors who cannot manage a portfolio actively.

The approach that I recommend is boring.

Almost everybody belongs on the passive end of the continuum. A very few belong on the active end. But the unfortunate fact is that an overwhelming number of investors find themselves betwixt and between. In that in-between place, people end up paying high fees whether to a mutual fund or a stockbroker or another agent. And they end up with disappointing net returns.

Y: Maybe we need new language, David. No one wants to be in the "passive" group.

S: No, they don't. The basic problem is, it's boring. The approach that I recommend is going to give you absolutely nothing to talk about at a cocktail party. You're going to be in a corner by yourself, and no one will pay any attention to you. But you'll end up with a better-funded retirement.

Y: So you can host the cocktail party.

S: Right.

Y: *Unconventional Success* delivered a scathing critique of the mutual-fund industry. You rightly pointed out that the vast majority of mutual funds charge high fees, trade too frequently, and under-perform the markets. How did the industry react?

S: I've heard stories of people in the fund management business being irate about the book. That's not surprising. The mutual fund industry is not an investment management industry. It's a marketing industry. And if somebody interferes with your marketing, you're not going to like that. So I was pleased to hear that there were senior people in the industry who were very, very unhappy with me and my book.

rather than a prescription for your specific situation. If you need investment advice, please consult a registered adviser.

Y: We should note that there's a distinction between the for-profit mutual fund industry and companies like Vanguard and TIAA-CREF.

S: One of the fundamental points in *Unconventional Success* is that there's an irreconcilable conflict in the mutual fund industry between the profit motive and fiduciary responsibility. There are two major organizations, Vanguard and TIAA-CREF, which operate on a not-for-profit basis. That conflict between profit and fiduciary duty disappears. Vanguard and TIAA-CREF are dedicated to serving their investors. They are shining beacons in this otherwise ugly morass. As a matter of disclosure, I'm on the board of TIAA.

But the sad fact is that this book, along with books written by Jack Bogle and Burt Malkiel and a handful of others, are relatively small voices when set against the cacophony of the fund management world. Look at Fidelity and Schwab with their full-page advertisements. Or Jim Cramer [host of CNBC's *Mad Money*]. The investor is bombarded with staggering amounts of information, staggering amounts of stimuli that are designed to get the investor to buy and sell and trade, to do exactly the wrong thing, to create excessive profits for these intermediaries that aren't acting in the investor's best interests.

Y: I was hoping you'd mention Cramer. In the new edition of *Pioneering Portfolio Management*, you write: "Educated at Harvard College and Harvard Law School, Cramer squanders his extraordinary credentials and shamelessly promotes stunningly inappropriate investment advice to an all-too-gullible audience."

S: Jim Cramer exemplifies everything that's wrong with the advice -- and I put advice in quotation marks -- that is given to individual investors. Investing is a serious business. We're talking about retirement security of American citizens, and he turns it into a game. It's a game where his listeners lose. It's ridiculous. These high-turnover, rapid trading strategies enrich the brokers. If you look at Jim Cramer's approach on an after-fee, after-tax basis, the individual doesn't have a chance.

Y: You were just named to President Obama's Economic Recovery Advisory Board. When do you foresee a recovery?

S: We can't start talking about a sustained recovery in the economy until the credit markets are fixed. Right now, the credit markets are broken. They're not functioning.

Y: Meaning businesses can't get loans?

S: It's commercial bank lending to corporations and individuals. It's the commercial paper market. It's the bond market. About the only market that seems to be functioning is the market for Treasury securities. That's exactly what you'd expect in a financial crisis. It happened in 1987. It happened in 1998. Right now, it's happening in a much more intense, much more pervasive fashion. Investors are selling risky assets of all types.

Y: Speaking of risky assets, I want to read you a line that jumped out at me from the appendix of *Pioneering Portfolio Management* about fixed-income securities. You write: "Asset-backed securities involve a high degree of financial engineering. As a general rule, the more complexity that exists in a Wall Street creation, the faster and farther investors should run." Can I conclude from this that Yale avoided exposure to the mortgage-backed securities and collateralized debt obligations -- the so-called toxic assets -- at the heart of the financial meltdown?

S: That's correct. One of the pieces of advice that I've had in my books, going back ten years now, is that investors in bonds should invest only in "full faith and credit" securities. Bonds that have call options or bonds that have credit risks or

bonds that are highly structured, like the asset-backed securities and CDOs, just don't belong in the portfolios of sensible investors.

Y: Both institutional and individual investors?

S: Correct. There's just systematic mis-pricing of credit and options and complexity. Now it's obvious when I say that. It wasn't so obvious when I wrote it ten years ago, and then again in *Unconventional Success*, and now again in the new version of *Pioneering Portfolio Management*.

People on Wall Street who are structuring these securities are more sophisticated than the people to whom they are selling them. With that kind of dynamic, when really smart, highly compensated, very clever people are on one side of the trade, and less highly compensated, less clever people are on the other side, you know who's going to end up in the soup.

**The activities
that I rail
against are so
profitable.**

Y: And yet the very same institutions that were packaging and selling these instruments ended up holding large quantities of them, to their dismay.

S: Stunning, isn't it? Maybe they're not as clever as I thought they were. I suppose complacency is one explanation. Or maybe they were blinded by greed.

Y: They must not have read your book.

S: The activities that I rail against are so profitable. Even though people may have read and believed what I wrote, they took the Chuck Prince [former CEO of Citigroup] attitude -- that while the music's playing, you've got to dance. The music played for a long time.

Y: What will we learn from this experience?

S: After 1987 [the stock-market crash] and after 1998 [the collapse of hedge fund Long-Term Capital Management], we learned nothing. I think the reason that there was not a sensible regulatory response to the issues that were quite apparent in 1987 and 1998 is that the markets and the economy bounced back quickly. We had a significant regulatory response after the Great Depression, because the country suffered for a protracted period.

I'm cautiously optimistic that we will have some sensible regulatory reforms prompted by this economic and financial crisis. Of course, the devil's in the details.


Y: What kind of regulation makes sense?

S: Having a universal financial regulator makes an enormous amount of sense. Why would you balkanize markets and have different regulatory regimes for different markets? And then you have to regulate every type of institution that could pose a systemic risk. It stuns me that we even ask the question about whether we should regulate hedge funds or not. Look at Long-Term Capital. How could we not have figured that out? The financial system almost collapsed because of a hedge fund, and today we haven't gathered even the most basic information about the activities of hedge funds.

Y: There's no transparency, even to investors, as we learned from Madoff.

S: It's stunning. It's the religion of the free market.

Y: Many young people today believe they will never be as prosperous as their parents. Should young adults have hope?

S: I'm an incredible optimist. We should be careful not to underestimate the resilience of this economy. I think we could have, in the next couple of years, a very hard slog. Looking five or ten years down the road, I'm very optimistic that we will come out of this strong and better. 

Readers respond

One of a kind

I applaud you for providing David Swensen's thoughts, soberly insightful and stunningly clear as always. But I am dismayed with your cover describing him as "Yale's own Warren Buffett." This was lazy and inaccurate and a thorough cheapening of all that David is. Mr. Buffett has a great multi-decade record but has much to answer for in recent years, not the least of which is the apparent conflict of interest in his 20% ownership of rating-agency Moody's, which in turn provides his Berkshire Hathaway with AAA ratings, though the market disagrees.

David, on the other hand, is far more of a visionary than Mr. Buffett ever was, and he has employed none of the questionable tactics of Berkshire Hathaway. While Mr. Buffett has been laudably low-key with his riches, David has willingly foregone the same in the interests of higher education.

"The greatest honor you could pay Warren Buffett would be to call him Omaha's David Swensen."

David Swensen is sui generis. The greatest honor you could pay Warren Buffett would be to call him Omaha's David Swensen, but it would be inaccurate and far too generous.

Bill Feingold '85
Dobbs Ferry, NY



Staying the course

David Swensen has spoken before the Yale Club of Boston twice over the past five years, most recently about a year ago.

At that time, I happened to be taking the elevator to the gathering when David hopped on. We started talking, and I asked him if his lecture would be similar to the one which he had delivered five years earlier. I was quite surprised when he said that it would be quite similar and perhaps, in certain areas, identical. When he asked me if I could recall his earlier lecture, I had to be honest and replied that my recollection of his prior talk was rather limited. "Great!" he answered, "then I won't have to be concerned that my audience will have heard my prior lecture."

Philip I. Hershberg '58MEng
Needham, MA



Yale Alumni Magazine, PO Box 1905, New Haven, CT 06509-1905, USA.
yam@yale.edu