

Notes

To: PMs

RE: *The Merit of Un-Conventional (Yale) Wisdom*

No doubt due in large measure to the recent strong returns, a growing number of investors today have interest in alternative asset classes. David Swensen, Yale's Endowment hotshot manager for the past 20 years, has gained widespread recognition and acclaim for his successful use of unconventional asset classes, further heightening this interest. So what exactly are the opportunities?

The following table contains index returns for the major asset classes available to investors,<sup>1</sup> which are most of the asset classes Yale used to amass their impressive performance record.<sup>2</sup> Years ago, Peter Lynch coined the term *diworsification* to describe diversification that lowered returns. For many investors, owning lesser returning assets in return for less risk<sup>3</sup> is appropriate. Other investors (like Yale's Endowment) seek the "*have your cake and eat it too (HYCAEIT)*" variety of diversification, i.e., lowering risk without sacrificing return.

Year	US Stock	EAFE	Emerging	Commodity	REITs	US Bonds
			Markets	Futures		
1988	16.8%	26.7%	34.9%	16.0%	17.5%	10.7%
1989	31.5%	9.2%	59.2%	4.6%	2.7%	16.2%
1990	-3.2%	-24.7%	-13.8%	5.1%	-23.4%	6.8%
1991	30.5%	10.2%	55.9%	-4.0%	23.8%	19.9%
1992	7.7%	-13.9%	9.1%	-3.2%	15.1%	9.4%
1993	10.0%	30.5%	71.2%	6.1%	15.1%	13.2%
1994	1.3%	6.2%	-8.7%	10.3%	2.7%	-5.8%
1995	37.4%	9.4%	-6.9%	8.9%	12.2%	27.2%
1996	23.1%	4.4%	3.9%	12.0%	37.0%	1.4%
1997	33.4%	0.2%	-13.4%	4.4%	19.7%	12.9%
1998	28.6%	18.2%	-27.5%	-20.5%	-17.0%	10.8%
1999	21.0%	25.3%	63.7%	2.1%	-2.6%	-7.5%
2000	-9.1%	-15.2%	-31.8%	14.3%	31.0%	12.9%
2001	-11.9%	-22.6%	-4.9%	-17.2%	12.4%	10.6%
2002	-22.1%	-17.5%	-8.0%	18.4%	3.6%	16.3%
2003	28.7%	35.3%	51.6%	11.3%	36.2%	5.3%
2004	10.9%	17.6%	22.5%	12.4%	33.2%	8.7%
2005	4.9%	10.8%	30.3%	18.9%	14.0%	2.4%
<b>Avg</b>	13.3%	6.1%	16.0%	5.5%	13.0%	9.5%
<b>StDev</b>	17.4%	18.5%	33.4%	11.0%	16.8%	8.5%
<b>%Loss</b>	22.2%	27.8%	44.4%	22.2%	16.7%	11.1%
<b>Correl</b>		<b>0.63</b>	<b>0.35</b>	<b>-0.17</b>	<b>0.15</b>	<b>0.19</b>

Bonds, the conventional alternative to Stocks, is the classic *diworsifying* asset. In its favor is a low correlation to Stock returns (the final row of the table) and low risk measures (both StDev and %Loss), but these are obtained via a return sacrifice. Per previous Notes, when risk is measured over longer than one-year investment horizons, the risk advantage dissipates and only lower returns result. We've used REITs for years as an income producing alternative to bonds, which of late has proven to be an outstanding HYCAEIT asset class, given its strong performance and low correlation to Stock returns.

<sup>1</sup> Data definitions: US Stock = S&P500 Index (Total Return); MSCI EAFE Index; MSCI Emerging Markets Index; Dow Jones/Wilshire REIT Index; US Bonds = Salomon Brothers Long-Term High Grade Corporate Bond Index (Total Return).

<sup>2</sup> Private equity and hedge funds are two other asset classes used, but are not available to individual investors.

<sup>3</sup> Per our prior Notes, the definition of this is all-important and is highly influenced by time horizon.

Less aggressively, we've used International Equities as a diversifying asset class. EAFA, which is essentially the international equivalent of the S&P 500 (comprised of mostly major European and Japanese companies), is perhaps an example of a *diworsifying* asset class, as it has a high correlation to US Stock returns (bad for a diversifying asset) and poor relative returns. Better has been Emerging Markets (sort of the Russell 2000 international equivalent), with a low correlation to US Stock returns and great long-term returns. However, this asset class is not for the faint of heart, as it experiences annual losses twice as often as US stocks (%Loss) and has nearly twice the one-year volatility (StDev). Managed Futures is presently a favored diversifying asset class (note the hard to find negative correlation to US Stocks) and has done well over the past few years, but its long-term performance record is disappointing, making it another potential *diworsification* candidate.

So how does one use this information to position their assets? Carefully! If we eliminate the *diworsifying* asset classes (Bonds, EAFA and Managed Futures), we're left with US Stocks, REITs and Emerging Markets. In the short run, our traditional favorite (to complement US Stocks) REITs are vulnerable to a correction after its extraordinary run the past six years. REITs have enjoyed better than 20% average returns over this period, which is more than twice their natural rate or return (8-9%), and now have inflated valuations and an average yield as an asset class (rent passing through) of less than 5%. Similarly, Emerging Markets have enjoyed back-to-back huge years, making it also potentially dangerously late in the game. Meanwhile, US Stocks, our forte, have just begun to recover from the epic bubble-burst of 2000-2002. Add to this the active-management opportunities we possess (3-S and stock-selection) and it makes a pretty compelling case to stay the course with US Stocks.

Clearly, there are investment opportunities beyond our specialization, with Yale's Endowment an excellent example. However, those juicy returns are not simple asset class plays and likely require a great deal of skill and dedication to achieve. And like US Stocks, these are all sum-zero games where winners cannot exist without a loser counterpart, and none of these playing fields are level (advantage always toward experience and resources). So I repeat, proceed carefully with these alternative asset classes, if you must at all.

Enjoy!

Lowell