The Yale Portfolio

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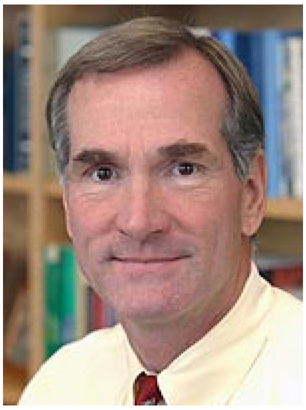
This is another in my series of posts on fixed asset allocation portfolios (AKA lazy portfolios.) You can read about the other ones here.



David F. Swensen is perhaps the most successful university endowment manager of all time. He began at Yale in 1985 and compiled such a great record that many other universities began copying his methods. He wrote Pioneering Portfolio Management: An Unconventional Approach to Institutional Investment, the bible for these managers. In 2005, he published a book called Unconventional Success: A Fundamental Approach to Personal Investment. As he initially planned it, this was going to be a book that took the approach he used at Yale and taught an individual investor how to do it in their own portfolio. As he prepared the book, he realized that what he did at Yale COULDN'T be done successfully by the individual investor. But he did see a way through which the individual investor could find investing success. The book explains the method. Here's what he says about it in the preface:

> *As I gathered information for my new book, the data clearly pointed to the failure of active management by profit-seeking mutual fund managers to produce satisfactory results for individual investors. Following the evidence, I concluded that individuals fare best by constructing equity-oriented,*

broadly diversified portfolios without the active management component. Instead of pursuing ephemeral promises of market-beating strategies, individuals benefit from adopting the ironclad reality of market-mimicking portfolios managed by not-for-profit investment organizations.

The recommended portfolio he eventually comes up with for the individual investor looks like this:

Domestic Equity	30%
Foreign Developed Equity	15%
Emerging Market Equity	5%
Real Estate (REITS)	20%
US Nominal Treasury Bonds	15%
TIPS	15%

I like this portfolio a great deal. Aggressive, but not too aggressive. It adopts the philosophy that you should take your risk on the equity side by using only very safe treasury bonds in the portfolio. It adopts a total market philosophy, which keeps costs down and ensures the investor will beat the average stock investor in that asset class. It takes advantage of relatively low correlation between its major assets. It has a good chunk of international stocks, certainly within the range of what I consider prudent. I also like the 50/50 split between nominal and inflation-protected bonds. I think a typical physician investor who adopts this portfolio, sticks with it, and saves an adequate amount will reach his investing goals over the long run.

I dislike two things about the portfolio. First, I think 20% REITs is way too high. In 2005, when the book was published, REITs had been on a ten year tear. The conventional thinking in the 90s was that they were LOWER risk than the overall stock market. The last 5 years have convinced me otherwise. As a sector of the overall stock market I find REITs to be a fairly high risk asset class. I think 20% of your overall portfolio (and 29% of your equity) is far too much for this narrow sector. I do believe REITs can have a place in your portfolio (my own has 7.5% of the portfolio, 10% of my equity), but 20% is too big of a bet IMHO. If you need convincing take a look at the Vanguard REIT Index Fund performance from 2007 to 2009. I watched the REITs I owned lose 75% of their value. That's a risky asset class by any definition.

Second, the portfolio gives nary a nod to the research published by Fama and French. Historically, small and value stocks have had higher returns than the overall stock market. Some think this is a free lunch. Others think it is because they are riskier assets to hold. Perhaps it was just a statistical anomaly due to a limited data set. But I think at least a small bet in this direction is worthwhile to the investor who can tolerate the tracking error and additional complexity.

Performance of this portfolio (using appropriate low cost index funds or ETFs) is tracked regularly by MarketWatch in their lazy portfolio section. Returns over the last ten years (current on 10/7/11) were 6.78% per year versus the S&P 500 returns of 2.82%. It also compares favorably to the Coffee House Portfolio, whose returns over that same time period were

5.66% (although with a bit more risk as it is 60/40 instead of 70/30).

If you’re still trying to design your own lazy portfolio, I suggest you give Swensen’s book a read. You could certainly do much worse.