MIT and other endowments are succeeding with a fresh spin on the Yale model. Families need an update as well.

From Star to Founder

EastRock

Family Portfolios: A New Framework

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IF YOU WERE MANAGING A POOL OF CAPITAL starting 10-20 years ago, there's a good chance you took inspiration from the Yale Endowment and its longtime CIO, David Swensen.

Swensen's extraordinary 36-year track record and his seminal book, Pioneering Portfolio Management, made a compelling case for allocating capital across eight specified asset types with a particular emphasis on alternative assets.

Today, a new generation of managers has put its own spin on the Yale model.

One manager we've been watching is Seth Alexander, who worked at the Yale Endowment under Swensen before joining MIT in 2006 as president of its investment management company. Since then, Alexander and his team have outperformed Yale and most other endowments:

ANNUALIZED RATE OF RETURN OF MAJOR ENDOWMENTS

	MIT	Brown University	Yale	Duke	Stanford	Harvard
15-YEAR	9.8%	8.6%	8.5%	8.4%	7.5%	6.4%
10-YEAR	13.0%	12.3%	12.0%	11.3%	10.3%	9.0%

Through June 2022

For those seeking to learn from MIT's experience, Alexander and his team share substantial insights here: https://mitimco.org/.

When I read through this website for the first time, I was struck by Alexander's choices—where he departed from Swensen and where he stayed faithful. Elements of his approach are unusual for an endowment, yet very similar to the playbook we created at East Rock during the same time period.

[Note: East Rock also started in 2006 with a goal of putting our own spin on the Yale model. I do not know Alexander despite both of us being members of the Yale Class of '95. I hope to meet him one day.]

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The following are three core beliefs that jump out from MIT's writings:

1. **MIT loves small, young managers.**

   Sure, David Swensen was well known for seeding young firms, but MIT has taken this to a new level. On its website, MITIMCo notes having invested in a "one-person stockpicking firm based in San Francisco with $10 million of AUM" and "a one-person stockpicker, based in Mumbai, with a decade-plus track record of compounding his own money." These aren't just small managers—they are tiny.

   In a 2014 interview in The Manual of Ideas (MOI), the MIT team stated: "[W]e spend a lot of time meeting with managers in their 20s and 30s… a meaningful number of our firms are one- and two-person shops, and… we are very content with unconventional firms and strategies."

2. **MIT still believes in active stock pickers.**

   Despite the anti-hedge fund narrative we often hear, MIT allocates aggressively to stock pickers managing hedge fund-style partnerships.

   While private investing may offer higher expected returns, MIT states that it sizes public market investments larger than private market investments. The reason: liquidity allows them to correct mistakes more quickly.

3. **MIT does not invest by filling allocation buckets.**

   In a departure from Swensen, Alexander does not adhere to an asset allocation policy. MIT letters do not even mention the categories that are tracked carefully by Yale.

   Alexander: "We actually try pretty hard not to categorize managers… The more we thought about it, the more we realized that perhaps exceptional investors by definition could not be easily classified. Once we got comfortable without having classifications and just focused on finding great investors, we were much happier."

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Of MIT's beliefs, the move away from asset allocation buckets is perhaps the most powerful, because it allows MIT to spotlight the things that really matter, such as maximizing exposure to small, idiosyncratic managers who find mispriced, off-the-run investments.

For families, we see a similar need to spotlight the things that really matter. And for this purpose, we have developed a portfolio framework comprised of three simple categories:

1. ***Generational Assets*** that are actively managed, less liquid (though not fully illiquid), and only moderately exposed to market swings.

2. ***Liquid Assets*** that are passively managed, highly liquid, and some of which (the equity portion) fully capture market swings, whether positive or negative.

3. ***Family-Directed Assets***, a category we include to capture the reality that families have the freedom to invest for reasons other than risk/return.

We bring all of this together in the following overview, which we think makes the framework easy to visualize, implement, and monitor:

EAST ROCK PORTFOLIO MODEL

	CENTRAL OVERSIGHT				
	GENERATIONAL ASSETS		LIQUID ASSETS		FAMILY-DIRECTED ASSETS
	Private Investments	Hedge Funds	Cash & Credit	Public Equities	Operating Businesses, Impact Investing, Etc.
Management Type	Active		Passive		Personal
Liquidity	Low	Medium	High		Typically Low
Market Risk	Medium		Low	High	Varies
Return Expectations	High	Medium	Low	Medium	Varies
Purpose	Long-Term Growth with Peace of Mind		Primary Source of Funds	Liquid Participation in Broader Economy	Personally Meaningful + Enriching + Potentially Fun

Why this particular framework? Because we believe it spotlights three issues that rise above the rest:

1. **Never lose sight of liquidity.** Families need to keep a clear picture of liquidity sources (1st option, 2nd option, etc.) so that they never, ever run out of cash.

2. **The amount of market risk must be sustainable**. Too much market exposure (beta) leads to poor choices at the toughest times. It is also antithetical to the idea of non-correlated return streams. The framework emphasizes tracking market risk and making sure there is never too much to hold through tough markets.

3. **The active side of the portfolio requires different skills than the passive side.** Management of the passive side should be kept simple. The active side demands more attention—and is more difficult—because that's where families need extraordinary managers (small ones, if you believe MIT and East Rock) that provide alpha, diversification, and non-correlation.

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The portfolio model described above is the product of 17 years of thinking about risk and return for families. The details could fill a book (and maybe they will someday!). But for now, I'll conclude with some Q&A that addresses key concerns that have been raised to us:

QUESTION: Instead of hedge funds, shouldn't I just buy ETFs and commit to holding on through ups and downs? After fees and taxes, won't I be better off?

ANSWER: Maybe. But research shows that individual investors typically sell their public equities at inopportune times and only captured about 2/3 of market gains over the last 30 years. In 2008-2009, the S&P 500 fell 50% from peak to trough. Other indices did worse. It was not only difficult to hold full positions through this period, it was arguably irresponsible.

Instead, we recommend that public market investments be a mix of hedge funds and traditional equities, with the latter accessed via ETFs or similar products that offer tax loss harvesting.

The reason: During market turbulence, it will be easier to make smart decisions—which typically means doing nothing—when your passive portfolio isn't too large and your hedge fund managers are addressing market conditions on your behalf.

QUESTION: Haven't hedge funds substantially underperformed markets and failed to justify their fees over the last 10-15 years?

ANSWER: The *average* hedge fund has. But smart manager selection (especially with a focus on smaller managers) offers the chance to do much better than average while avoiding the higher risk and volatility of traditional equities. This strategy has worked not just for MIT, but for most high-performing endowments we follow. Brown University, for example, has allocated more to absolute return strategies (32%) than any other asset class over the last ten years, with excellent overall results. While hedge funds are maligned in the press, no other asset class offers the same mix of liquidity and protection from downside and volatility, while preserving the potential for long-term upside.

QUESTION: How should I size private investments in my portfolio?

ANSWER: Give yourself an illiquidity budget—i.e. the portion of your portfolio that you are comfortable having limited access to for a long time. Then spend that budget only when you are being extremely well paid—not just in higher expected returns, but also structure (e.g. subordination that protects your investment), edge (e.g. price discount that skews your returns positively), and non-correlation (e.g. cash flows that do not vary with GDP, interest rates, commodity prices, etc.).

QUESTION: If I am not spreading my capital across a variety of allocation buckets the way Yale does, how do I know that I have sufficient diversification?

ANSWER: There are no shortcuts in risk management. Whether you use asset allocation buckets or not, you still need sufficient transparency from managers to track "factor" exposures—i.e. portfolio sensitivity to interest rates, commodity prices, consumer spending, growth vs value, etc. Transparency will never be perfect and neither will statistics-based risk management. So you need judgment to predict which positions will be correlated. It's part art, part science. Risk management ties back closely to liquidity—there must be sufficient liquidity so that you can correct excess exposure to any one factor. It's also worth considering tools such as portfolio hedging and flexible partnerships with external managers.

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Any other questions? Please feel free to ask.

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