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IF IT'S GOOD ENOUGH FOR YALE IT MUST BE GOOD ENOUGH FOR US

While reading the July 18th edition of the Sunday Business Post I came across an article written by David Clerkin entitled: "NPRF slashes its holdings". The article began as follows:

The National Pension Reserve Fund (NPRF) has slashed its shareholdings in blue-chip large quoted companies in favour of buying riskier assets, following a radical reassessment of its investment targets.

I was intrigued by this opening paragraph because I immediately began to wonder what was going on. Why choose to do it now? What riskier assets are they buying? What justification did they use?

The article partially answered these questions.

It said they were doing it now because they had gone through a strategic review: *The move follows a major reappraisal of the NPRF's investment strategy.*

It said the riskier assets were hedge funds and private equity funds: *It will also increase its exposure to so-called alternative assets, which include high-risk investments such as hedge funds and private equity deals.*

It said that they justified it on the basis that they hope to generate higher returns: *In order to deliver higher returns, the fund has decided to take on greater risk*

Having read the article I still felt it was worth investigating the story a bit more. Luckily the NPRF annual report can be found on their website and it has plenty of additional detail. I was particularly interested in the section describing how they decided to change their asset allocation. Here is the critical section:

Strategic Asset Allocation

In deriving a strategic asset allocation based on its Investment Objective, the Commission utilised a twin track approach combining asset allocation modelling on one hand with its own investment judgement and its analysis of the allocations of peer international funds on the other. It is important to emphasise that asset allocation modelling has limitations. These include the difficulty in specifying inputs (for example, expected returns and volatility for each asset class and expected correlations between asset classes), its extreme sensitivity to small changes in expected return, the way it strongly favours asset classes with high estimated returns and/or low estimated volatility and its difficulty in dealing with factors such as illiquidity. As a result of these limitations, modelling can only ever act as a guide to investment strategy and needs to be supplemented with qualitative considerations. Arising from this twin track approach the Commission agreed the Revised Target 2010 Strategic Asset Allocation as set out in table 2.1.

Reading between the lines I know exactly what this paragraph is really saying. It is saying that the NPRF is heavily influenced by what goes on in comparable funds in other parts of the world but because this does not sound sophisticated enough they feel it necessary to buy a software package that does asset allocation modelling. They admit that this modelling has "limitations" but they are not prepared to admit that they will ignore the output from this modelling.
I say all of this because this is exactly what used to happen with a similar modelling package we used in AIB Investment Managers. Management did not want to admit to clients that gut instinct and watching what the competition was doing was more likely to be used than any model. The model made it sound like a rigorous process was in place but the output from the model was ignored because we all knew that it was flawed!

The reason why the NPRF wants to do what everyone else is doing is because if anything goes wrong they can point to all these other eminent experts that have made the similar mistakes. This is a great way of trying to avoid blame!

Looking at the changes they are making I can see exactly what they have decided to move closer towards. I can see that they are now more closely following the "endowment" approach. This is an approach that was pioneered in Yale and is increasingly watched by many Universities and other state run funds like the NPRF even though very few have gone as far as Yale.

Here is a table showing the asset allocation models of Yale, other American Universities (mean), The New Zealand Superannuation Fund and the Singaporean Government Investment Corporation.

	Yale	Other U.S. Universities	New Zealand	Singapore GIC	NPRF
Equity	17.3	37.5	48	38	49
Fixed Income	4	16.2	17	24	17
Absolute Return	24.3	22.5	0	3	5
Private Equity	24.3	8.3	5	11	10
Real Assets	32	10.7	30	16	18
Cash	-1.9	4.8	0	8	1
	100	100	100	100	100

This table highlights that Yale is the most radical in terms of using Alternative assets and most other institutions have kept a higher allocation in traditional assets like equities. It also highlights the tendency of these government funds to do something similar.

I am trying to raise awareness of this issue because my gut instinct tells me that it is the wrong thing to do. I say this because I have real doubts about the ability of private equity and absolute return funds to generate the type of returns that are needed to justify this move.

My problem is that we will only know if I am right when it is too late because you need ten to twenty years to see if a strategy like this has worked!
My concerns primarily relate to a belief that there is not enough talent among all the absolute return and private equity funds to generate the anticipated returns. I believe that there will be specific funds that will do a good job but for every good one there will be a lot more bad ones.
Historically the average equity fund has underperformed its index. I believe that this will happen to the average absolute return fund and private equity fund.
The NPRF will continue with its existing approach of investing in a large number of funds and this makes me think that the returns they achieve will be close to the average.

I know that it sounds arrogant of me to say that the eminent managers of the Yale endowment are wrong but once again I am just following Warren Buffett. (Yes him again!).
This article highlights that Warren Buffett took out a bet in 2008 that a selection of hedge funds would not do better than the US stock market over a ten year period:
http://money.cnn.com/2008/06/04/news/newsmakers/buffett_bet.fortune/

If Buffett is right the NPRF should not be following this strategy. I think Buffett will be proven right.

In conclusion I will have to finish off by saying that this is another one of those issues that I will have to come back to in a later opinion piece (Ironically by that time the people in the NPRF that made the decision will be retired and enjoying the benefits of their defined benefit pensions!)

PERFORMANCE

In my own struggle to prove that I am better than the average manager I am happy to report that despite my BP troubles (see my June opinion piece no.56) the first six months of 2010 have been moderately successful. My fund achieved a return of 6.9% and this is reasonable relative to the world index and a number of competitor funds. Over the two and a half years that I have been reporting performance my fund is down 7.5% so although this is good on a relative basis I am still some way off of reporting positive overall returns and at the end of the day this is what counts.
The challenge goes on so watch this space!