Published Date: September 2, 2023

What Ted's Thinking

The Real Yale Model

Investors following David Swensen too often miss the mark in their interpretation of his theory. Like children playing the game telephone, they listen to other voices and echo beliefs with shakier foundations than Yale's.

Anyone adopting the "Yale Model" is well served to revisit David's writing from time to time. I had a chance to do that and found perspectives on illiquid investments, asset allocation, active management, private equity, and rebalancing that differ from the conventional wisdom that defines the Yale Model.

The Yale Model in David Swensen's Words

David's ability to articulate and act on an investment philosophy based on academic research was the foundation of his greatness. Reading the revised edition of *Pioneering Portfolio Management* reminded me of the clarity of his ideas and depth of his insight.

David put forth a framework for thinking about the investment problem and shared how he applied that framework to managing Yale's endowment. He wrote about an investment strategy for educational endowments with a perpetual time horizon, articulating a series of first principles. This core of the "Yale Model" in his words are as follows:

1. Equity bias. "Sensible investors approach markets with a strong equity bias, since accepting the risk of owning equities rewards long-term investors with higher returns."[1]

2. Diversification. "Significant concentration in a single asset class poses extraordinary risk to portfolio assets. Portfolio diversification provides investors with a "free lunch," since risk can be reduced without sacrificing expected return."[2]

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[1] David F. Swensen, *Pioneering Portfolio Management, Fully Revised and Updated*, *2009 edition*, page 55.
[2] Ibid, page 59.

3. Alignment of Interest. "Nearly every aspect of fund management suffers from decisions made in the self-interest of the agents at the expense of the best interest of the principals. By evaluating each participant involved in investment activities with a skeptical attitude, fiduciaries increase the likelihood of avoiding or mitigating the most serious principal-agent conflicts."[3]

4. Search for inefficiency. Focus on asset classes with a wide dispersion between top and bottom performers and employ external managers to exploit opportunities.[4]

David's Words of Warning

David preached an investment philosophy and a mission-driven purpose. Many others read his words and inferred a prescriptive recipe for investing broadly.

Interpretations of David's beliefs generally follow his principles, but his philosophy included three obstacles to investment success that most institutions and individuals are unable to overcome. As a result, David warned investors against playing follow the leader.[5]

1. Rigorous investment framework. David stresses the importance of taking actions within the context of an "analytically rigorous framework, implemented with discipline and undergirded with thorough analysis of specific opportunities."[6]

2. Agency Issues. "Agency issues interfere with the successful pursuit of institutional goals. Culprits range from trustees seeking to make an impact during their term on an investment committee to staff members acting to increase job security to portfolio managers pursuing steady fee income at the expense of investment excellence to corporate managers diverting assets for personal gain."[7]

3. Active Management Challenges. "Investors hoping to beat the odds by playing the game of active management face daunting obstacles ranging from the efficiency in pricing of most marketable securities to the burden of extraordinary fees in most alternative asset investment vehicles."[8] Success also demands substantial staff resources and contrarian behavior not typically practiced by institutions.[9]

What I also found worth consideration are the contradictions between David's words and others' interpretations of his work. It's where the students fall short of the master.

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[3] Ibid, page 5.
[4] Yale University Investments Office: February 2015. Josh Lerner, Harvard Business School Publishing, page 16.
[5] Swensen, page 5.
[6] Ibid, page 4.
[7] Ibid, page 5.
[8] Swensen, page 296.
[9] Ibid, page 7.

What David Said

…on Illiquidity

Embracing illiquidity is not a first principle of the Yale Model, despite many misinterpreting David's beliefs as such.

David discusses his tenets in the first pages of the book. He does not focus on the topic of liquidity until page 82. Illiquidity is neither a feature nor a bug in David's model; it serves as both necessary for diversification and a potential source of alpha.

Before *Pioneering Portfolio Management*, institutions typically held only public equity and bonds in their portfolios. In the U.S., asset owners tilted heavily towards domestic stocks and bonds. David believed in diversifying away from U.S. equity market risk. To diversify away from the most liquid equity market in the world, an investor necessarily accepts illiquidity. David described illiquidity as "the inevitable cousin of diversification and high-return investment opportunities." In that sense, illiquidity is a bug, not a feature.

When David wrote about illiquidity, he saw it as an innovation – an opportunity to go where others did not.

> Serious managers who attempt to identify inefficiency frequently gravitate towards relatively illiquid markets, since rewarding investments tend to reside in dark corners, not in the clear of floodlights.[10]

By moving against the crowd, David saw opportunities to take advantage of mispricings in less efficient markets.

> Because market players routinely overpay for liquidity, serious investors benefit by avoiding overpriced liquid securities, and by embracing less liquid alternatives.[11]

To the extent David tilted towards illiquid assets, it was primarily because others did not. For those like him willing to look in 'dark corners', opportunities to add value were plentiful. Investing in illiquid markets requires a long duration and an ability to lock-up capital, which Yale has in spades.

Further, David's desire to take advantage of market inefficiencies requires attractive prices. Without underpriced assets, illiquid markets would not offer strong risk-adjusted expected returns. The illiquid markets today are far more efficient than they were in 2000 and 2009 when David published his ground-breaking work.

[10] Ibid, page 82.
[11] Ibid, page 54.

…on Asset Allocation

Investors often cite a landmark study by Gary Brinson, Brian Singer, and Gil Beebower from 1991 to defend asset allocation as the most important driver of returns. Is asset allocation essential to investment success? Of course. Is it the driver of returns according to David? Not at all.

> Asset Allocation is not the driver of returns. Investors often treat asset allocation's central role in determining portfolio returns as a truism. It is not. The…study describes investor behavior, not finance theory.[12]
>
> Investor behavior causes policy asset allocation to dominate portfolio returns, since institutions tend to hold stable commitments to a broadly diversified portfolio of marketable securities.[13]

David was a staunch proponent of asset allocation, but he recognized that asset allocation drives returns in the rear-view mirror. If investors choose equities and equities outperform over time, then asset allocation mathematically dominates long-term return attribution. It's as simple as that.

…on Active Management

While Yale's approach relies on active management, David believed most should not try.

> Investors wishing to beat the market by actively managing portfolios face daunting obstacles…Intelligent investors approach active strategies with a healthy sense of skepticism.[14]
>
> Active management strategies, whether in public markets or private, generally fail to meet investor expectations.[15]

While he sought opportunities in private markets, David was fully aware of the massive hurdle to success created by the high cost required to participate.

> While illiquid markets provide a much greater range of mispriced assets, private investors fare little better than their marketable security counterparts as the

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[12] Ibid, page 51. Swensen cited Brinson et al in his first edition and a 2000 study by Roger Ibbotson and Paul Kaplan in the second edition.
[13] Ibid, page 97.
[14] Ibid, page 73.
[15] Ibid, page 7.

> extraordinary fee burden typical of private equity funds almost guarantees delivery of disappointing risk-adjusted results.[16]

Those following the Yale Model may presume David promoted active management for all. He did not. He believed that the chance of success is low and most who try will fail.

…on Private Equity and Venture Capital

It's ironic that *Pioneering Portfolio Management* became ignition fuel for capital flows to private markets. Readers followed an approach of "do what I do, not what I say," as David essentially begged all but the most well-resourced and sophisticated investors to play a different game.

> In the absence of truly superior fund selection skills (or extraordinary luck) investors should stay far, far away from private equity investments.[17]

David cites data that concludes most private equity and venture capital investors are better off investing in the public markets.

> In aggregate buyout investments failed to match public market alternatives. After adjusting for the higher level of risk and the greater degree of illiquidity in buyout transactions, publicly traded equity securities gain a clear advantage.[18]

> Over reasonably long periods of time, aggregate venture returns more or less match marketable equity returns, indicating the providers of capital fail to receive compensation for the substantial risk inherent in start-up investing.[19]

Importantly, David saw private equity and venture capital as opportunities to generate high returns without corresponding diversification benefits.

> Because of the strong fundamental links between private equity investments and marketable equities, private equity provides limited diversification to investors.[20]

In other words, if just showing up doesn't add diversification and you can't play to win, you better be careful playing at all.

…on Rebalancing

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[16] Ibid, page 7.
[17] Ibid, page 224.
[18] Ibid, page 223.
[19] Ibid, page 235.
[20] Ibid, page 220. David's definition of private equity included both leveraged buyout and venture capital strategies.

David believed rebalancing was an important risk management tool to ensure a faithful adherence to a policy portfolio. However, he saw rebalancing as a cost center, not the return enhancer many believe it to be.

> Investors hoping to profit in the short run from rebalancing trades face nearly certain long-run disappointment. Over long periods of time, portfolios allowed to drift with capital market returns tend to contain ever increasing allocations to risky assets, as higher returns cause riskier positions to crowd out other holdings. The fundamental purpose of rebalancing lies in controlling risk, not enhancing return.[21]

All followers of the Yale Model preach the importance of rebalancing. I suspect those who also understand David's rationale behind the activity will be better positioned to implement effectively without a goal of return enhancement.

What David Didn't Say

The well-followed gospel of Swensen changed the face of the investing world. Internalizing and implementing his approach, however, is as difficult as outperforming the markets.

I wish David was here to revise his work again. His revised edition includes valuable applications of his principles to market events in the decade after the original publication. The lessons he could have taught from the financial crisis and the fifteen years since would be worth their weight in gold. I would love to know what he thought about social media, artificial intelligence, ChatGPT, private credit, late-stage venture, and everything else new under the sun.

Sadly, we no longer can benefit from David's updated wisdom. Throughout *Pioneering Portfolio Management*, David alternately refers to those who follow his approach as "sensible investors", "serious investors", "careful investors", "thoughtful investors", and "effective investors."

Where can we find words of wisdom from practitioners who have demonstrated those adjectives over the test of time?

There are many who can fill that void, even among guests on the podcast. I'll suggest two who both learned at David's feet and have spent decades honing their adaptation of the model – Andy Golden and Seth Alexander. Andy, who will retire next year after thirty years at Princeton, shared his approach on an early Capital Allocators podcast. Seth, whose only two jobs have been at Yale and MIT, commemorated ten years and fifteen years at MIT and recently wrote an introduction to a chapter in the seventh edition of Graham and Dodd's Security Analysis. Each piece is a brilliant, personalized extension of David's first principles.

I drafted a follow-up blog reading into David's words to learn how he might have approached topical issues like inflation, hedge funds, and private credit. My dear friends, former colleagues

[21] Ibid, page 71.

at Yale, and thoughtful investors Casey Whalen and Paula Volent reviewed the draft and both warned me from making any attempt to channel David from above. They were exactly right; I’ll leave the game of telephone to you.