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MUTUAL FUNDS MONTHLY**Yale Manager Blasts Industry**

By **TOM LAURICELLA**
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Among individual investors, David Swensen isn't a household name. But he is an icon in the world of big institutional money managers such as endowments and pension funds.

Mr. Swensen's fame comes from his oversight of Yale University's \$15 billion endowment fund, which, since he was hired 20 years ago, has returned an average of 16% a year, far outpacing the market and other funds run for universities. Before arriving, Mr. Swensen had never overseen an institutional portfolio, and he brought to the job an unconventional approach for dividing up the portfolio among different asset classes. He is now Yale's chief investment officer.

**David Swensen**

Five years ago, Mr. Swensen set out to write a book that would bring the lessons he learned to individual investors. Instead, he says he found that the option most accessible to individuals -- mutual funds -- often makes it impossible to beat the market. And even when they do find good managers, individuals end up shooting themselves in the foot, he says.

So while Yale relies on actively managed portfolios, Mr. Swensen says individuals should just stick to index funds, especially those run by not-for-profit companies. He also likes exchange-traded funds, which trade on exchanges like stocks, but says "buyer beware."

Excerpts from an interview with Mr. Swensen follow:

WSJ: You had hoped to give small investors a road map for beating the market based on Yale's approach to investing. What happened?


Mr. Swensen: I found when I started down that path that individuals just don't have the same set of investment opportunities available to them that we do here at Yale. In fact, the evidence showed me that the mutual-fund industry has completely failed to provide reasonable active-management returns to individuals.

WSJ: To say that it completely failed -- that's a pretty harsh statement to make.

Mr. Swensen: I think the evidence is there. The crux of the failure is with the for-profit management of funds for individuals. Mutual-fund managers have a fiduciary responsibility to investors. Obviously, if they are operating in a for-profit mode, they have a profit motive. When you put the profit motive up against fiduciary responsibility, that fiduciary responsibility loses and profits win.

WSJ: But the investment managers that Yale hires -- or any other institutional investor hires -- are out to make money.

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Mr. Swensen: But there it's a fair fight. In the context of Yale, you've got a sophisticated institutional investor on the one hand and a for-profit provider of investment services on the other hand. And we can go toe-to-toe and end up with a fair result. If you look at Yale's history over the last 20 years, we have excellent results in terms of active-management returns.

MUTUAL FUNDS MONTHLY

• [J.P. Morgan Aims at Broader Audience](#)¹

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Mutual-funds data for August:

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looks like.

The problem in the mutual-fund industry is that you've got a sophisticated provider of investment services on the one hand and, on the other, you have an unsophisticated consumer. That imbalance leads to behaviors that line the pockets of mutual-fund managers and at the expense of the individual investor.

WSJ: What is some of the evidence that you believe shows that mutual funds have failed small investors?

Mr. Swensen: The data I cite in the book was put together and analyzed by Rob Arnott (chairman of manager Research Affiliates LLC). He adjusts for survivorship bias, an incredibly important phenomenon. If you don't do that, you are going to get a false picture of what the world

WSJ: So if you look at the regular data on fund performance, you're not seeing the whole story?

Mr. Swensen: You're not seeing the losers that disappear. They could disappear because they go out of business or because cynical managers of mutual funds will take poorly performing funds and merge them into better-performing funds, and so the record of the poor performer disappears. The picture that you get if you just look at the survivors is dominated by the winners -- but of course investor dollars were invested with the losers that disappeared.

And if you look at the aggregate results of the mutual-fund industry on an after-fee, after-tax basis and adjust it for survivorship bias, the probability that you are going to end up with market-beating returns is de minimus. According to (Mr. Arnott's data), the 10-year after-tax shortfall for mutual funds is 4.5% per year relative to what you would have gotten if you had put your money in an index fund.

That doesn't even take into account the fees for advice ... which takes you from a de minimus probability to a virtual certainty that you will end up losing relative to the market.

WSJ: What keeps funds from living up to their promise?

Mr. Swensen: So many of the behaviors that lead to high-quality investment performance diminish (managers') profits. For example, size is the enemy of performance. If you limit assets under management, you have a much better chance of beating the market. But asset gathering improves profits. So what happens? Almost invariably, managers are out there gathering assets, trying to increase profits, and it comes at the expense of generating investment returns.

Concentration is another important factor in generating high levels of incremental returns. We have managers in Yale's portfolio that will hold three or four or five stocks, or maybe eight or 10 stocks. You have to have an enormous amount of conviction, and you have to really believe that you have got an edge to make those kinds of concentrated bets. But it's not sensible for a mutual fund to do that from a business perspective because the volatility of the results relative to the market will be way too great, and the manager of the mutual fund will likely not be able to amass the same level of assets they would if they pursued a much more diversified strategy.

It also doesn't scale. If you are trying to run a concentrated portfolio and have a huge amount of assets under management, you just can't do it. One of the best managers out there has had as few as three securities and never

more than 10. If you're Fidelity Magellan, with \$50 billion or \$60 billion, there's no way you can just put three stocks in the portfolio.

As we're going down the laundry list of reasons why mutual funds fail, you have to talk about the turnover in the portfolios. A very significant portion of assets in mutual funds are taxable, and the overwhelming majority of mutual-fund assets appear to be managed with complete indifference to the tax consequences. It's probably not criminal, but it should be.

WSJ: But there are portfolio managers who practice a very low-turnover, high-conviction style of managing mutual funds.

Mr. Swensen: Southeastern Asset Management (manager of Longleaf Partners Funds) is one, and there are probably a handful of others. But that brings us to the second set of problems, which has to do with the way that individuals behave.

I looked at the results of three years before and three years after the technology-stock bubble. If you looked at the stated investment returns, they went up for three years and went down for three years. So the results over the six-year period were basically zero -- no harm, no foul.

Then you look at the cash flows. Because people chased performance, the overwhelming fund flows occurred in '99 and 2000. So individuals bought in right at the top and ended up suffering in the downturn. There was massive wealth destruction.

Even though Southeastern does a wonderful job of managing ... they suffered substantial withdrawals in '99 and 2000 because investors were disenchanted with the low turnover, concentrated, steady-as-she-goes strategy.

WSJ: You have issue with fees charges by funds as well.

Mr. Swensen: Not only the investment-management fees but the 12b-1 fees, which are completely at odds with investor interests. You are out there charging fees for marketing and distribution, and so you are charging the investor for adding assets under management -- which ultimately hurts the investor's prospective returns. It's a very sweet deal for the mutual-fund industry, and it's terrible for the investor.

WSJ: The fund industry says without these fees, it couldn't attract investors.

Mr. Swensen: That was the argument when the SEC allowed them quite a number of years ago. I thought it was a specious argument and viewed it without merit then, and it certainly doesn't have merit now.

WSJ: Some of these fees go to compensate financial advisers. Those folks are providing a service, so don't they need to be paid?

Mr. Swensen: The amount that people pay for financial advice relative to the quality of what they get is totally out of whack.

WSJ: For individuals, given the way the fund industry operates, you argue that they should be focusing on the not-for-profit companies and index funds such as Vanguard Group and TIAA-CREF. (Mr. Swensen is on the board of TIAA, but isn't directly responsible for mutual funds, which fall under CREF.) What does that get you?

Mr. Swensen: Well it doesn't give you much to talk about at cocktail parties! It gets you a well-diversified equity-oriented portfolio that ought to be good for all seasons.

WSJ: When it comes to diversifying a portfolio, you have somewhat unconventional asset-allocation

recommendations.

Mr. Swensen: When I arrived here 20 years ago, we had a pretty typical institutional portfolio, maybe two-thirds in domestic stocks and another big chunk in domestic bonds and a smattering of alternatives. And if you apply the principle of diversification and the notion of the equity orientation to these portfolios...they fail the test of diversification because there is a huge chunk in domestic equities, and they generally fail the test of equity orientation because there is too much in fixed income and cash. Currently at Yale, we've got a half a dozen asset classes with weights ranging between 5% and 25%. And I identify a half dozen asset classes that individuals ought to have in their portfolio. Traditional bonds, inflation-indexed bonds, domestic equities, foreign-developed equities, emerging-market equities and real-estate securities.

WSJ: You argue investors should have just 30% in domestic stocks. But most people think 'I'm a super-long-term investor, so I'm going to be loaded to the gills with domestic stocks or just stocks.'

Mr. Swensen: There are lots of ways you can produce equity-like returns without exposure to domestic stocks. So the foreign equities and foreign emerging equities and the real-estate positions ought to produce returns that are not dissimilar from those of U.S. stocks over reasonably long periods of time. It's important to point out that one size doesn't fit all and individual circumstance could lead an individual to hold a portfolio that would differ from the one that we're talking about right here.

WSJ: If you like index funds, where do exchange-traded funds fit in?

Mr. Swensen: To the extent that ETFs are focused on index management -- with the provision that the indexes are well-structured indexes -- I think they are absolutely great. It's another low-cost, even more tax-sensitive investment that people can use to implement a sensible asset allocation. But as they have grown in popularity, the waters have been polluted by a variety of ETFs that have essentially active-management components and poor fee structures. So it's a circumstance where buyers need to beware.

WSJ: Most average investors think an index is an index. What should they be on the lookout for?

Mr. Swensen: The S&P 500 is a well-structured index because it has relative low turnover and the low turnover leads to reasonable tax characteristics. But the Russell 2000, which consists of stocks ranked by market capitalization...as defined once a year, has ridiculous characteristics. The turnover is extraordinarily high. In a market that you expect will rise over time, it will have very poor tax consequences. It's very widespread and used a lot but ridiculously, poorly constructed.

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