Q Group
The Breakers
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The Best Way to Invest For the Long-Term?

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Reading:

Recent news articles related to the Harvard and Yale endowments

Discussion Questions

With the recent departures of key investment personnel and the arrival of its new CEO, Harvard Management Company needs to rethink from scratch how the endowment should be invested and managed. Please come prepared to discuss the following issues:

1. What is the best way today to invest a long-term pool of assets?

2. What is the best approach to making asset allocation and manager selection decisions?

3. How should Harvard think about internal versus external management? About Performance measurement? About the compensation of investment professionals?

4. What strategies are likely to perform best over the <u>next</u> twenty years?

Harvard portfolio managers' pay drops
By Robert Weisman, The Boston Globe, 22 December 2005

Dec. 22--Harvard Management Co., which invests the university's giant $25.9 billion endowment, paid its top six investment professionals a total of $56.8 million for the year ending June 30, a 27.6 percent drop from the $78.4 million earned by the group in the prior year.

The smaller payouts reflected a slightly lower endowment return in the university's fiscal year 2005, and the holding back of portions of departing executives' bonuses that were based on incentives for future performance, said James F. Rothenberg, the treasurer of Harvard University and chairman of the Harvard Manage-ment board.

Harvard's top-paid money managers again were David R. Mittleman and Maurice Samuels. Mittleman pulled in salary and benefits of $18 million for fiscal 2005, down from $25.4 million a year earlier, while Samuels pocketed $16.9 million, down from $25.3 million.

It was the final year at the endowment for five of the six executives who, led by former Harvard Management president Jack Meyer, left in September to form Convexity Capital, a private hedge fund that will manage up to $500 million of Harvard's assets. Meyer's paycheck was $6 million last year, down from $7.2 million a year before.

Harvard's endowment earned a return of 19.2 percent for fiscal 2005, higher than the 15.8 percent median return of the nation's 25 largest university endowments, but less than the 21 percent return for Harvard's endowment in 2004. "Last year's performance was impressive, and we're pleased with it," said Al Powell, a Harvard spokesman who noted that the endowment's return fluctuates from year to year.

Compensation for Harvard's endowment managers includes a base salary and performance bonuses based on measurements for the asset class they manage. The payouts have been a lightning rod for critics, including some Harvard alumni who have objected to money managers' earning more than the university's president and faculty members at a time when student tuition has been rising rapidly.

"This is inappropriate, unnecessary, and contrary to the values of a great university," Virginia author and playwright William Strauss, a member of the class of 1969, said yesterday, calling on the university to freeze tuition and forgive student loans. "There are many people who do outstanding work for Harvard -- people who head academic departments, people who work to find the cure for diseases, people who have won Nobel prizes. These people don't require the kind of bonuses and inducements given to Harvard's money managers."

Rothenberg, however, said Harvard would have had to pay more if it had turned over investment of its endowment to outside money managers who produced the same stellar results as Meyer and his team. "They did provide very good results over a long period of time, and all those benefits accrue to the university and to financial aid," he said.

Thirty-three employees of Harvard Management left to form Convexity. Harvard Management, which now has about 130 employees, manages about half of the university's endowment, while the other half is overseen by Harvard Management but managed by outside investment firms. The university in October tapped Mohamed El-Erian, a managing director of California's Pacific Investment Management Co., to replace Meyer. Rothenberg would not disclose El-Erian's base salary, but he said the performance-based compensation formula used for Meyer wouldn't change for the new Harvard Management president.

In addition to Meyer, Mittleman, and Samuels, the endowment paid $5.9 million to Andy Wiltshire, $5.4 million to Shawn Martin, and $4.6 million to Matt Early for their work in fiscal 2005. Mittleman, Martin, and Early managed Harvard investments in domestic bonds, Samuels in foreign bonds, and Wiltshire in timber, while Meyer had oversight for the entire fund. Wiltshire is the only one of the highest compensated executives who is remaining with Harvard Management.

El-Erian steps into Meyer's big shoes
10 November 2005, Institutional Investor - International

At first blush, Mohamed el-Erian may seem an unlikely choice to replace the famed Jack Meyer as Harvard University's investments chief. After all, el-Erian is a fixed-income specialist who has spent the past six years running $28 billion in emerging-markets portfolios at bond fund giant Pimco. Harvard Management Co., which oversees the university's $25.9 billion endowment, prides itself on its groundbreaking asset-class diversification.

El-Erian's investing experience may be narrower than Meyer's, but his track record has been astounding. During his tenure as portfolio manager, Pimco's flagship, $2.9 billion Emerging Markets Bond Fund delivered an annualized net return of 20.1 percent. The composite performance of Pimco's emerging-markets funds was 19.8 percent per year on average. Harvard hopes el-Erian, 47, will be able to generate similar numbers for its portfolio, which has realized a 16.1 percent annualized net return over the past decade under Meyer.

"I'm so aware of the responsibility," says el-Erian, who plans to move from Newport Beach, California, to Cambridge, Massachusetts, with his wife, two-year-old daughter and pet boxer sometime in the next few months. (He'll be transitioning into his new job, with Meyer retaining some responsibilities as a subadviser, over the next three to six months.) "I know what a 1 percent difference in the endowment return makes in terms of the Harvard community's ability to maintain its excellence."

Beating the market isn't the only challenge el-Erian faces. The new president and CEO will also have to withstand intense scrutiny of HMC's compensation structure, which, when salaries and bonuses are revealed every spring, inevitably results in a fusillade of criticism from Harvard alumni offended by HMC's multimillion-dollar payouts to top-producing portfolio managers. Meyer, who earned $7.2 million in fiscal 2004, admitted last winter that he was looking forward to leaving those arguments behind after returning to the private sector. This month he's launching a hedge fund firm, Convexity Capital Management.

El-Erian harbors no illusions about the political aspects of his new job. "I'm used to living in a world where I have such scrutiny," he says. "Pimco is such a large player in emerging-market bonds that everything we do -- and even many things that we don't do -- attracts attention. I recognize that this is part of the job at Harvard, and I'm going in with my eyes wide open."

Beyond his expertise with emerging markets, el-Erian -- who has an undergraduate degree from Cambridge and a master's and a Ph.D. in economics from Oxford -- also brings considerable management skills to his new role. Before joining Pimco he spent 15 years as an economist and senior personnel manager for the International Monetary Fund, with responsibility for a staff of 90. That experience should come in handy at HMC, which has bled talent in recent years as top officials have left to start hedge funds.

Punishing Success At Harvard
By JOSEPH NOCERA, 22 October 2005, The New York Times

THERE is a story -- apocryphal, I suspect -- that Boston-area hedge fund types like to tell about Jack R. Meyer's predecessor as head of the Harvard Management Company.

Harvard Management exists to do one thing: manage Harvard's assets. The head of the company in the 1970's and 1980's was a bearish sort who never warmed up to the bull market that began in August 1982. In late 1989, the story goes, Harvard's president, Derek Bok, began scribbling on a yellow notepad during a Harvard Management board meeting. When he was done, he ripped the sheet of paper out of his notepad, put it down in front of the man, and walked out of the room. It was the man's resignation letter.

What brings the story to mind, of course, was the news late last week that Harvard had named a successor to Mr. Meyer. During Mr. Meyer's storied 15-year tenure, Harvard's assets increased from $4.7 billion to $26 billion, with about $22 billion of that its endowment -- making it the largest university endowment in the country. Posting average annual returns of almost 16 percent, Mr. Meyer consistently outperformed not only the market, but virtually every other institutional money manager in the country, with the sole exception of David Swensen, who runs Yale's endowment. Within the world of institutional investors, Mr. Meyer is a legend.

So it's not as if the current Harvard president, Lawrence H. Summers, was scribbling out Mr. Meyer's resignation letter. "Jack Meyer did a great job for Harvard," Mr. Summers said the other day. Although Mr. Meyer declined to comment for this column, he has told friends that he was leaving of his own volition; he plans to start -- what else? -- a hedge fund with two Harvard Management fixed-income managers who departed with him.

And yet to talk to people in both the Harvard and the Meyer camps, you come away with the feeling that Harvard is not all that terribly sorry to see him go -- and that Mr. Meyer had come to feel that, if he wasn't exactly being pushed out the door, he was certainly not getting the deference or leeway he was used to. At a minimum, his successor, Mohamed A. El-Erian, an emerging markets specialist from the bond powerhouse Pimco, has his work cut out for him repairing the damage that has been done by the quiet rift between a great investor and a great university.

THERE are two models for managing endowment money: the Harvard way, and the way everybody else does it. Although virtually all endowments believe in the virtues of asset allocation, most search for talented outside fund managers who specialize in different asset classes, hedge funds very much included, and give them a small portion of the endowment to manage.

Harvard, by contrast, has historically managed its money itself. Especially in the 1990's, Harvard Management under Mr. Meyer had the feel of a big-time hedge fund, with a handful of its own talented fund managers who knew all of Wall Street's tricks. They employed complex derivative strategies, sold stocks short, searched for arbitrage opportunities, used leverage to bolster returns, and so on. They were a tight-knit group who operated out of an office in downtown Boston, several miles from the Harvard campus. They saw themselves not as Harvard employees but as Harvard Management employees.

Except they were Harvard employees, which created a problem. As a nonprofit, Harvard is required by law to publicly identify its most highly paid employees each year. Invariably, Jack Meyer's fund managers were at the top of the list.

In 2003, for instance, Maurice Samuels and David Mittleman, the two fund managers who are departing with Mr. Meyer, made $35.1 million and $34.1 million, respectively. (Mr. Meyer was paid in the millions as well, but not nearly as much as his top performers.) This in turn created an annual firestorm, led by a small group of alumni from the class of 1969. Their leader, William Strauss, believes that it's unseemly for Harvard employees to make that kind of money. "This is a nonprofit university," he told me recently. "It's just inappropriate."

Just about everybody in hedge fund land takes exactly the opposite view and thinks that the criticism is the height of foolishness. They point out, for starters, that Mr. Meyer saves the university money. After all, outside hedge fund managers who turn in investment performances like that of Mr. Mittleman and Mr. Samuels make far more than $35 million.

In addition, the compensation system Mr. Meyer set up included an extraordinary provision. When a fund manager outperformed his benchmark, he received only a certain percentage of his bonus. The rest was carried forward. If the fund manager beat his benchmark the next year, he got the rest of his "carry forward." But if he underperformed, he would have to give part -- or all -- of it back.

"I think Jack's compensation system was right on," said Scott C. Malpass, who manages Notre Dame's endowment, which has its own stellar record. "The incentives were aligned." That's what fund managers at Harvard Management believed as well.

Over the last half-dozen years, two things happened that began to change Harvard Management. First, the old gang broke up, as many of Mr. Meyer's proteges left to open their own hedge funds. Instead of replacing them, Mr. Meyer put Harvard endowment money in their funds, in amounts that started at $500 million. In return, he got special breaks for Harvard Management.

As a result, today about half of Harvard's money is managed by outside fund managers, though, of course, they are exactly the same people who once managed it internally. But now, the newspapers don't report their compensation.

And the second change? That would be the arrival, in 2001, of Mr. Summers, the former Treasury secretary, as president of Harvard. One of the raps on Mr. Summers is that he always has to be the smartest guy in any room, tossing off questions he means to be provocative, but which often have the effect of alienating the people he's questioning.

And so, at Harvard Management board meetings, Mr. Summers began questioning Mr. Meyer about everything from the positions in the portfolio to its level of risk. In addition, Mr. Summers's old boss, the former Treasury secretary Robert E. Rubin, became a fellow of the Harvard Corporation -- the equivalent of a regent -- and he began asking Mr. Meyer even tougher questions. (Mr. Rubin did not return my phone call.) For Mr. Meyer, the questioning felt like meddling, even if it wasn't meant that way.

But here was the real blow. For the last year or so, Harvard Management has been using a different compensation system -- one that Mr. Summers strongly backed and the Harvard Management board approved. The carry-forward provision was eliminated. The compensation at the low end was raised. But at the high end, the pay for overachievers like Mr. Mittleman and Mr. Samuels was capped at somewhere between $20 million and $25 million.

It would be hard to imagine a more politically boneheaded move. On the one hand, a $20 million paycheck is still far too high to mollify the class of '69 critics. On the other hand, it was a crushing blow to the fund managers still left, who felt that Mr. Summers was running roughshod over Mr. Meyer's incentive system. I don't believe that Mr. Summers imposed the new system as a means of getting rid of Mr. Meyer -- he simply thought it made more sense for a university endowment -- but that was the inevitable result. Mr. Meyer must have thought: who needs the hassle?

So where does that leave Mr. El-Erian? He is replacing a legend with a performance record that will be nearly impossible to match. Much of the talent at Harvard Management is gone, and those who remain are demoralized. Although Mr. El-Erian is viewed as a brilliant bond guy, he has no experience dealing with hedge funds. Indeed, should he decide that the Harvard model no longer works, and wants to farm out more of the endowment, he will be starting from scratch. Unlike other universities, Harvard doesn't have the expertise to evaluate outside hedge fund managers -- except Mr. Meyer's former Harvard Management colleagues.

When I spoke to him late last week, Mr. El-Erian sounded both aware of the challenges he faces, and undaunted. He insisted Harvard would continue to manage its own money. "A lot of hedge funds simply exploit inefficiencies," he told me. "If you can do that more cheaply on the inside, you should."

He liked the idea, he said, of connecting the management company more closely to the university, tapping into its brainpower for investing ideas and assistance. He noted that in the current difficult investing environment, returns were likely to be lower than they had been, that he would have to do a fair amount of "institutional rebuilding," and that he would be living, to some extent, in a "fishbowl." God bless him, he seemed pretty excited about the whole thing.

Bill Gross, the bond guru who has been Mr. El-Erian's boss at Pimco, told me that Mr. El-Erian was indefatigable, trustworthy, a great manager, a savvy investor and "very politically astute." From the looks of things, he's going to need all of those qualities.

THE MONEY GAME For years the Ivy League rivals have had dueling geniuses running their endowments. Now Yale's man is seeking the spotlight while Harvard's heads for the exit.
MARCIA VICKERS, 3 October 2005, Fortune

ON A HAZY AFTERNOON IN LATE August, two of the most successful moneymen of our age made their way among the steep bunkers and double-blind holes of the venerable Yale Golf Club. Their showdown wasn't much of a contest: Host David F. Swensen, who runs Yale University's $15 billion endowment, shot "somewhere in the 90s," he says. His longtime friend and rival Jack R. Meyer, manager of Harvard's $22 billion endowment, shot a 76. "Jack's a spectacular golfer," Swensen admits. "He crushed me."

When it comes to running money, though, Swensen and Meyer are much more closely matched. Swensen, 51, has managed Yale's endowment for two decades and built one of the most spectacular investment records on the planet--up 16.1% a year (while the S&P 500 index gained 12.3%). "Yale has the best returns of any endowment anywhere," he is quick to tell you. Meyer, 60, can't argue with that. Since he got the job at Harvard in 1990--thanks in part to a glowing recommendation from Swensen--he has trailed his Connecticut rival 15% annually to 15.5% (vs. 10.6% for the S&P 500, through June 30, 2004).

Meyer has a substantially bigger lead in pay, taking home $7 million last year to Swensen's $1 million. That big paycheck, though, is about to put an end to this remarkable rivalry-cum-buddy act. While reasonable enough by Wall Street standards, the pay doled out to Meyer and his top lieutenants has the university community up in arms--and Meyer heading for the exits. He will start his own hedge fund as soon as the university can find a new endowment chief. After years of neck-and-neck competition, Swensen may soon put Harvard in his rearview mirror.

THIS RIVALRY BETWEEN HARVARD and Yale matters not just because they are Harvard and Yale. That of course adds some spice--the nation's most prestigious universities, the oldest (Harvard) and third-oldest, combatants in a football rivalry that dates to 1875 (Yale leads the series 64 to 49, with eight ties). The fact that the two universities' endowments are the biggest is of some interest too. "An overwhelming part of what academia at the university level is about," says Bard College president Leon Botstein, "is managing its money." But the success that Swensen and Meyer have achieved, and even more important, the way they have achieved it, have given them both influence that goes far beyond their universities or even academia. It's not too much to say that Swensen at Yale and Meyer at Harvard have transformed the way endowments and pension funds invest. "Meyer and Swensen are both talented visionaries," says David Kabiller, a founding principal at AQR Capital Management in Greenwich, Conn. "They've carved out this space, and others are striving to replicate their success."

They did this not by riding the great stock and bond bull market of the 1980s and 1990s but by bucking it. Back when endowments and just about all other big pools of institutional money sported plain- vanilla portfolios of domestic stocks, bonds, and cash, they were the first to branch into different types of assets that don't move in sync with U.S. stocks. That strategy has delivered not just blowout returns but lower volatility. The proof came during the bear market that followed the crash of 2000. From July of that year through June 2003, while the S&P lost 33% of its value, Yale's endowment gained 20%, and Harvard's earned 9%.

For all that they have in common--and their current portfolios are remarkably similar (see chart on page 160)--Swensen and Meyer have achieved their results by very different methods. Meyer has run Harvard's money as a huge in-house hedge fund. That makes it hard to understand and even harder to emulate. Swensen, with a much smaller staff, has achieved his big gains in a way that at least superficially resembles what we all try to do: He picks really smart people to invest his money, outsourcing Yale's billions to some 100 different managers, including dozens of hedge funds. Twenty years ago hedge funds were a rarity, available only to wealthy individuals who traded investing tips at polo matches. Then David Swensen started putting Yale's ivy-covered money in them, and his success did not go unnoticed. Soon other institutions were knocking on hedge fund doors, hoping to capture some of the magic. An industry obligingly sprang up to service them. Now (as of January 2005) there are more than 8,000 hedge funds worldwide, according to the Hennessee Group, a New York City hedge fund advisory firm. The funds manage more than $1 trillion in assets--triple the figure of five years ago. And David Swensen is at least in part responsible for that.

For most of his career, Swensen was content to have his achievements celebrated only among Yale higher-ups and investing cognoscenti. His reputation among the latter group is remarkable: "Swensen is one of only a handful of investment geniuses on the planet," says Vanguard Group founder John Bogle. "Swensen is a true investment leader," says Burton Malkiel, a Princeton professor and former Yale dean and the author of A Random Walk Down Wall Street. "He was one of the first to realize illiquid investments could pay off." Even Meyer, who wouldn't comment about Harvard or his future for this story, is happy to praise Swensen: "David is the best in the business. He has an uncanny eye for investment talent, and he's not afraid to stray from convention. At the end of the day, if we're close to Yale, I'm generally a happy person."

The past few months have been something of a coming-out party for Swensen. After years of shunning what little press attention came his way, he now finds himself enjoying the limelight. He has a new book aimed at regular investors, Unconventional Success: A Fundamental Approach to Personal Investment. (One of his somewhat disheartening conclusions is that because so many mutual funds are high-fee, low-performance disasters, individuals are better off just buying index funds.) He's made the rounds of CNBC, the New York Times, and the Wall Street Journal to promote the book and has gotten gobs of other media attention. Swensen also recently was on the cover of the Yale Alumni Magazine, which dubbed him "Yale's $8 Billion Man"--the difference he has made for Yale over 20 years, vs. the 11.6% average annual return for all college and university endowments.

If Swensen had been working at a hedge fund for the past 20 years with the same assets and returns, he could now be worth around $1 billion. That led David "Tiger" Williams, who runs a trading operation for hedge funds and calls himself a "big Swensen fan," to ask Swensen at an alumni function in Manhattan last year, "What's the matter with you?" Swensen's answer: "A genetic defect."

On a recent morning Yale's endowment meister sits in his cozy, book-filled office with its antique roll-top desk and offers another explanation for his willingness to live with less than master-of- the-universe compensation. Looking more professor than portfolio pro in a crisp, yellow button-down shirt, khakis, and pristine loafers, he leans slightly back in his chair, relaxing his 6-foot-2 frame. "I once heard Goldman Sachs's Hank Paulsen give a speech listing five characteristics of Goldman and other great organizations," he recalls. "The last was having 'balance in your life.' I thought, that's a fallacy. I don't believe high achievers on Wall Street can have a balanced life." At Yale, he says, the story is different.

A divorced father of three who coaches his 11-year-old son's Little League team, Swensen grew up in an academic environment with a socially conscious twist in River Falls, Wis., which hosts a University of Wisconsin campus. His father and grandfather were chemistry professors, and his mother became a Lutheran minister after he and his five siblings were grown. In high school Swensen started a recycling project through a church group. People dropped off glass. Swensen smashed it and sent it to a plant. "Nobody was doing this stuff in the '60s," he says.

After getting an economics degree at the University of Wisconsin, Swensen headed east to Yale, where he was "exhilarated by the intellectual environment" and grew especially close to economics professor James Tobin. In Tobin's later years (he died in 2002), Swensen even shoveled his driveway and bought his Christmas trees for him. Among Tobin's many accomplishments were his contributions to portfolio theory. Building on ideas developed in the 1950s by Harry Markowitz at the University of Chicago, Tobin showed how spreading money over various asset classes that don't move in step with one another could lower risk and improve returns. In 1981, a year after Swensen got his doctorate, Tobin won the Nobel prize in economics.

Armed with his Ph.D., Swensen moved to Wall Street. At age 27 he earned a permanent place in Wall Street history by inventing the derivative instrument known as the swap. While working at Salomon Brothers, he spearheaded a deal that allowed IBM to reverse currency exposure on some foreign bonds by arranging to have the World Bank issue dollar-denominated bonds with matching terms. He proudly picks up the three- by three-inch Lucite tombstone sitting on his office shelf trumpeting the deal. "It was actually very simple," he deadpans.

WHILE SWENSEN'S WALL STREET career was flourishing, Yale's endowment was floundering. From 1970 through 1982 it earned a meager average of 6.5% a year. The university's buildings were ragged, and the surrounding city of New Haven seemed a Dickensian model of urban decay. The bull market that began in August 1982 provided a big boost, but Yale officials still believed they needed a fresh approach. In 1985, at the suggestion of Tobin and economics professor William Brainard, then Yale's provost, Yale offered Swensen the job of running the endowment.

At first Swensen, who had never managed money before, was overwhelmed. "I was dumbfounded about what to do," he recalls. Early on he hired Dean Takahashi, a pal from his grad school days, who remains his partner. He and Takahashi spent a year assessing the portfolio and considering different strategies. After a series of meetings with leading Yale investment thinkers, including Tobin, Malkiel, and finance professor Roger Ibbotson, Swensen decided to put portfolio theory to a real-world test. He started spreading Yale's money, three-quarters of which was in domestic stocks and bonds, over a wide array of investments that included buyout and turnaround funds and hard assets such as real estate, timber, and oil and gas. He also began putting money in hedge funds, a category he dubbed "absolute return." And he sharply deemphasized bonds and cash, which to him were sure ways of making below-market returns. While many of the investments he made would have been risky on their own, the combination turned out to work just as the theories predicted: Volatility went down, and returns went up. Says renowned pension consultant Charley Ellis, who as chairman of Yale's investment committee is the closest thing Swensen has to a boss: "David really got it!"

His success wasn't all a matter of science, however; gut instinct played a role. Swensen has an unusual knack for picking talented money managers. According to a 2003 study by Harvard economics professor Josh Lerner, "manager selection accounted for more than half the superior performance by Yale relative to the average endowment over the last five years."

How does he do it? "I'm interested in anyone who has an edge, regardless of the asset class," he says, "and a passion, bordering on obsession, for what they do." One telling sign: Swensen favors managers who invest a lot of their own money in their funds. And he is notoriously dogged when it comes to vetting his choices. Years ago he was interested in a manager named Glenn Greenberg, a Yale grad, who typically owns only five or so companies in his $4 billion fund, Chieftain Capital. So Swensen and his team called the heads of the companies Chieftain owned--Burlington Resources and Freddie Mac among them--and asked, "Who's your smartest institutional investor?" Unsolicited, each CEO mentioned Greenberg, recalls Swensen: "That's when we decided to approach him." Swensen has been one of Chieftain's biggest investors for over a decade. He has also long invested with Farallon Capital, Bain Capital, and Sutter Hill Ventures, among others.

Then there is the simple fact that the Yale name gives him his pick of the best managers anywhere. Yale economics professor Robert Shiller ponders if the "Yale effect"--the intense loyalty graduates have for the school--could be one reason for the endowment's stellar returns: "David has no shortage of top Yale graduates on Wall Street who really want to help. Their priorities are God, country, and Yale- -with Yale being first."

His clout within the financial world often helps Swensen to negotiate highly favorable terms not available to ordinary investors, according to Lerner. Low fees are essential, of course. But Swensen also occasionally demands that Yale's money be put in a separate account, reducing chances his performance will suffer from "hot money"--short-term investors who bail out the minute a fund loses steam. Swensen has also been known to request that certain funds--particularly in the private-equity arena--limit their assets at a specific amount. "David's not shy about requesting a cap," says Donald Gogel, head of Clayton, Dubilier & Rice, a New York City private-equity firm. More recently Swensen has been seeding small funds that focus almost entirely on Yale. "Being the 12th $20 million investor in a fund isn't going to impact our bottom line," says Swensen.

Then there's transparency: a must for Swensen. He once approached Eddie Lampert, the hugely successful investor and Yale grad. Swensen says he was impressed with Lampert's style--he typically holds fewer than ten companies at a time and takes an aggressive approach with their management. But there was one little catch: Swensen wanted Lampert to disclose the nooks and crannies of his portfolio. Lampert refused, causing a bit of a rift between the two. (Lampert declined to comment.)

Swensen also has a gift for dodging disasters. "David will sometimes meet with people who have stellar resumes and returns-- everything will seem perfect--yet he'll decide not to put money with them," says Ellis. "It's uncanny, but usually he's proven right in a couple of years." Swensen says he refused to take meetings with Long Term Capital Management because "the fee structure was greedy." He also dissed the Enron guys when they came calling.

Ironically, Yale's employee and student unions have faulted Swensen for not disclosing more details about the endowment's own holdings. Swensen says he understands the demands for more transparency but doesn't want to divulge the details of his strategy for competitive reasons. The unions have also complained that Swensen invests with firms run by some members of the Yale Corp. Investment Committee, including Joshua Bekenstein, managing director at Bain, and Henry McCance, chairman of Greylock Partners. Swensen says he follows Yale's strict code of ethics. And the unions are unhappy with Swensen's timberland investments in Idaho and Maine-- areas he's particularly focused on right now.

Despite those tensions, not to mention the amounts of money on the table, the atmosphere in Swensen's offices in a six-story brick building on Yale's neo-gothic campus has the feel of a graduate seminar. Around 20 professionals, mostly Yale alums, work there, vetting managers and debating new investment ideas. ("We usually have one or two Princetonians for diversification purposes," Swensen jokes.) It's a relatively relaxed, collegial atmosphere where people often end up staying for years. "David's people are very loyal to him," says Lerner. "They share a common language and have an incredible institutional memory. It accounts for part of the endowment's success."

LIKE HIS YALE BUDDY, JACK MEYER OF Harvard is often described in contradictory terms: self-effacing, genial, yet fiercely competitive. The small, wiry redhead also shares some of Swensen's unpretentious traits. He seldom wears a tie and takes the subway to work, according to the Boston Globe. But he presides over an operation that couldn't be more different from Yale's. With its rows of flat-panel monitors and mini televisions tuned to CNBC, the Harvard Management Co.'s trading floor, in the Boston Federal Reserve building, five miles from the Harvard campus, looks more like a Midtown Manhattan hedge fund than a college endowment. The 120 or so people who work there are masters of short-term trading, initiating as many as 250,000 transactions a year. Their bets have often focused on undervalued situations and arbitrage opportunities in global stock and bond markets.

"Yale's endowment has always been much more integrated into the life of the university," says Lerner. "For years Harvard has had a much more typical Wall Street approach. It's always been somewhat separate from the Harvard community." And some members of that community, at least, have never been comfortable with the money machine in their midst. The biggest complaint has been that Meyer and his team are paid too much. Meyer and his top six managers earned $78.4 million last year and $107.5 million in 2003. While their take would be nothing exceptional on Wall Street, it's Brobdingnagian by academic standards.

Over the past two years, people familiar with the situation say, Meyer has had to deal with a particularly knowledgeable and powerful critic: Harvard president Larry Summers, who wrote some influential papers in the 1980s on the workings of financial markets, then went on to jobs in the 1990s as World Bank chief economist and U.S. Treasury Secretary. He has voiced strong ideas about how HMC should be run. He's known to favor market-timing strategies (shifting the weighting of stocks and bonds depending on the market's direction) that Meyer has always shunned. Meyer, used to years of relative autonomy under former Harvard president Neil Rudenstine, "is fed up with Summers," says someone familiar with Meyer's thinking.

The public flap over Meyer's pay put Summers on the spot. He knows as well as anyone that Harvard could end up spending far more on outside money managers than it was paying Meyer and his crew. But for Harvard, a nonprofit institution, appearances can be more important than accounting.

While the dispute over pay has grabbed headlines in the national press, the complicated web of relationships Meyer has built up with former Harvard managers has attracted far less attention. In 1998, in the midst of the roaring bull market, Meyer became concerned that he wouldn't be able to keep the top-notch managers he'd worked so hard to recruit and cultivate, people close to HMC say. HMC went before the Harvard Corp., which oversees the endowment, and proposed that HMC be allowed to manage money for other universities so that Meyer and his staff could earn additional fees. The board, seeing a potential conflict, turned HMC down flat.

That refusal seemed to touch off an exodus of talent. Over the past seven years, Harvard managers have started at least five hedge funds, including Highfields Capital Management, launched by Jonathan Jacobson in 1998, and Regiment Capital, founded by Timothy Peterson, also in 1998. And of course Meyer himself is planning to launch a hedge fund, to be called Convexity Capital, after his departure. He plans to take four HMC executives with him, including bond stars David Mittelman and Maurice Samuels.

The managers who leave HMC don't go away empty-handed. Once they set up their funds, they often get a big chunk of Harvard money to run. Highfields received at least $500 million. And Adage, launched by Robert Atchinson and Phil Gross in 2001, got $4 billion--almost a quarter of the endowment's assets at that time. In most cases, the fees they pocket from Harvard and other clients are far greater than what they earned while on the university payroll.

But Harvard, too, has benefited from its cozy relationships with its former managers. For one thing, the university owns stakes in at least four of the offshoots. Documents show that the funds return a portion of the fees they earn from managing other institutions' money to HMC in "revenue sharing" agreements. In some cases the money HMC earned from those deals was enough to offset the management fees it was paying and create a profit. "You got the sense that HMC was clamoring for fees and more fees, which is inappropriate for a nonprofit academic institution," says William Strauss, one of a group of 11 members of Harvard's class of 1969 who have taken to publicly skewering HMC and Meyer.

In January the group of angry alums threatened Summers with "enormous opposition" if he hands Meyer and his team a hefty check as they walk out the door. They also want to bar Meyer and other former managers from running Harvard's money for at least five years. James Rothenberg, Harvard's treasurer, who is president of Los Angeles--based fund giant Capital Research & Management, responded that Harvard was "listening to all sides." But a source close to Summers' office says that Harvard will probably continue to invest with its former managers and Meyer after he leaves.

This hullabaloo couldn't come at a less opportune time: As Meyer exits, Summers will soon embark on a gargantuan fund-raising campaign. But big donors often shy away from controversy. "If there's any question over the effectiveness of the money management, that gives people a reason not to give," says Verne Sedlacek, president and CEO of the Commonfund, which manages money for universities and other nonprofits. Said Rothenberg in a recent interview with the Harvard Crimson: "It would be wrong to tell you that people aren't concerned."

Looking ahead, both Harvard and Yale face the same challenge. The hedge fund boom they helped create has shown signs of peaking. Now that everybody is investing in hedge funds, it's hard to see how they can keep trouncing the stock market. Yale finance professor William Goetzmann, who heads up a hedge fund research initiative at Yale, warns, "As hedge funds increasingly chase the same strategies, there are fewer anomalies to exploit." So managers will find it much harder to produce exceptional returns.

Yet Harvard is becoming more reliant on outsiders, especially hedge funds. At the end of 1997, it doled out just 15% to outside managers; that figure is now up to 50%, and when Meyer finally leaves, it will probably reach 80%. In other words, Harvard's endowment will look more like Yale's. Of course, Harvard hasn't built up anything like Swensen's years of expertise at picking outside managers and driving hard bargains with them. Meanwhile, the search for Meyer's replacement seems to be proceeding slowly; people in the investment community speculate that the pay brouhaha and the prospect of working for Summers may be discouraging top candidates. A Harvard spokesman says such talk is unfounded, but admits that the search "is challenging because it's such a visible position."

For his part, Swensen isn't concerned that hedge funds are losing their edge. "There are still opportunities for funds that are well positioned to take advantage of anomalies in the market," he says. Swensen, who continually rebalances his portfolio, is maintaining his hedge fund allocation but has added to his holdings of hard assets. In addition to his prized timberland, for example, he recently invested in an upscale boutique hotel and restaurant chain. Such investments now account for 25% of his portfolio, up from 18% last year.

On the dust jacket of Swensen's new book, a quote from Jack Meyer appears: "A masterful work by the master himself. We at Harvard wish that David Swensen would find a new job." Too bad for Harvard. David Swensen says he isn't budging.

HEADS OF THE CLASS

When universities are ranked by the size of their endowments, Harvard and Yale come out on top--and their returns lead the pack as well.

IN A LEAGUE OF THEIR OWN

Swensen and Meyer have been pioneers in diversification: spreading their money over a variety of asset classes that do not move in sync with one another. The resulting portfolios tend to be less volatile than simple stock-and-bond mixes and produce better returns.

Harvard -- Domestic equity 15% Foreign equity 15% Private equity 13% Fixed income 27% Real assets 23% Absolute return 12%

Yale -- Domestic equity 14% Foreign equity 14% Private equity 17% Fixed income 5% Real assets 25% Absolute return 25%

Data as of June 2005 for Yale and June 2004 for Harvard. Figures are target allocations; actual portfolio composition varies with market conditions. Harvard's total exceeds 100% because of leverage. Foreign equity includes emerging markets. For Harvard, fixed income includes inflation-indexed, high-yield, and foreign bonds. Real assets can include real estate and commodities.

HE'S YALE, YOU'RE NOT

Being chief of Yale's $15 billion endowment gives David Swensen an undeniable edge. He has a long time horizon and his pick of the nation's best money managers, and he can demand low fees and is free to invest in hedge funds, private equity firms, and real assets such as timber, golf courses, and luxury resorts. His advice for ordinary investors might be boiled down to "Don't try this at home." Since you don't have the Yale name behind you and billions to invest, what's your best strategy? Here are his tips:

-Diversify--hold U.S. and foreign stocks, inflation-indexed and other government bonds, and real estate.
-Avoid actively managed mutual funds, most of which "put profits before fiduciary duty."
-Buy low-cost index funds and exchange-traded funds.
-Avoid hedge funds and corporate bonds.
-Rebalance your portfolio at least once a year.
-Don't try to time the market or chase performance.

Meyer and his top six managers took home $78.4 million last year and $107.5 million in 2003."I'm interested in anyone who has an edge," says Swensen, "and a passion, bordering on obsession."