

A 45-Year Flood

The History of Alternative Asset Classes



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By Mark J. Higgins

OVER THE PAST SEVERAL DECADES, institutional investment plans have substantially increased allocations to alternative asset classes, such as private equity, hedge funds, private real estate and private credit. According to data collected by Equable, public pensions alone have increased alternative asset class allocations from a mere 9.3% in 2001 to 33.8% in 2023.

The thesis underpinning the shift into alternatives is that, despite much higher investment management fees and illiquidity, investors can anticipate sufficient offsetting benefits in the form of reduced portfolio volatility and return enhancement. The problem, however, is that multiple studies reveal that these benefits have

The individuals in this photograph are known as the "traitorous eight." Pictured from left to right are: Gordon Moore, C. Sheldon Roberts, Eugene Kleiner, Robert Noyce, Victor Grinich, Julius Blank, Jean Hoerni and Jay Last. After leaving Fairchild Semiconductor in 1957, they played critical roles in the rise of Silicon Valley and the venture capital industry.

fallen short of expectations. Moreover, the fundamental dynamic of the alternative asset class investment cycle strongly suggests that future benefits will become even more elusive. Understanding the history of these investments helps explain why this is the case.

Institutional Plans End America's Capital Drought

"We cannot depend safely for an indefinite period of time on the expansion of our big old industries alone... We need to marry some small part of our enormous fiduciary resources to the new ideas which are seeking support."

**—Ralph Flanders, president
of the Federal Reserve
Bank of Boston (1945)**

In the spring of 1979, Ian Lanoff, administrator of pension and welfare programs at the US Department of Labor (DoL), was summoned to the White House. He

later recalled that it was the only such invitation he received during his five-year tenure. When Lanoff entered the meeting, he noted the presence of several well-known politicians and financial executives. Their singular goal was to end the capital drought that constrained funding for many of the nation's most promising entrepreneurial ventures.

The root of the capital shortfall can be traced to the Allied victory in World War II. The demands of war accelerated technological innovation in the United States. Once combat operations ceased in the summer of 1945, American companies saw an opportunity to commercialize many inventions. But the biggest obstacle was obtaining capital. Commercial banks, which remained scarred by the Great Depression, considered such ventures too risky. This prompted the formation of the nation's first venture capital (VC) firms to fill the void.

Initially, wealthy individuals were the primary sources of funding for VCs, but by the late 1970s, their resources were stretched thin. In contrast, institutional investment plans, such as pension funds, foundations and endowments, had an

A Fatal Flaw of America's First VC Firm

“If one of our companies is suddenly in need of \$25,000, we can do nothing about it. We have to go to our lawyers...and it may be sixty days or more before we get an answer. By that time a small company, as you know, can become very, very dead.”

**—Georges Doriot, co-founder of ARD
(letter to Ralph H. Demmler, chairman of the SEC)**

In 1946, a group of leading academics, financiers and industrialists founded Advanced Research and Development (ARD), which was the first private venture capital (VC) firm in the United States. Under Georges Doriot's leadership, ARD blazed the path for the emerging profession. But unlike modern VCs, ARD was structured as a closed-end investment company and was thus subjected to SEC regulation.

ARD's structure ultimately proved untenable because SEC regulations failed to accommodate many fundamental aspects of venture investing. Examples included limits on incentive compensation for fund employees and caps on ARD's permissible ownership percentage in portfolio companies. Doriot battled constantly with the SEC to obtain waivers, but ultimately, the investment company structure was unworkable. Textron Corporation acquired ARD in 1972, and its influence waned.

Despite ARD's demise, Doriot proved the viability of VC investing, and several of his proteges launched firms of their own. But having witnessed ARD's struggles with the SEC, they structured their funds as limited partnerships. This provided the flexibility they needed to fund early-stage ventures, several of which would become the largest corporations in the United States.

abundance of capital. The only problem was that most trustees refused to invest in VCs because they feared that it violated the DoL's interpretation of the Prudent Man Rule under the Employee Retirement and Income Security Act (ERISA) of 1974. The law stated that trustees must discharge their duties “by diversifying the investors of the plan so as to minimize the risk of large losses.” Most trustees interpreted “the risk of large losses” as an implicit ban on VC funds, which invariably invested in many companies that were likely to produce large losses. Fear of ERISA violations forced trustees to stick with traditional funds that invested in high-quality bonds and stocks. Trustees of non-ERISA plans, such as public pensions, adopted similar

policies out of an abundance of caution. This starved VCs of desperately needed capital throughout the 1970s.

Under pressure from its membership, the National Venture Capital Association (NVCA) lobbied Congress to help end the capital drought. These efforts paid off, and on June 21, 1979, Lanoff announced a shift in the DoL's interpretation of the Prudent Man Rule, stating, “Although securities issued by a small or new company may be a riskier investment than securities issued by a blue-chip company, such an investment may be entirely proper under ERISA's prudence rule.”

No longer impeded by ERISA, trustees opened the spigots for VC funds. For the three-year period ending in 1977, VCs

raised a mere \$60.4 million. Over the next three-year period, they raised nearly \$800 million. But VCs were not the sole beneficiaries of the new DoL guidance. The limited partnership model that VCs embraced was soon replicated by former investment bankers to form the first buyout funds. Thus began a 45-year flood of capital into areas of the market that are collectively referred to as alternative asset classes.

Beautiful Decade for a Leveraged Buyout

“I am not a destroyer of companies. I am a liberator of them. The point is, ladies and gentlemen, that greed, for lack of a better word, is good.”

**—Gordon Gekko
in Wall Street (1987)**

In 1982, Federal Reserve Chairman Paul Volcker's legendary monetary tightening campaign ended the grueling, 17-year period known as the Great Inflation. The return of price stability also created a once-in-a-lifetime opportunity for another alternative asset class. Investors referred to these funds as leveraged buyout (LBO) funds, buyout funds or sometimes simply private equity funds.

The objective of a buyout fund was simple. Fund managers purchased companies using mostly debt and a small amount of equity. Then, they aggressively repaid the debt by selling non-strategic business units, eliminating extraneous costs and improving strategy and operations. After a few years, the fund would sell its entire position—often for a much higher multiple than the one applied at the time of purchase. The first buyout funds emerged in the late 1970s and 1980s and included firms such as Forstmann Little, Kohlberg Kravis Roberts (KKR) and Thomas H. Lee Partners.

Conditions in the 1980s were ideal for buyouts. First, the cost of debt steadily declined throughout the decade due to Volcker's victory over inflation. Second, price/earnings ratios of publicly traded firms increased, as lower inflation reduced the required return for equity investors. Finally, many companies were laden with inefficiencies due to the habitual practice of overdiversifying throughout the 1960s and 1970s. In combination, these factors provided buyout funds with an extraordinary

opportunity to generate exceptional returns.

With gale force winds at their backs, buyout funds produced gargantuan returns in the 1980s. For example, in 1983, KKR claimed to be generating an average annual return of 62.7% on its investments. But, as is always the case, exceptional returns attract a stampede of followers. By the 1990s, private equity firms were inundated with far more capital than they could deploy responsibly. Ted Forstmann, who was one of the more disciplined buyout managers, lamented the consequences, stating, “In the beginning, the innovators of this idea, of whom I was one, had a great deal of discipline... What has happened is imitators flocked in, discipline has eroded, and as a result, breakups that didn’t make sense have occurred.”

Forstmann didn’t have a name for it, but he was observing the late phase of a typical, alternative investment cycle.

New Haven for Unconventional Investing

“By operating in the institutional mainstream of short-horizon, uncontroversial opportunities, committee members and staff ensure unspectacular results.”

*—David Swensen, late CIO
of the Yale Investments Office*

In 1985, James Tobin and William Brainard approached David Swensen with an unsolicited offer to return to Yale

University to oversee its endowment. At the time, Swensen was a rising star at Lehman Brothers, where he established a reputation as an innovative financier. He initially hesitated to accept Yale’s offer, as he feared he lacked the necessary experience. But his love of Yale, deep sense of mission and natural talent for teaching outweighed his concerns.

Soon after returning to New Haven, Swensen invited his friend and fellow alum, Dean Takahashi, to join him. At the time, Yale’s portfolio was invested primarily in publicly traded stocks, bonds and cash. Swensen and Takahashi believed the allocation was suboptimal considering Yale’s long-term return objectives, higher-than-average risk tolerance and limited liquidity constraints. They crafted a new,

The Return of the Stock Operators

“We may as well tell the truth and put the blame where it belongs.

It’s up to Washington now. We have stepped aside... Eventually we will take control again.”

—William C. Durant (October 1929)

The stock operators who dominated Wall Street prior to the 1930s wielded a formidable weapon known as the stock pool. Under a pool arrangement, a group of investors consolidated their financial resources. Then, they appointed a pool manager who would use all sorts of nefarious techniques to manipulate the price of a stock to their benefit. But the stock pool disappeared after it was outlawed by the Securities Exchange Act of 1934.

William Durant, the famed stock operator, foresaw this outcome soon after the Great Crash of 1929, but he predicted that someday the stock operators would resurrect the stock pool. In 1992, his prophecy came true when the flawed mechanics of the European Union (EU)’s exchange rate mechanism (ERM) created a legal application of this forgotten market manipulation technique.

The ERM was intended to keep EU member currencies trading within a narrow band, but maintaining the band required periodic central bank intervention. In 1992, the pound sterling depreciated too far relative to the German mark. The Bank of England (BoE) purchased pounds aggressively to prop up its value. Observing the BoE’s efforts, co-founders of the Quantum Fund, George Soros and Stanley Druckenmiller, calculated that

the BoE lacked sufficient foreign exchange reserves to remain in the ERM. If the BoE failed, they would abandon the ERM, which would cause the pound sterling to depreciate sharply.

Soros and Druckenmiller knew that shorting the pound promised enormous profits, but it required selling pressure that was beyond their ability. They addressed this problem by sharing the plan with several hedge fund managers, and the group formed a virtual stock pool to short the pound. As predicted, massive selling pressure forced the BoE to abandon the ERM. After covering their short position, the Quantum Fund alone made a \$1.5 billion.

Wall Streeters were awed by the profits but were even more excited about the return of the stock pool. The “Breaking of the Bank of England” triggered rapid growth of hedge fund assets under management (AuM). In 1990, hedge fund AuM was less than \$10 billion. By 2000, it exceeded \$250 billion. But unlike buyout and VC funds, hedge fund growth was driven primarily by a fleeting opportunity. The resurrection of the stock pool was an anomaly that was not expected to last. Nevertheless, once the stock operators regained a foothold, they refused to yield. In 2024, hedge funds hold more than \$5 trillion of AuM.

The Neglected Cost Discipline of the Prudent Investor

“A trustee may only incur costs that are appropriate and reasonable in relation to the assets, the purposes of the trust, and the skills of the trustee... Wasting beneficiaries’ money is imprudent.”

—Uniform Prudent Investor Act (UPIA)

In 1994, the National Conference of Commissioners on Uniform State Laws approved the Uniform Prudent Investor Act (UPIA) and recommended enactment by the states. By December 31, 2023, nearly 50 states had codified the UPIA into law.

A key component of the UPIA is the application of the Prudent Investor Rule. Most trustees embrace the diversification principles implicit in the UPIA’s interpretation of the Prudent Investor Rule, but few appreciate the cost principles. Yet, as revealed in the above quote, cost management is a critical responsibility that is clearly articulated in the UPIA.

Evaluating costs is especially important for trustees who enter the opaque and expensive realm of alternative investments. Fees in these asset classes far exceed those charged by actively managed funds in traditional asset classes, much less low-cost index funds. For example, VC and private equity funds routinely collect a 2% management fee and 20% of profits above a specified return hurdle. Over the life of such funds, fees can easily exceed more than 3% per year.

For nearly 30 years, few trustees have questioned whether the benefits of alternative investments are worth the incrementally higher costs—even as mounting evidence consistently reveals they are not. For example, in June 2024, the Boston College Center for Retirement Research published a paper that cited four studies, all of which concluded that the average public pension plan substantially underperformed a passively managed portfolio with comparable exposures.

unconventional strategy that included a heavy equity bias, highly selective use of active managers and larger allocations to VC and buyouts.

The strategic shift was innovative and extremely well-executed, but it also benefitted from fortuitous timing. Swensen and Takahashi were early allocators to VC and buyouts, and they also benefitted from a shift to higher equity exposure at the front-end of an extended bull market. Luck does not diminish their

overall achievements—the Yale team has also consistently selected high-performing active managers—but it amplified their performance advantage.

Consultants Open the Floodgates

Yale’s unconventional strategy was highly successful. For the 13-year period ending June 30, 2000, the Yale endowment returned approximately 15.7% per year versus approximately 11.6% for the median endowment.

Performance like this was impossible to hide. In 1997, Professor Josh Lerner published a Harvard Business School case study profiling Yale’s strategy. Three years later, Swensen shared even more detail in his seminal book, *Pioneering Portfolio Management*.

Tragically, most investment plan trustees—and especially the investment consultants who advise them—misinterpreted Swensen’s advice. They concluded that blunt allocations to VC, buyouts and hedge funds were the sole driver of Yale’s performance. Few appreciated that it was the rare strength and stability of the people making the decisions that constituted the true secret of their success.

Over the subsequent 25 years, endowments, foundations and public pension plans substantially increased allocations to alternative asset classes. Nearly all were oblivious to the fact that the flood of capital all but guaranteed subpar returns for most investors.

The Alternative Asset Class Cycle is Revealed

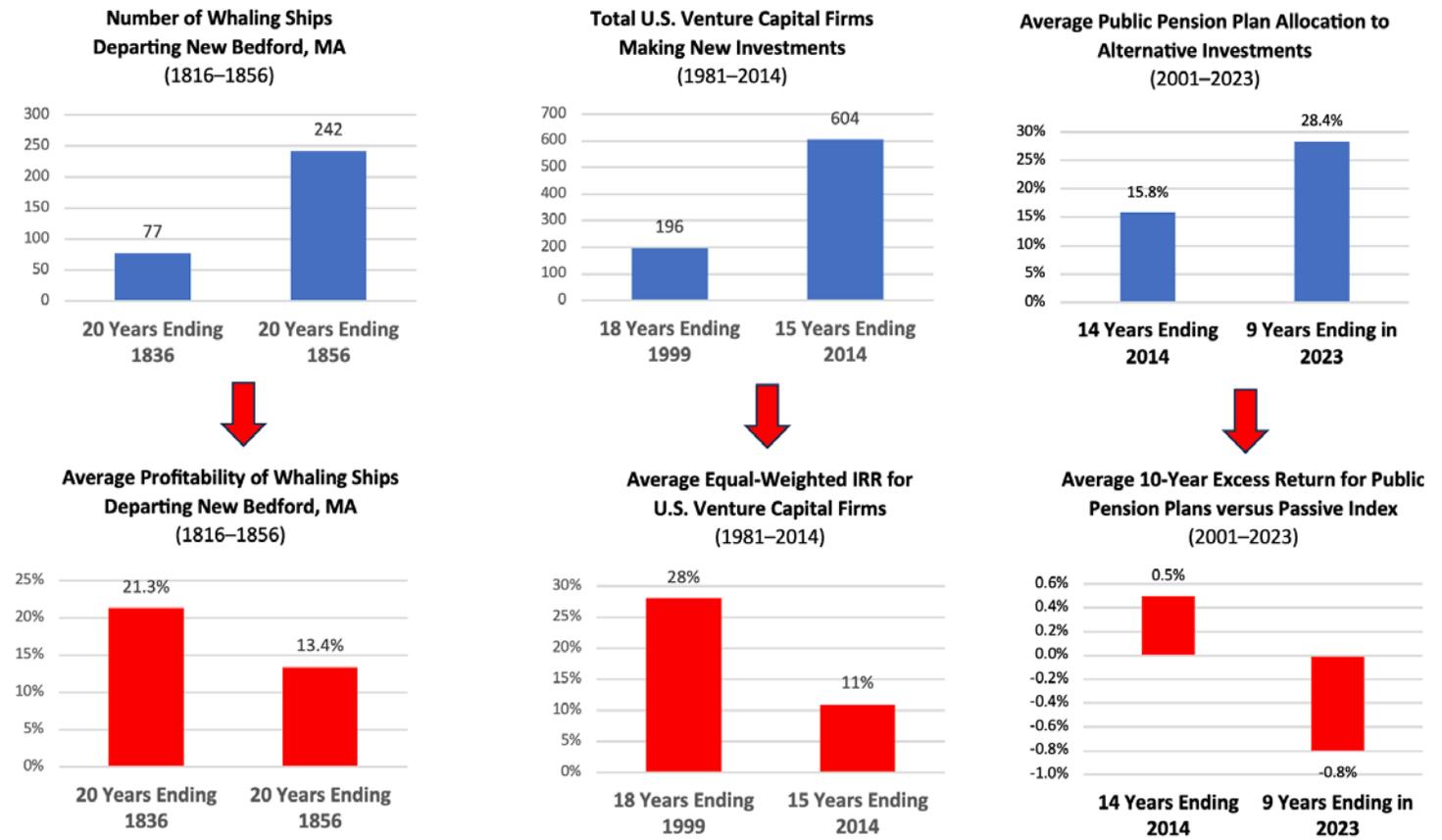
“Until 1858, every year saw an increase in the number of ships devoted to whaling; but the great numbers of whale hunters had done in the sea something very like that which other hunters afterward perpetuated on land. The herds of whales had been decimated.”

—Boyden Sparkes and Samuel Taylor Moore (1930)

The passage of 45 years has revealed the fundamental dynamics of the alternative investment cycle. It begins with the opening of a temporary void in capital markets. For example, the demand for startup capital after World War II prompted the formation of the VC industry and the end of the Great Inflation triggered the rise of buyouts. When these voids appear, capital providers have a real, but temporary, opportunity to generate above average returns because demand for capital far exceeds supply. But the supply/demand imbalance eventually reverses with the passage of time.

The next phase begins after peers witness the returns of early adopters and

FIGURE 1: Dynamics of the Alternative Asset Class Cycle for Whaling, VC and Public Pension Plans



Note: The 10-year average excess return versus a passive index for public pensions for the 14 years ending in 2014 includes five data points for the 10-year periods ending in 2010–2014.

Sources: Equable (2024); Aubry, Jean-Pierre and Yimeng Yin. 2024. “How Do Public Pension Plan Returns Compare to Simple Index Investing?” Issue in Brief 24-13. Chestnut Hill, MA: Center for Retirement Research at Boston College; Mark Higgins. “A Whale of a Tale: The History of Venture Investing in the United States.” *Financial History*, Fall 2023.

flood the asset class with capital. Within a few years, the supply of capital exceeds demand, which compresses future returns. But unlike the ebb and flow of publicly traded equity valuations, alternative asset classes become trapped in the late phase for many years. It may take several decades for allocators to appreciate that the supply and demand imbalance renders all but the most talented managers unable to produce returns that justify the corresponding fees, risk and illiquidity. Figure 1 shows the impact of the alternative asset class cycle on modern VC investors and 19th century whaling investors. It also shows how it has played out with 21st century public pension plan investors in multiple alternative asset classes.

A tell-tale sign that an alternative asset class cycle has entered the late phase

is when fund managers shift their sales pitches from “excess return” to “diversification.” This happened for buyout funds and hedge funds by the end of the 20th century, and it is now happening with the latest investment fad: private credit.

In the mid-1970s when investors began catching on to the dim prospects of active management, the founder of Eaton and Howard cynically advised his peers to embrace a new marketing pitch, declaring, “Well, fellows, when it comes right down to it, mutual funds offer the public only two things: First diversification of investments and second professional management. When times are difficult, as they are now, we should stress diversification.”

If trustees listen closely to the consultants, advisors and staff surrounding them, they will hear a similar siren song. These

voices often highlight the value of additional diversification without mentioning the imprecision of the asset class assumptions upon which such benefits depend. They tempt trustees with the promise of return enhancement without demonstrating that they possess the rare skills to capture it. Nevertheless, many trustees blindly accept the claim that investments in buyouts, VC, hedge funds and private credit are more likely to add value than destroy it.

In 2024, nearly all alternative asset classes reside squarely in the late phase of their distinct life cycle. More than 80% of public funds allocate to alternative asset classes, and the average allocation is roughly 34% of their portfolios. Few trustees realize that this is not a sign of an attractive opportunity—it is a red flag

Use and Abuse of Modern Portfolio Theory

“You don’t want to be average; it’s not worth it, does nothing. In fact, it’s less than the [public] market. The question is ‘how do you get to first quartile?’ If you can’t, it doesn’t matter what the optimizer says about asset allocation.”

—Allan S. Bufferd, treasurer emeritus, MIT (2008)

In 1990, Harry Markowitz received a Nobel Prize in Economics for his pioneering work on portfolio management. Dubbed Modern Portfolio Theory (MPT), Markowitz’s research demonstrated how investors could improve risk-adjusted returns by diversifying their portfolios among investments with imperfect return correlations.

Markowitz’s Nobel Prize coincided with an era of rapid growth for investment consulting firms. Many firms started by offering only investment performance reporting to institutional plan trustees, while bank asset management departments provided discretionary advisory services. Over time, consultants revealed that banks often produced lackluster performance and charged relatively high fees. Throughout the 1970s and 1980s, consultants convinced trustees to abandon banks and construct multi-manager portfolios with increasingly complex allocations. MPT was the tool that consultants used as a basis for their recommendations.

By the turn of the 21st century, MPT-based models were stretched far beyond their limits. The issue was that the utility of the output depended on the accuracy of return, volatility and correlation assumptions. But these assumptions were and always will be subject to a high degree of imprecision. While MPT models can help trustees visualize risk/return tradeoffs at a high level, they are far too imprecise to provide value in niche asset classes, such as alternative asset classes.

Abuse of MPT has intensified in recent years. Struggling to differentiate from competitors, many consulting firms concoct dozens of asset class assumptions that are highly misleading at best. This is especially problematic with alternative asset classes because expected returns are further distorted by the exceptional returns realized in the early phase of the cycle. Even more importantly, success in alternative asset classes is largely a function of skill, the presence of which is vitally important when an asset class is flooded with capital. Therefore, the most important metric to guide alternative asset allocations is the track record of the firm or person recommending them. But unlike the capital being deployed, such information is usually in short supply.

indicating that the opportunity has largely expired. In the late phase of the alternative asset class cycle, sufficient rewards only accrue to a small cohort of highly skilled investors. Trustees considering entry or expansion into these asset classes must ask whether the track record of their advisors is sufficiently robust to warrant such adventures. This raises another formidable challenge. Few consultants bother to calculate their track records, and those who do are unlikely to share them because they justifiably fear it will reveal the absence of skill rather than the presence of it. \$

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