

# Alternative History

## Would Some Investors Have Been Better Off Not Chasing Alts?

If you close your eyes and think back to the mid-2000s, you can still hear it: the institutional investment world's collective swoon over the "Yale model."

The Yale model, developed by the late Chief Investment Officer of the Yale Endowment, David Swensen, emphasized an asset allocation with heavy exposure to alternatives such as private equity, hedge funds, and real assets rather than a traditional 60/40 public equity and bond portfolio. Swensen argued that less liquid and more inefficient private markets could reward patient investors with superior returns.

During his 36-year tenure, Swensen grew the Yale Endowment from \$1.3 billion to over \$40 billion, making it one of the most successful endowments in the world.<sup>1</sup>

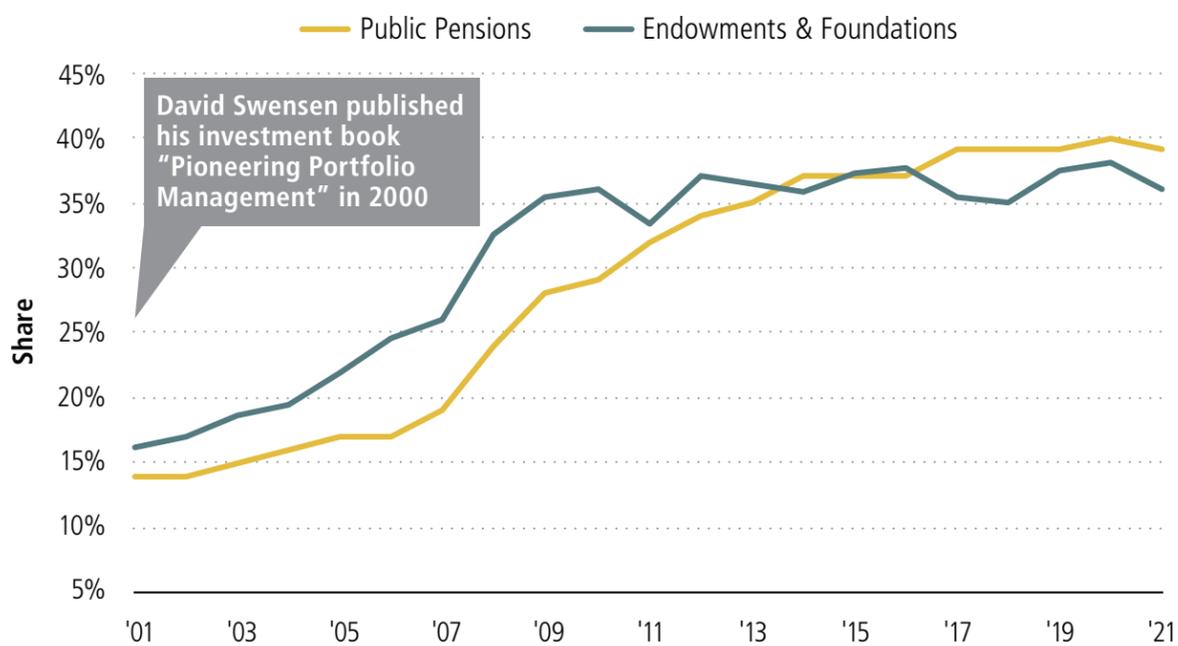
And so an idea spread: "Smart investors use alternatives."

Regardless of staffing resources, liquidity demands, and portfolio scales, the gravitational pull of "alts" was irresistible. Pensions and foundations, small and large, wanted a taste of the legendary returns from private equity and hedge funds.

Now it's 2026, and we have the benefit of hindsight, which allows us to assess how and why so many institutions migrated into the alternatives universe and how they've likely fared.

The punchline: Most institutions, especially smaller ones, would have been far better off doing absolutely nothing and simply sticking with a "boring" mix of public stocks and bonds.

fig 1. ALLOCATING ALTERNATIVES: ALTERNATIVES ALLOCATION IN U.S. ENDOWMENTS & FOUNDATIONS AND PUBLIC PENSIONS\*



Sources: National Association of College and University Business Offices (NACUBO), Begenau, J., Liang, P., "The Rise of Alternatives" (2025)  
\*Alternatives share of risky portfolio (non-cash and non-fixed income assets), dollar-weighted for public pensions and equal-weighted for endowments and foundations

**«MOST INSTITUTIONS WOULD HAVE BEEN FAR BETTER OFF DOING ABSOLUTELY NOTHING AND SIMPLY STICKING WITH A "BORING" MIX OF PUBLIC STOCKS AND BONDS.»**

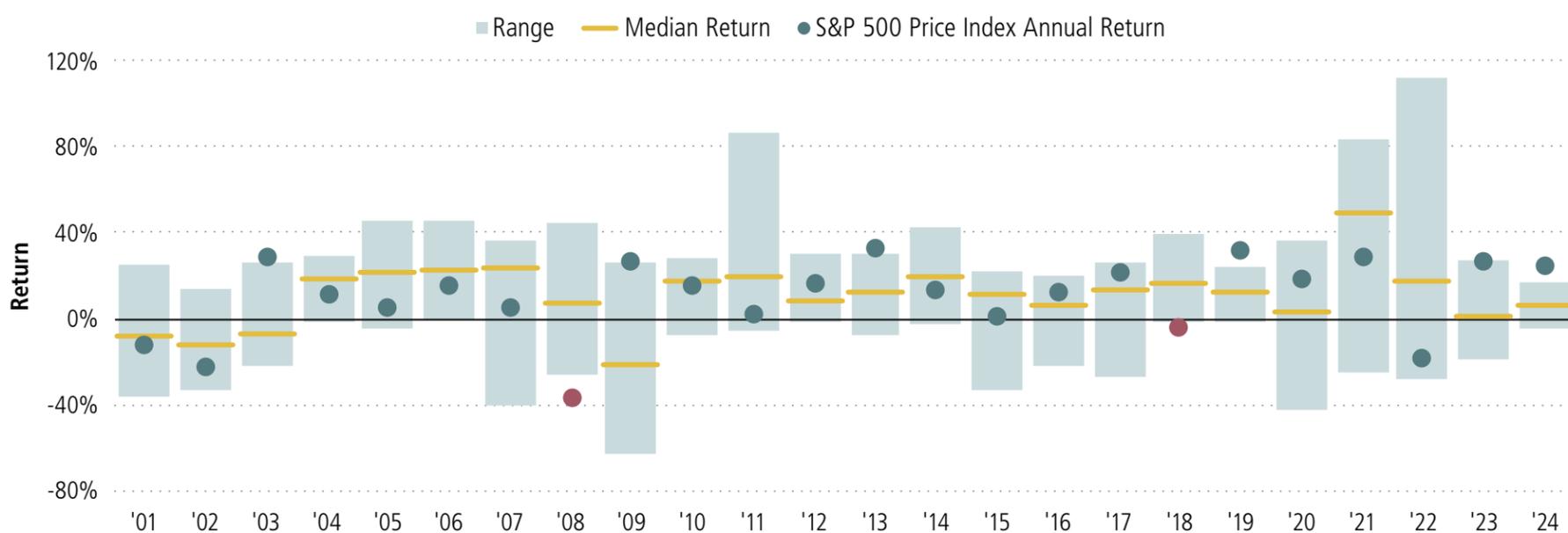
Let's explore the actual history as well as the alternative history—a world in which institutions *didn't* chase alternatives.

### THE GREAT DRIFT INTO "ALTS"

In 2000, Swensen published *Pioneering Portfolio Management*, outlining his philosophy behind alternatives in his Yale model.

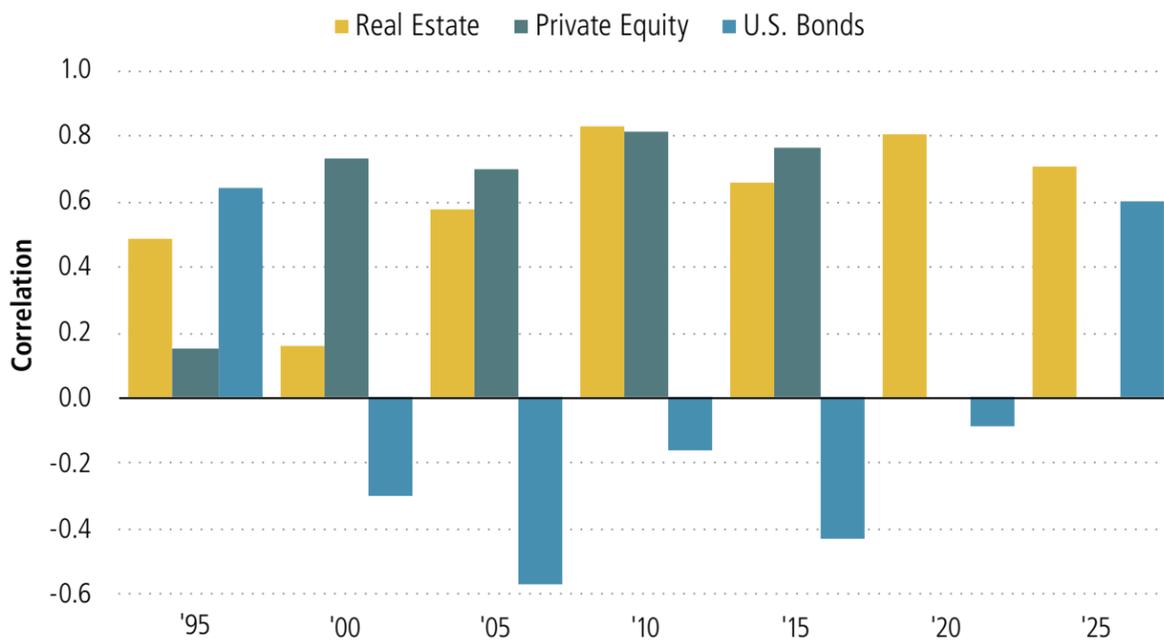
fig 2. NOT ALL FUNDS ARE EQUAL:

### NET RETURN DISTRIBUTION OF PUBLIC PENSION PLAN'S PRIVATE EQUITY INVESTMENTS



Sources: Public Plans Data, Bloomberg, Payden Calculations

*fig 3.* DIVERSIFICATION THEATER:  
5-YEAR CORRELATIONS OF ASSET CLASS\* QUARTERLY  
RETURNS WITH S&P 500 INDEX



Sources: Bloomberg, Cambridge Associates, Payden Calculations

\*Private equity data is only available through 2020; Real estate returns are represented by the Dow Jones REIT index from 1990 to 2003, and the Bloomberg REIT total return index from 2003 to 2025

Since then, U.S. public pensions have dramatically reallocated—not by increasing risk per se, but by reshuffling the contents of their risk-seeking bucket. In 2001, alternatives accounted for only about 14% of risky assets. By 2021, they were nearly 40% (see Figure 1 on page 11).<sup>2</sup>

Endowments, too, have increased their alternative allocation as a share of risky assets from 14% in 2001 (see Figure 1 on page 11 again). By 2021, large endowments had allocated over half of their assets to alternatives. Smaller endowments, too, had allocated nearly 20% to hedge funds, real assets, and private equity.

To fund the shift, national data indicate that U.S. public pensions mainly reduced public equity allocations—from 59% to 47%—while tripling allocations to “alternatives” from 11% to 30% over two decades.<sup>3</sup>

Why?

Not because of funding stress. Not because of forced reaching for yield. Not because of risk constraints.

Instead, textbook models of asset allocation tilted portfolios toward alternatives based on capital-market assumptions. In a typical mean-variance framework, an asset class is considered favorable (or has a higher alpha) if it is expected to earn more while being less correlated with public equities. In other words, an asset class is rewarded if it has higher expected returns, and penalized if it moves closely in line with assets already in the portfolio.

The keyword here is “expected”: a few simple assumptions can make alternatives look attractive. For example, one can easily assign higher expected returns to hedge funds or private equity.<sup>4</sup> It’s also easy to assume that real estate and commodities would have lower correlations with public equities—and *voilà*, the model outputs a higher alpha.

It turns out that *perceived* alpha on alternatives has increased by 58 basis points over the last two decades, driven almost entirely by higher expected-return assumptions, which have led to higher allocations to alternatives among pension funds.<sup>5</sup>

#### WHERE THE TEXTBOOK FAILED

The theoretical framework that favors alternatives applies primarily to large institutions with sufficient funds and investment resources for a few key reasons.

First, access is not equal. Large institutional investors get the phone calls from top-tier private equity funds first. Smaller institutions often receive allocations to a fund of funds, middle-market managers, or smaller, later-cycle funds. Sure, private equity funds can deliver superior returns to public equities, but the distribution

is wide. In all but two of the past 24 years, at least one pension fund’s private equity allocation underperformed the broad market (see Figure 2 on page 11).

Second: fees, fees, fees. Alternatives could include up to 2% management fees, 20% performance fee on profits, and additional administrative, legal, and due diligence costs.<sup>6</sup> For smaller asset owners, effective fees can easily reach 3–4% per year, all in.

«IF YOU CAN'T EVALUATE MANAGERS RIGOROUSLY, YOU'RE BUYING AN EXPENSIVE BLACK BOX. AND THE BLACK BOX DELIVERS ONLY ONE THING RELIABLY: FEES.»

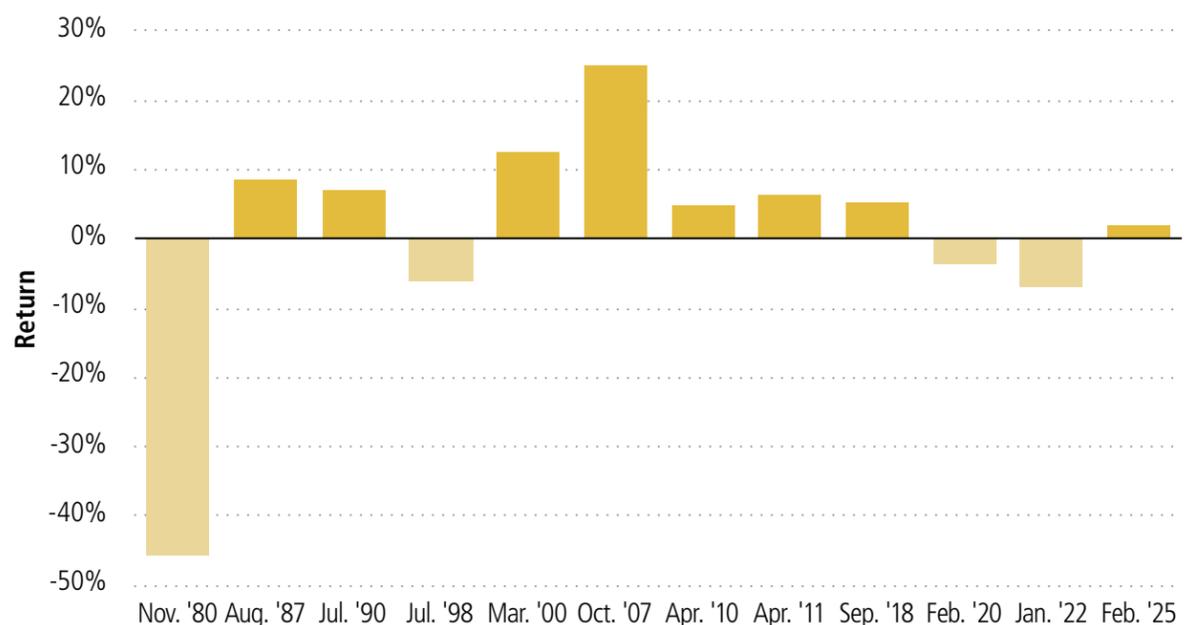
Third, private assets require deep due diligence, ongoing monitoring, manager replacement decisions, cash-flow management, fair-value oversight, and board education. Small institutions rarely have the internal bandwidth. If you can’t evaluate managers rigorously, you’re buying an expensive black box. And the black box delivers only one thing reliably: fees.

#### DIVERSIFICATION THEATER

Worse, for small funds, diversification from alternatives is a mirage. Large institutions build private equity or venture capital portfolios across many types of managers and strategies, whereas small institutions often don’t have the depth or capacity to do so.

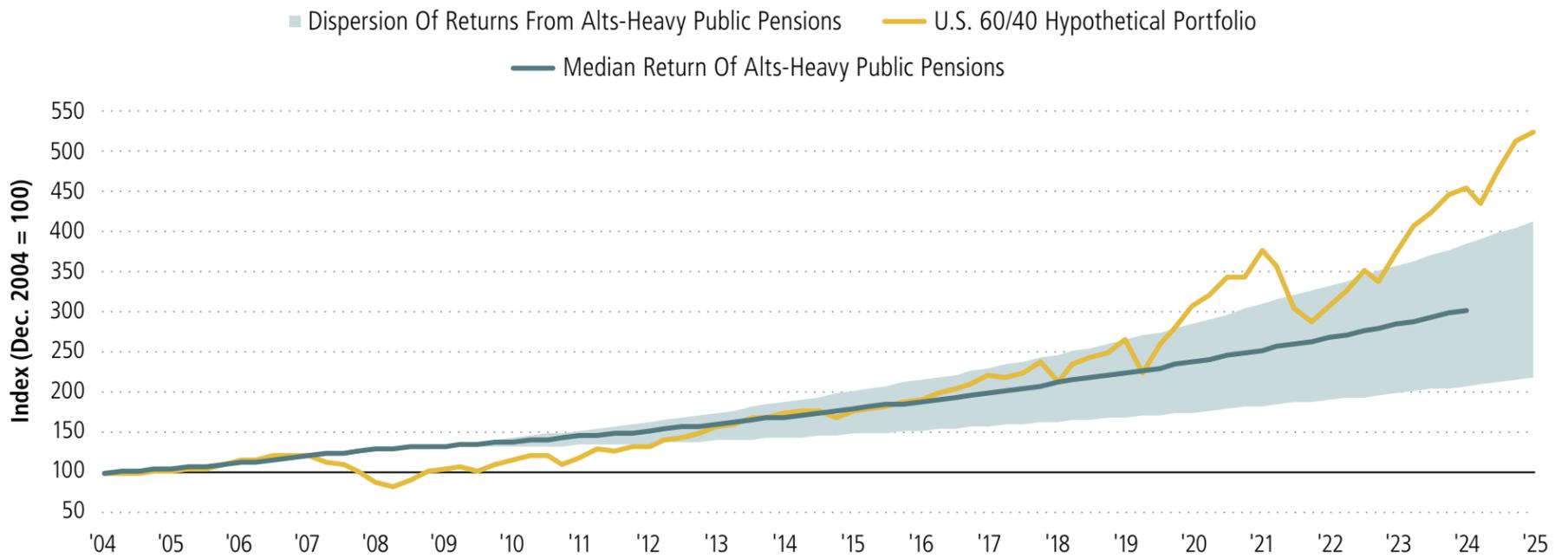
Data also show that the diversification benefits of alternatives actually declined over time.<sup>7</sup> In fact, the average returns of private equities and real estate funds move very closely in line with returns in the public equity market, while public

*fig 4.* GOLD LINING:  
GOLD SPOT RETURN FROM U.S. STOCK MARKET PEAK TO  
TROUGH IN PREVIOUS DRAWDOWNS OF 15% OR MORE



Sources: Bloomberg, Yardeni Research, Payden Calculations

fig 5. HYPOTHETICAL WEALTH GROWTH:  
HYPOTHETICAL WEALTH GROWTH OF A 60/40 PORTFOLIO\* COMPARED TO ALTS-HEAVY PUBLIC PENSION RETURN\*\*



Sources: Public Pension Dataset, Bloomberg, Payden Calculations

\*The hypothetical 60/40 portfolio assumes 60% asset allocation to stocks and 40% to bonds, with quarterly rebalancing and a 1% management fee

\*\*All public pensions with available net returns data and alternatives allocation of more than 20%; data as of December 2024

U.S. bonds have maintained a negative correlation with public equities in most of the period since 1990 (see Figure 3 on page 12).<sup>8</sup>

«DID WE REPLACE A ROBUST, PROVEN DIVERSIFIER (PUBLIC BONDS AND EQUITIES) WITH AN EXPENSIVE, OPAQUE ALTERNATIVE THAT DOESN'T WORK THAT WELL?»

In other words, did we replace a robust, proven diversifier (public bonds and equities) with an expensive, opaque alternative that doesn't work that well?

There's a gold lining, though: For small institutions without access to high-quality macro hedge funds, gold is one of the few alternatives on the list that's liquid and has a lower cost, while improving portfolio resilience. Gold has S&P 500 Index-like volatility but near-zero long-term correlation with the S&P, posting positive returns in eight of the last 12 major equity drawdowns of more than 15% (see Figure 4 on page 12).<sup>9</sup>

RE-RUNNING THE MOVIE

Now imagine a different world—the alternative history—where institutions didn't look longingly at the Yale model and instead said: "Fascinating, but not for us. We have neither the staff, the scale, nor the governance for this. Let's stick with what we can actually execute brilliantly: public markets."

Imagine they had held 60% of U.S. public equities and 40% of U.S. bonds.

Costs would fall. Transparency goes up. Investment boards can understand what they own. Liquidity is always there. Cash flows are manageable with no lockups or capital calls.

Stress tests are straightforward.

How would these institutions have done?

Pretty well, actually, albeit with more volatility. Some periods produced negative returns, such as most quarters in 2008 and 2021. However, over the long term, a U.S. stock-and-bond portfolio would have outperformed the median pension fund return by 50%, even without any rebalancing (see Figure 5).<sup>10</sup> For funds that prefer more active management, overweighting bonds in market downturns would have further improved results.

STILL WATERS RUN DEEP

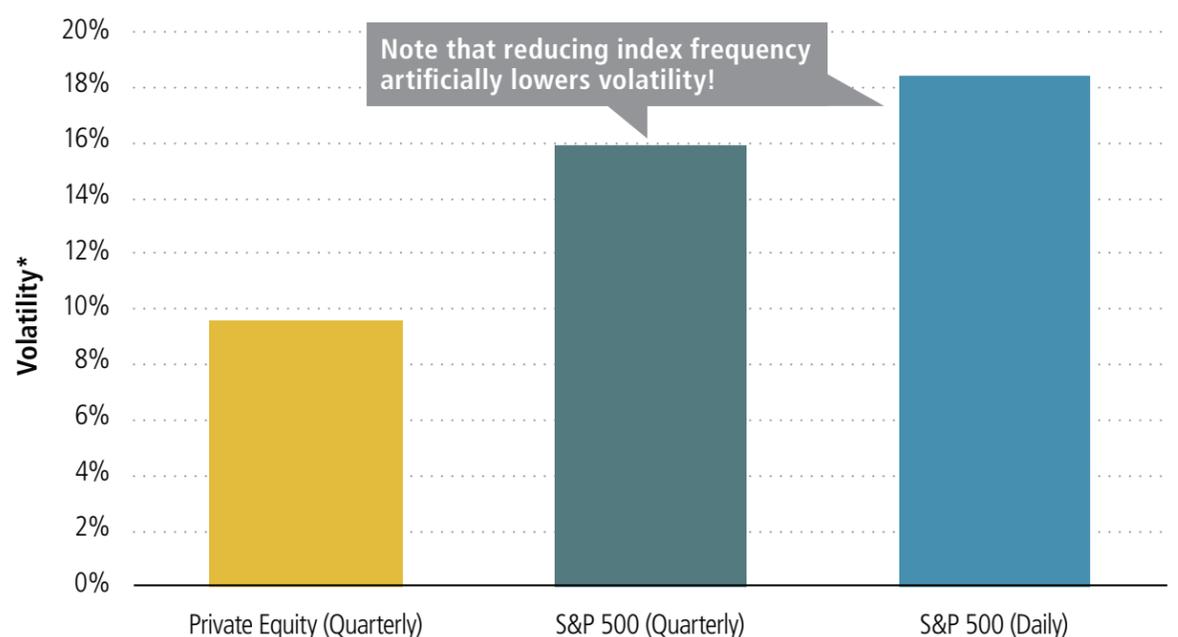
Sure, private markets are famously smooth, but perhaps artificially so. Valuations are not

«SURE, PRIVATE MARKETS ARE FAMOUSLY SMOOTH, BUT PERHAPS ARTIFICIALLY SO.»

reported daily, so they don't move daily, which lowers perceived volatility (see Figure 6). Certain alternative assets, such as real estate, rely on appraisals for valuation that often lag actual asset performance due to reporting gaps.

But this psychological comfort comes at a price. When real liquidity is needed, the bids disappear. Imagine pulling out of a hedge fund or selling real assets during a market crisis; chances are, you are out of luck. Worse, the lack of a historical track

fig 6. VOLATILITY SPECTRUM:  
ANNUALIZED VOLATILITY\* OF PRIVATE EQUITY FUNDS VERSUS S&P 500 PRICE INDEX\*\*



Sources: Cambridge Associates, Bloomberg, Payden Calculations

\*Volatility calculated using standard deviations of quarterly or daily returns

\*\*From 1986 to 2020 Q1 due to data availability of private equity benchmark index from Cambridge Associates

record and financial regulation for alternatives may further amplify downside risks.

On the other hand, public markets are brutally honest. They mark prices down swiftly, but also mark them back up just as quickly. You will find your counterparties willing to take your offer when you need it, *even in* market panics.

For small institutions, behavioral governance is simpler when focused on public markets: every holding is priced daily; volatility is visible and not suppressed; there are no capital calls; liquidity is available when needed; and the strategy is easy to explain to committees and auditors.

The best alternative for small institutions is no alternatives at all—just transparency, discipline, and keeping fees and costs in check.

### WITH THE BENEFIT OF HINDSIGHT

The real secret of the Yale model is not alternatives. It is scale, governance, and unique access. As Swensen mentioned in his book, alternatives are not for everyone—only “[a] few institutions exhibit the ability to commit the resources to produce risk-adjusted excess returns.”<sup>11</sup>

A smaller institution simply cannot replicate the elite access that large funds have, nor can it afford to ignore its liquidity needs.

If small institutions could redo the 2000–2025 investment era, the winning move—the highest volatility-adjusted return, the lowest governance burden, and the cleanest execution—would have been a U.S.-centric public equity portfolio, with a high-quality bond anchor, and maybe a low-cost diversifier (e.g., gold).

But it’s not too late.

**«THE YEAR 2026 MAY WITNESS THE MOMENT WHEN MANY INSTITUTIONS RETURN TO THE MOST UNDERRATED ALLOCATION IN HISTORY: A CLEAN, TRANSPARENT, LOW-FEE MIX OF STOCKS AND BONDS.»**

The year 2026 may witness the moment when many institutions return to the most underrated allocation in history: a clean, transparent, low-fee mix of stocks and bonds (see *Did You Know? The Case For A 60/40*).

In the end, the real alternative wasn’t private equity. It wasn’t hedge funds. It wasn’t venture, real estate, or infrastructure.

The real alternative was simplicity. 

## DID YOU KNOW?

### THE CASE FOR A 60/40

A daily-priced public stock-and-bond portfolio can feel a little wild at times, especially as we head into 2026 after a roller-coaster 2025. For example, many investors find today’s elevated stock market valuations unsettling. However, it’s still possible to have good returns even at high valuations. In fact, approximately 55% of months since 1995 with valuations similar to today’s have yielded positive returns. Ultimately, as long as the U.S. economy remains in expansion, U.S. stocks are more likely to deliver positive returns! For investors more concerned about a recession, bonds can come to the rescue. Today’s elevated bond yields should provide some comfort—longer-duration Treasuries could offer double-digit returns in a recession as rates fall aggressively. Sure, monthly and quarterly returns may not always look great, but if you close your eyes and come back to your clean, public stock-and-bond portfolio 20 years later, you are far more likely to outperform alt-heavy peers.

### ENDNOTES

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