



Enhancing the investment returns  
of non-profit organizations

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# COMMENTARY

A Quarterly Report of THE INVESTMENT FUND FOR FOUNDATIONS

JUNE 30, 2001

## HIGHLIGHTS

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Keeping a diary of timeless truths about investing has helped at least one fiduciary avoid **certain mistakes that investors tend to make** on a recurring basis.

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The **optimal size of an investment committee** is three persons.

Page 2

**Prices at the margin are moved by true surprises** — events so improbable that had anyone been bold or far-sighted enough to foretell their approach, (s)he would have had great difficulty persuading other fiduciaries to deploy capital in accordance with such forecasts.

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**Few (if any) trustee groups can gauge accurately their tolerance for poor results** until those results actually roll in. The idea of an “ideal” asset mix for organizations with different governing boards is thus an impossibility.

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Absent disciplined rebalancing, **most “efficient” mixes won’t produce anything close to their expected returns**: the inherently contrarian process of trimming relative leaders and plowing the proceeds back into relative laggards is what makes such mixes “efficient” in the first place.

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Manager selection is **the most important determinant of portfolio returns** when one defines “returns” in the manner most relevant to the actual behavior of fund fiduciaries.

## ABOUT TIFF

*The Investment Fund for Foundations* (TIFF) is a not-for-profit cooperative founded in 1991 by a nationwide network of foundations. Its mission is to improve the investment returns of eligible organizations by making available to them (1) a series of multi-manager investment vehicles and (2) resources aimed at enhancing fiduciaries’ knowledge of investing. Excepting TIFF’s president, all TIFF trustees serve as unpaid volunteers.

*Critical Mass.* TIFF currently manages assets in excess of \$2 billion for over 300 non-profit organizations worldwide.

*Carefully Researched.* TIFF’s investment programs are based on many years of extensive study into the investment needs of non-profit endowed organizations. The investment programs that TIFF administers enable member organizations to delegate selection and oversight of money managers and other essential vendors to experienced

investment professionals whose personal and professional interests are highly congruent with the interests of TIFF’s members.

*Investment Vehicles.* TIFF administers a variety of multi-manager investment vehicles that enable members to access a variety of asset classes and strategies, including US and non-US marketable securities, venture capital, buyouts, real estate, natural resources, and absolute return-oriented strategies. For more information, please refer to TIFF’s separate quarterly reports entitled *Marketable Investments* and *Alternative Investments*.

*Eligibility.* The investment vehicles administered by TIFF are open to all 501(c)(3) organizations. Certain TIFF vehicles also employ SEC-imposed accreditation tests. For more information, please contact TIFF at 434-817-8200 or visit our Website at [www.tiff.org](http://www.tiff.org).

## TIMELESS TRUTHS ABOUT INVESTING

### DEAR DIARY

*Shucking Oysters.* In the spirit of such celebrated diary-keepers as John Adams (whose remarkable life is described in a splendid new biography by David McCullough) and Bridget Jones (now playing at a theater near you), your editor has for some time kept a diary. It's not a daily diary, because entries in it are made only when its keeper identifies investment-related thoughts that merit permanent recording. They merit such treatment because they illumine aspects of investing with respect to which human beings (as well as machines programmed by them) tend to make recurring mistakes. Maintaining this diary has not prevented its keeper from making some of these mistakes more than once, but it has made his life's work more fun.

*Road Map.* This brings us to the excerpts from the diary described above, all of which are as germane to the endowed organizations that TIFF seeks to serve as they are to individual investors. Indeed, although the investment vehicles bearing the TIFF name are open exclusively to qualifying charities, the charitable assets in question are controlled by real human beings — individuals who are assumedly doing their best to steward such wealth but who might also be prone to the recurring mistakes that the diary excerpted here seeks to minimize. To facilitate their consumption by busy or repeated users, the excerpts are sorted by topic, with the topics themselves identified using terms commonly employed in institutional settings.

### GOVERNANCE — The All-Important Process of Getting “Structured for Success”

*Committee Size.* Assuming that all of its members are sufficiently expert, the optimal size of a group charged with investment decisionmaking is three persons. Larger groups cause responsibility to become too diffuse and have a nasty tendency to produce lowest common denominator decisionmaking. Smaller committees are equally problematic but for different reasons. Committees of two are prone to deadlock, while “committees” of one seldom produce an optimal level of risk-taking: taking due note of its singular powers and responsibilities, a “committee” of one can easily slip into excessive risk avoidance or its more sinister cousin, excessive gunslinging.

*Meeting Schedules.* Although a necessary evil for most committees (due to their flaunting of sensible rules respecting committee size), regularly scheduled investment committee meetings often do more harm than good. Assembling infrequently on dates set far in advance, committees tend to act when inaction would be the wiser course — or to miss opportunities to act when action would be wealth enhancing (see *Rebalancing* below). The optimal approach is to meet on an as-needed basis — an approach that concededly presupposes a very small number of decisionmakers.

*Discussion Topics.* Committee discussions of current economic trends (e.g., “the economy is picking up; let's increase our stock holdings”) are not useful unless accompanied by **informed** discussion of what “the market” has already discounted. Prices at the margin are moved by true surprises — events so improbable that had anyone been bold or far-sighted enough to foretell their approach, (s)he would have had great difficulty persuading other fiduciaries to deploy capital in accordance with such forecasts. Paradoxically, the more far-sighted an investment forecast is, the less useful it's likely to be in an institutional setting — especially to larger committees, which tend to shy from unconventional choices.

### ASSET ALLOCATION — Deciding Which Assets to Hold and in What Proportions

*Mimicry Decried.* The true measure of the appropriateness of a given asset mix for a given institution is whether it will produce the maximum return for whatever level of risk the institution's trustees are willing to bear. But few (if any) trustee groups can gauge accurately their tolerance for poor results until those results actually roll in. The idea of an “ideal” asset mix for organizations with different governing boards is thus an impossibility.

*Evidence vs. Intuition.* By the time investors accumulate sufficient evidence suggesting that an investment approach (or asset class) produces superior returns, the big bucks have already been made. There is irony at work here. Although institutions are accused of being hopelessly short term in their thinking, especially with respect to manager hirings and firings (see below), they're actually too far-sighted in other respects, especially with respect to asset allocation. The basic problem is that fiduciaries place too much emphasis on historical averages and too little emphasis on an asset's current price. Examples: domestic “value” stocks (very cheap in the mid-1970s, very dear by the late 1980s); small stocks in the US (horribly expensive by 1983, when the first wave of studies was unleashed extolling such stocks' virtues); real estate in the late 1980s (same story as small stocks); and venture capital *circa* 1999 (you guessed it). Studies extolling the virtues of particular investments have a nasty tendency to appear at or close to secular peaks in the returns on such investments.

*Hedging Costs.* Most institutional asset mixes comprise two generic parts: a total return segment aimed at generating satisfactory real or inflation-adjusted returns and a hedging segment that seeks to keep the volatility of capital values or current income within reasonable bounds. Alas, assets typically held for hedging purposes tend to be no less cyclical than assets typically held for total return purposes. Indeed, such “hedging” assets are sometimes so mispriced that the “insurance” they provide has a “negative cost,” i.e., investors get paid to become insured. An example: in 1981, long-term Treasuries (the classic deflation hedge) yielded more than

14%, an unprecedentedly high nominal yield that provided the potential for rich capital gains if the Federal Reserve succeeded in bringing inflation under control (as it subsequently did) and significant protection (via reinvestment of coupon income) if it did not. But there's an important corollary to the argument that investors occasionally get paid to become insured: such hedges can also become so overpriced that investors who acquire them at peak prices can wind up worse off than investors who lack such "insurance" — even if the event being insured against occurs. An example of the latter phenomenon: investors who acquired energy-related properties as "inflation hedges" at the peak of energy prices in 1980 were destined to do poorly even if inflation had continued spiraling upward. Of course, it did not.

*Rebalancing.* Most institutions could substantially enhance their long-term returns by adopting more sensible rebalancing disciplines. Indeed, numerous studies show that disciplined rebalancing can boost returns as much as a material change in the policy mix itself. Moreover, absent disciplined rebalancing, most "efficient" mixes won't produce anything close to their expected returns: the inherently contrarian process of trimming relative leaders and plowing the proceeds back into relative laggards is what makes such mixes "efficient" in the first place. "Efficient" in this context connotes an optimal tradeoff between risk and expected return.

**MANAGER SELECTION — The Most Important Determinant of Relative Performance for Most Institutional Funds**

*Con Game.* The received wisdom on investing holds that asset allocation rather than manager selection is the most important determinant of portfolio returns. Not exactly — not if one defines "returns" in the manner most relevant to the real-world behavior of fund fiduciaries. With the exception of the tiny handful of institutional funds employing passive strategies only (not just in marketable securities but across the board), manager selection and monitoring tends to be a preoccupying task for most investment committees. As such, it tends to crowd out truly **informed** discussion of evolving opportunities and perils arising from broad market (i.e., asset class) movements. Moreover, even if the typical committee had infinite time for asset allocation discussions (a luxury which, if exploited fully, would likely lead to **less** rather than more turnover at the asset class level), it's doubtful that asset allocation would supplant manager selection as the single most important determinant of returns. Why? Because investing, like golf, is (to quote golf guru Bob Rotella) inherently and overwhelmingly a "game of confidence." Just as a pro golfer is less likely to hit a great drive if he missed a crucial putt on the prior hole, investors are less likely to summon the courage to make sensible (meaning: contrarian) asset allocation choices if the manager picks for which they're responsible are faring poorly. Alas, the converse isn't quite true, because trustee groups whose manager picks are faring well tend to become **overconfident**,

making asset allocation shifts whose frequency or materiality presuppose more skill than the persons making them are likely to possess. In short, manager selection is the proverbial pebble in the shoe for most trustee groups. A lifetime of training and conditioning enables Tiger Woods to beat most of his fellow golfers most of the time. But place a big enough pebble in his shoe and he'd have a hard time beating most serious amateurs, to say nothing of most pros. Similarly, years of informed debate put many fiduciaries in the enviable position of controlling portfolios whose returns during the closing years of the 1990s eclipsed return goals adopted years if not decades earlier. Why then did these same fiduciaries make such a shockingly high number of manager changes as the 1990s drew to an end? Because a technology stock "bubble" caused the equity segments of many institutional portfolios to lag capitalization-weighted stock indices. Indeed, the performance pebble in question grew so irritating that many trustee groups did more than simply jettison value managers and reallocate the proceeds to growth specialists: they rotated substantial sums out of marketable stocks and into a different asset class called private equity, with an undue focus on technology-oriented venture capital. Ironically, such asset allocation shifts have made manager selection an even more important determinant of overall fund results than it was prior to such shifts: manager returns vary far more widely in venture capital and other "private" niches such as absolute return-oriented investing than they do in the marketable securities arena. Indeed, savvy fiduciaries recognize that it is folly to commit capital to such high-cost, high-risk niches as venture capital and absolute return-oriented hedge funds unless the managers available to them are truly first-rate.

*Damn Hard.* As the preternaturally wise investor Jeremy Grantham has observed, selecting superior managers is harder than selecting winning stocks. There are two reasons why: (1) the people making the decisions (i.e., trustees) have far less information about managers than investors have about publicly traded companies and (2) trustees must balance the conflicting propaganda of managers (many of whom are quite glib) against the only facts available to them, i.e., past performance. As sensible people, trustees will invariably base decisions on available facts rather than unprovable marketing claims. Governing boards will therefore favor recent winners whose returns are destined to regress to the mean.

*Unprovable Claim.* At bottom, all managers' marketing pitches boil down to a single unprovable claim: that the managers in question (or computers programmed by them) have a discernible and sustainable "edge" over other investors. The claim is unprovable (in a rigorous scientific sense) because it takes a very long time to prove (statistically) that favorable results reflect skill rather than luck. Indeed, the number of years needed to prove (statistically) that superior results reflect skill rather than luck typically exceeds the number of years that a truly superior manager chooses to manage other people's money for a living.

*Change is Bad (Generally).* Most manager changes (whether implemented via separate accounts or commingled vehicles such as mutual funds) are a mistake. Most firings are a mistake because clients usually “bail” just before the investment “style” that has disappointed starts performing satisfactorily; and most hirings are a mistake because the managers or funds so chosen are usually in the midst of “hot streaks” that cannot possibly endure.

*Selection Criteria.* In general, the more important and desirable an attribute is (e.g., a well-defined and preferably innovative investment philosophy), the more difficult and time consuming it is for trustees (or their consultants) to confirm its presence in a given money manager. Conversely, undesirable attributes (e.g., portfolio managers who are encumbered with excessive administrative or client servicing responsibilities) are relatively easy to detect. This suggests that screening criteria should generally be applied in **reverse** order — negative screens first, positive screens later, after the selection universe has been reduced to a more manageable number.

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**PORTFOLIO TURNOVER — The Most Common Mistake**

*Spotting the Pearls.* The time-intensive task of determining which of the many oysters published daily in the financial world contain true pearls of wisdom helps your editor avoid perhaps **the** most common investment mistake: excessive portfolio turnover. To be sure, from a public policy perspective, too little turnover is more worrisome than too much turnover because the smooth functioning of capitalism presupposes the continuing recycling of funds among choiceworthy endeavors based on investors’ return expectations and risk preferences. (As an aside, we wish policymakers in Washington appreciated more fully the nexus between free capital flows and economic growth, a nexus belied by revenue estimates which assume that taxing capital gains at lower rates would actually reduce the nation’s tax base over the long term. It would not, because lowered rates would liberate capital currently locked into low basis holdings.) In fact, most investors are excessively active, causing famed investor Warren Buffett to suggest that capitalism would function more effectively if investors were assigned a lifetime quota of decisions, the constrained size of which would assumedly reduce portfolio turnover to saner levels.

*One Last Note.* Consistent with TIFF’s aim of keeping its quarterly commentaries to four pages each whenever possible, we’ve published here just a small fraction of the aforementioned diary’s contents. If, after reading these excerpts, you’d like us to publish more, please zap a note to [info@tiff.org](mailto:info@tiff.org). ■

*Stellar Service.* Consistent with rotation policies that compel trustees to yield seats after serving three consecutive three-year terms, four trustees left the TIFF board in May. John Craig, Greg Curtis, Alice Handy, and Bill Nichols contributed countless hours and immeasurably valuable support as energetic stewards of TIFF’s mission. All four played important parts in TIFF’s founding and served the cooperative with distinction in leadership roles, despite being paid precisely nothing for their time. (With the exception of TIFF’s president, TIFF’s trustees serve as unpaid volunteers.)

*Worthy Successors.* Practicing what it has preached to TIFF’s officers respecting the need to “staff ahead of growth,” the board anticipated the departures mentioned above by electing two trustees last fall: Stanford University endowment chief Mike McCaffery and Ellen Shuman, chief investment officer of the Carnegie Corporation. At its May meeting, the board added another leading endowment steward to its ranks: Harry Hoffman, chief investment officer of the Mayo Foundation. As CIO of the non-profit corporation that operates the famed Mayo Clinic, Mr. Hoffman oversees approximately \$3.5 billion in investable wealth. A graduate of the University of Minnesota and the Yale School of Management, Mr. Hoffman joined Mayo in 1990 and has helped make its investment program one of the most advanced in the nation. TIFF’s board and staff are honored that Mr. Hoffman has agreed to serve and look forward to working even more closely with him in coming years. As is true of other TIFF trustees, Mr. Hoffman will be “eating his own cooking”: the Mayo Foundation has invested large sums via TIFF for some time and plans to continue doing so. ■

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**MEMBERSHIP SUMMARY**

	Number of Members	Assets
<b>TIFF Membership</b>	<b>332</b>	<b>\$2,143 mm</b>
▪ Private Foundations	164	\$1,138 mm
▪ Community Foundations	34	\$278 mm
▪ Other 501(c)(3) Organizations	134	\$727 mm



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*For further information about any of TIFF’s services, please contact TIFF at the address or phone number listed above.*