COMMENTARY

A Report of TIFF EDUCATION FOUNDATION

SUMMER 2005

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Legend

TEF **TIFF Education Foundation**
a tax-exempt private
operating foundation

TAS **TIFF Advisory Services**
the registered investment
advisor for all TIFF vehicles

TIP **TIFF Investment Program**
a mutual fund family
open to charities only

Highlights

- Our Summer 2005 *Commentary* extends thoughts presented in last quarter's edition, combining lessons gleaned by TIFF's representative to the seminar marking the 60th anniversary of *Financial Analysts Journal* with related thoughts on ways in which persons charged with stewarding endowment capital can do a more effective job discharging this solemn duty.

- Too many persons manage money for a living for the wrong reason, namely to make money for themselves. There's nothing inherently wrong or unethical about efforts to make a good if not handsome living, but when this is essentially the sole reason that persons pursue a certain trade, it tends to produce suboptimal behavior.

- Money managers need to display two things that fiduciaries engaged in manager selection arguably devote insufficient time to plumbing: integrity and an abhorrence of mediocrity.

- Most investment failures tend to be rooted in overly aggressive play. In an endowment management context, this means at least two things: (1) excessive manager turnover and (2) insufficiently far-sighted and hence excessively frequent investment policy shifts initiated at the trustee or board level.

- The remainder of this *Commentary* is devoted to excerpts from previous *Commentaries* that touch on topics germane to principles flagged above, including governance, behavioral finance, groupthink, pricing, manager selection, liquidity, and hedge funds.

About TIFF

Origins. In 1991, a network of foundations founded an investment cooperative whose organizational structure and eligibility criteria have evolved over time but whose core mission has not. Known colloquially as TIFF, the cooperative seeks to improve the investment returns of endowed charities by making available to them a series of multi-manager investment vehicles plus resources aimed at enhancing fiduciaries' knowledge of investing. The cooperative comprises three regulated entities at present: a tax-exempt private operating foundation whose d/b/a (TIFF Education Foundation) is more descriptive of its focus on education and research than its formal legal name (The Investment Fund for Foundations); the TIFF Investment Program (TIP), a registered mutual fund family; and TIFF Advisory Services (TAS), a taxable non-stock corporation and registered investment advisor that administers all investment vehicles bearing the TIFF name. As noted at left, there is substantial but not complete overlap among these three entities' boards, all of whose members except Richard Flannery and David Salem serve as unpaid volunteers.

Inquiries. For more information, please call TIFF at 434-817-8200 or visit www.tiff.org.

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Short and Sweet. As promised in the last edition of this publication (i.e., the TIFF *Commentary* for Spring 2005), we're devoting the document you're now reading to the second and final installment of thoughts that TIFF staff gleaned and generated on its own while attending a February 2005 seminar on investing sponsored by the CFA Institute to mark the 60th anniversary of its flagship publication *Financial Analysts Journal*.* Since these gleanings and thoughts provoked by them exhaust something less than the space budgeted for this *Commentary*, we've included also some thoughts published in previous *Commentaries* that seem germane to the issues discussed by the wise and gifted persons who gave talks at the seminar mentioned above.

Motivations Matter. In his talk, Capital Group chairman David Fisher raised and attempted to answer a fascinating question: which of the varied tasks that professional money managers must perform in order to do their jobs well do they truly enjoy performing? Obviously, given the tens of thousands of persons who — paraphrasing op-ed writer George Will's jest about his dad being chagrined that he "sank" into journalism — have sunk into money management, the only truly correct answer to Fisher's question is, "They vary." That said, by Fisher's lights, too many persons manage money for a living for the wrong reason, namely to make money for themselves — and often lots of it. There's nothing inherently wrong or unethical about efforts to make a good if not handsome living, Fisher emphasized, but when this is essentially the **sole** reason that persons pursue a certain trade, it tends to produce suboptimal behavior. In a money management context, he argued, such suboptimality manifests itself conspicuously, increasingly, and — TIFF staff would assert — depressingly in managers' undue focus on maximizing fee income as distinct from other measures of professional success. This focus on maximizing fees, in turn, produces an undue preoccupation with relative as distinct from absolute returns, a mindset that Fisher has trouble reconciling with his preferred formulation of a money manager's foremost duty: to keep to a tolerable minimum the probability that his or her clients will incur permanent losses. In Fisher's view, the best and hence most choiceworthy investment pros are "in it" not solely or even primarily to make big bucks but because they truly enjoy engaging in the three generic disciplines that successful money management comprises: art, science, and craftsmanship. Ironically, we would add, money management pros need not be world-class in **any** of these disciplines in order to rise to the top of the heap in their chosen profession. They need to be adequate at worst in each of them, of course, but more importantly they need to display two things that fiduciaries engaged in manager selection arguably devote insufficient time to plumbing: integrity and an abhorrence of mediocrity. In this context, what baseball executive Branch Rickey said about his team's athletically challenged but feisty second baseman Eddie Stanky seems to capture nicely the gravamen of Fisher's talk: "He can't hit, he can't run, he can't field, he can't throw. He can't do a darn thing ... but beat you."

Don't Lose. In his seminar talk, the widely published and highly respected investment thinker and fiduciary Charley Ellis reprised salient portions of his seminal 1985 book on investing entitled *Winning the Loser's Game*. As in his beloved sport of tennis, where avoiding "unforced errors" tends to be a sufficient condition for success at even the very highest levels of the game, Ellis's considerable experience at the highest levels of institutional investing (including his service as chair of Yale's investment committee) suggests that most investment failures tend to be rooted in overly aggressive play. What precisely does this mean in an endowment management context? At least two things: (1) excessive manager turnover and (2) insufficiently far-sighted and hence excessively frequent investment policy shifts initiated at the trustee or board level. To be sure, trustee groups that engage in such behavior may post large gains, especially relative to their peers, but such gains invariably prove fleeting in the same sense that tennis pro Andy Roddick's many stupendously flashy winning shots against his preternaturally calm arch-rival Roger Federer have proven unavailing: Roddick has lost nine of the 10 matches he's played against Federer as a pro. How might trustee groups best heed Ellis's advice? Our answer is as simple to articulate as it is difficult to implement: think long term and control your emotions. Not very concrete guidance, we know, which is why we've devoted the remainder of this *Commentary* to excerpts from past TIFF *Commentaries* (cf. especially those for 1Q and 2Q 1999 and 2Q and 3Q 2001) that add what we think is useful flesh to the all-important bone outlined in the prior sentence. By way of reminder, all TIFF *Commentaries* are available for downloading at www.tiff.org/tef.

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* For more information about the CFA Institute and its conferences, please see www.cfainstitute.org.

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Excerpts from Previous TIFF Commentaries

GOVERNANCE

- 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. The optimal approach is to meet on an as-needed basis — an approach that concededly presupposes a very small number of decisionmakers.
- The chief obstacle to investment success for many eleemosynary funds is excessive diffusion of responsibility at the governing board level.
- Unfortunately, a fear of underperforming other investors (especially peer institutions) plays a central role in the stewardship of most eleemosynary organizations' assets (especially institutions engaged in ongoing fundraising).

BEHAVIORAL FINANCE 101

(A "Must" Course For All Fiduciaries)

- Overreaching — attempting to play many games adequately rather than a few games well. To the extent that institutional funds engage in "overreaching," they tend to do so most frequently with respect to active manager selection.
- Herding — the natural human instinct to move with the crowd. In an institutional setting, it manifests itself in an aversion to "reputational risk," which in layman's terms means simply the risk of being wrong and alone. Given most investors' extreme discomfort with being wrong and alone, investments entailing a high degree of reputational risk tend to provide disproportionately high expected returns.
- Representativeness — assigning too much weight to recent events. Representativeness manifests itself repeatedly with respect to so-called alternative investments, creating big problems for institutional investors who mistakenly believe that strategies which have produced very strong returns in recent years can continue doing so even if they become infused with shockingly large amounts of fresh capital.
- Risk Aversion — a distaste for uncertainty per se, including unexpectedly favorable outcomes. Thus, when confronted with a choice between a certain gain (e.g., a 5% return) and an uncertain outcome whose expected value exceeds the certain gain (a 50% chance of a 30% gain coupled with a 50% chance of a zero gain), most investors opt for the certain gain. Risk averse decisionmaking is not always in the best interest of an institutional fund with a very long-term investment time horizon.
- Loss Aversion — a distaste for certain failure. Although much of the academic literature on investing assumes that investors are risk averse, the typical investor is more properly described as loss averse. When confronted with a choice between a certain loss (e.g., closing out a position entailing a 10% loss) and an uncertain outcome whose expected value is even more detrimental (a 50% chance of a 30% loss coupled with a 50% chance of a zero loss), most investors opt for the uncertain outcome. Loss averse decisionmaking and a related phenomenon known as "pride of ownership" tend to inhibit decisionmakers from redeploying capital from suboptimal investments to potentially more productive ones.
- Framing — the tendency to try to make a complex world simple by attaching overly broad and convenient labels to data or ideas that merit more heterogeneous treatment. A topical example: treating the strategies and tactics employed by commingled investment vehicles operated pursuant to specified contractual arrangements (i.e., hedge funds) as a distinct "asset class."
- Whipsaw — the reflexive sale of holdings at depressed prices not to meet cash flow needs but to satisfy the risk tolerances of the persons charged with stewarding the foundation's endowment. Whipsaw is especially worrisome when fiduciary risk tolerances are themselves unstable, a phenomenon that cannot be ruled out even in the absence of trustee turnover.

GROUPTHINK

- 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.

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- 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.

PRICING

- It is unwise to rely solely on unadjusted historical returns as inputs because such data ignore the dynamism of capital markets. Simply stated, the current price of an asset is always more important than historical averages. Moreover, studies extolling the virtues of particular investments tend to appear at or close to secular peaks in the returns on such investments.
- Hedging assets are sometimes so mispriced that the "insurance" they provide has a "negative cost" (i.e., investors get paid to become insured). Further, 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.
- Most institutions could substantially enhance their long-term returns by adopting more sensible rebalancing disciplines.

MANAGER SELECTION

- 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.
- 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.
- As important as it is in the current environment for fiduciaries to commit bold acts in pursuit of compelling investment opportunities, it's equally important to avoid rash decisions to "bail" from managers or strategies whose best days seem to have ended.

LIQUIDITY

- Liquidity is beautiful in most investors' eyes. However, as Sir Francis Bacon (1561-1626) once memorably observed, "There is no excellent beauty that hath not some strangeness in the proportion." What makes liquidity strange? Two things: first, it tends to disappear when an investor wants (as distinct from needs) it the most; second, precisely because liquidity (i.e., the capacity to convert a security or portfolio into spendable cash) is such a fair weather friend, most institutional investors seek more liquidity than they need and obtain less liquidity than they seek.
- Investments entailing long-term lock-ups are often less risky than those entailing no lock-ups precisely because the former are truly illiquid: they cannot be sold "at the bottom," and the fact that they can only be liquidated at pre-specified times permits and encourages the investment pros charged with their day-to-day management to take proactive steps to enhance their value over long-term holding periods.
- Non-securitized or privately traded assets generating high current income yields are more "liquid" in the ultimate cash flow sense than those generating scant or no income.

HEDGE FUNDS

- Hedge funds' inherent heterogeneity renders all generalizations about them false except this: as with most forms of "alternative investing," hedge funds can have highly dispersed returns, making any given portfolio of hedge fund managers or strategies anything but a sure-fire means of earning annualized real returns exceeding 5% over the next 7–10 years.
- Hedge funds whose redemption windows pop open at intervals much shorter than a prudent investment time horizon for the strategies such managers employ create potential problems.

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