COMMENTARY

A Report of TIFF EDUCATION FOUNDATION

SUMMER 2006

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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

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a mutual fund family open to charities only

Highlights

On July 26, 2006, the TIFF Education Foundation (TEF) hosted an endowment management seminar in Cambridge, Massachusetts. Modeled loosely after the highly-praised cable TV show *Inside The Actors Studio,* the seminar comprised interviews by TEF president David Salem — a suspect substitute indeed for James Lipton of *ITAS* fame — of five leading lights in endowment management broadly defined. This *Commentary* comprises excerpted transcripts of three such interviews:

- **Harvey Dale,** University Professor of Philanthropy and the Law at NYU, summarizes his paper on the prudent investor rule and sheds light on the deceptively clever tax aspects of Warren Buffet's recent contingent transfer of substantial sums to the Gates Foundation;
- **Mohamed El-Erian,** President and CEO of Harvard Management Company, discusses the challenges HMC faces in deploying the world's largest educational endowment; and
- **Bill McCalpin,** Executive VP and COO of Rockefeller Brothers Fund, comments on challenges he's confronted as a mutual fund director and foundation investment professional, devoting special attention to the challenges of environmentally sensitive investing.

Excerpted transcripts of the other two interviews conducted on July 26 — with highly respected venture capitalist Bill Helman and notably successful investment strategist Jeremy Grantham — will be published in due course. Unabridged recordings of all five interviews are available for free at www.tiff.org/TEF. TEF acknowledges gratefully the fine work of summer interns Julia Ireland, Grace McEniry, and Virginia Shannon in organizing its July 2006 seminar and of summer associate Sam Beattie in preparing this *Commentary.*

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), an SEC-regulated mutual fund family; and TIFF Advisory Services (TAS), a taxable non-stock corporation and SEC-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. The members of these three entities' boards (except Richard Flannery and David Salem) serve as volunteers who receive no fees or salary but are eligible for expense reimbursement and matching charitable gift programs.

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

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Harvey Dale

Harvey Dale is University Professor of Philanthropy and the Law and director of the National Center on Philanthropy and the Law at New York University. Excerpted below is an interview of Professor Dale by TEF president David Salem that, while focusing on legal standards governing endowment fiduciaries, addresses other topics germane to the non-profit sector, including the deceptively clever tax aspects of Warren Buffet's recent contingent transfer of substantial sums to the Gates Foundation. Professor Dale's bio and paper entitled "Prudence Perverted: Politics, Perceptions, and Pressures," which is still in draft form, appear at www.tiff.org/TEF.

Not So Sweet in Pennsylvania

David. Harvey, one reason among several that we asked you to join us today is to discuss the paper you wrote recently on the prudent investor rule. Your paper is terrific because it discusses clearly and critically three examples of threats to the still-nascent harmony between prudent investor standards and modern investment thinking. The first case study you examine is what happened in Pennsylvania when the trustees of the Hershey Foundation decided to diversify its portfolio by unloading its majority interest in Hershey Foods. Can you summarize what happened and what should have happened in your view?

Harvey. Milton Hershey made lots of money in chocolate. After his wife died, he gave most of it away to a school for orphans called the Milton Hershey School. He made clear that his gift, which comprised Hershey Foods stock and other assets worth $60 million – which has grown to more than $6 billion today – was exclusively for the use of the school. At some point, it became clear to many observers, including apparently the attorney general's office in Pennsylvania, that significant concentration in securities of a single issuer wasn't a good idea[1], so the AG's office began putting informal pressure on the trustees of the Hershey School to diversify. The school's holdings of Hershey Foods are in Class B shares, which have 10 votes per share. So the shares – technically held by the trust established by Milton Hershey to establish and operate the school – accounted for more than three quarters of the total voting power in Hershey Foods. Although the trust's holdings accounted for just 30 percent of Hershey Food's common stock, the trust had effective control of the company.

David. Sounds like a pretty sweet arrangement.

Harvey. Indeed. So, when the trustees decided to diversify, they started by selling stock back to the company. But they were selling the school's shares at the market price for the A shares, which have just one vote per share. They weren't realizing any of the embedded value – a control premium – of a B share's 10 votes. At some juncture, as fiduciaries of the school, the trustees decided – in my view correctly – that they'd explore the possibility of a sale to the market so they could capture this control premium's value for the charity. Several newspapers reported that the Wrigley Company in Chicago, after chewing it over for some time, made an offer to the school in the range of $7.5 billion to $8 billion – a premium of between $1.2 billion and $1.5 billion above the A shares' market value. However, the attorney general of Pennsylvania interceded, stopped the sale, and took the position that under Pennsylvania law all charities must operate in the public interest, which includes the interest of the town, the community, and the state. Therefore, the control stake could not be sold without considering the sale's impact on the town of Derry. Indeed, the attorney general introduced legislation that amended the Uniform Prudent Investor Act such that in Pennsylvania, it is now the law that in diversifying a portfolio you can't dispose of control of a business without going to the AG and proving a whole series of things – burden of proof on you – about not harming the community in which the business is situated. In my view, this is a terrible perversion of the prudent investor rule and probably an interference with the purposes of Milton Hershey's trust.

When the school's Alumni Association found out about the attorney general's decision, they challenged it in court. The attorney general tried to claim that the Alumni Association didn't have standing. The problem was that he had made clear that he represented not just the school but the public as well. The interests of whatever he meant by "the public" and the interests of the school are not necessarily the same: there may be conflicts. Therefore, the court found that he couldn't be counted on to represent the school's interests and the Alumni Association had to be allowed standing because it uniquely could.

The result is that in Pennsylvania, there's a very broadened definition of standing in certain charitable sector cases with uncertainty about who has it. Not surprisingly, well-advised people are moving out of Pennsylvania to form charities so they can avoid this problem. Pennsylvania is losing money and funds, and the attorney general has weakened his own office. His decision was a disaster and a bad mistake. It's important that AGs have standing; it's important that they oversee the work of charities; but their supervision and oversight must be calibrated with prudence rather than imprudence.

Perilous Perceptions

David. Let's turn to the second case study discussed in your paper. It concerns endowment management at a well-known eastern university. Could you summarize this case study for us?

[1] Fifty-two percent of the school's assets were in Hershey Foods stock in mid-2002, down from 80% in the early 1980s. (Dale, Harvey. "Prudence Perverted: Politics, Perceptions, and Pressures." 2006.)

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Harvey. For years, because of the unique approach Harvard took to managing its portfolio, a significant portion of its investments were handled in-house. This is a very unusual model, particularly for a major endowment. Most endowments give this responsibility to outside managers, but if an endowment wants to manage assets in-house – and certainly it was done very successfully at Harvard Management Company – it must compete for talented professionals who have other opportunities. Obviously, an important tool for retaining talented employees is compensation. The compensation packages that were worked out by Jack Meyer and the board of directors of HMC had very substantial upside, certainly vis-à-vis a professor's salary. Charities like Harvard must file annual returns that disclose compensation, and although HMC is a separate corporation, Harvard's annual returns must include compensation paid by subsidiaries such as HMC. Accordingly, each year, the amounts paid to HMC's top earners are made public. For what it's worth, I favor this kind of public disclosure. But, it caused and continues to cause consternation and dismay among some constituencies. It's almost certainly the case that the aggregate compensation paid under this plan was less than would've been paid – but never reported – through the use of outside managers because the salaries paid by HMC to its employees were lower on balance than those that would have been paid by outside managers to their people. Harvard was doing very well because HMC was doing a great job **and** had lower costs. But the **perception** of the compensation situation eventually became intolerable. For decades this had been handled reasonably well by Harvard itself, but some alumni seemed particularly upset and wrote some angry letters. Eventually, this friction became so unpleasant for some people at HMC that they left.

UMIFA to UPMIFA

David. Your paper discusses another noteworthy development which is the recent effort by certain attorneys general to modify UMIFA – the Uniform Management of Institutional Funds Act – in a manner that you deem unwise. Why are attorneys general trying to modify it, and why should anybody here today care about what's going on in this realm?

Harvey. I wrote this paper in February of this year, and at that time the re-drafting of UMIFA was still underway. The Uniform Management of Institutional Funds Act was promulgated in 1972 and has been adopted by 44 states. It's essentially universal. There are things wrong with it, but it governs the conduct of institutional funds, which are in general endowed assets held by trusts and charities. UMIFA had grown out of date because most lawyers barely understood modern portfolio practices back in 1972, and lots has happened in this realm since then. It had some provisions that were increasingly deleterious, one of the most important of which was the historic dollar value [HDV] rule. The rule said you had to keep a record of the dollar value of contributions to endowments whenever they were made, preserve it forever, and if the nominal value of the portfolio drops down to this level, you can't spend anymore. The rule is crazy because as time passes, the original unadjusted dollar cost is never inflated and becomes less and less relevant but remains just as binding. If I give money to Harvard for student scholarships in 2000 and the market value of my gift drops below the original dollar value of the gift in 2001, it doesn't mean I don't want to give the money to students. But, in this hypothetical, UMIFA would probably require the fund to be frozen or at least force Harvard to reinvest it such that it yields only income – because there's an exception that allows you to spend current income even when you're below historical dollar value. But then, of course, you never recover the value! So killing HDV was an important part of the project, along with tweaking UMIFA such that it synchronized with the Uniform Prudent Investor Act. Two weeks ago, the new version of UMIFA was approved. It's now called UPMIFA – the Uniform Prudent Management of Institutional Funds Act.

Eternal Vigilance

David. I'd like you to reflect on how society can do a better job of keeping legislators and regulators from doing things that don't make sense and don't comport with best or even acceptable practices in endowment management. It seems like lots of wasted effort: to yank the vehicle all the way over to the wrong side of the road and then yank it all the way back, trying to somehow find a prudent path.

Harvey. The basic problem is that platonic guardians are hard to find. We're governed by human beings. Judgment necessarily plays a crucial role in governing society. Adopting bright line tests that are easy to promulgate but muddle-headed is one path that policy-makers are sometimes inclined to take. The better solution often is to remain aware of the crucial importance of wise regulators and legislators. Didn't someone once say, "eternal vigilance is the price of liberty"?[2] We need to monitor and police misbehavior.

Here's another example, I think, of a great abuse. The Ford Foundation is incorporated in Michigan, but its offices have always been in New York. Its endowment is about $12 billion. More than a year ago, Michigan's attorney general told the foundation he was commencing an investigation of its practices. I am told that he let it be understood early on that he'd probably quit his investigation if the Ford Foundation agreed to do 20 percent of its grantmaking in Michigan. About four or

[2] It's thought that John Philpot Curran – in his 1790 speech, "Election of Lord Mayor of Dublin" – was the first to say, "The condition upon which God hath given liberty to man is eternal vigilance." Many others, including Thomas Jefferson, Patrick Henry, Andrew Jackson, and Wendell Philips, have adapted this proclamation since.

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five weeks ago, two legislators in Michigan introduced legislation that if adopted mandates that the decision to form a charitable organization in Michigan means the donor has irrevocably chosen to gift at least 50 percent of the assets to programs conducted in Michigan. I hope and believe this is not going to be enacted into law, but if it does, people won't form charities in Michigan but instead will move their assets elsewhere. Interestingly, in the wake of this, an organization of southeastern grantmakers covering six or seven states wrote a letter to the president of the Ford Foundation saying they had noticed what the attorney general and legislators in Michigan were trying to do and that any one of their seven states would welcome the Ford Foundation to come and reincorporate if it would like to. That's a good message.

The Conditions of a Gift

David. You and I have talked offline about Warren Buffet's decision to eventually turn over a large fraction of his fortune to the Bill and Melinda Gates Foundation. What do you think of this?

Harvey. There's been much misunderstood about Buffet's gift. The Gates Foundation is worth about $30 billion. Buffet promises to give over time about $32 billion, equaling roughly 85 percent of his wealth. So in due course – according to *The New York Times, The Economist*, and other media – the Gates Foundation will be worth $60 billion. This is inaccurate because Buffet didn't make an outright gift. Rather, he imposed three conditions: (1) that Bill and Melinda remain active in the Foundation's governance; (2) that the Gates Foundation continue to be a charity, eligible for a tax-deductible gift; and (3) that starting in 2009 the Gates Foundation every year give away the sum of five percent of its assets plus 100 percent of Buffet's prior year's gift.

This last condition is really important. The normal rule is that if a person gives appreciated assets to a public charity like Harvard, he or she gets a tax deduction equal to the gift's fair market value and in addition he or she doesn't pay tax on the implicit gain. There's an exception to this rule. If you give property to a private foundation – for example the Gates Foundation – your deduction is limited to your cost. In Buffet's case, this is probably vanishingly small because he's held stock in Berkshire Hathaway for more than a few years. But there's an exception to the exception! You get a fair market value deduction even for a gift to a **private foundation** if it's of qualified securities or qualified appreciated stock, i.e., publicly-traded stock. So Buffet does get a fair market value deduction. But there's an exception to this exception – the qualified appreciated stock exception works only as long as the donor's aggregate gift of stock doesn't exceed 10 percent of the stock's market capitalization. In Buffet's case, this will happen soon because he's giving away lots and he owns 37 percent of Berkshire Hathaway's assets. My best guess is that he has three or four years before he maxes out on his qualified appreciated stock exception. After this, he'll get only a cost basis deduction, even though he's giving publicly-traded stock. But there's another way out! There's another exception for gifts to a private foundation that agrees it's going to dispense the money within one year. If it does, it's treated as a public charity for purposes of the donor's income tax deduction, and the deduction goes back up to fair market value.

The structure of Buffet's gift is clever for a variety of reasons. The first is that it doesn't matter very much to Buffet because his deduction will be limited to 30 percent of his adjusted gross income, and his AGI isn't very big compared to the $2.5 billion he's going to be giving away every year. He doesn't need the income tax deduction. He does need the gift tax deduction, but happily that's simple and doesn't have all of these complexities in it. Why does he want it? I have two theses on this. First, he probably could use a little bit of that deduction anyway. His cost basis might be too low, so he might really like the fair market value even though it's going to end up being much more than he can use. After all, Bill Gates can't use his income tax deductions for gifts to the Gates Foundation, either. Second, it makes that foundation a public charity for Buffett's purposes. And other people can make gifts to it on the same pass-through terms. I assure you that there have already been approaches made to the Gates Foundation to consider whether they should open up and allow other people to make gifts to it.

Now let me come back to why Buffet's gift is bigger than originally thought. If you think that in due course the assets of the Gates Foundation will be $60 billion and will be complying with the tax rule that requires private foundations to spend five percent per annum, then at some point in the future it will be spending five percent of $60 billion, or $3 billion. But in reality, by 2009 it's going to be spending $1.5 billion **plus** Buffet's $2 billion plus. It's going to be spending $3.5 billion, which makes it implicitly the size of a $70 billion foundation two years from now. This is much different and much more powerful. The Gates Foundation will have to expand its back office and staff significantly to accommodate this additional money. I'm sure the requirement to become a spending foundation doesn't begin until 2009 so that Buffet can use the qualified appreciated stock exception for two years and also allow the Gates Foundation to ramp up in preparation for the drastic increase in grantmaking dollars it will have to disburse each year. It's astonishingly clever.

The Anonymous Philanthropies

David. You served as president for many years and

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continue to serve as a trustee and a member of the investment committee of The Atlantic Philanthropies, formerly The Atlantic Foundation. It's actually a keiretsu of affiliated foundations, governed by essentially the same relatively small group of trustees, that remains highly distinctive in at least two important respects. First, it declines to consider unsolicited requests for funding, preferring instead to award grants only to operating charities that the foundation itself proactively identifies as choice-worthy. Second, The Atlantic Philanthropies is pursuing a conscious strategy of self-liquidation in nominal terms, as distinct from the unconscious strategy of self-liquidation in inflation-adjusted terms being pursued by some endowed charities whose investment programs can't possibly generate real returns commensurate with their spending rate. I might add that during the many years you served as its president, The Atlantic Foundation conducted all aspects of its operations, including grantmaking, in a non-disclosed or anonymous manner – to the point where even the CEOs of certain organizations receiving grants from Atlantic didn't know those grants' true source. Tell us the reasons why Atlantic operated so secretively for so many years.

Harvey. Many folks don't know of Atlantic, and this is intentional. The Atlantic Philanthropies is a substantial charity. During the 20 years I ran it, we gave away a little over $2.5 billion. We've given away over $3.5 billion by now. We have about $3.8 billion in assets, and we intend to give it away at about $350 million per year. We will have given away about $8 billion by the time we close the doors. We operated anonymously for a whole series of reasons, the most important of which – at least for me – I'll come to in a minute. The first was simply history. The initial asset that generated the wealth to found The Atlantic Philanthropies was Duty Free Shops. Duty Free Shops ran shops in airports – you've all been through them. We eventually sold our share of DFS – 38 percent – to LVMH in 1996 for $1.7 billion. DFS was a pretty big operation. It was always run in **strict** confidentiality, and the basic reason for this, apart from the fact that it suited our style, was that neither our potential competitors in bidding for these airport concessions nor – very importantly – the governments which were posting these bids could understand the business. Our business plan was very powerful, and nobody had it. Since secrecy already permeated the organization when we began serious philanthropic giving in the late '70s and early '80s, it was easy to maintain.

There was a second reason for our anonymity. The good work that's done in the non-profit sector is done by people who are delivering goods and services. It's not done by the people who dole out grants. By keeping the profile of the foundation low, there was nothing to do but focus on the work being done by the charities that were delivering services. This seemed to me to be very powerful.

By the way, one extremely important reason why we abandoned anonymity is that non-profits in general are unaccountable. People in government can be elected to or booted out of office. For-profit corporations can be sued by their shareholders – and this happens regularly. Non-profits' fiduciaries generally don't get voted into or out of office and generally can't be sued by anybody because of the rules of standing. The supervisory power in the United States overseeing approximately 1.3 million charities is **fewer** than 200 people in the aggregate – comprising agents from the IRS and the offices of the 50 attorneys general. In other words, these charities are largely unsupervised. Effective policing of them depends on other entities, such as the media. Now think about The Atlantic Philanthropies: it was not only non-accountable, except to the attorney general of Bermuda – which is where we formed it – it was anonymous and hidden. Not even the media could get at it. This was a problem with which we had to deal and was the biggest pressure for giving up anonymity. But in doing so, we gave up a third and what I believe is the **most** important aspect of anonymity.

When we were anonymous, we of course never took credit for the grants we doled out because essentially nobody knew we were making them. One of the most serious problems of foundation giving – and I confess it's so important to me that it sets my teeth on edge – is that when you're perceived to have the ability to give away money, everybody lies to you always. When it became public that I'd been president of The Atlantic Philanthropies, you'd be surprised how much better looking and how much better a dancer I became in some folks' eyes. The result of this is tremendous pressure towards arrogance and narcissism, and I hate it. Anonymity helps to prevent this.

Conscious Self-Liquidation

David. Can you talk about the investment policy pursued by a foundation consciously seeking to self-liquidate?

Harvey. It's a necessity over time that you must roll out of volatility and into liquidity because grantmaking has so-called fat tails. When you commit a dollar today, our experience is that you spend about 30 cents this year, 40 cents next year, and 30 cents over the ensuing years. Some of these tails are quite long. Even though you maintain investable assets, these assets are hypothecated to paying off the stream. We intend to give away $350 million a year – nearly 10 percent of our assets today – and it will become much more than 10 percent over time because the portfolio's value will continue to decline. As we do this, we must keep tilting the portfolio. Today, we're happy having material exposure to illiquid and highly volatile assets such as venture capital. But we've shifted the portfolio so that we're now nearly 50

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percent in alternative assets, hoping that we'll get more alpha with lower beta, at least on the downside. As we move forward, we'll make fewer lock-up investments, giving up the premium that we get for accepting lock-ups and reducing our expected returns in the hope of having enough liquidity to meet our last several years' grantmaking obligations. This poses an unusual – and unusually severe – challenge for our investment team, to say the least!

David. Thanks for joining us today, Professor.

Mohamed El-Erian

Mohamed El-Erian is president and CEO of Harvard Management Company, the subsidiary of Harvard University responsible for investing over $30 billion of endowment, retirement, and planned giving assets. Before joining HMC in February 2006, Dr. El-Erian was a managing director and senior member of PIMCO's portfolio management and investment strategy group. Excerpted below is an interview of Dr. El-Erian by TEF president David Salem. Dr. El-Erian's bio appears at www.tiff.org/TEF.

Structured for Success

David. A necessary condition for effectively stewarding an endowment of any size is being structured for success. At Harvard Management Company, this means among other imperatives ensuring a substantial if not complete overlap between the goals you and your staff are pursuing and the goals that HMC's many external constituencies think it should be pursuing. The pool of money being stewarded by HMC is anywhere between 50 percent and 100 percent larger than the investment pools of universities comprising Harvard's peer group for investment performance purposes. Given this fact, how reasonable is it to think that HMC can keep pace with let alone outperform this peer group?

Mohamed. Let me start with our goals. We have a simple mission, and one that was instrumental in attracting my colleagues and me to work at HMC. Our mission is to help deliver superior returns over time on the endowment and related accounts. We believe that doing so is important not only for Harvard but for the education sector more broadly. A successful year at HMC can be measured in three ways. First, and most importantly, have we generated total returns sufficient to maintain and enhance the value of the endowment after taking into account annual distributions to the University and the impact of inflation? Second, has HMC added value through active management relative to its benchmark? And finally, have we performed well relative to other similar institutions? If we accomplish all three, we've had a great year.

You asked about size, which is an important issue. As you mentioned, Harvard's endowment is slightly less than twice the size of the next largest university endowment. When thinking about the implications of size, I am reminded of my days at PIMCO. PIMCO managed approximately $150 billion when I joined and over $600 billion by the time I left. Throughout the process, we thought intensively about the size issue. We learned that while size may have disadvantages, it also has advantages. Size forces you to constantly monitor and reinvent yourself at the appropriate times. If you're large and the world changes quickly, you must recognize the changes and adapt in order to stay ahead. Size also affords you access to certain activities, while making others more difficult to exploit. At HMC, size prevents us from doing certain things that our peer group has done for years. For example, even if we wanted to, we could not move quickly to 100 percent external management and hope to find attractive capacity among managers. At the same time, size enables us to maintain certain internal portfolio management capabilities that enhance our comparative advantage, are cost effective, and hold the potential of generating attractive returns over time. These activities tend to be scalable and provide superior risk management due to transparency and timeliness of information. In summary, we are clear on what size does and doesn't allow us to do. And because of our size, by both choice and necessity, we will look different from significantly smaller endowments. Indeed, if we simply attempt to imitate other endowments that do not have our set of structural advantages and disadvantages, the long-term value of our endowment will suffer.

We have also found that by having a mindset open to internal management, we become a better manager of external managers. I came across this when I was an external manager and observed the difference in approach between some clients who were exposed to the markets and some who were not.

Policing Policy Portfolios

David. The eminent economic historian and investment thinker Peter Bernstein caused quite a stir a few years back when he published a paper arguing that policy portfolios often do more harm than good to the institutions that employ them. Where do you stand in the ongoing debate about policy portfolios?

Mohamed. We think of this issue within a multi-step framework aimed at generating superior returns over time for the endowment. Step one is defining a policy portfolio, or the neutral asset mix. The easiest way to think about policy portfolios is to suppose that you had to choose a single asset mix to meet the objective of your endowment in terms of return over a long period of time given the information that you have right now.

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We all know that the world doesn't proceed in a linear fashion. There are lots of uncertainties, changes, and unanticipated shocks. By necessity, we deal with a world of limited and asymmetric information. As such, the policy portfolio needs to be reviewed on a regular basis, perhaps annually.

Step two is actively managing the asset allocation in an attempt to add alpha. This can be done using both internal and external portfolio management resources.

Step three is to step back and ask whether the decisions of all the smart individuals managing various pieces of the endowment – decisions that are totally rational at their level – are rational and internally consistent when viewed across the whole endowment. If they're not, then the endowment at the macro level should make appropriate adjustments. For example, it can either hedge exposures that are excessive when aggregated across all the individual portfolios, or it can augment those that are insufficient.

A policy portfolio becomes a problem when people assume that it's totally rigid and that you should never question it. If this happens, you risk becoming a prisoner of what, by definition, should be an organic thing – because the world changes and new information becomes available on secular developments. A policy portfolio provides important discipline, but you must review it on a periodic basis. We do so every year.

Once you have a policy portfolio, you can implement an investment process that not only delivers an appropriate mix of market returns, or beta, but also seeks to deliver excess returns, or alpha. **How** we do this – how we pursue alpha and beta – is secondary to our fundamental objective of maximizing the total value of the endowment. Institutions can go wrong – and I've seen this with some funds – when they lose sight of sensible absolute return goals and simply chase alpha, thereby paying insufficient attention to how they're going to get the beta right.

At the end of the day, what is really important is delivering to the University the superior absolute return outcome. If you gave me the choice – and I hope I never have to make this choice – between generating wonderful absolute returns but being well behind other universities **or** generating dreadful absolute returns but outperforming other universities, I'd choose the former. After all, the former translates into real dollars for funding important educational activities.

Juggling Jargon and Judgment

David. When you were appointed CEO of Harvard Management, you also accepted an appointment as a member of the faculty of the business school, an institution which I can reliably tell you does a pretty good job advancing at least one aspect of its multi-pronged mission: inculcating in its graduates enough specialized jargon to persuade unsuspecting laypersons to hire them as money managers. Although you didn't attend HBS, I know you have a working command of not only the specialized jargon taught across the Charles but of the techniques to which it refers, including three whose pros and cons I'd like you to discuss. More specifically, to what extent does HMC use three widely employed analytical techniques: mean-variance optimization, Monte Carlo simulation, and value at risk analysis (VAR)?

Mohamed. We use all three tools at HMC. For example, they're part of a tool kit that helps us think about risk. Mean-variance analysis seeks, through an optimization process, to minimize volatility for a given level of return. Monte Carlo simulation is simply a way of generating potential outcomes in an unbiased manner, i.e., random outcomes. Finally, VAR analysis tells you, given a set of assumptions, how much of a portfolio's value is at risk at a certain confidence level.

These are powerful tools, but they can be dangerous if misused. Obviously, the inputs are critical. A typical approach is to use a set of historical assumptions, but history often is not a reliable guide to the future. It's critical that you understand and appreciate the assumptions you're using. Furthermore, a number of underlying, simplifying assumptions must be made in order to render these tools usable. Unfortunately, it's hard to square these assumptions with the real world at times, so in effect you "change" the way the world behaves when you use these tools. Given all these considerations, you should never use these important tools in isolation as each provides a single and by definition limited window into the future.

David. So you're essentially using these tools for descriptive rather than prescriptive purposes.

Mohamed. We use them in concert with other tools to help us understand the world and how we are positioned. At the end of the day, we believe that much of what we do is a combination of science and art. It's important to strike the right balance.

For example, if you were to passively run a mean-variance analysis right now, it would likely push you heavily into two asset classes: commodities and emerging market equities. Now, we all know instinctively that this isn't right in terms of sensible portfolio diversification considerations. You must use judgment. It is smart to ask such questions as, "What is the model is telling me; **why** is it telling me this; are we going through a structural break of some sort; are

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there other considerations that should supplement what the model is telling me?" You should use these tools because they provide important insights. But they don't provide infallible answers. Judgment remains necessary and important.

Commodities' Changing Face

David. As always happens in investment markets, when asset classes or subclasses have had a great run, investors pile into them even though they've perhaps never owned them before. Of course, the question that always arises is whether the tidal flow of money that moves into the asset class doesn't ultimately change its fundamental characteristics, undermining the original thesis. Given the vast difference between the holders of commodities today versus the types of folks who held them as recently as three years ago, can commodities continue to play the role that institutional investors typically suppose they will?

Mohamed. As you know, commodities have been in Harvard's policy portfolio for a long time. Indeed, we believe that commodities have certain characteristics that make sense not only from a strict portfolio construction point of view but also from a broad secular point of view.

There's an economics notion called Goodhart's law which is the equivalent in the social sciences of the uncertainty principle in physics: as soon as an economic or market indicator becomes a target for purposes of conducting policies or strategies, it loses the characteristics that initially qualified it to play such a role! We believe that the role of commodities is going to change. Indeed, and more generally, words like "conundrums," "aberrations," and "puzzles" are featured more regularly in speeches and articles on commodities. Analysts sequentially romance different projections that are inconsistent with each other over time. This is because existing models are no longer as predictive as they used to be.

There are two reasons for this. First, the world is changing. Countries such as China and India that previously were not systemically important have become so. At the margin, these countries are starting to influence the variables – global growth, global inflation, capital flows, and trade – that impact asset allocation and implementation including the demand for commodities. Second, Wall Street has created a set of derivative products that effectively enhance access to markets including the area of commodities. Let me give you a simple example that is closer to home. Eighty percent of new mortgages in California over the last 12 months have been "exotic mortgages." This is a polite way of saying that some people now own houses they couldn't have previously afforded. An exotic mortgage divorces long-term affordability from short-term affordability. This structural change is effected through derivative products.

By facilitating access to a broader range of markets, derivatives have impacted the landscape which includes commodities. This, combined with the demand for physical stocks coming from fast-growing emerging economies, has changed the dynamics for commodities. But the phenomenon is not linear. There will be times when commodities will do very well, and there will be times when they'll do worse, and this is where active management becomes important.

David. When you look at commodities' long-term real returns, they're one or two percent per year at best. Indeed, some folks who've studied commodity returns think that the real return over the long term is actually zero or even negative. How do you justify the permanent inclusion of commodities in a portfolio that's seeking to generate four or five percent real return when they constitute such a seemingly heavy drag?

Mohamed. They're a seemingly heavy drag because of the way they're viewed. Commodities traditionally have had a very low correlation to other asset classes. If I told you that investing in commodities only gets you two or three percent real return but does so with virtually no correlation to any other asset classes or subclasses, you'd want commodities because the only other way you could get a correlation that low would be through cash at essentially a zero real rate. Now, I think the correlation of commodities to other asset classes will change. Indeed, a hypothesis that will certainly be tested over time is that in five or ten years we're going to see a structural break in the return, variance, and co-variance characteristics of commodities.

Risky Business

David. People used to joke that India is a country characterized by too much democracy and too little capitalism whereas China is the reverse. Looking ahead, do you think it's sensible to consciously overweight China and India? I pose the question against the historical precedent that if you were investing from an equity or stock point of view in the most rapidly growing countries throughout recorded history, you would have earned a below average return. The dilution of corporate earnings flowing to shareholders in economies characterized by rapid GDP growth mathematically would have caused you to earn below average returns relative to what you would have earned in more established economies.

Mohamed. All of us, whether we do it implicitly or explicitly, are taking a view of the world, and you can't do this today without recognizing that certain emerging economies are having a more profound effect on global capital flows and hence market movements. In the old days, if you got the US right, you'd have solved 90 percent

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of the puzzle. Now, you've got to get more than the US right, and you must take seriously what's happening in China and India.

There is a tendency among investors to simply pursue a China theme or an India theme, and this may be inappropriate. Having spent a lot of time investing in emerging markets, I can tell you that as soon as you start aggressively investing in a country simply because you think it's a country that "matters," you're going to risk losing money. You must carefully pick and choose your opportunities if you want to invest in developing countries.

Many endowments and foundations now have considerable international exposure. It makes sense and has served them well. But very few endowments have foreign exchange expertise in house. A few months ago we hired a person for this and set three goals for her. First, help us get our arms around the level and nature of the foreign currency exposure that is embedded in existing investments. Second, help us advance our thinking in this rapidly developing area. Third, we said, generate risk-adjusted alpha as the opportunities arise.

Once you make the decision to go international, you must recognize that you're assuming risks incremental to and in important respects different from those you may have incurred in the past. This speaks to risk factors that pertain to currency, convertibility, *et cetera*. The world has been an incredibly benign place for the last few years, but there's no guarantee that it'll continue to be so. Sophisticated risk management by foundations and endowments is going to become an even more critical element going forward.

David. Isn't there the question of examining the basket of goods and services that's being purchased with the endowment to determine what fraction of such spending is actually denominated not in US dollars but in foreign currencies?

Mohamed. Absolutely. Those investing domestically and buying the S & P are increasingly buying a more global basket because US companies are now deriving more revenues and profits from outside the US. Similarly, those investing in less developed countries are increasingly incurring truly global as distinct from country-specific economic risks because these countries are selling commodities that are priced globally. Our approach is to knowingly manage these risks rather than simply say there's nothing we can do about them.

Serious Money

David. What do you do to prepare yourself for macro shocks like what we've seen in the Mideast in recent weeks?

Mohamed. Let me give you an example. I spend the first three hours of my day on the trading floor with our portfolio managers. The reason why I do this is not because I necessarily add value there. It helps me understand how different parts of the endowment are evolving and behaving under different market conditions. Over time, you develop a better sense for how the endowment reacts to a variety of economic and geopolitical shocks.

Being on the trading floor also allows you to see how investment professionals react to inevitably fluid markets. If you're managing the risk of an endowment, you should have a feel for how portfolio managers react when they confront unanticipated shocks.

Like you, we interview routinely many investment professionals and funds with impressive resumes. We ask all of them a very simple question: How would you position yourself today? Unless you have a feel for how the market is behaving and why, it is hard to engage portfolio managers at a level that enables you to develop sufficient confidence in their abilities to entrust serious money to them.

David. Thanks for joining us today, Mohamed.

Bill McCalpin

A founding member of TIFF's board, Bill McCalpin joined the Rockefeller Brothers Fund in September of 1998 as executive vice president and chief operating officer. Excerpted below is an interview of Mr. McCalpin by TEF president David Salem that addresses, among other topics, today's regulatory environment, so-called socially responsible investing, and the potential effects of global climate change on investors' portfolios. Mr. McCalpin's bio appears at www.tiff.org/TEF.

The Costs of Regulation

David. Several years ago, you joined the board of one of the largest mutual fund complexes in America, the Janus Funds, as an independent or "non-executive trustee." I'd like you to reflect on the patchwork of laws and regulations governing mutual funds. On balance, does this patchwork do more harm than good for the American economy?

Bill. I joined the board of the Janus Funds in the summer of 2002. In September 2003, the New York attorney general announced that he had launched a major investigation of market timing abuses in the mutual fund arena. It was not a fun experience to live in the spotlight of the New York attorney general, the Colorado attorney

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general, and the SEC. As problems were discovered and examined, the Janus Funds' life changed. These investigations in turn spawned a series of legislative and regulatory initiatives that are still unfolding today. While this was an uncomfortable experience for Janus, I think it was a positive one on balance. It has changed the governance landscape for mutual funds, for sure. However, in these kinds of situations, the pendulum of regulation often swings too far. New rules have spawned new costs that are being passed through to mutual fund shareholders.

David. To what extent can someone who's not engaged full-time understand and govern effectively enterprises as complex as Janus or Harvard Management or Fannie Mae?

Bill. It's more difficult in the case of mutual funds, particularly in circumstances in which the investment advisor is a publicly-traded company, as is the case at Janus. Janus Capital Group – the publicly-traded entity managing the mutual funds – has its own board that has fiduciary responsibilities to both its shareholders and our board, which represents the interests of mutual fund shareholders. There are lots of interesting conflicts to manage. In fact, serving on the Janus board is the most challenging governing role I've ever played.

David. You mentioned the costs that are incurred because of all of this new regulation. They're enormous, and they go way beyond regulatory filings, paperwork, and paying lawyers and accounting fees. There are immeasurable opportunity costs that are the result of strictures imposed on mutual funds and their managers, typically by federal lawmakers. Why not deregulate at least the investment process for mutual funds and say simply that they can do whatever they want as long as it's disclosed adequately in the prospectus?

Bill. It's helpful to have something interposed between the retail investor and the investment company. Lots of regulation grew up to fill this gap, but now we've got a different circumstance which might invite going back to first principles and examining whether or not we need as much regulatory infrastructure. About 80 percent of the flow into mutual funds these days is coming through advised channels – 401(k) plans, broker-dealers, and all sorts of intermediaries. The direct retail channel is drying up. With the explosion of these advised channels, we might have a sufficient structure of representation of the individual investor vis-à-vis the investment company to allow for mutual fund structures other than the current highly-regulated one.

David. How worried are you that the regulatory environment in which we're operating today is repelling truly talented and wise people from the boards of these important entities?

Bill. When you're described as being asleep at the switch, when you're served with lawsuits, or when you're the subject of plaintiff lawyers' depositions, it's not fun. Today's regulatory environment does serve as a deterrent to board service for many people.

David. Are there any silver bullets from a public policy perspective that could be fired to mitigate this problem? Does it go beyond simply offering directors and officers insurance to people? Isn't it essentially the time, the stress, and the hassle that you're trying to mitigate?

Bill. It is. For me it's a very demanding role – not at all casual. It takes up lots of days per year. There's lots of reading. I chair Janus's legal and regulatory committee, which has oversight of regulatory filings and the prospectus. I spend lots of time reading this material and focusing on disclosure and presentation issues. Getting back to your question of why we don't just require everything to be disclosed in the prospectus and let that be sufficient regulation – well, who's going to say what's "everything"? No one's going to argue for more aggressive disclosure – certainly not the fund manager – if the lawyers don't.

John's and John's

David. You finished law school 22 years ago and have been with foundations ever since. You were with Rockefeller Brothers Fund for seven years, MacArthur Foundation for seven, and then RBF again for eight. I'd like you to discuss the differing joys and frustrations of working at a big foundation whose founding family is still very much involved in its governance – RBF – versus a foundation at which the founding family is totally removed from the scene and which is governed by an outside board of non-family members, namely MacArthur.

Bill. There are huge differences. Rockefeller Brothers Fund was formed in 1940 by the six offspring of John D. Rockefeller, Jr. As they entered their adult lives, they wanted to do something different from what their parents and grandparents had done. RBF is an institution that had a running head start in terms of its philanthropic culture because its founders had sat at the knee of their grandfather and at the dinner table with their father and talked about philanthropy. By the time they reached adulthood, philanthropy was in their DNA. They knew what they were doing and established a clear identity and a clear philosophy for the foundation.

The MacArthur Foundation had very different origins. As far as I know, John D. MacArthur didn't give away much during his lifetime. He created a foundation in a

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great act of generosity during his demise, but he didn't pass any philanthropic identity to it. Further, he named to the initial board individuals who didn't have much philanthropic experience. The foundation had to spend lots of time figuring out what it wanted to be. This led to a prolonged childhood and adolescence during which the foundation's resources, perhaps from a societal standpoint, weren't necessarily being put to their highest and best use. This relates to Buffet's gift to the Gates Foundation. Buffet understands that the Gates Foundation has an identity, has structure, and has experience, and he's chosen to give his money to it instead of spending years trying to reinvent the wheel so to speak. This is a very interesting decision, and we'll see whether or not it has an effect on other philanthropists.

It's All About Learning

David. You spend lots of time thinking about "socially responsible investing" – or "constrained investing" as it's sometimes called because what's responsible to one person may not be wholly responsible to others. However you label it, it's a very hot topic these days. You spent lots of time at MacArthur administering an initiative entitled Investments Related to Programs (IRPs). This is a terminological reversal of the more widely known grantmaking model entitled Program-Related Investments (PRIs). My understanding is that the IRPs at MacArthur were explicitly seeking to earn a market rate of return in a manner consistent with the foundation's programmatic goals. Talk to us about the joys and difficulties you experienced in pursuing this unusual two-pronged mandate.

Bill. Your terminology is correct. The official definition of "program-related investments" in the Internal Revenue Service regulations is that in fulfillment of the five percent spending requirement to which private foundations are subject, they can include administrative expenses, grants, and – since the late 1960s – program-related investments. The two-part test of a program-related investment is that (1) there must be a philanthropic purpose to it – which any good lawyer can generally find – and (2) there must be some element of concession to what would otherwise be a market rate of return. I joined MacArthur in 1991 to open up a third window in addition to grants and PRIs – to find ways to deploy some of the foundation's investable wealth in a manner that would produce returns competitive with those produced by the overall endowment while also advancing explicitly one or more of the foundation's articulated philanthropic interests.

Before a foundation decides to undertake what MacArthur calls Investments Related to Programs, it should ask itself why it wants to do this – because it certainly doesn't have to. There are several reasons to pursue IRPs. First, there's a "feel-good" reason: you feel good that some of your capital is being deployed in a manner that's consistent with your mission. I don't think this is a very good reason for pursuing IRPs. Your reason should have greater depth and substance. Second, you might be able to make an impact in certain areas with investment dollars that you simply can't with grant dollars. This is tricky to sort out but a more compelling reason to pursue IRPs. Third, you may want to learn something. Your participation in certain fields through the investment window gives you insights, access to information, and perspectives that actually make you better on the philanthropic side. To me, this is the meatiest reason for deciding to allocate time and effort to IRPs.

Too High, Too Low?

David. Imagine that you were czar for a day and could change the mandated five percent annual payout for private foundations. Taking all relevant factors into account – including society's best interests, foundation management behavior, and perhaps most importantly expected capital market returns – is five percent about right, too high, or too low?

Bill. I'd be inclined to bump it up a bit. RBF undertook an exhaustive study on spending last year and found that six percent is about the breaking point. If you spend more than six percent annually, over time you begin to increase the risk of depleting the real value of the endowment. We spend about five-and-a-quarter percent per year philanthropically and about three-quarters of one percent per year on investment management and taxes. So we're at about six percent. I think the mandated payout rate could be a little higher than five percent – but not by much – and I certainly don't think five percent is too high because my personal view is that unlike universities, foundations shouldn't be in the business of accreting real value over time. They should be giving back to society. That's their role, and that's the reason why they enjoy the tax benefits that they do.

David. How far do you go with this argument? Would society be better off if we bumped the mandated payout rate to seven or eight percent? In asking the question I'm mindful that unless foundations achieve extraordinary investment returns, a spending rate north of five or six percent will put them on a path toward liquidation in purchasing power terms.

Bill. That's a good point. Foundations shouldn't be forced to spend themselves out of existence over time. A perpetual life is a policy choice that every foundation should have the opportunity to make for itself. And every foundation board should take on this question at least once a generation. I don't believe in a legislative mandate for it. But there's a fine line.

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Hot Topics

David. You've spent much of your 22 years in the foundation field thinking about environmental issues, including global warming. I know you've seen Mr. Gore's movie, *An Inconvenient Truth*. What did you think of it?

Bill. Before assuming the role of film critic, I'd like to straighten out some terminology. I think "global warming" is the right term to use to engage the public, but technically it's "climate change" we're talking about. It could be warming, but in certain parts of the world it could be the opposite.

David. Isn't this debate really about man-made or man-induced climate change? Because if it's natural, there's not much we can do about it.

Bill. That's right, and that's what the film is about. It seems to me that the purpose of the film is to help a mass audience embrace the problem of man-induced climate change and its implications. It's a tall order for our society. How do you take a problem that's going to manifest itself over a very extended period of time – beyond the lifetimes of all of us – and depict it in a way that prompts people to act? I think the film generally succeeds... But it falls short in presenting solutions. In order to truly engage the issue, people need to see that they can take steps and that it is possible to do things without radically altering their lifestyles in the process.

David. Assume you're running a state-of-the-art investment program at a perpetual life charity, and after seeing *An Inconvenient Truth,* you want to tweak your investment program in a manner that's reflective of man-induced climate change, how could you exploit, in a narrow and selfish capitalist sense, the environmental problems that the movie highlights?

Bill. After seeing the movie, you might think that there's going to be increased storm activity around the globe as a result of the warming of the waters that's occurring as a result of human activities releasing more carbon dioxide into the atmosphere. You might look at where the risks are in your portfolio. In your real estate portfolio, for example, you must examine how much coastal exposure you have in areas which are likely to experience potentially damaging storms. You could look at your timber holdings to see if there are areas of the globe that are more likely to be susceptible to infestations or to climate change-induced events. Would looking at these things cause you to restructure your portfolio? I don't know, but you must understand the risks you're incurring, and acute environmental sensitivity can help lots in promoting such understanding.

You could even go beyond the film. Perhaps you believe that within the foreseeable future we'll be living in a carbon-constrained world. In this case, a price to carbon and indeed a regime for controlling carbon will presumably emerge. The beginning of such a regime already exists in Europe. At some point, there is likely to be a similar regime in the US. Many chief executives of large companies operating throughout the world would acknowledge this. I don't know when it will happen, but if you believe that there will be a price to carbon, then examine your portfolio and understand where your carbon risk is. Within certain sectors, if your holdings are weighted heavily toward coal assets and not as heavily toward natural gas, perhaps you'll want to change your weighting. Coal is a dirtier fuel, and there's more carbon exposure in coal producing assets than there is in natural gas assets. Do you want to overweight BP, which seems to have more of an enlightened view of the future than Exxon-Mobil? You should be asking yourself these types of questions...

We're moving into an era in which we'll think about energy in a way that's different from the way human civilization has thought about it for the last 100 to 150 years. Whether you give lots of thought to climate change or not much thought at all, the age of relatively inexpensive fossil fuels is ending. This new era will open up an array of interesting opportunities in electricity generation, distribution, and consumption, as well as in transportation fuels. The shift already underway is going to play out over a very long period of time – longer than my lifetime or my children's lifetimes – but there are some interesting investment opportunities arising today as a result of this shift, and this is where I'd like to focus my energy when I leave RBF.

David. Thanks for joining us today, Bill.

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