COMMENTARY

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Highlights

With the assistance of two highly capable collegians — Caroline Whitton and Richard Littlehale — TIFF's founding president delivered an address on January 25, 2007, to a gathering of endowment officers and trustees assembled in New York City by the National Association of College and University Business Officers (NACUBO). This address — entitled *Endowment Management Circa 2007: Art, Science or Craft?* — appears in its entirety herein. Its author hopes readers have as much fun consuming it as he had preparing and delivering it, and thanks his fellow thespians Caroline and Richard for their help with the latter task.

About TIFF

Mission. In 1991, a network of foundations founded a cooperative-style investment organization whose structure and eligibility criteria have evolved over time but whose core mission has not. Known colloquially as TIFF, this organization 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.

Means. The organization 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 than its formal legal name (The Investment Fund for Foundations); 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 salary for their service to such boards.

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

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Surprise. I have a surprise for all of you, and I do mean all of you, my friend Bill Spitz included. I mention Bill because he's the guy who called me many moons ago with a plea along the following lines: "Big NACUBO event. New York City. Early next year. All-star cast. Talk about whatever you want, for as long as you want, so long as it's entertaining." "Why's that, Bill?" I asked. "Your other speakers a bunch of stiffs?" "Hope not," Bill replied. "I'm one of them. But you'll be last man up at the end of a really long day." Not exactly: you see, the surprise I have for all of you is that I have no intention of filling my allotted time solely with the sound of my own voice. Rather, on the assumption that many of you have jobs that prevent you from spending meaningful time interacting with students at the schools that employ you, I'm going to summon to the stage two very capable collegians. Both attend a school that's posted enviable endowment returns — returns whose stellar character is rooted in endowment management techniques described at length in a book authored by this school's CIO published several years ago. The reason I've asked my two guests from Yale— Caroline Whitton and Richard Littlehale — to join me on this stage is because they're going to help me answer the question comprising the title of my talk here today: *"Endowment Management Circa 2007: Art, Science or Craft?"* They're going to help me answer this question via the medium of what, for lack of a better term, one might refer to as a Socratic dialogue — a conversation scripted by me that seeks to do at least three things. The first is to provide some historical perspective on endowment management as it's evolved over time, with the aim of demonstrating that the soundest approaches to it necessarily combine art, science and craftsmanship. A second aim of the dialogue you're about to hear is to highlight what I perceive to be some especially noteworthy perils and opportunities confronting endowment investors at present. A third and final aim, of course, is to entertain, in keeping with my pledge to Bill to do whatever I reasonably can to reward you good folks for spending the entire day in a windowless room talking about what I'm fortunate to do for a living.

This brings me to two final points by way of preface. First, rather than asking my fellow thespians to play characters radically different in age or experience from themselves, I've crafted the dialogue in a manner that makes their roles relatively familiar ones. More specifically, both Caroline — or rather Cricket, which is the nickname her parents chose for her when she was an infant — and Richard are cast here today in the role of college students — young persons seeking to determine whether endowment management would be a fun and fitting way to make a living and, if so, how they can best prepare themselves to succeed at it.

Final point by way of preface: although the dialogue you're about to hear refers repeatedly to the TIFF publications furnished in your binders, familiarity with them isn't a prerequisite to understanding what follows. [Editor's note: all such publications are posted at www.tiff.org.]

Cricket. So ... Mr. Salem ... Rich and I did what you suggested and read all of the materials you gave us about money management, including that tome on asset allocation that you wrote for TIFF a few years back.

David. You mean *Message in a Bottle*?

Cricket. That's the one.

David. Whad'ya think of it?

Cricket. Depressing.

Richard. Agreed.

David. Why's that?

Richard. Because the stuff you gave us to read makes it plain as day that even the best minds in the business don't agree on the optimal way to invest endowment money. I'm not sure I want to go into a line of work where what even the expert players **know** is dwarfed by what they **don't** know.

Cricket. Don't know and **can't** know!

David. Time out: isn't what you've just said true of any line of work that clever folks like the two of you would want to pursue? I'm biased because I sank into money management

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almost 25 years ago, but by my way of thinking it's one of the most interesting professions on the planet, for one simple reason: changing asset prices aren't merely the by-product of the dynamism that capitalist economies display; they're the root cause of it. In other words, even though the market opens and closes at the same time every business day, each day tosses up a fresh set of challenges — a novel set of boundary conditions, if you will, for investors to exploit or be exploited by.

Richard. Not according to the guy who wrote all those essays about investing that you asked us to read.

David. You mean Peter Bernstein?

Richard. Yeah — Bernstein. You've said he knows more than just about anyone alive about the people and ideas who've made the money management business what it is today. But wasn't it Bernstein himself who wrote in one of the essays you asked us to read that there hasn't been any truly innovative work done in your field since the early 1970s?

David. Not exactly. What Peter was brave enough to say when he gave the keynote at a big meeting of quant types a few months ago [Editor's note: the Q Group's Fall 2006 conference] is that essentially all of the theories underlying what's known colloquially as modern portfolio theory or MPT were conceived before 1972.

Richard. I think it's incredible that with so much computing power at their fingertips and with so much at stake in terms of money and Nobel Prizes and the like ... it's just incredible to me that none of the many really smart people in finance has produced anything truly innovative since 1972. That seems about as plausible to me as Tolkien's beef about English literature, which he once said essentially ended in the year 1100!

Cricket. If I recall correctly the Bernstein piece you guys are alluding to, there's something even more rotten in the state of finance, if you will, than bedrock theories that are getting long in the tooth. I haven't done much reading in the field, but what little I've done tells me that the central theories underlying modern finance aren't merely dated, they're **wrong**.

Richard. Wrong in what sense?

Cricket. Wrong in the sense that if you applied them rigorously in managing serious money you'd end up worse off than if you ignored the theories — or applied them in reverse!

Richard. You're the so-called expert here, David. Is what Cricket says true? More to the point, if everything that's been done in finance over the last 30 years is either useless or worse than useless then how did the guy who runs Yale's endowment earn such a towering reputation as an innovative thinker and doer?!

David. Good question, Rich, that last one — one I'll come back to in due course. But before I talk about the success that David Swensen has had at Yale, and why it'll be difficult for any endowment including Yale's to earn such stellar returns moving forward, I'll answer your implied question about the use and abuse of so-called modern portfolio theory. For better or worse, I've spent lots of time in recent months on this question, all with the aim of ensuring that the investment team I head is exploiting to the max whatever theories, computer models, algorithms or other quantitative techniques are available to invest effectively the capital entrusted to us.

Cricket. Hasn't your team done a joint venture of sorts recently with some quant jocks at MIT — a project aimed at identifying and exploiting state-of-the-art approaches to asset allocation in particular? I recall seeing a paper that the MIT team produced in the stack of materials that you asked us to read.

David. Didja read it?

Cricket. I read it, but I'm not sure what to do with it. All it really says, at bottom, is what you wrote several years ago in your paper entitled *Message in a Bottle*: that model-based approaches to asset allocation tend to be highly flawed — the old garbage in, garbage out

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problem — and that they're therefore best used for descriptive rather than prescriptive purposes. In other words, they're best used to analyze the potential impact of asset allocation decisions reached by more intuitively appealing means.

David. Pretty good, Cricket. I can see why you landed one of those coveted internships in David Swensen's office!

Richard. I'm a year behind Cricket at Yale so it's too early for me to go after an internship like the one she's landed. But even if I were a year or two older I'm not sure I'd follow in her footsteps. I'm majoring in history, not econ or math or one of the natural sciences, and the more I learn about what folks like you and David Swensen do for a living the more convinced I become that people like me who gravitate toward the humanities wouldn't enjoy or be good at endowment management. I mean ... I read the MIT paper too, and if the key to success in your line of work is to apply more cleverly than other investors a bunch of quantitative tools that are imperfect at best — mean-variance optimizers, power utility functions, Monte Carlo simulators; the list goes on and on — well, I think I'm better off doing something else for a living.

Cricket. You left out my favorite, Rich: Stein-James estimates!

David. I know you're kidding, Cricket, but — honestly and truly — of all of the arrows that quant jocks can pull out of their quivers and sling, Stein-James estimators happen to be the most intuitively appealing to me.

Cricket. They are?! I mentioned them only because the MIT team used a baseball example to explain how they work, and I know from the TIFF materials you had us read that you love baseball. David Swensen likes it too, I'm told, although I've never heard him or anyone who works for him mention Stein-James estimates. In fact, getting back to Rich's question about the extent to which leading endowment types like David Swensen use science broadly defined to do what they do, my sense is that David and his staff make very little use of quantitative tools. What they do is more art than science.

David. Ironically, Cricket, that's exactly how I'd describe not only Stein-James estimators but a whole host of techniques that quant jocks have devised to mitigate the biggest problem investors confront in applying quantitative tools to financial markets: unlike the natural world, where the basic properties of things being measured and manipulated tend to be stable over time, even the most basic properties of investable assets tend to change over time. They change because the most basic property of any asset, or indeed any investment strategy, is its return, by which I mean of course its expected return.

Richard. Hold on: I would've thought that the most basic property of any asset or strategy is its **past** return, not its **future** return. The past, after all, is knowable. The future isn't.

David. Spoken like a true history major! As an aside, Rich, do you know what answer I get more than any other to a question that I pose to every investment luminary who takes the stage for the seminars on endowment investing that I host in my day job? The question I pose to these luminaries is this: what undergraduate major constitutes the best preparation for the career path you've chosen? I've posed this question to dozens of investment professionals over the years — men and women who've been very successful in a wide variety of jobs in investing and finance — and the college major cited more frequently than any other is ... you guessed it ... history.

Richard. You're joking.

David. I'm not. Don't get me wrong: the advent of massively increasingly powerful and decreasingly costly computers over the last few decades has given investment pros with quantitative backgrounds a growing edge in the essentially zero-sum game of generating superior returns from the portfolios they manage. But the surest way to turn a large portfolio into a small one is to assume in deploying it that the past constitutes a reliable prologue to the future. Unfortunately, most model-based approaches to portfolio construction do exactly that.

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Richard. Not necessarily — not according to the MIT report we keep referring to. It talks about the garbage in, garbage out phenomenon, but it also argues that model-based approaches to portfolio construction can work better than more qualitative approaches so long as the inputs are sound. I don't know much about the process that David Swensen uses in figuring out where in the world to invest Yale's billions, but I've read enough about Yale's approach to know that it includes some heavy-duty modeling aimed at ensuring that Yale's portfolio doesn't fluctuate too much.

David. Not exactly, Rich. Like most well-managed endowments, Yale uses computer-based models to analyze the potential impact of policies fashioned by more intuitively appealing means — and it does so by focusing on downside volatility or risk rather than total volatility.

Cricket. That makes sense to me, but don't you reach essentially the same conclusions if you look at total risk rather than downside risk when vetting the pros and cons of various asset mixes?

David. Some folks might, but I wouldn't! More to the point, unless you adjust the assumptions you feed into an asset allocation model to the point where they differ materially from historical trends — especially recent trends — well ... unless you engage in that kind of artistry your model's going to prove useless at precisely those times when policy changes are most indicated.

Richard. I'm thoroughly confused. We started this conversation talking about the paradoxical fact that quantitative methods for allocating endowment assets across markets are as widely used today as they've ever been — despite the fact that they tend to be antiquated at best and silly at worst.

David. Silly but strangely comforting — like the notoriously unreliable weather forecasts ordered up by that World War II general you came across in your military history course.

Richard. Exactly: the geeks doing the forecasting kept telling the general's chief of staff that their forecasts were wildly inaccurate and hence a waste of everyone's time, to which the chief replied, "The general knows your forecasts tend to be wrong, but he needs them for planning purposes!"

Cricket. You were saying, Rich ...

Richard. Right ... I was saying that I'm confused ... because even the best minds in the endowment arena seem to rely heavily on quantitative techniques ... implying that endowment management when done well is more science than art ... but David said a minute ago that scientific methods don't work well in his profession unless they're coupled with, well, I think the exact word he used was "artistry." I'm not even halfway through college, but I've had enough exposure to both art and science to know that artists look at the world in a fundamentally different way than scientists — and I find it hard to believe that the best if not only way to do what David Swensen's done for Yale is to combine art and science in some mystical manner. That doesn't sound like a smart career path to me.

Cricket. Me neither, which is strange, because I've really enjoyed my talks with the folks who work in Yale's investment office. They don't seem like mystics to me — just smart folks working really hard to keep Yale ahead of the pack.

David. Let me see if I can clear up at least some of your confusion. Either of you ever heard of a baseballer named Yastrzemski?

Richard. You kidding? I'm a Red Sox fan by birth so I know all about Yaz. Won the Triple Crown the year the Sox lost to the Cardinals in the World Series — about 20 years before I was born.

David. Which was 10 years **after** I was born! Yaz was one-of-a-kind: not especially gifted strength- or speed-wise but extraordinarily focused and tenacious. Blunt too. Come to think of it, Cricket, Yaz was and indeed still is a lot like our mutual friend Dave Swensen.

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Cricket. I wouldn't know. I'm a Yankees fan by birth. But I suspect that Yaz didn't work half as hard during his ball-playing days as the folks running leading endowments like Yale's have to work to stay at the top of the heap so to speak.

David. Funny you should say that — because the reason I mentioned Yaz was to make what I think is a fundamentally important point about endowment management *circa* 2007. Indeed, I think it's a fundamentally important point about endowment management in any market environment, but especially in the current environment, the hallmarks of which are asset prices that make downside risks worrisomely large in relation to upside potential.

Richard. Risk versus return. Wasn't Yaz really good at getting other teams' base runners to make foolish tradeoffs between the two?!

David. He sure was, Rich. One reason Yaz won seven Gold Gloves as an outfielder is because he would freeze base runners by standing as if he were about to catch fly balls that were actually destined to ricochet off the wall behind him. At the last instant, he'd whip around, grab the caroming ball and rifle it to the infield, often converting a bad turn of events for the Red Sox into a good one. The key to this gambit, of course, was to get the enemy to misgauge the risks of running while the ball flew toward Yaz in left field — to think the risks of running were higher than they actually were.

Cricket. Don't I recall your telling me the other day that you think investors are making essentially the **reverse** mistake today — putting their money to work in ways which assume that the risks are **lower** than they truly are?

David. I **did** say that, Cricket, and I meant it. I'm glad you reminded me of that because it helps me tie together what I've been saying about art, science, Yale, Yaz, investing, baseball ... everything we've been talking about, including the old-fashioned but by no means obsolete notion of gaining an edge not through scientific savvy or abnormal artistry but rather through hard work. Speaking of which ... although Yastrzemski was pretty reticent, he's the guy who uttered one of my favorite sports quotes of all time.

Richard. What was that?

David. "I loved baseball," he once said, after his playing days had ended. "But I never enjoyed it. It was all hard work, all the time."

Richard. **That's** one of your favorite sports quotes?! Sounds pretty Puritanical to me.

David. Perhaps, but if you had the pleasure as I did of watching Yaz get inducted into the Hall of Fame — on TV, mind you, not in person — you'd know that Yaz himself thought all of his hard work was worth it. He was a true craftsman, by which I mean that he showed up for work day after day for 23 years, performing essentially the same tasks over and over again until he became very good at all of them and extraordinarily good at some of them — like decoying runners when fly balls were sailing toward the left field wall at Fenway.

Cricket. Yaz played **23** years for **one** team? Isn't that some kind of record?

David. It sure is: no one in the history of baseball has played longer for one team, although one of Yaz's contemporaries — Brooks Robinson — played for **his** team, the Orioles, the same number of years Yaz played for Boston.

Cricket. What's the record for chief investment officers? I ask because David Swensen's been Yale's CIO for 21 years, which seems like a mighty long time to hold such a stressful job.

Richard. It does, although Swensen's been lucky, because the Dow has compounded at something like 14% a year since he took over Yale's endowment, so it's no surprise that he's grown the pot at such a rapid rate over the last 21 years.

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David. There's some truth to that, Rich, but Yale's endowment as well as those of some other schools in its peer group has compounded rapidly enough to refute the notion that the folks running them are merely lucky. If they're lucky, it's the sort of good fortune that one of Yastrzemski's archrivals allegedly enjoyed.

Richard. Who was that?

David. The pitcher who beat the Red Sox not once but **three** times in the '67 World Series: Bob Gibson. Gibson's catcher for all three games was a guy whom you've surely seen on baseball broadcasts, Tim McCarver. When asked once by a reporter why Gibson was so effective on the mound, McCarver replied: "Bob Gibson's the luckiest pitcher I've ever seen. He always pitches on days when the other team gets no hits."

Richard. I get it.

Cricket. Me too — although I **don't** get why we're spending so much time talking about baseball. Can we get back to our focal point before you guys started waxing nostalgic about baseball *circa* 1967, namely your view that investing *circa* 2007 is unusually challenging due to an apparent misgauging of risks by the average investor?

David. Thanks, Cricket, for keeping us on track. As I was saying ... in my opinion, the typical institutional fund these days is deploying its assets in a manner that's far riskier than its owners perceive. It's doing so via a variety of means, the most significant but perhaps not most conspicuous being leverage or borrowed money. The true degree to which institutional funds are leveraged is tough to figure out because most of them are invested partly if not primarily via commingled pools: hedge funds, private equity, realty partnerships ... that sort of thing. The strategies these pools employ are all over the map, but when you take several steps back and consider them as a group, one large and troubling fact emerges: they're leveraged to an extent that's unprecedented in the modern annals of institutional investing. By that, I mean that the typical institutional portfolio is using borrowed money to juice its returns to a degree never before witnessed since the rule book for institutional investing was revised several decades ago.

Richard. What rule book? You told us not long ago that the only book that's truly essential reading in your field is the one on endowment investing that David Swensen wrote six or seven years ago!

David. I did say that, 'cause it's true, although lots of folks who read David's book and try to mimic the strategies and tactics discussed in it may end up rueing the day they read it. I'll explain why later, but before I do let me answer Rich's question about the rules under which hired guns like me go about our work. For better or worse, they changed rather completely around the time I gave up my dream of playing for the Red Sox and sank instead into money management a few decades ago. In a sentence, the laws governing the investment of what for lack of a better term we might call **Other People's Money** morphed in a manner that essentially jettisoned scrutiny of the riskiness of individual holdings in favor of an overall portfolio definition of risk. Putting the same point differently, the so-called prudent man rule changed from one that treated certain types of investments as being imprudent *per se* to a rule that lets fiduciaries like myself invest in essentially we what want so long as the overall portfolios we assemble aren't excessively risky.

Richard. Does that explain why so-called alternative investments are attracting so much dough these days?

David. Sort of. The legal change I've been alluding to constitutes a **necessary** condition for the increasingly widespread use of hedge fund, private equity and other non-traditional strategies. But it's not a **sufficient** condition. What's really causing big bucks to flow into these alternative strategies is a phenomenon underlying every major change in institutional portfolios in recorded history: seductively stellar recent returns. Of course, it doesn't hurt to have someone as thoughtful and articulate as David Swensen out there lending his seal of approval to strategies that the typical

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institutional fund generally wanted no part of when he took over the Yale endowment in 1985.

Cricket. That seems a little unfair to Mr. Swensen, because he's tilted Yale's portfolio away from some of the strategies and managers that enabled it to perform so brilliantly during his first 15 years or so as CIO and toward strategies and managers that other institutions aren't able or willing to bet on as heavily as Yale has and does.

David. True enough, Cricket, but that simply proves my point, which is that there's far too much complacency among institutional investors these days — too much **comfort**, if you will ... comfort rooted in the conspicuous success in recent years of some of the strategies that pioneering institutions like Yale have used to post truly superior results. The fact that especially clever investors like Dave Swensen have cut their percentage allocations to certain strategies such as venture capital in favor of enhanced commitments to other forms of investing doesn't mean that the niches David's tilting away from are uncrowded: they're more crowded than ever, due not only to new entrants but to the fact that the total assets stewarded by long-time players like Yale have moved sharply higher since the most recent bear market for stocks ended in the fall of 2002. In other words, even though some notably well-managed institutional funds have trimmed their percentage allocations to venture capital and other historically helpful strategies, they're still allocating big bucks in absolute terms to these niches — niches that would be overcrowded in any case due to oversized commitments from Swensen wannabes.

Richard. Are you implying that even the master himself is going to get hammered if the global liquidity boom that you've written about in your recent commentaries goes bust?

David. By master I assume you mean David Swensen?

Richard. Swensen for sure. But I really mean anyone who in your opinion has truly mastered the science ... or rather the art ... shoot, I don't know what to call it ... let's call it the magic of compounding endowment money at abnormally high rates.

David. I'm glad you've invoked the notion of mastery, Rich, because it's a concept I myself invoke when answering the question we've been struggling with this afternoon: does effective endowment management constitute an art or a science? As you know from my writings, I think it's more art than science. But I think it's a third thing too — something that, like playing left field in Fenway or hitting major league pitching, takes years to master: it's a **craft**. And ... because it's a craft above all else ... it's entirely possible that truly dedicated craftsmen like David Swensen will continue posting satisfactory returns even if the liquidity boom you alluded to a minute ago goes bust.

Richard. That's encouraging ... or at least it's encouraging for Yale if its master craftsman decides to stay in his job for at least as long as Yaz played for the Red Sox. But I'm not sure how encouraging it is for neophytes like me who know little about investing other than the fact that it seems like an interesting way to do good things for the world without putting yourself in harm's way.

Cricket. You mean harm's way **physically** ... as opposed to harm's way **professionally**. I'm a neophyte too ... when it comes to investing ... and because I am I wouldn't want to dive into a profession where all but the most skilled players stand a good chance of getting hammered by the downturn that you, David, think is destined to unfold some time soon.

David. Forgive me, Cricket, but I've made no such forecast. What I've alluded to here today, and written about elsewhere, is that a combination of (1) unprecedentedly low volatility in financial asset prices and (2) cheap credit has induced lots of investors to assemble portfolios that are riskier than they think. They're riskier than they think because just about everything in financial markets, and indeed life generally, regresses to the mean, including volatility. The irony, of course, is that the low volatility we've seen in recent years is causing investors in general, and VaR junkies in

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particular, to boost their leverage ratios in order to maintain pre-specified risk and expected return targets. Sadly ... but very importantly ... low yields and low credit spreads have pushed down expected returns at the same time that low volatilities are inducing VaR-driven investors to boost their leverage ratios.

Richard. VaR junkies?! Who are they?

David. They're folks who use so-called value at risk measures to determine how to deploy money entrusted to their care and to figure out how much leverage if any to use in order to achieve whatever return goals they happen to be pursuing.

Cricket. I find it hard to believe that anyone old enough to have earned the privilege of investing serious money — the kind of money we've been talking about — is also naïve enough to assume that financial markets will continue behaving the way they have over the last few years.

David. Trust me, Cricket: many of them **do** believe that, perhaps because they tend to have less investing experience than you're assuming they do. Less experience and, for that very reason, less of the accumulated goodwill among the ultimate owners of the capital they steward that all truly superior money managers inevitably draw upon on their unavoidably unsteady paths to investment glory.

Cricket. If you're half as good at managing money as you are at b.s.'ing about money management, you'll probably wind up in the investing hall of fame along with Mr. Swensen! All of which is to say that as glibly as you put the last point I'm not sure I understood it. You said something about goodwill and something about a bumpy ride on the road to investment glory but I don't understand the connection between the two ...

David. The connection is this: since it's virtually impossible for even the most skilled money managers to buy and sell at precisely the right times, it's virtually impossible for anyone to get to the top of the performance heap and stay there without enduring periods of underperformance along the way. In fact, if you examine the track records of the most celebrated craftsmen in my profession ...

Cricket. Craftspeople, thank you very much!

David. I'm using craftsmen in a gender-neutral sense, of course ... As I was saying, if you examine the track records of truly great investors you'll find that virtually all of them have gone through periods in which their weapons have misfired. Warren Buffett, Bill Gross, my former partner Jeremy Grantham, ... you name 'em ... every notably successful investor I know has stumbled and indeed stumbled badly on his or her journey toward superstardom.

Cricket. Mr. Swensen hasn't ... **has** he?

David. Perhaps not as conspicuously as other investment pros who also inhabit the investment pantheon that David has perhaps permanently joined. But he and his bosses at Yale — which is to say Yale's trustees plus the several presidents David's worked under — all of these folks have had their share of sleepless nights attributable to endowment setbacks. Ask David about the sleep he's lost during the several periods in which his so-called absolute return portfolio has produced losses rather than gains.

Cricket. It never has ... **has** it?

David. It certainly has, as David acknowledged in his book, but not for periods long enough to cost him his job. The fact that he lived to fight another day is a tribute to Yale's trustees, of course, who've given David the license needed to practice his craft to the max. It's also a tribute to David, of course, who's as obsessive about the details of his craft — fees, terms, lock-ups, fund sizes, conflicts: stuff like that — David's as obsessive about these things as Yaz was about the tricks of his trade. Importantly, David's also obsessive about an aspect of his craft that Yaz never truly mastered: PR. That's no criticism of David; it's a compliment, really, because David's communications skills underpin and enhance his

investment edge. They do so by giving him the credibility among his various constituencies that he needs in order to keep doing uncomfortable things with Yale's portfolio. I'm choosing my words carefully, of course, in a conscious effort to highlight the close relationship between comfort and returns. They're closely related, of course ... closely and **inversely** ... which is to say that the more comfortable an investment is, all else equal, the lower its expected return. That's one reason among many why I think the odds are high that institutions shifting large fractions of their assets into the truly gigantic buyout funds being formed these days will end up regretting such moves. Like equity real estate in the late 1980s or early stage venture capital in the late 1990s, supersized leveraged buyouts *circa* 2007 constitute an inherently sound investment strategy that's poised to disappoint due to the comfort ... I repeat: comfort ... that this form of investing currently entails. Comfort equals popularity equals overfunding equals disappointment.

Richard. I have a history paper to write so I gotta go in a minute, but before I take off I have one more question for you — a question triggered by your suggestion, veiled though it was, that success breeds success in the endowment management arena ... that the goodwill spawned by great results like those Swensen has posted at Yale gives an already skilled craftsman an increasingly big edge over the competition.

David. That's well put, Rich, and that's indeed what I'm suggesting.

Cricket. I think I know where Rich is headed with his question.

Richard. You do?!

Cricket. Yup. You're going to ask David whether he thinks Harvard made an even bigger mistake than its critics have claimed by failing to take the steps needed to keep Jack Meyer and the winning team he'd assembled on the Harvard payroll. I know ... I know ... the team I'm talking about pocketed such big bonuses that the work it was doing became the proverbial two-edged sword for Harvard's president and trustees: great returns, terrible publicity. But if David's right that success breeds success due to the enhanced discretion that proven players enjoy to make contrarian bets, then the last thing a governing board wants to do is essentially force a winning team to disband.

Richard. She nailed it ... that's exactly the question I was going to ask!

David. Lemme see if I have the question right: the Harvard endowment did very well during the 15 years Jack Meyer headed it ... 1990 to 2005 ... underperforming Yale, to be sure, but by a margin much smaller than one might reasonably have expected given Harvard's much bigger asset base throughout Jack's tenure at Harvard. Harvard failed to retain Jack and his team, despite or rather because it performed so well ... performance that caused the team's pay to soar to politically incorrect heights ... and now a new team has taken the field on Harvard's behalf ... a team burdened by an asset base almost 50% larger than Yale's but bereft of the massive reservoir of goodwill that will make it that much easier for Swensen to keep doing uncomfortable and hence potentially profitable things at Yale.

Cricket. Was there a question buried in there or did you answer our question without actually restating it in your own words?

David. I'll let you and Rich decide. I'll also let you get back to your studies, but not before saying that I know the guy who succeeded Jack at Harvard; I think he's very smart; and I know with certainty that he's acutely aware of the relatively unfavorable boundary conditions under which he's working. In other words, Mohamed El-Erian is a brave guy — brave, smart and well-intentioned.

Richard. He's also an economist by training, which might not bode well if endowment management is at least as much art as it is science — art ... plus science ... plus, as we've discussed *ad nauseam*, lots of craftsmanship too.

David. Hey ... don't sell economists short. Swensen's an economist by training, you

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know — one who by his own admission knew nothing about investing when he took over the Yale endowment in 1985.

Richard. What do you mean his own admission? If he'd confessed that during his interviews he never would've gotten the job!

David. I had nothing to do with David's hiring by at Yale back in 1985 so I have no idea what he said or didn't say during his interviews. What I do know with certainty is what David himself told me during our very first conversation, which occurred the same month he took over at Yale.

Richard. What did he say?

David. He leaned over the table at which the two of us were having lunch, whispered, "Can you keep a secret?" and ... after I nodded yes ... said, "I don't know a thing about investing."

Richard. I'm outta here.

Cricket. Me too: I might want to run the Yale endowment some day, and if I do I wanna be able to say that I know as much about investing as Mr. Swensen did when he got the job in 1985!

David. You mean ... you're worried if you keep talking to me you might actually learn something about investing?

Cricket. Stranger things have happened.

David. Like what?

Cricket. Like your favorite ball club coming from three games down to beat my favorite ball club in the American League playoffs three years ago.

David. What a blissfully happy note to end on! Good luck with your history paper, Rich, and good luck interning for Swensen, Cricket. By luck, of course, I mean the type of luck that Bob Gibson had on all those days when the batters he faced got no hits.

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TIFF Education Foundation
Endowment Management Seminar
Cambridge, Massachusetts
July 26, 2007

In furtherance of its mission of promoting the dissemination and adoption of best practices in endowment management, the TIFF Education Foundation (TEF) will conduct the next edition of its popular seminar series on Thursday, July 26, 2007, in Cambridge, Massachusetts. Like prior editions, the fruits of which are posted in both PDF and podcast form at www.tiff.org/TEF, our July 2007 seminar will comprise five 45-minute interviews of notably successful institutional investors conducted by TIFF's founding president, David Salem. The seminar is open to trustees and officers of endowed charities plus their designated representatives, with participation subject to TEF's discretion.

Confirmed Speakers

Joanne Hill
Managing Director, Pension Services Group,
Goldman, Sachs & Co.

Marty Leibowitz
Managing Director,
Morgan Stanley

Tom Steyer
Managing Partner and CIO,
Farallon Capital Management

Remaining speakers to be arranged.

Event Details

Place: The Charles Hotel
One Bennett Street
Cambridge, MA 02138
800-882-1818

Time: 8:00 a.m. – 3:00 p.m.
(breakfast and lunch included)

Cost: Free
(excluding participants' out-of-pocket expenses)

How to Register

If you're interested in receiving registration particulars when they become available, please email this staff at tiffevents@tiff.org

Please continue to visit www.tiff.org/TEF for seminar developments.

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