COMMENTARY

A Report of TIFF EDUCATION FOUNDATION

2009 Edition 3

Highlights

Wrapping Up. On July 22, 2008, the TIFF Education Foundation (TEF) hosted in Cambridge, Massachusetts, its annual Endowment Management Seminar. Modeled loosely after the broadcast series *Inside the Actors Studio*, this event mimicked its predecessors in that it comprised interviews by TEF President David Salem — a suspect substitute indeed for James Lipton of *ITAS* fame — of five highly respected institutional investors. This Commentary comprises the transcript of David's interview with Jon Moulton, founder and former managing partner of the London-based private equity firm Alchemy Partners, and with Arshad Zakaria, founder and chief executive officer of the New Jersey-based hedge fund New Vernon Capital.

Worldly Experts. A veteran private equity investor, Jon Moulton comments on global private equity investing, firm structure, the tough task of private equity manager selection, his being an oenophile, and what keeps him up at night. Arshad Zakaria, an expert in India and emerging markets broadly defined, discusses the benefits and perils of investing in India, the future of investing in emerging markets, outsourcing, and what it was like to be in Manhattan on September 11, 2001.

2009 Endowment Management Seminar. The 2009 TEF Seminar took place on October 1 in Cambridge, Massachusetts. If you were unable to attend, the podcasts are posted at www.tiff.org/TEF.

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), a regulated mutual fund family; and TIFF Advisory Services (TAS), a taxable non-stock corporation and regulated investment advisor to TIP that also administers investment vehicles bearing the TIFF name.

Inquiries. For more information, please call TIFF at 610-684-8000 or visit www.tiff.org/TEF.

JON MOULTON

Private Equity Defined

David. We're very pleased that Jon was willing to make a special trip from London to be with us. I'm going to start, as you know, with a question that invites if not encourages you to say unflattering things about the profession of which you are both a proud member and a vocal critic. My question focuses on the premise underlying most institutional allocations to private equity, namely that it's a reliable means of outperforming relevant indices of publicly traded stocks, provided that one uses due care and skill in picking which private equity managers to employ. So my multi-part initial question for you runs as follows: (A) How much volatility in private equity managers' alphas, or excess returns, relative to marketable benchmarks must clients of the proverbial top quartile managers be able and willing to accept in pursuit of those excess returns? (B) If you were running a big endowment or pension fund, how confident would you be that you could pick those top quartile PE managers in advance? (C) What criteria would you use in separating the wheat from the chaff? Take as much time as you want to answer A, B, and C.

Jon. Right, the first question is extremely difficult to answer. Private equity is a very broad range of things. Its definition has changed a lot over recent years. Up to the middle of 2007, the largest amount of private equity ever deployed was deployed in the middle of the largest debt bubble we have ever seen. That's not correlated with anything in the past of the private equity world, or probably its future. That wall of excess debt hit our business just as much as subprime. So a lot of people made an enormous amount of money by the simple technique of paying the most for assets in the early 2000s, leveraging them up as much as possible at acquisition, leveraging them up again, and then selling them to a leveraged buyer. All of the gain was taken out in debt increase. That mechanism has gone into complete reverse. Everything that ran to drive the returns of the very large buyout funds – and they did return very good numbers in 2006 and the early part of 2007 – is now in reverse. Those same firms, instead of sitting on assets which they can pass on to somebody else at a still higher price are now the proud possessors of very overvalued assets with leverage choking the companies to death. So how are you going to say what returns you're going to get out of it? You can actually say that in the deals done during that 18-month period – the big buyouts – the equity is probably worth something like 25¢ or 30¢ on the dollar. That's a defensible number. So you'll take a loss on that. Rather like the end of the tech bubble. If you came in too late and you were near the top when it all fell over, you'll lose money.

If you're in private equity of a more traditional nature such as small/mid-market buyouts, turnarounds, development capital, or venture capital, then all the evidence says you do get a respectable return over the long period. But it's quite variable. The asset class is far from homogenous. Let's go through it: Top quartile US venture is a good business; bottom quartile US venture is terrible! The bottom quartile has absorbed nearly all losses. If you go over to Europe to invest in venture capital, that is merely for the deep enthusiast and the believer in the visitors from the alien planets! There's no period – 1, 3, 5, 10, or 20 years – where you get a return higher than deposits on the average.

Looking at the buyout world, middle-sized and large buyouts in Europe are actually the most stable component of private equity globally. Over pretty much any period you'll probably get a return somewhere in the 15-20% net range by investing in mid-market buyouts in the UK and the rest of Europe. It's an incredibly stable class. In the US, the returns from buyouts have been lower, but relatively stable, and mostly twitching above the public markets.

Private equity is quite correlated to public markets, but I don't believe it adds massive diversification. It's even more correlated now by the fact that we're being forced to mark to market, and private equity becomes a leverage play on the public markets in a way it really historically was not in terms of performance figures. But of course, economically, the only thing that will ever matter is when you get the cash. In my view, private equity may generate you a bit of return over a long period. You need to be diverse; you need to be taking a long-term view; and you need to understand what you're doing. Again, the excesses of the spring of 2007 were as much bubble as the subprime. The same sorts of errors were made, in scale. And now of course there's a lot of money being made – or could be made – by people playing on the distress of those over-leveraged companies being reorganized.

Actually, I recently saw something I'd never seen before. A question which, if somebody had asked me I couldn't have answered: "How can you lose more than 100% of the capital structure of a buyout?" And the answer is, you can now because things are in steady decline. Say you buy a company, with, say, four layers of debt equity at the top. If somebody bought the debt in the most junior debt level in January, and paid 90¢ on the dollar for it, it'll now be worth 30¢. So you'd lose all the original capital structure and the additional capital in the distress market. So far, the worst I've seen is a deal where 140% of the capital's been lost. That's quite an achievement!

It is very difficult stuff that you have to view over the long-term. Five percent over the public markets is a reasonable benchmark and reasonable objective. I believe if you pick well, you'll get that. But it is an asset class where picking is critical. The difference between top and bottom quartiles is huge over short, medium, and long periods, so you always want to be trying to find the best managers. Finding the best managers is really hard. The only thing that's easy, I think, is finding the idiots at the bottom quartile. And they tend to stand out pretty clearly. They don't interview very well; they don't know their own numbers; they can't remember what's in the portfolio; they keep losing their investments and don't realize anything. But don't forget, there's an element of randomness, particularly if you're a technology investor in the US, for example. You might just get lucky and have one or two very good deals out of pure chance. So the predictive value of the analysis of performance is actually quite poor. The persistence in private equity returns is not great. People end up buying brand names because they can't find anything else to actually assess. But you can do better than that. You can assess the quality of the people you're with, and the quality of their processes; you can look at their record; you can apply a degree of intelligence to it. You can certainly do better than random selection, and you need to. If you do random selection – particularly in an asset class like US venture – your returns will be diabolical.

Firm Structure

David. Let me jump in. One of the things we've looked at, of course, is firm structure. Alchemy, which you founded – and you had worked at several other private equity firms before founding your own – is actually structured along fairly unconventional lines. I want you to describe for the benefit of the folks briefly how it's structured, how it differs from the industry norm, and why you think it gives Alchemy an edge to have it structured that way.

Jon. We don't have a 10-year fund, but we do have a partnership. And what we do is go to an individual investor. The easiest way to describe it is as follows: Let's pretend you wanted to put $20 million into a regular 10-year fund. You probably expect that to be invested over approximately four years. Call it $5 million a year. With us, you actually commit to $5 million a year. You commit in parallel with a lot of other investors, adding up at the moment to about $600 million a year of capacity. And you get your own partnership. So we actually run 70 current partnerships, all investing in parallel. We have a giant spreadsheet!

You can stay with us as long as you like. The fund expires in 2047. So a long-term view is possible, but you only actually commit on a 12-month rolling notice basis. So from an investor's viewpoint, this is very flexible. If you decide you don't like us, or decide you want to get out of doing UK buyouts, you give us a year's notice and you're out. You've got more liquidity and ability to vary the size of your commitment, too, because by cooperating with us, we can get you to go up or down in size by getting somebody else in or out.

We charge a budgeted management fee. Now this is an incredibly rare thing in private equity. We actually have all of our investors get together once a year and agree to a budget for the year going forward. As a result of that, we actually charge about half in management fees that other firms charge. We also charge a different carried interest structure. We charge at 10% carried interest. That sounds suicidal, but again, it's not. It's 10% deal by deal, not offset. So it is possible we'd collect some carried interest and be terrible. But the good news for investors is, if we are terrible, they give us a year's notice and fire us, which is deeply satisfying, and an improvement on anything you find in other funds around.

So the capital structure is very flexible; it enables us to grow or shrink our business, both of which we've done in line with market demand. It also allows investors greater flexibility, and we are more motivated. Typical structures in Europe now are at 20% carried interest after a 6% or 8% return of capital to the investors. It sounds great, unless you're the 25-year-old in the firm, and you realize you're going to be 34 before you see the proverbial carried interest. I don't know about you, but the idea of being motivated by a payment in nine years' time is just unsustainable. So you pay less with us and it's more motivating. So that's the structure. It's unconventional. Investors actually get used to it quite quickly, because the reporting is a standard partnership and legal documents are the same.

Fear vs Greed

David. Let's talk about the political side of what you — necessarily, or perhaps by choice — have done and are doing. You've been pretty outspokenly critical of what's going on with the Northern Rock problem in the UK. So I guess the particular question I would ask you to try to answer is, how will your game change, if at all, in light of the way Northern Rock was dealt with by the authorities in Britain?

Jon. Northern Rock's a fascinating collapse. Everything about Northern Rock was on its website. The reality was that nobody understood it. Its last off-balance-sheet vehicle had a prospectus running to 415 pages, eleven layers of debt, three currencies, interest rate swaps, and swaps on the currencies. This was all against an infinitely variable mortgage portfolio, so I didn't understand it. But clearly the rating agencies managed for the payment of a small fee to get to grips with it! So they made nearly all of it triple A rated, and the vast majority of the money was raised at eight basis points over Euribor. Eight basis points! I don't know how much risk you would take for that, but I wouldn't even take the risk of not understanding the document, which clearly nobody did.

As of June 2008, the UK mortgage market was worse than the US mortgage market, and Northern Rock played a big part in that collapse. Housing transactions were down 56% on the prior year in June 2008. The average consumer debt in the UK was 20% higher than the US, which the Americans mostly don't understand or believe, but it's true. Consumer confidence has evaporated, and there are horrible numbers appearing at a tremendous pace.

This will be very good for private equity. We like turnarounds; we like messes; we prefer deals driven by fear than greed. Of course a couple of years ago, it was all greed. Next year, it'll be mostly fear. So the opportunities will be there to buy things at a very low cost. However, falling knives will be out there. We'll buy some things too early, and people have already made that mistake and lost money. Sovereign wealth funds coming into US banks are an example, but we have exactly the same potential in the UK.

Apparent Incompetence

David. Let's stick with this topic of the constant cycle between greed and fear. Clearly the executives at Northern Rock – and it's definitely true of a lot of financial intermediaries in the US that have since hit the shoals – made a lot of money in the up part of the cycle. And yet you said, at Northern Rock, the problems were evident even on the website. You can go back, and you could have said, in essence, these are not skilled managers. Or they may be skilled managers, but they have the wrong incentives. So how do you spot a flawed – if not also corrupt – management team in real time if the reported results seem to be so favorable?

Jon. Northern Rock's quite extraordinary. The level of incompetence is mind-blowing. There are so many things that went wrong with Northern Rock. It was certainly the greed of the senior people. They were just the same as the guys who were flogging subprime debt, CLOs, and CDOs, and receiving massive bonuses, which had the traditional effect on judgment at Northern Rock. The regulators couldn't handle the complexity of the company. That's a problem on both sides of the water.

These types of organizations are everywhere. Absolutely everywhere. Nobody understands how to regulate them, because we ended up with these monstrously complicated, highly connected and interconnected things. Now, how would you spot it? It's so obvious. I actually gave a speech to the British Bankers Association in September 2007. And I used some graphics about a wedding cake falling over slowly. So you get the general optimism of the presentation. And for 40 minutes I explained that they were all going to be in terrible trouble and nobody understood the industry anymore. The really depressing thing was that they all agreed with me. There was nobody in that audience saying, "Oh, nonsense. It's all going to be fine." They all knew it was going wrong. But they were all making a ton of money out of it. It was easier to ride the bubble than get off the game. Psychology's a really weird thing when it gets to this. It's very hard to go against the tide.

Divorce Rates

David. So, let's talk about bad management, because it's as important to identify bad private equity management as it is to identify good private equity management. Certainly management that lets the balance sheet and the operations of the enterprise get more complex than they themselves can manage is a big problem. Besides incentives and misalignment of interest you just alluded to, what else do you look for when you're looking at management teams that just don't get it?

Jon. Well, first of all, I actually like bad management teams. You can make a lot of money buying companies that are run badly. It's actually quite hard to go from a good management team to an excellent management team. But from moron to good is actually quite easy. Because we hang out for difficult deals, we actually have extremely entertaining meetings. We meet with chief execs who haven't visited their own sites and can't remember what the budget is for the sales or for their share. You know, these people are out there! There's one kind of really dangerous manager, and it's the same in investment management: the good presenter, lousy operator combination. Because most of us believe somebody who gives a good presentation is a good manager. It doesn't work that way. Some very good presenters are just awful managers.

There are some objective things about managers you can pick up, besides not understanding their businesses. Let's try a question for the audience. Would you prefer to back a chief executive who's had no divorce or one divorce? Which do you think is most likely to lead to success? Those who think no divorce? Those who think one divorce? The audience is absolutely right. One divorce is better than no divorce in a chief executive by quite a serious statistical amount. Who thinks two divorces is better than one? In reality, two divorces are much worse statistically. Now, when you get to three divorces overall, the picture is entirely clear. You lose all your money! And, you know, it's very easy to rationalize. Their heads are clearly on something other than the business. So one of the most efficient patterns of assessing a deal in private equity is how much money you are looking for. And how many divorces you have had. And now, what business are you in? That's actually the right sequence!

So that's one real characteristic. There's another one, actually, that occurred to me recently. This is a much less attractive thing. I see a lot of fraud. Collusive fraud is virtually impossible to find with bright people. Sometimes they last two or three years before you get to it. But one thing that's a very clear predictor: overtly, aggressively religious – and it doesn't really matter what religion we're talking about here – chief executives are 100% fraudsters in my record. I know, it's not a very attractive thing to say. But it's something to really watch for. It's not that people are religious that's the problem. It seems to be that if they make a point of making sure you know about it, in the first few sentences, that's designed to mislead you as to their ethical base, I think.

Bank's Role

David. So shifting gears a bit, we have the Fed, you have the Bank of England. We have SEC, you have FSA. Let's talk about the UK side of the equation. What do you think of the Bank of England, the role it currently plays in the UK economy? And while you're talking about the Bank of England in particular, are there conditions under which you would actually like to see the pound collapse into the euro and have the ECB regulate monetary policy in the UK?

Jon. Well, first of all, you probably think the Bank of England rules our economy and our banks. It doesn't. The government took those powers away from it about three years ago. The only thing the Bank of England does now is it has a thing it calls the Monetary Policy Committee, which sets a thing called base rate, which nobody takes a blind bit of notice of anymore. You can't borrow at base rate and the bank doesn't provide liquidity at base rate. It's a really, really weird thing. They pontificate about it, and the real market rates are 1.5% percent or even more above the base rate.

The Bank of England is very weak. They've been given a few powers back again, at the moment, which would be better, because they're better equipped to deal with it than the FSA. Do we want to give up our remaining sovereignty and go into the euro? It would be politically extremely difficult. The European Central Bank has probably made a better job of regulating things than either the Fed or the Bank of England. They've provided a lot of liquidity. But they've got a better environment to do it in. They can actually do it very quietly. If the Bank of England supports a bank in the UK, it has to disclose it pretty instantly. And that ruins the bank. The European Bank's been able to do it quietly, without disclosure. And it's done better. There is no support for going on to the euro, though, on a political level.

David. But do you think it would be the right move, if you had unilateral control over that decision?

Jon. If I got unilateral control over that, there'd be a lot of other things first! The euro itself is under terrible stress. So you can actually make the case that the euro's unstable. Because all you've got are different parts of Europe going at different paces. Germany's doing quite well. Ireland's doing terribly. But all countries share the same interest rate, same currency, and theoretically similar tax routes. So what the hell's going to happen? How does that get worked out macroeconomically? Well, the only thing left to give is unemployment. And if you're going to start talking about shoveling large amounts of unemployment around, the euro is unstable. So I don't think there'll be a great rush to go into the euro.

US/UK

David. So here's an even bigger public policy question. We've both lived and worked in the US and the UK. Do you think the UK would be better off if it had the system we have: separation of powers, the three allegedly coequal branches of government? And separately, do you think the US would be better off, on balance, if we actually had a parliamentary system rather than the system that we have now?

Jon. This is an especially broad question. I mean, the evolution, and of course the unfortunate separation of our two countries, was a little complicated. The only thing that I'm certain of in answering that question is that I would do anything to get rid of the length of your election campaigns. They bore us to death, so God knows what they do to you! The UK parliamentary system works reasonably well. Could it be better? Of course it could. I am just going to avoid it and say, it beats the heck out of me. I would prefer a dictatorship in any case.

A Political Future?

David. We're going to segue into personal questions. This one is a hybrid, a stopping point. And this may seem a little nasty. But some would look at you and say you've been lucky, you were in the right place at the right time, you've made a tidy fortune and had a lot of fun doing so. And others would say, look, you have a real responsibility to give back. And it's one thing to sit on the sidelines and carp and criticize and say what the folks in the arena are doing wrong. But do you ever feel guilty that you are not entering the arena in elected politics to try to right some of the problems that you're so skilled at identifying?

Jon. Right. First of all, my wife would leave me, which is the central problem. I've been able to, in recent times, get some influence politically. We've been able to lobby changes – effective changes – in pension law, in the taxation of capital gains, and so on. This can be done relatively quietly, and usually by sarcastic logic, which works fairly well with our politicians. To actually enter electoral politics in the UK is essentially impossible for me, even were I willing to do it. I'm too old for the Conservatives, who are positively discriminating for younger candidates. And they also like people who agree with the leader. And I certainly can't agree with the converted public relations manager we have leading the Conservative Party. He is a man of negligible beliefs, I think. So in terms of influencing things, I do. And you would find more going on there than you'd probably imagined. And we said that criticism is a lot more fun, because other people's mistakes are more fun than your own!

English Oenophile

David. Let me toss a strictly personal question at you. You are a notably accomplished investor who also happens to be an avid collector and consumer, and indeed producer, of fine wine. And given those facts, plus the related fact that, as you know, multiple partnerships have been formed in recent years for purposes of investing in wine for total return as distinct from more sybaritic purposes, my question is, if you were forced by dint of law to make a living not as a private equity manager but as the manager of a wine partnership, what would the fees and terms look like? And how might the expected returns compare with those you'd target in private equity investing?

Jon. First of all, you have obviously not tasted any of our wines, or else you wouldn't refer to them as fine! We are talking English wines, folks. Making wine in England is a loss-making activity. So any fees you would charge would definitely be excessive; and any carried interest would be of totally academic interest.

Grace Under Pressure

David. The other question you're well prepared for: What's the most memorably impressive display of grace under pressure that you have witnessed in real time?

Jon. This I find quite difficult. Probably the one thing that made the most impression to me was when I was 11 years old. My grandfather was dying. And he knew he was dying. And what really impressed me at the time, and still does to this day: the only thing he was worried about was whether I was upset. And that was all he was talking about. And I think it was remarkable. Because he was in tremendous pain, and knew he'd got hours to go. So this is probably the most moving idea I have.

Sound Snooze

David. One more question, Jon. What sort of stuff keeps you awake at night?

Jon. The only thing that keeps me awake at night is my wife!

David. Have you tried earplugs?

Jon. I don't keep awake at night, actually. One of the things that makes me able to have been in this trade, which is fundamentally quite a stressful one, for a very long time and enjoy it is I don't worry. My wife gets very upset with me, simply because I go to bed, and within a few seconds I'm snoring. So I really don't have any difficulty sleeping. And I don't worry. I have a mindset that is as follows: I'll analyze a situation, work out the courses of action, and typically decide on one, often too quickly. That's definitely a character weakness, but I have to make lot of decisions. And once I've decided, I stopped being concerned, or I don't really mind. You could call it unemotional, you could call it cold. But actually, I just don't worry about things.

David. Thanks very much for joining us, Jon.

ARSHAD ZAKARIA

Fast Growing Economies

David. I'd like to welcome Arshad Zakaria to the stage. I thought I would start off this session with a concern that I try to keep foremost in mind when we're pondering investment opportunities in rapidly growing economies. This is a concern that's rooted in the study of capital market history, which suggests that there's often slippage between the cup and the lip, so to speak, for investors in fast-growing economies. The slippage I'm alluding to is the slippage that results from the dilutive impact of stock financings needed to finance corporate growth. So if we concede for the moment that India's GDP will continue growing at a relatively rapid pace, how confident are you that this growth will indeed redound to the benefit of shareholders in well-managed companies that are domiciled in India?

Arshad. I think this is a very important question, not just when you're looking at India from an investment perspective, but when you're looking at any investment in fast-growing economies as well. I think people tend to invest on what I call a macro basis rather than looking at investing on a bottom-up or micro basis. By that I mean when you're looking at investing in a company, let's take an Indian company for example, the one advantage in India is that there are more listed companies there than in any other country in the world. India probably has too many listed companies because many of them are too small! But what you have is a culture of businessmen and entrepreneurs who've been focused for decades not just on running the business, but also on looking at return on capital. That I think is the critical aspect; there is an interesting history, especially because India has had an economy that has been capital-starved for a long, long time. The last few years have been a very unique period in India's history. When you've had a capital-starved economy, you've in turn had businessmen who've really focused on return on capital. Return on equities in India, for instance, is higher than anywhere else in the world. So on a micro basis, it's very important to look at the various companies and ask the question, are these companies focused on return on capital? And, are they in industries where you can earn substantial returns on capital, as opposed to looking at the macro story? Now, the converse says because of the last three or four years, what that leads one to do, in my view, is focus on the macro-concept stories. At our firm, our team is not allowed to spend more than 10% of any presentation on the macro story. The problem you have in India or China is that you can make any investment look fantastic by running the macro math. You take 1.2 billion people and you multiply that by any number, you can come up with a fantastic result. But what you see in a lot of these industries is profitless growth. The perfect example is the two-wheeler industry in India where there are two players. This should have been a perfect industry, because of a price war and great volume growth, but it never made any money. So if return on capital becomes the critical target, you have to go back to looking at this the way you would a developed economy, which is that the macro is great but it's just one small factor. You've got to look at return on capital, so you have to stay away from a lot of the sexy industries, because on a macro perspective, the growth numbers are fantastic. But when you're looking at return on capital, the numbers end up not being as attractive, which is an important point to focus on.

BRIC Bloc

David. So let's stick with the macro picture again for a bit. One comment that you hear voiced repeatedly during the debates about the relative merits of investing in the so-called BRIC (Brazil, Russia, India, and China) bloc is that the two biggest fish in that barrel have defects that are actually extremely contrasting, but also deeply rooted, so the argument goes. That is specifically that China has too little democracy and maybe too much capitalism and India has the converse, maybe too much democracy, too little capitalism. Leaving aside the second point, which has changed a lot in the last four years, talk to us if you will on the first point, about the degree to which you think India's otherwise commendable commitment to democracy has spawned excessive rules and regulations that could actually put a real damper on its capacity to marshal its human as well as its natural resources.

Arshad. I think that is the interesting distinction. When you're looking at China and India, the way I'd look at it is I'd say India from an economic growth perspective is probably 15 years behind China. The interesting thing to look at, just to take two steps back for a minute, is India from 1947 when it gained its independence. It was almost bankrupt in 1991. Foreign exchange reserves were zero. A series of reforms were initiated, and over the last 15 or 17 years it's been the second-fastest-growing country in the world other than China. I think you bring up an important point, which is that the two countries have taken two very different approaches. China's approach has been a much more effective approach in my view for any macro project when you're looking at infrastructure. When you're looking at anything that needs to be done top-down in terms of allocation of capital, a top-down system is going to work very well. Conversely, it's India's bureaucracy, but also the fact that it's a democracy, which stand in its way for macro projects. Three or four years ago we had a group of investors whom we took back to India. And I think the Chief Minister at that point was saying he was looking to expand the roads in Bombay, because obviously growing 8% creates huge demands in terms of traffic on the road. The concern he had, which was totally expected, was that there were slum-dwellers on both sides of the roads who were taken to court, and the project effectively got shelved. And what you don't have there is the ability to move people to build the roads, so they're now building a raised road in Bombay. It's a more expensive and cumbersome system. In that sense, I do think bureaucracy ends up creating a cost when it comes to growth. What I think is that having a bottom-up system and a market mechanism to allocate capital in the long run proves to be beneficial. And so if you have a perfect dictator, things should work out great because he will allocate capital perfectly and efficiently. In India, you've got both elections and a system where the market mechanism for allocating capital kicks in. It has all the problems that we know and we live with here, but it does prevent excesses from going too far. So there is that allocation of capital.

One of the lesser-known things about India is that it has a first-class business community, which I think is as good as it is because it has had to live with this inordinate bureaucracy. So in some sense, as they're getting unshackled, and they're taking growth step-by-step, they're really building first-class growth companies. From my perspective, I'd rather live in a country growing 8% a year where there is free press, free speech, and free capital, but I do think that makes it tougher to achieve the double-digit growth levels that China has.

Perfect Dictator

David. You just used the term perfect dictator as a sort of hypothetical, so let me pick up on that. It's clear and obvious to everyone in the room why I'm going to ask this question. As we think about what signs we should look for to determine whether India is poised to renew the great economic gains that it made in the last several years, if you were the perfect dictator and had omnipotent control over the rules, regulations, and laws, what would be the two or three things that you would change right up front that would enable, in your judgment, the Indian stock market to outperform the broad US stock market over a sufficiently long time horizon, say 20 years? What would be the key things that need to change?

Arshad. I hate the term perfect dictator, because it is a bit of an oxymoron! But I think from my perspective, if you look at the two principles that you want to achieve, in what I think is a very good bottom-up growth story and where you are going to have volatility, the secular story remains. I think you want to improve productivity and capital efficiency. If you look at what really drove the United States through the last 25 years, you had an increasing focus on productivity and capital efficiency. So in that vein, I think the most important thing for India is for the corporate debt market to open to foreign investment. And we need to phase out some of these rules that are making it difficult for Indian companies to borrow abroad. Now, it seems like a fairly technical issue, but in my view, what you're really doing there is you're bringing down the cost of capital. In a country that is going to need a ton of capital to grow because of the massive infrastructure investment that needs to take place, driving the cost of capital down will make it better. So the first step you do is create a free flow of capital to the debt markets. A lot of the 1980s and 1990s boom in the US was actually the privatization through leveraged buyouts of companies on the New York Stock Exchange. India has a number of family-owned businesses that could be run much more efficiently. You basically have both shareholder control and no corporate debt market or high-yield debt market, to effect any such change of control. So again, if you believe in productivity and efficiency, you've got to open up the debt markets.

Same thing would be point number two: phase out divestments of government enterprises. The government owns large stakes of a lot of companies. I think there's tons of data to show that private enterprises will do their work much more efficiently than government businesses.

I think the third thing I would do is a general phase-out of subsidies and move to make the currency fully convertible. The current Prime Minister, Dr. Manmohan Singh, was the finance minister and an ex-governor of the Reserve Bank. And he has made this a goal. The question in all these three areas is not whether they're happening or not, because I do think they're happening, but rather the fact that moving faster is an absolutely critical element to getting it all done. The one thing to remember in India is that the concept of time is even more critical in a country growing 8% or 10% a year. So whether it's bureaucracy or whether it's slowly phased reforms, they become much more important when you're growing at 8% real and 13% or 14% nominal, because you have to run to stand still. We've seen it in Las Vegas – if you go back to Las Vegas every two years, you've seen absolutely crazy build-ups. And in India, whether it's on the reform side or on the infrastructure build-up side, the scale of what has to be done is one aspect of it. The speed of it is absolutely critical. And that's why in all these three points, India has to move at a faster pace.

Outsourcing Trends

David. Let's talk a bit about outsourcing. It seems as though the term comes up in every conversation about India. So we've all heard about or experienced directly the outsourcing to firms in India of customer service or other functions. But you have a pretty unusual perspective being born and raised in India and educated in the US. I want you to shed light, if you will, on the evolving educational systems as well as the political climates — I'm referring specifically to trade policy — as you answer the question: how far do you think, over the long term, the outsourcing trend could go? Could it encompass eventually types of jobs not currently outsourced in large numbers? Ones that come to mind are medical diagnostics, maybe even teaching, which can be done at a distance with technology.

Arshad. I think when you're looking at outsourcing, the trend has the potential to become more significant. I think there are one or two things that need to be focused on, which are risks to this trend. In the end, a strategy that is based on just being the low-cost producer is not a long-term viable strategy for growth because other countries, for example the Philippines, will show up. You're going to have a lot of competitors for outsourcing. So from India's perspective, you need to focus on quality as well as cost, because you do have the cost advantage. And the second part of that is that you need to get an education and training system developed that allows you to train and educate people to be able to do this. It's interesting when you hear a lot of these numbers that are saying, you know, "x million engineers graduate in India." But the question is not the number of graduating engineers. The issue is the number of well-trained graduating engineers, and it's this number that needs to be the focus. If you're looking at industries where this might happen, I think healthcare is one. Financial services is actually an industry where we're seeing more and more of that happening. Education definitely is an area. There is clearly going to be a back and forth in terms of political backlash. I think innovation is what gets you to focus on new areas. I do think the trend of a globalized world will mean that there will be centers where different tasks will get done more effectively. I think just general business process outsourcing is something that is actually growing faster. I think the critical element for India is that it has to be value based, which is quality based, not just cost based, because in the long term, that is not a viable advantage. The one caveat to that is when you're looking at the India growth story, it's very visible from here. But in India, 80% of the economy is domestic. So the actual power of the story is a domestic demand story. You just have the advantage of the low-base economy. I think most studies show that it's easier to go from $300 to $3,000 per capita. So given the population and the domestic demand story, the outsourcing story is nice because it gives visibility to the country. The essence of the India story is that it's 80% a domestic demand story.

David. Of course, the 80% is where it is relative to China, which is a lot lower.

Arshad. Yes.

David. And that's because of the rules and regulations that we're alluding to. It's essentially a closed economy still, relative to what it could be.

Arshad. And infrastructure. The big difference in India and China is the infrastructure is not there in India as well as the fact that commodity exports have become very difficult to do in India because the friction cost is too high.

David. So what would you do about that if you were czar for the day, start building roads?

Arshad. Well, you'd love to have an infrastructure system that allows you to move as fast as you can. I think there's an upside, which is when people go to India, there are a lot of good things to see. But you see the massive need for infrastructure right away when you visit.

Business in India

David. That brings us to another question that I did share with you in advance. One question I ask my colleagues when they're returning from their first research trip to a given country or region is to tell me what most surprised them about what they saw and heard. So for example, when I made my first extended trip to China, which was several years ago, I was very surprised to learn how intensely the Chinese dislike the Japanese. Of course, I've also been to Japan, and sadly, maybe ominously, that view tends to be somewhat reciprocated in Japan. There are probably quite a few folks in the room who've been to India, but many perhaps have not. What are some of the most surprising things, beyond the infrastructure problems, that US-based fiduciaries seeking to determine how much to invest in India would discover upon making their first extended visit to India?

Arshad. Let me start by giving you some of the three or four interesting things that you will see, which are different from some of the other Asian economies. The first thing you see is that the Indian culture is essentially like an occidental culture. It is a Western culture. So in simple ways, when we have investors over, they feel completely comfortable with the Indian business community and to a smaller extent with the political community, mainly because India has a large agricultural population. But you do have a culture where it's very comfortable for Westerners to fit in on a social basis. That ties in with what I think is the second point, which is that the language of business in India is English. I think one of the big changes that's taken place in the world is the language of the global multinational is now English. That interestingly gives India an advantage not just over other emerging markets, but over some of the European countries as well because a lot of people in India actually speak English as their first language or have learned it in school to the extent where they've not only mastered the language but also the nuances of the language. These two points allow Westerners to fit right in to the system and culture — it's sort of like being in London or the United States. When you travel on roads where you may see a bull or a cow on the side of the road, you're reminded quickly that you're not in London, but once you get into a new building, which is being priced at New York or London prices because of this infrastructure issue, you will see from a societal basis that India has quite an advantage.

I think the other thing you focus on is the fact that India, again, is truly a democracy, where you've had smooth transitions of power, which allow you to see all the ups and downs of democracy. You have a free press, which is both a good thing and a bad thing. You've got TV channels sensationalizing everything, very much like Westerners are used to. There is very much a strong Western influence. I'd say the biggest issue other than infrastructure that you'd find when you go there, especially if you go to northern India, is the poverty and the scale of poverty. It is, I think, incredibly telling when you look at it and it's something that people aren't used to. I would say that's why there are a decent number of people who will leave feeling uncomfortable without being able to pinpoint why. It's unlike a lot of places because the poverty sits right next to the wealth. So you'll see the best roads in Bombay with slums right next door. The proximity of poverty with incredible wealth is something you see clearly in India, and the scale of it is tremendous. And that's just something that, no matter what you're expecting, tends to shock some people.

Immigration Policy

David. I want to talk about immigration policy, including the US's policy, and what might happen down the road in India. We're having an increasingly heated debate about who we let in and who we don't here in the US. Obviously you were born and raised in India by a very talented family, and that talent now resides in the US. What do you think India's long-term policy regarding immigration should be? And just as an aside, what do you think it should be here?

Arshad. I think this is one of the most important issues, which is obviously being discussed here, but in India as well. Let's briefly talk about the United States. The country is built on the foundations of immigration. If you look at the educational institutions in the US, they include the best education institutions in the world that educate the best people from all over the world. I think there needs to be more and more focus to continue that policy. If you look at the statistics, the United States still takes in more immigrants than any country in the world, and it is important that this stays very much the case both for the United States and for other countries. I think from India's perspective, you actually have statistics now where the vast number of people graduating from IITs (Indian Institutes of Technology) in India actually stay in India. India conversely needs to be very careful that it goes down the path of the United States and not the path of Europe or China. I think it's going to be difficult for India to actually get that done, because there are outside forces pushing against it. But in my view, I think it is important to go down that path because the country has a lot of advantages and has the ability to be the United States in 30, 40, or 50 years from now because of democracy, rule of law, and the fundamental bottom-up business community. The question is, can you get some of these big things right that will allow that to happen? I think immigration is something that not much is being done about right now, but it needs to be a focus.

David. You just said India has the potential to be the United States 30 to 50 years from now. Do you mean the United States circa 2008, or 1958 or 1908?

Arshad. I think 1958. Part of what goes on in any country is it starts off and leverage builds up in the system. It's in some sense dealing with affluence. The United States right now is dealing with the effects of affluence. What you have in India and China, that you don't have here, is primary demand as the driver for growth for everything. Most of the people don't have a house. Most of the people don't have a car. So everybody's going ahead and buying those types of things. When everything you buy becomes a replacement for something you already have, you end up with no leverage there but with a lot of leverage here, and growth becomes harder and harder to achieve. And there are some social pressures, such as healthcare, that are becoming more difficult to manage. So I think countries go through cycles. India has potential. But again, the country has got to get some of these big policy reforms correct. I think over the next five to ten years will be critical to see that.

Allocating Capital

David. So again, not to sound too dour or pessimistic, but what would be some signs one would look for in allocating capital from the US to India, even to regional approaches that would cause you great concern?

Arshad. My view in general is that when you invest in India or any other emerging market, you have to view it as a private equity investment because you're making effectively a long-term bet. You have to look at the fundamental changes that are taking place in reforms, even if they're small steps, to make growth easier and easier. I think for instance in the last four years, there were no backward steps but the steps were smaller than we would've liked and slower than we would've liked. So again, when you're looking at the various three or four reforms that we're talking about, you have to look at their progression. One advantage you have in India is both the major parties (Congress and the BJP) seem committed to a free-market economic system. But if you look back 15 years, that wasn't actually the case, because you had a socialistic regime. So as long as you look at the steps of reform, and they continue in the right direction, that's the critical aspect. Conversely, if you start seeing backtracking in the reform process, and I don't mean around election time because that happens in every country, but over a longer period of time, I think you have to worry.

The C Word

David. Let me introduce the C word into the conversation – that would be corruption. It's an awkward question to pose, because anyone familiar with the way Bill Clinton used the Lincoln bedroom or the way people are trying to raise money for W's library that he's going to build would be cautious about saying other countries have a problem with corruption. But I want to talk about it in India. How pervasive is it? How much room is there for improvement in the ethical norms governing commercial as well as political behavior in India?

Arshad. The structural issue that India faces may create a system in which corruption could be pervasive. I think the way to address this is to look at the government effectively giving up control and giving it away to private enterprise, because otherwise you've got a structural issue. In India, there have been a couple cases where it's worked well. If you look at the public securities market and the private equities market, where foreigners have been involved for the last 15 years, the government actually has been a good regulator. However, it has effectively turned it over to private companies, and you see a huge improvement in that period where you're operating more and more on Western standards in public and private equity. So I do think there's an issue in India and a lot of these countries where the government is involved. I think the process has to continue where the government basically gives up responsibility to private enterprises. As that happens faster and faster, you will see more and more improvement, because that's the structural issue, and it happens in countries like India where you have had effectively a socialistic system where the government was intricately involved. The good sign now is when you're looking at private money, and especially because they need a lot of foreign capital, you're going to see this moving to the private sector. And that I think is the positive step. In all things, it should be happening faster. But I think that step is a positive one.

Long-Term Edge

David. I want to turn to some personal questions, but before I do, are there any fully globalized industries in which India doesn't have a material presence at present that you think really long-term it actually has a distinct compelling edge in, that it might therefore be entering in coming years or decades?

Arshad. I think that India, because of its scale, is in a lot of businesses, which I think is a two-edged sword. I do think if you look at some of the commodities such as the petrochemical business or the refining business, there are a number of businesses that India is involved in. If you look at the cost of capital, the scale at which they've managed to get in, and the efficiency with which they've managed to get in, I think you're going to see them become larger and larger players. The reason I said it's a two-edged sword is the fact that many of us are asking the same question: Are people doing it with the same environmental costs that are being imposed on other firms and countries? That's something we're all going to have to look at. But if you put that aside, you're seeing a lot of businesses where we're looking at the numbers and the cost of capital, and I think you're going to see very efficient global companies in the future. I do think they're going to have to factor in some cost of the environment and that's going to be another interesting issue we haven't debated, which is what happens as they start doing that?

NYC, 9/11

David. A few personal questions before we wrap up. The one that I've posed to everyone, which you're familiar with, is this idea of the most memorably impressive display of grace under pressure that you've witnessed in real-time.

Arshad. For me, the most difficult moment that I had to deal with was when I was running all of global risk and credit at Merrill Lynch in 2001. We were right across the street from the World Trade Center. So we were right there on 9/11. We evacuated the trading floors, and just seeing the aftermath, which was a haze because it was so surreal, and the weeks following, was really challenging. Our building was moved to Jersey City and our people were all over the place. Seeing how the entire financial community came together for that four- or eight-week period was incredible. And seeing how the entire city came together at that time was absolutely remarkable, and in some sense the atmosphere was almost non-Wall Street-like because people were helping each other out and being extremely cooperative. I think all the actors and the way they behaved in that period was quite remarkable. It was remarkable because I had spent 15 years on the Street before that, and being at the epicenter of that tragic event, it was remarkable how everybody was behaving. It was just incredibly cooperative and just a very positive way of dealing with an incredibly tough experience.

Contrarian Views

David. What about role models, either personal or professional?

Arshad. I'm sure my answer here is going to be somewhat different, because I was a math and physics major going through school. My parents wanted me — and this is a characteristic of Indian culture — to get a PhD in mathematics. They were not into the finance and investment industry. In fact, they didn't look upon this as a very good business to be in! So in reality, I have to say my role model right through was Isaac Newton. Not only is he inspiring from an intellectual standpoint, he was also able to stick to contrarian views, which is impressive for someone in his time.

Bucking the Crowd

David. So if I can ask you to suspend all modesty for a minute, in your own career, what's the most successful example that you've been able to accomplish of bucking the crowd in that manner and getting paid off for having done so?

Arshad. Well, it's interesting, because when I left Merrill Lynch 2003, I had an opportunity to do something very different than what people thought I should do. I had wanted to do something related to India. It was both a personal thing as well as a professional one, because I'd run all the trading businesses at Merrill. This seemed like it was sort of a niche opportunity. I had a very well respected private equity person take me out for lunch and say, because of the scale of India, what I wanted to do just didn't make sense, because it was too small. But I did it anyway, and having been right on the timing, which is a lot of luck, and being able to say that this does make sense to do, it was a fun thing to have been right, even if a large portion of it was luck!

David. Thanks for coming, Arshad.

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Office Locations
Cambridge, MA
West Conshohocken, PA
Bethesda, MD
Palo Alto, CA
London, UK

Mailing Address
97 Mt. Auburn Street
Cambridge, MA 02138

Phone: 610-684-8000
Fax: 610-684-8210
Website: www.tiff.org/TEF
Email: info@tiff.org

