

THE TWO-PERCENT DILEMMA — AN ASSET ALLOCATION PRIMER REVISITED

WHAT IF ...

Sobering Stuff. The table below was prepared in connection with the publication of TIFF's *Commentary* for 1Q 2002 (available via the Education and Research section of TIFF's Website). The focal point of the aforementioned *Commentary* is identical to the focal point of the TIFF *Commentary* that immediately preceded it (for 4Q 2001): how can trustees of endowed charities deploy their assets in a manner that will give them a "fighting chance" of maintaining purchasing power while consuming 6% of endowment assets per annum? The initial essay in this series (i.e., TIFF's *Commentary* for 4Q 2001) was entitled "The Six-Percent Solution: An Asset Allocation Primer." It received this title because the "illustrative policy portfolio" that accompanied it contemplated a long-term real or inflation-adjusted return of 6% — a return sufficient to maintain endowment purchasing power in the face of customary withdrawal rates (5% for programs plus 1% for investment expenses plus related overhead). The return assumptions underlying this

portfolio appear below, along with revised assumptions for certain asset classes and for the portfolio as a whole. (Figures through which horizontal lines appear are those that appeared in TIFF's *Commentary* for 4Q 2001.) TIFF has published the table below in order to answer an important question posed in the TIFF *Commentary* for 1Q 2002: "What if Peter Bernstein is right?" Mr. Bernstein is a respected economist and market historian who has argued that the assumed real return of 4.5% on marketable stocks embodied in "The Six-Percent Solution" is too high. If Mr. Bernstein is right, then at least two conclusions follow: first, the expected returns of asset classes and strategies whose performance is dependent (even in part) on global stocks' return must be adjusted downward; second, the overall portfolio's expected return must be adjusted downward also. TIFF members seeking to understand the logic (or lack thereof) underlying the adjustments shown below should direct inquiries to info@tiff.org.

ILLUSTRATIVE POLICY PORTFOLIO

- Assumes a 15-year investment horizon (2002–2016) and access to top-tier managers in all markets.
- Portfolio seeks to avoid peak-to-trough declines exceeding 25%.
- Assumes ILBs purchased near or below par to maintain their utility as deflation (and inflation!) hedges. See TIFF *Commentary* for June 30, 2000.

Segment / Eligible Assets	Allocation Ranges*			Expected Gross Returns					Reason(s) Held	Benchmark
	Minimum	Normal	Maximum	Real Return	Value Added**	Real Total Return	Real Return	Real Total Return		
Total Return Segment	55%	70%	80%	3.8%	5.8%	0.4%	6.4%	4.2%	Preserve and enhance purchasing power in non-extreme market environments	MSCI All Country World Free Stock Index (currently roughly 50% non-US)
US Stocks	} 36%	40%	64%	3.0%	4.5%	0.8%	5.5%	3.8%		
Non-US Stocks		11%	18%	25%	4.8%	8.5%	subsumed	8.5%		
Private Equity	5%	12%	19%	5.0%	6.5%	subsumed	6.5%	5.0%		
Inflation Hedging Segment	8%	16%	24%	5.6%	7.8%	subsumed	7.8%	5.6%	Preserve capital values during periods of high inflation	10-year US Treasury Inflation Protected Securities (TIPS) plus 4%
Real Estate	7%	12%	17%	6.0%	8.0%	subsumed	8.0%	6.0%		
Resource-Related Assets	1%	4%	7%	4.5%	7.0%	subsumed	7.0%	4.5%		
Deflation Hedging Segment	4%	7%	15%	2.5%	3.0%	negligible	3.0%	2.5%	Preserve capital values during deflations	10-year US Treasury notes
US\$ High Grade Bonds	4%	7%	15%	2.5%	3.0%	indexed	3.0%	2.5%		
Non-US\$ High Grade Bonds	0%	0%	5%	2.5%	3.0%	indexed	3.0%	2.5%		
All-Purpose Hedging Segment	2%	7%	12%	3.3%	3.4%	negligible	3.4%	3.3%	Avoid forced sale of other assets to meet cash flow needs	10-year US Treasury Inflation Protected Securities (TIPS)
Inflation-Linked Bonds	2%	7%	12%	3.3%	3.4%	indexed	3.4%	3.3%		
Cash Equivalents	?***	?***	10%	2.0%	1.5%	negligible	1.5%	2.0%		
Total		100%		3.7%	5.6%	0.3%	6.0%	4.0%		Weighted average of segment benchmarks

* Minimums and maximums for sub-segments may not sum to minimums and maximums for each segment because sub-segments serve as partial substitutes for each other.

** Expected value added from the use of assets or strategies that could cause a sub-segment's returns to deviate from the returns of its parent segment's benchmark.

*** Minimum and normal cash positions could be negative, subject to trustee discussion of appropriate leverage ratios. Endowed charities can lever their portfolios without incurring unrelated business taxable income — if they're clever about it. Of course, if leverage is permitted, non-cash ranges must be tweaked accordingly.