

Dear Diary Part III

[a follow-up to **Dear Diary Part II** and **Timeless Truths about Investing**]

Source: 2003 1Q *Commentary*

Presumptions

The prior edition of this *Commentary* (4Q 2002) was extraordinary in at least three respects: four times longer than normal (16 pages vs. 4), it's generated more requests for reprints than any TIFF *Commentary* published previously, despite being devoid of baseball arcana. Presumably, this tome's popularity is attributable not to the third attribute but to the first, i.e., the fact that it treats at length policy issues with which many trustee groups are wrestling at present. We presume further that fiduciaries added to TIFF's mailing list over the years who deem intolerable this editor's penchant for leavening these missives with baseball arcana have long since asked TIFF to drop them from the list. Having received no such requests of late but taking due note of the coincidental starts of a new baseball season in the US and major military conflict in the Mideast, we've made abnormally heavy use of baseball arcana in this edition. In doing so, our aim is not to belittle the brave and just efforts of coalition forces working to oust a horrific regime in Iraq but rather to make it perhaps slightly more enjoyable for persons engaged in the **relatively** unimportant task of stewarding endowment wealth to perform their assigned duties.

Layered Substrata

This essay is entitled Dear Diary — Part III because it represents a continuation of prior efforts (cf. TIFF's *Commentaries* for 2Q and 3Q 2001) to record permanently facts and opinions that (quoting Part I) "illumine aspects of investing with respect to which human beings ... tend to make recurring mistakes." As such, this diary echoes in its aims the writings of modern baseball's most eloquent scribe, Roger Angell, from whose works most of the anecdotes used below are drawn. Proving conclusively that baseball and investing have much in common, Angell writes:

... [I]t is my secret Calvinist fear that baseball will run out on me someday ... [that] I will ... go newsless on some sun-filled afternoon and so at last lose this sweet franchise. Baseball saves me every time — not the news of it [but] its elegant and arduous complexity, its layered substrata of nuance and lesson and accumulated experience. ... Almost everything in baseball looks easy and evident, but really learning the game, it turns out, can take a lifetime, even if you keep notes.

Of course, in baseball as in investing, wisdom sometimes arrives late — or goes unheeded when it's needed the most. Echoing the laments of value-oriented stock managers whose irate clients lost faith in their abilities during the growth stock mania of the late 1990s, veteran catcher Dave Duncan said this as the baseball season commenced

20 years ago: "By the time you're really proficient, you're almost too old to go on catching." As frustrating as it was for Duncan to hang up his cleats just as he'd mastered his craft, it was even more frustrating for teammates of journeyman Rick Peters to endure a pivotal loss in 1986 that might have been a win had Peters paid more attention to his surroundings. Thinking mistakenly that the bases were loaded, Peters trotted slowly from third base to home after the plate umpire awarded a base on balls to a teammate. The opposing team's catcher greeted Peters with a smile — and a tag, ending a potentially game-winning rally. Alas, some fiduciaries pay equally little heed to their surroundings, ignoring both glaring perils (e.g., the extreme vulnerability of growth-oriented approaches to stock investing circa early 2000) and glaring opportunities (e.g., the extreme attractiveness of inflation-linked bonds at the same memorable moment in capital market history). To what perils and opportunities are fiduciaries paying insufficient heed today? For better or worse, readers must penetrate an insulating layer of baseball arcana (none used previously by this writer) to lay hands on this essay's multi-part answer to the question just posed.

Fear of Losing

"We all have such a fear of losing," baseball executive Roy Eisenhardt once noted, "that we do things that actually increase the chances of our losing." Although speaking of baseballers, Eisenhardt might have been describing investors, especially endowment stewards seeking to achieve prespecified return goals at a time when proven methods of achieving same seem not to be working. Historically, the broad US stock market as well as some non-US bourses have produced real returns high enough to preserve the purchasing power of endowments investing liberally but not exclusively in stocks (65% or higher stock ratios) while supporting reasonable spending rates (up to 5% per annum). But these same equity-oriented mixes have produced distressingly large losses since the US and most other developed stock markets peaked in March 2000, some vicious "bear market rallies" notwithstanding. Anticipating prolonged and pronounced stock price volatility at best and further stock price declines at worst, some respected investment pros have argued recently that trustees should make greater use of tactical asset allocation ("TAA") techniques, i.e., permit themselves or managers tapped by them to make frequent and material shifts between stocks and other asset classes in an effort to exploit stock index prices projected to oscillate markedly around a sideways or (gulp) downward trend. Having acknowledged in these pages last quarter that TAA techniques can indeed prove very profitable under such conditions, we're disinclined to label them wholly unsuitable for institutional use. "Unnecessary" would be more apt. By our lights, the chief reason some esteemed strategists are extolling TAA techniques at present is because they see little hope that **US stocks** will produce more than derisory real returns over the next 7-10 years. Many trustee groups harbor similar fears, as manifest in their decisions over the last year or two to shift large sums away from US stocks and toward two "asset classes" that have performed relatively well of late: high quality bonds and absolute return-oriented ("ARO") hedge funds. As we noted last quarter, very high quality bonds acquired at today's prices are anything **but** risk-free, even if they bear the full faith and credit of the only superpower in human history to consistently leave vanquished foes vastly more free than it found them. Rather, such bonds are priced at levels that make

their purchase by trustees interested in achieving the elusive goal of 5% real returns a losing proposition, assuming such bonds are held to maturity. As for ARO hedge funds, their inherent heterogeneity renders all generalizations about them false except this: as with most forms of "alternative investing," ARO manager returns can be highly dispersed, making any given portfolio of ARO managers or strategies anything but a sure-fire means of earning annualized real returns exceeding 5% over the next 7-10 years.

Extreme Measures

This brings us to a question, one that fiduciaries whose minds function like Eisenhardt's (i.e., well) are asking themselves these days: "what can we do to increase the chances of our winning?" with **winning** defined as the pocketing of annualized real returns exceeding 5%. This writer's answer, unchanged since penning TIFF's *Commentary* for 4Q 2002 — nay, reinforced by a March 10 presentation to TIFF's board by a hugely successful investor who (like this writer) eschews forecasts over time horizons shorter than Nomar Garciaparra's tenure-to-date as baseball's best shortstop — is this: foreign stocks. [1] The fact that many trustee groups view overseas investing with extreme skepticism these days weakens the arguments in its favor not at all. Indeed, it lends weight to arguments extolling one especially offputting form of foreign investing: private equity. Precisely because it embodies very high levels of some forms of risk for US-based fiduciaries — i.e., informational, liquidity, and reputational risk — foreign private equity ("FPE") also holds the potential for very high expected returns. This is true even if one excludes from the FPE selection universe three countries whose economic systems seem hopelessly torpid, two of which many Americans view negatively these days for non-economic reasons also: France, Germany, and Japan. In this writer's judgment, FPE's expected returns are proportionate to the most important measure of this or any asset class's inherent riskiness: the risk of permanent capital loss. As with ARO investing, FPE's inherent riskiness can be reduced **materially** through careful manager selection — a safeguard generally not available to trustees shifting capital into high quality US bonds at today's prices. **Must** trustees take the highly unconventional step of shifting money (but not too much, please!) into FPE in order to achieve 5% or higher real returns over time horizons appropriate to endowed organizations? Perhaps not, although the outlook for US stocks — the traditional "engine of growth" for US-based endowed charities — seems poor enough to make unconventional strategies choiceworthy, just as such strategies seemed choiceworthy to a ballplayer competing against Eisenhardt's Oakland A's two decades ago. Asked what he would do about the Oakland Coliseum's infamously bumpy diamond, Dan Quisenberry replied that the A's should try dragging a whale across the infield.

Unreliable

As eminently quotable as he was politically incorrect, "Quis" said many memorable things during his tenure (1979-90) as one of baseball's best relievers. A "submariner" (i.e., a pitcher whose hand dropped below his elbow during deliveries), Quis added the knuckleball to his repertoire halfway through his career but stopped throwing it soon thereafter, citing reasons similar to those that have induced many trustee groups to reduce

materially what had been hefty long-term allocations to equities as the current bear market has ground on: "If the knuckleball was [sic] my wife," Quis explained, "I'd divorce her ... [S]he's not reliable — I just can't depend on her at all." To be sure, equities broadly defined have indeed charted an erratic course in recent years, displaying tendencies as schizoid as those of the '85 Twins, a team that won nine consecutive games early in the season and then lost the next 10. Like investors who were lured back into stocks by their impressive rally during 4Q 2002, gamblers who placed bets on the Twins as their impressive winning streak was unfolding experienced subsequently what investment pros refer to as "bad gamma." As noted in a brief piece on gamma published originally by TIFF in early 1998, investment pros would be lost without a working command of certain Greek symbols, including alpha (a synonym for excess return), beta (an asset's sensitivity to broad market movements), delta (the sensitivity of an option's price to changes in the price of the asset underlying it), and gamma (a measure of how an option's delta changes in response to changes in the underlying asset's price). An option's delta tends to be stable for small changes in the price of the underlying asset but wildly unstable for very big price moves. Although stocks and stock portfolios do not have "gammas" that can be measured explicitly (only options do), the returns that investors require for holding them logically tend to rise (i.e., equilibrium prices tend to fall) as stock price volatility itself rises. This nexus is logical because few investors can afford to "buy and hold" stocks on a truly permanent basis, perpetual life charities not excepted. The latter can't "buy and hold" forever because overall portfolio income yields sometimes fall below targeted spending rates — as at present.

Mean-Averting

Fortunately, most endowed charities remain **able** to act logically under such conditions, selling off appreciated bonds as distinct from depreciated stocks to fund income shortfalls and rebalancing their portfolios in the process. Whether such charities' trustees remain **willing** to rebalance in this manner in the face of stocks' persistently high volatility is a separate question, one that not a few investment committees have **opted** to answer in the negative and that many financial institutions have been **forced** to answer negatively. Thinking wrongly that the late great bull market in stocks would continue indefinitely, many such institutions adopted investment policies that rendered them excessively vulnerable not only to declining stock prices but to rising gammas. "Excessively" is the operative word, because regulatory strictures too arcane to discuss here are forcing these perpetual life corporations to "sell low" — or go bust. Such forced liquidations may not yet have run their course, although they appear to have peaked last summer, judging from the depths to which many portfolios displaying "bad gamma" fell during 3Q 2002, including those stuffed with high P/E stocks or low quality corporate bonds. As noted in prior TIFF publications, in recent years rating agencies have taken **stock** price movements explicitly into account in determining **bond** quality ratings, to the detriment of institutions holding corporate bonds or **issuing** securities linked thereto, e.g., credit default swaps. Taking all market phenomena discussed above into account — plus other phenomena lying beyond the scope of this essay if not also its author's grasp! — one forms inevitably a view of current market conditions that both helps explain why many accomplished money managers seem to have "lost it" of late and constitutes a guide for

action: although the general tendency of broad equity indices over the last three years has been "mean-reverting," with valuations falling from historically high levels toward more "average" ones, individual securities and indeed clusters of securities displaying relatively concentrated ownership (e.g., distressed bonds held primarily by loss-plagued European banks and insurers as well as stocks of these and other European firms joined at the hip by heavy cross-holdings) have been essentially mean-**averting**, going down and down still more because ... they have gone down. What to do? One suggestion: redouble one's efforts to understand precisely why formerly successful strategies (e.g., some forms of event driven, "special situation," and long/short equity investing) are misfiring, taking extreme care to distinguish true and lasting failures from apparent and ephemeral failures caused by the career-threatening circularity just described. As important as it is in the current environment for fiduciaries to commit bold acts in pursuit of compelling investment opportunities (e.g., private equity offerings in selected foreign markets), it's equally important to avoid rash decisions to "bail" from managers or strategies whose best days **seem** to have ended. This brings us to a final baseball anecdote, one involving a Hall of Famer who became so popular while still active as a player that thankful fans gifted to his team a life-size wax statue of him. Seeking a yuk on an otherwise slow day, the team's mischievous trainer spirited the statue into the clubhouse, laid it on the training table, lowered the lights and summoned the team doctor, telling him that the star had collapsed inexplicably. The doctor raced to his "patient," took one horrified look, and felt for a pulse, triggering the loudest guffaws ever heard in a clubhouse not occupied by players who've just won the World Series.

Endnotes

1. Red Sox shortstop Nomar Garciaparra reached "the show" or big leagues in 1996.