Enhancing the investment returns of non-profit organizations

Trustees

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Mayo Foundation, MN

Sheryl Johns
VP, Treasurer, and CFO
Houston Endowment Inc., TX

Michael McCaffery
President and CEO
Stanford Management Co, CA

William McLean
Senior Managing Director
MacArthur Foundation, IL

Jack Meyer
President and CEO
Harvard Management Co, MA

Fred Renwick
Professor Emeritus
New York University, NY

David Salem
President and CEO
TIFF, VA

Ellen Shuman
Chief Investment Officer
Carnegie Corp of NY, NY

Ann Brownell Sloane
President
Sloane & Hinshaw, NY

Jeffrey Tarrant
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Arista Group, Inc., NY

Arthur Williams
President
Pine Grove Associates, NJ

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COMMENTARY

A Quarterly Report of THE INVESTMENT FUND FOR FOUNDATIONS **SEPTEMBER 30, 2001**

Highlights

Page 2 Boiled to their essence, **all prescriptions for investment success have just two active ingredients**: "think long term" and "control your emotions." Some investors can gain and hold an edge by ignoring the first principle — but only if they are uncommonly good at abiding the second.

Page 3 **The human memory is a passive system** that sorts incoming stimuli into patterns. Once a pattern takes shape, arriving stimuli are forced into it. This process continues until some major stimulus arrives that is utterly incompatible with the existing pattern. The resulting rearrangement can be hugely costly.

Page 3 **Most institutional investors seek more liquidity than they need** and obtain less liquidity than they seek.

Page 4 **The higher stock prices climb, the less liquid stock portfolios become in a strictly accounting sense**, because rising prices unaccompanied by commensurate increases in dividend payouts cause the time period that stockholders must wait to receive a return of their capital to lengthen.

Page 4 **Current income remains an overlooked source of liquidity** for investors reliant on portfolio withdrawals to meet cash flow needs.

Page 4 If and when fiduciaries adopt a more income-centric view of endowment management, at least **one relatively illiquid asset class now out of favor will likely come back into vogue**.

About TIFF

The Investment Fund for Foundations (TIFF) is a not-for-profit cooperative founded in 1991 by a nationwide network of foundations. Its mission is to improve the investment returns of eligible organizations by making available to them (1) a series of multi-manager investment vehicles and (2) resources aimed at enhancing fiduciaries' knowledge of investing. Excepting TIFF's president, all TIFF trustees serve as unpaid volunteers.

Critical Mass. TIFF currently manages assets in excess of $2 billion for over 300 non-profit organizations worldwide.

Carefully Researched. TIFF's investment programs are based on many years of extensive study into the investment needs of non-profit endowed organizations. The investment programs that TIFF administers enable member organizations to delegate selection and oversight of money managers and other essential vendors to experienced investment professionals whose personal and professional interests are highly congruent with the interests of TIFF's members.

Investment Vehicles. TIFF administers a variety of multi-manager investment vehicles that enable members to access a variety of asset classes and strategies, including US and non-US marketable securities, venture capital, buyouts, real estate, natural resources, and absolute return-oriented strategies. For more information, please refer to TIFF's separate quarterly reports entitled *Marketable Investments* and *Alternative Investments.*

Eligibility. The investment vehicles administered by TIFF are open to non-profits operating under §501(c)(3) of the Internal Revenue Code plus their non-US equivalents. For more information, please contact TIFF at 434-817-8200 or visit our Website at www.tiff.org.

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Dear Diary — Part II

Staying Focused

Indelible Mark. As TIFF's quarterly commentaries approach their eighth year of publication, their author confesses that he occasionally has difficulty deciding which of myriad topics germane to TIFF's members he should discuss in a given edition. This quarter's choice was especially difficult — the temptation was great to dwell exclusively on September 11 and its aftermath — but your faithful scribe ultimately decided that this commentary should focus on musings whose half-lives assumedly will be longer than those focusing solely on recent events. This is not to minimize the large financial toll — and the permanent and infinitely sadder human toll — of the attacks in question, which have left an indelible mark on America and the world. TIFF's board and staff express heartfelt condolences to the families and friends of those killed on September 11, and we salute the heroism displayed by countless public servants and private citizens, especially the brave souls who prevented another hijacked plane from reaching the nation's capital. Along with millions of his fellow citizens, this writer feels helpless to a depressing extent — not against the possibility of future attacks but rather in his inability to take physical (as distinct from financial or intellectual) steps to relieve the suffering of those directly affected by these hideous crimes. To be sure, there **are** concrete steps that concerned citizens living far from the disaster scenes can take to help — cash donations being foremost among them — but within hours of the attacks authorities began pleading with the public to focus on indirect means of helping those in need, physical resources such as rescue workers and food having already manifested themselves in overabundant quantities.

Renewed Vigor. In fact, this writer and members of TIFF's board and staff were attending a TIFF board meeting in Manhattan when tragedy struck. None of us were ever in physical danger, but we were close enough to lower Manhattan to experience the frustration of citizens who wish their training or circumstances had enabled them to provide physical assistance to persons injured or displaced that fateful morning. Indeed, for those of us engaged in the abstract task of endowment management, it has been difficult since September 11 to focus on assigned duties at work when so many families affected directly by the recent violence remain so acutely in need. Fortunately, fulfilling such duties and helping those in need are not mutually exclusive. Indeed, those of us who labor exclusively on behalf of endowed charities can legitimately view these two imperatives as complimentary because the organizations we seek to serve are themselves contributing directly to the alleviation of human suffering. Ironically, the chief question that those of us trained in the inherently abstract but potentially beneficent work of endowment management must ask ourselves in these trying times is identical to the chief question that experienced fiduciaries pose to prospective money managers: what is your "edge"? TIFF's "edge" is a body of knowledge and experience conducive to the prudent stewardship of endowed charities' financial assets. Accordingly, perhaps the single best way TIFF's leaders can help the nation is to perform their assigned duties with renewed vigor and confidence. One measure of such confidence is TIFF's decision to follow through on plans (conceived prior to September 11) to add two highly skilled persons to its growing team of investment professionals: San Francisco-based David Burke and London-based Michael Costa. (Capsule biographies for all staff members are furnished on TIFF's Website.) Another measure is our decision to devote the remainder of this report to thoughts that have less relevance to near-term market perils and opportunities than they do to longer-term challenges confronting endowment trustees. Of course, trustees who abandon sensible long-term disciplines in times of crisis can do permanent danger to the endowments they steward, so the musings that follow are hardly inapposite to any near-term decisions that our readers should (or should not) make.

More Diary Entries. These musings take the form of a second set of excerpts from the diary of "Timeless Truths about Investing" introduced in these pages last quarter. Interestingly but perhaps not surprisingly in light of the topics covered in the first installment (posted in the *Publications* section of TIFF's Website), last quarter's *Commentary* generated more feedback than any prior edition in TIFF's history, with numerous readers encouraging us to publish "more of the same." We're pleased to oblige. As noted last quarter, entries in the diary are made only when this writer identifies investment-related thoughts that merit permanent recording. They merit such treatment because they illumine aspects of investing with respect to which human beings (as well as machines programmed by them) tend to make recurring mistakes. Maintaining this diary has not prevented its keeper from making some of these mistakes more than once, but it has made his life's work more fun. We hope the entries below don't disappoint, even though some necessarily address challenges that may seem less universal than those addressed by the first batch. In fact, most of the mistakes that investors make have a common root cause, and most of the challenges they confront can be met successfully by abiding two simple principles. The root cause is human nature, the contemplation of which by "behavioral finance" scholars has yielded important insights into market movements summarized in a user-friendly dialogue on this nascent discipline that appeared in a quarterly report on TIFF's marketable investments dated March 31, 1996 (also posted on our Website). The two principles are easily identified and stated, although many persons (including this writer) get paid to discuss them in frustratingly obtuse ways, the diary entries below not excepted. Boiled to their essence, virtually all prescriptions for investment success have just two active ingredients: "think long term"

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and "control your emotions." To be sure, some abnormally skilled or energetic investors can gain and hold an edge by ignoring the first principle — but only if they are uncommonly good at abiding the second. But most investors — and virtually all trustee groups — have no chance of achieving their goals unless they abide both principles. The diary entries that follow, like the ones published last quarter, are all essentially variations on these two themes.

Governance — The All-Important Process of Getting "Structured for Success"

Genetic Imperative. Not long after this writer sank into money management some years ago, an accomplished investment professional (Stephen Butt) drew his attention to the seminal work of cognitive process expert Edward de Bono. The human memory, de Bono has observed, is an inherently passive system that essentially lets incoming stimuli sort themselves into patterns. These patterns form the underpinning of beliefs, biases, and cues for action. This system is powerful, but it has at least one big flaw: once a pattern takes shape, later-arriving stimuli are forced into it, making it increasingly dominant over competing views. This process continues until some major stimulus arrives that is so incompatible with the existing pattern that the latter must be discarded in favor of a new one. The resulting rearrangement can produce big behavioral changes (e.g., the public's vastly decreased interest in traveling by air in light of September 11). When the jigsaw puzzle being assembled is an endowment portfolio, the resulting rearrangement of its pieces typically causes some to be tossed out, producing turnover that is deceptively costly in two respects: trading costs (e.g., those arising from manager changes) are often submerged in overall fund results; and opportunity costs (e.g., those arising from the ill-timed sale of cheap assets) are seldom tallied and almost never acknowledged by even the most conscientious fiduciaries. To be sure, most trustee groups properly shun market timing — defined as the shifting of material portions of a fund's assets across asset class boundaries based on short-term return forecasts — and few endowed charities routinely suffer large losses as a result of trustees' too-frequent rearranging of their mental maps. But the genetic imperative that de Bono has identified — undue stasis followed by abrupt action — can be quite harmful even if it operates infrequently and especially if it drives major policy choices. Conspicuous recent examples include (a) the abandonment of active approaches to equity investing (most of which entailed value biases) in favor of indexed approaches (most of which entailed growth biases) in the late 1990s and (b) the more or less simultaneous allocation of large sums to private equity managers by trustee groups that formerly eschewed illiquid assets and strategies. A less conspicuous recent example: governing boards of operating charities (including schools) that maintained seemingly miserly spending policies throughout the late 1980s and 1990s only to relax such disciplines as the new millennium dawned. What caused them to boost spending levels above previously agreed limits? The answer seems clear: the very high inflation-adjusted returns that most institutional portfolios pocketed in the late 1990s (i.e., 25+% per annum for several years) constituted a major stimulus that didn't fit the pre-existing pattern (i.e., inflation-adjusted returns in the mid-single digits). Of course, there's nothing illegal or inherently unwise about boosting endowment withdrawals to meet choiceworthy programmatic aims, provided that trustees don't let the spending tail wag the portfolio dog. Alas, it seems that some trustee groups have done precisely that, boosting allocations to high risk strategies (technology-oriented venture capital being foremost among them) on the assumption that such changes constitute sufficient conditions for sustaining unprecedentedly high endowment withdrawals.

Liquidity — Investors' Fair Weather Friend

Large Irony. Liquidity is beautiful in most investors' eyes. However, as Sir Francis Bacon (1561-1626) once memorably observed, "There is no excellent beauty that hath not some strangeness in the proportion." What makes liquidity strange? Two things: first, it tends to disappear when an investor wants (as distinct from needs) it the most; second, precisely because liquidity (i.e., the capacity to convert a security or portfolio into spendable cash) is such a fair weather friend, most institutional investors seek more liquidity than they need and obtain less liquidity than they seek. With respect to liquidity's chief quirk — its evanescent character — trustees would do well to contemplate precisely why they typically view publicly traded securities with far less jaundiced eyes than privately traded ones. As market historian Roger Lowenstein has emphasized in his writings, public markets such as the New York Stock Exchange have two primary roles: "discovering prices" and providing liquidity. Importantly, given the genetic imperative discussed above, the price pendulum for most publicly traded assets tends to swing between psychological extremes. Moreover, it tends to move in a discontinuous rather than smooth or gradual manner. Excluding truly anomalous events that cause all trading to cease (e.g., 9/11/01), public markets do indeed reliably "discover" or determine securities prices even when investor psychology reaches an extreme. But it is precisely at such points that liquidity tends to be frustratingly low, raising serious doubts about the inherent soundness of the valuations streaming across the market's "tickertape." At psychological bottoms (known only in hindsight, of course), current owners seeking to dump losing positions must accept huge haircuts to do so. Whether they actually **need** to sell under such conditions is often a debatable proposition: many ill-timed sales are made to satisfy psychological needs rather than cash flow demands.

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DEAR DIARY — PART II *concluded*

Interestingly, a similar phenomenon occurs at psychological peaks: because the buyers who set prices "at the peak" tend to be both emotionally charged and few in number, current owners seeking to sell when prices reach parabolic highs (also known only in hindsight) must accept large haircuts from quoted bids in order to unload meaningfully large positions. The irony in this is that investments entailing long-term lock-ups are often less risky than those entailing no lock-ups precisely because the former are truly illiquid: they cannot be sold "at the bottom," and the fact that they can only be liquidated at pre-specified times permits and encourages the investment pros charged with their day-to-day management to take proactive steps to enhance their value over long-term holding periods.

CURRENT INCOME — An Overlooked Source of Liquidity

Puzzling Facts. The powerful "equity culture" that flourished in financial markets during the closing decades of the 20th century rested on several pillars, one being the increasing tendency of institutional investors to pursue a "total return approach" to portfolio construction. In a sentence, this means a scheme whereby cash withdrawals not covered by current income get financed via asset sales. Paradoxically, the higher stock prices climbed in the 1990s, the **less** liquid stock portfolios became in a strictly accounting sense, because rising prices unaccompanied by commensurate increases in dividend payouts caused the average time period that stockholders must wait to receive a return of their capital to lengthen. Of course, most people shifting fresh money into stocks aren't thinking first and foremost about a return **of** their capital; they're thinking primarily about a return **on** their capital, perhaps because they take the ultimate return **of** their capital for granted. To be sure, the comments just offered applied more readily to the average investor's mindset in the 1980s and 1990s than they do today. But current income remains an overlooked source of liquidity for investors reliant on portfolio withdrawals to meet cash flow needs. This may explain why at least one investment strategy that generates relatively high levels of current income — namely real estate — remains somewhat out of favor. Real estate's unloved status could reflect other factors also: astute fiduciaries surely recognize that the relatively high levels of current income that diversified realty portfolios generate partly reflect compensation for the underlying properties' ongoing depreciation, and they recognize too that realty isn't going to soar if the overall economy weakens materially. But they may not recognize fully that non-securitized or privately traded assets generating high current income yields are more "liquid" in the ultimate cash flow sense than those generating scant or no income. Interestingly, fiduciaries who had the unenviable task of stewarding eleemosynary funds during the decades immediately following the Great Depression seemed to appreciate this point more fully. Although few had the temerity to move heavily into stocks (despite dividend yields that rivaled those available from bonds circa 2001), most tolerated if not advocated purchases of privately placed bonds issued by high quality borrowers. Avoiding stocks for the most part, they also emphasized an asset class that constituted the **sole** cylinder in most endowments' engines prior to the 20th century: real estate. Analyzing today's generation of trustees through de Bono's lens (see above), it may take more than a few years of negative total returns for equities before governing boards adopt a more income-centric view of endowment management. And it would be unwise indeed for endowed charities to revert to the pre-modern view that endowment withdrawals must be limited to current income (i.e., dividends, interest, and rent). But spending policies rooted in the modern view that capital gains as well as current income may be spent in no way preclude investment policies that pay due attention to current income, i.e., policies which ensure that targeted withdrawals can be at least partly financed through current income, especially if stock dividend yields collapse. Lacking a crystal ball, we're unwilling to predict that market movements over the next few years will indeed cause endowed charities as a group to adopt more income-centric investment policies. But we will hazard a guess that if such a rearrangement occurs, non-securitized real estate will come back into favor in a big way, its privately traded status notwithstanding. ■

MEMBERSHIP SUMMARY

	Number of Members	Assets
TIFF Membership	**340**	**$2,195 mm**
▪ Private Foundations	168	$1,118 mm
▪ Community Foundations	35	$268 mm
▪ Other 501(c)(3) Organizations	137	$809 mm

THE INVESTMENT FUND FOR FOUNDATIONS
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2405 Ivy Road
Charlottesville, Virginia 22903
Phone: 434-817-8200
Fax: 434-817-8231
Website: www.tiff.org

Electronic mail inquiries:
Services offered by TIFF: info@tiff.org
Member-specific account data: members@tiff.org
Manager selection procedures: managers@tiff.org

For further information about any of TIFF's services, please contact TIFF at the address or phone number listed above.

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