TIFF

Enhancing the investment returns of non-profit organizations

COMMENTARY

A Quarterly Report of THE INVESTMENT FUND FOR FOUNDATIONS

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About TIFF

The Investment Fund for Foundations (TIFF) is a non-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.

Carefully Researched. TIFF's investment programs are based on 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 broad array 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.*

Critical Mass. TIFF currently manages approximately $2.5 billion for more than 350 non-profit organizations worldwide.

Eligibility. The investment vehicles administered by TIFF are open to non-profits operating under section 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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Carpe Diem. When asked why he spends so much time crafting *Commentaries* that don't discuss let alone promote investment vehicles offered by the organization that he heads, your scribe tells the truth but not the whole truth. The avowed reason for publishing such disinterested pieces is because a central part of TIFF's mission is to improve the investment returns of all endowed charities, including those eschewing intermediaries such as TIFF. An unspoken reason for publishing such essays is that they afford an opportunity to make regular use of this writer's prized collection of baseball quotes, a suitable selection from which can usually be found to render more memorable whatever lessons these ramblings seek to impart. This quarter's *Commentary* focuses narrowly — and perhaps memorably for some readers — on an aspect of institutional investing whose importance is eclipsed only by its unpleasantness: scrutinizing and (if necessary) tweaking money managers' fees and terms. Admittedly, with capital markets in disarray and with even seasoned strategists puzzled by the conflicting character of the macroeconomic tea leaves confronting them, devotees of these *Commentaries* might plausibly ask why this quarter's version focuses on the unhot topic of fees and terms. It does so for two reasons. First, although many investment pros won't concede their inability to forecast accurately economic and market trends, this writer freely concedes that his forecasting skills aren't materially superior to Alan Greenspan's. Accordingly, as glib as this writer could be on pressing macroeconomic concerns (e.g., worrisomely large recent increases in discretionary non-defense federal spending; US government bond yields that could prove absurdly low if continued economic torpor causes already expanding federal deficits to widen to levels repellent to Uncle Sam's foreign creditors, thus causing them to dump Treasuries if not also other dollar-denominated assets, etc.), it makes no more sense to discuss such imponderables in these pages than it does for the typical investment committee to discuss macroeconomic trends as it goes about its work. (After 20+ years working with countless such committees, this writer can identify on one hand the number of trustees that rigorously examine the extent to which any macroeconomic assumptions underlying their strategic biases are **already** reflected in securities prices.) The second and more important reason to discuss fees and terms **now** is this: precisely because so many forms of investing have failed of late, the demand for certain types of managers is shrinking relative to available supply, making it easier on the margin for attentive investors to negotiate more client-friendly fees and terms.

Small Succor. Before pinpointing opportunities for such investors to make or at least plant some hay while the sun is **not** shining on certain types of managers, we feel compelled to discuss the opposite phenomenon: investment niches in which the leverage that institutional clients plausibly can exert in negotiations over fees and terms is waning rather than waxing at present. For example, some hedge fund jockeys (typically those pursuing long/short or "macro" strategies) have had such a hot hand since broad stock indices turned south two years ago that they're pushing clients to approve contractual changes which advance the managers' interests while offering little or no succor to clients. Despite having trumpeted the inherent liquidity of the positions that they hold (as measured by the fractional number of trading days that it would take to liquidate such holdings), such managers are replacing quarterly or annual exit windows with multi-year lock-ups. Mindful that longer-term lock-ups are necessary and indeed nearly sufficient conditions for success in some forms of investing, many clients assent to them in the hedge fund arena without making the reasonable demand that incentive fee payments be withheld (substantially or *in toto*) until the lock-ups in question have expired.

Parade of Horribles. To be sure, so-called clawback provisions — under which managers forfeit incentive bonuses earned for prior periods if later ones produce sufficiently bad results — help mitigate mismatches between multi-year lock-ups on the one hand and managers' annual visits to the incentive fee trough on the other. But clawbacks are the exception proving the rule in the hedge fund arena — a corner of the investment world which, like private equity in the late 1990s, is one characterized by fees and terms that are becoming increasingly lopsided in managers' favor. Consider the following hedge fund practices, which we find offensive at best (due in part to their inconspicuous treatment in promotional materials) and non-starters at worst if coupled with other terms and conditions — including rapidly expanding assets under management — that make the overall "deal" being proferred one entailing too high a probability of sub-par net returns to outside clients:

- "**Side pockets**" may permit managers to hold illiquid or hard-to-value securities (often without limitation) pursuant to incentive fee and redemption provisions (if any!) respecting such sub-portfolios that tilt sharply in the managers' favor.

- **Compulsory redemption rights** may enable managers to liquidate willy-nilly specified share classes. Invoking such rights violates the spirit albeit perhaps not the letter of "high water marks" (in the case of managers who've stumbled and want to "reset the clock" on a portion of their asset bases) or contractual limits on assets under management (in the case of managers who replace lower

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fee-paying capital with higher fee-paying dough). Some loyal clients of managers who've stumbled learn too late that the proverbial "fine print" enables the funds in which they've made multiple purchases over many years to redeem mandatorily shares with relatively lofty high water marks without netting the losses such shares entail against gains produced by shares whose lower water marks render them unsuitable (from the manager's perspective) for forced redemptions. An aside: if your eyes are glazing over at this point, imagine what it's like to scrutinize fees and terms for a living. This writer finds only modest joy in such work and rejoices daily that he's surrounded by colleagues who perform it with the zeal that home run king Hank Aaron applied to his work as a batsman. "Trying to sneak a pitch past Hank Aaron," a pitcher who tried repeatedly to do so once lamented, "is like trying to sneak the sunrise past a rooster."

■ **Redemption "gates"** are illogical in many instances and offensive in some. Typically, such gates limit to specified levels (10%–15% being the norm) the fraction of clients' capital that can be withdrawn at any given exit window. Such limits are sensible if but only if the underlying holdings are sufficiently illiquid. But even under such conditions "gates" can be offensive if they're worded in a manner that limits withdrawals to specified fractions of each client's capital — or **all** clients' capital — on the exact dates such withdrawals must necessarily occur. The practical effect is to transform such funds into "roach motels," i.e., easy to get into but impossible to flee.

■ "**Holdback**" **provisions** may serve little purpose other than to boost managers' incomes. Sensible on their face, such provisions permit hedge funds to withhold specified fractions of redeeming investors' capital to guard against the possibility that final audits (often completed months after the redemptions in questions) will produce unit values lower than those available on the redemption dates themselves. Many funds pay no interest on withheld sums, thus enabling managers earning incentive fees to pocket material fractions (typically 20%) of the interest their funds garner during the months that redeeming holders must wait for "holdbacks" to be released. Why in this age of highly automated accounting systems holdbacks are needed at all in the case of **fractional** redemptions remains a mystery, as overpayments arising from misestimated unit values can readily be offset against a client's residual units. The case for holdbacks when a client is redeeming fully is less weak but far from compelling, especially with respect to intra-year redemptions from offshore funds, which typically cannot change unit values once they've been struck (except at calendar year-ends). More to the point, why are 5% or bigger holdbacks needed on redemptions from funds investing almost exclusively in marketable securities? Could preliminary net asset values (NAVs) really be "off" by more than a few percentage points? One would hope not. Of course, "stuff" happens, and sometimes it's impossible for hedge funds to strike 100% accurate exit NAVs (or indeed any NAV whatsoever) until weeks if not months have lapsed following a given exit window or period-end. Under such circumstances, ongoing fee payments should reflect conservative guesstimates of asset values. Alas, fund agreements don't always guarantee such conservatism respecting manager fees. Nor do the agreements governing some funds specify (as they should) that **redemption fees** (if any) be paid to the funds' residual holders (**not** their managers).

Much Ado about Something. We could go on and on — and indeed we routinely do so when confronted with operating agreements that seem too solicitous of managers' interests. Happily, some of the hedge fund pros we encounter are embarrassed by their lawyers' initial overreaching and agree to contractual changes that enhance clients' downside protection without undermining materially the managers' right to make big bucks. Such statesmanlike behavior is laudatory in its own right, and doubly so in light of the boatloads of money that investors are shifting into hedge funds at present. Of course, a few first-rate private equity managers handled fundraising and related tasks in a similarly statesmanlike manner even at the height of the private equity (PE) frenzy a few years ago. This frenzy having abated, the next few years could be ones in which institutional limited partners (LPs) succeed in tilting the PE playing field more in their own favor. Coming years could also witness client-friendly changes in the contracts governing realty partnerships, most institutional-quality realty having moved sideways or downward in price in recent years, so-called trophy properties excepted. Just as the prior part of this essay focused on relatively unobvious ways in which hedge fund documents unduly advance managers' interests, the remainder of it focuses on relatively unobvious ways in which PE and realty partnership documents can be tweaked to make them more client-friendly.

■ **Distribution rules** should specify that all forms of income pocketed by managers — including the myriad consulting, investment banking, transaction, property management, and other third-party payments garnered by PI managers whose documents don't steer such miscellaneous receipts into LPs' coffers as they should — be returned to investors before the general partners (GPs) receive one cent of incentive compensation or "carry."

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■ **Key man provisions** should be watertight (i.e., incapable of being subverted if a truly key person dies or is incapacitated) and self-executing (i.e., trigger an automatic unwinding of the fund unless the remaining investment pros persuade LPs to stay the course).

■ **No fault clauses** should give LPs the unambiguous right to wind up a fund by supermajority vote even if the GP has done nothing illegal or unethical.

■ **Clawback** and **escrow provisions** should be worded in a manner that makes it impossible for GPs to earn large incentive fees unless LPs' final — as distinct from interim — returns exceed prespecified hurdle rates by required margins. Hurdle rates are common in the buyout arena but remain uncommon in the venture arena. We're pushing hard for VC hurdles and encourage other LPs to do likewise.

■ **Cost-sharing rules** should ensure that sufficient sharing does indeed occur. Alas, this is increasingly untrue in the PI arena — and in the hedge fund arena for that matter — with managers sneaking into operating agreements the contractual right to make clients pay for administrative work (increasing portions of which are now "outsourced") that in a gentler age were covered by GPs' annual management fees (e.g., maintaining a partnership's primary books and records).

Inglorious Ends. Of course, it's unsurprising that PI partnership agreements generally have evolved in a manager-friendly manner since this writer began lugging them in his briefcase two decades ago. As turbocharged plays on rising stock prices, many PI strategies produced bountiful returns during the 18-year bull market in stocks that ended in March 2000. Being in such high demand throughout the last half of this bull market, many PI managers found it irresistible to tweak their funds' operating agreements in a manner that shifted more of the upside to themselves and more of the costs and risks to their clients. In doing so, they displayed a sensitivity to their clients' interests not different from the sensitivity toward his mates displayed by baseballer Dan Osinski. Surrounded during one post-game outing by teammates who would surely consume any food left uneaten by him, Osinski answered a waitress's query as to whether he wanted his pizza sliced into six or eight pieces as follows: "Better make it six. I can't eat eight." Coupled with modest physical abilities (manifest most conspicuously in two dismal appearances during the Red Sox's failed bid to win the '67 World Series), Osinski's unthinking ways made his tenure in the "show" decidedly undistinguished. Unless certain PI managers begin proffering fees and terms that reflect adequately the risks to which they've so conspicuously subjected their clients' capital of late, they may find that the current bear market in equities (private as well as public) has brought their careers in the big leagues to as inglorious an end as Osinski's. Dapper Dan pitched a grand total of 3.66 innings during his last year as a big leaguer, garbed in the garish attire worn by the 1970 Houston Astros, and then vanished from baseball — a fitting fate for a man whose sorry play helped extinguish this writer's boyhood dream that the '67 Red Sox would capture Boston's first World Series crown in 49 years. Of course, such boyhood travails provided useful training for this writer's adult passions: investing capital for perpetual life charities, and rooting for a team that, judging from its most recent collapse, may have no more success winning the Series during the next 84 years than it has since 1918. Regardless of how the Sox fare, this writer won't give up on them. But he does stand prepared to part company with money managers whose income demands would make even the most accomplished member of the '67 Bosox blush. During the sixth of his 22 seasons as a major leaguer, Hall of Famer Carl Yazstremski won the exceedingly rare triple crown for batsmen as well as a gold glove for his play in left field. By the time he retired in 1983, the well-but arguably under-paid Yaz had produced 452 homers and 1,844 runs batted in, all for the Bosox. ■

MEMBERSHIP SUMMARY

	Number of Members	Assets under Management
TIFF Membership	**367**	**$2,484 mm**
▪ Private Foundations	166	$1,179 mm
▪ Community Foundations	37	$289 mm
▪ Educational Organizations	23	$223 mm
▪ Other 501(c)(3) Organizations	141	$793 mm

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