TIFF

COMMENTARY

A Quarterly Report of TIFF EDUCATION FOUNDATION

DECEMBER 31, 2004

Highlights

By popular demand, a fictional investment committee whose past deliberations have proven entertaining to many regular readers and illuminating to some returns to the TIFF stage this quarter. Focusing as it's wont to do on two deceptively similar fields of human endeavor — endowment management and a certain sport in which contrarian thinking also tends to be rewarded over time — the committee discusses energetically …

… lessons that fiduciaries might glean from a fine new book on investing (*Capital Accounts*).

… why strong financial incentives are a necessary but arguably insufficient condition for eliciting the best efforts of the most competent players in investing as well as The Sport That Shall Not Be Named.

… the unnecessarily high costs that endowed charities and other investors incur due to a misalignment of interests between owners or principals on the one hand and agents (including money managers and the managements of companies in which they invest) on the other.

About TIFF

Origins. In 1991, a network of foundations founded an investment cooperative whose organizational structure and eligibility criteria have evolved over time but whose core mission has not. Known colloquially as TIFF, the cooperative 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. The cooperative 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 and research than its formal legal name (The Investment Fund for Foundations); the TIFF Investment Program (TIP), a registered mutual fund family; and TIFF Advisory Services (TAS), a taxable non-stock corporation and registered investment advisor that administers all investment vehicles bearing the TIFF name. As noted at left, there is substantial but not complete overlap among these three entities' boards, all of whose members except Richard Flannery and David Salem serve as unpaid volunteers.

Inquiries. For more information, please call TIFF at 434-817-8200 or visit www.tiff.org.

Necessary and Proper

Familiar Faces. The dialogue that appears below marks the fourth installment in a serial publication of sorts that sprang to life a **long** time ago — back when The Team That Shall Not Be Named won the most recent of its 26 world championships in The Sport That Shall Not Be Named. Why won't we name the team and sport? Because the principal author of these TIFF *Commentaries* pledged in our 10th anniversary edition (dated June 30, 2004) to stop larding them with references to his favorite spectator sport. Of course, we made this pledge prior to the stunning events that unfolded in this same sport during the quarter just ended — including an unforgettable come-from-behind playoff win by our favorite ballclub over The Team That Shall Not Be Named. But a promise is a promise, and the report that follows honors the letter as distinct from the spirit of the pledge to which we're alluding.

Feisty Fiduciaries. As with the first three installments of the dialogue that appears below [*cf*. TIFF *Alternative Investments* for 3Q 2000 and TIFF *Commentary* for 4Q 2002 and 4Q 2003], this quarter's musings take the form of a "transcript" of the deliberations of the investment committee of a fictional foundation. This merry band of highly engaged and feisty fiduciaries returns to the TIFF stage this quarter to continue its discussion of necessary and proper means of achieving the foundation's goal of generating five percent or higher inflation-adjusted returns over time horizons appropriate to perpetual life charities. Consistent with the distinctive governance principles extolled by this writer at every opportunity, the committee in question comprises just three members and displays abnormally low turnover. Indeed, its composition remains unchanged since its initial appearance in these pages: the ever-tactful Graham Bell chairs a committee comprising the ever-thoughtful Thomas More and the ever-forceful Victoria Woodhull. The committee is joined, as per usual, by its ever-watchful consultant, Abigail Adams.

Homework and Headgear

More. What's with the hats, Graham?

Woodhull. And the books — homework for next time?

Bell. Homework is right. Abby told me not long ago that she thought this newly published collection of essays on investing by the investment team at Marathon Asset Management in London [*Capital Accounts*: *A Fund Manager Reports on a Turbulent Decade*, edited by Edward Chancellor, Texere/Thompson, 2004, ISBN 1-58799-180-2] was "must reading" for committees like ours. I've read it, and she's right.[1] So I've picked up a copy for each of you and —

Woodhull. — lemme guess: you want us to submit book reports at our next meeting.

Bell. I can't force you to read this or any other worthy works, but I do share Abby's view that *Capital Accounts* is a "must read" for investment committees seeking to elevate their games.

More. And the hats? Are we supposed to don them for all future meetings of this committee?

Woodhull. You can't get me to wear one of those, Graham. If I've said it once I've said it a thousand times — more if we counted **all** of the times you've injected anecdotes from **your** favorite sport into this committee's deliberations — I think it's silly to draw parallels between the work of this committee and the spectator sport to which you devote a depressingly large fraction of your free time. Besides, you promised to stop subjecting us to tales from the crypt.

[1] To ensure that readers do not confuse the aforementioned Marathon Asset Management with a similarly named US-based investment advisor, the London-based firm in question is henceforth referred to as Marathon-London.

More. Crypt! What crypt?

Woodhull. We can't see it now because it's covered by a hat with a "B" on it, but the crypt to which I'm referring is that part of Graham's brain holding his many haunting memories of blown playoff chances.

Bell. That same part of my brain now also holds the infinitely happier memory of my team's recent playoff run, which ended in cheers rather than tears and which teaches many lessons for this committee — as does *Capital Accounts*. That's why I'm giving each of you a team hat as well as a copy of *Capital Accounts*.

Woodhull. This whole discussion underscores the wisdom of advice that this committee received a few years back but evidently has forgotten.

Bell. What advice was that?

Woodhull. That investment committees should meet on an as-needed rather than preprogrammed basis.

More. I remember the guy who told us that. He and Graham bored us to tears exchanging trivia about the team whose hat Graham wants us to don.

Woodhull. That's the guy. I have his handout here in my journal. "Assembling infrequently on dates set far in advance," it reads, "committees tend to act when inaction would be the wiser course — and miss opportunities to act when action would be wealth enhancing." [*Cf*. the TIFF *Commentary* for 2Q 2001.]

Bell. And your point is …

Woodhull. My point is that today's meeting isn't doing much to enhance this foundation's wealth, or at least it hasn't thus far.

Adams. With all due respect, Vicky, I think it can and will, if …

Bell. ... if you read *Capital Accounts* and support my efforts to put some of its precepts into practice here.

Woodhull. Must we also wear these foolish hats — and root for "your" team to do in future seasons what it did this year?

Bell. It can't possibly repeat in our lifetimes what it did this season, namely win it all after 86 years of failing to do so. As for the hats, the reason I'm doling them out is because they underscore the central lesson of both the winning season you just mentioned and the winning essays on investing furnished in *Capital Accounts*.

Woodhull. What lesson is that — that investors seeking to pocket superior returns must be prepared to wait 66 years for favorable results to roll in?

Bell. It was 86, but who's counting.

Specific Mindset

Adams. The point Graham's trying to make is that the demonstrably successful investment policies espoused in *Capital Accounts* and the demonstrably successful personnel policies underlying his favorite team's recent triumph are rooted in a specific mindset — a form of courage that produces winning results precisely because it's so rare.

More. Courage? Courage is what soldiers from this country plus dozens of our allies display as they go about the hard work of helping well-intentioned Iraqis establish the rule of law.

Adams. Point well taken, Tom. **Discipline** would be a more apt term — the discipline to take an unpopular stance and stick with it until, well, indefinitely.

More. You can't possibly mean that, Abby — certainly not in an investment context. If you shift funds into an unloved stock that remains unloved forever, you won't do very well.

Adams. It depends. If you buy shares in a sound company when they're unloved **enough**, you can do very nicely even if they remain unloved forever, provided that enough of the company's inherent profitability flows back to you in the form of dividends or share buybacks. We'll come back to this idea in due course, when we talk about steps this committee can take to boost your endowment's cash flow yield. But the point of departure for my comment on the virtues of high entry yields on unloved stocks was the contrarian mindset that suffuses *Capital Accounts,* a mindset which presupposes extraordinary patience. Paradoxically, the utility of this mindset inheres not only in acquiring unloved stocks at opportune and therefore uncomfortable times but also in discarding profitable positions at times when they seem to provide the most comfort and safety.

Bell. For purposes of this committee's self-assigned role as a manager of managers, the mindset to which Abby's alluding also entails backing folks who steward other people's money in the inherently contrarian manner Abby just described, regardless of how much discomfort such tactics entail.

Woodhull. Buy low, sell high, ho hum. If that's all that *Capital Accounts* has to teach us, I'm not going to waste my time reading it. As for Abby's comments about timely sales, I don't see how you can win a world championship in any sport by **selling** anything, excepting possibly lots of tickets so you can pay the outrageously high salaries needed to field a winning team.

Bell. *Capital Accounts* goes way beyond the simplistic notion of buying cheap stocks and selling expensive ones, which is a perilous course in any case, as the book itself makes plain: something that's cheap because it's unloved can get cheaper still, and something that's dear because it's popular can get pricier still, thereby threatening the reputations if not livelihoods of the investment pros doing the buying and selling.

More. It sounds like the book's authors have been burned by ill-timed short sales. Did they short tech stocks too far in advance of their zenith in the spring of 2000?

Adams. Not exactly, although the money management firm whose client letters comprise the main body of *Capital Accounts* did make a big and initially losing bet against tech stocks as they were racing upward in the late 1990s. And it underwent the same painful experiences — early pain, and lots of it, followed by outsized gains — when it turned bearish on Japanese stocks in the late 1980s and on many emerging markets in the mid-1990s.

More. I can infer the rest of the story: Marathon-London did some modest shorting of each of the stock groups you named — tech, Japan, emerging — as they moved from overvalued to extremely overvalued, used stop-loss disciplines to stay in the game, then re-established short positions after the dominant trend became their friend, right? If that's the discipline to which you and Graham are alluding, I agree with Vicky: there ain't much fresh learnin' in this book for us.

Adams. That's **not** what enabled Marathon-London to do so well during the 11 years of stock-picking covered by the client letters comprising the main body of *Capital Accounts*. Although the book's otherwise excellent introduction by the respected economic historian Edward Chancellor might have made the point more forcefully, Marathon-London has compiled one of the most impressive track records in the modern annals of money management without doing any appreciable amount of short-selling. To be sure, Marathon-London launched a few long/short stock vehicles not long ago — more as a retention tool for highly talented staffers than as a means of augmenting directly its founders' incomes — but the track record that induced Mr. Chancellor to compile a book comprising about six dozen of the more than 500 essays generated by Marathon-London over the 11 years in question (1991 – 2002) is the result of well-chosen "longs," with short sales *per se* accounting for no portion of the large excess returns in question.

Woodhull. Short sales ***per se***? Why the hedge — no pun intended!?

Adams. Because, as with the so-called long-only portfolios that this foundation maintains, the long-only portfolios that Marathon-London has stewarded so skillfully for so many years can properly be viewed as comprising two parts: long positions in all of the stocks comprising such portfolios' benchmarks, coupled with long/short portfolios comprising positive or negative bets respecting the benchmarks' constituent issues — long positions in stocks Marathon-London seeks to overweight relative to the benchmark, and short positions in stocks it seeks to underweight relative to the benchmark.

Woodhull. If Marathon-London's principals were indeed as astute at long/short investing as your last comment implies, then surely they would have morphed into hedge fund managers long ago. After all, 2 and 20 (i.e., the 2% annual fee and 20% profit interest charged by the most coveted hedge funds) surely beats whatever asset-based fees Marathon-London customarily charges its long-only clients.

Central Lessons

Bell. You've hit on one of the central lessons that I draw from *Capital Accounts* — and from the championship season that my favorite ballclub completed recently.

Woodhull. And that would be …?

Bell. That strong financial incentives may be a necessary condition for eliciting the best efforts of the most competent players in any field of endeavor, but they're typically not a sufficient condition — and they can do as much harm as good if they're unaccompanied by other motivations, including a true love for whatever game is being played — be it a team sport played by grown men in knickers, or institutional investing, or indeed the management of a publicly traded company. In fact, the team whose hat you refuse to don, Vicky, has an annual payroll about two-thirds that of its arch-rival …

More. … The Team That Shall Not Be Named!

Bell. Correct. And **my** team is world champ, for the first time in 86 years, due in large part to its general manager's skilled recruitment of a star player who gave up the certain promise of a bigger pay package from another team for the uncertain chance to be part of a championship squad.

Woodhull. What's your point? That we should scour the planet for investment pros willing to manage this foundation's assets at cut-rate prices? Or do you want to go a step further and invest directly in listed companies whose dividend yields are abnormally high due in large part to their managements' willingness to work for abnormally low wages?

More. If I got stuck owning shares in such companies, I'd **want** them to maintain abnormally high payouts— so that the dolts running them wouldn't squander my wealth via foolish capital expenditures or acquisitions!

Bell. Maybe Tom doesn't need to read the book after all, eh Abby?

Adams. What Graham means, Tom, is that you've just hit on another central lesson of *Capital Accounts* — the fact that it's better to invest in maturing industries from which capital is fleeing than in growing industries to which capital is flocking.

More. What does that have to with doltish managements willing to toil for subpar wages? I'm lost.

Adams. The discipline that's enabled Marathon-London to generate such attractive excess returns is called capital cycle investing, the essence of which is captured nicely in Chancellor's introduction to *Capital Accounts*. Indeed, if you can't find time to read the whole book, you should at least make time to read the introduction, which arguably is as clear and thorough a treatise on investing as any author could compile in 44 pages. As it makes plain, capital cycle investing is a highly opportunistic yet highly disciplined approach to stock selection premised on the indisputably sound notion that excess returns in a given industry attract excess capital and hence ultimately excess competition …

Bell. … and vice versa: unacceptably poor returns repel capital, thereby setting the stage for uncommonly high returns for investors bold enough to shift capital into industries undergoing high and therefore ultimately restorative rates of **disinvestment**. *Capital Accounts* is filled with contemporaneous examples of both phenomenon — the tech stock, emerging market and Japanese "bubbles" mentioned earlier as well as **real-time** analyses of shrinking industries and companies that provided large profit-making opportunities to Marathon-London and its long-only clients precisely because they were shrinking. My favorite example of the latter is General Dynamics, whose share price soared 600% even as the company's management took affirmative steps to **shrink** its revenues by almost 50% in the early 1990s.

More. Why did you make a point of emphasizing "real time" when describing Marathon-London's writings?

Bell. Because that's what makes *Capital Accounts* so compelling: the essays comprising it were written not years or decades after the events they describe occurred but rather as they unfolded. Indeed, they were written for the principal purpose of inducing Marathon-London's clients to stay the course — to wait patiently for the capital cycles that Marathon-London seeks to exploit to run their inevitable courses. A shining example of the genre is *Bear Thoughts* [§5.3], a strikingly strident and prescient list of 19 reasons why Marathon-London was extremely bearish on technology stocks *circa* December 1999. Admittedly, some of the client letters that Chancellor chose to include in *Capital Accounts* are primarily backward looking — e.g., Marathon-London's reflections on industrial consolidation in late 19th century America — but Marathon-London shared these thoughts with its clients as a means of justifying via historical precedents the seemingly risky strategies it employed when these essays were published.

More. **Seemingly** risky?

Bell. Seemingly in the sense that, however much initial pain some of Marathon-London's bolder bets inflicted on its clients, most of them entailed only a *de minimis* probability of permanent and material losses, provided that …

Adams. … provided that clients stayed the course! Let's not kid ourselves: since no practitioner of capital cycle investing — or indeed any other form of investing, for that matter — can forecast accurately and precisely inflection points in either industrial or market cycles, a money manager as intrepid as Marathon-London is inevitably going to display large dollops of what consultants like me refer to as tracking error or active risk.

Woodhull. But you said a minute ago that Marathon-London has a great track record. Doesn't that imply that its so-called active risk has been more than offset by sufficiently juicy active returns?

Adams. Yes, but there are plenty of money managers displaying even more attractive risk/reward ratios than Marathon-London's to whom you wouldn't want to entrust even small fractions of your capital.

Woodhull. Why not? If a manager's risk/reward ratio is **that** good then surely we could safely entrust a small portion of our endowment to her even if her active risk is extraordinarily high. The only legitimate reason we wouldn't do so is if the manager's active returns would be highly correlated with those of other managers we already employ and plan to retain.

Adams. That would be **one** reason to eschew certain managers that have posted impressive risk-adjusted returns. But there's a more compelling one — one best appreciated by reading *Capital Accounts* in its entirety.

Ex Ante Explanations

Bell. Or by watching the official highlight film of my favorite ballclub's 2004 campaign!

Woodhull. Come again?

Adams. What *Capital Accounts* demonstrates above all else is that Marathon-London's winning track record is the product of skill rather than luck. As I noted a minute ago, plenty of managers have generated market-beating returns even after one adjusts for the tracking errors or active risks that they've incurred along the way. But that fact alone doesn't prove that all or even any of them are truly skillful. It merely proves what we already know, which is that money management is a very crowded field — so crowded in fact that the laws of probability virtually guarantee that at any given point in time **many** managers will display risk/reward ratios that make them seemingly compelling hires.

More. You're preaching to the choir: I sit on another investment committee that's constantly hiring and firing managers, and I can't remember a time when it fired a manager and didn't have at least a dozen managers with alluring track records waiting in the wings — all served up by the committee's consultant.

Bell. The committee you're referring to interviews a **dozen** managers for every one that it hires?

More. Of course not. Three or four per slot is closer to the norm. For better or worse — and I suppose it's worse in light of this other committee's abysmal record in hiring and firing managers — every manager interviewed tends to serve up perfectly plausible explanations for why they've performed as well as they have — "we anticipated that such-and-such a company would post a rebound in sales," "our proprietary research told us that such-and-such a sector was turning up," etc., *ad nauseam*. It all seems so believable … until we actually hire the glibbest presenters, at which point their so-called excess returns invariably turn negative!

Adams. It sounds like the other investment committee to which you're alluding has trouble distinguishing between luck and skill. What it ought to do is show the door to any manager unable to prove that it made the right portfolio picks for the right reasons — **and** that it articulated these reasons in a verifiable manner in **advance** of the market moves underlying its success.

Bell. Just like my favorite ballclub's general manager (GM) did when he executed the hugely controversial mid-season trade that enabled his team and mine to win its first world championship since 1918. He said **at the time** that he traded away the team's most popular player in order to both shore up its defense and give it more speed on the basepaths. Watch the official highlight film of the team's '04 campaign and you'll see that its GM still can't talk about the controversy that the trade stirred up without telegraphing how stressful the whole experience was for him — even though the strategy that he articulated at the time of the trade was validated by subsequent events.

More. What if things hadn't worked out? Where would your hero be now?

Bell. Hard to say, although I'd like to think that the team's owners would give him more than a few years to prove his worth as a general manager. He's the youngest GM in the sport's history, you know. Interestingly, he assumed his current post at roughly the same age that Marathon-London's principals left their relatively high paying posts at a very large money management firm to set up their own shop.

Looming Presence

Adams. They don't mention their former employer by name in *Capital Accounts* but you sense its looming presence, especially in several passages explaining why the firm's founders migrated toward a capital cycle approach to stock selecion.

Bell. And indeed in the "bubble era" essays that highlighted in real time both the egregious flaws in the business models of most money management organizations and the egregious conflicts of interest inherent in the business models of most "sell side" firms.

More. Let me guess what the book has to say about such matters: "the Street" depends primarily on commissions, which induces it to do everything it can to promote portfolio turnover, and it makes money floating new issues, which causes or rather caused "Street" research to be biased in the extreme.

Woodhull. Until Eliot Spitzer drained that particular swamp.

More. He hasn't drained it completely, but he's made it smaller and less fetid for sure. As for the "buy side," I'll hazard a guess that *Capital Accounts* highlights the perversity of business models that induce most money managers to favor growth in assets under management above all other measures of organizational success.

Bell. The book makes all of the points you've just outlined, Tom, and many more, but the fact that some portions of it address issues that have been rendered moot, in whole or part, since the essays in question were written doesn't undermine the book's utility in the slightest, at least not to me. For one thing, investors worldwide are still dealing with the aftermaths of some of the signal events that Marathon-London's brutally frank client letters anticipated and in some instances helped to trigger …

Adams. Like the ultimate rationalization of global stock indices whose illogical construction promoted a woeful misallocation of capital in certain foreign stock markets in both the late 1980s and late 1990s.

Bell. Correct. Moreover, because the essays were written in real time — before the anomalies to which they refer had been eliminated by market movements or regulatory changes or other means — the book provides a tutorial of sorts on how folks like you and me should **think** about the challenges that we confront as endowment fiduciaries.

Adams. Especially gaming.

More. Gaming as in casinos?

Adams. No — although capital cycle theory would suggest that legalized gambling has become so widespread in America as to justify a short position in gaming stocks generally —

Bell. If not a short position in US stocks generally!

Adams. The so-called casino society is with us still, you're right. But I meant gaming in the sense most germane to this committee's work, especially as you consider the extent to which you want to shift more of the foundation's capital into so-called alternative investments (AI).

Woodhull. I know that manager fees tend to be higher, and lock-ups longer, in the alternatives arena than they are in traditional stock and bond management. So that fact alone might cause us to worry more about gaming by AI managers than by traditional managers —

More. Meaning, I take it, antics that augment managers' incomes without necessarily augmenting their clients'?

Woodhull. That's a workable definition of gaming for our purposes here, Tom, so I'll put the question directly to Abby: are we more vulnerable to gaming in non-traditional investment niches than we are in traditional ones?

Adams. Yes and no. Yes, in the sense that some non-traditional niches provide opportunities for gaming that aren't readily available to traditional managers investing exclusively in actively traded stocks and bonds.

Woodhull. Like exquisitely timed revaluations of illiquid or semi-liquid holdings that just happen to augment hedge fund profits immediately before 20% of such profits are shifted into managers' coffers at calendar year-ends?

Adams. Year-end price manipulation is one form of gaming that's much harder to execute in traditional forms of investing than it is in, say, the hedge fund arena. And it's a growing concern in the latter as hedge fund jockeys address the problem of ballooning assets by shifting large dollops of dough into private equities. That said, it would be naïve to think that this foundation's wealth would be immune to gaming as Tom defined it earlier even if it were invested wholly in marketable stocks and bonds.

Bell. Just read chapters seven and eight of *Capital Accounts*, which catalog pretty comprehensively the many ways in which managements of operating companies can and do take their outside shareholders for a ride.

Woodhull. Hold it right there. The fact that managements of many public companies tend to game whatever compensation schemes they labor under is one reason we find it necessary to pay active stock managers such hefty fees. If we could achieve our return goals while investing in marketable stocks on a purely passive basis we could cut out the middlemen so to speak and earn even higher net returns. So it seems to me that this committee ought to focus its attention not on how corporate managements can harm us via gaming but rather on how the money managers we employ can do so.

Agents vs. Principals

Adams. You have a point, Vicky: we **do** need to guard against gaming by money managers. But the games that money managers play aren't qualitatively different from those that corporate managements play, and —

Bell. — and it behooves us to understand well the potential flaws of compensation schemes aimed at addressing arguably the biggest problem confronting this committee and indeed most institutional investors.

Woodhull. You mean **other** committees must also wear silly hats and talk about a sport played by grown men in knickers all the time?

Bell. You know what I mean, Vicky: the principal-agent problem — the opportunity cost that this foundation and virtually all investors maintaining truly diversified portfolios incur due to a misalignment of interests between owners or principals on the one hand and managements or agents on the other. By agents, of course, I mean both the men and women running companies in which we invest **and** the money managers we employ to pick such companies for us.

Woodhull. Surely you're not suggesting that we start picking stocks ourselves, are you Graham?

More. Or buy companies outright so that we can control their managements directly?! That's what foundations used to do decades ago, before Congress put an end to profiteering by grantors who'd shift companies they'd founded into private foundations and use the resulting tax shield to advance their own selfish interests. Quite apart from legal barriers to outright ownership by endowed charities of corporate assets, Graham, you know as well as I do that most efforts to mitigate the so-called agency problem we're discussing here have fallen woefully short of their stated aims. They've fallen short when implemented via direct control mechanisms —

Woodhull. Who could forget that lecture we heard a few years back about the foundations that have botched so thoroughly their ownership of the Reader's Digest franchise? [*Cf*. the TIFF *Commentary* dated June 30, 2002.]

More. Indeed. And institutional investors also tend to fall short when they combat the agency problem indirectly. Just look at the sorry record of the private equity industry, which on a dollar-weighted basis has underperformed publicly traded stock indices by a depressingly large margin after one adjusts for fees and leverage.

Bell. Now **you're** preaching to the choir, Tom. I'm the first to concede that private equity (PE) is a reliable way of **reducing** our risk-adjusted returns if we back the wrong PE managers. And I concede your broader point, which is that most efforts to combat the agency problem we're discussing here have misfired, if not immediately then ultimately. They've misfired for reasons explained nowhere more clearly than in *Capital Accounts*. I recognize that you and Vicky are busy folks, but if you read nothing else before our next meeting, promise me you'll read Chancellor's introduction to the book — it won't take you that long — plus the essay in Chapter 8 entitled *Goodhart's Law.*

More. Not the same Goodhart I read about in grad school? The central banker who argued that when economic measures become so widely monitored as to become targets they cease to be good measures?

Bell. Very good, Tom! That's precisely what Goodhart's Law holds. And the essay bearing that name in *Capital Accounts* draws parallels between Goodhart and Heisenberg, the physicist who taught the world that the act of observation interferes with the object being measured, thereby making impossible perfectly precise measurements.

Woodhull. I thought you said that the main body of *Capital Accounts* comprises client letters issued by a money management firm based in London.

Adams. Correct: Marathon Asset Management.

Woodhull. Why on earth would its principals lecture the firm's clients about Heisenberg's Uncertainty Principle? More to the point, how on earth do they find the time to think let alone write about such things? I thought the reason money managers make so much money is because they have to work zillions of hours researching an ever-expanding universe of public companies.

Bell. That brings us full circle to your opening comment here today, Vicky, which is a good thing as we're nearing our scheduled adjournment time.

Woodhull. It **does**?

Bell. You did remind us earlier today that inaction is often a wiser course than action in an investment context, no?

Woodhull. True, but that was simply by way of reminding everyone that preprogrammed committee meetings are counterproductive if they produce decisions that are best made at a later date — or not at all.

Bell. "Not at all." That's the point I'm driving at — and a dominant theme running throughout *Capital Accounts*: there's way too much turnover in institutional portfolios, and hence way too much slippage between cup and lip if you will for clients like us.

Adams. And the reason there's excessive turnover — and typically also excessive diversification, I might add — is because agency problems are pervasive in the money management business. And they're pervasive due in large part to widespread flaunting of Goodhart's Law — the simple and ugly truth that when measures become targets they often cease to become good measures. Quarterly earnings results are the most obvious example, and an obvious root cause of the excessively high turnover of institutional stock portfolios that Graham just mentioned. Of course, some folks would argue that Wall Street's preoccupying focus on quarterly earnings is rooted ultimately in the business model pursued by most money management firms — a model which makes assets under management (AUM) the dominant metric of organizational success and which for that very reason is inimical to the unarguably sound approach to long-term wealth accumulation that *Capital Accounts* espouses. For what it's worth, I think the book espouses this approach more clearly than any single volume I've read excepting perhaps the collected writings of Warren Buffett.[2]

Bell. When I read it, I couldn't help but think that Marathon-London's investment professionals devoted so much time to essay writing not only to induce the firm's clients to stay the course but also to ensure an appropriate degree of consistency in the way the firm's investment professionals analyze stocks.

Adams. Marathon-London's client letters have indeed served that purpose, because the firm's three founders aren't the only pros now toiling there that display both a keen understanding of the theories underlying capital cycle investing and a discernible knack for implementing this approach in practice.

Bell. Ah yes, the age-old disjunction between theory and practice. Are you implying that Marathon-London authorized the public dissemination of what some observers might logically view as proprietary material because its principals have learned through experience how hard it is to apply the firm's distinctive investment approach in practice?

Adams. They're pretty savvy guys, so that's indeed my assumption. I've actually read just about all of the client letters that Marathon-London has published since its founding in 1987, and I don't think the firm pressured Chancellor to withhold any true gems. Indeed, the collection's only glaring omission is the untitled introduction to Marathon-London's *Global Investment Review* dated November 15, 2001, which comprised a superb analysis of the **diseconomies** of scale in multiple aspects of money management achieved or rather tolerated willingly by many large investment advisory organizations. Chancellor omitted that gem, and he necessarily omitted two superb follow-up essays on the same theme that Marathon-London published after the end of the 11-year period covered by *Capital Accounts* (*Specialists vs. Generalists* in the September 2003 *GIR* and the untitled introduction to Marathon-London's November 2004 *GIR*).

Farmers vs. Cows

More. Why does a business model entailing fees tied more or less exclusively to AUM necessarily produce excessively short-term decisionmaking?

Adams. Because it's vastly more expensive for a money manager to attract an incremental dollar to manage than it is to retain a dollar that's already in the barn. So job number one for most money managers when they come to work every day is not to identify companies capable of compounding their clients' capital in a satisfactory manner over long-term holding periods but rather to ensure that none of the cows, if you will, already lodged in the managers' barns will escape.

Woodhull. Are you implying that institutional clients like this foundation are the equivalent of cows in a barn — ready and willing to be milked by cagier creatures whenever they please?

More. The analogy is more perfect than you might realize, Vicky, depending on how much time you've spent on farms: cows, like money

[2] A splendid compilation of Buffett's writings appears in *The Essays of Warren Buffett: Lessons for Corporate America*, Cardozo Law Review, Volume 19, Numbers 1-2. Be forewarned: the compilation just mentioned comprises 816 pages, almost all of which are gems.

management clients, get milked at regular intervals!

Adams. I'm starting to regret that I mentioned cows and barns at all. Having done so, however, I'll stick with what's admittedly a dangerous analogy by noting two things. First, at well-managed dairy farms, there's a healthy and symbiotic relationship between farmers and cows. Most of the time, the cows give and the farmers take. This is a good thing because milking keeps dairy cows healthier than they'd be if no demands were placed on them, and the milk they yield provides income to their owners. Of course, at other times, the farmers give and the cows take, as when disease strikes and a vet is called in to administer antibiotics. The drugs cost money, of course, reducing temporarily the incomes of farmers electing to pay for them, but the long-term gains derived from a healthy herd more than offset the short-term pain of temporarily depressed net yields.

Woodhull. We all understand how dairy farming works, Abby. What's your point?

Bell. I dare say that if you'd read *Capital Accounts* you'd be able to infer where Abby's headed with all of this.

Adams. Actually, the book we've been discussing here today doesn't go quite as far as I'd like this committee to go as it explores enhanced means of achieving the foundation's return goals, but it certainly lays the groundwork for what I'm about to say … especially the essay entitled *The Two-Handled Pump* [*cf*. §6.7]. The essay's title is a historical allusion to the sordid but immensely profitable business practices of some 19th century mine operators who made even more dough via stock market machinations than they did via sales of their mine's pleasingly robust output. What this essay and many accompanying it in the book suggest is that fiduciaries like you can and should —

Bell. Reverse the curse!

Woodhull. Oh no! More allusions to Graham's favorite sport. I thought your favorite team reversed whatever curse afflicted it with its recent playoff triumph.

Bell. It did, and if it can triumph after more than eight decades of suboptimal play then we shouldn't shrink from the task that Abby wants us to undertake, namely to reverse the curse of agency effects in institutional investing by restructuring our investment program so that —

Woodhull. So that we're farmers rather than cows?

Bell. If you want to put it that way, yes. I prefer to describe in a less earthy manner the new policy paradigm Abby and I have discussed offline, using the term that Abby herself has devised as short-hand for it: **fecundity**.

Adams. Actually, the nomenclature isn't mine but rather Jim Garland's, a wise and seasoned fiduciary who published an essay not long ago extolling **fecundity** as a useful means of stating succinctly the ultimate goal of most perpetual life endowments ["The Fecundity of Endowments and Long-Duration Trusts" by James P. Garland, *Economics and Portfolio Strategy*, September 15, 2004, posted with permission alongside this *Commentary* at www.tiff.org].

Woodhull. Fecund means fruitful, right?

Adams. Precisely. And **fecundity** in Jim Garland's lexicon means a portfolio's long-term capacity to generate cash for its owner, periodic cash withdrawals being the effective or rather exclusive fruit of any truly perpetual life trust.

More. Hold on: periodic cash withdrawals aren't a permanent endowment's exclusive fruit if such withdrawals are limited to the traditional legal definition of income — namely, dividend, interest, and rent. After all, using that definition of permissible withdrawals, our current portfolio yields only about half of our targeted spending rate of 5%. Surely you're not advocating a return to an income-only approach to spending, are you Abby? That might be OK for publicly supported charities, which are free to set their own endowment spending rates, but private foundations like ours must spend 5% on average from our endowments each year or incur the tax man's wrath. The corollary is that when current income yields are as low as they are today we have no choice but to dip into capital gains. Make that capital gains or capital itself, depending on whether market values are rising or falling.

Bell. Abby knows that Tom, but she also understands what you yourself will understand after you read Jim Garland's essay, which is that the fecundity if you will of an equity portfolio lies somewhere between its earnings yield and its dividend yield. Moreover, for reasons we lack time to discuss today, an equity portfolio's fecundity is generally closer to its dividend yield than its earnings yield, so we do indeed have a problem when stock dividend yields are as low as they are today.

More. To say nothing of bond yields. Let's not forget that we don't invest 100% in stocks.

Bell. Good point. And the fact that we don't invest exclusively in stocks means that our overall portfolio's fecundity — which is to say the maximum rate at which we can siphon off cash while fulfilling our ultimate goal of maintaining the foundation's current grantmaking firepower — falls short of 5% per annum. Far short, in fact, although there are steps we can take that might boost our portfolio's fecundity to desired levels.

More. Are you suggesting that our current investment policies have us headed on a path toward the foundation's ultimate liquidation, at least in purchasing power terms, if we continue withdrawing 5% per year?

Bell. Yes — but we have plenty of company. The plain and ugly truth is that many endowed charities **seem** to be achieving the goal of intergenerational fairness, i.e., not favoring current generations of beneficiaries at future generations' expense, but they're not actually doing so.

More. That's a pretty strong statement, Graham. Isn't the math pretty straightforward? Take our own foundation, for example. Our endowment's real or inflation-adjusted market value is almost exactly what it was when I joined the board many years ago. So there's been no favoring of current beneficiaries over future ones **on my watch**.

Bell. Not if you apply the metric you've just espoused — inflation-adjusted market values measured point to point.

More. What other metric makes sense?

Bell. Let me rephrase the question: what other metric makes **more** sense? I've highlighted the relative in my rephrasing of your question because Goodhart's Law teaches us that —

More. — that good measures often cease to be good when they become targets. Therefore?

Twin Evils

Adams. Therefore many fiduciaries' otherwise commendable focus on maintaining the inflation-adjusted market values of endowments stewarded by them has caused them to pay inadequate attention to endowment fecundity. Why do I say this? Because Garland's work as well as that of other keen observers of capitalism suggests a shocking degree of slippage between reported corporate profits on the one hand and outside shareholders' returns on the other. The reasons are numerous and discussed thoroughly and indeed eloquently in *Capital Accounts*, so I won't catalog them here. I'll note only that most if not all of them are rooted ultimately in the agency problem we discussed earlier, with two especially pervasive manifestations of the problem accounting for most of the slippage in question. These twin evils have a common paternity, namely the extension to an unjustified extreme of the principle underlying modern capitalism's undeniable success: the separation of ownership and control. Without this cardinal aspect of modern economic life, the risks inherent in entrepreneurial capitalism could not be as readily controlled via diversification, there'd be less risk-taking generally, and there'd be lower returns for all owners of wealth excepting perhaps those who stash their investable wealth under their mattresses.

Woodhull. Go girl!

Adams. I'll end this sermon ASAP. As I said, most of the return slippage that this and other endowed charities experience is attributable to two specific and related aspects of the agency problem we examined earlier. These twin evils are, first, investment strategies and structures that enable so many middlemen to insert themselves between businesses on the one hand and their ultimate owners on the other that these ultimate owners never see a third or more on average of the free cash flow these businesses generate; and second, corporate strategies and structures that cause the underlying businesses themselves to generate suboptimal amounts of cash.

More. Who are you to say that it's suboptimal? Have you ever tried to run a big multi-national company? As for your comment that too many middlemen have their noses in the fee trough, well, I'm fond of you Abby, but who are you if not one of the very middlemen you're critiquing?

Bell. We do indeed pay Abby for her services, but on a retainer basis aimed at eliciting truly disinterested advice. And we're getting just that here today, as Abby herself is the one who's encouraging us to consider a paradigm shift of sorts in the way we go about investing our endowment, so let's not attack the messenger. The undeniable fact is that, however self-satisfied we are with the returns this foundation has enjoyed on our watch, there's always room for improvement. For example, it bothers me to no end that we've let preprogrammed or automatic turnover creep into so many segments of our portfolio, especially the really illiquid ones like commercial real estate and timber. With some creativity and probably also some cooperation from like-minded institutional investors, we could almost certainly reduce what *Capital Accounts* refers to (quoting legendary investor Charlie Munger) as "the croupier's take." It won't be easy to do this, I admit, because revised investment structures that inhibit counterproductive turnover could easily end up violating Goodhart's Law by substituting one flawed measure of investment success for another —

More. Like multiples-of-capital measured over very long-term holding periods as against shorter-term IRRs (internal rates of return) on private investments (PIs)?

Bell. Exactly — the risk in that context being that, for example, private equity professionals whose revised compensation schemes enabled them to make hefty incomes without liquidating **fecund** holdings held on behalf of their limited partners might become excessively patient middlemen, letting the underlying firms reinvest cash that would be more profitably deployed elsewhere.

Adams. Since you're on a roll Graham, and since I try to keep my mouth shut once committee meetings I'm attending roll beyond their scheduled adjournments, I'll let you wrap things up by describing the second of the twin evils to which I alluded earlier — what *Capital Accounts* refers to as **bezzle.**

Bell. Bezzle is a term lifted from Ken Galbraith's classic account of the Crash of '29. [*The Great Crash: 1929*, published originally in 1961.] By it, Professor Galbraith meant the unquantifiable sums that agents of all kinds siphon from operating businesses, with agents defined broadly to include managements, investment bankers, lawyers, and other birds of prey. In flush times, like the 1920s or 1990s, bezzle so defined can reach staggering proportions. But like everything else having to do with investing —which is to say with capitalism — bezzle tends to be cyclical, reaching a nadir when economic conditions are depressed, wallets are guarded tightly, and ethical standards are tight rather than lax.

Woodhull. If the debit to our returns arising from bezzle fluctuates in the manner you've just described, Graham, isn't it a little late to get so worked up about it? After all, the data in our committee docket for today shows that the broad US stock market compounded at about 17% per year during the 1990s, versus a tad worse than -1% per year since the start of the current decade.

More. The hat Graham's wearing tells you that he takes a multi-decade view of **everything**, so he's undoubtedly looking ahead to the next prolonged upswing as much as he's looking back at the last one. But I know why he's so worked up about bezzle just now.

Woodhull. Why?

The Last Straw

More. Because one of the managers we employ put us into Bank of America. Actually, it bought some B of A shares for our account in mid-October, held them for about six weeks, and then sold them.

Woodhull. For a profit or a loss?

More. A small loss, but that's not what got Graham's goat.

Woodhull. What did?

More. Two things. First, the fact that the manager flipped the darn thing so quickly. We suffered just a small loss, but we would've broken even at worst and perhaps made a little dough over the holding period in question if we'd hadn't incurred frictional costs getting in and out — commissions, price impact, SEC and custodial charges, etc. When Graham asked the manager to explain precisely why it bought B of A shares in the first place and how any new information about it generated over the brief holding period in question could have altered so fundamentally the manager's long-term prognosis for the company, well, the manager just dissolved.

Woodhull. You mean that he couldn't articulate with sufficient clarity or cogency the criteria that he employs in determining whether and to what extent to invest our capital on a more or less permanent basis in a given company?

More. Well put, Vicky. When did you learn to imitate Graham so well? Those are almost the exact words that Graham used in describing his dissatisfaction with the manager we're alluding to — a firm that's done well by us but which rotates our holdings far more rapidly than Graham would prefer. But what really upsets him is that while we owned B of A —

Bell. — **partially** owned B of A, and very partially at that.

More. Right … while we owned a tiny sliver of B of A, its board saw fit to reward its departing chairman with a retirement package that included, get this, a bunch of season tickets **for life** to home games of the team whose hat Graham's now wearing.

Bell. Actually, Tom, what the board forked over — in addition to other riches — was the right to **buy** from B of A's sizable inventory of such passes a defined number of tickets to a specified number of home games every season for the rest of the chairman's life.

Woodhull. C'mon, Graham, there's nothing horribly wrong with that. The guy's going to pay for his seats, and the whole arrangement is fully disclosed. I'm sure we could find much more egregious examples of bezzle in our portfolio if we put our minds to it.

Bell. I'm sure we could, Vicky, although I'm much more interested in preventing bezzle in the first place than I am in detecting it once it's been created or rather pocketed. But it's going to take lots of hard work, some pretty acute negotiating skills, and some very savvy lawyering to reduce materially the slippage we incur due to either bezzle or the so-called croupier's take.

Truth be told, some savvy investment pros that I've consulted think it's naïve to think that an endowment of our size or indeed any size can take affirmative steps to reduce materially what *Capital Accounts* succinctly and helpfully refers to as "the croupier's bezzle." Of course, it also seemed naïve for the ballclub whose hat I'm proud to be wearing to think that it could win the final **four** games of a best-of-**seven** playoff— something no team in the history of its sport had ever done.

Woodhull. I heard about that. The seventh game must have been one for the ages. Did you watch it in person?

Bell. Yes, but it was anti-climatic, because my guys seized a big lead early on and held it throughout the game. The fourth game, on the other hand [sighs] …

Woodhull. What about it? What's wrong, Graham?

More. Graham is steamed because the **fourth** game was played in **his** team's ballpark, which is the smallest one in the major leagues —

Bell. If not also the stadium more perfectly suited to the sport customarily played in it than any other sports venue built by man …

More. Perfect but relatively small … so small in fact that it's virtually impossible for even diehard fans like Graham to buy season tickets.

Bell. Not just season tickets — **any** tickets, playoffs or otherwise.

Woodhull. So there are probably thousands if not millions of diehard fans who also didn't attend the fabled Game Four, Graham. Why are you still so hot about it?

More. Because he was glued to his TV set the entire game, and the telecast kept flashing shots of the visiting team's "on deck" batters.

Woodhull. So what?

More. The seats immediately behind the "on deck" circles are the best ones in the whole ballpark, and one of them was occupied by —

Woodhull. Lemme guess: the outgoing chairman of Bank of America.

More. You got it.

Woodhull. Poor Graham … Wait: wasn't it freezing cold at the ballpark for Game Four? I bet the esteemed chairman of B of A left his seat long before Graham's team staged its miraculous comeback in the late innings. So Graham's nemesis likely missed the epic climax also.

More. We better change the subject. What **really** ticked Graham off was seeing a choice seat this foundation had paid for — however partially — go empty during his beloved ballclub's finest hour.

Bell. Make that its finest hour **yet.** I've waited a **long** time for this particular investment of mine to bear fruit, and now that its true fecundity has become evident I have no intention of unloading it. Besides, what would I do with all these hats?

■

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