TIFF

COMMENTARY

A Report of TIFF EDUCATION FOUNDATION

SPRING 2005

Highlights

- Our Spring 2005 *Commentary* combines lessons flagged by TIFF's representative to the recent seminar marking the 60th anniversary of *Financial Analysts Journal* with related thoughts on ways in which persons charged with stewarding endowment capital can do a more effective job discharging this solemn duty. We encourage readers to procure copies of the seminar proceedings via www.cfainstitute.org.
- The most widely employed means of assigning weights to individual stocks in equity benchmarks or indexes — capitalization-weighting — tends to hamper materially the long-term returns of portfolios that march to the beat of this highly suspect drummer.
- Blinded as some fiduciaries are by the theoretical virtues of diversifying their "bets" across a broad variety of "asset classes" and strategies, many trustee groups end up paying too much for "beta," i.e., they end up sharing with managers excessive portions of the very long-term or secular gains produced by most asset classes.
- Many mutual fund sponsors are pursuing essentially the same business strategy as casinos, doling out rewards to patrons in an episodic and enticing manner that "keeps 'em comin'" while also fulfilling corporate profitability goals.
- People tend to mistake information for knowledge. Far from being material that is legitimately viewed as knowledge, much of the research pumped out by "sell side" vendors is best viewed as anti-knowledge.

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.

Elevating One's Game

Mixed Results. When TIFF's publications program entered its second decade in June 2004, your editor promised two changes to it: first, to stop larding TIFF reports with baseball quotes; second to introduce new voices to them. Like the forgettable baseballer Rocky Bridges, whose weight loss vows produced mixed results we'll examine shortly, your editor intended to honor both pledges when he made them. But he's abandoned the first, due not only to the intolerably reduced fun derived from publishing reports bereft of baseball arcana but also to the unforeseen fact that at least of one of the "new voices" now emerging at TIFF is that of a diehard baseball fan: John Thorndike. A Seattle native who's lived in Red Sox Nation since matriculating at Bowdoin College a month before the BoSox bowed out of the 1998 MLB playoffs, John became a Boston fan long enough before their recent championship to prove his innate contrarianism and has done a fine job discharging a variety of investment-related duties since joining TIFF's staff last year. In February 2005, John represented TIFF at a conference organized by the CFA Institute commemorating the 60th anniversary of its flagship publication, the *Financial Analysts Journal* (*FAJ*). The commentary that follows, drafted initially by John, comprises highlights of this conference selected by John interwoven with his thoughts plus other TIFF staffers' on ways in which all persons charged with stewarding endowment capital can do a more effective job discharging this solemn duty. Surely, all of us have the potential to achieve more uniformly favorable results than the aforementioned Rocky Bridges, who described his weight loss regimen as follows: "I mix two jiggers of Scotch with one jigger of Metrecal. So far, I've lost five pounds and my license." (For readers too young to recognize a brand name from a bygone era that's now in the process of being revived, Metrecal is a "weight loss" drink.) Barring developments that might dictate a different path, we plan to devote the next edition of this *Commentary* to a second installment of principles professed at *FAJ's* 60th anniversary confab.

Focus on Fundamentals. The fundamentals of hitting are universally agreed-upon — and well-remembered by anyone who's received decent coaching in baseball at any level, from Little League to The Show: "Hands back, eyes on the ball." The fundamentals of benchmark construction, on the other hand, are sharply disputed in the investment game, as Rob Arnott observed in his talk. To be sure, most investors seeking to gauge how well they or agents hired by them are performing relative to "the market" use capitalization-weighted indices to this end. As a corollary, most of the billions of dollars invested "passively" are deployed via "cap-weighted" index funds, i.e., portfolios whose constituent parts are weighted according to their aggregate market values rather than alternate criteria. Wait: What principle of benchmark construction could possibly be sounder than Mr. Market's ultimate "vote," i.e., an issue's current price tag? Actually, several inherently objective measures trump capitalization as a means of constructing "passive" stock portfolios insofar as long-term return generation is concerned, including book values and revenues. We put "passive" in quotes because we've never seen an index entailing zero turnover, even those relatively free of the enormous discretion that Standard and Poors has given itself in constructing its S&P 500 Index. The latter isn't as loopy as the "Dow Jones index" that still gets mentioned in just about every broadcast news update, often by Barbies and Kens who know so little about investing that they assume the Dow's or any other index's absolute price change unaccompanied by other data points will be useful to listeners. The Dow index mentioned regularly on newscasts is constructed in a manner that leaves it and hence passive portfolios based on it no less vulnerable than the S&P 500 to human tinkering and hence potentially costly turnover. Of course, even a benchmark tied rigorously to a fundamental measure such as book value or revenues will display turnover, mergers and acquisitions being an essential feature of a well-functioning capitalist system. Thus, low turnover isn't itself a choiceworthy goal for investors to pursue: it's a means to the inherently worthy goal of deploying investable wealth in a manner likely to compound it at satisfactory rates. As Arnott proved conclusively, benchmarks and hence "passive" portfolios based on "fundamentals" do a better job of achieving this goal than do those based on that ultimate measure of investors' hopes and fears for a given enterprise: its current price tag.

Blinded by Theory

Eyes on the Prize. Like Nixon going to China, a thinker who's published numerous highly-regarded papers on investing in refereed journals has extra credibility when challenging a key but unspoken premise underlying such refereeing: the notion that the propounding of new "theories" does more to advance the "science" of investing than the empirical testing and periodic re-testing of old ones. Arnott is such a thinker, and argued forcefully that too much investable wealth gets stewarded by folks who are "blinded by theory." As a means of encouraging our readers to procure their own copies of the conference proceedings (available via www.cfainstitute.org*), we won't recite the examples

* At CFA Website, see Professional Development section, Reflections and Insights: Provocative Thinking on Investment Management Conference.

that Arnott offered of the phenomenon just mentioned. But we will point to the most conspicuous manifestation of it in the endowment arena — fiduciaries' acceptance of manager fee arrangements which assume implicitly that most or all of a manager's realized return is attributable to skill rather than other variables. Blinded as some fiduciaries are by the theoretical virtues of diversifying their "bets" across a broad variety of "asset classes" and strategies, many trustee groups end up paying too much for "beta," i.e., they end up sharing with managers excessive portions of the very long-term or secular gains produced by most tradable assets, tangible or not. To be sure, some tradable assets evaporate rather than levitate over time (we wouldn't pay much if anything for Jose Canseco's "rookie card") and it's unsurprising that fiduciaries would flock to investment pros with a proven ability to "beat the market." Alas, due to varying combinations of inattention, inexperience, and inadequate bargaining power (a/k/a dollars to deploy), many institutions employ external managers pursuant to terms that provide the latter with the economic equivalent of continually refreshed supplies of lottery tickets. This is especially true respecting an "asset class" whose current popularity is as high as its fulfillment of the practical as distinct from theoretical criteria for asset class treatment is low: hedge funds. As past TIFF *Commentaries* have noted repeatedly, to merit treatment as an asset class, the holdings categorized as such must display (among other attributes) a distinct and homogeneous set of return drivers. In theory (sic), clients should share with managers gains generated by these return drivers only to the extent that manager as distinct from client choices cause such clients to incur or shed exposure to such systemic risks. Frustratingly, in perhaps no other aspect of investing is there such a large disjunction between sound theory and current practice as there is respecting manager fees — for reasons rooted partly in the blinding character of contemporary theories about asset allocation.

Agency Issues. Speaking of the all-important distinction between principals and agents, several conference speakers did so provocatively and persuasively, including Vanguard founder Jack Bogle and accomplished hedge fund jockey Cliff Asness. Following the lead of pension policy expert Keith Ambachtsheer, who argued that "agency issues" cost the global economy and hence the pensioners who indirectly "own" much of it countless billions of dollars each year via unsound capital allocation choices, Bogle fingered banks and financial conglomerates as especially unworthy agents. (Note: The conference highlighted here occurred prior to Mark McGwire's stunningly obtuse Congressional testimony about steroid use in baseball — a performance which if indeed orchestrated by McGwire's handlers as many observers have surmised sets a new standard for agent incompetence.) Why, Bogle asked, do mutual funds sponsored by banks and financial conglomerates perform so poorly? Because their *raison d'être* in their sponsors' eyes is to generate profits for … their sponsors. Why, Asness asked, do the true owners of the capital deployed by these funds continue to absorb such punishment? Check out the skies over Las Vegas, Asness answered (paraphrasing). 850 flights per day carry 30+ million visitors per year into the world's "gaming" capital. What makes people so game for gaming (sic)? They're "bored and innumerate," Asness suggested, and there've been enough such patrons over the last decade to cause S&P's index of gaming stocks to return almost 800% cumulatively, more than four times the return on the S&P 500. Asness noted further that many mutual fund sponsors are pursuing essentially the same business strategy as casinos, doling out rewards to patrons in an episodic and enticing manner that "keeps 'em comin'" while also fulfilling corporate profitability goals. The most reliable method for doing this? "Benchmark-hugging," a/k/a "closet indexing," whereby fund sponsors diversify their holdings to the extent needed to avoid intolerably large performance shortfalls while charging disproportionately large fees for this "service." Why do mutual fund investors continue to go along for the ride? For the same reason that gamblers keep Vegas's roughly 120,000 slot machines busy enough to justify casino owners' capital investment in them: because their innumeracy prevents them from recognizing the grim fact that the "house" is destined to win. How innumerate is the average investor? We don't know, but we know **well** some investment pros who were surprised to learn that a mutual fund sponsor that charges fees equal to the 1.49% industry average for US stock funds (as reported by Lipper) for the privilege of investing in a fund generating an annualized **gross** return of 8% will pocket over a 50-year holding period the same amount per dollar invested in the fund as the **net** amount pocketed by an investor in the fund. How well do we know the relatively innumerate investment pros to whom we're alluding? As well as you would if you stared at them in the mirror each morning.

Information vs. Knowledge

Hot Potatoes. If the final four games of the 2004 American League playoffs proved anything, they proved that the caveat repeated endlessly in mutual fund ads ("Past performance does not guarantee future results") rings as true in other fields of human endeavor as it does in investing. (The winning team was the first in MLB history to overcome a 0-3 deficit in a best-of-seven playoff series.) Generalizing the point this caveat seeks to convey, conference speaker Gary Brinson examined a root cause of investor foibles: people's tendency to mistake **information** for **knowledge.** Again, not wishing to undermine potential sales of conference proceedings by our friends at CFA Institute, we won't recite here the examples Brinson gave of investors' mistaking of information for knowledge. Rather, we'll offer up an example specifically germane to the stewardship of endowed charities' wealth — one that facilitates our sharing here of some pearls of wisdom offered by a speaker who followed Brinson to the podium. Our example involves the "in-kind" stock gifts or distributions that endowed charities as a group receive routinely, the former from donors and the latter from private equity partnerships. As a general rule, and probably a sound one in light of the transferors' assumedly superior knowledge of the stocks' intrinsic values, charities tend to sell securities received "in-kind" ASAP after their receipt. Not infrequently, however, endowment fiduciaries will hold securities received in-kind pending their collection and review of **information** they deem germane to the "hold or sell" decision they've shouldered by not selling immediately upon receipt. Question: does the information so gathered —typically comprising primarily analyses and opinions published by "sell side" analysts — constitute relevant **knowledge**? We have our doubts. Perhaps surprisingly, so too does another conference speaker whose candid comments on "sell side" conflicts of interest may or may not have anything to do with the generally downward movement of stock prices and "sell siders'" reputations since the bull market of the 1980s and 90s ended five years ago. As Abby Joseph Cohen of Goldman Sachs reminded her audience, Wall Street analysts are essentially and ineluctably salespersons, publishing "facts" and opinions that are suspect at best due to both conflicts of interest and (less widely understood but perhaps more troubling) data gathering difficulties. What difficulties? Cohen identified several, the most disturbing being the excessive reliance that investors place on government-supplied data whose compilation is so flawed methodologically and so excessively prone to later revisions (some released as long as 36 months "after-the-fact") as to render suspect any judgments founded on initial findings. In short, far from being material that is legitimately viewed as knowledge, much of the research pumped out by "the Street" and hence much of the material that endowment fiduciaries consider when determining what to do with stocks received in-kind is best viewed as anti-knowledge. (Readers seeking to know how **we** would handle in-kind transfers in light of this grim fact are invited to contact John Thorndike via jthorndike@tiff.org.)

Be Careful What You Wish For. Fiduciaries also tend to mistake information for knowledge in the increasingly crowded domain of hedge fund (HF) investing — an arena so marred by past scandals as to make inevitable the hiring of multiple HF managers by the typical institution seeking to play in it. Like most good things in life excepting perhaps skilled left-handed pitchers employed by the Red Sox, hiring multiple HF managers is wise **up to a point**. (Playing roughly half of its games each year in Fenway Park, which has an abnormally "short" left field, the Sox arguably could employ gainfully a potentially unlimited supply of proven southpaw pitchers.) This tipping point tends to be reached when manager proliferation causes time spent truly understanding each manager's evolving tactics and returns to be displaced by time spent compiling and "aggregating" manager-specific data. More often than not, this aggregation process constitutes the analytical equivalent of shoving square pegs into round holes. Why do so many institutions undertake these exercises in futility? Brinson helps us see why: it's because people tend to assume that a lack of information (read: data) implies a lack of knowledge. This assumption is as dangerous as the related assumption that information implies knowledge — indeed, perhaps more so as the pursuit of data that's unlikely to be used in any meaningful manner tends to crowd out the pursuit and hence potential capture of worthwhile knowledge. As is true in so many other respects, when it comes to the use and abuse of statistics, investing and baseball have much in common. Of the latter pursuit, columnist Jimmy Breslin said, "Baseball isn't about statistics. It's about Joe DiMaggio rounding second base."

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TIFF THE INVESTMENT FUND FOR FOUNDATIONS

590 Peter Jefferson Parkway, Suite 250
Charlottesville, Virginia 22911
Phone: 434-817-8200
Fax: 434-817-8231
Website: www.tiff.org

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

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