TIFF

COMMENTARY

A Report of TIFF EDUCATION FOUNDATION

SPRING 2006

Highlights

A fictional investment committee whose past deliberations have proven surprisingly popular returns to the TIFF stage this quarter to debate vigorously numerous investment policy issues, including ...

... the troubling trend whereby what were formerly distinct modes of alternative investing (e.g., private equity, absolute return, private realty and resources) are converging, thereby causing time-tested ways of deploying investable wealth to become increasingly ineffective;

... the pitfalls of viewing portfolio exposures through an insufficiently robust analytic prism; and

... the pros and cons of a novel approach to policy portfolio construction entailing a highly unconventional approach to risk budgeting.

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 volunteers who receive no fees or salary but are eligible for expense reimbursement and matching charitable gift programs.

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

FAMILIAR FACES

Back At It. Fiduciaries who read regularly TIFF's published reports have grown familiar with an investment committee whose deliberations, though no less fictional than the committee itself, have proven entertaining to many TIFF members and useful to some. This committee makes another appearance here, continuing a conversation about investment policy formulation that kicked off in the TIFF *Commentary* for 3Q 2000 and continued in the 4Q 2002 and 4Q 2003 editions of that publication. (NB: all such conversations are "informed" by a two-part essay on investment policy formulation entitled *Message in a Bottle* that appeared in the TIFF *Commentaries* dated March 31 and June 30, 1999. This essay generated much heat and hopefully also some light within endowment and foundation circles, and considerable push-back from financial economists, with the latter expressing upset over the essay's strong critique of "efficient frontier" models in particular.) Consistent with governance precepts extolled by TIFF, the committee in question comprises just three members and displays abnormally low turnover. Indeed, its composition remains unchanged since its first appearance in these pages: the ever-cautious Graham Bell chairs a committee that comprises the ever-thoughtful Thomas More and the ever-avant garde Victoria Woodhull. The committee is joined, as per usual, by its sagacious and seasoned consultant Abigail Adams, who seeks to earn her keep here by helping the committee come to grips with two dominant and related trends in institutional investing: (1) the burgeoning popularity of "alternative investments" ("AIs") and (2) the growing convergence of formerly distinct modes of alternative investing.

CROWDED AND CONVERGING

Bell. Let's get right to it, Abby: should we or should we not stay the course with the policy portfolio we adopted a few years back [see Exhibit 1 at page 3]? I **do** worry — and lots — that the alternative investments which have served us so well may be losing some of their firepower.

Woodhull. Because we have the **wrong** AI managers?

Bell. Not really. Admittedly, given the wide dispersion of managers' returns within the AI niches I'm alluding to — private investments of all kinds, including private equity, private realty and resources and absolute return —we're better off avoiding a given niche altogether if we can't use the best managers within it. But even if we assume as I do that our access to top quartile managers will persist, I worry that the tidal wave of money flowing into most of these niches will depress future returns for even the best managers below the levels needed for us to achieve our overall endowment's goal of a five percent real return.

Woodhull. Aren't you painting with too broad a brush, Graham? After all, about the only thing that the various forms of investing you just mentioned — private equity, privately-traded hard assets and absolute return — have in common is that all three get sorted into the same excessively big bin by many investors.

Adams. Actually, they have something else in common, Vicky — something that poses a problem as well as an opportunity for this committee and indeed most well-intentioned endowment fiduciaries.

Bell. Give us the bad news first, Abby. In what sense do the AI strategies that have helped us do so well in recent years pose a problem?

Adams. They pose a problem because what were formerly distinct modes of investing are converging, causing time-tested ways of deploying investable wealth — and of measuring and monitoring risks once it's been deployed — to become increasingly ineffective. Take, for example, the hedge funds employed within your absolute return ("AR") segment —

More. Take 'em? You can have 'em, or rather I'd be happy to see some of them get the boot.

Woodhull. Why's that, Tom? Some have performed spectacularly, others very well and the rest solidly at worst. Why boot any of them?

More. Because they're cheating — not in the legal or even ethical sense, of course, but in a strategic

EXHIBIT 1: ILLUSTRATIVE POLICY PORTFOLIO

Primary goal: Maintain purchasing power in face of maximum sustainable withdrawals.

Principal risk parameters: (1) Not more than a 30% probability of a 15% or worse decline in real capital values over any 5-year period.
(2) Not more than a 30% probability of a 50% or worse decline in real capital values over any 25-year period.

Segment/Eligible Assets	Expected Real Return	Expected Value Added [a]	Expected Real Total Return	Normal Allocation	Benchmark
TOTAL RETURN ASSETS				**68%**	
Marketable Equities	3.5%	0.7%	4.2%	30%	MSCI All Country World
Private Equity	8.5%	subsumed	8.5%	20%	MSCI All Country World + 5% per annum
Absolute Return	6.0%	subsumed	6.0%	15%	Treasury Bills + 5% per annum
High Yield Bonds	3.0%	3.0%	6.0%	3%	Merrill Lynch US High Yield Master II Constrained
INFLATION HEDGES				**18%**	
Resource-Related Assets [b]	5.0%	subsumed	5.0%	5%	Global Index of Resource-Related Stocks
Marketable Real Estate (REITs)	2.0%	2.0%	4.0%	3%	Morgan Stanley REIT Index
Private Real Estate	4.0%	subsumed	4.0%	7%	CPI + 4% per annum
Commodities	0.5%	0.0%	0.5%	3%	DJ AIG Commodity Total Return Index
DEFLATION HEDGES				**5%**	
Conventional Treasuries	1.5%	0.0%	1.5%	5%	10-year US Treasury Bond
ALL-PURPOSE HEDGES				**9%**	
Inflation-Linked Treasuries	2.5%	0.0%	2.5%	9%	10-year Treasury Inflation-Protected Security
Cash Equivalents [c]	1.0%	0.0%	1.0%	0%	
TOTALS					
Percent Allocated				100%	Weighted average of segment benchmarks
Expected Real Total Return				5%	

Assumes access to top-tier managers in all markets.
Assumes ILBs purchased near or below par to maintain their utility as deflation (and inflation!) hedges.

[a] Expected value added from the use of assets or strategies that could cause a sub-segment's returns to deviate from the returns of its parent segment's benchmark.
[b] Public and private.
[c] Minimum and normal cash positions could be negative, subject to trustee discussion of appropriate leverage ratios. Endowed charities can lever their portfolios without incurring unrelated business taxable income — if they're clever about it. Of course, if leverage is permitted, non-cash ranges must be tweaked accordingly.

sense, by incurring what strike me as excessive risks in exchange for excessive fees.

Bell. **Excessive risks?** The hedge funds employed in our AR segment generally produced very solid absolute returns when stocks were in the tank earlier in the decade and have continued to do so since global stock prices turned upward in the fall of '03. I admit that the hedge funds we employ aren't cheap, but shouldn't we be willing to pay a premium price for asymmetry, by which I mean the tendency of our hedge funds to do very well when broad stock indexes are moving higher and decently at worst when they're moving lower?

More. You're assuming that the conditions that enabled our hedge fund managers to perform so brilliantly during the most recent bear market in stocks will recur — that broad stock indexes will fall sharply due to even sharper declines in the prices of ludicrously overvalued stocks that our hedge fund jockeys will have sold short. What if a different bear market scenario unfolds, with stocks falling sharply more or less across the board, and with the relatively illiquid stocks that hedge fund jockeys tend to favor becoming even harder to trade than normal? From what I see and hear, a lot of the new money flowing into hedge funds is borrowed money: capital that investors of all stripes but especially high net worth types have borrowed from banks or brokers in an effort to boost their returns by maximizing their exposure to hedge fund jockeys who seem to have an edge in picking stocks, short or long. The long positions tend to be much less liquid than the shorts, as you'd expect —

Woodhull. Because?

More. Because the longs comprise relatively unloved stocks and the shorts relatively loved ones, which is not a problem when the hedge funds holding them have stable or growing asset bases. But it becomes a big problem if and when clients start withdrawing money — or when portfolio losses cause the banks and brokers from which hedge funds have themselves borrowed capital to make margin calls.

Bell. I share your concerns, Tom, although as Abby keeps reminding us liquidity seems to be of decreasing importance to the hedge funds we employ. That's your main point, isn't it, Abby — that hedge fund managers as a group are morphing into a whole new breed of cats, shifting vast sums into private investments of all kinds, including the so-called hard assets we've traditionally held within our inflation-hedging segment: private realty, energy-related investments, even —

More. — even power plants, for heaven's sake. I mean, I can understand why hedge fund managers with vast sums to deploy are finding it necessary if not wise to load up on private investments, but I can't understand why their clients are willing to go along for the ride — not with your typical hedge fund fee structure permitting managers to pocket 20% or more of **unrealized** gains.

Woodhull. That's a bit unfair to hedge fund managers, isn't it? Don't most hedge funds stick private investments into so-called side pockets, essentially foregoing their customary 20% carries on these holdings until they're sold off?

Adams. Many do, Vicky, although Tom's point about hedge fund managers potentially overreaching is well taken.

Bell. Maybe, Abby, you could get us back to the main topic at hand — the growing obsolescence of conventional asset allocation frameworks — by sharing with the committee your take on the issues we've discussed so far as well as where we might go next.

More. That'd be great, especially since Abby herself is the main architect of the framework we've been using for the past several years!

Bell. She is indeed, so all credit to her for suggesting to me in advance of today's meeting that we consider replacing it with a better way of parsing the risks to which our endowment is subject, of necessity or choice.

BACK TO THE GREEKS

Adams. Not a replacement, Graham, at least not yet, but rather a supplement of sorts — an alternate prism through which this committee can do what you just suggested: parse the risks to which your endowment is subject, of necessity or choice.

More. That's a good way of framing today's debate, Abby, because I personally think we're incurring risks that we certainly haven't chosen **consciously** to take, and arguably don't **need** to take, in order to achieve our goal of maintaining endowment purchasing power while spending 5% of our assets each year. After all, we didn't **choose** to tilt as heavily toward private investments as we're now tilted: our hedge fund managers have pushed or rather pulled us there, making our overall portfolio much less liquid than I personally prefer or that this foundation arguably **needs.**

Woodhull. **Arguably** is right, Tom, because as I look around the world I don't see how we can plausibly pursue our goal of earning 5% or higher real returns without assuming even more liquidity risk than we're taking right now, even after adjusting our tally of illiquid holdings upward to reflect the fact that some hedge funds we're using with annual liquidity windows hold private investments. I concede the point that some of these PIs may prove misguided in hindsight — because the hedge fund jockeys in question paid too much for positions in well-managed firms, or bought into poorly managed ones that proved harder to turn around than originally supposed — but with marketable stocks having risen so sharply over the last few years I don't think we can get to 5% real without moving even more heavily into PIs, either proactively via conventional private equity or hard asset partnerships or indirectly via hedge funds. How did you put it, Abby, when we discussed this dilemma over lunch the other day — something about alphas getting us to places that betas alone cannot?

Adams. That was the gist of it, but let me put the point in context by cycling quickly through the questions we've left hanging as this conversation has unfolded, starting with the question Vicky just posed as it highlights well our chief challenge as asset allocators and managers-of-managers. As we've already noted, what have heretofore been viewed by many fiduciaries as distinct forms of investing — if not also distinct asset classes — are becoming less distinct as time passes, with so-called absolute return partnerships in particular employing lock-up periods and investment strategies that cause them to look decreasingly like the vehicles this foundation tapped when it first entered the hedge fund arena about a decade ago and more like the private equity and hard asset partnerships you've employed for at least that many years.

More. For what it's worth, I've never really bought the argument that absolute return merits treatment as a distinct asset class. To the extent that the strategies employed within our own AR segment merit such treatment, the segment ought to be relabeled **kitchen sink.**

Adams. Point well taken, Tom, and one that leads us logically back to the Greeks, by which I mean the Greek letters Vicky mentioned a minute ago. The plain truth is that as more and more capital flows into the so-called alternative investments we're focusing upon today, the valuation anomalies that used to enable the most talented AI managers to produce very strong returns more or less regardless of general market conditions are getting arbitraged away, making it increasingly hard for them to continue generating truly superior risk-adjusted returns or **alphas.** Of course, that's the precise definition of alpha as that Greek letter is used by academics as distinct from practitioners: the margin by which a manager outperforms relevant market benchmarks after adjusting for the systemic risks or **betas** that the manager's portfolio entails.

More. Hold on. I thought **beta** meant the sensitivity of a portfolio to broad **stock** market movements. Are there other betas we should worry about?

Adams. Yes. And in fact we've worried about them all along, or at least I certainly have in helping you fashion appropriate investment policies and guidelines. I've worried about your portfolio's bond market beta, for example, which is usefully subdivided into an interest rate or duration bet on the one hand and a credit bet or beta on the other. And you have a realty beta too, as well as an energy beta ... a foreign currency beta ... it's a pretty long list.

Bell. And a daunting one for that reason alone, to say nothing of the fact that the betas or systemic risks to which you're referring tend to overlap, Abby, as you and I discussed off-line in preparation for today's meeting.

Adams. Exactly, Graham. They overlap to a considerable extent — as can easily be seen by pondering the extent to which the value of your REIT portfolio [i.e., portfolio of publicly-traded real estate investment trusts], for example, is sensitive to broad stock market movements, interest rate changes, credit spreads and a host of other variables.

Bell. Indeed. But our REIT portfolio's betas or systemic risks are **easy** to identify relative to those inherent in our absolute return portfolio, aren't they Abby? I'm not sure I favor Tom's suggestion of changing its name from absolute return to "kitchen sink" but it does subject us to a variety of systemic risks, does it not?

Adams. It does ... but ... again ... of necessity more than choice. You could probably reduce the various betas or systemic risks that your AR portfolio entails by lowering from 5% to some much lower hurdle the margin by which it seeks to outperform T-bills — by moving, in other words, to a so-called market neutral approach that would favor AR managers employing lower risk strategies. But doing so arguably would move you away from rather than toward your goal of earning a 5% real return on your overall endowment, which seems impossible to achieve without incurring at least some systemic risk, especially of the stock market variety, unless you can implement successfully the policy some fiduciaries are pursuing of borrowing heavily to finance outsized allocations to market neutral managers.

UNSETTLING THOUGHTS

Woodhull. **Really?** What if we put together a roster of truly exceptional managers capable of beating the markets in which they invest by an average of, say, seven or eight percent a year? Couldn't we use derivatives to essentially neutralize whatever betas or systemic risks the managers incur, thereby locking in something close to the seven or eight percent excess returns they'd assumedly deliver without bearing systemic risks? If we could do that, we'd have no trouble achieving a 5% real return.

Adams. Can't be done, Vicky, at least not by any person or committee known to me. Admittedly, some truly outstanding managers have generated annualized excess returns or alphas of eight percent or more — some of the leading private equity and private realty firms come immediately to mind — but such managers tend to be in short supply. And even if they're able and willing to manage money for you, any effort by you to pocket their alphas without also exposing yourselves to whatever systemic risks or betas they incur would expose you to some wholly new and troubling risks.

Woodhull. Such as?

Adams. Such as the risk that the underlying managers' portfolios won't behave as expected, causing your hedges to work imperfectly if not perversely. Or the risk of a cash flow mismatch, as could easily result if, for example, you get margin calls on short positions in stock futures used to hedge the stock market risk inherent in your private equity portfolio at a time when that portfolio or indeed your overall endowment isn't generating a commensurate amount of liquidity to meet such calls. Of course, PE portfolios tend to generate relatively robust cash flows when stock prices in general are rising, which would be the condition under which you'd most likely get margin calls on short positions in stock derivatives, but you could run into a cash flow mismatch nonetheless.

Bell. But the bigger risk is that of a fundamental mismatch, isn't it, for the reason you just highlighted: we don't really know with sufficient certainty how our external managers' portfolios will behave, especially in relation to each other — and especially to the extent that we'll be relying increasingly heavily on alphas or excess returns rather than betas to achieve our return goals in coming years. After all, as difficult as it is to forecast accurately our external managers' betas — especially as investment strategies and structures converge in the manner you spoke of at the outset — it's even more difficult to forecast accurately how our managers' alphas will correlate.

Adams. Agreed.

More. Unless I'm mistaken, Graham, what both you and Abby seem to be hinting is that what we **don't** know about our portfolio vastly exceeds what we **do** know and **can** know — that the asset allocation framework [see Exhibit 1] we've been using is becoming increasingly obsolete, if indeed it ever reflected with tolerable accuracy the actual or potential deployment of our investable assets. That's a pretty unsettling thought — as is the notion that we're going to rely increasingly on alphas or manager skill as distinct from betas or market exposure to achieve our overall fund return goal of a 5% real return. I see and hear a lot of investors trumpeting this notion these days and it gives me real pause, especially when I see these same investors funneling vast sums into hedge funds that don't have a plausible chance of producing a 5% or higher real return unless the investors themselves or the hedge funds they employ pile on lots of leverage.

Woodhull. That phenomenon gives me real pause too, Tom, and I don't think we want or need to mimic the approach you've just critiqued of using leverage to gin up our hoped-for alphas to the levels needed to generate a 5% real return on our overall endowment. I'd rather keep moving down the path we've been treading for some time of incurring as broad an array of risks as we can possibly assemble — be they alphas or betas or other forms of risk that might be Greek to us at first blush but that Abby can help us exploit profitably — so long as the overall array gives us a fighting chance of getting to 5% real without driving off a cliff.

More. Which you would define as ...?

Woodhull. Which I would define the way we've customarily defined our risk tolerance: investment policies and practices that we expect to produce a 5% real return with not more than a 30% probability of a 15% or worse decline in endowment spending over any five-year period or a 50% or worse decline in endowment spending over any 25-year period.

More. That was a mouthful, Vicky, which you rattled off as if you've memorized it.

Woodhull. I have, because the parameters I just recited have been the primary determinants of our asset and manager mix for some time, and I see no reason to tweak them. I do, however, see ample reason to intensify our search for diversifying investments, especially via active managers whose skill sets or investment niches might enable them to produce decent real returns even if the markets in which they invest generally do not. Of course, as this search proceeds and especially if it **succeeds,** we may need more powerful analytical tools to manage and monitor the various forms of risk we're incurring.

Bell. Spot on, Vicky — tools of the sort that Abby's encouraging us to employ as an alternative to the more conventional asset allocation framework she helped us put into place several years ago.

Adams. Not so fast, Graham. As I said earlier, I'm not pushing you to scrap **entirely** the framework you've been using, although I do think you should do away with the practice of assigning each manager you employ to just one asset class segment in favor of a more flexible scheme entailing multiple bins for some managers. For example, if you know that a hedge fund manager you employ has shifted 25% of its capital into private equity deals and 15% of its capital into private real estate, you might want the dollars you've allocated to this manager to appear not as a single line item in your absolute return segment but as three line items — one in private equity, one in private realty and one in AR.

More. That sounds like a cure worse than the disease it seeks to remedy. If your hypothetical hedge fund manager is in fact pursuing the return goal we've articulated for our absolute return segment — namely, T-bills plus 5% per annum — and he's doing so within volatility constraints compatible with those we've articulated for this segment, why would we complicate things and include the manager in other segments' exposures?

PORTABLE ALPHA

Bell. We wouldn't, Tom, if we wanted to maintain merely a crude understanding of how the capital entrusted to us has been deployed. But I, for one, would like to go further — and we arguably need to go further in any case to facilitate our prudent use of multi-strategy managers as well as so-called portable alpha strategies.

More. Portable alpha?

Woodhull. You know what Graham means by that, Tom: the use of active strategies within a given asset class that, through the use of derivatives or other means, can be pursued without necessarily augmenting our exposure to the asset class in question. For example, you'll recall that we funded recently a hedge fund manager that uses exclusively fixed income arbitrage strategies in its pursuit of consistently positive absolute returns. In doing so, we agreed that the capital to fund this allocation would come from our global stock segment, with stock index futures overlaid on top of this new hedge fund allocation to keep our overall commitment to global stocks essentially unchanged. If past serves as prologue, the hedge fund in question won't display any discernible levels of either interest rate or credit risk, making it just about the ideal portable alpha engine — **in theory.** In practice, of course, this engine so to speak might sputter or fail altogether, but our use of it does seem compelling, especially in light of the difficulty we've encountered of picking active managers who can outperform relevant stock market indices on a reasonably consistent basis through conventional stock-picking methods.

More. But isn't that precisely the problem, Vicky — or rather Abby, since you, Abby, are the brains behind this operation: isn't it foolish to assume that we or any other committee of this sort can deploy whatever capital we've allocated to marketable stocks in a manner that will outperform relevant market indices on a highly consistent basis? You've preached to us to *ad nauseam* over the years that if we want our marketable stocks portfolio to generate positive alphas or excess returns over time that we have to be prepared for potentially prolonged periods of underperformance. Has this newfangled approach known as portable alpha done away with the need for such patience?

Adams. Not at all, although many investors seem to be accepting uncritically the argument that they can gin up their returns by discarding more or less completely traditional long-only portfolio management techniques — whether applied to common stocks or high-grade bonds or other asset classes such as high yield — in favor of asset mixes comprising portable alpha "engines" of the sort that Vicky described a few minutes ago coupled with derivatives capable of keeping their targeted asset class betas within pre-specified bounds.

Bell. In other words, 100% hedge funds overlaid with derivatives?

Adams. Not 100%, typically, because the asset mixes we're talking about comprise private investments too, which are tough if not impossible to own on an indexed basis via derivatives. But the vast increase in recent years in the breadth and depth of the derivatives market, which I define broadly to include exchange-traded funds or ETFs, has unarguably induced many institutions to rely increasingly on absolute return-oriented hedge funds overlaid with derivatives rather than traditional long-only managers as their hoped-for means of pocketing alphas or excess returns. In doing so, these institutions have created a self-negating prophecy of sorts: by shifting excessive sums into the hands of these AR-oriented hedge funds, they've made it increasingly hard for such funds to generate as a group returns that exceed by acceptable margins the yields on short-term T-bills or LIBOR [i.e., the London Interbank Offered Rate that constitutes a good proxy for the cost of very short-term corporate capital].

More. Define "acceptable."

Adams. Will do, Tom, although quite obviously the institutions to which I'm alluding employ wildly differing definitions of what constitute acceptable margins by which the AR-oriented hedge funds they employ are expected to outperform T-bills. Of course, the same phenomenon manifests itself respecting other forms of investing, be they traditional or non-traditional, with institutions targeting and indeed accepting or not wildly differing levels of alpha depending on their risk tolerances and, if I can say so without sounding too smarmy, their understanding or ignorance of the risks they could or should incur in pursuit of their return goals.

PUSHING THE ENVELOPE

More. Smarmy is OK so long as it's smart. Show us your smarts by telling us what types and levels of risk we should incur in pursuit of our goal of earning inflation plus 5% on our overall endowment.

Woodhull. That's a bit unfair to Abby, isn't it, Tom? She's our consultant, after all, not a trustee like the rest of us here today. Admittedly, Abby can help us identify the risks inherent in various managers and strategies. But choosing the types and levels of risks this foundation should incur in pursuit of the goal you just mentioned is a non-delegable decision, is it not?

More. Maybe not. It would be, of course, if we weren't crystal clear about risk tolerance, but you yourself recited our key risk parameters earlier in this meeting: not more than a 30% probability of a 15% or worse decline in real capital values over any five-year period or a 50% or worse decline in real capital values over a 25-year period. Given these parameters, Abby, what **should** we do?

Adams. Obviously, Tom, there's no single solution to the problem that's unarguably correct, because the plausible solutions turn on a host of inherently uncertain factors, including obvious ones like the assumed future direction of the various markets in which you'd be investing plus more subtle ones like the number and size of future opportunities this committee will have to put money to work with truly superior managers in each of the investment niches you seek to inhabit. The latter variable is key, of course, because investment guidelines that might be well-suited to a foundation seeking the same return goal as yours within the same volatility constraints might be totally unsuited to your foundation if the investment talent available to each entity differs sufficiently.

More. You can't wiggle off the hook that easily, Abby! You know the talent available to this committee because you help us find it. We've done OK in the marketable arena, pocketing modest but nonetheless positive alphas net of the incremental costs of active management, and we've done very well in the alternative arenas we're focusing on here today: absolute return, private equity, private realty and the like. Unless our assets balloon in size, which is unlikely to happen given our private foundation status, it seems reasonable to assume that our generally happy past of picking winning managers will serve as a reliable prologue to the future. Assuming it does, what **would** you have us do?

Adams. Do you want me to throw all my punches now, Mr. Chairman, or hold some back for another day, as you and I agreed I would so as not to overload the committee here today?

Bell. I did suggest you go slow, Abby, but Tom seems keen for you to lay more of your cards on the table, and Vicky is always keen to push the envelope so ... go for it.

Adams. Will do. There's not much to it, actually, "it" being the refinements I'd recommend to the way this committee discharges its primary duty of fashioning investment policies and guidelines responsive to the return goal and risk parameters we discussed earlier. At bottom, there are just two such refinements. First, as I hinted earlier, I'd like to see you drill down at least one more level when monitoring your actual exposures, so that — for example — you sort the capital you've placed at risk via a given AR manager not wholly into your AR bucket but rather into the various buckets reflecting the manager's actual exposures. This brings me to the second refinement or rather series of refinements I'd recommend, which would be more fundamental than the one I just outlined and for that reason alone will likely require considerable discussion before being implemented by you. You can get some sense of the further refinements to which I just alluded by perusing this handout [see Exhibit 2 at page 10] which, as you can see, introduces a new element if you will into your policy mix — a so-called targeted contribution from active risk. As you can also see, the revised policy portfolio I've sketched here has the same expected real return as your old one, namely 5%, despite some apparent changes in the targeted or normal segment weights.

EXHIBIT 2: ALTERNATIVE POLICY PRISM

Primary goal: Maintain purchasing power in face of maximum sustainable withdrawals.
Principal risk parameters: (1) Not more than a 30% probability of a 15% or worse decline in real capital values over any 5-year period.
(2) Not more than a 30% probability of a 50% or worse decline in real capital values over any 25-year period.

Segment/Eligible Assets	Expected Real Return	Normal Allocation	Measured Over Five-Year Periods: Average Cumulative Return When Fund Return < -15%	Risk Contribution When Fund Return < -15% [a]	Marginal Contribution to P (Return < -15%) [b]	Benchmark
TOTAL RETURN ASSETS		**53%**				
Marketable Equities	3.5%	30%	-25.4%	66.0%	0.12%	MSCI All Country World
Private Equity [c]	8.5%	20%	-12.7%	27.1%	-0.14%	MSCI All Country World + 5% per annum
High Yield Bonds	3.0%	3%	0.0%	1.6%	-0.04%	Merrill Lynch US High Yield Master II
INFLATION HEDGES		**18%**				
Resource-Related Assets [c][d]	5.0%	5%	22.2%	-4.8%	-0.22%	Global Index of Resource-Related Stocks
Marketable Real Estate (REITs)	2.0%	3%	-16.3%	4.8%	0.11%	Morgan Stanley REIT Index
Private Real Estate [c]	4.0%	7%	8.7%	-0.5%	-0.15%	CPI + 4% per annum
Commodities	0.5%	3%	8.3%	-0.1%	-0.10%	DJ AIG Commodity Total Return Index
DEFLATION HEDGES		**5%**				
Conventional Treasuries	1.5%	5%	2.8%	1.6%	-0.07%	10-year US Treasury Bond
ALL-PURPOSE HEDGES		**9%**				
Inflation-Linked Treasuries [e]	2.5%	9%	12.6%	-3.0%	-0.17%	10-year Treasury Inflation-Protected Security
Beta Segments Above [f]	3.7%	85%	-1.7%	100%	<-0.01%	
Targeted Contribution to Overall Fund Return from Active Strategies [g]	**1.3%**	**As needed to achieve "Boxed" Increment at left**	**6.7%**	**-8.4%**	**NA**	
Total	**5.0%**					

Assumes a 5% annual spending rate.
NA: Not applicable.

[a] Risk contribution is calculated as the average return posted by a segment when overall fund loss exceeds the maximum tolerable peak-to-trough drawdown (i.e., in this case, 15%). A minus sign indicates that the segment reduces the overall fund loss during such periods.
[b] Marginal contribution to P(Return < -15%) is the change in the probability — given a 1% increase in allocation to each segment — that the overall fund return breaches the maximum tolerable peak-to-trough drawdown (i.e., in this case, 15%). Positive values indicate that the probability of a breach increases; negative values indicate that probability of a breach decreases. Thus, negative values are desirable.
[c] Assumes access to top-tier managers.
[d] Public and private.
[e] Assumes ILBs are purchased near or below par to maintain their utility as deflation (and inflation!) hedges.
[f] Total allocation to specified betas could be more or less than 100% subject to trustee discussion of tolerable risks including acceptable leverage ratios. Endowed charities can lever their portfolios without incurring unrelated business taxable income — if they're clever about it.
[g] Targeted contribution from active strategies is essentially a plug figure denoting the incremental return that such strategies need to generate — above and beyond returns spawned by the fund's incurrence of systemic risks (a/k/a betas) — in order for the overall fund to achieve its stated goal of a 5% real return. Importantly, the assumed "returns to beta" on privately-traded assets (i.e., private equity, private real estate and the privately-traded portion of the resource-related asset segment) embody or reflect any expected outperformance of these segments relative to industry norms, such segments or exposures being inherently "active" or unsusceptible of indexation, at least at present.

More. **Apparent?!** A better word might be **astounding!** Unless I'm misreading your handout [Exhibit 2], the absolute return segment is gone ... zeroed out ... nuked. I know that I said some harsh things about our AR managers earlier, but even I admit that they've been our biggest alpha generators outside our private investment buckets. Are you really recommending that we fire the whole lot of them, Abby?

Adams. No. Indeed, you might **add** new AR managers, if compelling opportunities arise. When doing so, however, you'd hopefully view any new AR managers you hire the way I've implicitly encouraged you to view your existing ones in the handout: as the means by which you gain exposure to both alphas and betas, with the betas incurred by each AR manager reflected in the non-zero allocations to asset classes that are truly worthy of the name —

Woodhull. Absolute return **not** fitting that bill, correct?

Adams. Correct ... and with the alphas you expect your non-private managers to generate being reflected in the new line item I mentioned a minute ago – your targeted contribution from active strategies pursued outside your purely private investment segments.

More. I can understand why you've distinguished our private investment managers from all others in the handout ... because the alphas so to speak that our PI managers seek to generate are inseparable from the betas they incur on our behalf, private equity and other forms of private investing in which we're engaged being unavailable to us on an indexed or passive basis. But do we really want to sort all of our non-private alphas into one bin, as if they can be as easily detached from the asset classes in which they're generated as an interest coupon can be detached from a Treasury bond?

POTENTIALLY PROFITABLE PRISM

Adams. The handout embodies just one prism through which you'd view your portfolio if I had my druthers, as a supplement to rather than replacement of more conventional prisms. But the very feature you've questioned does underscore a fundamentally important reform I'm proposing: that you view active risk holistically, incurring it not unwittingly or involuntarily as a byproduct of efforts to achieve desired levels of systemic risks or betas but rather wittingly and in a manner consistent with the assumption that all managers incurring active risk on your behalf are essentially competing with each other for capital — or rather for units within your defined budget for active risk.

More. I'm all for holistic approaches to endowment management — and to life generally! — but I don't see how we can possibly compare the risk-reward tradeoff inherent in, say, a merger arbitrage partnership with the analogous tradeoff inherent in, say, a long-short fund focusing on emerging market bonds.

Adams. But that's precisely what you've been doing all along — albeit not as explicitly as I would have you do moving forward.

More. Sounds complicated.

Bell. Perhaps less so than you might think, Tom, judging from my experience on the investment committee of another endowed charity that Abby advises. What say we make implementation of Abby's recommendations the focal point of our next meeting?

Woodhull. So moved.

More. OK by me.

Bell. Motion approved, meeting adjourned.

TIFF Education Foundation
Endowment Management Seminar
Cambridge, Massachusetts
July 26, 2006

In furtherance of its mission of promoting the dissemination and adoption of best practices in endowment management, the TIFF Education Foundation (TEF) will conduct a seminar on Wednesday, July 26, 2006, in Cambridge, Massachusetts. Details appear below. Due to space constraints, we cannot guarantee admission to all interested parties, but will do our best to accommodate qualifying applicants. If you are interested in attending, please email this staff at tiffevents@tiff.org.

Confirmed Speakers

Harvey Dale
New York University
Professor of Philanthropy and the Law
Founding Director – The National Center on Philanthropy and the Law
Founding President and Director – The Atlantic Philanthropies

Mohamed El-Erian
President and CEO – Harvard Management Company

Jeremy Grantham
Chairman – GMO

Bill Helman
Managing General Partner – Greylock Partners

Bill McCalpin
Executive Vice President and COO – Rockefeller Brothers Fund

Event Details

Place: The Charles Hotel
One Bennett Street
Cambridge, MA 02138
800-882-1818 Phone
617-864-5715 Fax

Time: 9:00 a.m. – 3:00 p.m. (lunch included)

Cost: Free
(excluding participants' out-of-pocket expenses)

Registration:
tiffevents@tiff.org

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