COMMENTARY

A Report of TIFF EDUCATION FOUNDATION

2008 Edition 1

Board Members

Highlights

On July 26, 2007, TIFF Education Foundation (TEF) hosted an endowment management seminar in Cambridge, Massachusetts. Modeled loosely after the highly praised cable TV show *Inside the Actors Studio*, the seminar comprised interviews by TEF president David Salem – a suspect substitute indeed for James Lipton of *ITAS* fame – of five leading lights in endowment management broadly defined. This *Commentary* comprises excerpted transcripts of two such interviews:

Hilda Ochoa-Brillembourg, president and CEO of the Strategic Investment Group, talks about "semantic" risk and its effect on institutional investment practices and the differences between corporate America and for-profit management outside the US; and

Tom Steyer, founder and CIO of Farallon Capital Management, discusses investment opportunities and perils confronting hedge fund investors and operators, focusing special attention on hedge fund IPOs (boo).

About TIFF

Mission. In 1991, a network of foundations founded a cooperative-style investment organization whose structure and eligibility criteria have evolved over time but whose core mission has not. Known colloquially as TIFF, this organization 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.

Means. The organization 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 than its formal legal name (The Investment Fund for Foundations); TIFF Investment Program (TIP), an SEC-regulated mutual fund family; and TIFF Advisory Services (TAS), a taxable non-stock corporation and SEC-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.

Inquiries. For more information, please call TIFF at 610-684-8000 or visit www.tiff.org/TEF.

Hilda Ochoa-Brillembourg

Hilda Ochoa-Brillembourg is president and CEO of the Strategic Investment Group and managing director of Emerging Markets Management, both groups that she founded in 1987 to create global investment strategies for institutional investors. Excerpted below is an interview of Ms. Ochoa-Brillembourg by TEF president David Salem concentrating on the multi-faceted nature of risk and thoughts on long-term investing. Ms. Ochoa-Brillembourg's bio appears at www.tiff.org/TEF/seminars.

Group Therapy

David As with all of today's interviewees, we have a baseball quote that's germane to Hilda's work. The quote comes from San Francisco Giants great Willie Mays, who said, "In order to excel you must be completely dedicated to your chosen sport. You must also be prepared to work hard and be willing to accept constructive criticism. Without 100 percent dedication, you won't be able to do this."

Hilda, as you know, we polled the folks in this room via email, hitting them with this question: "Assume hypothetically that you have unilateral control over an endowment, and you were offered the opportunity to swap the entire endowment for a contract from a risk-free creditor to get a guaranteed return with no possibility of default. Assume further a 50-year holding period. What would be the minimum guaranteed real return that would induce you to make the swap?" The median answer was seven percent, and the arithmetic average was a tad north of eight percent. I know you're keen to comment on this. Are these achievable numbers?

Hilda First, I'd like to know who brought the average up to 8.2! Let's have a very valiant show of hands — because we're going to get you into group therapy. My first reaction was, "What a bunch of irrational, wishful thinkers!" Alternatively, I thought that maybe you all like your jobs so much that you wouldn't want to give them up for a long-term swap!

David Let me restate the question and see if I can tie it to your work specifically at Strategic Investment Group. You have the full panoply of global instruments from which to choose on behalf of your clients — TIPS included. How high would the real yield on 30-year TIPS have to go for you to shift a very substantial fraction of assets into that instrument? [The real yield on 30-year TIPS on July 26, 2007, the date of this interview, was about 2.4%.]

Hilda That's a tricky question, but it would have to be at least equal to the long-term bond rate plus the volatility of the expected inflation rate. I'd then leverage that and load up on lots of market neutral strategies and some wonderfully cheating-heart private equity. If I manage the risks properly, I should end up with a higher rate of return than that found in the marketplace because I was opportunistic about extracting a better yield.

Semantic Risk Defined

David When I saw the survey results, I immediately wanted to talk about risk-taking, which of course is a topic that you've written about widely, distilling the lessons you've learned into some very interesting essays. They're interesting to me in part because you discuss at length a form of risk that gets virtually no attention in the literature on investing but is actually acutely important for investors in general and institutional investors in particular. I'm speaking, of course, of what you call **semantic risk**. Could you please define it and discuss the means available to control it?

Hilda Semantic risk is the risk we have to deal with most frequently and the one that leads to a joyful and challenging part of our business: educating clients — and ourselves along the way. In my writings on semantic risk, I focus on three areas in which semantic ambiguity appears most apparently. One is institutional appraisals of hedge funds, which tend to be oversimplified across the board. Second are institutional discussions of risk. Risk is an ambiguous word. Finally, related to risk and equally ambiguous are the concepts of leverage and liquidity. For example, people used to overestimate the need for liquidity, holding lots of fixed income investments in their portfolios when they didn't need to. Then, smart people such as David Swensen said very eloquently that folks were attaching too much value to liquidity. Of course, Yale's returns speak for themselves — he was right. Today, I think many people are not attaching sufficient risks to illiquidity and will face unexpected surprises. In the search for diversification and higher returns, some investors are reducing liquid investments like bonds to unwisely low levels. The general problem is that most people don't understand the risks they're taking because they don't understand the different meanings of risk. They seem to overestimate the risk implied in leveraging, even though there are all kinds of leverages with varying levels of risk.

In Scandinavia, there are eight different words for snow; in Latin America, there are at least five different words for love. Because of this, exact meanings can be understood at a granular level. In the US there's one word for risk, and as a result we need to achieve a more granular understanding of its exact meanings so investors can distinguish carefully between the risks they want to take and those they want to avoid.

David Do you want to share some of the grains with the folks in the room? When you try to discuss semantic risk with your clients, where do you gain the most traction?

Hilda It's important to separate market risk, leveraging risk, peer risk and *process interruptus* risk. *Process interruptus* risk is when something goes horribly wrong in your portfolio and bankrupts your decisionmaking process. We push for intelligent risk-taking, which includes the limits permissible by the market as well as the demands of liquidity and prudence in managing a portfolio. We avoid going past the point of understanding how much risk our clients and their portfolios can tolerate under worst-case scenarios, which is about four or five standard deviations. I think an abhorrence of volatility is something that is hardwired in the human brain — it's genetic.

David But if we're focusing on semantics, you actually don't mean volatility: you mean half of it. You mean semivariance.

Hilda Yes.

David Downside risk. People don't seem to be too concerned about upside volatility.

Hilda Upside volatility is also dangerous because it creates changes in behavior that can be harmful to a portfolio. There are addictive people out there: they'll load up on anything that's going up and never want to give it up.

You must establish a flight path. If you're in an airplane, it would be more comfortable to step out of the plane every time you're about to hit an air pocket. This isn't possible, however. It's the same with a portfolio — there are inevitably air pockets and everyone should understand this and be prepared. The most successful tool we've developed for dealing with turbulence is scenario analysis, which is an illustrative model that allows you to contemplate how bad (or good) things could get.

Peer Risk

David Let's focus on endowed charities that have the simplest possible spending rule, such as five percent of some kind of a moving average. As an outsourced vendor of investment services, why can't you move on behalf of your clients to an almost entirely illiquid portfolio on the assumption that it's going to be very diversified? At any given point in time, if you need liquidity — even if you need it from a hedge fund or private equity vehicle in which you're invested — some of those illiquid investments are going to be doing well enough that at the very worst you can sell them off in the secondary market. Those that are performing well in a crisis because the portfolio's very diversified will over time capture a greater illiquidity premium because you're willing to go where others fear to tread.

Hilda You could do that, except you'd be taking on a huge amount of peer risk. Peer risk is the wolf in the Little Red Riding Hood story, and it can come back to bite you when you least expect it. Peer risk is something you ought to take as long as you've got an enormous amount of goodwill behind you — the amount David Swensen has at Yale. But if he were to experience three years of underperformance in his illiquid investments for whatever reason, even he would likely encounter a problem.

David Isn't what you call peer risk simply a synonym for governance risk? There's an agency problem

— even if your investment policies and strategies are fundamentally sound, if the interim volatility they produce is excessive, it could pose a problem.

Hilda Yes, it could. Every college and university compares itself to its competitors in order to track its progress. They're all fighting to attract the best students, and one of the ways they compete is by having larger endowments than their competitors. University investment committees are willing to take some but not infinite peer risk. Also, although there's an illiquidity premium, you can't leverage or borrow against your private equities, which means you're giving up an opportunity if you invest in them. If there were a liquidity crisis caused by a collapse in the equity and fixed income markets, even if you had laddered all your private investments, distributions would dry up.

Invested for the Long Run

David I want to talk about another topic, which is keeping your institutional clients happy for an extended period of time. When the market goes down, people can be very quick to take their money and run, which is usually bad for everyone. How do you keep your clients on board for the long haul?

Hilda There's no magic answer. The only way to keep people invested long term is by producing good short-term results. You must continually earn the right to invest your clients' capital. I'm going to use a statistical term called the information ratio [excess return, or alpha, divided by tracking error] to explain this idea. While I know nothing about baseball and have never been to a game, I'm sure this ratio is similar to batting average or throwing lots of pitches or hitting home runs frequently… Well, let me quickly say that I seem to recall that I went to half a baseball game about 25 years ago in Detroit. But I was there so briefly that it was like virtual reality: truly weird. What was the question?!

David I asked you to elaborate on the idea that the best way to keep clients over the long term is to deliver good short-term results.

Hilda Right! Well… The current market environment is cruel because all assets are becoming more fairly priced. It's hard to find a good deal. Fair pricing has destroyed many of the levers that added value to portfolios. However, if you know how to pick them, hedge funds and alternative investments allow you to make alpha portable. Five years ago, we started implementing diversified overlay strategies — overlaying diversified alpha sources that we expect to give us four to six percent real returns with relatively low risk.

The Lock Up

David Let's segue from that thought to the broader question that you alluded to earlier of illiquidity because many of the strategies you just talked about are increasingly illiquid. Hedge fund terms are becoming more manager friendly and less client friendly, with longer lock-up periods to say nothing of higher fees. If you look not at marketable or publicly traded investments but rather at privately traded assets, we as institutions access such assets through partnerships that have finite lives that may be 10 or 12 years with some permissible extensions. Why do we let ourselves be participants in a scheme in which there are very high frictional costs to turnover but in which turnover is built into the system? Why is that, and is there a better way?

Hilda It's bad enough to give somebody 10 years if it's a private equity or a private real estate deal. It's bad enough to give a hedge fund manager a two-year lock-up, or in some cases a five-year lock-up. Those lock-ups, by the way, are very manageable as long as you ladder the investments. If you don't want to be locked up for five years, just divide the $100 you were going to invest into five sets of $20, and then you've got laddered liquidity. There are ways of building liquidity into an otherwise broadly diversified portfolio of illiquid investments. As we talked about earlier, I suppose you could put together a venture capital portfolio or a private equity portfolio in which you are always generating some amount of liquidity — that is unless there was a widespread liquidity crisis. But the reason not to lock up is that we like to have the ability to change our minds — sometimes for the wrong

Hilda Ochoa-Brillembourg *continued*

reasons, but hopefully more often for the right ones.

Is Socially Responsible Investing Responsible?

David Let's talk about what others call socially responsible investing but what I prefer to call constrained investing for the obvious reason that what's responsible to one person may not be wholly responsible to others. But however you label it, it's a hot topic these days for a whole bunch of reasons. What are your thoughts on the feasibility and wisdom, from an economic as distinct from an ethical standpoint, of adopting non-economic constraints on an institutional portfolio?

Hilda They are irrational, emotional constraints — not rational ones. For an ethically minded investor, there are more important things to worry about than whether a manager is investing in tobacco or alcohol. It's not wise to invest in such a constrained manner. You can get lucky and end up with a constrained portfolio that's better than it'd otherwise be, but we're **not** in the business of managing assets to count on luck as an investment tool. That's something from which you try to diversify away.

From an economic standpoint, SRI is foolish because you're never going to be able to be pure about it. There are better and more positive ways of dealing with issues of social responsibility, such as letting your unconstrained portfolio produce as high a return for the risk you're willing to take as possible and **then** extracting some portion of that portfolio to support a given cause. A good example was apartheid. Since the US government was involved in South Africa, people wondered if they should stop buying government bonds. The answer was no. If you wanted to bring in democracy and eliminate apartheid in South Africa, you shouldn't have constrained your portfolio. You should have taken some of the money that you made out of the portfolio and given it to the most worthwhile groups effecting positive change in South Africa. That would've been a more productive approach.

David But isn't that precisely the problem? In many of these contexts, that method makes explicit that there is a real cost. If you're going to write out a grant check, you're going to transfer wealth to people in South Africa, essentially admitting your investments were not socially responsible.

Hilda Yes, but it's a more honest and efficient way of doing it.

David In candor, can I ask, have you **ever** seen that argument hold the day?

Hilda No. But I've tried it!

David So have I!

Ethics

David The next question is one suggested by one of my colleagues who said, "Let's ask Hilda if she thinks, based on her wide travels, that there are more lasting blemishes so to speak on people who are caught in ethical problems outside the US than there are on those who're caught in the US, knowing that the US has a rich tradition of giving everyone a second chance?"

Hilda In terms of getting second chances, I don't think you can generalize. Human beings, thank goodness, give other human beings second chances. This happens everywhere. There are some people who are born unethical — they're thieves, and nothing will stop them. I don't know what percentage of the population is born a thief, but it's a small percentage. I've done lots of thinking about corruption in emerging markets, particularly in Latin America where it's so prevalent. Are human beings there inherently more corrupt than in America? No. Human beings are human beings. We're more similar to one another than different. What brings out malfeasance and corporate immorality in some countries is cyclicality and the discount rate or risk premium people apply to morality. We saw most of the corporate immorality and malfeasance in this country during the very volatile period of '97, '98 and '99 because the discount rate to being honest got so high that people stopped being ethical and started being opportunistic. In developing countries, it's a bit different. There is so much volatility in the economic cycles of these countries that people know they're going to be exposed to erratic government policy. You

HILDA OCHOA-BRILLEMBOURG *concluded*

believe less in rational conduct and more in whatever you can control over the next 60 days. If this means bribing a government official, you pay to do it. I don't engage in bribery — that's why I left Venezuela. But it's not that human beings are different there, it's that the volatility is so high that it induces corrupt behavior.

Witchcraft

David What's the greatest display of grace under pressure that you've witnessed?

Hilda When I heard this question, I thought about famous leaders such as Nelson Mandela, Bill Clinton and Ronald Reagan. All these people caught fire from the media at one point or another, and I thought about how they handled it more gracefully than others. But I thought I should come up with an answer rooted in an unexpected source.

I've worked all my life, since I was in college. I was very young when I had my first child — he's 38 now. I had a nanny, and the nanny was a witch. A real witch! One day I went to her room and there were all kinds of things in there, like feathers …

David This **is** an unexpected answer.

Hilda I was young and inexperienced, and I didn't know if this was good, bad or neither in terms of bringing up a child. But she was there, she was helpful and she seemed to be responsible with my young one. In any case, one day I went to buy shoes for my son, and I bought the wrong size. I was in a hurry because I had to go to work, and I had to go and exchange the shoes on my way. I searched the house for the shoes, and when I finally found them they had no laces! I found the witch and asked her, "Hortencia, where are the shoelaces?" She told me she didn't know. Now, a little kid couldn't have removed them, and sure enough a minute later I found the laces in the witch's "witch altar"! I figured she stole them and was planning to hang a little doll with them! Then, the witch comes up from behind me and says, "Well, what's the problem?" I said, "The problem is that I have to run to the shoe store and exchange the shoes." Again, she said, "What's the problem?" I said, "They're not going to exchange them without the shoelaces!" Then, the witch said, "No problem," and told me to put them in a box, take them to the shoe store and ask for them to be exchanged. Then, she said when they bring the new shoes, I should remove the shoelaces from the new shoes, put them on the old ones and be done. Good thinking. And it worked! You should've seen the face of the saleswoman when I opened my box, exchanged the shoelaces and said, "Here are the shoes!" That is one of the most brilliant solutions to a problem I have ever seen in my life. I kept the nanny despite the fact she was a witch because I concluded she was a genius. Now, every time I run into a situation where someone has lost shoelaces, I say, "No problem."

David Wow. I have just one question: how big a hedge fund is your former nanny-witch running?

Hilda If you're talking about thievery, you know, she tried! She suggested to a friend that they steal my son and demand ransom!

David Incredible. Thanks, Hilda, for joining us.

Hilda You mean you're not going to ask me about what I would do?

David Do?

Hilda No, no, no. You have to ask me. You have to ask me that question you often ask about secret feats — you know: what's the one thing I'd most want to do assuming no one would know about it.

David Of course. Fire away.

Hilda I can pick anything I want, right?

David Yes, anything …

Hilda George Clooney. A platonic night with George Clooney. [*Audience erupts.*]

David We'll edit that out. Thanks, Hilda.

Hilda My pleasure.

TOM STEYER

Tom Steyer is a managing partner and the Chief Investment Officer at Farallon Capital Management. Excerpted below is an interview of Mr. Steyer by TEF president David Salem centering on the recent phenomenon of alternative managers going public as well as various topics relating to the current corporate and subprime credit crunches. Mr. Steyer's bio appears at www.tiff.org/TEF/seminars.

Firing on the Fox Hole

David I'm delighted to welcome to this stage somebody I've known for a long time. Just a few minutes ago, I asked Tom, "So, which of those long, prolix questions that we've prepared for you would you like to start with?" And he said, "Let's just talk about all this going public stuff." So, fire away!

Tom In the last six months there's been lots of attention drawn to alternative managers going public. As one good friend of mine said, "Going public is like calling fire down on your own fox hole." It's been a terrible mistake strategically, as it draws attention to things that managers are doing that they probably shouldn't be doing. Also, in order to make these public offerings, managers had to extrapolate lines and to assume future behavior and opportunities that now seem certain not to occur during the next 12 months and unlikely to occur even after that. There's no question that by going public, alternative managers have made themselves the faces of selfish capitalism. As an investor, I'd look at how this affects firm culture, behavior and risk and return.

David Are you implying that there are dishonest or unethical things going on? Are managers doing things internally that aren't known to outside clients — things that if clients knew about them would cause the clients to withdraw their money?

Tom No, I'm not saying that. Let me be more specific. Going public is a financial transaction that has financial effects — and it may or may not have some operational effects because you're changing to whom the firm is responsible. You're changing who owns the firm, and you're changing the dynamics of the relationships among people who work there. The financial deal generally has to do with generational transfer, which for the most part centers on senior members of the firm trying to sell something they've created over a period of time. I don't consider that unethical. They've created something. Whether they've created as much as they claim, I don't know — but it's reasonable for them to seek a sale.

The operational effects of going public impact primarily less senior people, those who have been at the firm for a shorter time but who certainly are responsible for its present and future success. I've always said that the traditional Wall Street model for relationships between junior and senior people is that senior people do less work. They rob junior people for as long as they can. Junior people hate senior people, so as soon as they can they fire them; then, they turn around and rob the new junior people! That's been going on for as long as I can remember. When I started in 1979, I was working 100-hour weeks. There was a very nice gentleman who was probably 60 years old and a great sailor. He probably was making 100 times more than I was. He'd stop in once a week to see how it was going, and I'd think, "Wow, how did he get into that position and how does he think I could possibly want to talk to him?!" But that's the traditional Wall Street model. To an extent, going public both ingrains that model and takes away upside from junior people. It perpetuates a hierarchical model.

Stone Age Simplicity

David When we first met each other a long time ago, Farallon's asset base was much smaller than it is today. This is all by way of compliment to you, and I want to focus on the issue to which you just alluded: culture. Beyond just offering folks large or potentially large incomes, what are the cultural means you've employed to expand the asset base while also giving yourself a fighting chance — and it's obvious you've delivered! — of achieving investment excellence?

Tom People in this room have heard me say the following, so if I'm boring, at least I'm consistent. We try to be honest with ourselves about how much opportunity we have. We're trying to make 15 percent over the risk-free rate, and we keep this goal in mind when looking at opportunities. When we're all sitting around a table discussing

TOM STEYER *continued*

investment opportunities and my colleagues are saying, "we can't achieve that," then we hold cash and don't take money. I believe our people are honest in these conversations.

I always say we have the sophistication of a Stone Age company. It's pretty simple. If we see real opportunities, we want to fund them. Having said that, the question of size is threefold. One, do you have the intellectual horsepower to make the decisions to invest the amount of money you have? Two, are you organized in a way so you not only have the intellectual horsepower but also the decisionmaking ability? We've seen organizations fail when they have only one main decisionmaker — this is a model that has human limits. And three, is size going to change the risk/reward of your whole investment endeavor? An example of this was in the late 1990s when venture funds raised multiples of what their previous funds comprised. As a result, the whole industry grew enormously and risk/reward changed. If funds grow so much that risk/reward changes significantly, they've gotten too big. So, the real question we're asking is, "Do we have the human capability to deploy the capital we control, and are there markets offering us opportunities to make the returns we're seeking?"

Sailing and Structuring for Success

David This leads to a question about getting structured for success. If you were starting Farallon all over again, in what ways, if any, would you structure it differently?

Tom The thing that most differentiates us from comparable firms is that every year we try to divvy up whatever money we've made based on performance. If David and I were partners and his investments had made 100 percent of our fund's return and my investments had made zero, he'd get 100 percent of the income. Even if we'd been partners for 20 years and I'd had some success over those 20 years, we'd still do that. That's the way I set up Farallon originally, partially because when I was working as a junior analyst and associate on Wall Street, I thought, "Could we please allocate the money to the people who actually make it versus the people who **allocate** it?" Of course, I now realize that was misguided!

David You enjoy sailing, do you?

Tom I'm kidding. We have a very flat organizational structure at Farallon, mostly because we hire people we view as peers. We bring our new hires along quickly, offering them lots of responsibility while challenging their points of view. It's easy for anyone to have an impact, and that's important given the way the money is distributed. Our system allows everyone to have a shot at doing well if they do good work. We're now organized in operating groups, and the heads of those groups have discretion over how money gets allocated. Almost everybody who is in charge of one of those groups is a nicer person than I am and tends to mitigate this Darwinian approach, so the compensation structure is not quite as ruthless as I make it sound. So, that's the precursor to actually **answering** your question about how I'd structure Farallon differently.

I might do two things differently. First, I might take some part of the profits, 10 percent to 15 percent, and distribute it based on the previous 20 years of performance. Allocating a small portion of the money based on past performance is fair in my opinion — I tend to believe that what we're trying to do is allocate money fairly according to the work that's been done. Of course, some of Farallon's current returns are a result of the work that's been done over the past 20 years, and some are a result of the work that's been done in the past year. We try to reflect both of these views in how people get paid.

The other thing that I'd change, which would be hard to do at this point, would be to put part of the ownership — or the carry — into a foundation. Steve Mandel did this when he set up Lone Pine. Although some senior people at Farallon give away some of their income, not everybody does. It would've been really good if we'd set it up so that doing so was baked in the cake for everyone. Of course, in 1986 when I started Farallon, we weren't talking about big money, and we certainly weren't talking about giving away what little we had at the time.

TOM STEYER *continued*

Beware Stampeding Elephants

David One of the big state pension funds in your home state of California recently announced that it plans to expand its real estate portfolio from 11 percent of the fund to 30 percent over four years. Since the asset base is $170 billion, CalSTRS alone is going to shift $35 billion into real estate between now and the end of the decade. Beyond telling your own real estate team at Farallon to get ready to do some serious selling, what do you think about that move? Is it a classic sign of a market top?

Tom I don't look at real estate as one market; I look at it segment by segment. While some people still feel pretty good about commercial rent increases in certain cities, renting to retailers is and will continue to be a difficult business. Then, you've got the home building business, which looks absolutely horrible through the end of 2008. There's no question that the home ownership market in the US is under siege. I assume CalSTRS will try to take advantage of what's going to be some significant real estate pain, and if it's going to be buying it will be from distressed or washed-out sellers. One of the questions people have been asking is whether the publicly acknowledged subprime disaster will spread to the rest of the mortgage market. Maybe that was a question last spring, but it's not a question anymore. It certainly has. Now, the question is how long it's going to take and how bad it's going to be.

You can't say real estate is begging for $35 billion right now. In general, it's very levered with very good financing — meaning small spreads to the curve. People are using cap rates that I've never seen before, and putting money into this asset class for those kinds of returns is difficult to understand. But on the other hand, $35 billion ain't that much in the context of the US real estate market. It's not going to move the market.

Debits and Credits

David Let's talk about risks and returns more broadly. You can go in whatever direction you want.

Tom There's obviously a real rollback in credit availability in both the US and Europe. Corporate credit has really turned on a dime in the last month. We like to use spreads to the curve on the single B as our measure for the cost of corporate debt. In Europe, the single B was 190 basis points over the curve a month ago, and this morning it was about 419 basis points over. That's a one-month move, and it's a **big** move. In the US, the single B has probably gone from 245 to over 400 in the last month. Now, 190 and 245 are unbelievably tight. Credit has been very good for a long time, so people just kept ratcheting it tighter.

Additionally, managers were leveraging the credits themselves so that there was a huge collateralized loan obligation (CLO) market that was enabling people to get decent returns based on highly leveraged, structured investment processes. Now, the CLO business is at a complete standstill. Some CLOs are being liquidated, which is causing the less-than-single B market — the risky part of leveraged buyout (LBO) financing — to be liquidated while at the same time there's a $300 million overhang in money committed to LBOs. This is **not** good.

Watching this process move through the system, which probably will take several months, is going to be really painful. As I said, spreads to the curve have already blown out, but I'd say they've blown out to what we think is somewhere in the context of fair. However, they can easily blow out to lots more than fair. In 2002, which was the last true corporate credit crunch in the US, the spread was 1,200 basis points over the curve, just to put this current situation in context. So spreads have blown out — but not to outrageous levels in an historical context. Twelve hundred basis points was ridiculous but it didn't last very long. That's getting 17 percent on corporate debt! I mean, either the debt isn't good or it doesn't stay at 17 percent. Those are the two options. But right now, because the funding mechanism has broken down, people really don't know how to price things, and banks are long an enormous amount of paper through guarantees they've made to underwrite deals at prices that don't work any more. Banks can't sell that debt without taking big losses, so they've stopped new underwritings, regardless of whether the deals are good, bad or somewhere in between.

TOM STEYER *continued*

Reaching for Returns

David Do I need to plunk another coin into the jukebox?

Tom That would help. But I've given you nothing but bad news. Come on, give me an easy one!

David I want to return to something you said earlier, about Farallon's goal of generating 15 percent over LIBOR. Shouldn't this goal vary over time? The history of capital markets suggests that the cost of capital, and hence the return on capital, varies over time. As you're trying to attract and retain younger people who've studied this stuff in an academic setting, what do you say when you hear someone ask, "Gee, Tom, doesn't it vary over time, and why doesn't your hurdle rate change from one market environment to the next?"

Tom The real question that I think you're asking — or the question that I'd like to answer! — is, "Are you stretching on risk to make your hurdle rate?" If I could buy US treasuries at 15 percent over LIBOR, that's one thing. If I have to go buy a Ukrainian IPO at five times book because it'll be a good deal in 2012, that's another thing. We've never really gotten very far out on the risk curve in terms of leverage, but what we have done is gotten less structured in what we own. We've made longer duration investments over the last eight or nine years, and they're going to have more volatility.

Do I think we should change our discount rate for different risks and different investments? We already do. If you say that you want to put on that Ukrainian IPO for 15 percent over LIBOR, we're going to show you the door. So it's more a question like, "Within the context of the overall return target, are you using fair return expectations for the risks of the specific investments you're making?" If what you're really doing is forcing your hurdle rate onto every investment in the world, you're never going to make a safe investment and you're presumably going to start accepting returns far too low for stuff that's really risky.

Getting Personal

David Let's do a couple of personal questions before we wrap up. My favorite one is, "What's the most memorably impressive display of grace under pressure that you've witnessed in real time, either in person or on TV?"

Tom I didn't really hear Hilda's answer. I just heard it had to do with a shoe saleswoman and was very funny! I don't have a funny story, but my favorite display of grace under pressure is when Joan Benoit Samuelson won the 1984 US Olympic trials in the marathon. She was heavily favored to win, which she did, leading from start to finish. While her race was impressive, what really struck me was her interview afterward, during which she was wearing a helicopter beanie. She had just completed something that was very difficult, that hurt a lot, and she was making fun of herself during her big moment. I've seen lots of people achieve something under pressure and do a great job, but I really admired the remarkable humility that she displayed. Staying humble while reaching the pinnacle of your career is a very difficult feat, especially since it happens so rarely.

David Most successful people will freely admit that they've had mentors on their way up, particularly if they're gracious …

Tom I've had none. Sorry for interrupting … what was your question?

David Since you are both successful **and** gracious, which person, dead or alive, has been the mentor to whom you're most grateful?

Tom From a business standpoint, there's no question that the person who has made the biggest impact on my career is Bob Rubin. He hired me at Goldman Sachs, and we worked together in a small group. He was nice to me, gave me lots of responsibility and continues to help me in lots of ways, both personally and professionally. He's the best boss I've ever had because he's extremely clear and he's extremely fair. He lays out at the beginning what it is you're trying

TOM STEYER *concluded*

to do, he doesn't blame you if you go through everything well but the end results come out poorly — he understands that's possible — and he's very objective and supportive as long as you play by the rules. He's not only the best boss that I've had but the best boss I could imagine and someone who has continued to be a good friend, even though it's been 22 years since I've worked for him. Although he sometimes forgets that it's been that long!

The person I think of as a mentor — the person who both led me someplace good and gave me an example of how to get there — is my mother. She's clear, honest and someone who leads by example.

David How 'bout the feat that you'd most like to accomplish even though you wouldn't receive any public credit for doing it?

Tom I have four kids, and if I could help them achieve happiness, that would be my supreme joy and no one would ever have to know.

Second Chances

David You just alluded to playing by the rules, so here's my final question. The best-known player on your hometown ball club, the Giants, is surely nearing the end of his controversial career. My question is this: if Barry Bonds came to you looking for work after he hangs up his cleats, would you give him a job?

Tom On one level, the answer is obvious. I think anybody who is on a jury would conclude that he has been breaking the rules of baseball consistently for a long period of time. Even though he's a talented athlete, he gave himself an advantage that was, at least for part of the time, against the rules. I'm not sure it was against the rules when he started doing it, but it has clearly been against the rules for a long time, and he knew that. Obviously, we wouldn't hire someone who behaves like that. I will say this, however: I believe in personal redemption, and I believe that if Barry came clean and said, "I've made a mistake, I want to remake my life and I want help doing it," people would want to help. I don't know that we at Farallon would choose him as the person we'd help, but I certainly would hope that we'd be willing to help someone like that who was seeking personal redemption. I don't think he's going to apologize; he has shown no sign of doing it. But if he did, I'd hope that there would be people who would say, "If you're sincere, we'll try to help you." I wouldn't be ashamed if I were one of those people.

David I'll close with a baseball quote, because we've had one for each of our interviewees. The one that comes to mind for you, which is intended as a sincere compliment, is my all-time favorite baseball quote, which means many of you have heard it before. Tim McCarver, now a well-known broadcaster, said that, "Bob Gibson is the luckiest pitcher I've ever seen. He always pitches on days when the other team gets no hits." You've worked very hard for many years to achieve an outstanding reputation, and we're grateful you made the trip east to be with us. Thanks.

Tom My pleasure.

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TIFF Education Foundation
Endowment Management Seminar 2008

In furtherance of its mission of promoting the dissemination and adoption of best practices in endowment management, TIFF Education Foundation (TEF) will conduct the next edition of its popular seminar series on Tuesday, July 22, 2008, in Cambridge, Massachusetts. Like prior editions, the fruits of which are posted in both PDF and podcast form at www.tiff.org/TEF, our July 2008 seminar will comprise five 45-minute interviews of notably successful institutional investors conducted by TEF's founding president, David Salem. The seminar is open to trustees and officers of endowed charities plus their designated representatives, with participation subject to TEF's discretion.

Confirmed Interviewees

Seth Klarman
President
The Baupost Group

Jon Moulton
Founder and Managing Director
Alchemy Partners

Stu Porter
Managing Partner
Denham Capital Management

Arshad Zakaria
President and CEO
New Vernon Capital

Fifth interviewee to be announced soon.

Event Details

Date:	Tuesday, July 22, 2008
Time:	8:00 a.m. to 3:00 p.m. breakfast and lunch included
Place:	The Charles Hotel One Bennett Street Cambridge, MA 02138 800-882-1818
Cost:	Free excludes participants' out-of-pocket expenses

How to Register

If you are interested in receiving registration particulars when they become available, please email TIFF staff at tiffevents@tiff.org. Please continue to visit www.tiff.org/TEF for seminar developments.

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West Conshohocken, PA 19428

Phone: 610-684-8000
Fax: 610-684-8210
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