



# COMMENTARY

A Report of TIFF EDUCATION FOUNDATION

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## HIGHLIGHTS

On October 1, 2009, the TIFF Education Foundation (TEF) hosted in Cambridge, Massachusetts, the most recent edition of its highly idiosyncratic Endowment Management Seminar series. Modeled loosely after the broadcast series *Inside the Actors Studio*, the October event mimicked its predecessors in that it presented interviews with five highly respected institutional investors. This *Commentary* comprises excerpted transcripts of three such interviews, all conducted by TIFF President David Salem:

**Ian Wace**, co-founder of London-based Marshall Wace Asset Management, recounted the origins and ongoing challenges of efforts he's led to revolutionize interactions between the "buy" and "sell" sides of public equity markets;

**Jeremy Hosking**, co-founder of London-based Marathon Asset Management, discussed opportunities and perils in the marketable stock arena, with a focus on the evolving impact (if not insanity) of "mark-to-market" accounting; and

**Antoine van Agtmael**, chief investment officer of Virginia-based Emerging Markets Management, shared lessons learned from his 25+ years investing in an asset class whose name he helped coin (emerging markets) – and one whose perceived risks tend more often than not to differ sharply from actual risks.

## 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), a regulated mutual fund family; and TIFF Advisory Services (TAS), a taxable non-stock corporation and regulated investment advisor to TIP that administers as well many other investment vehicles bearing the TIFF name.

**Inquiries.** For more information, please call TIFF at 610-684-8000 or visit [www.tiff.org/TEF](http://www.tiff.org/TEF).

## IAN WACE

**David.** Good morning. I'm David Salem, ringmaster for today. If you want to know more about my background or that of anyone who's going to appear on the stage today, you'll find it in the program. I'll caution you, however, that everything that's written about me in the program is false. I didn't do any of those things before joining TIFF. Actually, I was in the Red Sox farm system trying to make my way to Fenway as a player rather than a fan, and failed miserably at that. But I did succeed in getting two of my colleagues to help me with the interviews today: Stephen Vicinelli, who's based here in Cambridge and will do our session with Mike Eisenson; and Chris Douvos, who's in our Palo Alto office and will interview Josh Kopelman.<sup>1</sup>

Before asking Ian Wace to join me on the stage, I want to address briefly a question that I know is on some of your minds, namely why we're not focusing explicitly any of today's sessions to the big-picture investment policy issues that have been raised by the meltdown in asset prices over the last 24 months or so. My answer to this question is two-fold. First the investment policies that have produced so many problems of late for so many endowed charities were, and in my view remain, fundamentally sound when viewed in isolation. But they were woefully unsound when coupled with budget trajectories that paid insufficient heed to the inescapable lumpiness of returns on even the best-managed institutional portfolios. We're going to come back to this point later in the day when I summarize for you the results of the survey that we asked all of you to complete when you registered for the program.<sup>2</sup> Second, to the extent that the losses to which I'm alluding were rooted in factors having little to do with investment policies *per se* but rather in flawed incentives, botched implementation, or execution of otherwise sound strategies and tactics — and lest I let politicians or regulators off the hook, rooted too in arbitrary and capricious regulation — we're going to be discussing precisely these topics throughout the day.

On that note, I'd like to welcome Ian Wace to the stage. We invited Ian for multiple reasons, including

the path breaking work he's done in designing a new paradigm for interactions between the so-called buy side, as institutional money managers broadly define it, and the sell side. What I'd like to do for the first part of our conversation, Ian, is have you talk about the ways in which the sell side historically has tried to transfer wealth from other people into its own pockets.

**Ian.** David and I have discussed this issue for about nine years, and during the course of this discussion, we've agreed on certain things and disagreed on others. But we're still friends, and that's the interesting part. The reality is that I spent 14 years on the sell side, and I had a pretty intimate understanding of whether or not it added value. If you spoke to the buy side, the general feeling was the sell side didn't add value. Yet you had no mechanism for quantifying, from either side, what that value transfer actually was. That is still the case today, which I find extraordinary. Here we are in 2009. There are very few people in the brokerage community trying to work out the value of their output, or within the client community, trying to work out the value of the sell side's input. Therein lies an enormous arbitrage. Given the fact that the brokerage industry spends something like \$25 billion a year trying to produce output, you would have thought it would try to quantify the value of its research. But it doesn't. We're one of the few buy side firms that actively tries to work it out and inform the sell side community. So in asking the question, you're assuming the method of transmission has changed. It hasn't, not really. Of course it has gone from a pigeon to a phone to a fax to the Internet, but the reality is that it is still totally and utterly random as to how you communicate with the Street, how deep are you going to the Street, who are you going to on the Street, why are you going to the Street, and what you get from the Street. As I say, \$25 billion a year in the cost of this information, \$48 billion a year in commissions. The real failing is not with clients, it's with sell-side firms that produce this information, because they don't know the value of their output and therefore can't price it rationally. So the methods of distributing street research are the same as they've always been: random, inefficient, and ineffective. The distribution channels are the same. Technology totally and utterly enables change, yet technology is not utilized fully in funds management.

<sup>1</sup> Transcripts of these two interviews will appear in a future *Commentary*.

<sup>2</sup> Please see the back cover for survey questions and results.

**David.** Tell us about the paradigm you've adopted. We'll call it TOPS, although everyone in the room, including you, is aware we're not permitted to market money management services here.

**Ian.** TOPS got started when I tried to measure the value of Street research, work out its persistence and compare the results to what I was producing as a fund manager. I had been relatively successful as a manager, with a success ratio of 55%. I produced about \$700 million worth of P&L for my clients and was feeling pretty good about it. The problem was, when I measured the sell side and looked at its success ratio, mine was 55% and theirs was 70%. My alpha was 9%, theirs was 15%. The other thing that was interesting is this: I was looking at about 100 stocks; the street as a whole was looking at 2,200. And I was interfacing with 10 people. By the time I carried this methodology, I was interacting with 3,000 people in 800 securities companies in 64 countries by interfacing with them electronically and asking them to please tell me their best idea or their best group of ideas, but conditioning these individuals by saying, "I'm going to give you a fantasy football world. I'm going to let you take whatever risk you want, but I will measure you on everything you do, electronically, with the aim of telling you what your persistence is, what your skill factor is, and what your return profile is. And, by the way, I'll give your boss this information!"

Now, the way to do this is to condition individuals saying to them that you are probably going to be better if you have just five or 10 ideas at any one time. If you want to have an 11th idea, get rid of one. You're probably going to be better if you don't set some directional bias, and you're probably going to do better if the ideas reflect your fundamental alpha or edge. Presto! By conditioning these individuals, you've made their life relatively simple. By making their life relatively simple, they become relatively good. When they become relatively good, they become relatively profitable, at which point you can monetize their work. That is the genesis of an electronic application called TOPS, and that is the genesis of something called alpha capture, which we were the first in, but now there are other people operating in this space. Technology enables it.

**David.** Before we explore the legal barriers you ran into, take a minute to describe the old paradigm employed when somebody who's now participating in TOPS got an idea — how they would communicate it to you and how it works today.

**Ian.** Historically, the delivery of sell-side insights was verbal and random, because there was no mechanism for them to efficiently transmit them, and there was no mechanism for you to efficiently receive them. I think everyone knows how ideas are distributed to the Street, right? So, I don't really want to go there. But let's try to look at how you can do this using electronic means. It is fairly clear that if you're going to promulgate an idea, what you've got to try to do is deconstruct effectively what happens in the typical sell-side research phone conversation. I don't care about whether I had dinner with them, I don't care about a hockey game, and I don't care about their wife or husband. If you deconstruct such sales calls, about 60% has zero added value! You can do well without all of that. The electronic telephone call if you will is far briefer and concentrated on relevant information, which is how you can make money: buy or sell a security, price target, rationale, plus some kind of liquidity adjustment. Rationales are important because you can apply word searches on them to come up with something substantive and value added. Liquidity adjustments reflect the fact that we don't like illiquid investments.

So the doorway into the fantasy football world is to deconstruct research-oriented telephone calls. This information goes into a vast database that looks like a sack full of ideas. You don't yet know if they're good or bad. But be careful, because 70% of these ideas tend to be good, assuming careful analysis. And in our case it's a sack of over four million ideas, so it's not a small random sample. The Street, when it gives you an idea in a conditioned way, is right 70% of the time. And we're talking about 3,000 contributors, 800 securities companies, 64 countries, 4 million data points. That's pretty powerful.

The next part is optimization. You have the repository. You can sift it, however you want, because you've got high-quality data. We've committed a lot of resources to understanding how to optimize databases. It's not a black box, *per se*, but of course it employs black box methods, because you have to sift through vast

quantities of information to get what you want. If you want a market-neutral portfolio, find that. If you want some persistence of alpha or beta, find that. If you want something with duration X, find that.

**David.** So as we keep in mind the overriding point — that there's value added potentially to be extracted by the buy side from the sell side — let's talk about the legal barriers you've run into. A lot of people came out of the woodwork to oppose this system, particularly as you spread it around the planet.

**Ian.** What you're trying to do is deconstruct research that already exists. And you're doing it in a better fashion than the recorded telephone call, because with voice recording, you can never retrieve information properly. You try finding that call in 2006 on the 17th of January at 4:33 with X component. You will not find it. It's a serious problem to retrieve that kind of information. The great beauty about TOPS and similar alpha capture applications is that they compare a full data record: when the idea came in, why it came in, and what it was actually saying. And all of these bits of information are available by return path to the contributor, the contributor's management, and most importantly, the contributor's compliance department. Therefore, if you electronically record research ideas at the point they exit a research house your counterpart there can't tell you anything they shouldn't be telling you. And if you create a return path into a controlled environment, you make sure you couldn't have done anything with the information that you shouldn't have done. Doing this makes everyone more compliant. The problem was that people didn't like all of this because it represented new and disruptive technology. We took a manual environment where people were happy in the ways they operated, and changed it. And when we changed it, there was an outburst of criticism. The most damaging was an article that was utterly wrong in *The Wall Street Journal*. It took me two years to overcome a half-page story by someone who didn't know what on earth they were talking about and hadn't even investigated the issue. We went through this with the FSA formally and the SEC informally to increase their knowledge, and while the SEC didn't ultimately opine, the FSA did and said that this represented good market practice. They will never tell you that it represents best market practice

because obviously if you say best market practice then the whole market has to adopt best market practice. I didn't want them to say best because then I was going to lose my competitive edge, which was hard won and which persists today, six years after we first implemented the application. That's what I find so extraordinary; the market remains wide open. There's a sort of not-invented-here mindset that I find extraordinary. So from a legal perspective, there were issues because we had to explain why it was important to log all information. People don't like to log **all** information. If you log it, you attract compliance concerns, because people know they can be caught. The reason you have police is not to stop crimes that actually unfold, it's to prevent crimes from being committed, and obviously to solve crimes that have happened. But the deterrent factor is far greater than the post-crime investigative factor. That is the beauty of an electronic application; you self-police. That is what we had to win in terms of a legal argument. It was expensive, but it happened and...we won.

**David.** But it's not merely the not-invented-here syndrome that's caused the slow adoption of this around the world. It's also presumably fear on the sell side — that they're going to be measured and that their value added is going to be proven to be negative.

**Ian.** Correct. If you've spent \$25 billion you'd better bloody be sure your output is worth it. If you as a contributor spend \$1 million in Argentina and your alpha is greater than the whole of Morgan Stanley, Morgan Stanley has a serious problem. In an electronic world, the information consumption will migrate based on the quality of information, irrespective of the cost of producing it. Just because it's expensive doesn't mean that it's good, and just because it's cheap does not mean that it's bad, which is ironic when neither adjective captures sensibly the economic value of information or indeed why information is valuable. Is it valuable because of the distribution chain, or because of market share, or because of other external factors that you can't quantify? I don't believe that paying out lots of commission dollars is a bad thing, by the way. Because we're one of the largest commission allocators on the Street, we're in a position to force the industry to change its mindset. It's been easier

in Asia and Europe than it's been in the US. But the intellectual challenge has been won, and since the big research houses are global, they recognize the value of supporting alpha capture globally. So globalization was one of the things that has slowed down implementation, but the real obstacles have been self-interest and prejudice.

**David.** Let me ask you to comment briefly on the so-called huddles that Goldman Sachs has been conducting that we read about a few weeks ago in *The Wall Street Journal*. You might explain what they are and then give us your take on them.

**Ian.** Well, a huddle is when clients get preferential treatment in receiving certain pieces of information. Now, the principle of transmitting valuable information to a select group of people who can reward you handsomely for it is not necessarily wrong; it's the verbalization of a practice that has been followed on the Street forever and a day. What's ironic is that Goldman Sachs is the firm that's actually attempting to do it. Now, does anybody in the room work at Goldman Sachs? There's one very low hand over there. Didn't quite even get above shoulder height! Actually, if you measure the output of Goldman Sachs, it is one of the worst of all of the bulge bracket securities companies, by an enormous factor, which is not quite what you would have expected. People have had this fascination with Goldman Sachs because it is very profitable. But let's distinguish where Goldman actually makes money: its profitability is proportional to its trading success. It makes an awful lot of money in spreads and capital positioning rather than quality of ideas. If you look at the quality of Goldman's ideas as distributed through its sales force, which may or may not be an effective mouthpiece for its research department — which in Goldman Sachs is really not very good, in my opinion — the return profile is deeply uninteresting. Now, if you look at the return on capital of Goldman Sachs, 25% or 35%, on a minimum of 10 times leverage, that's only a 3.5% return on an unleveraged basis, which you know is not very impressive. But we see 35% and we think: Goldman Sachs, very profitable, great, let's follow them. Then you look at Credit Suisse as another example, as a major securities house. Goldman Sachs's ideas, and I'll go back about a year, were up about 10%, which was negative alpha. Credit

Suisse, on broadly twice as many ideas as Goldman Sachs, was up 55%.

Now, Goldman Sachs had a 35% return on capital, but its stock picks were up just 10%. Credit Suisse had a return on capital of 15%, yet its picks were up 55%. So it tells you that Credit Suisse was incapable of exploiting its own ideas effectively whereas Goldman Sachs was extremely clever at doing just that!

**David.** If we'd had this conversation a year ago, and I'd been tempted by your comments about Goldman Sachs to race out and short its stock, I would have been legally prohibited from doing so because short selling financial stocks was banned. But of course GE was on the list, so the ban went well beyond the financial sector.

**Ian.** But GE was a financial company in terms of profits and losses.

**David.** Right. Turning to a question I asked you to think about on the plane last night: if Her Majesty came to you and said, "Ian, you have to give up hedge fund management, but I'm going to transfer to you the accumulated wealth of J.K. Rowling in exchange for your pledge to be a lifelong securities regulator in the UK," what long term restrictions if any would you put in place on short selling that you would deem conducive to the health of democratic capitalism?

**Ian.** Last night you also offered me a knighthood.

**David.** True. But our lawyers made me rescind that offer.

**Ian.** Typical! First of all, I'm not interested in the accumulated wealth of J.K. Rowling. The question is, was it right to implement a short sale ban at the time? It's difficult to know what rules worked or didn't work — nobody likes it when rules change. In that moment of inflection, where the world broke down, it was hard to know which rule changes were justified and which weren't. There was no evidence to suggest that prices were driven by short sellers. But it's clear that money managers decided they didn't want to be invested in financials.

By far the largest outflows were generated by long-only managers. They were getting out because they didn't want financial stocks in their portfolios for obvious reasons.

In a world of complete transparency, these things are disclosed in real-time. You disclose your position of 5% in Citibank or whatever it is. But the rules were not the same for shorts. Politically, it's not great if you're saying that you're making money out of your short positions while someone else is suffering pain on the other side with their long positions, especially where the owner is a pension fund that is doing diabolically badly over a long period of time. So politically, you can quite understand why short selling of financials got banned. What I found interesting is that regulators maintained the ban for a long period of time, especially in the UK. They didn't even have a review mechanism for ending the ban. That's very knee-jerk. By the way, the regulator is deemed to have done such a bad job that they're likely to not even exist as a regulator next year when the UK government changes.

The short selling ban hurt our funds a lot, because it was clear that financials were a sector where you could protect your portfolio. I found it somewhat ironic that a hedge fund holder was not allowed to protect his portfolio where a long fund holder was allowed to sell his position. Remember that a hedge to a long position is a short position, and a hedge to a short position is a long position. But the rules changed and caused the most extraordinary short squeeze in history. The regulators rigged the market. The focus on shorts is like the focus on compensation. The amount of political pressure that's being exerted on that issue is deeply disproportionate to its importance in corporate governance. There should be some degree of proportionality.

**David.** There's still a lot of conversation in developed countries, and all around the world, about an appropriate regime for short sales. What would be sensible moving forward — in addition to more stability in the rules so they're not constantly changing?

**Ian.** The world is becoming more trading oriented. So you'd better make sure you have the technology to constantly recognize whether you're

going from short to long to neutral to whatever. That's a necessary prerequisite. The uptick rule is actually a good one. I could never understand why it was abandoned. It enables you to have positive momentum as opposed to negative momentum. But then I don't understand — and this is obviously the reason it was removed — why if you are long a security you can just keep going down that path. But if you want to short, which is, after all, an insurance policy for a hedge fund, why you don't have the freedom to do that. But I do think the uptick rule makes a great deal of sense in most environments. We don't have it in Europe, yet.

Naked short selling, by the way, is a total irrelevance, because it's just a matter of timing. It probably occurs in very illiquid stocks, but the reality is if you can find the security, it's just a question of price. For instance, when Citigroup broke down, the cost to borrow that stock was up to 90% per year. That's a pretty good trade, just to be lending that security to pick up 90% and still have the economic call option in the security as a long holder. But it's up to the person who's shorting that stock whether they're prepared to pay the 90% coupon. So a rule that says you can't sell something naked is a bit ridiculous, because in the settlement process you've still got to deliver it. If you can't, you're going to be bought in anyway. The market that needed some clarity was the CDS market. It was the real disaster area.

**David.** I'd like to pose a few personal questions. The first is as follows: if you were granted one professional do-over — the chance to modify a major business or career decision that you've made that didn't go the way the way you'd hoped — what would it be and why?

**Ian.** I know you want me to say that my life is full of regrets and I turned left when I should have turned right, but the reality is if you're not really content with what you're doing, something's wrong. Sitting here next-door to Harvard, I'm struck by the fact that I have no academic qualifications, which is marginally intimidating with the brains in this room. Assuming I was given a bigger brain, I could have pursued an academic career, I guess. But since I was given the brain I was given, I've gone down my own path and I'm perfectly happy with it, thank you very much.

**David.** If you could do anything other than managing money for a living and make twice what you're currently making, what would it be?

**Ian.** This is sort of linked to the previous question. I'm not in this business for money. I think in life, if you've had a couple of good ideas and you can exploit them, you're doing well. I had a couple good ideas and I'm trying to exploit them — not exploit in the financial sense but in the intellectual sense — and exploit in such a way that you can actually make a positive difference for a large number of people. I'm not interested in just the financial side. I know this goes against the American dream, although it's not so un-American now because we've all become far more levelheaded about things! The important thing is making a difference. Have you created a unique selling proposition? That is rare in an industry that does not really have unique selling propositions. If you've got one, nurture it, grow it, exploit it.

**David.** Great segue to my final question. I know that you've put a lot of time and money into Absolute Return for Kids — ARK is its acronym — which is a UK-based charity that seeks to improve the lives of underprivileged children. Talk about it, please.

**Ian.** ARK, in my mind, is the best achievement of a group of us. It's a philanthropic cooperative that makes a meaningful difference on a global scale. Six years into its life, it operates in three countries — as an operator, not a grant giver. It has 65,000 patients on HIV provisions in Southern Africa. It has 12,000 kids in UK schools in 12 city academies with 780 teachers directly on our payroll, and it has closed down nine state institutions in Bulgaria and Romania and taken 3,500 kids out of those institutions and got them adopted or placed into foster homes. In the process, it has spent £120 million of its own money plus £550 million in government grants. And that is just in its first six years of life. It is very satisfying. A soul is a soul. If you can transform the lives of 10 kids in some country versus one in the US or the UK, you should try to transform 10. But I also believe that a world built on philanthropy is a poor world. The person who just receives a handout loses self-esteem. ARK has 11 board members from the money management industry. We're coming into the

US to raise money plus do some grantmaking and operating. I think we will get into micro-financing in some way. By the way, the best thing about ARK is that we've managed to exit some of our projects. South Africa is an interesting example. If you put an HIV patient onto drugs, they're on those drugs for life, and that is a hell of a tail. If you have 65,000 patients, your tail is about \$9 million a year just to keep them going.

Thank heavens, PEPFAR (US President's Emergency Plan for AIDS Relief) scored a victory by actually taking over our liability, enabling us to move about \$20 million per year into another area of catalyst-based work in Africa. If that hadn't happened, it wouldn't have been very sensible philanthropy because we would be putting so much money into the funding of our tail we could never act as a catalyst for change elsewhere, which is our mission.

**David.** A good note to end on. Thank you very much for joining us today.

## JEREMY HOSKING

**David.** Sitting here in Harvard Square, within 100 yards of the Kennedy School [of Government], it's perhaps heresy to argue that the market meltdown that commenced about a year ago was, in part, attributable to foolish if not capricious regulation. But that's my opinion. We're going to explore this sensitive topic with our next guest, Jeremy Hosking, who agreed to come over from London to talk to us today. Jeremy's done some extraordinary thinking and writing over the years about many aspects of investing, including mark-to-market accounting and the extent to which it exacerbated some of the problems experienced as the meltdown unfolded. Jeremy, please talk about how we got to where we were about a year ago with mark-to-market standards, why the accounting profession adopted them, and the extent to which you thought they were misguided. Then we can talk about potential resolutions to the problem.

**Jeremy.** Thank you, David. It's terrific to be here. First, on mark-to-market accounting, I've written a number of pieces saying it exacerbated both the boom and the bust. There are a number of strands

to this debate. One, which I'm not going to talk about, is the phenomenon by which both counterparties to a complex derivative transaction mark up the value of a security on a mark-to-model basis. That's not an accounting issue but rather a fraud issue. With mark-to-model accounting, if you mark your own report card, you'll overvalue your assets 100% of the time. The good news about mark-to-market accounting is that over the course of an entire market cycle, you only overvalue your assets 50% of the time! The defining characteristic of mark-to-market accounting is that it treats unrealized gains or losses as if they've been realized. It does this on whatever frequency accountants and auditors choose to assess values. The accounting profession has for about 200 years been obsessed with liquidation value. With the innovations of the last 25 years, with more and more assets being tradable or securitized, accountants were finally able to realize their 200-year ambition to value financial institutions as if they were going to be liquidated tomorrow. They finally got the opportunity to apply what I call bank run accounting to banks, which isn't very helpful if you're not trying to generate a bank run! I think these two things have combined to produce the professional enthusiasm for mark-to-market accounting.

There are several features of this system that are important. First, there's the unspoken premise that price equals value. This is something accountants don't discuss. Clearly, you'd only be marking things to market if you thought market prices were the best estimator of underlying value. As investors, we know that most of the time, prices bear little relation to underlying intrinsic value. By treating unrealized gains as if they were realized, you subscribe to price-equals-value, otherwise known as the efficient market hypothesis, and you do so unconsciously. Also, profits get inflated on the way up and losses get exaggerated on the way down because of two effects of the market pricing system. First, there's the tendency to overshoot, and second, there's the discount mechanism by which you're bringing forward flawed estimates of all future losses and capitalizing them today. If you combine exaggerated losses with capital-based regulation, regulators say, "You've got losses of X. You must raise X amount in new capital." The stock market starts to worry about this and down go share prices. The whole thing feeds on itself. Very rapidly, the number of prospective

or outstanding shares tends to infinity and the stock prices tend to zero, as Citibank, in particular, so wonderfully demonstrated.

There are a number of related examples. The first is State Street, the global custodial bank, which in January or February of this year announced that it was writing down its off-balance-sheet assets – stuff it wished it didn't have, presumably – by \$3 billion. Within minutes of this announcement, State Street's stock market capitalization dropped \$9 billion. At the same time, the firm announced to anyone who cared – not that anyone did – that all these loans and assets on which it now had implied unrecognized losses of \$6 billion were current on interest and principal. The question is, what were the losses in fact? The three billion that State Street just recognized; the nine billion that the stock market imputed to it; or something in between? We're dealing with huge numbers here. A second example is Washington Mutual, which was acquired by J.P. Morgan for \$2 billion. Within nine months of this acquisition, you could read on the Bloomberg that J.P. Morgan was going to write up the value of Washington Mutual by \$29 billion, because the assets were purportedly worth more than Morgan supposed when it bought WaMu.

Warren Buffett likes to tell the story of a farm boy in class for the first time. The teacher asks him, "Johnny, if there are nine sheep in a pen and one runs out, how many are left in the pen?" The boy answers, "Ma'am, if one sheep runs out of the pen, obviously there aren't any sheep left in the pen," to which the teacher says, "Johnny, you don't appear to know much about math." The boy answers, "And you, ma'am, don't know anything about sheep." In the melt-down, all the sheep ran out of the pen; bank shares outstanding tended toward infinity; bank share prices tended toward zero. The situation was reinforced by regulation. For a fixed amount of losses, the number of shares that had to be issued to top up banks' capital base increased. So, due to the positive feedback loop, the more bank share prices went down, the more valuation fundamentals were undermined – from the viewpoint of long-term investors. This is why the share price of a company like Citibank declined from \$50 to \$1. It would be quite amazing, in my opinion, if Citi's share price ever got back into double digits without a reverse



split, because of the dilution investors have suffered. Needless to say, Citi has already announced plans for a reverse split.

**David.** In a recent essay you identified four major causes of the global financial meltdown: one, mark-to-market accounting — which we’ve already discussed; two, TARP [i.e., the US Treasury’s Troubled Assets Relief Program]; three, what you think is another botched initiative by Uncle Sam — TALF [i.e., the Fed and the Treasury’s Term Asset-Backed Securities Loan Facility]; and four, AIG. What lessons can long-term investors glean from AIG’s sorry saga?

**Jeremy.** The role AIG played in the crisis was absolutely pivotal. It seems to have stood behind the credit of the entire system by writing infinite amounts of credit insurance at the wrong price. Even now, the situation is misunderstood. The bailout of AIG, of course, was the means by which even greater sums of taxpayer dollars were funneled toward the financial community. The money sort of went whooshing through to investment banks to ensure that positions they thought were hedged were indeed hedged. Credit default swaps were written to the tune of \$60 trillion of insurance, roughly ten times the value of bonds underlying them. That’s why people are trying belatedly to regulate and generate at least some transparency in the CDS market.

There are a number of lessons for investors from AIG. First, incentives really do change behavior. AIG was reaching for earnings growth, so it was writing lots of contracts, confident that the offsetting losses, if any, lay in the future. Also, AIG epitomizes the danger of using mathematical models in complex transactions — a catastrophic failure of intellectual capital. As Keynes said, the goal is to be roughly right rather than precisely wrong; a lot of financial institutions in the UK and US have inadvertently targeted being precisely wrong — and they’ve succeeded in this foolish aim.

None of this is new. There was a celebrated case in 1887 in the UK called *Shepherd v. Leeds Building Society*. In those far off days, the Leeds Building Society had incentivized its management by paying bonuses proportional to the amount of distributable

profit that could be paid in dividends. And surely as night follows day, distributable profits rose and bonuses were paid to management accordingly. The judge eventually decided that all those bonuses and dividends had actually been paid out of capital rather than profits.

You’ve got duration conflicts, incentive bias, and the fallacy of mathematical precision. Individually, they’re terribly dangerous, and in the case of AIG, they combined to produce a legendary disaster.

**David.** Let’s pick up on executive compensation, and then we’ll turn to the topic of how our own industry could do a better job of structuring compensation. Assume that somebody handed you the reins of a well-endowed charity whose mission was extremely important to you, subject to the condition that you deploy 100% of its endowment in a single stock that you’re required to hold for 25 years. In general terms, what would the executive pay plan for that company look like?

**Jeremy.** I assume I can’t fire the CEO. He’s in for 25 years?

**David.** I think it’s helpful if we stipulate that, because it sharpens the point — you’ve got to get it right the first time.

**Jeremy.** The main problem is what economists call the agent-principal problem. I would go to the compensation firm Ratchet, Ratchet & Ratchet to find out what the going rate was, and then cut it in half. I would offer the CEO half rations in cash and the rest in restricted stock that gets reinvested in the enterprise and cashed out only at the end of his or her 25-year term. That would help attract managers capable of thinking about long-term outcomes and prepared to eat — and be enthusiastic about eating — their own cooking.

**David.** Fair enough. Now apply these same principles to money management. Imagine that endowed charities all over the world came to you as a group and said, “Devise a comp scheme for a professional money manager, a stock picker in particular, that has the best chance of helping us attract and retain the talent we need to deploy our assets over the long term.” What would your preferred comp scheme look like?

**Jeremy.** We looked at this in depth a few years ago. We talked to prospective clients about the merits of performance fees, under the eating-your-own-cooking principle. Because we were offering at the time both fixed fees and incentive fees, more and more of the clients preferred fixed because they extrapolated our historic performance and concluded that fixed fees would wind up being lower than incentive fees over time. We call it the performance fee paradox. I think it explains why, if a product is successful and grows, you end up with all the assets being managed on a fixed fee, and you introduce, over time, performance disincentives from the point of view of both the manager and its clients. We decided that the way to deal with this was to apply the Henry Ford model: you can have any car as long as it's black. New clients can have any fee structure they want, provided it's primarily performance-rather than asset-based. We've had this Model T if you will in place for about three years.

The next question is: what sort of performance fee structure is fair? I was able to sit on the beach and do a bit of reading this summer. One of the books I read was Niall Ferguson's *The Ascent of Money*. Toward the end of the book, he quotes a study that purports to show what would have happened to the shareholders of Berkshire Hathaway if Warren Buffett had been working for the proverbial "two and twenty." The answer was that \$57 billion of the \$64 billion in wealth generated during Buffett's tenure as head of Berkshire would have wound up in his pocket rather than shareholders'. So "two and twenty" — 2% of assets as a management fee plus 20% of any profits — basically shifts almost all gains into the hands of the croupier, which is obviously a thoroughly good thing if you're a croupier. We took the "two and twenty" and changed it to 25 basis points plus 20% of our relative performance over five years. If you assume we outperform our benchmark by approximately 4% a year, our all-in fees will be about 1%. We'll get our 1%, but only if we generate 4% alpha per annum.

By the way, one leading consultant did a study which concluded that most active managers pocket 100% of the alphas or excess returns they generate in the form of fixed fees, and that incentives equaling 50% of their excess returns would represent a better deal for clients than fixed fees equaling in essence 100% of the managers' value-added. We wrote a piece

applauding this study and drawing attention to the very obvious fact that clients would be even better off paying managers 25% of value-added than paying 50%. The consulting firm called us and complained about this essay. In particular, they complained about an exhibit we'd labeled, "A Perfect Performance Fee." We told the consultant that we chose this title because it was identical to the one the consultant itself had used when plumping the merits of a 50% incentive fee. The consultant demanded a retraction, but the whole exercise was getting a bit surreal and we decided to leave matters as they were. The point of my tale is that in the ecosystem in which we're operating, everyone seems to enjoy paying high fees; even the people who argue for fairer management fees don't really seem to mean it.

**David.** That's a good segue to our next topic. Even though the vast majority of firms in our business are privately owned, there are a few that have gone public: Fortress; Invesco; Janus; The Man Group; and Blackstone ... to name a few. As a follow-up to the conversation we've just had about pay plans for money managers, one of the purported reasons firms have tried to float their shares is that it helps them attract and retain talent. Comment, if you will, on the pros and cons of entrusting capital to an investment advisory firm that's gone public.

**Jeremy.** I had warning of this question, and I couldn't think of any pros, so I thought I'd just concentrate on the cons.

**David.** I figured you would.

**Jeremy.** One of the things we've noticed in the life cycle of the traditional asset management firm is that there's a tension between the commercial and the fiduciary. Bizarrely, the commercial tends to gain ascendancy as firms get bigger and more successful, whereas I think the opposite is more intuitive. In any case, public quotation heightens the tension between commercial and fiduciary interests. Capitalizing income streams by going public tends to turbo-charge the commercial imperative, often at the expense of the fiduciary one.

**David.** Underscoring the admirable fact that you're a bottom-up stock picker, I'm now going to read an excerpt from an essay you wrote

a few months ago and ask you to comment on its continuing validity. “While the evidence, in our view, points to a new cyclical bull market having begun, the duration of this move is open to question. The authorities have put a great deal of vodka into the punchbowl and the question is when it should be watered down. However, the bears, who are emboldened by their recent triumphs, cannot have it both ways. To argue that the economy will continue to slump and that inflation is just around corner, simultaneously, will not really wash. We say melt-up first, inflation second.” My question is obvious. Inflation: what, when, how, and how much?

**Jeremy.** Well, David, the passage you’ve just quoted sounds dangerously like forecasting.

**David.** Which you don’t do.

**Jeremy.** Right.

**David.** If it’s the only forecast you ever make, you should stop now, because you got it spot-on: a stock market melt-up is indeed what we’ve had since you penned the words I just quoted.

**Jeremy.** Early on in the meltdown, I described what was going on as a “tempest in a teacup,” and I was very much wrong on that. But what this misanalysis led to, by looking into the accounting, was my thesis about extreme pro-cyclicality. Wherever you looked, you saw that institutions created to dampen cyclical volatility had been removed or interfered with, thus unleashing extreme pro-cyclicality. This led to the thought that if a way could be found to throw some grit into what John Dizard of the *Financial Times* called the “doomsday machine,” the whole thing might operate in reverse. Finally, in a relatively quiet announcement in March, the US said it was going to offer infinite amounts of preferred share capital to US institutions with a fixed conversion into common stock if they needed it. That was a real breakthrough moment, and the conversion prices were, for the record, \$3 in the case of Citi and \$6 in the case of BofA. That was quite interesting news, because Citi shares, by that stage, were under a dollar, and BofA shares were trading for about \$3. Clearly, if you can raise infinite capital at a price that is twice your current share price, then eventually book value will converge on the higher figure. Of course, in the

event, Bank of America issued shares at much higher prices than \$6. The doomsday machine did indeed begin operating in reverse. One of the things that’s been perplexing to money managers in this melt-up is that companies which are perceived by investment pros as complete rubbish are the ones that are rising the most. This gets at the essence of the recent crisis, which was all about a freezing of credit markets. If you’re a company with lots of debt maturing over the short term, then your equity is effectively an out-of-the-money, short-duration call option with minimal value. If credit markets start to unfreeze and you can roll your debt for, say, three years, your equity goes from being a three-month call option that’s significantly out of the money to a three-year call option that’s massively in the money. The effect on share values is extreme. This explains why the melt-up has been so violent. The pro-cyclical thesis that we’ve been running with for the past year has the great merit of explaining the meltdown **and** the more recent melt-up, whereas most academics and politicians are still trying to explain the meltdown.

**David.** What about inflation?!

**Jeremy.** Inflation is very tricky. It’ll return, and real interest rates will go up, and both of these nasty things will unfold at the same time. But for holders of riskier assets, like stocks or corporate bonds, particularly poorer quality corporate bonds, the medium-term returns are going to be quite satisfactory. One framework that’s useful for thinking about all of this is one fashioned originally by Warren Buffett, who asked: “You’ve got two choices — a 10% steady return and a 15% volatile return. Which do you go for?” He answered his own question by saying that Berkshire would always go for the 15% volatile return. What seems to have happened over the last several years is that most investors have opted for the 10% non-volatile return. This collective choice has pushed the 10% non-volatile return down to about 4%, which, presto, is what government bonds yield. My question is: what are the unintended consequences of all the money in the world chasing this seemingly low-risk, low-volatility return? My hunch is that the risks of this approach will be higher, and the returns a lot lower, than people pursuing it assume — and, as a corollary, the returns to investors willing to pursue seemingly high risk strategies will be a lot higher than the people fleeing them suppose.

**David.** Let's talk about portfolio turnover. You and I entered the profession at about the same time, when turnover levels in institutional equity portfolios were a fraction of what they are today. Good thing? Bad thing? Any opportunities created by the high turnover?

**Jeremy.** High turnover contributes to pro-cyclicality. Let's go back to December 1999. That was three months ahead of the great reversal in the TMT sector — technology, media, and telecommunications. You'll recall that virtually all the money in the world was flowing toward TMT shares in late 1999. With a one-month average holding period, there was still time for three trades! That's three last drinks before you hit the road — three strong brandy and sodas before you pick up your car keys and head home. Obviously, high turnover increases the bandwagon effect. The same thing happened in the recent bust. There was still time to short Citi, which was going to issue equity at a much lower price, so shorts were able to hang in there, increasing pro-cyclicality by selling Citi short even as it was plummeting in price. Of course, the high turnover that you and I lament has been encouraged by consultants and their performance measurement protocols, which are the functional equivalent of pulling up flowers every three months to see how their roots are doing. That's not very good for flowers, as the active investment management community so wonderfully proves.

**David.** Let's talk about the opposite extreme — a buy-and-hold approach. Imagine that a charity about which you care deeply came to you and said, "Jeremy, pick one stock for us to buy and hold for the next 25 years, without regard to interim volatility." Which stock would you recommend and why?

**Jeremy.** I'd focus on the characteristics of a stock you'd want to hold for 25 years. One of the things I've learned managing money over the last quarter century is that inside ownership is fantastically important — a lesson I tried to invoke in the compensation discussion earlier. I think it'd be helpful if the company were 25% to 50% owned by a family that had arrangements for ensuring its ownership level would endure. It'd be helpful if the company's business lines were diversified to some degree and also if these lines had a low level of

projected obsolescence. Finally, it'd be helpful if this company operated in Asia, but not necessarily in China. So I'd recommend one of our largest holdings: Jardine Matheson. Interestingly, because of cross-holdings, Jardine Matheson scores zero out of 10 on the corporate governance scale. In fact, it's been expelled from every known stock market index; under an index tracking mentality, it has the distinction of being one of the riskiest stocks in the world! But, obviously, it can't be extraordinarily risky, because it focuses on low-volatility businesses in a growing part of the world, and is dominated by very long-term shareholders who care deeply about long-term outcomes. The catch, if there is one, is that Jardine Matheson has done very well over the last 10 years. I don't know how well it will perform over the next 25, but it displays a lot of the attributes one might look for in a 25-year stock.

**David.** I'm going to pose a few personal questions, starting with one of my favorites. What's the most memorably impressive display of grace under pressure that you've witnessed in real time, whether in person or on TV?

**Jeremy.** Being an Englishman, we don't really do personal! Also, the answer I'm about to give may be affected by an announcement in today's newspaper. As you know, we position ourselves toward the activist end of the fund management spectrum. Surprisingly, we found ourselves voting in favor of the re-election of Ken Lewis as BofA's CEO and chairman, despite the proxy voting services arguing strongly that the guy should be not only sacked but strung up. The thinking behind our vote is the old Chinese proverb that crisis equals opportunity. Here's a big bank that, in its purchase of Countrywide at a very low price, and its subsequent purchase of Merrill Lynch at a depressed price, was trying to convert crisis into opportunity. I think that, five years down the road, these two acquisitions might be seen in a very different light from the one in which they're seen today, which reflects a vicious mark-to-market personal witch hunt. Obviously, if we're going to sack every CEO who buys before prices bottom, then we're not going to have any CEOs trying to acquire assets at attractively depressed prices. Of course, there's today's announcement of Lewis deciding to retire at the end of this year. I don't know whether his decision reinforces or refutes my

thesis that he's displayed grace under pressure. But it's definitely consistent with our concern about procyclicality, which is an extremely bad thing.

**David.** One more question. If you could lead not your own life but rather the life of a person now deceased, whose life would you be most gratified to lead and why?

**Jeremy.** Well, once again, as a proper Englishman, I'm not really going to answer this highly personal question head-on. But if I can answer a variant of it, I'd reply as follows. I'm sure many of you in this room have read *Lords of Finance*. It's a fantastic book. And if I'd read it six months earlier than I did, I'd have been even more bullish on the prospects for a big rebound in US stock prices than I actually was. In any case, I'd like to come back as Montague Norman, the governor of the Bank of England during the inter-war years, with the forlorn hope that one would not recreate some of the mistakes that were made during that pivotal period.

**David.** Thanks very much for flying across the ocean to do this for us. We appreciate it.

**Jeremy.** Thanks for having me.

#### ANTOINE VAN AGTMAEL

**David.** Interviewing Antoine van Agtmael about emerging markets is like talking to James Naismith about basketball, or Abner Doubleday about baseball, or perhaps more to the point with Werner Heisenberg about uncertainty; Antoine goes way back with emerging markets investing. He is very thoughtful, and I'll say by way of compliment, very tough. You need to be tough if you spend your career investing in emerging markets and dealing with sketchy food, risky airlines, and bad hotels. So I thought I would start this conversation with a tough if not impolite question. Emerging markets is a term that Antoine coined back in 1981. Today, the most widely recognized emerging market index has as its four largest components China at 18 percent, Brazil at 15 percent, Korea at 13 percent, and Taiwan at 11 percent. My first question for Antoine is about Korea and Taiwan, because he helped put this whole asset class and construct together. My question has two

parts. First, does it still make sense for institutions to view stocks of firms domiciled in Korea and Taiwan as components of an asset class that's separate and distinct from one comprising stocks in developed markets like Japan and Singapore? If your answer to my first question is yes, and Korea and Taiwan don't really belong with India and China but rather with Japan and Singapore and other developed markets, what does this say about the soundness of institutional investment programs that distinguish between emerging market stocks on the one hand and developed markets on the other?

**Antoine.** An interesting question; you may be surprised by my answer. I think Korea and Taiwan belong more to emerging markets now than they ever did. Now, I have no illusions. They will, and in fact already are, leaving Footsie's emerging markets index, but they'll also be eliminated from MSCI's emerging markets index within a few years. Actually, I made a prediction a number of years ago that they wouldn't move out of MSCI's emerging index as fast as people expected, and they haven't gone out yet! But they will. Like other things that MSCI does, it's nonsensical to take them out. I thought it was nonsensical to go from a broad index to a narrower index with fewer stocks in its "standard," but that's a different issue. Why do I say Korea and Taiwan belong more to the emerging markets universe than before? What is Taiwan? Taiwan is the headquarters and R&D center for many major companies in China. If you look at the big corporations in Taiwan, most of them, with the notable exception of TSMC [Taiwan Semiconductor Manufacturing Co.], have a large portion of their production in China. So you're really buying a piece of China. Also, I believe Taiwan will eventually become a part of China. Officially, it really is a part of China, which Taiwan doesn't recognize now, but the US does. It will eventually become a part of China if China becomes more democratic. That's a very big if. With respect to Korea, like Taiwan, it was much more oriented to and dependent on exports to the United States and Europe. Now Korea and Taiwan are becoming much more dependent on exports to China. In an economic sense, they belong more to emerging markets rather than less. The other question you asked is whether it makes sense to differentiate between developed and emerging markets. Here, again, you may be surprised by my answer. I think it makes less and

less sense to differentiate. It used to make a lot of sense simply because people overlooked emerging markets. They don't any longer. The differences between developed and emerging markets are eroding, even evaporating. In my book, *The Emerging Markets Century*, I argue that 25 years from now, emerging markets as a group will be more important economically, as measured by GDP, than what is now called the developed world. Obviously, this can only become true if emerging markets catch up in terms of GDP per capita. In other words, the difference between the two will be less and less. For example, you lamented earlier the fact that I had to do this job staying in bad hotels and eating poor food. Actually, the hotels in most emerging markets are often better than here, and the food, frankly, is often delicious. Anyway, my wife says I like living out of a suitcase, and it is true that I love visiting countries and companies. It's a passion of mine, I love doing it, and it's certainly no hardship on me to visit emerging economies.

**David.** I want to walk around the universe you're investing in, focusing on the BRICs. I was going to start with Brazil, but let's start with China because you just alluded to it. One of the questions that holds a longtime fascination for me has to do with China's path long term. If you look at the leaders in China, and it's a changing cast of characters, you think, well, they're being sensible: they're trying to keep the economy growing and creating jobs so they can absorb the migration from rural to urban areas. That's a very sensible means to their ultimate end — perhaps. What **is** the **end** they're ultimately pursuing, in your view?

**Antoine.** The Chinese would never admit it, but their goal is to be the world's most important economic and political power. My view is that in 25 years, they will be the largest economy in the world and one of the most important political powers. What is very interesting about the Chinese leadership is that there is going to be a huge change. We know who the next leaders are going to be: we know they are going to be picked from a group of 25 people, and we know who those 25 are. All China experts know this. What is interesting is that, thus far, the typical top leader in China has been an engineer. In fact, they're all dam-building engineers. The next generation of leaders is going to look more like America's. They're going to be lawyers!

**David.** And China's GDP growth will therefore start slowing down!

**Antoine.** Correct! The reason I'm comfortable predicting that China will be the largest economy is that GDP has two components. Real growth undoubtedly will slow; China is not Superman. But at 5%-8% over the longer term it will still be a lot faster than the rest of the world, even most emerging markets. On the other hand, the exchange rate will be revalued. So if you put the two together, China will become the world's largest economy, without question.

**David.** When you're talking about China's ambition to be the dominant economic and military power, we could have substituted Putin and Russia, although it's probably not as realistic an aim. Is that the Russian regime's aim?

**Antoine.** Putin's aim is for Russia to be recognized as a serious power rather than as a nincompoop nation. For a while, the United States treated Russia as a country that had lost all power. Now, Russia is making it clear that it has not lost all power. It does not have the illusion that it is challenging the United States for world leadership, because that's not feasible, and Putin and everyone else in the Kremlin knows it.

**David.** Let's say you were to buy a cap-weighted index of Russian stocks at today's prices and hold it for 20 or 25 years. Given what's going on in Russia — corruption and the problems with corporate governance — what's a reasonable rate of return you'd expect to earn?

**Antoine.** I have never expressed such an opinion and don't feel I can with any kind of certainty. What I **am** willing to do is answer the following question about the BRICs: will they do better than the global average of the world, or better than the average emerging market?

If you talk about Brazil on a market-weighted basis, it's easy because it's basically two or three stocks: Petrobras, Vale, and, since the merger, Itau Unibanco. I would be overweight Brazil on a 20- or 30-year basis. Within that framework, Brazil will do better than the average emerging market, and I

believe the average emerging market will do better than the world average.

**David.** From today's prices?

**Antoine.** Yes, from today's prices. Today's prices are somewhat on the high side, so if you ask me for a 12-month forecast, it's a very different matter. But over the long term, big outperformance by Brazil could be the rule. Why? We have to look at the two major stocks, because they're so important. By the way, 20 years from now, they may be among the top 10 stocks in Brazil, but probably only one of them will be among the top two stocks. That one will be Petrobras, I think. What I like about Petrobras is that it probably has more new oil and gas reserves than any oil company in the emerging markets and probably any oil company in the world, thanks to the discovery of a lot of oil in Brazil's so-called Pre-Salt basin. It will be expensive to get the oil out, but they will get it out; they have the deepwater technology. I believe Petrobras is one of the most attractive energy companies in the world. Obviously, a lot depends on your view on energy. My view on carbon-based energy is that there is much more around than people think. Certainly there is a lot more gas around than people think, including right under our feet — if you live in Pennsylvania or Texas. The official Department of Energy estimates recently have gone way up. Strangely, people are not talking about it, but there is basically energy security in the United States. The frenzy about dependence on foreign energy is like the missile gap during the Kennedy administration. It's something that is not really a problem, but we think it's a problem.

**David.** It helps you get elected.

**Antoine.** Well, that's right.

**David.** The so-called missile gap worked for JFK.

**Antoine.** That's right, but that doesn't mean that he acted on it. My view on energy is that there is way more oil, and particularly more gas, than people think. Also, we are going to use way less oil and more gas than people think. Generally, we will be more energy efficient in the future than we now think is possible.

**David.** Will this happen as a result of concerns about global warming and climate change?

**Antoine.** Yes. The technologies to deliver alternative energy are going to be revolutionized over the next 10 years — interestingly enough, in some form of partnership among the United States, where some of the R&D is done; Europe, where some of the energy saving is much more advanced than in the United States; and China. China has made a major commitment to alternative energy — an amazing 40% of total energy by 2020. Just as the automobile helped the United States become a dominant economy, China wants to become a dominant economy with the help of electric vehicles.

**David.** Let's return to Brazil, where the index is dominated by Petrobras. Isn't that company threatened by the very trends to which you just alluded?

**Antoine.** Yes, but these trends are going to kick-in in a big way only 10 or 15 years from now. So, I think Petrobras still has a very good run ahead. Plus, when I say there's going to be more oil supply and less demand than thought, it simply means we're not moving toward an energy crisis and \$200 oil but to an oil price in the \$50 to \$100 range, which is still very profitable for Petrobras.

**David.** I was going to ask you about the dollar and its role as the global reserve currency a little later, but let's go to that right now, because you can't really talk about oil and its future price without talking about where the dollar's headed relative to other media of exchange.

**Antoine.** True. I think the renminbi will displace the dollar the way the dollar displaced the British pound — within the next 25 years, not tomorrow. This will be a gradual and carefully orchestrated process where people will not get hurt. They may get hurt by ups and downs of the dollar, but because this move will be fairly gradual it will not be damaging. But it's going to happen.

**David.** What about the dollar relative to the euro even as the yuan uptrend unfolds?

**Antoine.** Dollar versus euro is above my pay grade. It's outside the area I focus on. I believe that for the coming five years, the United States has some structural problems that will be hard to resolve and can only be resolved with a relatively weak dollar. Relative to a basket of global currencies, the dollar will be weak rather than strong.

**David.** Let's go back to China for a minute. How worried are you about the US imposing a 35% tariff on Chinese-made tires under pressure from organized labor?

**Antoine.** It's an irritant, and rather stupid. But it's not something that's going to take our relationship with China off track. Obama is smart enough and China's leaders are conservative enough that they won't let that happen.

**David.** But if the folks in the White House are so smart, why did they let the tire tariff go forward to begin with?

**Antoine.** It was, in my view, a purely political move.

**David.** To throw a bone to the unions?

**Antoine.** Obama, in my reading, is a pragmatist. Right now, he can stand a bit of a fuss with China if he gets his health care bill through. In order to get his health care bill through, he needs the support of unions, and this was a critical bone to throw. It's really as simple as that. I think he knows this is the wrong road. I think he knows this is a form of protectionism. It's a slippery slope that's very dangerous. But I think his calculation is, it's manageable.

**David.** We talked about Russia. Let's talk a bit about some of its neighbors to the west. Certainly equity prices in Eastern Europe fell a lot from their most recent peak, and have now bounced back. But Eastern Europe looks awfully sick. Are stock prices there low enough to reflect the looming sickness of that part of the world?

**Antoine.** We were very underweight in Central Europe for a number of years because I felt they were just pursuing irresponsible macroeconomic policies:

large budget deficits and large current account deficits. These never last. Now, I think they're getting back on track, but I'm still a bit underweight.

**David.** Let's head south. Is Africa ever going to get its act together?

**Antoine.** You have to differentiate between Africa as an economic universe and as an investment universe. We have been investors in Africa for the past 16 years, and the cumulative return has been four times as good as our returns in emerging markets as a whole, with half the volatility. So as an investment universe, it has worked very well, and it will continue to work very well because you can simply pick up companies everybody hates. That's the game of active investing. You can pick up more companies in Africa that everybody hates than anywhere else in the world, because people hate it so much. And they have some good reasons to hate it. There are economic, political, and other factors that make you skeptical about Africa. What people forget is the types of companies you buy in Africa; I call them beer, banks, and bullion. Beer always makes money, wherever it is, and we're buying companies like Guinness and Heineken on the local stock exchange with good corporate governance, a growing market, and the fattest margins anywhere in the world. That, to me, is attractive.

**David.** Paul Romer, among other economists, has argued in favor of using city-states to promote reform in sub-Saharan Africa. The Brits are doing it in the Turks and Caicos. They basically went in and said, "Let's do a reset here. We're going to start over and get the regime right." Do you think this idea could work effectively in Africa to overcome the seemingly unending problems it has?

**Antoine.** The short answer is no. I should say that it has worked, for example, on Batam Island and in Singapore. If used very sparingly, this idea occasionally works. I think the Chinese will make it work in a few places in Africa – but they will not be able to make it work in many other places in Africa.

**David.** I assume they'll try to use city-state arrangements in places loaded with natural resources?



**Antoine.** Yes. Zambia would be one. Nigeria is another. And possibly the Congo. By the way, if there's truly a place I don't like to visit, it's the Congo, even though you can find very good food there.

**David.** But your medium- and longer-term forecast is that the Chinese will indeed be the agent of change in sub-Saharan Africa?

**Antoine.** Yes. The Chinese have been at work there for the past five years. They're building most of the roads, and they're total mercenaries about it. The risk is that there will be an "ugly Chinese" syndrome in Africa just as there was an "ugly American" syndrome in the 1960s.

**David.** Speaking of road building, let's talk about India. If you were to buy Indian stocks on a cap-weighted, indexed basis and hold them for 25 years, how well do you think you'd do from today's starting point?

**Antoine.** I believe India will do better than the average of emerging markets and the world. One reason is what I would call the "Avis" factor. India is really jealous of the "Hertz" — China. It wants to be like China. Indians don't say this very often, but it really bothers them that when you go to Beijing or Shanghai, there are great roads, but when you go to India, there are few great roads. So the "Avis" factor will drive them to succeed. Second, if you take a 25-year perspective, having experience with democracy is a big plus. Russia and China are still quasi-democracies and quasi-markets; in the case of China, it's not even a quasi-democracy. India has a real market and a real democracy. That's a big plus. Then, there are demographics: India has a very young population. Let me make a plug for an interesting book on India by Nandan Nilekani, one of the founders of Infosys, called *Imagining India*. Nandan argues that instead of viewing India's huge population as a handicap, you should view it as an advantage. I agree. Of the major emerging markets, India has the youngest population by far. That, in the end, is a plus for economic growth. In addition, India is lucky because it was on a spree of stupid M&A that was cut off by the financial crisis. Indians said, "Hmm, maybe this is not such a good idea" and didn't go forward with it. So on the whole, I'm bullish on India.

**David.** I want to get back to the BRICs and their proper weight in a long-term portfolio. Let's say the new head at Calpers calls you and says, "You're the godfather of emerging markets investing. My staff is telling me, and I intuitively believe, that we've got to be indexed. We can't be active. We're too big. I just want to know as I set up my emerging market index fund and look at it through a 25-year lens, should I knock any of these countries out — like Russia — and simply not risk capital there?"

**Antoine.** Calpers actually asked me a similar question once. I said that I didn't think it was a good idea to eliminate significant markets, or exclude them for "social responsibility" reasons, because there is too big a risk of "politically correct" selection of countries by public pension funds, Calpers included. Although I'm an active manager, an organization like Calpers should invest in emerging markets and put a significant portion in index funds. In index funds, not in ETFs, by the way. For those of you who think that the largest ETFs track the emerging markets index, they don't. Not even close. I was astonished to see that this year, the largest emerging markets ETF was over 10% below the "broader" IMI Emerging Markets Index and over 7% below the narrower "standard" index, which is its benchmark. That's tracking? I would go for index funds, which have a tax disadvantage for an individual investor but not for a pension fund. Then, I would actively manage the rest. And if you have to throw a bone to politicians and exclude certain countries, throw a bone within the actively managed portion. But I would not exclude Russia.

**David.** Let's stick with our hypothetical — that we need a mechanistic approach to investing because we're Calpers and can't have human judgment entering into the equation, except perhaps up front, where we decide between a cap-weighted index for emerging markets or an equally weighted one with regular rebalancing. Which do you think would do better over our assumed 25-year time horizon?

**Antoine.** I would not use either. I would use a GDP-weighted index. If you use a cap-weighted index, the time you invest is usually the wrong time unless you average in. Investors usually go into the cap-weighted index just when everybody's

enthusiastic, which is the worst time. An equally weighted index is impractical in emerging markets: Argentina and China with the same weight makes no sense. But if you use a GDP-weighted index, I believe it would outperform a cap-weighted index over the long run.

**David.** So isn't the logical corollary that big institutions ought to give managers like you a GDP-weighted benchmark rather than a cap-weighted benchmark?

**Antoine.** Yes.

**David.** 'Cuz it's a faster rabbit.

**Antoine.** Yes. I'm not advocating it, because it would be tough to beat. My current benchmark is already challenging enough. I advised our clients to use the IMI instead of the standard index. The IMI index includes small caps and has done nearly 3% better year-to-date. So it's swift enough.

**David.** We haven't talked about Mexico. Where do you see it headed over the long term?

**Antoine.** Mexico had an opportunity to trump Brazil but blew it. Mexico still has serious problems. There's a war going on. It has some terrific people, a good administration, and some great companies. But in the long run, I think Brazil's potential is greater than that of Mexico's. The basic reason is size. Also, the experience with inflation in Brazil was so bad that it actually created a better class of management.

**David.** So the risk for Brazil would be that, as institutional memory recedes and veteran managers move off the stage, those lessons will be forgotten, which could result in reflation.

**Antoine.** You're absolutely right. That's why I'm more optimistic for Brazil over the next 10 years than the 10 years after that.

**David.** Let me ask you the professional do-over question I asked some of our earlier guests. If you had one major business or career decision you could do over, what would it be?

**Antoine.** If we're talking about investment decisions, I could talk for the next four hours! In terms of business decisions, I've been extremely lucky. Things have worked out, both career-wise and business-wise, many multiples better than I ever would have expected in my wildest dreams. That doesn't mean we haven't made bad decisions. We were late in recognizing that we should have a serious presence in China and Hong Kong; we thought that if you're based in a given emerging market you may be too biased toward it, but that's no longer a big worry with China.

**David.** When did you start staffing up in China?

**Antoine.** Our team has visited China for years, but we didn't set up an office there until last year.

**David.** Describe how you go about staffing the effort, and the extent to which you want people out in the field versus under the same roof as you – where you can see them every day. What are the pros and cons?

**Antoine.** Things have changed a lot because of technology. I can talk to anyone who works with us on the cell phone anytime, or we e-mail, and we all have BlackBerries or iPhones. We have video-conferencing facilities, which make an amazing difference. On staffing, we always want to make sure that in every country where English is not the dominant language, we have someone who speaks the native tongue, because otherwise you miss a lot of nuances. Also, you have to realize that Hong Kong Chinese, Mainland Chinese, and Singaporean Chinese approach things differently. They have certain prejudices. So you want to have a mix of people. In my view, you now need offices in each of the BRICs, because they are so important. The world looked different 10 years ago. Back then, the best analyst was always in New York. Now, the best analyst may be in Hong Kong or another emerging market.

**David.** We'll wrap up with a few personal questions, which you've had a chance to think about. The first is what I call my Mount Everest test. You see a lot of people taking huge risks to climb

Mount Everest, and I often wonder: would they climb Everest if there were a law stating that they could never tell anyone they climbed Everest? So, my question is this: what's the one feat you're most keen to accomplish, subject to the condition that you could never talk about it?

**Antoine.** Let me pick two: first, to find a huge donor for National Public Radio so the endowment could exist in perpetuity, because I think it's so important to our national discourse; I would be delighted to find that person and not take any credit. Second, to outlaw internal combustion engines within 10 years. I wouldn't want to take credit for it because people would shoot me. Nobody would like it, including my clients. But I believe that if we don't do something akin to it, we in the United States will lose out.

**David.** Why can't we deploy nuclear power in the United States in the same manner as France, where it's a major contributor to energy supply?

**Antoine.** Stupidity – including stupidity on the left. When an analyst comes to me and says, "This is a no-brainer," I say, "OK, next." Nuclear power is a no-brainer in the sense that it's actually quite clean. All the talk about the impossibility of getting rid of nuclear waste is nonsense. That said, nuclear power is not the ultimate solution. The ultimate solution is the sun, to put it in very simple terms. But solar is a solution that's going to take a while.

**David.** One more question: if China's leaders are so farsighted, why is China building so many coal-fired power plants? Why aren't they leapfrogging coal and going straight to cleaner energy?

**Antoine.** Basically, it has to do with what I mentioned earlier — an engineering mentality. Talk to an American engineer about a green building, and you go back to the 20th Century. Talk to a Chinese engineer about coal plants, and you also go back to the 20th Century. We need to change this. I believe that the Chinese leadership — and certainly the people one level down, including those in the think tanks that feed the top leadership with information and analysis — they get it better than we do. And so they're going to make major changes. But in

the meantime they have to feed the machine for us, because we use a lot of the stuff they make. So you could say that the Chinese are indirectly doing the dirty work for us as well as for themselves.

**David.** Pun intended, right?

**Antoine.** Yes.

**David.** Thanks for joining us today.

**Antoine.** My pleasure.

**Unilateral Control.** Assume hypothetically that you have unilateral control over an endowment and are offered the opportunity to swap the entire endowment for a contract from a risk-free creditor to lock in a guaranteed return with no possibility of default. Assume further a 50-year holding period. What would be the minimal guaranteed real return that would induce you to make the swap? \_\_\_\_\_%

# of attendees responding: **64**

Low answer: **2.5%**

High answer: **18.0%**

Mean: **7.4%**

Median: **7.0%**

**Unfettered Control.** Assume that in October 2009 you'll be assuming unfettered control over a tax-exempt endowment with zero cash inflows and an annual spending rate of 5%. Assume further that your goal is to maximize this endowment's net annualized return over a 25-year holding period with no interim measurement of results. By "net annualized return" we mean in essence the endowment's compound annual growth rate net of all investment-related expenses, whether paid to external vendors, internal staff, or some combination of the two. Here's my question: how much capital would you ideally like to have in hand when your assumed 25-year tenure commences in mid-October? Obviously, your answer won't be \$1 because one can't do anything interesting with such a small asset base. Just as obviously, at least by my lights, your answer won't be \$1 trillion because one can't be very selective investing such a behemoth asset base. Accordingly, your answer assumedly will fall between \$1 and \$1 trillion. What's your ideal starting figure – assuming you could invest the capital anywhere you want, anytime you want, employing whomever you want in the process so long as you pay them via the netting process mentioned above? \$\_\_\_\_\_

# of attendees responding: **60**

Low answer: **\$10 million**

High answer: **\$50 billion**

Mean: **\$3.0 billion**

Median: **\$1.0 billion**



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