Much Ado about Bonds

The dialogue that follows focuses on the proper size and structure of an endowed institution's bond portfolio. The dialogue is intended to serve as a companion piece to an even lengthier dialogue on related policy issues entitled *Why Not 100% Stocks?* As was true in the earlier dialogue, the two protagonists in the colloquy that follows are trustees of a private foundation. One (*Mother*) is the foundation's founder and chair; the other *(Daughter)* is a successful investor who loves her mother dearly but doesn't necessarily agree with Mom's views on foundation asset management.

Framing the Issue

Daughter: I hate to beat a dead horse, but I can't let another board meeting end without saying once again that we ought to consider shifting from active to passive management.

Mother: An index fund? No way: indexing is unAmerican.

Daughter: That may be true for your generation, but it's not for mine. Besides, I'm not talking about an equity index fund. I'm talking about a bond index fund, or rather a passive bond portfolio that would replicate only a portion of the overall bond market. If you give me a few minutes, I think I can prove to you that it would be anything **but** unAmerican.

Mother: My time is yours, but before you tell me what you want to do with our bond portfolio, tell me what's wrong with the one we've got.

Daughter: As I've said before, the foundation's bond strategy makes no sense.

Mother: And as I've said before, this board doesn't involve itself with **strategy** issues. If there's one thing I've learned in my many years as a trustee, it's that governing boards are ill-equipped to make **strategic** decisions.

Daughter: And if there's one thing I've learned in my many years as your daughter, it's that I should choose my words more carefully. Let me start over: the foundation's bond **policies** make no sense.

Mother: Why do you say that?

Daughter: Because we have too much in bonds, and the wrong bonds at that.

Mother: Don't tell me you want to put 100% of the foundation's assets into stocks.

Daughter: Not at all. In fact, I think that would be wildly imprudent.

Mother: And I think it would be imprudent to invest less than a quarter of our assets in bonds. When I was your age, there were just a handful of institutions that had more than 25% of their assets invested in equities, broadly defined. Today, the mindset is reversed, and most endowed institutions have only 25% or so of their assets in bonds, including our own foundation. How low do you want to go?

Daughter: How about half that much?

Mother: Just twelve-and-a-half percent in bonds? That's not nearly enough protection against a rainy day in the stock market. Besides, how would we generate the income we need to make grant payments if we cut our bond portfolio in half?

Daughter: With all due respect, Mom, that's a red herring, and you know it. Even with 25% of our assets in bonds, our overall portfolio is generating a yield well below the mandatory payout rate of 5%, so cutting our bond exposure to just 12.5% won't create any problems we're not already wrestling with. Besides, I haven't said where the proceeds from the bond sale should go. Maybe we should invest them in assets that generate an even **higher** current yield — like real estate, or oil and gas.

Mother: Higher current yield? What a hoot! The only reason those investments generate a higher yield is because they're wasting assets: buildings wear out, wells run dry, and the so-called higher yields that real estate or energy properties generate merely compensate their owners for the depreciation they suffer each and every day. I suppose the next thing you're going to tell me is that we can boost the foundation's current income by selling off our Treasuries and buying emerging market bonds!

Daughter: Funny you should mention that, because I was going to suggest precisely the opposite. In fact, the reason I raised a question about our bond portfolio is because it contains too few Treasuries, and too much higher yielding paper.

Mother: Talk about the pot calling the kettle black! If memory serves, you were the one who pounded the table not too many years ago in favor of high yield bonds!

Daughter: True, but if you review the minutes from those meetings you'll see that I never suggested high yield bonds deserved a permanent place in our bond portfolio. In fact, I went out of my way to emphasize that if we invested in junk bonds at all, it should be as a so-called equity substitute. At the time, which was 1991 if I'm not mistaken, junk bonds were priced so low that they offered equity-like potential returns, whatever label you cared to attach to them.

Mother: I have to admit, your timing was good. We made a lot of money with those high yield bonds, and I'm proud that as a Depression baby I had the good sense to listen to my Baby Boom daughter when you suggested we make that move. A lot of my contemporaries thought I was nuts to go along with you, and we've proven them wrong.

Daughter: Yes and no. We were right to move into junk bonds when the market for them collapsed in the early '90s, but your friends who lived through the Depression have a point when they scold you for forgetting the lessons of the past.

Mother: Lessons of the past? That's precisely what **you're** forgetting when you make the ridiculous suggestion to cut our normal allocation to bonds to just 12.5%. There's simply no way that an umbrella that small is going to keep us from getting drenched if a storm breaks out in the equity market.

Daughter: That depends on how soundly the umbrella is constructed. I have to admit, if it's built like our existing bond portfolio, you're right.

Rainy Day Blues

Mother: What's wrong with our existing bond portfolio?

Daughter: It's got too many securities that will perform well when we need bonds the least, and too few securities that will perform well when we need bonds the most.

Mother: Come again?

Daughter: The only reason to hold bonds on a truly permanent basis is to hedge against a major deflation like the 1930s. And the only bonds worth owning in a major deflation are long-term, high quality, non-callable ones. I have no problem with our owning other types of bonds from time to time — in fact, I favor bonds over stocks in the current environment — but our so-called permanent bond portfolio should hold high grade paper only, and it should be non-callable, to boot.

Mother: Why is that?

Daughter: Because that's the only kind of paper that will hold its value in a major deflation. If deflation strikes, all the other securities that our bond manager currently owns will prove about as useful as last year's Christmas tree.

Mother: Isn't that overstating the point quite a bit? The last time I looked, at least half of our bond portfolio was invested in mortgage-backed issues, which are triple A rated. In fact, if I'm not mistaken, most of them are backed by the full faith and credit of the United States.

Daughter: Not exactly. In fact, one reason the portfolio is invested so heavily in mortgage-backed securities is because they yield a tad more than Treasuries on an options-adjusted basis. And the reason they yield more on an OAS basis is because, with the exception of so-called Ginnie Maes [securities issued by the Government National Mortgage Association] the government guarantee they seemingly provide isn't a guarantee at all — it's more of an unwritten promise that Uncle Sam will step in if the ultimate borrowers [i.e., homeowners] default.

Mother: Excuse me for interrupting, but what in the world does OAS mean?

Daughter: Sorry. OAS means Options-Adjusted Spread, which is simply a fancy term for the incremental yield that mortgages provide over Treasuries when you adjust for the fact that mortgage bonds display what's known as negative convexity. When interest rates fall, bond prices rise — they're opposite sides of the same coin, after all — but price gains on mortgage-backed bonds are hampered by the fact that the underlying borrowers have heightened incentives to refinance their debts. The "option" in OAS refers to the fact that mortgages are typically prepayable at the borrowers' option.

Mother: You don't have to tell me about mortgage prepayments. One of the reasons we have so much money in the foundation is because I refinanced all of the family company's debt when long-term bond yields plummeted in the mid-'80s.

Daughter: That simply reinforces my point, which is that most of the bonds our foundation holds today are inherently callable — not only the mortgage-backed ones, but most of the corporates also.

Mother: Wait just a minute: a lot of corporate bonds are non-callable, so there's no reason why they shouldn't hold up pretty well if the economy undergoes a major deflation.

Daughter: I couldn't disagree more. Bankruptcy has become far less stigmatized than it was the last time the economy had a protracted downturn, and I suspect default rates on corporate debt would be shockingly high if disinflation gave way to deflation.

Mother: Get real. The odds of that happening are pretty low, don't you think?

Daughter: Ironically, the lower the probability people attach to a deflationary crack-up, the more likely one is to ensue.

Mother: Why?

Daughter: Because people will arrange their affairs as if deflation were an impossibility: the marginal borrower and the marginal lender will combine forces to build the marginal project, and when enough useless or redundant capacity has been added to the economy the downturn will begin. To my way of thinking, investing an endowed institution's assets on the assumption that deflation has been abolished is like playing a single round of Russian Roulette. The odds are actually in your favor, but the consequences of losing are so severe that one would have to be under extreme duress to play such a game.

Mother: True, but I don't see where you're headed. You were the one who suggested a few minutes ago that we ought to **reduce** our policy commitment to bonds, not **increase** it. Now you're suggesting that we're **under**insured against an extended deflation. Which is it?

Daughter: Unfortunately, the answer is both. If I can use an analogy, it doesn't make sense to buy $20,000 of collision insurance on a $10,000 car, especially if the policy becomes void if the car is totaled in a wreck. Why bother with insurance at all if it won't protect you when you need it the most?

Mother: I can't disagree with you on that, but I'm not sure your analogy holds. With 25% of our assets in bonds, a lot of them could get called at par or even default without jeopardizing the foundation's capacity to weather an extended deflation. In the meantime, we're presumably being well compensated for the incremental prepayment and credit risk that we're bearing.

Daughter: I'm not sure the foundation is being adequately compensated for the risks it's taking, but I'm sure about one thing: our bond managers are being well compensated for their work.

Mother: Nothing wrong with that: they've outperformed their benchmarks, haven't they? What more could you ask for?

Daughter: Nothing, except that you consider firing our active bond managers while we're still ahead in the game.

Gambling with Others' Money

Mother: People say that "the apple doesn't fall far from the tree," but I have my doubts about you! If our active bond managers have all outperformed their benchmarks since inception, why on earth would you consider firing them? More to the point, why aren't you proposing the same approach on the equity side, where some of our managers are actually lagging the market?

Daughter: Because the two situations are completely different. Unless you believe all that nonsense about so-called high beta stocks outperforming the market over the long-term, there's no more or less automatic way for an **equity** manager to outperform the market, at least under normal market conditions. But the opposite is true for bond managers: under normal market conditions, all a bond manager needs to do to outperform the market is to buy lower rated paper.

Mother: Or buy longer maturities.

Daughter: True — **if** the yield curve is positively sloped, as it normally is.[1] But bond managers recognize that the typical client won't tolerate underperformance caused by an above-market duration — duration bets are just too darn visible. So they attempt to hang on to their well-paying jobs by putting their clients' money into lower quality paper, or callable bonds, or both. Mind you, we're not talking about **really** low quality bonds — we're talking about fairly strong credits that generate just enough incremental yield to enable the manager to outperform his or her benchmark, net of fees.

Mother: What's wrong with that? If the manager outperforms his or her benchmark net of fees, isn't that a good deal for us?

[1] The yield curve or term structure of interest rates is positively sloped when long-term rates exceed short term rates.

Daughter: No, it's not. If I pay someone who's headed to Las Vegas $100 to take $1,000 of **my** money and play the slot machines with it, am I going to label them a genius if they comeback with $1,200?

Mother: Maybe not, but a quick $100 profit on a $1,100 investment is nothing to sneeze at, especially if you annualize the return!

Daughter: You're missing the point: paying someone else to gamble with our money is a pretty foolish thing to do —

Mother: — unless we're convinced that they're not in fact gambling. I can see why you might regard interest rate forecasting as a form of gambling, but what about a bond manager who outperforms the market **without** making interest rate bets? Isn't there any room for skillful active management in the bond market?

Daughter: Of course there is, but not very much. I have no problem with our letting bond managers exploit the very modest pricing anomalies that crop up from time to time in, say, the Treasury bond market, but I have serious doubts as to whether we should let active managers muck around with other types of bonds — even if the bond sectors that we pass by are less efficient in the valuation sense. I also have doubts as to whether we as a governing board can distinguish truly skillful managers from merely lucky ones.

Mother: In that sense, putting our money to work in the bond market is no different than putting our money to work in the stock market: we can simply index the portfolio and accept a market-like return, or we can use an active manager and hope to do even better.

Daughter: Correct, but before we can intelligently decide between an indexed approach or active management, we need to choose an appropriate benchmark for our bond portfolio. In my view, the appropriate benchmark leaves very little room for active management.

Mother: What benchmark do you have in mind?

Daughter: You're not going to like the answer.

Mother: Try me.

Daughter: The answer is: it **depends**.

Mother: It depends **on what**?

Daughter: It depends on how big a slice of our overall assets we allocate to our permanent bond portfolio. The smaller the slice, the more reliable the portfolio's deflation-hedging characteristics should be.

Mother: You already tipped your hand on that one. You said earlier that you favor a permanent bond commitment of just 12.5% of our assets, which is half of our current policy commitment. Assuming that I'm foolish enough to go along with such a hare-brained scheme, what would our bond portfolio's benchmark be?

Daughter: A pure Treasury index.

Mother: In other words, our permanent bond portfolio would be very high quality, and essentially non-callable.

Daughter: Precisely, and it would be fairly long term.

Mother: How long is long?

Daughter: At least ten years — maybe even longer. I personally like ten years because that's a relatively easy bogey to track: you simply measure what you would have earned holding a ten-year Treasury on a so-called constant maturity basis.

Mother: By "constant maturity," you mean that the benchmark simulates what you would earn if you bought a ten-year Treasury at the outset and then continually rolled your money into newly issued notes, effectively keeping the stated maturity at ten years.

Daughter: Correct.

Mother: What about the Treasury's new inflation-linked bonds? Where do they fit into the picture?

Daughter: They don't — or, rather, they don't fit into the permanent bond portfolio in any way.

Mother: Why is that? They're Treasuries, after all, and the first big slug of them that the government issued not too long ago had a maturity of ten years.

Daughter: True, but they're not really bonds.

Mother: They're **not**?

Daughter: Not in the sense we've been discussing bonds here today. As we discussed earlier, the only reason to hold bonds on a permanent basis is to hedge against deflation. The Treasury's new inflation-linked bonds may perform well when inflation is moving higher, but they're going to perform miserably in a deflationary environment, so in that sense they're not really bonds.

Mother: It sounds to me like you've been spending too much time reading those reports that we get from TIFF!

Daughter: I take it you mean the dialogue on inflation-linked bonds that TIFF published last year. I don't know what you thought of it, but I thought it laid out the pros and cons in a pretty thorough manner.[2]

Mother: Me too, but I'm surprised that you'd cite TIFF as an authority on bond management. After all, the TIFF Bond Fund looks nothing like the all-Treasury portfolio you've been advocating here today.

Daughter: Yes, and no. I admit that it holds way too many corporate and mortgage-backed bonds for my taste, but that's because its aim is to outperform the Lehman Aggregate Index, which includes a lot of corporates and mortgages.

Practicing What You Preach

Mother: If the folks running the TIFF Funds are so smart, why don't they practice what you've been preaching and switch to passive bond management?

Daughter: Funny you should ask that question, because I asked the same thing myself when I chatted with TIFF's president recently.

Mother: What did he say?

Daughter: He said that several members of his board agreed with me, and have persuaded the institutions they work for to essentially index their permanent bond portfolios to a ten year Treasury index. He also said that the board has had several extended debates about adopting the same approach in the TIFF Bond Fund, but has decided for the time being to stick with active management.

Mother: Why?

Daughter: For several reasons. First, he said that most foundations hold way too many bonds on a more or less permanent basis, so they're adequately hedged against deflation even if some of the bonds are lower quality or callable.

Mother: I'm not sure I follow.

Daughter: Let me give you some concrete numbers. The benchmark for the TIFF Bond Fund is the Lehman Aggregate Index, which is roughly 50% government bonds and 50% corporates or mortgages. If the average foundation puts 30% of its assets into the Fund, then its true deflation-hedging bond allocation is at least 15%, which is slightly higher than the 12.5% that I, and apparently several TIFF directors, regard as adequate.

Mother: That's true only if the TIFF Bond Fund resembles the Index. What if its managers reduce the portfolio's duration way below that of the Index, or buy a lot of low quality paper?

Daughter: They can't. The Fund's guidelines state that its duration must be equal to the Index's, plus or minus 15%. So if the Index has a duration of five years, the Fund's duration must be between 4.25 years and 5.75 years.

Mother: Which means that, in the current environment, the Fund's average maturity is likely to fall somewhere between eight and twelve years.

Daughter: Right. And the Fund's guidelines also state that its weighted average quality must be at least AA. So the TIFF Bond Fund displays at least two of the three deflation-hedging characteristics one would want to see in a permanent bond portfolio.

Mother: What's the missing link?

Daughter: Call protection. Because corporates and mortgages represent roughly half of the Fund's benchmark, its managers tend to hold a lot of callable bonds.

Mother: Why doesn't the board do something about that?

Daughter: As I was saying a minute ago, many of the directors believe that the typical foundation allocates too much to bonds in the first place, so it's not a real problem if some of them are callable.

Mother: That sounds a bit disingenuous to me, if not also a bit patronizing.

Daughter: It's hardly disingenuous if they're so open about it. And it's hardly patronizing for the cooperative's directors to give members what they want. If you define patronizing as treating someone in a condescending manner, the patronizing thing for the board to do would be to offer products that member foundations such as ours do **not** in fact want. At least the folks who run the TIFF Funds are honest about what they do. A lot of bond managers won't admit that they're essentially gambling with their clients' money.

Mother: Are you suggesting that the TIFF Bond Fund is gambling with its shareholders' money?

[2] Editor's note: inflation-linked bonds were the subject of a lengthy "dialogue" published in TIP's Quarterly Report dated June 30, 1996. Copies are available upon request to organizations eligible to invest through TIP.

Daughter: No. The Fund's guidelines are much stricter than what you see in the typical bond fund, and the managers are carefully selected and monitored to make sure that they don't take undue risks.

Mother: I'm glad to hear that, because my understanding is that they all work for performance-based fees. Talk about gambling with other people's money!

Daughter: Incentive fees are indeed a great way to **destroy** wealth, as well as compound it, but the TIFF Funds use all kinds of safeguards to ensure that they work as intended. For example, the managers' incentives are capped at a level of performance consistent with what the directors regard as a reasonable level of risk.

Mother: Fine, but you haven't answered my central question. If the directors truly believe that bonds should be held for deflation-hedging purposes only, why don't they convert the Bond Fund into an indexed portfolio of long-term Treasuries?

Daughter: Because it wouldn't sell.

Mother: Since when did the folks who run the TIFF Funds start worrying about **that**?

Daughter: That's not my point. My point is that the directors are trying to do the greatest good for the greatest number of foundations, and it doesn't make sense to offer a product that appeals only to the handful of crazies like me who want to own bonds strictly for deflation hedging purposes.

Paying the Bills

Mother: What about income — doesn't that count?

Daughter: It **does**, to a lot of people. Whether it **should** count is another question. Excluding institutions that cannot legally spend principal, I personally don't see why income *per se* matters very much. What really matters is not income in a formal accounting sense, but rather **cash flow**, which can take many forms.

Mother: True, as we discussed a few minutes ago: you get a lot of cash flow from wasting assets such as real estate or oil wells, but a portion of it is essentially a repayment of principal, even if it's not labeled as such.

Daughter: I can't argue with you there. In fact, you've just hit on one of the chief reasons I want to reduce our so-called permanent bond ratio.

Mother: I have?

Daughter: Yes. Why hold bonds above and beyond what you need for deflation-hedging purposes if there are other assets that provide equal if not more stability to the overall mix at a lower opportunity cost?

Mother: An opportunity cost relative to what?

Daughter: Relative to equities, which are assumedly the main engine of growth for any long-term portfolio. Unless a bond portfolio is heavily invested in junk bonds — which are really bonds in name only — it's almost surely going to have a lower expected return than equities broadly defined, by which I mean common stocks as well as any number of assets and strategies whose expected returns rival those of common stocks.

Mother: I don't want to challenge the professor in her own classroom, but what you've just said sounds mighty familiar. I don't suppose you've been reading the propaganda we received not long ago promoting the TIFF Multi-Asset Fund?

Daughter: In fact, I have, although I'm not wild about some aspects of it. I like the idea of one-stop shopping — of a Fund that aims to cover the waterfront in terms of marketable securities — and I like the idea of including assets and strategies that seek to dampen the Fund's overall volatility if the U.S. stock market in particular encounters some rough air. But I think the Fund's normal 20% allocation to bonds is too high. I also don't like the fact that the benchmark for the Fund's bond segment includes corporates and mortgages, although I understand why that's the case.

Mother: Why?

Daughter: For the same reason that the TIFF Bond Fund uses the Lehman Aggregate as its benchmark: if you're going to have too much in bonds over the long-term — for example, 20% as opposed to the 12-15% that you need for strictly deflation-hedging purposes — you might as well try to earn incremental returns by taking a controlled amount of credit or prepayment risk.

Mother: What you seem to be saying is that the TIFF Funds' directors have adopted surreptitiously certain policies that they themselves regard as suboptimal.

Daughter: It's not surreptitious at all: they're very open about it. Also, whether the policies are suboptimal or not depends on your point of view. If the goal is to do the greatest good for the greatest number of foundations, perhaps the current policies are indeed optimal. Look at all the non-profits in the Upper Midwest that got burned investing in those godforsaken Piper Jaffray bond funds a few years ago. If people are going to use bonds for something other than deflation-hedging anyhow, then it makes sense for the TIFF program to offer a tightly controlled but nonetheless actively managed bond product. And if the mix of strategies and managers in the TIFF Multi-Asset Fund has a higher expected return than a conventional foundation portfolio, then I'm not hugely troubled that the Fund's normal bond ratio is a bit higher than we purists would prefer.

Begging the Question

Mother: In other words, as they say in politics, "the perfect is the enemy of the good."

Daughter: It is indeed. In fact, investing and politics have at least two important things in common.

Mother: What?

Daughter: First, there is seldom if ever a "perfect" solution to any problem in politics or investing.

Mother: Why is that?

Daughter: Because as soon as you think you've got the world figured out, it moves on you.

Mother: What's the second thing they have in common?

Daughter: The second thing that politics and investing have in common is this: while effective marketing is by no means a necessary condition for success in either field, it **is** a sufficient condition for success in both!

Mother: That may be true, but that doesn't mean that you and I should vote for the smoothest-talking politician who comes along. And it emphatically does **not** mean that we should have our foundation's assets managed by folks whose reach exceeds their grasp.

Daughter: I agree, which is why I'm proposing that we adopt a passive or semi-passive approach to bonds. Even if a bond manager has beaten its benchmark, you can never be sure whether the outperformance is due to skill or excessive risk-taking. If I had my druthers, I'd keep our permanent bond holdings to an absolute minimum; I'd have them passively managed; and I'd spend as much time and energy as possible optimizing the return on the rest of the portfolio.

Mother: I'd be curious to know what the folks at TIFF say about such an approach. Have you discussed it with them?

Daughter: Yes — briefly.

Mother: With who?

Daughter: TIFF's president.

Mother: What'd he say?

Daughter: I think he's spent too much time in politics!

Mother: What do you mean by that?

Daughter: I mean that he gave me a rather artful answer. He said that some of his directors agreed with me, while others did not, but that the issues I raised were important ones. In fact, the board has them under active discussion. He also said that the cooperative is committed to offering products that are responsive to its Members' needs.

Mother: But that begs the most important question: who decides what the Members need?

Daughter: The directors, I suppose, although ultimately the Members do, because they control who sits on the board. Also, we can always vote with our feet, so to speak. In the meantime, it's comforting to know that we have a voice in how the Funds are structured and also that the directors and staff are interested in Members' views on such matters.

Mother: Speaking of voting with our feet, I move that we adjourn for today, subject to an agreement that we will continue this discussion at future board meetings.

Daughter: On that we can both agree. I second the motion.

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Much Ado about Bonds - The Sequel

Daughter: Did I tell you about my trip to Charlottesville?

Mother: What on earth were you doing in that cultural backwater?

Daughter: Some backwater. The Man of the Millennium made his home there, and there are lots of interesting things to do. You'll see for yourself when we go there for the TIFF Members' meeting next spring.

Mother: **Now** I remember: you got invited to TIFF's May board meeting. How was it?

Daughter: It reminded me of what a veteran soldier once said about war: endless periods of inactivity punctuated by moments of sheer terror.

Mother: Very funny. Was it really that bad?

Daughter: I was teasing. Actually, it was quite interesting, although I hit the wall a bit sooner than most of the directors. I joined the proceedings at mid-morning on a Monday and they didn't adjourn until late on Tuesday.

Mother: What took so long?

Daughter: Lots of complex issues to discuss, plus multiple manager presentations.

Mother: Where did the board come out on the questions about bond investing that you and I have been discussing?

Daughter: The directors basically agreed to disagree. A few of them wanted to make the changes that I advocated in my talk with you — cut the normal allocation to bonds, tighten up the quality and callability constraints, and invest the proceeds in higher-returning assets — but the majority favored maintenance of the status quo. Evidently, the policies I favored are too radical for most of the organizations that TIFF aims to serve.

Mother: Was that the only reason your side didn't prevail?

Daughter: No, the board also decided that it would be unseemly for the cooperative to suggest that foundations shift money out of bonds and into strategies with a higher expected return until TIFF's absolute return fund is up and running.

Mother: You mean a vehicle that would mimic the Equity Substitutes or absolute return segment of TIFF's Multi-Asset Fund?

Daughter: Exactly. That's a logical place for money removed from the bond market to flow, but TIFF wants to beef up its staff before it adds any more products. My understanding is that this process will be completed this fall.

Mother: What about TIFF's so-called Private Investment Program? Why can't the board tell foundations to shift bond proceeds into it?

Daughter: For several reasons. First, PI's don't provide nearly as much diversification against stock market declines as their fans allege. In fact, the risk reduction they theoretically provide is attributable mostly to the fact that they're not marked to market very often. If you marked PI's to market with the same periodicity as marketable assets, many of them would be just as volatile. Second, the directors are concerned about how much institutional money is flowing into PI's these days, and they don't want the pressure of having to put large sums of money to work in an overheated PI market. In fact, the PI market is so overheated that the board had to wine and dine several PI managers at dinner after the first day of meetings.

Mother: I thought managers are supposed to treat clients, not the other way around.

Daughter: The managers I'm talking about are forming partnerships that are vastly oversubscribed, so the shoe's on the other foot, so to speak.

Mother: Were the managers impressive?

Daughter: Very — not only the PI types but also the marketable securities managers that made presentations to the board.

Mother: What about the directors? Were they equally impressive?

Daughter: No comment. You can judge that for yourself when TIFF holds its first Members' meeting next May in Charlottesville.

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