Why Not 100% Stocks?

[Stock Allocation Discussion]

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The following is an address presented by TIFF president David Salem at a recent symposium on endowment and foundation investing. It takes the form of a conversation between two people who have different views on the wisdom of investing 100% of an institution's assets in common stocks. The two people are a father and his son. The father is a self-made man, now retired, who spends most of his time tending to a private foundation that he founded. The son is successful in his own right, and is a member of the Board of Trustees of the college that both he and his father attended.

Son: Did I tell you about the college's new investment policy?

Father: No, but it sounds ominous.

Son: Very funny. Seriously, the two neanderthals that you've heard me complain about before have finally rotated off the Board, and we finally mustered enough votes to adopt a new investment policy.

Father: A new investment policy? Isn't that an oxymoron?

Son: What do you mean?

Father: I mean that, whatever the policy is, it may be new to the college, but it's almost certainly been tried before. As Harry Truman said, the only thing new under the sun is the history that you don't know.

Son: I wish we could have just one conversation in which you didn't quote Harry Truman.

Father: Don't you go knocking Harry Truman. Harry Truman was the —

Son: I know . . . I know. Harry Truman was the greatest president in your lifetime. In any case, I doubt very much that the policy we've adopted has been tried before.

Father: What is it?

Son: We're going to put every penny of the endowment into common stocks.

Father: That's not new, that's madness.

Son: I knew you would say that. What do you mean, it's not new? Do you know any other college that invests its entire endowment in stocks?

Father: I don't know of any colleges that do that these days, but I know that the last time a bunch of colleges decided to put all of their money into stocks it was the perfect contrary indicator — like seeing the stock market on the cover of "Time" or "Newsweek".

Son: I take it the disaster you're referring to was the big bear market of the early '70s.

Father: That's right.

Son: No — it's wrong, or rather I should say that the idea that the bear market of the '70s proved that an all-stock portfolio is the wrong approach for long-term investors like the college is wrong.

Father: Are you trying to tell me that it was not a mistake to climb aboard the stock market bandwagon just before it hit a brick wall in the early '70s?

Son: Actually, Dad, if you study the data, what you discover is that the brick wall that equity investors supposedly hit in the early '70s was really just some heavy fog. If they had just kept their wits about them, and not bailed out at just the wrong time, they would have done just fine. Do you have any idea how much better stocks have performed than bonds since the early 1970s?

Father: I suspect the margin is pretty impressive, especially if you use the stock market trough at the end of 1974 as your starting point.

Son: You know me better than that. Aren't you the one who taught me that you can't be sure your views are correct until you weigh them against the strongest possible counterarguments?

Father: You should be grateful I taught you that lesson — it cost me more than I care to recall to learn it on my own.

Son: Spare me. The point I'm making is that, even if you use the peak of stock prices in 1972 as your starting point, rather than the trough in 1974, stocks have done a lot better than either bonds or cash — about 11.5% annualized for stocks, versus 9.6% for bonds and just 7.3% for cash. The problem with the all-equity approach that a lot of colleges adopted in the early 1970s is not that the approach was wrong, but rather that they didn't have the discipline to stick with it.

Father: In other words, Mac Bundy and the other know-it-alls at The Ford Foundation were right: the only sensible thing for truly long-term investors to do with their money is invest it entirely in common stocks.

Son: Exactly. The numbers are overwhelming.

Father: Let me ask you a question: why was it that the schools which climbed aboard the Ford Foundation bandwagon chose to bail out at such an inopportune time?

Son: Because their trustees didn't have the courage to stay the course.

Father: Exactly. Now let me ask you another question.

Son: Don't even bother asking it — I know what it is: what makes me and the other trustees think we'll have the courage to stay the course if the stock market heads south in a hurry?

Father: That's a good question that we should come back to, but it's not the question I had in mind. I was simply going to ask why you and the rest of the board feel so compelled to invest the whole endowment in equities. What is an equity, anyhow?

Son: What kind of a question is that? You know perfectly well what an equity is, and you know better than I do that ownership is much more profitable than creditorship over the long term. I doubt that any of the bankers who lent you money to build your own business have a net worth one-tenth the size of yours, to say nothing of their own private foundations. Remember how you used to rant and rave at the dinner table about how hard the bankers were squeezing you? Look who wound up on top in the end. They would have been a whole lot better off if, instead of lending you the money for a fixed rate of return, they had taken some of the equity instead. But, knowing you as I do, I bet you would have done just about anything to avoid selling them a piece of the business when it was just getting started.

Father: Are you kidding? I would've sold them stock in a heartbeat. Just because the bankers themselves didn't get rich doesn't mean the bank didn't make out like a bandit. The reason I used to rant and rave about the bankers is because I knew they were charging me too much for the money, but there was nothing I could do about it. I had no track record running a business, no staff to investigate other ways of financing our growth — basically, I was stuck, and the bank knew it. That's why the bank was able to drive such a hard bargain, and it's why I used to complain that I was doing all the hard work while the bankers were out doing whatever it is that bankers do.

Son: What you seem to be saying is that, even though you were the sole stockholder, the bank was actually an owner in a certain sense. If that was true, why didn't the bank get rich like you did?

Father: It did, in a way. Because the bank knew that I had no other source of funds, it charged me the highest rate of interest it could without forcing me out of business. So even if the bankers themselves didn't get rich, the bank's shareholders sure made out nicely, at least with respect to my loan.

Son: Then you concede my point: it's better to be a shareholder than a creditor, especially over the long term.

Father: I've done nothing of the sort. The reason the bank's shareholders earned such high returns on the money I borrowed is not because they held a piece of paper that let them share in the bank's profits but rather because they were on the winning side of a tilted playing field.

Son: What do you mean?

Father: What I mean is that the bank's shareholders were in a position to exploit the inefficiencies I mentioned a minute ago. Even though I knew the business was going to succeed, nothing I could say could convince the bankers that the loan was less risky than it seemed, and I didn't have the time or money to identify other ways of financing our growth. The best way to make lots of money over the long term is not by loading up on pieces of paper that say "common stock" on them but by making bets whose actual risks are lower than their perceived risks.

Son: I hate to say it, but — again — you've conceded my point. The reason we're moving to an all-stock portfolio is exactly what you've just said: for a truly long-term investor, the actual risks of stock ownership are a lot lower than the perceived risks. Did you know that there isn't a single 20-year time period when you would have lost money in the stock market, and there are only two 10-year time periods when you would have done so?

Father: I didn't know the exact figures, but I'm not surprised they're as rosy as you let on. The reason, of course, is that whenever you use a time series containing more positive years than negative ones, the rolling time periods you just referred to will be skewed to the upside, especially if the worst years come in the middle of the time series, as they do with the Great Depression. Let me turn the tables on you and ask you this question: how many times this century has the stock market declined 20% or more?

Son: Let's see, there was the Panic of 1907 ... the big inflation scare right after World War I ... the Crash of '29, of course ... That's three. I think there was a pretty big reversal in the mid-30s, and there may have been a 20% decline when Kennedy had his fight with the steel companies ... and then there was the big break in '73 and '74 that we already discussed. What's that make? Six?

Father: Six! Talk about a gap between actual and perceived risk! The correct answer is 31, meaning that the market has fallen by more than 20% about once every three years. Let me ask another question. Suppose you do move 100% of the endowment into stocks? Are you going to dump the whole thing into an index fund, or are you going to use active managers?

Son: Active managers.

Father: Why?

Son: Because the college has had pretty good luck picking money managers, or I should say picking other people who in turn pick money managers. As you know, we rely heavily on The Common Fund.

Father: And The Common Fund has done a good job picking managers. But let me ask this question: if you're going to invest the entire endowment in stocks, and have the stocks actively managed, are you going to raise the spending rate to reflect the value that you expect your managers to add versus the market?

Son: Yes and no. As you may recall, when the endowment was throwing off such high current yields in the early '80s, the Board shifted from a spend-all-income policy to a so-called constant growth policy. The idea was to peg the initial spending rate at an amount equal to five percent of the endowment, then grow that amount at five percent per year. But the endowment has performed a lot better than we expected, so the actual spending rate has fallen. So we've decided to make a one-time adjustment in the nominal spending amount so that it equals five percent of the endowment's current market value, then grow that figure at the same five percent rate we've been using all along, which is roughly what we think we can earn from stocks net of inflation and fees and things like dividend withholding on foreign equities.

Father: Isn't five percent too conservative an estimate of the real return you can earn from stocks over the long term, especially if you invest a portion of the endowment overseas?

Son: As you can imagine, we had some pretty heated debates about that. Some of the folks in the Econ department lobbied in favor of a six percent growth assumption, while others favored a figure even lower than five percent, so we compromised on a one-time increase in the nominal base amount coupled with a five percent growth rate to reflect the portfolio's assumed return net of inflation.

Father: What about the assumed premium from active management?

Son: Too uncertain.

Father: What do you mean it's too uncertain? I thought you said that the college has had pretty good luck relying on active managers.

Son: It has, but you know as well as I do that active management is a two-edged sword, and we figured the prudent thing to do was to exclude an assumed premium from active management when choosing an appropriate spending rate.

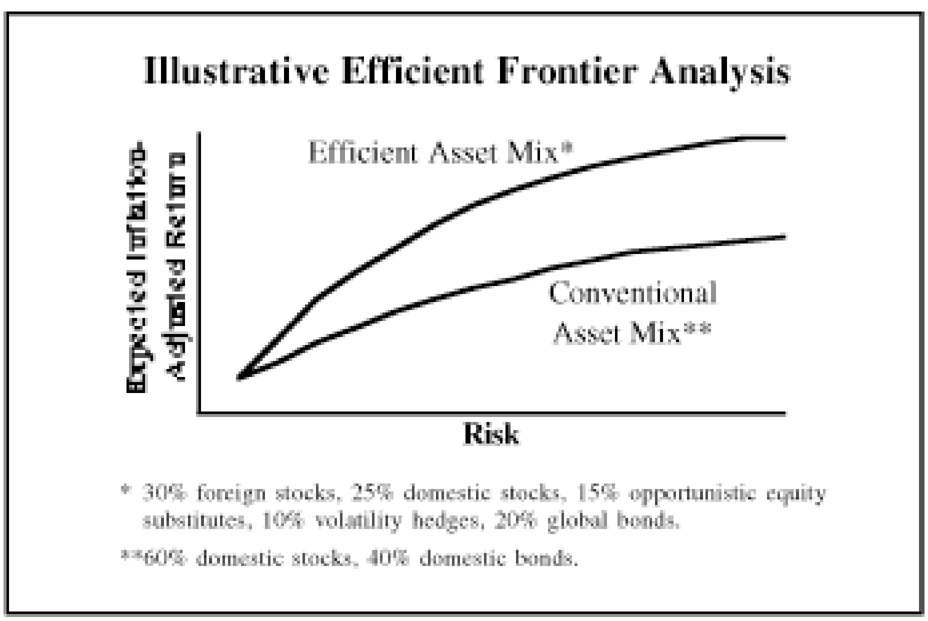
Father: And when choosing your new asset mix.

Son: What do you mean? I told you, we're going to invest the whole endowment in stocks, which are the highest producing asset class anyhow. Even if you make the assumption that our managers will continue to add value, that simply reinforces the case for an all-equity portfolio. So the premium, if any, that we earn from active management is irrelevant to the asset mix decision.

Father: Let me get this straight. You're going to shift all of the money into stocks based on the indisputable fact that, historically, stocks have been the best-performing asset class, but you're going to ignore the equally indisputable fact that, historically, the college's active managers have beaten the market. Sounds like a pretty selective use of history. Didn't anyone argue that if your managers add enough value you can maintain the same five percent growth rate in endowment spending without having to bear the risks of an all-equity portfolio? I can't do the numbers in my head, but I suspect that you can justify shifting a lot of money out of stocks and into other asset classes without sacrificing much, if any, real growth if you simply use the right managers — not only on the stock side, but wherever you happen to invest.

Son: I hear you, but as I've already said, the investment committee wasn't comfortable assuming that the managers we use will continue outperforming the market, especially after some folks from the Econ department sobered us up with some studies showing how difficult it is to beat the market.

Father: What makes you think anyone in the Econ department knows the first thing about how to compound wealth? Right after I sold the business and set up my own foundation, I spent a lot of time reading the academic literature on investing. What a bunch of hooey — especially all that nonsense about so-called efficient frontiers.



Son: What do you mean nonsense? Isn't it a fact that you can improve your portfolio's risk-return profile by dialing in assets that rise and fall at different times?

Father: I'll answer that question in a second, but before I do, let me ask this: if you're so impressed by efficient frontier analysis, why do you support the college's shift to an all-stock asset mix?

Son: That's an easy one: because we want the best return we can get over the very long term, and when you run an efficient frontier model using a really long time horizon it basically ignores the short-term price fluctuations, and it quite logically puts you 100% into stocks.

Father: Oh no it doesn't — it puts you 100% into whatever asset class has performed best over the multi-year time series you plug into the model. If you tell the model that venture capital or foreign stocks or impressionist paintings have historically performed best, that's the asset class the model will drive you toward.

Son: True, but when the folks in the Econ department ran a model for us we told them to limit the choices to stocks, bonds, and cash.

Father: Why on earth did you do that?

Son: Because almost every time the college has invested in alternative assets of the sort you just mentioned, they've done poorly, and several Board members have said that if the college is going to earn subpar returns they'd rather do so the old-fashioned way! They dabbled in oil and gas in early '80s, and that didn't work. They dabbled in venture capital in the mid-80s, and that didn't work either. Then they got excited about real estate, only to discover that it doesn't produce anything close to the stable five percent real returns that the marketing types trumpeted at the time the investment was made. The basic problem is that the storybook returns from so-called alternative assets that you read about always flow to someone else.

Father: Ever wonder why that's the case?

Son: I figure it's because the insiders keep the good deals for themselves, but pass along the bad ones to outsiders.

Father: That's not it at all. The reason a lot of folks have never made serious money investing in alternative assets is because they wait until the pitch is in the catcher's mitt before they take a swing.

Son: I just knew you'd sneak in a baseball metaphor at some point. What the heck does that mean?

Father: It means that by the time enough evidence rolls in to confirm that an asset class or strategy has really favorable risk-return characteristics, the big bucks have already been made. The basic problem is that comfort and expected return are inversely related, which is why I said earlier that efficient frontier approaches are all a bunch of hooey.

Son: You lost me. What does the fact that, on a dollar-weighted basis, most institutions have done poorly investing in alternative assets have to do with the statistical assumptions underlying efficient frontier studies?

Father: That's exactly the problem. The underlying assumptions aren't statistical at all, they're behavioral. What's more, they're directly at odds with the way most committees actually behave.

Son: What do you mean?

Father: I mean that few if any committees I know of are both able and willing to do what's needed to actually realize the returns that so-called efficient asset mixes theoretically produce. The chief reason those asset mixes appear so attractive is because they assume that investors can and will rebalance their assets mixes every year back to the target weight for each asset class.

Son: What's wrong with that?

Father: Two things. First, most committees lack the discipline to make the contrarian rebalancing moves that efficient frontier approaches presuppose — to sell Asset A when it's up 50% and shift the proceeds into Asset B. Second, even if they have the necessary discipline, it's difficult if not impossible to rebalance as needed because some of the asset classes that make so-called efficient mixes efficient are illiquid — venture capital, for example. The irony is, if you truly believe that stocks produce the best returns over the long term, you eventually wind up with an all-stock portfolio anyhow, regardless of your initial asset mix, so long as you don't rebalance the portfolio.

The Power of Diversification (?)

	Start of Year 1	End of Year 1	Start of Year 2	End of Year 2	Cumulative Return
Return Assumptions					
Asset A		50.0%		-25.0%	12.5%
Asset B		-25.0%		-50.0%	12.5%
Diversified Portfolio: **Rhetoric***					
Asset A	$100	$150	$113	$84	
Asset B	$100	$75	$113	$169	
Total	$200	$225	$225	$253	
Return on Total		12.5%		12.5%	26.6%
Diversified Portfolio: **Reality****					
Asset A	$100	$150	$150	$113	
Asset B	$100	$75	$75	$113	
Total	$200	$225	$225	$225	
Return on Total		12.5%		0.0%	12.5%

* Assumes 50% in A and 50% in B; rebalanced at end of Year 1.
** Assumes 50% in A and 50% in B; no rebalancing.

Son: True, because the best-performing asset class eventually becomes the only asset class — if you don't rebalance. But why are we talking about rebalancing — with an all-stock portfolio, the problem of determining when to rebalance goes away, as does another problem I think you're overlooking.

Father: What's that?

Son: You said a minute ago that you thought we could justify investing less than 100% of our assets in stocks without reducing our return objectives by assuming that our managers will beat the market. But that creates a Catch-22: we can't estimate the margin by which we expect to beat a given benchmark without at least some idea of how much we're going to invest in each asset class, because the excess returns themselves depend not only on how much we're going to put to work in each area but also on the amount of time we're going to spend selecting and monitoring managers. The Catch-22 is that the Committee can't determine how it's going to allocate the finite amount of time it has at it's disposal until we've formulated at least some idea of how much money we're going to invest in each asset class. The beauty of our new, all-stock approach is that it not only helps us break out of this viscious circle, it also helps us determine what the Committee should do with its time.

Father: Which is what — micromanage the stock portfolio?

Son: Of course not — we're going to spend all of our time making sure that we're using managers and strategies that give us the best possible chance of earning those elusive excess returns you keep referring to.

Father: What if an opportunity comes along to earn even higher returns with less risk by investing in something other than equities?

Son: I don't see how that could happen, unless you assume that the asset class itself will outperform stocks over the long term, which is pretty far-fetched.

Father: What if the assets are so inefficiently priced that good active managers can produce alphas that will more than offset the long-term advantages of stocks?

Son: You sound like the fellow who ran the Orange County investment pool into the ground. You know as well as I do that it's a lot harder to wring excess returns out of the fixed income markets than it is to wring them out of the stock market, especially if you invest globally. You do believe in global diversification, don't you?

Father: Global investing, yes. Global diversification, no.

Son: What's the difference?

Father: Global investing means that you're willing to move your money around the world to wherever it will earn the optimum return. Global diversification means that you've swallowed hook, line, and sinker the poppycock which states that you can reduce risk without reducing return by adding foreign stocks to an otherwise all-domestic portfolio.

Son: You can — the evidence is pretty clear.

Father: Not the way I look at it. What the data tell me is that foreign stocks provide a lot of diversification when you need it least, but almost no diversification when you need it most — when your domestic stocks are plummeting.

Son: You're not suggesting that we should plow the entire endowment into domestic stocks, are you? That's exactly where the Ford Foundation went wrong back in the early '70s. You know what Harry Truman said about studying history —

Father: Yes — but I also know how dangerous it is to draw the wrong lessons from the past, which is what you're doing.

Son: How so?

Father: The mistake made by Mac Bundy and the other smart-alecks at the Ford Foundation who encouraged colleges to load up on stocks at exactly the wrong time was not that they failed to invest on a global basis but rather that they misunderstood completely why stocks perform so much better than bonds.

Son: Why do stocks produce a higher return than bonds?

Father: Because they're priced to do so, or I should say they are normally priced to do so. As far as I'm concerned, the historical data don't mean a thing. The only thing that matters is the current price tag — whether it's cheap or expensive in relation to the cash flows you're buying.

Son: Come again? Isn't the long-term superiority of stocks rooted in the very nature of capitalism? I don't see how we can possibly go wrong with an all-stock portfolio, unless capitalism itself fails to survive.

Father: Actually, just about the only condition under which capitalism could be extinguished, at least temporarily, is if all other investors also moved to an all-equity asset mix.

Son: What are you talking about? If everyone sold off their bonds and shifted the money into stocks, it would usher in an era of economic growth the likes of which the world has never seen.

Father: On the contrary — it would set us on the road to economic ruin, except for people wise enough to load up on the bonds that everyone else would be dumping. If no one were willing to hold bonds, governments could spend only what they're able to take in by way of taxes. That may sound like a good idea to a lot of folks — governments spending only what they take in by way of taxes — but it would pretty quickly destroy the infrastructure needed to make capitalism function smoothly in the first place.

Son: Goodness gracious — you sound like a socialist. Talk about a role reversal!

Father: Let's not get into the reasons why you and I didn't get along very well back in the '60s. My point is that I think you're making a big mistake if you don't carry your own arguments to their logical extreme, and see if they hold true even then. Doesn't it bother you that the arguments you've made in favor of an all-equity mix are becoming the norm rather than the exception? I noticed the other day that the largest public fund in the country is basically moving in the same direction. If that isn't a contrary market indicator, I don't know what is!

Son: Just because a lot of other folks are increasing their stock exposure doesn't mean that it's wrong. Besides, a rising tide lifts all boats.

Father: Not if the hull has a hole in it.

Son: You don't think we have the discipline to stay the course do you?

Father: Maybe I do, and maybe I don't. Let's assume that you do — you're still making the wrong decision, for the wrong reason.

Son: What do you mean the wrong reason?

Father: You're plowing all of the money into equities because it's the comfortable thing to do.

Son: Comfortable — you've got to be kidding! What could be less comfortable than plowing the entire endowment into stocks?

Father: How about plowing none of it into stocks?

Son: What would be uncomfortable about that? Why don't we put the whole endowment into CDs?

Father: I know why you asked that question — because you think holding no stocks is the most comfortable choice a board can make — but that's because you haven't studied your history well enough. Ever heard of a man named Dean Mathey?

Son: No. Who was he?

Father: Probably the most successful endowment investor of all time, or rather I should say the most successful American investor of all time. Know who the most successful endowment investor of all time was — American or otherwise?

Son: Only 'cause you've told me at least five times: John Maynard Keynes — King's College, Cambridge.

Father: Very good. Next question: how heavily did Keynes invest in common stocks?

Son: Come to think of it, not very much. I think his asset mix varied from time to time, but I think he invested pretty heavily in commodities, didn't he?

Father: Exactly right — and when he did dabble in the stock market, he was as likely to be short as many issues as he was long.

Son: Ahead of his time, wasn't he?

Father: So was Dean Mathey.

Son: Mathey ... right: your nominee as the most successful American endowment investor of all time. In what sense was he ahead of his time?

Father: To be precise, by about a year, which almost cost him his career. Mathey was the fellow who had the courage to shift Princeton's endowment completely out of stocks in 1928, when bonds were yielding three percent and stocks had been compounding at the rate of twenty-eight percent per year for eight years.

Son: It must have been pretty painful for him when the stock market kept rising for another year.

Father: Damn right, especially since he had his own career as well as Princeton's endowment on the line: even though he was only 38 at the time, he was already CEO of one of the largest trust companies in the country.

Son: That's a great story, Dad, but you missed my earlier point. Even if you buy into the market at a peak like 1929 or 1972, if you stay the course for a long enough time stocks will still do a lot better than bonds or cash. In other words, for all the short-term pain he caused himself and the university as stock prices continued to rise in 1929, I'm not sure that Dean Mathey did Princeton a favor by selling off its stocks. Maybe Princeton would be better off today if it had simply kept its stocks. You know the old saying — getting out at the top doesn't do you much good unless you also know when to get back in.

Father: True, but you don't have to get back into the market at the exact bottom to beat a buy-an-hold approach. Any idea when Mathey put Princeton back into stocks? You know he must have done so at some point, otherwise Princeton wouldn't have the largest endowment per student of any major university, which it does.

Son: Let's see. If he got out when everyone else was clamoring to get in, I suppose he got back in when no one else wanted to do so ... I don't know ... 1933?

Father: Actually, he moved back into stocks in the summer of 1942, when the Japanese were sweeping the Pacific and the future of capitalism was very much in doubt.

Son: Gutsy call.

Father: True, and a brilliant one also. Did you know that if you go back in time to any year prior to 1974, and pick the single best time to initiate a buy-and-hold approach from that date through the present, the optimal entry point turns out to be 1942?

Son: You mean that waiting until 1942 to reenter the stock market was more profitable than jumping back in, say, 1933?

Father: Yes, because the big rally over the next three years was followed by a big decline in 1937.

Son: My Father — the market-timer! I enjoy your war stories, Dad, always have, but I'm not sure they have much relevance for the college.

Father: Why not?

Son: You know full well why not — because committees are terrible at timing the market.

Father: True — but why?

Son: Lots of reasons. I suppose the biggest problem is that they meet on a part-time basis, in an environment where consensus comes first, which is the worst possible environment for investing.

Father: That's a big part of the problem, I admit, but it's not the chief reason I'm opposed to your new all-equity investment policy.

Son: Don't tell me — you think we're going to pull a Dean Mathey in reverse, loading up on stocks at the peak and then unloading them at much lower prices after the first severe decline.

Father: Stranger things have happened. Tell me, what's the average tenure of a member of the investment committee?

Son: Not as brief as you might expect — it's about five years.

Father: Interesting. That means that their average tenure is twice as long as their average time horizon.

Son: What are you talking about? How do you know how long the Committee's time horizon is? You don't even know half the people who sit on it.

Father: Don't have to — the fact is, regardless of how different their liability streams are, all committees have the same time horizon — two-and-a-half years.

Son: That's prepostorous. We wouldn't assume the risks of investing the whole endowment in stocks if we weren't trying to lock in high returns net of inflation over a much longer time horizon.

Father: You're missing the point: the true measure of an investor's time horizon has nothing to do with the liabilities he or she is trying to finance. The true measure of an investor's time horizon is how long he or she is willing to tolerate unexpectedly poor results, and the way most committees function the trigger point for bailing out of a bad investment or manager is almost invariably two-and-a-half years. Nobody bails out after just one year because everyone knows that successful investing requires more patience than that, and — besides — it takes most people a fair amount of time to admit that they've made a mistake. It doesn't take more than about two years, however, for people to develop that queasy feeling that they've taken a wrong turn somewhere, so what typically happens is that an investment or a manager that performs poorly for a second consecutive year gets earmarked as a top agenda item for year three ... Why are you smiling?

Son: I'm smiling because I know how the rest of the story goes: the first meeting of year three arrives, the committee hems and haws but can't quite bring itself to pull the trigger, but it finally does so if things haven't turned around by the second meeting of the third year, which takes place about two-and-a-half years after the performance first turned south.

Father: A chip off the old block, that's what you are. Why do you think so many institutions make so little money investing in alternative assets? It's because their actual time horizons are a lot shorter than their stated time horizons. The trustees all recognize that investing in non-traditional assets requires patience, but what they don't recognize is that the form of patience needed to do well is not the patience to wait for the returns to roll in — it's the patience to wait for an especially opportune time to enter the game — to resist moving to a fully invested position when too many other players are crowding on to the field.

Son: Look Dad, why don't you come right out and say it? The reason you don't like our new investment policy is because you think we lack the discipline to stay the course.

Father: Not true — I gave you a bunch of other reasons too, but I must admit, staying the course is my biggest concern.

Son: I'm glad to hear you say that, because I was beginning to worry that we've made a big mistake. But since your real concern is that we won't stay the course — whereas I think we will — why don't we just agree to disagree?

Father: Because I want to prove to you that you're wrong. You know, at my age, there aren't many pleasures in life, but one of them is to win an argument outright — to hammer the nail flush to the plank.

Son: I wouldn't think of denying you that pleasure, Dad. Hammer away.

Father: Thanks. Here's my final question: why is the Board so intent on earning such high returns?

Son: Are you serious? Do you have any idea how much pressure there is at the College to generate more revenue? We already give financial aid to something like 60% of the students, and the way costs keep going up there's going to be even more pressure on the endowment, especially if government grants and so forth keep shrinking. Did you know that the sticker price of a full four-year program at the College has quadrupled since I graduated? I hate to tell you how much I've had to set aside to make sure that my own kids can go to the college of their choice when their time comes.

Father: That's exactly the kind of thinking that leads me to conclude that you and your fellow trustees can't possibly have the courage to stick with an all-stock portfolio over the long-term.

Son: Come again? I don't see any connection whatsoever between our very legitimate concern that the college do what it can to beef up its revenues and your unproven claim that we lack the discipline to stay the course with an all-stock portfolio.

Father: Let me explain. Remember what we said about Lord Keynes — that he would dabble in stocks from time to time, buying those he deemed cheap and shorting those he deemed overvalued? Know what he looked for in determining which stocks to sell short? He looked for the very things that makes higher education as you yourself just described it an ideal short sale.

Son: Such as?

Father: Such as a large and growing gap between the true costs of the product, taking into account all relevant subsidies, and the price that the ultimate consumer of the product is able to pay for it . . . And the fact that higher education is on the receiving end of one of the most lethal regulatory changes that's ever hit any industry, namely the ban on mandatory retirement for tenured faculty. And if both of those trends weren't bad enough, the very pressures you yourself described tell me that in not too many years there's going to be an incredible amount of excess capacity in higher education.

Son: Why's that?

Father: Because technology has finally evolved to the point where the age-old limits on the number of students that a professor can effectively instruct have been removed, and there's no reason why society should continue to employ thousands of Shakespeare scholars or professors in other disciplines when just a small fraction are truly superior teachers, and an even smaller fraction publish anything of lasting merit during their careers. Believe it or not, I still read the alumni bulletin, and I see what's been happening: top professors are already selling their talents to the highest bidder —

Son: : — like pro athletes, but for a whole lot less pay!

Father: Exactly, and the problem — if it can be called that — is only going to get worse as technology improves and students find it easier to assemble their own custom-designed programs from courses offered all around the country — all from the comfort of their own homes.

Son: Get serious, Dad: you can't possibly argue that delivering a college education through a modem is a better way of teaching people than having them right there on campus.

Father: Of course not. But try as I might, I don't see how we as a society can posssibly generate the wealth to pay for such an experience for more than a small fraction of those seeking a college education. I admit that we're still going to need physical campuses in order to transmit certain knowledge — laboratories for the physical sciences, studios for the visual and performing arts — but there's no reason why we can't transmit other forms of knowledge electronically, and as much as we would both prefer to maintain the status quo of ivy-clad buildings and tailgate weekends, I doubt that we as a society will be able to afford it much longer, if indeed we're not fooling ourselves in thinking that we can afford it today.

Son: I'm inclined to agree, but what does your outlook for higher education have to do with the question we were discussing, which is whether the College's trustees have the discipline to stick with an all-stock portfolio over the long term?

Father: They're opposite sides of the same coin. The only reason the College's trustees have decided to go with an all-stock portfolio — with all the problems that entails — is because they think that doing so will help them avoid an even less comfortable choice, which is to get the College's costs into line. In doing so, they're making a classic investment mistake, which is to let the returns that you need to earn dictate how much risk you're going to take, rather than the other way around. The irony is, the College can probably earn equal or higher returns with less risk by diversifying the endowment beyond publicly traded stocks, especially if it dials in some exposure to relatively inefficient asset classes. But even if you assume that an all-stock portfolio has the highest expected return, I doubt very much that a board that's unwilling to make hard choices now so that the college won't face even tougher choices down the road will have the discipline to stick with an all-stock approach if we get into a serious bear market.

Son: I have to go in a minute, but before I do let me ask one final question: what are you doing with your own foundation's money?

Father: Heck, it would take me hours to describe everything we own. But let me say this about what we're doing on the grantmaking side: we're not giving a single penny to any colleges whose trustees don't recognize that higher education is headed for a massive shakeout.

Son: How can you tell whether they do or they don't?

Father: Two ways: first, by the type of person they've chosen as president; second, and more importantly, by whether they've made it clear to everyone involved — students, faculty, alums, grantors, you name it — that they'll support fully any steps the president takes to eliminate the problems that make higher education such an ideal short sale.

Son: Excuse me while I phone the College's V.P. for development and tell him not to bother taking you to lunch!