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INVESTMENT MANAGEMENT

Three Ideas I Wish I Had Understood From the START

Lessons That Have Made Us Better Investors

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Every summer, TIFF welcomes new first-year analysts. Their arrival reminds us of our own early days in the investments industry. Specifically, it reminds us of some basic principles that we wish we had understood on our first days. We didn't hear about them in our economics or finance classes. We had to learn them the hard way. You'll notice that these ideas aren't specific to investments. These concepts may be more relevant than ever – to us and to our members – in the current market environment.

Creativity is vitally important – and often underappreciated

One good, transformative idea is worth somewhere between 10x and 100x more than a year's worth of fancy spreadsheets. Because investment management is a highly competitive industry, and many practitioners are type-A personalities, my peers and I tend to prioritize executing day-to-day tasks at a high level. Examples include performing error-free calculations, amassing detail to support assumptions, or figuring out newly disclosed information more quickly than the competition. Delivering on these objectives adds value.

However, none of these exercises will add as much value as a single creative new investment that can generate higher returns than alternative positions in the portfolio. As an industry, we tend to spend a lot of time on matters that are urgent, but not always important. In contrast, creativity is important, but never seems urgent. It's easy to get bogged down in projects focused on incremental improvements. Periodically, it's important to take a big step back and try to address the question, "What could make this portfolio or process *much* better?"

For example, for many years, TIFF tended to avoid managers whose funds focused on a particular sector, country, or geographic region. We'd had poor investment experiences previously with a few managers with those characteristics. One day in 2015, several analysts challenged this assumption. That discussion led to a research project that compared returns generated by various specialist managers versus relevant benchmarks

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over time. The research indicated that these funds often outperformed, particularly in certain areas. We just hadn't picked the right managers in the right areas.

Since reconsidering specialists, the managers we've added to the Equity-Oriented portion of our portfolios have in the aggregate outperformed our main equity benchmark MSCI ACWI by nearly 2% *on an annualized basis* with no material increase in the level of portfolio volatility versus the benchmark.[1] Similar creative sparks with positive outcomes resulted in our investments in China after a large correction in that market, a revamping of our asset allocation framework in 2015, and an innovative approach to direct investments. Of course, not all of our new investment ideas have been fruitful, and we have terminated some specialist managers. Examples include specialist managers in the energy, real estate, and emerging markets small cap sectors.

There is a stereotype that successful people on Wall Street wear business suits and spend their days barking buy and sell instructions into telephones. In our experience, the best investors are more likely to be iconoclasts in jeans or flip flops who see the world differently from the crowd.

Being open-minded is more important than being smart

Most successful investment approaches use some form of a Bayesian process: At any given point in time, our assumptions are a function of the then-best-available information; as we encounter new data, we adjust the prior probabilities accordingly.

Sometimes the probabilities can change a lot. Sometimes new information disproves the original hypothesis – maybe a short really should be a long. The industry dedicates enormous resources to gathering information every year. However, if the recipient of the information – typically the portfolio manager or the CIO – isn't open-minded, then the new information has no impact.

[1] Includes 11 manager additions between May 2016 and December 2018 across TIFF's portfolios that are Equity-Oriented specialist managers (managers with a focus on a particular sector, country, or geographic region). Performance calculation is from May 1, 2016 (earliest manager inception date) through August 31, 2022; is net of manager fees and expenses; and is both asset-weighted and time-weighted among managers within TIFF's one portfolio that includes all 11 managers. The 11 managers represent a mix of fund investments and separate accounts. The author and current investment team assumed responsibility for the Equity-Oriented portion of TIFF's portfolios at the beginning of 2016. Volatility comparison based on rolling-three-year volatilities as of December 2015 and December 2021.

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In Q3 2021, our team added carbon credits managers to the Diversifiers segment of our portfolio. Carbon credit allowances were a newer, less-proven part of the capital markets. The managers' positions were 100% long credits, so the additions didn't have some of the obvious diversification properties of a typical hedge fund with material short exposures. Some members of our investment team (maybe even the author of this paper) were not big fans of this idea. After healthy debate, our CIO added the investments to our portfolios.

Although one year is just a start, so far, our carbon credits managers have been additive to our portfolio. In the aggregate, they have generated nearly a 20% net return, roughly 30% better than equities (as represented by the MSCI ACWI), with a beta to equities of just 0.47.[2] As additional information about the damage of climate change continues to emerge, the case for carbon credits has become stronger. The most powerful word in this industry could be "maybe."

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A steady temperament might be the most important characteristic of all

To succeed over the long run, investors need to tolerate some very difficult periods along the way. Regardless of how hard the team works, how thorough the process is, or how intellectually sound the strategy may be, it is inevitable that there will be periods of poor results.* No active manager has a 100% success rate on key assumptions. No investment style is in favor 100% of the time. In fact, the better the long-term results are, the more likely it will be that the periods of underperformance will be large and will not coincide with difficult periods for a majority of the peer group or the market.

These periods will be a very tough test. Failing unconventionally draws a particularly bright and harsh spotlight. Clients who have trusted us to steward their hard-earned

[2] Includes three manager additions between August 2021 and November 2021 across TIFF's portfolios that pursue a pure buy-and-hold carbon credit-allowances (CCA) strategy. Does not include one additional manager added during this time period that has some CCA exposure, as that manager's strategy is not a pure buy-and-hold CCA strategy. Performance calculation is from August 1, 2021 (manager inception date for all three managers) through July 31, 2022; is net of manager fees and expenses; and assumes equal weighting among all three managers. The three managers represent fund investments. Beta comparison is based on 1-year beta to MSCI ACWI as of July 2022.

*Unless focused exclusively on Private Equity during an era of free money and continuous inflows (I jest of course). This comment is not meant to be a thinly veiled jab at my private equity colleagues – though I am jealous at how little time they spend explaining short-term results. I'm simply pointing out that general market conditions for this asset class over the past decade were about as good as it gets. The next decade will likely be more challenging.

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capital will be disappointed. Most of our clients rely on the operating draws from their investment portfolios to make payroll and to fund key aspects of their programs. There are immediate, direct consequences resulting from disappointing returns. At TIFF, we align our interests with our clients'. Beyond the mental angst that underperformance causes us, investment professionals' compensation is tied directly to client outcomes. Finally, because fund flows tend to follow results, underperformance can lead to outflows, which reverberate throughout the firm. The sales and marketing folks' jobs will become much more difficult. The longer and deeper the period of underperformance, the louder will be the calls to, "Change. Fix it! Fix it! *Do Something!!!*"

Our response in these periods of high stress is everything. Distinguishing between an idea that was a mistake versus an idea that is simply out of favor is challenging in the best of times. In periods of underperformance, there will be more of these decisions to confront, and they will often come during periods of greater market uncertainty. Sometimes an adjustment to the portfolio is warranted. Having the humility to admit it is never easy. More often, the point of maximum discomfort is the worst time to change.

One of the most important skills of a good investor is the ability to balance the natural tension between being open-minded to the possibility of a mistake with the confidence to stay the course. Investments that turn out to be research mistakes generally don't recover. Investments that are fundamentally sound – but are currently out of favor – do tend to recover. Adding to good ideas in tough times at attractive valuations can supercharge subsequent results. Great investors have the resolve to ignore the noise, focus on the facts, and trust the integrity of their processes.

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At TIFF we design policy portfolios aimed to weather a variety of market conditions. Trusting our process and sticking to our strategy caused us to add to equities in March of 2020 when it was scary to do so. It caused us to reduce equities, especially tech and internet positions, over the course of 2021. (Honest self-assessment after 1H 2022: We probably didn't cut enough.) People who choose to work in investments are signing up to face these difficult situations and make tough decisions with imperfect information. It's a good idea to start the psychological preparation early to handle challenging times with curiosity, humility, integrity, and courage.

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MSCI ACWI is the **MSCI All Country World Index**, which tracks large- and mid-capitalization stocks worldwide. **One cannot invest directly in an index, and unmanaged indices do not incur fees and expenses.**

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