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Lessons We Might Learn from the Financial Panic

Part I: For Institutional Investors, Especially Endowments and Foundations*

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* Part II ("The Implications for Investment Managers") will be published separately.

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Executive Summary

The financial panic has changed the investment landscape. For institutional investors, the implications may be:

- More liquidity
- Better management of cash flows
- Reduced leverage
- Selected alterations in asset allocations
- More contingency planning
- Different spending policies and stabilization reserves
- Especially acute stress for foundations
- Changes in governance
- Challenges in the investment consultant business model
- In general, a seismic shift in investment management practices

The following are some highly personalized thoughts on the challenges as well as some predictions of the potential outcomes.

Background

I believe that the 2007-09 economic and financial tsunami will have a profound impact on institutional investing. Many of these investors are still in crisis mode but, in time, they will refocus on their long-term strategies. I have interviewed about 50 highly experienced professional investors to determine those strategic topics that are of greatest interest and concern. In all cases, I have promised my respondents total anonymity in their views expressed to me. I have also listed below (*in italics*) my personal conclusions.

Of course, the investment reaction to the financial panic will be contingent in part on whether markets experience renewed setbacks or continue their rebound. If the markets deteriorate sharply, the financial revolution will probably be even greater, but if the rebound continues, memories of the pain will fade faster. My working assumption in this report – correct or not – is that the markets, having bounced off the lows, are more likely to be in wobbly stability than deteriorate or rebound dramatically. In any event, the 2007-09 financial panic has caused enormous pain, with huge implications. Thus, there is a critical need for institutional investors and investment management providers to learn the right lessons from a bitter experience.

1. Liquidity

Many investors have found themselves desperately short of liquidity, requiring a sharp reduction in the financial support for their mission and/or the need to sell the few assets that remained marketable, at distressed prices to avert an even greater squeeze. Of course the problem is that many investments (e.g., highly rated securitized bonds or even some pools of cash equivalents) were perceived as liquid before the crisis but were illiquid as it took place. Virtually all my respondents agreed that for defensive (and perhaps offensive) purposes, they will need to have greater holdings of more liquid assets in the future. This will entail some opportunity costs, given the adage that “investors typically overpay for liquidity.” Especially in

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the near-term, liquidity is very costly since yields on very short-term high quality instruments are currently only a little over 0%. Some suggest that increased holdings of large cap equities will be a good source of future liquidity, while others have sold equities to raise cash and used futures for equity exposure. A few investors recommended that to the degree liquidity is a drag on returns, the overall risk level of the portfolio should be raised to offset the adverse impact.

My belief is that institutions will increase their holdings of liquid assets such as public market assets – particularly short-term bonds – moderately but not dramatically because of the perceived sacrifice in return. Perhaps the opportunity cost of holding a liquidity reserve will be counted as an “insurance premium” or part of the “enterprise cost” but be excluded from the investment performance of the endowment or other invested assets. It would be appropriate to have tiers of liquid assets running the spectrum from short-term high quality cash equivalents to programs such as out-of-the-money puts that might benefit from market turmoil. We should beware of the classic confusion between “marketability” and “liquidity,” the latter connoting both marketability and price stability. Large cap equities do not meet my definition of “liquidity.” I dissent from the concept of raising portfolio risk to offset the cashdrag – a tactic that was one of the chief causes of the financial panic.

2. Cash Flow Planning

Many investors underestimated cash flow pressures, which came from a number of sources besides the general illiquidity of portfolio assets. Cash inflows from older private equity commitments dried up, spending requirements remained high, the need to meet calls (and in some cases margin calls) for private equity commitments persisted, and ongoing programs for the institutional mission continued to require funding – all of which occurred at a time of extreme pressure on philanthropy. Some endowments were required under duress to liquidate long-term investments at distressed prices or to borrow in order to meet cash requirements.

It seems obvious that assessing cash flow requirements is critical. My respondents were universally of the opinion that institutional investors will be much more careful in measuring future cash flow requirements and risks. A powerful negative lesson will be to avoid investing working capital monies in long-term endowment assets. Endowment funds may even overreact: I have heard some investors mention cash flow planning assuming zero investment returns, no inflows from existing private investments, two years of spending policy at 5% each, plus 10% for typical calls on existing private equity commitments – all of which add up to a draconian target of 20%. Executing a policy to protect cash flow will be complex, given questions about future “liquidity,” the drag from holding cash, and the contingent nature of many cash inflows and outflows. Clearly cash flow planning needs to be integrated with the size of a liquidity reserve.

3. Lines of Credit

Lines of credit represent an alternative to maintaining cash and/or liquidity, and some institutional investors are arranging or renewing such lines. However, the related complexities are daunting. Will the line actually be available at the moment of acute distress when the borrower almost by definition will be more fragile? Will the line be dedicated to the underlying institution (which in many instances already has outstanding debt) or to the investment management activity? Will the line when accessed be unsecured (preferred by the borrower) or secured (preferred by the lender)? Will there be a heavy cost of arranging a contingent line of credit? If secured, how will the collateralization differentiate between liquid or illiquid assets – a distinction that becomes especially hard to make during periods of financial distress. How will one disaggregate the collateral if there are large amounts of restricted assets commingled in the endowment, especially if they are “underwater?” Does accessing a line of credit in order to hold long-term investments represent a *de facto* margin account of leveraging the assets? Most philosophically, will a secured lender in reality be willing to run the reputational risk of seizing collateral from a distressed nonprofit organization with a visible public purpose?

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Superficially, a line of credit seems an attractive alternative but, as one examines the complexities and costs, my judgment is that lines of credit will ultimately be a minor part of the attempted solution.

4. Investment Leverage

There is broad agreement that one of the fundamental causes of the financial panic was excessive leverage. **Leverage, financial engineering, and structured** have become dirty words. The existence of leverage accentuated cash flow problems, increased the already high volatility of returns, and torpedoed some investment pools. In some instances, the magnitude of leverage has not been obvious until after the damage has been done. My respondents displayed considerable interest in attempting to both understand and quantify the magnitude of risk through leverage.

At the very least, I expect that asset allocation policy portfolios will no longer have a target for “negative cash,” e.g., leveraging the entire portfolio. It is my belief that institutional investors will be demanding much more transparency on use of leverage, perhaps requesting real time monitoring. However, actually calculating the risk of leverage is a complex subject, especially when derivatives are involved. I expect renewed attention to attempting performance attribution on the return benefits of leverage vs. other sources of return. On balance, I believe leverage will decline. But especially over the long-term, institutional investors may find the additional return that leverage can generate to be too attractive to eliminate altogether.

5. The “Endowment Model” and Optimization

The common and previously successful practice of building a theoretically well diversified policy portfolio by extrapolating recent volatilities, correlations, and returns did not work well in the financial panic. Virtually the entire spectrum of risky assets became tightly correlated under pressure, and theoretically optimized portfolios exposed endowments and foundations to great risk and poor returns. Some respondents argue that the “endowment model” is broken. They contend that in the future it will be superseded by more qualitative judgments and less quantitative modeling, and by the application of more “common sense.” Less radically, many institutional investors and consultants state that past asset allocation policies have been too thinly sliced and that future policy portfolios should be more broadly defined (e.g., protection against inflation or deflation or perhaps combining buckets for equity and credit risk).

While the “endowment model” as symbolized by Yale and Harvard[†] has been subjected to some recent criticism, I believe it is premature to discard it. In reality, the actual implementation of the endowment model was quite heterogeneous among major endowments and foundations. Despite the difficult times of the last year, the long-term records of Yale, Harvard, and many others are still excellent. I concede that the foundations of building a purportedly diversified portfolio have been shaken and execution by some of the endowments has been flawed. Under the influence of admirers and consultants, perhaps there was simply too much money trying to follow Yale and Harvard. Maybe smaller adherents had less sophistication or poor timing. The optimization models may have been based on history that is too short, and slavish rebalancing has been contraproductive. On the other hand, the truly extraordinary market events, which could serve as enhancements or alternatives to current optimization models, are separated by many decades. I cannot imagine that investors would rely heavily on quantitative models that involve what will be perceived as multi-decades old “ancient history.” The conundrum is that if indeed the traditional endowment asset allocation principles are broken or badly damaged, I have not yet encountered a good description of a future disciplined model that will be materially better than the old one. It is hard to argue against the application of “common sense” but I am skeptical of its efficacy. An interesting embellishment to the evolution of the “endowment model” is that institutions might define a set of conditions (e.g., exceptionally low volatilities, high complacency, unusually low risk premiums) that, if reached, would trigger an override of the normal asset allocation policy portfolio. The trick will be to identify the critical conditions for the next panic rather than extrapolating experiences from those of the past.

[†] In the interest of full disclosure, I was a member of the Board of Directors of Harvard Management Company from 1984 to 2005.

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6. Consultants' Market

The financial pain associated with the crisis has provided a mixed message for investment consultants. Some critics contend that consultants have been excessively focused on establishing high-risk, long-term policy portfolio targets, over-reliance on quantitative modeling and strict rebalancing. Thus, having been on automatic pilot, they purportedly led endowments “over the cliff” with failure to recognize the bubble in risky assets. Specific problems have arisen when consultants have been the gatekeeper for hedge funds that have gone bad. True cynics suggest that one of the benefits of consultants is that they can be fired easily if things go bad. Defenders of consultants argue that the endowment model espoused by many consultants worked for long periods prior to this crisis. Small institutional investors in particular may not have the resources and sophistication of external consultants. It will take a longer period after the crisis to ascertain whether the typical consultant approach is correct. Indeed, some consultants are benefiting from outsourcing asset allocation and manager selection (a variation of which is outsourcing the full responsibility to external management) on the grounds that lay investment committees, having failed to protect their endowments, do not have the skills to manage the endowment directly.

Great financial pain inevitably brings criticism, some of which is now being directed at consultants. One hears reports of more churn among institutions in their use of consultants. A specific question regarding who is truly the fiduciary arises in cases where endowment funds delegated the selection of managers to consultants, especially for high-risk alternative asset pools. Consultants are retained as advisors and do not have either the fee structure or capital base to operate as fiduciaries. On the other hand, increasingly lean and stressed institutional investors may perceive a strong need for objective advice and research, up to and including the full outsourcing of the investment responsibility. I suspect that there is a strategic benefit to larger consulting firms with deeper research and more resources, which may lead to consolidation within the consulting community. On balance, we are undergoing a testing period for consultant practices and a need for more precise identification of roles and responsibilities.

7. Hedge Fund Allocations

In my interviews, very few topics created as much controversy as hedge funds. Hedge funds are an extremely heterogeneous set of investment strategies, and one can debate whether they meet the test of comprising a distinct asset class. During the financial panic, a handful of disastrous, outlier hedge funds collapsed, producing exceedingly poor returns; some even proved to be frauds. Prime brokerage relationships and access to leverage have been tightened. The number and assets of hedge funds have declined by about 15% and 30%, respectively. Whether hedge funds were “effective” during the panic is controversial, and depends on your point of view. On the one hand, hedge funds on average declined considerably less than equities. However, if investors expected a positive absolute return, they have been disappointed. Investors have been dismayed by the imposition of “gates” and the inability to withdraw capital. Some institutional investors believe the fees have been too high and the fee structure too asymmetric. Thus, led by public pensions, there is now an intensive effort to change the fee structure to favor investors. Particularly contentious is the subject of whether hedge fund of funds will disappear because of high fees and asset/liability mismatches or thrive because investors and consultants don't want the responsibility of selecting individual hedge funds.

Given the desire for reduced leverage by investors, I believe that allocations to hedge funds will decline, but only modestly, from current diminished levels. For a period, the bad apples among hedge funds will have an undue impact on the willingness of institutional investors to stomach the risk. However, the greater investment flexibility of hedge funds and the desire for absolute return represent a secular change in investment practices that will persist. The decline in proprietary trading from investment banks may open up more opportunities in a market where risk premiums are now (finally) attractively high. There may be some melding of investment activities that have previously been classified as “hedge funds” with opportunistic and flexible strategies executed by larger institutional investment providers. The most common example of this is the increasing use of long/short strategies by previously long-only managers. In the meantime, the scrutiny of hedge funds will remain high. Their regulatory burden, compliance requirements, custodial scrutiny, and demands for more transparency will almost certainly

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increase, further raising the critical mass required for successful hedge funds. Hedge fund managers will probably press for longer lock-up periods to reduce the chaos from untimely withdrawals, while investors will resist, pushing for more liquidity and ease of exit. I suspect those hedge fund of funds that have not suffered reputational damage will persist, especially for smaller institutions without the resources to diversify, perform sophisticated due diligence, or meet the minimums of investment consultant gatekeepers. Lastly, the future attractiveness of hedge funds faces two structural challenges. Many of the smaller entities face the hurdle of executing generational leadership change. In addition, if the carried interest potential looks bleak (a major revenue source for fund managers), funds may close at what would likely be an inopportune time for investors. Thus I believe hedge funds will remain a potent force but there are a lot of questions to be answered as this relatively young investment activity matures.

8. Private Equity

The term private equity also has a broad spectrum of heterogeneous activities, ranging from early stage venture capital to very large corporate buyout funds, with many strategies in between those poles. The venture partnerships have little or no leverage but face delayed returns of capital to investors as the market for initial public offerings has virtually closed and corporate acquisition appetite has been stunted. However, at the opposite pole, large corporate buyout funds employed substantial leverage, and are experiencing significant distress. The biggest problems for those funds comes from deals purchased at premiums during the stock market bubble, which were viable only because of loose lending standards. Among such deals, the problems are exacerbated problems when debt rollovers are required to sustain the enterprise.

I believe that the appetite for venture capital and the continuing benefits from explosive technology change will remain strong, even though investors may be disappointed by the longer time periods that will likely be necessary to achieve returns. However, some corporate buyout funds have been revealed as highly dependent on leverage to achieve attractive returns, rather than funding technology or innovation, per se. I suspect that institutional investor appetite for investing in new corporate buyout funds will wane sharply given the disappointing returns and distaste for leverage. The dollar weighted returns from corporate buyout funds have probably been poor, given the surge of new investment that occurred in the period leading up to the panic. I detect a growing secondary market in private equity assets which may deter the creation of some new partnerships, if older and partially seasoned funds are available at big discounts.

9. Asset Allocations That Might Increase

Prior to the panic, allocations to private equities and hedge funds increased dramatically as institutional investors came to view traditional equity and fixed income investments as less exciting, maybe even “boring.” My respondents indicated a desire for less complex and exotic investments, on balance lower fees, and some return to more traditional assets. Should corporate buyout and hedge fund allocations decline, what other asset classes might be increased to fill the gap?

I believe there will be an increase in fixed income (in part the desire to have greater “liquidity”).[‡] Some investors are also being attracted to fixed income since yield spreads on investment grade and distressed debt remain wide. However, I suspect that over the long-term, assuming spreads revert to more normal levels, the increased allocations to fixed income will be moderate rather than dramatic.[§] In connection with both fixed income and real assets, there is intense debate on whether the future will produce deflation or inflation. Proponents of the former note that with economic weakness, the output gap is large and that prices are under downward pressure. Proponents of the latter argue that it will require extraordinary wisdom to remove the stupendous amount of monetary and fiscal stimulus on a timely basis, and thus there is a risk of long-term inflation. My personal leaning is that deflation may be the near-term outcome but that inflation is a potent long-term threat, implying higher interest

[‡] In this and other matters, I wish to acknowledge my judgment be perceived as prejudiced and self-serving because I have spent a career managing fixed income investments.

[§] Pension funds will probably be an exception in their appetite for bonds because matching assets with defined liabilities will be deemed ever more important. However, matching may make the underfunding even more acute for those pension sponsors that do not have the ability or willingness to develop the cash flow to meet the unfunded liabilities.

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rates. In either case, the pace of price changes is likely to be volatile – it seems improbable that the U.S. will return to low, steady inflation and I observe many institutional investors are taking anticipatory action to build asset allocations focused on real, rather than nominal, returns, because of apprehension about inflation.

10. An Opportunistic Asset Allocation “Bucket”

Some large institutional investors have talked publicly about building a pool of assets that could be used opportunistically outside the existing asset allocations to acquire cheap assets. This “bucket” might be designed to experiment and learn from new asset classes, used tactically, and/or serve as cover for politically charged asset classes such as distressed debt. Presumably when not deployed, this pool or “bucket” would be invested in cash equivalents.

This strikes me as an interesting theoretical idea. One can understand the desire for more asset allocation flexibility, especially with the benefit of hindsight, given the tight correlations and stratospheric volatility of many risky assets during the recent financial panic. While the lessons from the past are always interesting, I predict confidently that the next financial panic will be different, and hindsight will not be especially helpful. I suggest that it will be very difficult, especially for very large and publicly visible funds, to forgo normal disciplines and execute distinctly contrary tactical investment actions in the midst of a period of acute distress by most other investors. In the meantime, undeployed opportunistic buckets invested in low yielding liquid assets will penalize the benefits of this type of strategy.

11. Endowment Spending Policies

Most endowment funds have voluntarily operated with a policy based on a spending rate (usually around 5%) of a three year rolling average of market values. While the desirable intent is to smooth the impact of market fluctuations on operating budgets, such smoothing did not insulate institutions during this financial panic. Perhaps this failure is just the poor recent returns and increasingly tight correlations on risky assets, but institutions are rethinking spending policies.

My view is that spending policies need to be redesigned. Some endowments are using variations of the traditional approach with caps on the magnitude of any increase in contributions to operating budget in any one year, the balance going into a stabilization reserve. An embellishment is that the size of the stabilization reserve should vary directly to either the proportion of the assets invested in private “illiquid” assets or the proportion of the operating budget derived from endowment income.

Another more radical alternative is to change the objective from achieving long-term, risk-adjusted total return to maximizing the stability and growth of income that can be used for the operating budget. While future episodes as severe as the current crisis may be infrequent, they are so painful that strategies of smoothing market volatility, creating reserves, and focusing more on sustainable income deserve substantial attention. I believe that when we return to better investment times, it will be prudent to adapt some stabilization reserves to further smooth the impact of market volatility.

12. Foundation Spending Policies

Foundations are locked into a required minimum annual 5% grant that is quite restrictive and does not allow smoothing during volatile markets. Furthermore, foundations have understandable difficulty in ramping down future grants, especially those dedicated to helping underserved populations where the needs for social service activities rise dramatically during bad times. Thus in periods of weak markets, the tendency is for the grants to rise relative to market values, even though this means a greater effective spending rate and depleting principal at a decidedly suboptimal time in the markets. An additional

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complexity is that, unlike endowments, foundations usually have a fixed body of assets without much likelihood of additional contributions from donors. Many foundations have responded by making difficult decisions to cut staff, pare back grants, focus on existing grant relationships, rather than new ones, and liquidate assets under duress.

The constraints facing foundations create an investment nightmare, probably requiring an investment policy with greater liquidity and less risk. While the pain for endowments has been severe, the challenges facing foundations appear even greater, and thus the investment reaction will probably be even more pronounced. Unfortunately, those perverse constraints likely require a lower-risk and more-liquid asset policy, an attempt to dampen multiyear obligations, and an effort to keep grants to the bare minimum during what are perceived as the good investment times.

13. Governance

The failure of existing spending policies has raised a broader question by a few observers of whether the typical governance of endowments (and even foundations) is misaligned with the interest and mission of the institution being supported. The specific complaint is that current senior administrative leadership of the institution is too incented to spend the maximum amount possible, while investment management is too focused on maximizing near-term total return. These observers suggest there may be insufficient attention to the very long-term needs of the institution. Some critics suggest that institutional investors should establish another power center in terms of an even-more independent chair of the Board or a lay financial leader specifically charged with emphasizing the long-term goals of the endowment.

While I understand the nature of the complaints about governance, the practical reality is that any fundamental change in the existing governance structure is complicated, controversial, time-consuming, and difficult to implement given the near-term pressures on the institutions. Nonetheless, the governance challenges are profound, requiring an even greater need for those charged with the responsibility for investments and finance to perform a rigorous and regular analysis of the holistic needs of the institutions, to stress test the impact of market fluctuations on the entire enterprise, and to be clear about priorities and institutional risk tolerance. The key will be to have a governance force that recognizes the truly perpetual nature of the underlying organization and its mission, and that manages the assets in accordance with this time horizon.

A Concluding Note

Many institutional investors are either still in the crisis mode or just emerging, so it is probably premature to define the lessons we should learn, despite my belief such lessons exist.

However, there is one area where I despair that we will not learn the correct lessons, namely, adjusting our time horizons to be good investors so we do not overreact to either overpriced euphoria or to values created in panic. I hope I will be proven wrong, but we are collectively very short-term and reactive. We are confronted with ever-growing oceans of data, and feel compelled to respond to virtually all of it. Our herding instinct is incredibly powerful.

Therefore, my last request is not only to try to learn the right lessons but also to try to avoid forgetting them too soon. Unfortunately, there will probably be not only a difference between what we should learn and what we do learn, but also between what we learn and what we remember.

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