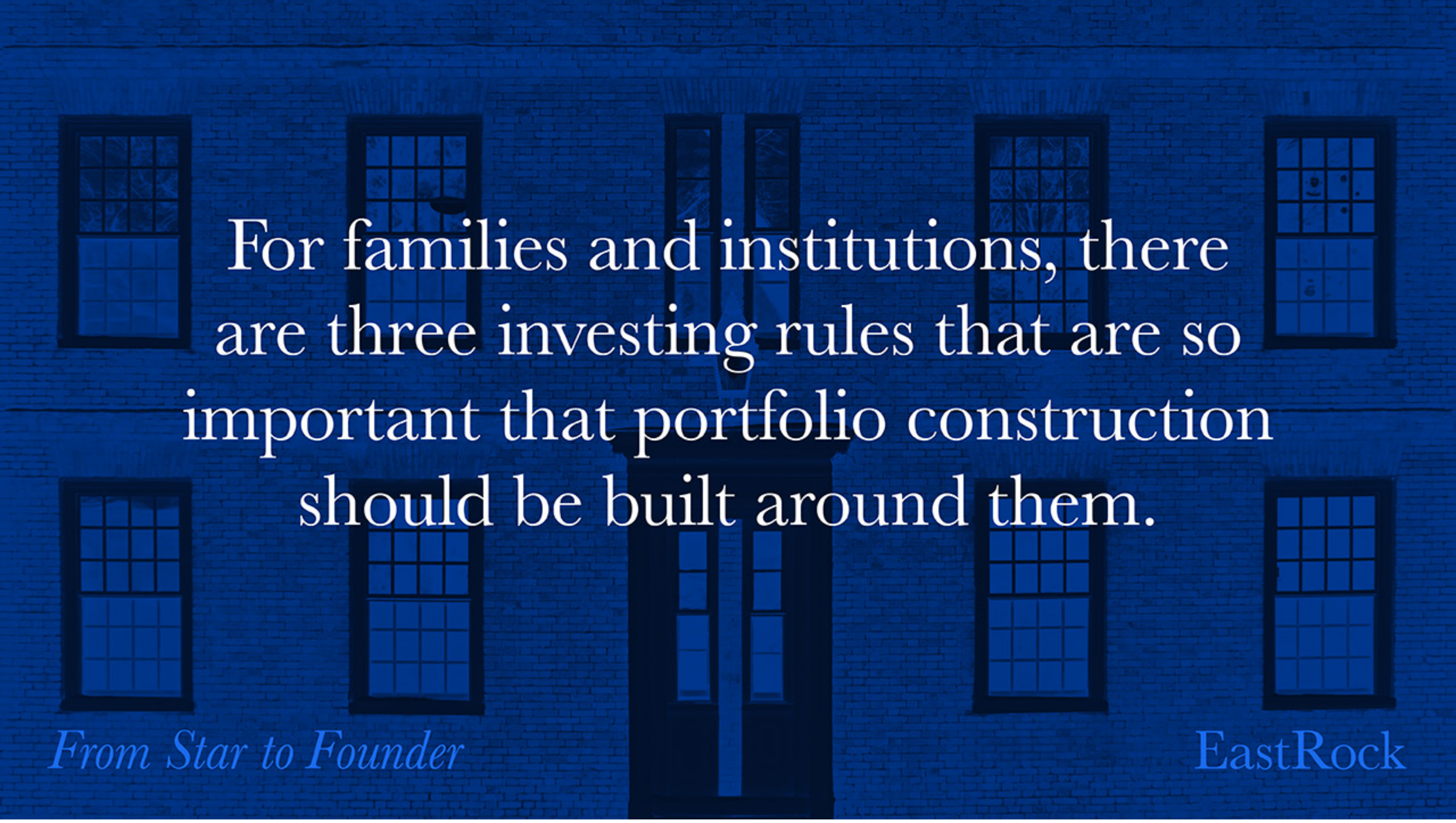

When Genius Failed: Family Wealth & Endowment Edition

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ON MY LIST OF GREAT business books, When Genius Failed by Roger Lowenstein is near the top. It tells the fascinating story of Long-Term Capital Management (LTCM), a hedge fund run by two Nobel Prize winners, various Wall Street legends, and an army of PHDs, which failed so spectacularly it had to be bailed out in 1998 to avoid a systemic financial crisis.

Why should you read this book? It's a page-turner of a story and a fascinating introduction to the world of hedge funds. But also, it's a chance to learn from the mistakes of others, which, as I've discussed in the past, is a more effective way to learn than from your own mistakes.

And if you are going to study the mistakes of others, you may as well study the mistakes of geniuses. After all, any mistake a genius might make, isn't it likely that you or I might fall for the same thing?

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When it comes to avoiding big mistakes in the management of large asset pools (family wealth, endowments, etc.), there are three rules that are so important, I believe portfolio construction should be built around them:

Portfolio Rule #1: Never, ever run out of liquidity

Portfolio Rule #2: Limit market risk to an amount you can handle in a crisis

Portfolio Rule #3: Monitor obsessively for concentrated bets

These rules may seem simple, but let's look at some cases in which they were broken by smart, highly-regarded people—perhaps geniuses—who were hardly expected to make the mistakes they made.

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First up: the Harvard Endowment, a large asset pool overseen by some of the most accomplished financial professionals in the world.

In 2008, Harvard broke **Portfolio Rule #1: Never, ever run out of liquidity**.[1]

How did this happen?

The answer is that Harvard's $43bn endowment as of June 30, 2008 was vulnerable due to several aspects of its portfolio, including:

1. Roughly **$10bn of derivative investments** tied to commodities, foreign stocks, and interest rates

2. A rate of contribution to university spending that had reached roughly **$1.4bn per year**

3. **$11bn in unfunded commitments** to private equity-style funds that were expecting to "call" those obligations in the near future

When the Great Financial Crisis (GFC) hit, Harvard received margin calls on its derivative positions, which set off a cash crunch. Harvard was forced to sell stakes in various illiquid assets at low prices, reduce private equity unfunded commitments by $3bn via sales and "negotiations," and raise $2.5bn in the bond market at high yields.

As a result of this episode:

1. 275 workers were laid off

2. University operating budgets were reduced and building expansions postponed

3. Investment decisions made under duress likely resulted in years of underperformance:

Major Endowment Performance
5 Years Ending June 2013
Annual Rate of Return

1. Columbia	6.8	7. Princeton	4.2
2. Penn	5.4	8. Yale	3.3
3. MIT	5.3	9. Stanford	3.3
4. Chicago	4.8	10. Cornell	2.9
5. Dartmouth	4.4	11. Brown	2.7
6. Notre Dame	4.3	**12. Harvard**	**1.7**

There are three lessons here I'd like to highlight:

1. Almost every financial calamity involves leverage. Harvard's leverage was largely in the form of derivatives and funding obligations that were "off-balance sheet." This type of leverage is easy to ignore in good times but impossible to ignore when things turn.

2. Annual outflows (e.g. contributions to university spending) may appear to be variable and therefore less "leverage-like." But in downturns, it can be hard to cut outflows to constituents because funds are needed more than ever.

3. Many institutions (and families) lean heavily on unfunded commitments as the "fuel" that allows them to hit their asset allocation targets in private equity and real estate. In good times, they worry about falling below targets set in their policy portfolios. The Harvard case shows us how that fuel can act like unwanted leverage at the worst possible time.

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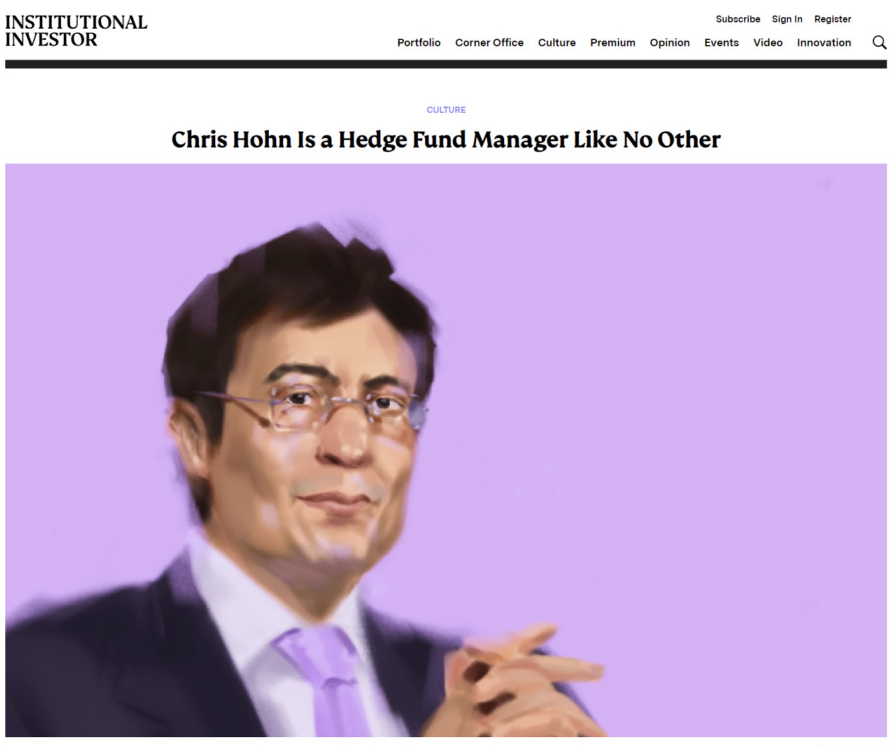
Next, let's talk about **Portfolio Rule #2: Limit market risk to an amount you can handle in a crisis**.

I am often asked why families should bother with alternative assets when index funds are liquid, low-fee, and have performed so well for so long. [I've answered this question a few different ways](). Here, I'll add a new answer, posed in the form of a question:

If one of the best investors of all time blinked at the worst possible time due to excessive market risk, why do you think you won't do the same?

Let's look at the case of Chris Hohn, a "manager like no other" according to Institutional Investor.[2]



Since its founding in 2003, Chris Hohn's The Children's Investment Fund (TCI) has generated a 17% annualized rate of return, which was more than double its benchmark, the MSCI World Index. The fund manages approximately $42bn in public markets and $7bn in real estate. Prior to the Great Financial Crisis, TCI's performance was 42% per year from 2004 through 2007. For most of this time, TCI held a net long position of greater than 100% (i.e. it used leverage to purchase stock positions that exceeded its net worth).

In late 2008, as the GFC unfolded and TCI suffered substantial losses, Chris Hohn decided that enough was enough. By March 2009, he had sold the majority of his positions and eliminated his market risk completely.

As a result, he missed an extraordinary rally that started almost exactly when he took exposure down. From March 1 until October 31, 2009, TCI's benchmark rose 53% while TCI rose only 5%. That was an expensive blink!

This being Chris Hohn, he steadied himself and re-entered the market by November 2009. That wise decision made all the difference. From 2013-2023, TCI returned 17.5%, an extraordinary run.

Is Hohn one of the best ever? His track record makes this a reasonable claim. I also admire the way he returned to form after two rough episodes (losing money in 2008 and missing the rally in 2009).

For those who believe they would hold their ETFs through a difficult storm, it's worth remembering the moment when Hohn's genius failed and wondering whether mere mortals would do better.

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Finally, we have **Portfolio Rule #3: Monitor obsessively for concentrated bets**.

Sometimes, a variety of investments add up to a single bet on a particular market outcome.

Such was the case of the Orange County Investment Pool (OCIP) in the years leading up to 1994.[3]

From 1973 to 1994, OCIP was run by a locally high-profile manager named Bob Citron.

Bob's track record was strong. For over twenty years, OCIP earned an average yield of 8.5%, while neighboring Los Angeles County earned 3.9% on a similar pool.

For his work, Bob received substantial praise. Some was from third parties:

"I don't know how in the hell he does it, but he makes us all look good."
- Thomas Riley, then Chairman of the County Board of Supervisors

And some was from Bob himself:

"We have perfected the reverse repo procedure to new levels."
- Bob Citron

By 1994, neighboring counties had invested substantial capital in OCIP, which grew to $21bn in assets through the use of 2:1 leverage.

Shortly thereafter, it all came crashing down:

Why? Citron's talk of "perfected procedures" masked a simple reality: that OCIP had made a large, levered bet on falling interest rates. All that was required for OCIP to fail was a reversal in rates:

It may be hard to believe, but the largest municipal bankruptcy in U.S. history (a record that stood from 1994 until 2011) was caused by a cocktail with just two familiar ingredients: (1) a concentrated bet + (2) leverage.

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For geniuses and non-geniuses alike, there are no shortcuts in monitoring for the most lethal portfolio risks.

One shortcut I worry about: a false sense of diversification provided by the classic "endowment model." While spreading capital across asset classes such as "domestic equities," "commercial real estate," and "private equity" makes portfolios appear heterogeneous, evidence tells us that these "buckets" are highly correlated. In protecting downside, the endowment model is a starting point, not a solution.

There is simply no substitute for really knowing what you own and having a reasonable thesis for how your portfolio will behave in different market outcomes.

Similarly, there is no substitute for careful liquidity management and strict budgets on market risk.

Finally, when you hear the word "genius," raise your guard! Managers placed on this high pedestal are the hardest to question when they break a portfolio rule. The best portfolio management requires a culture in which no one's judgment is beyond debate.

[1] Sources for this section: https://hwpi.harvard.edu/files/fad/files/2008fullreport.pdf; https://www.forbes.com/2009/10/24/harvard-university-endowment-business-wall-street-harvard.html; https://www.harvardmagazine.com/2009/11/harvard-endowment-update; https://www.harvardmagazine.com/2010/01/harvard-2009-financial-losses-grow; "Liquidating Harvard," Andrew Ang, 2012, Columbia Business School Case Study.

[2] Sources for this section: https://www.institutionalinvestor.com/article/2bstnug68kijmzi8f50cg/culture/chris-hohn-is-a-hedge-fund-manager-like-no-other; East Rock Capital internal notes

[3] Sources for this section: https://medium.com/limited-liabilities-by-colbeck/orange-pulp-lessons-from-orange-countys-investment-malpractice-83d581c670a; https://merage.uci.edu/~jorion/oc/case.html#:~:text=The%20strategy%20worked%20fine%20as,to%20a%20%241.6%20billion%20loss; https://www.latimes.com/archives/la-xpm-1994-12-10-mn-7298-story.html; https://www.ocregister.com/2019/12/06/heres-how-orange-county-went-broke/

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