TIFF INSIGHTS

TIFF THOUGHT LEADERSHIP

CIO Quarterly Commentary

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Are You Nervous Yet?

The world can be a scary place, even for investors. While we may not be on the front lines protesting the proposed extradition law in Hong Kong or in the Straits of Hormuz defending supertankers filled with oil against attack, these serious situations can cause great injury to investment portfolios, including ours. So, at least for us, the answer is yes, we are nervous. We struggle to assess geopolitical issues about which we have limited insight and even less control. These episodes tend to spring up and take center stage quickly, with a concomitant impact on financial markets. Typically, then, our job is to "read and react," which means something different to every investor. For those investors whose amygdala[1] is in charge, the tendency is to sell now and watch things unfold while waiting in cash. Many humans are wired this way. The modern-day economic answer to the evolutionary survival question "fight or flight" is often to sell on bad news.

Without getting into too much psychobabble, we note that behavioral economics suggests that selling on bad news may not be the correct response. For those of you who have closely tracked TIFF's behavior over the last several years, you may have noticed that we tend to sit tight in situations like those described above, resisting the natural urge to sell. More to the point, we often prepare ourselves to buy should any meaningful pricing weakness appear following episodic bad news. Baron Rothschild famously said, "The time to buy is when there's blood in the streets." Maybe a little more cheerily, Warren Buffet reminds investors to "be fearful when others are greedy and greedy when others are fearful." Both maxims suggest that ignoring your amygdala is generally a good idea.

So, are we currently becoming more aggressive and increasing stock weightings in our comprehensive portfolios? No. The implication that accompanies both the Rothschild and Buffet quotations is that asset prices have declined appreciably, and by most measures today, they have not. The S&P 500, for example, is near its all-time high as we write. Not much fear there. The forward price/earnings multiple on the S&P 500 is about 16x. Not high, but not low either. Similarly, the MSCI All County World Index is just shy of its peak, and the price/earnings ratio is about 14x. There are markets that have pulled back further, with MSCI China about 15% below its peak with a 10x forward price/earnings multiple, and those that recently set new highs, as MSCI Australia did after gaining roughly 20% year to date. The interesting thing about the China and Australia dichotomy is that much of what drives resource-rich Australia is Chinese economic growth.

Looking inside the US markets, we note that the leader of the most powerful financial institution in the world has learned well how important his words are. Yes, we mean Chairman Powell of the Federal Reserve Board, who, after stating in December that the Fed would not **raise** interest rates for nine months, is now signaling a rate **cut** at any time to counter the impending effects of US tariffs on China and other nations. Markets seem quite confident that a rate cut will happen at the Fed's July meeting. This Fed willingness to act to offset economic drags is certainly supportive of equity markets. On the other hand, investor uncertainty caused by the tariff merry-go-round is likely to keep equity prices

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[1] The amygdala is a set of neurons located deep in the brain's medial temporal lobe that play a key role in processing emotion.

contained, at least for a while. We continue to think the US and China will eventually find a compromise that is at least acceptable for both and leads to continued global growth.

We'll end this set of observations by reminding everyone that most good endowments and foundations react to changing capital market environments by rebalancing their portfolios toward some sort of long-term target asset allocation, often called the "policy portfolio." A policy portfolio, re-visited periodically, is intended to represent a strategic allocation that should enable the institution to achieve its long-term return objectives. Basic human wiring tempts many investors to try to time the market, often causing purchases or sales that, with the benefit of hindsight, are undertaken at inopportune times. Following a disciplined plan to rebalance into weakness is much harder, but it is also usually more rewarding.

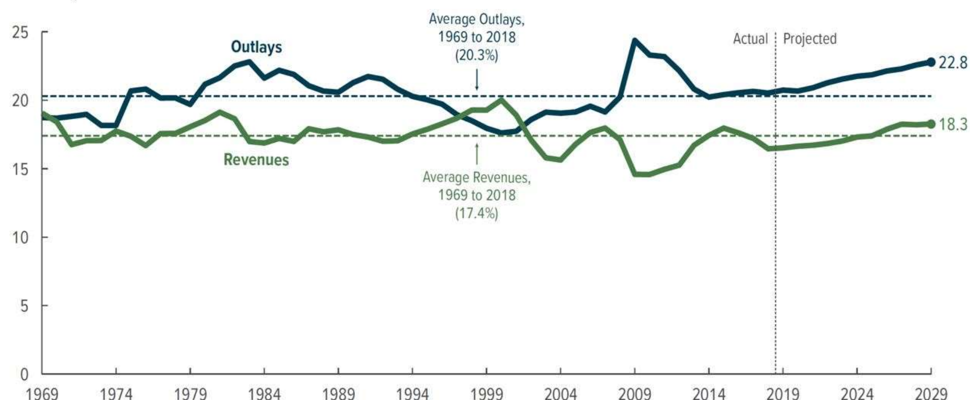
Speaking of asset allocation, we just reviewed ours with TIFF's board. As a refresher, we test assumptions and model expected returns for the Constructed Index (CI), TIFF's own policy portfolio, at least once every year. Spoiler alert: at our June board meeting, we decided to keep the CI unchanged at 65% equities / 20% diversifiers / 15% fixed income (staff has the authority to "tilt" somewhat positively or negatively from the CI targets). Our annual CI review requires TIFF's investment team to provide the board with our asset category target returns, volatilities, and return correlations with other assets. We go a step further and estimate how much alpha, or excess returns over a benchmark index, we expect from each of our underlying managers and the expected volatility of that alpha contribution. Our team runs all these numbers through our computers, which then generate Monte Carlo simulations to help us and our board get comfortable with the possible range of outcomes that may occur given our assumptions.

Our assumptions this year did not change much from those we used last year, except we assumed modestly higher cash returns, which also flow through to our diversifying strategies (or hedge fund) return expectations. For global equities, we continue to expect nominal annual returns of 7.4% (5% real + 2.4% inflation, in line with long-term historical global equity returns). We expect bonds and cash to each return 2.4% (bonds flat from last year and cash up 1%). Our hedge fund expectations are 20% of equities (we try to keep our hedge fund managers' aggregate beta to equities, or sensitivity to broad equity market moves, at 0.2) plus 80% of cash. That comes out to an estimated 3.4% nominal returns for hedge funds. Mixing these expected returns together according to the target weights of the Constructed Index, without alpha, comes up short of the inflation-plus-5% return that we target for our comprehensive portfolios, coming in at about 3.7%. If everything we assume were to come true and markets were to produce the exact middle return out of all the possible returns given our assumptions, then without alpha an investor would fall 1.3% short of achieving inflation plus 5%. In addition, we calculate that without alpha, there is a 63% probability that our portfolios will underperform the inflation-plus-5% return target over the next 10 years and a 1% probability of a drawdown of 20% or more in any single year. Using every investment strategy we think prudent, we hope manager alpha will lift the annual portfolio return by over 2% per annum. If we accomplish this goal, we still see a 35% probability of underperforming inflation plus 5% over the next 10 years and a 1% potential for a drawdown of 20% or more in any given year.

As implied above, we do believe our underlying managers can produce alpha, or market-beating returns net of fees. Inspecting their track records gives us comfort in this assumption, as does our up-to-the-

moment understanding of each manager's "edge" and how the various "edges" fit together in our portfolios. There is no certainty, of course, that any manager will produce alpha, and we expect surprises on that front, both good and bad. We also believe our managers treat us fairly, like partners. This goes for all our managers — public equity, private equity, hedge funds, and fixed income. Given the capital markets' big start to 2019, a better-than-average year may be in the cards, following last year's mostly disappointing results. Whether the balance of 2019 is strong or weak in overall capital markets, we have confidence in our manager roster, and we think we are now in an environment where alpha will become even more important as a regular contributor to portfolios aiming to achieve inflation plus 5% returns. In the past, the beta (or market returns) of public equities plus bonds may have been sufficient to hit that target, but in the future they may not be.

We discussed Modern Monetary Theory (MMT) in our Commentary last quarter, and MMT has gained more traction in the press since then. (As a reminder, MMT states that in countries with their own currency, deficits don't matter so long as inflation is contained because the country can always print more money to pay interest on its debt; siphoning money from the economy via increased taxes to contain any inflation that does develop.) We may return to a deeper discussion of MMT in another quarter or two, but in the meantime, we think a brief review of the US government's budget deficit is in order.



Source: Congressional Budget Office.

When October 1 (the first day of the fiscal year) falls on a weekend, certain payments that would have ordinarily been made on that day are instead made at the end of September and thus are shifted into the previous fiscal year. All projections presented here have been adjusted to exclude the effects of those timing shifts. Historical amounts have been adjusted as far back as the available data will allow.

After adding $985 billion in the last 12 months, the annual federal deficit is just about to cross back into the $1 trillion zone. We expect that crossing the $1 trillion threshold will cause the deficit to get more attention. Including federal, state, and local entities, the US now has a staggering $22 trillion of total government debt. The good news is that today's low interest rates mean that the cost of servicing the federal portion of that debt is fairly low at about 11.7% of federal spending, according to Ned Davis Research. Except for a few recent years, 11.7% is about as low as the federal debt service figure has been in the last 60 years.

The big question is: can this continue? Unfortunately, the answer is probably not. The federal budget deficit is expected to come in at -$897 billion in fiscal 2019 and to grow almost every year until 2028, when it will be -$1,435 billion, according to projections by the Congressional Budget Office (CBO). Adding these 10 years' worth of estimated annual deficits means we could add over $11 trillion to the total deficit. Anything is possible, but it is hard to imagine that interest rates will go down by a third so that the deficit can rise by 50% and leave aggregate interest payments flat. After all, global interest rates are lower than ever–so low that, as the chart at left shows, the amount of global debt yielding **negative** interest has reached roughly $13 trillion (based on the Bloomberg Barclays Global Aggregate Negative Yielding Debt Index). Another problem with this scenario is that the CBO projections assume a modestly growing economy throughout the period, with no recession. Any recession would likely wreak havoc on the budget. Also, any growth acceleration, while helping reduce the deficit, would likely push interest rates higher. The CBO assumptions about the economy are what we used to call the "Goldilocks scenario." Now they have become the base case scenario. That concerns us.

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There is yet another significant problem with all this budget prognosis, namely that as time marches on, the portion of the deficit accounted for by mandatory federal spending on entitlements continues to rise. Each year, more baby boomers retire (Social Security), health care costs rise (Medicare), and interest costs are likely to build with the rising debt. As these mandatory categories consume a larger share of the government's budget, less is left for "discretionary" spending such as defense, education, and transportation. Most reasonably objective analyses show that the US is sorely in need of bipartisan leadership that addresses these mounting deficit issues before they become intractable. The trick will be finding political leaders who can lead us to a fair solution. As the chart above suggests, without some sort of solution, current federal tax collections, at about 18% of GDP, seem likely to rise—perhaps significantly.

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