TIFF
INVESTMENT MANAGEMENT

RISK MANAGEMENT in an OCIO Model

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TIFF Spotlight Series: Risk Management

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Executive Summary

TIFF collaborates with clients to understand their distinct goals and situations and to define their investment needs. Additionally, TIFF seeks out those active managers that we believe to be the best from across the investment landscape to meet these needs. Less apparent is the third leg of TIFF's investment work: the portfolio construction that allows TIFF to harness active management risk and mold it to meet our clients' investment needs. TIFF employs a multi-layered approach involving asset-class allocation, diversification, exposure management and focused asset-class views. This process helps us tailor a portfolio's return potential, drawdown risk and liquidity profile, bridging the gap between active managers' capabilities and clients' objectives.

Managing Investment Risk

As our clients' CIO, TIFF's job is to understand each client's goals and objectives and seek out and manage investment risk to meet each client's needs. TIFF's process consists of three basic elements:

1. TIFF begins its work by collaborating with each client to understand their goals, evaluate their financial circumstances, and establish objectives and constraints for their investable assets. Having established this starting point, TIFF determines investment parameters in two basic dimensions of risk tradeoff required to meet the client's needs. The first dimension is return/drawdown tradeoff: optimizing the potential to generate the required return without incurring intolerable drawdown risk. The second dimension is return/liquidity tradeoff: optimizing the willingness to tie up capital for greater potential return while ensuring access to funds when needed. TIFF expresses these investment parameters in terms of a strategic asset allocation (SAA) and a liquidity profile.

2. In parallel, TIFF continuously seeks out sources of risk with maximum potential in these same dimensions: return vs drawdown and return vs illiquidity. The risks we seek are "compensated" ones: risks intentionally identified and incurred, where outsized return potential compensates for the downsides of drawdown potential and/or illiquidity. TIFF sources compensated risk primarily via active managers across a variety of investment spaces or "exposures" and a variety of investment

strategies. Equity exposures include, for example, geographies, sectors, and "styles" such as value, growth or quality; while diversifying exposures can include a variety of asset types such as commodities or bonds alongside stocks. Strategies include concentrated, systematic or quantitative stock selection; long-only or long-short strategies; and everything on the liquidity spectrum from high-frequency trading to private equity. Each specific exposure/strategy combination has the potential for expert managers to take well-compensated risks and deliver outsized returns. TIFF scours the broad landscape for the best of these opportunities.

3 Step three is to construct client-specific portfolios that use these idiosyncratic sources of well-compensated risk to match each client's required tradeoff between potential return, drawdown risk and liquidity. This paper focuses on this third step and delves into the layers of portfolio construction required to shape a portfolio to meet a client's needs.

Multi-Faceted Portfolio Risk Management

1 Allocation

The first level of risk management via portfolio construction is **allocation**. Based on a client's target return/drawdown profile and liquidity profile, TIFF determines a strategic asset allocation (SAA) among three basic asset classes:

- Equity is a portfolio's primary return engine. TIFF will allocate between private and marketable equity strategies based on the client's liquidity profile.
- Fixed income is the primary liquidity source of a portfolio. Fixed income also serves as the primary drawdown dampener, helping to keep drawdown potential within determined tolerance.
- Diversifying strategies are ones designed to deliver attractive but more modest returns than equities and to be largely uncorrelated with long-oriented equity strategies. They represent an efficient compromise between return-generating and drawdown-dampening assets that improve a portfolio's overall return/drawdown profile.

2 Diversification

The second level of risk management via portfolio construction is **diversification**. Within each asset class, we create diversified portfolios, optimized based on return/drawdown potential and liquidity. While each manager individually has an attractive compensated risk profile, each alone is generally taking much more drawdown risk than our clients would desire. We create diversified portfolios to limit the size of each manager's idiosyncratic risk and to take advantage of the principle of diversification, whereby the total risk in a portfolio of individually uncorrelated idiosyncratic risks is significantly less than the sum of these risks.

- We limit exposure risk by diversifying among exposures.
- We limit strategy risk by diversifying among strategy types.
- We limit manager-specific risk by capping individual manager allocations.
- We make larger allocations to managers demonstrating the strongest alpha[1] generation potential with respect to downside risk. We make smaller allocations to promising but less-proven managers, such as startups with shorter track records. Similarly, we allocate less to managers operating in niche market segments that offer higher return potential but come with increased volatility.
- We control liquidity by capping our exposure to less liquid strategies and again by capping our exposure to individual managers and the risk of any one manager failing to provide promised liquidity.

3 Exposure Management

The third level of risk management via portfolio construction is **exposure management**. These diversified asset class-specific portfolios of active managers are the roughed-out framework for achieving the client's target SAA and liquidity. However, though diversified, they will generally have exposures that are unwanted and inefficient, generating what we refer to as "uncompensated" risks. "Uncompensated" means that the exposure's return potential does not justify the accompanying drawdown risk, generally because the unwanted exposure is a byproduct of portfolio construction and not an intentional, alpha-seeking decision. These uncompensated risks take the form of unwanted exposures to the same dimensions mentioned above, including geography, sector, and market capitalization, as well as styles such as value, growth, or momentum. These

[1] "Alpha" represents the amount of an investment's return, on average, that is independent of the market's return.

unwanted exposures can arise due to TIFF's efforts to engage only those investment managers that we believe to be the best. From time to time, we will find that the best opportunities are, for example, disproportionately in the US versus non-US markets, in tech versus financials or in growth strategies versus value strategies. We want these best managers and do not want to compromise by including subpar managers to fill out exposure underweights. However, in this example, we do not necessarily want to accept the resulting overweights to the US, tech and growth, or underweights to non-US, financials and value.

To smooth out these rough edges, we use liquid passive investments, allocating a portion of each asset class for this express purpose. The passive assets can be invested in exposures that complement the actively managed exposures, filling unwanted gaps to complete the desired portfolio exposure. We can also use these passive assets to hedge out and reduce unwanted excess exposures via short positions. These shorts often take the form of futures, swaps or other derivatives, collateralized by part of these liquid passive allocations. The portfolio construction process is careful to only manage unwanted exposures, leaving in place those consciously put on by active managers in their effort to outperform and deliver alpha. The process also allows TIFF to intentionally take on exposure to a geography, sector or style when we believe that the exposure will likely outperform and that the potential returns sufficiently compensate for the downside risk.

Asset class-specific portfolios are generally constructed individually and sized according to the client-specific SAA determined at the outset; but portfolio-wide considerations do impact their construction. For example, TIFF currently finds the return vs drawdown tradeoff in active management relatively unattractive in fixed income, and so does not typically use active management in fixed income, leaving more risk budget for more productive deployment in equities and diversifiers.

4 Asset-Class Views

The fourth and final level of risk management via portfolio construction is the adoption of focused **asset-class views** designed to manage specific portfolio risks after allocation, diversification and exposure management are in place. Once the portfolio is allocated appropriately and each asset class is diversified and completed for exposure management, it is generally in good shape and positioned for long-term performance.

However, from time to time, we will make adjustments to manage return/drawdown potential in response to or anticipation of changes in the investment landscape. These adjustments can take two basic forms:

- One is a temporary adjustment to the long-term strategic asset allocation that has been specified for a given client. We may for example reallocate modestly from equity to fixed income to reduce drawdown potential in an environment where downside risks seem elevated; or we may do the opposite when we believe equity upside outweighs taking on increased drawdown risk. Conditions driving these decisions could, for example, involve equity valuations being very high or low with respect to history or to our outlook. Interest rates could be another driver, impacting both the outlook for equities and the relative value of fixed income investments.
- Another type of adjustment involves hedges, positions taken on outside the core strategic asset allocations. Such hedges can take the form of options, swaps or other derivatives designed to offset drawdown risks in the core portfolio. A simple example is an equity put option which gains when the core equity asset allocation loses value. Another example is an inflation hedge such as an inflation swap or a commodity derivative. Each of these would be designed to increase in value when inflation picks up, which would generally be detrimental to the core equity and fixed income portfolios. We will generally expect and indeed hope for these positions to be unproductive: for an equity put to expire worthless as equities perform well, or for an inflation hedge to be unproductive as inflation remains benign. Their value is usually in allowing the portfolio to remain fully invested in times of uncertainty and greater downside risks, giving the portfolio a better chance of continuing to perform well in most environments.

Conclusion

While our clients most directly observe the first two parts of TIFF's process - the collaborative development of a custom investment plan and TIFF's selection of the best available active management – the third element of portfolio construction is critical to delivering desired results.

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