Investment Practices of Leading Charitable Foundations

Speech of Charles T. Munger, Vice Chair, Berkshire Hathaway, at Miramar Sheraton Hotel, Santa Monica, CA, on October 14, 1998, to a meeting of the Foundation Financial Officers Group sponsored by The Conrad Hilton Foundation, The Amateur Athletic Foundation, The J. Paul Getty Trust, and Rio Hondo Memorial Foundation. The speech is reproduced here (http://www.tiff.org/pub/library/Other_Resources/Munger_Speech.html) with Mr. Munger's permission.

I am speaking here today because my friend, John Argue, asked me. And John well knew that I, who, unlike many other speakers on your agenda, have nothing to sell any of you, would be irreverent about much current investment practice in large institutions, including charitable foundations. Therefore any hostility my talk will cause should be directed at John Argue who comes from the legal profession and may even enjoy it.

It was long the norm at large charitable foundations to invest mostly in unleveraged, marketable, domestic securities, mostly equities. The equities were selected by one or a very few investment counselling organizations. But in recent years there has been a drift toward more complexity. Some foundations, following the lead of institutions like Yale, have tried to become much better versions of Bernie Cornfeld's "fund of funds." This is an amazing development. Few would have predicted that, long after Cornfeld's fall into disgrace, leading universities would be leading foundations into Cornfeld's system.

Now, in some foundations, there are not few but many investment counselors, chosen by an additional layer of consultants who are hired to decide which investment counselors are best, help in allocating funds to various categories, make sure that foreign securities are not neglected in favor of domestic securities, check validity of claimed investment records, insure that claimed investment styles are scrupulously followed, and help augment an already large diversification in a way that conforms to the latest notions of corporate finance professors about volatility and "beta."

But even with this amazingly active, would-be-polymathic new layer of consultant-choosing consultants, the individual investment counselors, in picking common stocks, still rely to a considerable extent on a third layer of consultants. The third layer consists of the security analysts employed by investment banks. These security analysts receive enormous salaries, sometimes set in seven figures after bidding wars. The hiring investment banks recoup these salaries from two sources: (1) commissions and trading spreads born by security buyers (some of which are rebated as "soft dollars" to money managers), plus (2) investment banking charges paid by corporations which appreciate the enthusiastic way their securities are being recommended by the security analysts.

There is one thing sure about all this complexity including its touches of behavior lacking the full punctilio of honor. Even when nothing but unleveraged stock-picking is involved, the total cost of all the investment management, plus the frictional costs of fairly often getting in and out of many large investment positions, can easily reach 3% of foundation net worth per annum if foundations, urged on by consultants, add new activity, year after year. This full cost doesn't show up in conventional accounting. But that is because accounting has limitations and not because the full cost isn't present.

Next, we come to time for a little arithmetic: it is one thing each year to pay the croupiers 3% of starting wealth when the average foundation is enjoying a real return, say, of 17% before the croupiers' take. But it is not written in the stars that foundations will always gain 17% gross, a common result in recent years. And if the average annual gross real return from indexed investment in equities goes back, say, to 5% over some long future period, and the croupiers' take turns out to remain the waste it has always been, even for the average intelligent player, then the average intelligent foundation will be in a prolonged, uncomfortable, shrinking mode. After all, 5% minus 3% minus 5% in donations leaves an annual shrinkage of 3%.

All the equity investors, in total, will surely bear a performance disadvantage per annum equal to the total croupiers' costs they have jointly elected to bear. This is an unescapable fact of life. And it is also unescapable that exactly half of the investors will get a result below the median result after the croupiers' take, which median result may well be somewhere between unexciting and lousy.

Human nature being what it is, most people assume away worries like those I raise. After all, five centuries before Christ Demosthenes noted that: "What a man wishes, he will believe." And in self appraisals of prospects and talents it is the norm, as Demosthenes predicted, for people to be ridiculously over-optimistic. For instance, a careful survey in Sweden showed that 90% of automobile drivers considered themselves above average. And people who are successfully selling something, as investment counselors do, make Swedish drivers sound like depressives. Virtually every investment expert's public assessment is that he is above average, no matter what is the evidence to the contrary.

But, you may think, my foundation, at least, will be above average. It is well endowed, hires the best, and considers all investment issues at length and with objective professionalism. And to this I respond that an excess of what seems like professionalism will often hurt you horribly — precisely because the careful procedures themselves often lead to overconfidence in their outcome.

General Motors recently made just such a mistake, and it was a lollapalooza. Using fancy consumer surveys, its excess of professionalism, it concluded not to put a fourth door in a truck designed to serve also as the equivalent of a comfortable five-passenger car. Its competitors, more basic, had actually seen five people enter and exit cars. Moreover they had noticed that people were used to four doors in a comfortable five-passenger car and that biological creatures ordinarily prefer effort minimization in routine activies and don't like removals of long-enjoyed benefits. There are only two words that come instantly to mind in reviewing General Motors horrible decision, which has blown many hundreds of millions of dollars. And one of those words is: "oops."

Similarly, the hedge fund known as "Long Term Capital Management" recently collapsed, through overconfidence in its highly leveraged methods, despite I.Qs. of its principals that must have averaged 160. Smart, hard-working people aren't exempted from professional disasters from overconfidence. Often, they just go around in the more difficult voyages they choose, relying on their self-appraisals that they have superior talents and methods.

It is, of course, irritating that extra care in thinking is not all good but also introduces extra error. But most good things have undesired "side effects," and thinking is no exception. The best defense is that of the best physicists, who systematically criticize themselves to an extreme degree, using a mindset described by Nobel Laureate Richard Feynman as follows: "The first principle is that you must not fool yourself and you're the easiest person to fool."

But suppose that an abnormally realistic foundation, thinking like Feynman, fears a poor future investment outcome because it is unwilling to assume that its unleveraged equities will outperform equity indexes, minus all investment costs, merely because the foundation has adopted the approach of becoming a "fund of funds," with much investment turnover and layers of consultants that consider themselves above average. What are this fearful foundation's options as it seeks improved prospects?

There are at least three modern choices:

> 1. The foundation can both dispense with its consultants and reduce its investment turnover as it changes to indexed investment in equities.
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> 2. The foundation can follow the example of Berkshire Hathaway, and thus get total annual croupier costs below 1/10 of 1% of principal per annum, by investing with virtually total passivity in a very few much-admired domestic corporations. And there is no reason why some outside advice can't be used in this process. All the fee payor has to do is suitably control the high talent in investment counseling organizations so that the servant becomes the useful tool of its master, instead of serving itself under the perverse incentives of a sort of Mad Hatter's tea party.
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> 3. The foundation can supplement unleveraged investment in marketable equities with investment in limited partnerships that do some combination of the following: unleveraged investment in high-tech corporations in their infancy; leveraged investments in corporate buy-outs, leveraged relative value trades in equities, and leveraged convergence trades and other exotic trades in all kinds of securities and derivatives.

For the obvious reasons given by purveyors of indexed equities, I think choice (1), indexing, is a wiser choice for the average foundation than what it is now doing in unleveraged equity investment. And particularly so as its present total croupier costs exceed 1% of principal per annum. Indexing can't work well forever if almost everybody turns to it. But it will work all right for a long time.

Choice (3), investment in fancy limited partnerships, is largely beyond the scope of this talk. I will only say that the Munger Foundation does not so invest, and briefly mention two considerations bearing on "LBO" funds.

The first consideration bearing on LBO funds is that buying 100% of corporations with much financial leverage and two layers of promotional carry (one for the management and one for the general partners in the LBO fund) is no sure thing to outperform equity indexes in the future if equity indexes perform poorly in the future. In substance, a LBO fund is a better way of buying equivalents of marketable equities on margin, and the debt could prove disastrous if future marketable equity performance is bad. And particularly so if the bad performance comes from generally bad business conditions.

The second consideration is increasing competition for LBO candidates. For instance, if the LBO candidates are good service corporations, General Electric can now buy more than $10 billion worth per year in GE's credit corporation, with 100% debt financing at an interest rate only slightly higher than the U.S. Government is paying. This sort of thing is not ordinary competition, but supercompetition. And there are now very many LBO funds, both large and small, mostly awash in money and with general partners highly incentivized to buy something. In addition there is increased buying competition from corporations other than GE, using some combination of debt and equity.

In short, in the LBO field, there is a buried covariance with marketable equities — toward disaster in generally bad business conditions — and competition is now extreme.

Given time limitation, I can say no more about limited partnerships, one of which I once ran. This leaves for extensive discussion only foundation choice (2), more imitation of the investment practices of Berkshire Hathaway in maintaining marketable equity portfolios with virtually zero turnover and with only a very few stocks chosen. This brings us to the question of how much investment diversification is desirable at foundations.

I have more than skepticism regarding the orthodox view that huge diversification is a must for those wise enough so that indexation is not the logical mode for equity investment. I think the orthodox view is grossly mistaken.

In the United States, a person or institution with almost all wealth invested, long term, in just three fine domestic corporations is securely rich. And why should such an owner care if at any time most other investors are faring somewhat better or worse. And particularly so when he rationally believes, like Berkshire, that his long-term results will be superior by reason of his lower costs, required emphasis on long-term effects, and concentration in his most preferred choices.

I go even further. I think it can be a rational choice, in some situations, for a family or a foundation to remain 90% concentrated in one equity. Indeed, I hope the Mungers follow roughly this course. And I note that the Woodruff foundations have, so far, proven extremely wise to retain an approximately 90% concentration in the founder's Coca-Cola stock. It would be interesting to calculate just how all American foundations would have fared if they had never sold a share of founder's stock. Very many, I think, would now be much better off. But, you may say, the diversifiers simply took out insurance against a catastrophe that didn't occur. And I reply: there are worse things than some foundation's losing relative clout in the world, and rich institutions, like rich individuals, should do a lot of self insurance if they want to maximize long-term results.

Furthermore, all the good in the world is not done by foundation donations. Much more good is done through the ordinary business operations of the corporations in which the foundations invest. And some corporations do much more good than others in a way that gives investors therein better than average long-term prospects do. And I don't consider it foolish, stupid, evil, or illegal for a foundation to greatly concentrate investment in what it admires or even loves. Indeed, Ben

Franklin required just such an investment practice for the charitable endowment created by his will.

One other aspect of Berkshire's equity investment practice deserves comparative mention. So far, there has been almost no direct foreign investment at Berkshire and much foreign investment at foundations.

Regarding this divergent history, I wish to say that I agree with Peter Drucker that the culture and legal systems of the United States are especially favorable to shareholder interests, compared to other interests and compared to most other countries. Indeed, there are many other countries where any good going to public shareholders has a very low priority and almost every other constituency stands higher in line. This factor, I think is underweighed at many investment institutions, probably because it does not easily lead to quantitative thinking using modern financial technique. But some important factor doesn't lose share of force just because some "expert" can better measure other types of force. Generally, I tend to prefer over direct foreign investment Berkshire's practice of participating in foreign economies through the likes of Coca-Cola and Gillette.

To conclude, I will make one controversial prediction and one controversial argument.

The controversial prediction is that, if some of you make your investment style more like Berkshire Hathaway's, in a long-term retrospect you will be unlikely to have cause for regret, even if you can't get Warren Buffett to work for nothing. Instead, Berkshire will have cause for regret as it faces more intelligent investment competition. But Berkshire won't actually regret any disadvantage from your enlightenment. We only want what success we can get despite encouraging others to share our general views about reality.

My controversial argument is an additional consideration weighing against the complex, high-cost investment modalities becoming ever more popular at foundations. Even if, contrary to my suspicions, such modalities should turn out to work pretty well, most of the money-making activity would contain profoundly antisocial effects. This would be so because the activity would exacerbate the current, harmful trend in which ever more of the nation's ethical young brainpower is attracted into lucrative money-management and its attendant modern frictions, as distinguished from work providing much more value to others. Money management does not create the right examples. Early Charlie Munger is a horrible career model for the young, because not enough was delivered to civilization in return for what was wrested from capitalism. And other similar career models are even worse.

Rather than encourage such models, a more constructive choice at foundations is long-term investment concentration in a few domestic corporations that are wisely admired.

Why not thus imitate Ben Franklin? After all, old Ben was very effective in doing public good. And he was a pretty good investor, too. Better his model, I think, than Bernie Cornfeld's. The choice is plainly yours to make.

Master's Class

Berkshire Hathaway's vice chairman shreds the conventional wisdom on foundation investing

By Charles Munger, 1999

It was long the norm at large charitable foundations to invest mostly in unleveraged, marketable, domestic securities, mostly equities. The equities were selected by one or a very few investment counseling organizations. But in recent years there has been a drift toward more complexity. Some foundations, following the lead of institutions like Yale, have tried to become much better versions of Bernie Cornfeld’s "fund of funds." This is an amazing development. Few would have predicted that, decades after his fall into disgrace, leading universities would be leading foundations into Cornfeld’s system.

Now, in some foundations, there are not few but many investment counselors, chosen by an additional layer of consultants who are hired to decide which investment counselors are best, help in allocating funds to various categories, make sure that foreign securities are not neglected in favor of domestic securities, check validity of claimed investment records, ensure that claimed investment styles are scrupulously followed, and help augment an already large diversification in a way that conforms to the latest notions of corporate finance professors about measures of volatility.

But even with this amazingly active, would-be-polymathic new layer of consultant-choosing consultants, in picking common stocks the individual investment counselors still rely to a considerable extent on a third layer of consultants. The third layer consists of the security analysts employed by investment banks. These security analysts receive enormous salaries, sometimes set in seven figures after bidding wars. The hiring investment banks recoup these salaries from two sources: First, from commissions and trading spreads borne by securities buyers; and second, from investment banking charges paid by corporations which appreciate the enthusiastic way their securities are being recommended by the security analysts.

There is one sure thing about all this complexity, including its touches of behavior lacking the full punctilio of honor. Even when nothing but unleveraged stock-picking is involved, the total cost of all the investment management, plus the frictional costs of fairly often getting in and out of many large investment positions, can easily reach 3 percent of foundation net worth per annum if foundations, urged by consultants, add new activity year after year. This full cost doesn’t show up in conventional accounting. But that is because accounting has limitations and not because the full cost isn’t present.

Where Every Investment Advisor Is Above-Average

Now is time for a little arithmetic: It is one thing each year to pay the croupiers 3 percent of starting wealth when the average foundation is enjoying a real return, say, of 17 percent before the croupiers’ take. But it is not written in the stars that foundations will always gain 17 percent gross, a common result in recent years. And if the average annual gross real return from indexed investment in equities goes back, say, to 5 percent over some long future period, and the croupiers' take turns out to remain the waste it has always been, even for the average intelligent players, then the average intelligent foundation will be in a prolonged, uncomfortable, shrinking mode. After all, 5 percent minus 3 percent minus 5 percent in donations leaves an annual shrink of 3 percent.

All the equity investors, in total, will surely bear a performance disadvantage per annum equal to the total croupiers' costs they have jointly elected to bear. This is an inescapable fact of life. And it is also inescapable that exactly half of the investors will get a result below the median result after the croupiers' take, which median result may well be somewhere between unexciting and lousy.

Human nature being what it is, most people assume away worries like those I raise. After all, in the 5th century B. C. Demosthenes noted that: "What a man wishes, he will believe." And in self-appraisals of prospects and talents it is the norm, as Demosthenes predicted, for people to be ridiculously over-optimistic. For instance, a careful survey in Sweden showed that 90 percent of automobile drivers considered themselves above average. And people who are successfully selling something, as investment counselors do, make Swedish drivers sound like depressives. Virtually every investment expert's public assessment is that he is above average, no matter what is the evidence to the contrary.

"But," some will say, "my foundation, at least, will be above average. It is well-endowed, hires the best, and considers all investment issues at length and with objective professionalism." And to this I respond that an excess of what seems like professionalism will often hurt you horribly—precisely because the careful procedures themselves often lead to overconfidence in their outcome.

Not long ago, General Motors made just such a mistake, and it was a lollapalooza. Using fancy consumer surveys, its excess of professionalism, it decided not to put a fourth door in a truck designed to serve also as the equivalent of a comfortable five-passenger car. Its competitors, more basic, had actually seen five people enter and exit cars. Moreover they had noticed that people were used to four doors in a comfortable five-passenger car and that biological creatures ordinarily prefer effort minimization in routine activities and don't like removals of long-enjoyed benefits. There are only two words that come instantly to mind in reviewing General Motors horrible decision, which has blown many hundreds of millions of dollars. And one of those words is: "Oops."

Similarly, the hedge fund known as "Long Term Capital Management" collapsed last fall through overconfidence in its highly leveraged methods, despite I.Q.'s of its principals that must have averaged 160. Smart people aren't exempt from professional disasters from overconfidence. Often, they just run aground in the more difficult voyages they choose, relying on their self-appraisals that they have superior talents and methods.

Investment Secrets of Richard Feynman

It is, of course, irritating that extra care in thinking is not all good but actually introduces extra error. But most good things have undesired "side effects," and thinking is no exception. The best defense is that of the best physicists, who systematically criticize themselves to an extreme degree, using a mindset described by Nobel laureate Richard Feynman as follows: "The first principle is that you must not fool yourself and you're the easiest person to fool."

But suppose that an abnormally realistic foundation, thinking like Feynman, fears a poor future investment outcome because it is unwilling to assume that its unleveraged equities, after deducting all investment costs, will outperform equity indexes, merely because the foundation has adopted the approach of becoming a "fund of funds" with much investment turnover and layers of consultants that consider themselves above average. What are this fearful foundation's options as it seeks improved prospects? There are at least three modern choices:

• The foundation can both dispense with its consultants and reduce its investment turnover as it changes to indexed investment in equities.

• The foundation can follow the example of Berkshire Hathaway, and thus get total annual croupier costs below 0.1 percent of principal per annum, by investing with virtually total passivity in a very few much-admired domestic corporations. And there is no reason why some outside advice can't be used in this process. All the fee payer has to do is suitably control the high talent in investment counseling organizations so that the servant becomes the useful tool of its master, instead of serving itself under the perverse incentives of a sort of mad hatter's tea party.

• The foundation can supplement unleveraged investment in marketable equities with investment in limited partnerships that do some combination of the following: Unleveraged investment in high-tech corporations in their infancy, leveraged investments in corporate buy-outs, leveraged relative value trades in equities, and leveraged convergence trades and other exotic trades in all kinds of securities and derivatives.

For the obvious reasons given by purveyors of indexed equities, I think choice #1, indexing, is a wiser choice for the average foundation than what it is now doing in unleveraged equity investment. And particularly so as its present total croupier costs exceed 1 percent of principal per annum. Indexing can't work well forever if almost everybody turns to it. But it will work alright for a long time.

Contending with Supercompetitors

Choice #3, investment in fancy limited partnerships, is largely beyond the scope of this article. I will only note that the Munger Foundation does not so invest and briefly mention two considerations bearing on leveraged buyout (LBO) funds.

The first consideration bearing on LBO funds is that buying 100 percent of corporations with much financial leverage and two layers of promotional carry (one for the management and one for the general partners in the LBO fund) is no sure thing to outperform equity indexes in the future if equity indexes perform poorly in the future. In substance, an LBO fund is a better way of buying equivalents of marketable equities on margin, and the debt could prove disastrous if future marketable equity performance is bad. And particularly so if the bad performance comes from generally bad business conditions.

The second consideration is increasing competition for LBO candidates. For instance, if the LBO candidates are good service corporations, General Electric can now buy more than $10 billion worth per year in GE’s credit corporation, with 100 percent debt financing at an interest rate only slightly higher than the U.S. government is paying. This is not ordinary competition, but supercompetition. And there are now very many LBO funds, both large and small, mostly awash in money and with general partners highly incentivized to buy something. In addition, there is increased buying competition from corporations other than GE, using come combination of debt and equity.

In short, in the LBO field there is a buried "covariance" with marketable equities, toward disaster in generally bad business conditions, and competition is now extremely intense.

This brings us to foundation choice #2—more imitation of the investment practices of Berkshire Hathaway in maintaining marketable equity portfolios with virtually zero turnover and with only a very few stocks chosen. And that in turn raises the question of how much investment diversification is desirable for foundations.

I am more than skeptical of the orthodox view that huge diversification is a must for those wise enough that indexation is not the logical mode for equity investment. I think the orthodox view is grossly mistaken.

In the United States, a person or institution with almost all wealth invested long-term in just three fine domestic corporations is securely rich. And why should such an owner care if at any time most other investors are faring somewhat better or worse? And particularly so when he rationally believes, like Berkshire, that his long-term results will be superior by reason of his lower costs, required emphasis on long-term effects, and concentration in his most-preferred choices.

I would go even further. I think it can be a rational choice, in some situations, for a family or a foundation to remain 90 percent concentrated in one equity. Indeed, I hope the Mungers follow roughly this course. And I note that the Robert Woodruff Foundations have, so far, proven extremely wise to retain an approximately 90 percent concentration in the founder’s Coca-Cola stock. It would be interesting to calculate just how all American foundations would have fared if they had never sold a share of the founder’s stock. Very many, I think, would now be much better off. But, some would say, the diversifiers simply took out insurance against a catastrophe that didn’t occur. And I reply: There are worse things than a foundation’s losing relative clout in the world, and rich institutions, like rich individuals, should do a lot of self-insurance if they want to maximize long-term results.

Furthermore, all the good in the world is not done by foundation donations. Much more good is done through the ordinary business operations of the corporations in which the foundations invest. And some corporations do much more good than others in a way that gives investors therein better than average long-term prospects. And I don't consider it foolish, stupid, evil, or illegal for a foundation to greatly concentrate investment in what it admires or even loves. Indeed, Ben Franklin required just such an investment practice for the charitable endowment created by his will.

Investing Abroad—at Home

So far, there has been almost no direct foreign investment at Berkshire and much foreign investment at foundations.

Regarding this divergent history, I have to agree with Peter Drucker that the culture and legal systems of the United States are especially favorable to shareholder interests, compared to other interests and compared to most other countries. Indeed, there are many other countries where any good going to public shareholders has a very low priority and almost every other constituency stands higher in line. This factor, I think is underweighed at many investment institutions, probably because it does not easily lead to quantitative thinking using modern financial techniques. But some important factor doesn't lose its "share of force" just because some "expert" can better measure other types of force. Generally, I tend to prefer over direct foreign investment Berkshire's practice of participating in foreign economies through the likes of Coca-Cola and Gillette.

To conclude, I will make one controversial prediction and one controversial argument.

The one controversial prediction is that, if some foundations make their investment style more like Berkshire Hathaway's, in a long-term retrospect they will be unlikely to have cause for regret, even if they can't get Warren Buffett to work for nothing. Instead, Berkshire will have cause for regret as it faces more intelligent investment competition. But Berkshire won't actually regret any disadvantage from their enlightenment.

My controversial argument is an additional consideration weighing against the complex, high-cost investment modalities becoming ever more popular at foundations. Even if, contrary to my suspicions, such modalities should turn out to work pretty well, most of the money-making activity would contain profoundly antisocial effects. This, because the activity would exacerbate the current harmful trend in which ever more of the nation's ethical young brainpower is attracted into lucrative money-management and its attendant modern frictions, as distinguished from work providing much more value to others. Money management simply does not create the right examples. Early Charlie Munger is a horrible career model for the young because not enough was delivered to civilization in return for what was wrested from capitalism. And other similar career models are even worse.

Rather than encourage such models, a more constructive choice at foundations is long-term investment concentration in a few domestic corporations that are wisely admired.

Why not thus imitate Ben Franklin? After all, old Ben was very effective in doing public good. And he was a pretty good investor, too. Better his model, I think, than Bernie Cornfeld's.

Charles T. Munger is vice chairman of Berkshire Hathaway Inc., and president of the Los Angeles-based Alfred C. Munger Foundation. This article is adapted from Mr. Munger's recent speech at a meeting of the Foundation Financial Officers Group.