

Statement by John Geanakoplos at the FAS Senate meeting on October 15, 2020

Budget

The Covid pandemic has brought the world terrible suffering, and most of us awful inconvenience. It brought us a health crisis and a financial crisis.

I remember the days in early August when school after school announced they were not taking students back onto campus, including my Harvard senior son. I would like to express my heartfelt thanks to the administration for handling the Covid health crisis so well. They listened to the science and did what other schools could not. They looked at Yale's resources and strengths and took calculated risks that even many faculty thought were too dangerous. That is leadership. They once again made me proud to be at Yale. Thanks to Scott and Peter and Tamar and Marvin.

Now I hope the Yale administration will listen to the science of financial crises and take the right calculated risk to deal with the Covid financial crisis. Yale is unlikely in the next 50 years to have so good an opportunity to make progress in faculty excellence and diversity as it has right now (and to be honest, may continue to have for another year or two). Many other first tier schools like Penn and Chicago and NYU and Berkeley and all the state schools are having financial troubles and are unable to do their usual hiring and graduate student recruiting. The opportunity now is huge. Seize it. Make us all doubly proud to be at Yale.

Fortunes are made and organizations are transformed when you can buy low. Seeing an opportunity is rare. Seeing an opportunity while having the money at the same time is truly extraordinary.

The Provost Scott Strobel told us in his open meeting with the faculty a few weeks ago that he has not forgotten his pledge to close the excellence deficit that has built up in faculty size and faculty salaries compared to our competition.

Now is the best time to make good on that pledge. Financial economic science speaks with crystal clarity. The financial situation of Yale does *not* require a 50% hiring freeze, it does *not* require a continuing salary freeze, and it does *not* require a *pause* in graduate admissions.

The COVID Pandemic is a terrifying threat to life and work. It is completely understandable that a responsible and prudent Provost would be alarmed and frightened. We were all frightened and we still are. It is not surprising that a Ship's captain going on his maiden voyage and immediately confronting a once in a decade storm would want to Pause.

Though the new captain may not have experienced one before, scary *financial* storms have blown through many times before. Every experienced investor knows the sickening feeling you get when it seems your fortune and your life plans are suddenly in jeopardy of being destroyed. An entire financial economic science and investor folk wisdom has been built up around how to cope with this very situation.

The first and most important rule is not to panic. Stay the course. Do not make changes that will be expensive to reverse if things return to normal. Crises usually seem to be worse at first than they ultimately turn out.

Imagine if in March, David Swensen had said uncertainty is high, Yale will take a pause from the market, and will sell the endowment assets off and wait until uncertainty resolves and then go back in. We would have been selling while the market was 20% lower than it had just been and would be again a few months later. The *additional* transactions expense of selling it all then buying it all back would also have been huge, and that is the loss that should absolutely be avoided. Pausing like that would have been called panic selling.

The second rule is that in a crisis the advantage lies with the investor endowed with money and the ability to borrow. Such an investor cannot be forced into selling. The rational behavior of the liquid investor is radically different and in fact often completely the opposite from the cash constrained investor.

The third rule is that in crises there is *opportunity*. Buy low if you can get the money. Jack Welch, for whom I indirectly worked for five years, the CEO of General Electric and the most famous business leader of the 1980s, said that you can best judge a manager by how he does in the down cycle.

The wisdom in these three financial principles is enshrined in the celebrated Yale Endowment spending rule. It was created by the greatest macro-finance economist in the world James Tobin and his Yale disciples, including David Swensen, and imitated across the country. It recognizes the advantages Yale has from its huge endowment. It is designed to protect the long run intergenerational excellence of the University. Surprisingly, but in accordance with financial economic science, the Yale endowment spending rule protects the future by ensuring stability for the present.

The Senate explained this in three documents last year. You know of course the Yale spending rule that specifies expenditures of 5.25% out of the endowment. Some of you might not know that it is not 5.25% out of the current endowment, but 5.25% out of the average historical inflation corrected endowment. The reason for that is a windfall gain or loss in one year has only a small effect on the long run average, and so only a small effect on spending until the change is revealed to be more permanent. The rule stabilizes current spending.

In recent years the endowment had been doing very well and increasing in real terms. The endowment spending rule therefore prevented the current generation from profiting from these outsized returns and prescribed only 4.70% spending out of contemporaneous endowment last year.

The beauty of the spending rule is that it is also a recipe for how to cope with financial crises, which Yale has seen many times. In short, the rule specifies slow and gradual adjustments in spending even in the face of big fluctuations in the endowment. The financial losses from COVID have been small compared to past financial crises, yet the cutbacks to faculty hiring and

salaries and graduate admissions are disrupting the core mission of the FAS. The appropriate response would have been to STAY the COURSE.

Stay the course at least until we find out how bad things really are. Most financial crises look scarier than they turn out to be. Things very often return to normal.

Stay the course because abrupt changes are unnecessarily damaging, like selling off a portfolio and then buying it back. Freezing hiring in midstream loses candidates and time and cannot be made up by hiring twice as fast later when things turn around. Stay the course because if there is a genuine crisis, it takes long deliberation and planning to sort out what the right response is. Panicking today in the misguided effort to protect tomorrow is the surest way to compromise tomorrow.

Stay the Course because the fundamental principle of Long-Term Sustainability, which is the mission of the Yale endowment manager, is to leave every generation equally well off. That means the current generation does not have the right to disproportionately consume windfall gains (say from alumni contributions) but also it means the current generation should not be crushed by bad luck, such as from Covid. The gains and losses must be spread across all generations.

Administration employees are often quoted in the Yale Daily News saying that we need to cut spending now to preserve the endowment for future generations. That is a misunderstanding of the letter of the Yale spending rule and a grievous misunderstanding of the spirit of the spending rule. The spirit is exactly the opposite of insulating the future from what is happening now. It is the current generation that is meant to be protected by passing on windfall fluctuations to the future. That is how best to protect the future excellence of the University.

By the Provost's own accounting in the letter he sent us, the total losses so far, including last year's expenses, all the hospital losses, this year's tuition loss and the extra zoom equipment etc., have come to \$250 million dollars. That sounds like a large number. But it is ONE DAY's average fluctuation in the value of the Yale endowment. The Yale endowment spending rule is designed to prevent expenditure fluctuations based on only one year's move of the endowment. Imagine how foolish it would be to radically change spending on the core mission of the university due to one day's average fluctuation in the endowment.

Of course, there are rules constraining what the current generation can spend. These rules guard against the temptation every college president has to say now we are facing an unusual problem that requires extra spending. But there is no clearer case imaginable than COVID to describe a legitimate windfall expense that should be treated like an endowment loss and not like irresponsible overspending.

The administration and the Trustees have the freedom to spend more. They have it because we have a huge endowment, and because David Swensen has squirreled away hundreds of millions of cash to protect us against such a crisis, and because he has maintained Yale's AAA rating to borrow.

But most obviously, there is lots of room to spend more because we ran a \$125 million surplus last year! The salary freeze in FAS saved us \$5 million. Was running a \$125 million surplus instead of \$120 million worth freezing salaries of an underpaid faculty? Why of all years would we want to run a surplus?

Nothing seems more natural than to pause in a world pandemic. It almost sounds like common sense. But that is because pausing sounds like holding steady. Staying the course is in fact the right thing to do. Pausing by contrast is a euphemism for cutting.

The Senate released a report last year explaining the damage Yale has inflicted on itself by partially freezing hiring and salaries in past financial crises. Every hiring freeze led to shrinking the faculty and to declining excellence of the Yale faculty.

Pausing graduate admissions will have the same deleterious effects. There is no better moment to recruit good graduate students, when so many other universities cannot. Pausing Graduate admissions for a year means missing out on an entire cohort of students, just when we can get the best. It means Yale will award fewer PhDs. The graduate dean Lynn Cooley sent a letter to chairs recommending that departments pause admissions for a year. She said it would not be a sign of weakness, but of strength. No, it most certainly is a sign of weakness. It is also a signal to graduating seniors that Yale does not value the PhD degree.

Pausing to get the cuts over with might make sense for some departments faced with a budget balancing rule that for every student given a seventh year because of COVID, a year must be taken out of the prospective new class. (One less new student means six less years, so pausing for a year looks to me like an overpayment.). But why would we impose such a budget balance rule on the graduate school for COVID expenses? If a once in a century hurricane blew off a roof, we wouldn't say you can fix that roof, but not next year's roof. Somebody has to spend less if we spend more on roofs this year, but it doesn't have to be right away, and not in something so important as roofs, or the core mission of the university.

The PhD is becoming a more important degree, not a less important degree. It is increasingly required for many more jobs and not just professorships. As sure as the sun will rise, the number of PhDs will grow, just as the number of BAs has grown. Reducing the number of PhDs at Yale is moving in the wrong long run direction. Of course, some reallocation of the number of students across different departments might be needed. The model of paying full tuition and \$35,000 stipends might not work forever given that more and more PhDs will not become professors. But there is absolutely no reason to pause admissions when we do know the number must eventually grow just because we don't know the details of the future.

We lurched around the university last year with hiring freezes, pay freezes, and actually persuading departments to renounce graduate students for next year (art history for example). Now we are lurching the university back in the other direction by restarting some of those searches. The cost in lost time, missed candidates, and a demoralized faculty shows the wisdom of the Yale endowment spending rule, which is meant to prevent such waste.

The markets didn't end up as low as the administration worried, nor did our donors abandon us. The medical school hospital is giving colonoscopies again. This isn't a divine reward for our prudence. This turn back to normal is what usually happens in crises and is precisely the reason why the endowment spending rule is not to cut, but to stay the course.

The cuts last year were ill advised. Consultation with the faculty about the budget was almost nil. But bygones are bygones. All in all, the Provost and the administration did a remarkable job getting us through last year, especially considering it was his first semester on the job in an astoundingly difficult situation, with much more than just finances to worry about.

But the grading standard is tougher this year, because the path forward is so much clearer. We have a huge intact endowment. We have the world's best endowment manager. We are in a completely different situation from almost every other university because they have no choice but to cut back. As the second and third principles of financial management make clear, the institution with the money and the ability to borrow should act differently from everyone else. We have a once in a generation chance to hire good faculty and to recruit good graduate students. Maintaining hiring at half speed and pausing graduate admissions is profoundly irrational. Missing this opportunity would be unforgivable.

The Provost and President have a chance to have their names reverberate through history. Most great institutions reached greatness in jumps, not smoothly. And often because the competition was hamstrung. Think of Yale in the 1930s. We had just gotten the Sterling donation in 1929, which improved our faculty, and our buildings, and our student support. Think of the Harkness donation of 1930 that allowed us to build 8 residential colleges during the depression, when building costs were at their lowest. President Angell was loath to accept the contribution from Harkness because he thought a new college system was too bold. It might upset the alumni who were devoted to fraternities. Only after Harkness gave Harvard \$11 million for their houses did he come around to taking the money, which Harkness raised to \$14 million to keep his alma mater ahead.

Now is the time to be bold. I was reminded of this last Monday when the Nobel Prize was announced in economics. One of the winners Paul Milgrom had been a professor at Yale in the 1980s when I was a junior professor myself. We wrote papers together and played basketball at his house. Once he left for Stanford we stayed in touch but never wrote another paper together.

The late 1970s and early 1980s were a difficult time financially in the country and for Yale. But Yale had decided to get the business school up and going and was willing to be bold. The economics department already had two Nobel prize winners, the retired Tjalling Koopmans and the magisterial James Tobin. And a third dazzling young economist named Bill Nordhaus, who of course would go on to win a Nobel Prize. Yale hired Steve Ross, who died just before getting what would have been Yale's fourth Nobel. It hired Bob Shiller who was the fifth Nobel to be at Yale in the 1980s. It hired Paul Milgrom, who was the sixth Nobel laureate to be. It hired Oliver Williamson, the seventh. And again, in the same few years while I was a junior faculty, we hired

Bengt Holmstrom, who also went on to win the Nobel Prize. I spent my junior years at Yale with 8 Nobel Prize winners, 5 of whom were recruited in a very short period of time when Yale decided to be bold while others couldn't.

We can be bold again. Bold enough to be the best again. Mr. Provost, seize your moment for us all.