Finding Alpha in Crisis: How the Experts Are Investing Now

Part V: Asset Allocation: Building Better Portfolios for HNW Investors

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Asset Allocation: Building Better Portfolios for HNW Investors

- Today's Presenter:

Prescient ADVISORS

- Jeff Joseph
  - CEO of Prescient Advisors and managing partner of Prescient Capital Partners, former managing director of alternative strategies, Rydex Investments
  - Alternative investment specialist and former private wealth manager
  - Author of the RIA blog at www.venturepopulist.com
  - *Investment Advisor* monthly columnist on alternative investments for the past seven years.
- Moderator
  - **James J. Green**
  - Mr. Green is Editorial Director of *Investment Advisor* and *Wealth Manager* magazines.

Today's Objectives

- Re-examine investment industry conventional wisdom (risk/return)
- Re-evaluate priorities in portfolio management
- Build smarter and better investment portfolios
- Consider new advisory practice core values that will attract HNW investors
- Embrace concepts that will grow your practice
- Insulate your clients, portfolios, and practice from future *Black Swan* events

Black Swans

An event or occurrence that deviates beyond what is normally expected of a situation and that would be extremely difficult to predict.

Characteristics:

- The event is a surprise.
- The event has a major impact.
- After the fact, the event is rationalized by hindsight, as if it had been expected.

The main idea in Taleb's book is not to try to predict Black Swan events, but to ***build robustness to the negative ones, while being able to exploit positive ones***.

Why a New Approach to Portfolio Construction?

- Old models have failed
- New data is compelling
- Investors have lost confidence in advisors
- An opportunity to redefine and re-assert your value proposition
- Increase the marketability of your practice to the most desirable HNW and ultra-HNW investors.

Re-evaluate

- Risk
- Equities
- Asset allocation
- Asset classes
- Investor and portfolio priorities
- Role of liquidity and safety of principal
- Origins of wealth

Did Modern Portfolio Theory Fail?

- *"We learn from crisis to crisis that MPT has the empirical and scientific validity of astrology, without the aesthetics…In 1990 William Sharpe and Harry Markowitz won the prize three years after the stock market crash of1987, an event that, if anything, completely demolished the laureates' ideas on portfolio construction….I would ban portfolio theory immediately. It's what caused the problems…* ***Portfolio theory simply doesn't work. It uses metrics like variance to describe risk, while most real risk comes from a single observation, so variance is a volatility that doesn't really describe the risk.*** *It's very foolish to use variance"*—Taleb

- "*Genuine diversification worked:* ***what failed was partial diversification****. If you owned a diversified portfolio of risky assets—global equities, corporate bonds, commodities and so forth, then all of your holdings suffered because you had an extreme global flight to* <u>*safe assets*</u> *such as government bonds*—Jaeger

- "*What you needed was* <u>*real diversification*</u> *between risky assets and safety assets"*– Jaeger

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Did Modern Portfolio Theory Fail Your Portfolios?

2008 In Review, Selected Market Index Returns

Sampling of Returns	2008
20-30 Year Treasury STRIPS	56.5%
Barclays Capital US Aggregate	5.2%
1-Year Treasury Bills	3.3%
HFRI Composite Fund Of Funds Index	(20.7)%
HFRX Global Hedge Fund Index	(23.3)%
S&P 500	(37.0)%
MSCI EAFE	(43.1)%
S&P GSCI	(46.5)%
MSCI Asia Pacific ex Japan	(50.0)%
MSCI Emerging Markets	(54.5)%
HFRX Convertible Fixed Arbitrage Index	(58.4)%

Source: Research Affiliates

Did MPT Fail Your Practice?

- Public perception is nasty…

> Although media attention has focused on the Wall Street banks and the expense to taxpayers of bailing them out, the retail financial services industry also shares blame for the trillions investors have lost. If you use traditional asset allocation ir your portfolio, your losses over the last eighteen months have been stomach-churning. Advisors using passive asset allocation have stood by and watched with their clients as the stock market and the economy have turned from bad to worse. Their only guidance is a Wall Street mantra: "Stay the course." They charged fees for this advice.

- 57% of investors plan to fire their advisor and a jaw-dropping 86% said they would not recommend their advisors…only **2% would recommend their advisors** to others -- Russ Alan Prince & Associates

Introducing Hybrid Portfolio Theory

- Core Values—Safety, liquidity, Income and favorable risk/reward allocations for growth
- A highly adaptive portfolio concept defined by the practitioner's discretion
- Achievable portfolio objectives via proven approach supported by real-world data
- Compelling and attractive to desirable high-net-worth and ultra-HNW investors

HPT--Two Distinct (Hybrid) Portfolios

- **Portfolio A**
  - Allocation: 75-90%
  - Objectives: **Safety of principal, liquidity, income**
  - Benchmarks: Risk-free rate to short-term Treasuries (blend)
  - Vehicles: Cash, MMs, CDs,T-Bills, short-term municipals, Treasuries, TIPS
- **Portfolio B**
  - Allocation: 10-25%
  - Objective: **High ROI, capital appreciation, opportunistic**
  - Benchmarks: 15-25%
  - Vehicles: Private investments, publicly traded securities and derivatives with the potential to achieve a ***positive asymmetrical outcome***

Positive Asymmetrical Outcome

- PAO is a positively-skewed risk/reward ratio that can be achieved via investments such as venture capital, private equity, direct (angel) private investment in start-ups and emerging small businesses (PVI), private manufacturing businesses, private real estate, private debt, franchises, operating cash-flow businesses, as well as, publicly traded emerging growth companies, leveraged (*long vol*) option strategies, and highly specialized investment strategies employed by managed futures and *some* hedge funds.

Private Venture Investment

- Best long-term returns of any asset class

Thomson Reuters' US Private Equity Performance Index (PEPI)
Investment Horizon Performance through 12/31/2008

Fund Type	1 Yr	3 Yr	5 Yr	10 Yr	20 Yr
Early/Seed VC	-20.6	1.7	3.7	36.0	21.8
Balanced VC	-26.9	4.6	8.4	13.5	14.5
Later Stage VC	-6.8	9.5	8.7	7.5	14.5
All Venture	**-20.9**	**4.2**	**6.4**	**15.5**	**17.0**
NASDAQ	-38.1	-10.3	-4.6	-3.2	7.3
S&P 500	-36.1	-10.0	-4.0	-3.0	6.1
All Venture (through 9/30/2008)	**-2.1**	**6.3**	**8.4**	**17.1**	**17.0**
All Venture (through 12/31/2007)	**20.1**	**9.5**	**8.6**	**18.1**	**16.7**

Source: Thomson Reuters/National Venture Capital Association

- "*Managers can exploit inefficiencies in the pricing of less familiar assets*"—Swensen

HPT Target Returns

Conservative

$(.90 \times 4.0) + (.10 \times 15) = (3.60\% + 1.50\%) =$ **5.1%**

Aggressive

$(.75 \times 5.0) + (.25 \times 25) = (3.75\% + 6.25\%) =$ **10%**

Gratuitous Buffett Break

"Beware of geeks bearing formulas"

"The first rule is not to lose. The second rule is not to forget the first rule"

"Should you find yourself in a chronically leaking boat, energy devoted to changing vessels is likely to be more productive than energy devoted to patching leaks"

"Your premium brand had better be delivering something special, or it's not going to get the business"

What Investors Want

- Not to lose the money that they have saved.
- To grow their assets and keep their dreams alive

In short, they want it all…

safety, liquidity **and** ***opportunity***

HPT Delivers

- Mitigates impact from Black Swans
- The Empowerment of Liquidity
- The opportunity to achieve material and sustainable capital appreciation

Proponents of HPT Concepts

"*Staying Rich in the New Normal,*" **Bill Gross**, June 2009

> *"It is probable that trillion-dollar deficits are here to stay because any recovery is likely to reflect "new normal" GDP growth rates of 1%-2% not 3%+ as we used to have. Staying rich in this future world will require strategies that reflect this altered vision of global economic growth and de-levered financial markets. Bond investors should therefore confine maturities to the front end of yield curves where continuing low yields and downside price protection is more* ***probable…All investors should expect considerably lower rates of return than what they grew accustomed to only a few years ago****. Staying rich in the "new normal" may not require investors to resemble Balzac as much as Will Rogers, who opined in the early 30s that he wasn't as much concerned about the return <u>on</u> his money* ***as the return <u>of</u> his money."***

Proponents of HPT Concepts

Fooled by Randomness (2004); The Black Swan (2007) **Nassim N. Taleb**

*"**Put yourself in situations where favorable consequences are much larger than unfavorable ones**"*

"You need to put a portion, say 85% to 90%, in extremely safe instruments, like Treasury bills—as safe a class of instruments as you can manage to find on this planet. The remaining percent in extremely speculative bets, as leveraged as possible (like options), preferably venture capital-style portfolios"

*"…the barbell strategy of **taking maximum exposure to the positive Black Swans while remaining paranoid about the negative ones**"*

"I worry far more about the "promising" stock market, particularly the "safe" blue chip stocks, than I do about speculative ventures—the former present invisible risks, the latter offer no surprises since you know how volatile they are and can limit your downside by investing smaller amounts"

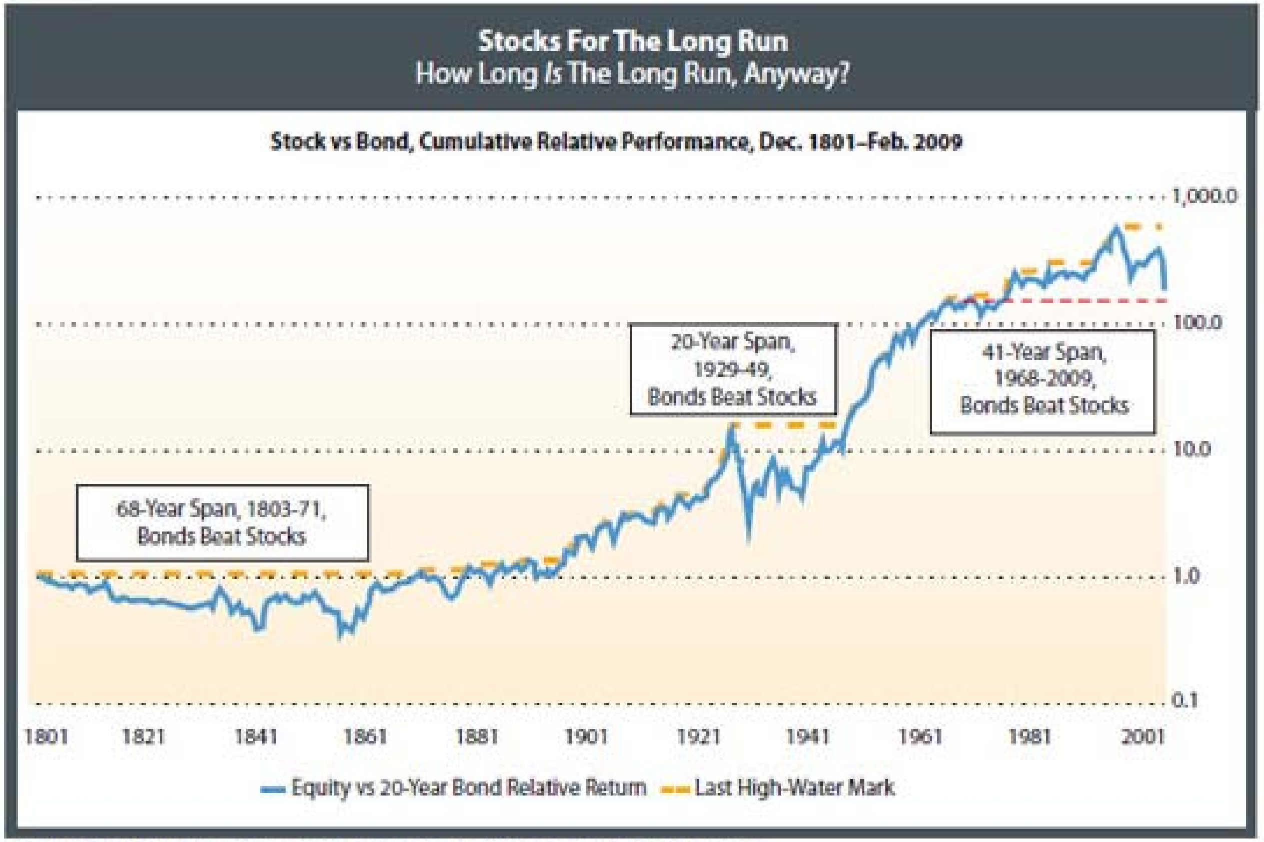
Proponents of HPT Concepts

Bonds, Why Bother? **Robert Arnott,** Journal of Indices, April 2009

- **Over the past 40 yrs there has been no equity premium in stocks**
- Starting at any time from 1980 up to 2008, an investor in 20-year treasuries, rolling them over every year, beats the S&P 500 through January 2009. Going back 40 years to 1969, the 20-year bond investor still outperforms by a marginal amount, even with the Carter-era inflation and traumatic bond market in the seventies.

  "…the common interpretation that stocks should be the core of your portfolio always is wrong"

Proponents of HPT Concepts



Source: Standard & Poor's, Ibbotson Associates, Cowles Commission and Schwert

Stocks had zero risk premium for the past 40 years

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Proponents of HPT Concepts

Daniel Kahneman, 2002 Nobel Prize, ***Prospect Theory*** and ***Loss Aversion***

- The pain of a dollar loss **2X** as much as the joy of a dollar gain, (counter to prior risk models that put equal weight on loss & gains)
- Hired by Guggenheim Investment Advisors ($40B, 220 families, $25M min) to develop *Riskometry*

"Many investors have return expectations that are completely disconnected from reality…People have two goals—not to lose money and to make a lot more money. Since they are essentially rivals, we try to ***separate them and address then specifically and differently*** *– A. Rosenfield, CIO*

- Riskometry results in two portfolios per client:
  - "Bold" – ***to grow wealth***
  - "Conservative" – ***to preserve wealth***

Proponents of HPT Concepts

Dale Swensen, Yale CIO, architect of the "Yale Model"

Asset allocations of Yale and Harvard endowments:

Asset Classes	Domestic Equity	Absolute Return	Foreign Equity	Private Equity	Real Assets	Fixed Income	Cash
Yale	11%	23.3%	14.1%	18.7%	27.1%	4%	1.9%
Harvard	12%	18%	22.%	11%	26%	16%	-5%

- Yale = 16%, Endowment avg. = 6.5%, S&P = 2.9%

"*Accepting illiquidity pays outsized dividends to the patient long-term investor*"

Proponents of HPT Concepts

Robert A. Jaeger, Senior market strategist, BNY Mellon

"Investors need liquidity just as fish need water, but you don't know how much you need until you don't have it"

"Without liquidity you cannot buy during stress periods and you may even become a forced seller"

*"**You need cash to buy during a panic**"*

"Forced selling also came from non-leveraged investors who didn't have enough liquidity"

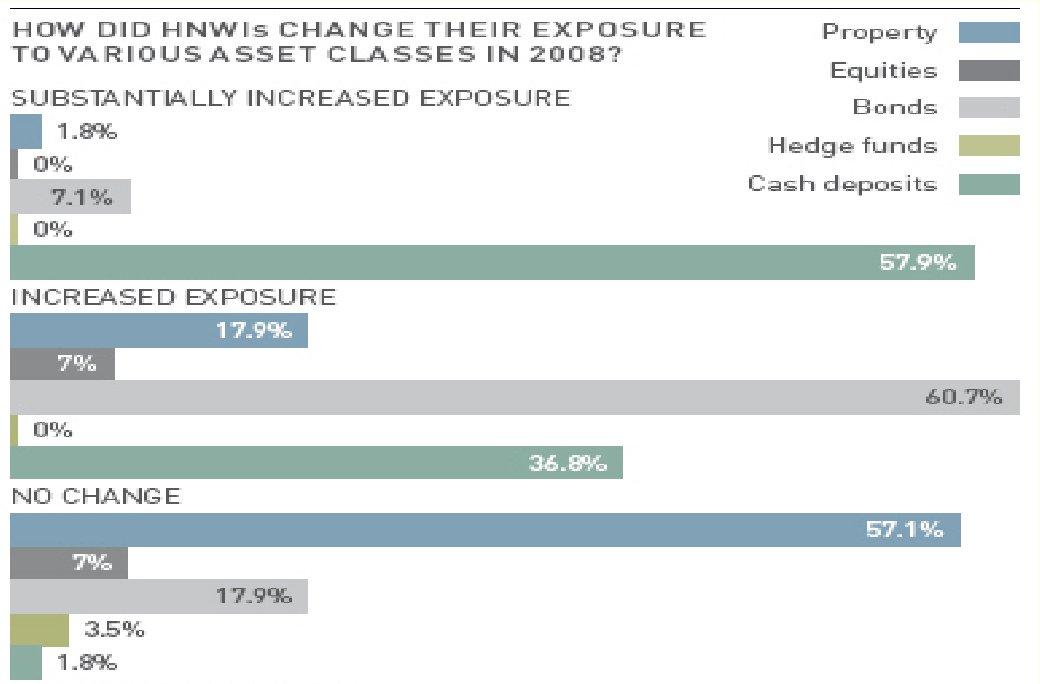
*"**The liquidity cushion has to be simple, high quality and real**"*

"The <u>expected</u> return on cash is lower than that of many risky assets…but the <u>actual</u> return on cash may be much higher"

*"**Liquidity has to be built into the foundation of the portfolio**"*

Preaching to the Choir

- Poorly served by investment models, HNW investors rushed (*too late*) towards liquidity…



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PAO Opportunities are Plentiful

- Start-up and emerging companies offer high multiple returns on capital and higher potential for revenue, asset, brand and cash-flow growth than mature companies.
- Some PVI investments offer distressed or special situations pricing opportunities
- There are far more sellers of private investment opportunity than buyers

"*At any given time there are more than 1 million U.S. companies actively seeking outside investment partners*" – The Funded.com estimate

"*Approximately 495,000 new companies are started every month in the U.S.*" – Kaufman Institute

"*Managers can exploit inefficiencies in the pricing of less familiar assets*" --Swensen

Private Investing Has Its Challenges

Microsoft Corporation, 1978

Practice Implementation – *You May Already Have the Resources*

- Proprietary deal flow
- Due diligence resources
- Professional advisors
- Access to angel investors

The Origin of American Wealth

The Millionaire Next Door: The Surprising Secrets of America's Wealthy --Thomas Stanley & William Danko, 1998

"*80% of today's American millionaires are first-generation rich. More than half never received as much as $1 in inheritance, and 91% never received as much as $1 from their previous generation's ownership of a family business."*

- The same was true a century ago according to the citation of a 1892 study of the 4,047 American millionaires: "84% were nouveau riche, having reached the top without the benefit of inherited wealth."

- The vast majority of this nation's wealth has been created by private venture and enterprise.

Today, That Wealth is in Motion

- Just under half of all wealthy people are set to change their private banking arrangements, as the impact of the credit crisis forces a rethink on the industry.
- **80% of wealth managers thought their performance was good or very good during the financial crisis. Only 30% of clients agreed** and a further 30% thought it was poor or very poor.
- The battle for clients is likely to be most acute for the ultra-high net worth individuals
- The wealth industry needs a more engaged and radical insight of **what prospective buyers want** to achieve to shape the strategy and sales proposition of tomorrow.

'The Wealthy Lose Faith in Their Bankers", Dow Jones Wealth Bulletin, 6.15.9

HPT Implementation Discretion

- Investor Priorities and Values
- Allocation percentages
- Constituent asset classes, vehicles and investments
- Benchmarks

Your Portfolio Wins

- Stable principal
- No exposure to negative Black Swans
- Access to positive Black Swans
- Liquidity to deploy after market implosions

Your Practice Wins

- Investors value safety and liquidity and will embrace HPT
- HNW investors accept PVI as a wealth creation vehicle
- More HNW and ultra-HNW investors…more referrals
- PVI develop stronger and “stickier” client relationships
- Liquidity events increase AUM
- Deal flow development and due diligence develops a strong client community
- Distinct competitive differentiation of your practice
- Margin expansion opportunity

New Pricing Model?

- Hybrid Pricing:

80% (A) @ 75 bps = 60 bps
20% (B) @ 200 bps = <u>40 bps</u>
1.00%

- Hybrid Incentive:

80% (A) @ 60 bps = 48 bps
20% (B) @ 100 bps = 20 bps
4% (B) @ 2000 bps = <u>80 bps</u> **(incentive fee @ 20% return)**
1.48%

The Best Time to Plant an Oak Tree?

The Economic Future Just Happened
-- Dane Stangler, Kaufman Foundation, June 9, 2009

- More than half of the companies on the 2009 Fortune 500 list were launched during a recession or bear market, along with nearly half of the firms on the 2008 Inc. list of America's fastest-growing companies.
- Rising unemployment can benefit new enterprises: entrepreneurs may view unemployment as an opportunity to start a company, and seize the advantage provided by the ability to tap into a larger pool of potential employees.
- Burger King, FedEx, Microsoft, CNN, GE, HP Google, PayPal, Salesforce.com… *and many others*

Q&A

- *To ask questions of Jeff Joseph, please submit via the GoToWebinar question pane.*

Continuing the Dialogue

- View archived presentation the week of June 22 at InvestmentAdvisor.com and WealthManagerMag.com (events page).
- Visit VenturePopulist.com and comment on the boards
- Connect with Jeff Joseph via Linkedin
- Attend the final webinar in of the series:
  - July 1, 2009, 3:00 PM Eastern Time
  - Portfolio Construction in a New World
  - Asset allocation guru Roger Gibson, *Investment Advisor* and *Wealth Manager* columnist and Sovereign Wealth Management CIO Ben Warwick, and *Wealth Manager* Editor Kate McBride

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