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ON THE COVER



Message From the Sea

Sasa Palmata Nebulosa Bamboo, Waxed Linen Thread,
Steel, Maple, 2012

108 × 48 × 48 inches; 274.32 × 121.92 × 121.92 cm

Charissa Brock (American) is a bamboo sculptor based in Portland, Oregon. The artist's technique and weave is highly detailed, and inspired by her close relationship with the material. Each work contains handpicked bamboo of different varieties, harvested locally, and uniquely combined with other earthly materials. The artist's work is included in numerous institutional collections across the United States. The artist's body of work leaves a lasting impression of how raw materials are unified in today's contemporary art scene. Charissa Brock is represented by Cavin-Morris Gallery in New York, NY.

Visit www.cavinmorris.com to view more works by this artist.

A couple of issues that had remained dormant in my consciousness for quite some time resurfaced in the past several weeks, and they both relate to the same problem: the propensity by many to over-simplify things to the point of rendering labels meaningless and even, in many cases, damaging. My focus here is on the use of “hedge funds” and “private equity” as asset classes in the context of a strategic asset allocation exercise.

Let me first honestly admit that many wealthy individuals and families would rather have the strategic asset allocation challenge simplified. This should not surprise. Even within a goals-based process, individuals rightly feel they should not have to learn “financialese” in order to reach agreement on their investment policy structure and details. Understood! Similarly, many people who do not really care about cars or trucks might feel that we should simply call them all vehicles and be done with it. How about a bike?

This poor analogy illustrates the obvious: the use of overly broad labels causes significant loss of meaning or texture. Though individuals who might only be casual users of some category of product or service may not need to see its many variations, someone needs to note that there are material differences among a truck, a car, and a bike. Simply claiming that we should not complicate matters does not help our clients.

This brings us back to the issue of “hedge funds” and “private equity.” In reality, “hedge funds” are not an asset class; they are a fee structure. And “private equity” only conveys information about the illiquid nature of the investment. Intelligent individuals will want to dig deeper and “place” these strategies in the appropriate context, along the efficient frontier.

Consider “hedge funds” first. As amply discussed in several articles we published in the past 10 years, these cover a wide range of strategies. In many ways, these strategies all can be somehow “located” on a spectrum defined by levels of portfolio activity; typically, managers tend to be more active and with a larger variety of instruments than traditionally. In particular, risk management is less driven by the well-understood tool of diversification and more focused on the use of active strategies designed to control certain factor risks, often with a greater assumption of other risks, such as security-specific risk.

Thus, they can be analyzed in groups spread along a traditional volatility range, for example. At the one end of the expected volatility spectrum one will tend to find relative value strategies, such as

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arbitrage and market neutral portfolios. Here market risk is often hedged and the expected return is driven by individual security mispricing relative to certain others, plus some base return on cash, as being market-neutral in some way is equivalent to creating synthetic cash, plus some mismatch from which one expects to earn some excess return. Fixed income and credit strategies are still a part of that same spectrum, but it is not unusual for some residual exposure to interest rate risk to be present.

Higher still, one might find event-driven, distressed, or restructuring strategies, where the expected return is based on some important anticipated trigger, and where market risk is broadly accepted while one waits. Global macro also resides within that spectrum. It usually offers interesting diversification potential to traditional fixed income strategies, though it is most often characterized by gladly accepting—in fact seeking—market risk, but not in any given or predictable direction.

Higher up on the volatility spectrum one typically finds equity-oriented strategies comprising some intentional exposure—net long or net short—to equity market risk. The vast bulk of these strategies live in the so-called “long/short” space, and retain net market exposures in the 30% to 70% range, although quite a few managers can be found outside these boundaries. Concentrated long-only equity portfolios, as well as dedicated short portfolios, also belong in that space, though their exposure to market risk, positive or negative, is often even more pronounced. Similar to global macro in the fixed income space, managed futures—or systematic, as opposed to discretionary, trading—can provide useful diversification to equity market risk, by seeking market risk exposure indifferently on the long or short side, depending on certain systematic trading signals.

Aggregating all these quite disparate strategies under one header does indeed seem quite surprising. A cynic might argue that this allows advisers to cross into the “product space,” in that they can offer their own in-house funds of funds and not have to bother with the various strategy differences. One might temper such a cynical observation with the comment that these advisers rarely charge for the management of these funds of funds, and thus that one should properly not infer a product-creation motive.

A more reasonable—and charitable—interpretation is that looking at these alternative strategies as one single alternative, rather than as a set, simplifies their management

activities. Though both may lead to enhanced profitability for the adviser, the management-efficiency motive leaves less of a bad taste in one’s mouth than the idea of making a product-management fee when one is already paid an advisory fee. The question however remains: does aggregating all these strategies under a common header help clients as well?

A detailed analysis of the impact of aggregating these strategies into a single asset class is beyond the scope of a Letter from the Editor. However, experience does suggest that breaking these strategies into four categories alongside traditional long-only asset classes can be a more efficient investment approach than a very rough use of some single “fund of funds” that aggregates all the strategies into a single glob. These four categories might be: (1) lower half of the volatility spectrum, (2) global macro, (3) long/short equity, and (4) managed futures. The relative size of the exposure to (1) and (3) would normally be somehow dictated by the relative equity/fixed income mix of the overall portfolio. Categories (2) and (4) can be effectively used as volatility diversifiers in some proportion of the same equity/fixed income mix.

The very fact that the diversity of client goals will naturally lead to a wide range of equity/fixed income mixes argues against the idea of using a single “fund of funds” whose exposures to the four categories above is the same for all clients. It should also be noted that a finer definition of these strategies as they are included in a portfolio can also promote a greater degree of tax efficiency for families and “locations” where it matters. One can view categories (1) and (3) above as tax-inefficient providers of value added, to be juxtaposed with tax-aware or even hyper tax-efficient long-only strategies focused on replicating market beta rather than the generation of alpha.

A similar thought process leads to the conclusion that the “one-size-fits-all” use of “private equity” to classify illiquid strategies and calibrate the appropriate overall portfolio exposure level is equally misguided. There are indeed at least three basic categories of illiquid strategies, all masquerading under some “private equity” label: 1) illiquid fixed income, which might include senior middle-market loans and mezzanine credit; 2) illiquid equity, which might comprise buyouts, growth capital, and venture capital; and 3) illiquid real assets, which might cover energy, timber, land, real estate, and a few other similar assets.

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At a first level of logic, thinking of the area as comprising at least three distinct sub-groups helps the analyst, in that it promotes a solution to the otherwise tricky effort of forecasting expected returns and volatility. Illiquid fixed income can be analyzed as a variant on traditional fixed income, with the addition of some illiquidity premium with respect to both return and volatility. Senior loans could typically be viewed as floating-rate instruments with an illiquidity premium, while mezzanine can be construed as a high-yield strategy, with the same illiquidity premium.

In the same framework, one can imagine that buyouts are large-capitalization equity investments with an illiquidity premium, while venture capital is more like illiquid small- or micro-capitalization equities. The framework can be extended to real assets, with illiquid real estate, for instance, estimated as a REIT with an illiquidity premium and similar conceptual assumptions for other real assets that are available in a liquid form. The advantage of this line of thinking is that it greatly expands the range and volume of available historical data from which certain structural patterns of risk and returns can be inferred. In short, it can help the analyst arrive at forecasts where the underlying assumptions are considerably more explicit. While this does not guarantee accuracy, it does provide for some means of evaluating the cause of any error or of adjusting to some real or perceived structural change.

It should thus become immediately obvious that a single “private equity” overall portfolio allocation is almost by definition sub-optimal. I recently found myself in an investment committee discussing the relative benefits of illiquid fixed income, in that case principally focused on sponsored and non-sponsored senior loans. In an environment where vintage year considerations are important, allocating vintage year and illiquidity spaces in an aggregate portfolio sense quickly foundered. Yet, the moment the notion that “private equity” really did not exist per se, and should rather be viewed and analyzed into its three major constituents, entered the discussion, it became fruitful and quickly brought the group to a consensus.

Illiquid fixed income in that context was to be assessed in terms of the interest rate and credit risk that the portfolio could bear, within some overall portfolio illiquidity constraint. Similarly, allocations to buyout, growth capital, and venture capital were analyzed in terms of the kind of large versus small capitalization risk one was willing to take.

Finally, illiquidity with the real asset component was also a simpler conversation to have. Ostensibly, other dimensions also came into play, related to geographical considerations or the actual expected length of the illiquidity period, to name just a few.

Hopefully, the point is by now sufficiently clearly articulated. Admittedly, there will be times where overall portfolio size considerations will militate—and rightly so—against the kind of asset class or strategy definition that larger portfolios might permit. It is an unfortunate fact of life that strategies that comprise significant individual “bite size,” or minimum investment, considerations will require uncomfortable aggregation for investors who could not meet both these minimum investment and sensible portfolio diversification requirements. Yet, whenever that thorny issue is not the preeminent factor, it should be reasonably clear that advisers should refrain from an aggregation that would be as senseless as labeling all assets “financial assets” and be done with it! It is our firm hope that this letter will stimulate authors to explore these questions in more depth and submit articles trying to put meat on these bones, or even refuting our logic on some ground that we simply have missed.



The Spring 2014 issue of the *Journal of Wealth Management* attempts to stay as broad as usual, but still introduces a new feature that we will endeavor to maintain across all future issues. Feedback from our readers strongly suggests that they look to the *Journal* as a source of reviews of current books pertaining to the industry, and reactions to the few that we published in the past were particularly positive. We will therefore now make it a point to review books that are mentioned or made available to us, to the extent that we feel they represent useful reading. Please, feel free to send us titles you believe ought to be considered.

The first two articles in this issue look at radically different elements of broad investment policy formulation. The first, by Alessia Zorloni and Randall Willette, examines the role of art in the overall wealth-management strategy of a single family office, and the issues faced by wealthy families in managing a private art collection. It concludes with general recommendations on what constitutes sound art governance in order to preserve and protect a family collection. The second, by Peter Mladina, develops a dynamic

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asset allocation process that exploits the reduced horizon risk of equities relative to fixed income, based on the classical observation that the risk of equities relative to fixed income is more acute at short time horizons than long time horizons, confirming previous research.

Our next three articles deal with various aspects of what we still call emerging markets. (I often wonder when the industry will stop distinguishing developing versus emerging countries and rather adopt a broader global geographical focus.) The first, by Gregory Curtis, offers four reasons why emerging market equities may not continue to provide superior returns: the unstable link between growth and returns, a possible breakdown in the development model for emerging societies, the frequent absence of social and political progress, and the growing economic competition from both developed markets and frontier markets. The next piece, by Timothy Atwill, examines relationships between emerging market equity returns and commodity returns, given the frequent recommendation to view emerging market equities as a proxy for commodities. It concludes that emerging market equities are a poor proxy for commodities futures in an investor's portfolio. Our final piece takes us to India, as Manu Sharma, Gunwant Singh Saini, Esha Prashar, Rajnish Aggarwal, and Gauravdeep Kaur investigate the relationship between Indian Policy rates and the Market indexes of the largest economies of the world. It concludes that long-term lending by the Reserve Bank of India was more dependent on the world's largest market indexes as compared to its short-term lending activities.

Our next three articles really deserve their own individual classification, and are thus combined here for

simplicity purposes. The first, by Vichet Sum, focuses on a topic that has increasing relevance both to markets and to families. He examines firms in the United States that have quality training programs, and concludes that they can enjoy above-the-market-average performance. Next, Ray Sturm's slightly exoteric paper seeks to determine whether market reactions to elections are a valuable source of information for investors. It suggests that the difference in campaign information during the election and actual subsequent economic policy implementations may explain why the market's vote does count. In the final piece in this trio, Olfa Hamza and Maher Kooli examine the performance persistence of Funds of Hedge Funds (FoHFs) and confirm that overall, FoHFs that show performance persistence over a short time horizon are more likely to be persistent over a longer one.

In our last article, Jean Brunel reviews four books: "The Stewardship of Wealth, Successful Private Wealth Management for Investors and Their Advisors," by Gregory Curtis, Wiley Finance; "The Value of Debt, How to Manage Both Sides of A Balance Sheet to Maximize Wealth," by Thomas J. Anderson, Wiley; "Risk-Return Analysis (Volume 1), The Theory and Practice of Rational Investing," by Harry M. Markowitz with Kenneth Blay; and "Introduction to Risk Parity and Budgeting," by Thierry Roncalli, Chapman & Hall/CRC Financial Mathematics Series.

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