GreenHills Ventures Wealth Management360

Family Offices - Taking A Cue From Institutions

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The last 12 years have been challenging, with the bursting of the tech bubble and the world credit crisis, but the adversity has shown us that institutional investors do a better job of minimizing damage.

This suggests that family offices would be wise to emulate institutional strategies when managing their portfolios.
The numbers reinforce this view:

For the 10 years ending in 2011, balanced portfolios composed of equity and fixed-income returned 1.11% per year, according to Dalbar. In other words, the average investor turned a $1 million portfolio into just over $1.11 million.

Meanwhile, the median institutional investor returned 5.04% per year over the same period, according to Investment Metrics. A $1 million portfolio grew to over $1.63 million.

That's a difference of over $518,000 annually on a $1 million portfolio. Starting with $10 million, the difference in gains over 10 years is more than $5 million.

Families Vs. Institutions
There are important differences between families and institutions. Taxes play an important role in families' planning and portfolio construction, while most institutional retirement plans and foundation and endowment portfolios are tax-exempt. In terms of investment horizons, institutional investors are looking into infinity, while most families base their strategies on life expectancy. Most families have a lower risk tolerance than institutions; however, it's interesting to note that the median institution performed much better in down years than the median family. Institutional portfolios benefit from lower fees because of their bargaining power. However, it's estimated that this discrepancy costs the typical individual investor no more than 0.50% per year.
Despite these differences, there are a number of institutional characteristics that family offices can adopt into their own practices:

Set clear goals and objectives. Families should have a specific investment return target and quantify their downside risk tolerance. Investors need to identify how much of a loss they can tolerate in the short term to reach their long-term return target. There must be a direct relationship between the target return and downside risk tolerance. Investors who expect high returns with "low-risk" portfolios are often disappointed and make emotionally driven mistakes. For an institution, the relationship between risk and return is usually well understood and documented, as it is one of the basic principles of fiduciary law.

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Use objective advisors. Most Wall Street firms sell open architecture. However, they have a high incentive to use more profitable proprietary funds, creating a conflict of interest. Institutions typically use independent consultants who provide objective expertise on manager and product selection and monitoring. By contrast, families often end up letting Wall Street firms take the reins, resulting in a portfolio laden with proprietary products. Independent advisors and consultants are among the primary reasons institutions outperform individuals.

Be process oriented. For institutions such as retirement plans and foundations, the law suggests that fiduciaries, trustees and plan sponsors use a prudent process in managing assets on behalf of their participants and beneficiaries. While the law does not dictate a specific process, all the major tenets of a prudent process can be easily developed. 3Ethos and The Foundation for Fiduciary Studies recommends the following process to prepare leaders to serve more effectively as stewards in critical decision-making:

1. Analyze goals and objectives. Time frames, income needs, tax statutes, experience levels, etc., should be reviewed. Many family entities and trusts may have different objectives. Downside risk should be quantified. For example, how much are you willing to lose in a one-year period in order to meet your long-term return objectives?

2. Strategize to develop an asset allocation strategy. Institutions typically conduct an asset allocation study with the help of an independent consultant to take a forward-looking view of the capital markets and apply it to their situations. Families should be no different. Miniscule yields in the fixed-income markets should have a notable impact on the way an investor thinks about long-term goals and objectives. A formal study can be an excellent tool to make decisions about asset allocation design, which studies show is the primary driver of portfolio returns. Strategies should be reviewed at least once per year.

3. Formalize your investment policy. Document your goals and objectives and the asset allocation strategy. Outline the process for selecting managers, products and strategies, as well as the benchmarks and process for the monitoring of not only the managers, but the fund. This document, typically a fiduciary requirement, is an important paper trail and helps avoid Monday morning quarterbacking, keeping the portfolio on course. As with the portfolio strategy, it is prudent to review the investment policy statement at least annually. Benchmarks for each investment strategy should be identified, and a custom portfolio benchmark should be constructed based on the overall allocation of the portfolio. This tool will help you judge whether your managers are adding value.

4. Implement the strategy with capable managers. Each manager should be accountable and the “best of breed” in each asset class. Too often, investors focus on short-term performance and a cumulative time frame—such as the last five years. Manager consistency is crucial. We analyze managers’ one-year and three-year rolling performance versus benchmarks and peer groups to gauge their likelihood of outperforming or underperforming. All managers will underperform at times, but how often? Also, judging the qualitative aspects of a firm can lead to sound manager selection. Understanding a money manager’s culture, turnover, personnel depth, and compensation structure, as well as philosophy and process, is

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crucial to determining future performance.

5. Monitor the portfolio. A rebalancing strategy should be determined in advance. The tax implications of rebalancing should also be considered. The performance of each manager, product and strategy should be reviewed regularly. Particular emphasis should be placed on why the performance happened, good or bad. Style drift, which occurs when managers begin purchasing securities outside of their core mandate, should be monitored, as well as the firm's personnel and ownership issues. Too often, investors make manager changes based solely on recent performance, just before relative returns rebound. Institutions tend to be more patient with managers and are less apt to get whipsawed.

These steps should be part of an ongoing process. "Set it and forget it" does not work. Market expectations change, particularly in fixed income. Pay close attention to rebalancing, portfolio risks and manager changes. Adhering to this disciplined process should add significant value.

6. Focus on better diversification. Larger institutions take advantage of investments in less liquid areas such as timber, farmland and direct real estate. Private lending strategies have provided liquidity to companies in a tight lending environment. Private equity, mezzanine and distressed debt, and hedge funds are also more commonly used by institutional investors. With interest rates so low, it may be prudent for investors to consider low-volatility strategies as a replacement for some fixed income. Bonds have become an expensive hedge. Many pension plans and non-profits are considering strategies to reduce volatility without a substantial reduction in their portfolios' expected total returns. Remember that downside risk should always be quantified and a move from bonds to stocks could significantly increase portfolio risk.

7. Use quality due diligence. Investment products are too often "sold" to investors and not objectively analyzed. When a firm's proprietary products are recommended, a giant red flag should go up. A firm cannot conduct objective due diligence on a proprietary product, particularly when it helps advisors' compensation. Huge commissions that are built into structured products and strategies are often difficult to understand.

Conclusion

High-net-worth investors, families and family offices have much to learn from institutions. We are confident that if families take a more institutional approach, their portfolios will perform better and their portfolio expenses may decrease. While there are certainly well-run high-net-worth and family portfolios, historical performance shows that high-net-worth investors have significant room for improvement. By taking a cue from the most successful institutions, all investors have a tremendous opportunity to improve their results.

About GreenHills Ventures
GreenHills Ventures, LLC., established in 2001 as a private investment holding company and General Partners for GHV Fund I and GHV Fund II, (GHV Fund), an early stage venture fund and GHV Wealth Management Holding, LLC. (GHVWMH), a wealth management firm focused on alternative investments for its single and multi-family offices and institutions. For more information visit www.greenhillsventures.com

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