Right-Sizing Your Portfolio to Accommodate Alternative Investments

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Ultra high net worth investors and their family offices naturally seek institutional caliber investment management and results.

They are also continually exposed to new and compelling investment opportunities, particularly in the alternative investment arena. However, the traditional approach to investing in these alternatives can have serious ramifications for the risk/reward metrics of a family's investment holdings. This White Paper introduces a new model for incorporating alternatives into one's portfolio in a way that may be better aligned with your long-term goals.

THE CRUCIAL DIFFERENCE BETWEEN HIGH NET WORTH AND INSTITUTIONAL INVESTORS

Many high net worth clients sit on the boards of major foundations and institutions. They see the institutional-quality investment returns that these organizations enjoy, driven in part by an increasing use of alternative investments.

While it's natural to want access to institutional quality investment opportunities, there are enough differences in the needs of affluent families to warrant a different approach. Wealthy individuals and families are clearly not of an "institutional mindset" when it comes to market volatility.

Affluent families rely on the safety and stability of their wealth to provide for their lifestyle needs. For example, there are multiple real estate properties, major assets to look after, as well as philanthropic goals and the differing needs of multiple generations within the family.

An institution with a 20-year investment timeframe may be able to ride out the storm of unstable markets. But high net worth families do not want to learn they cannot make a major purchase simply because of a drop in the value of their investments. There's a portion of a high net worth family's portfolio that must be dedicated to provide for the preservation of capital and to meet current income needs.

THE LURE OF ALTERNATIVE INVESTMENTS

Nevertheless, like many highly affluent investors, you are continually exposed to compelling investment opportunities, particularly in the alternatives arena.

By alternative investments we mean those that do not trade publicly on an organized exchange. Examples include private equity, new business ventures, real estate and hedge funds.

Alternative investments offer the potential for higher returns than publicly-traded stocks and bonds. Some alternative investments attempt to mitigate market risk ("market neutral" strategies) and provide steady, predictable returns. Others aim to outperform the market. Alternatives can be an important part of your asset allocation since they are sometimes managed in a way as to not mirror the overall direction of broader stock and bond markets.

WHY THE TRADITIONAL APPROACH TO ALTERNATIVES MAY NOT BE RIGHT FOR YOU

The invitation to participate in alternatives may come from one of your existing advisory relationships. Sometimes it comes from a family member or friend who is involved with an investment or who hears about a new venture.

The traditional approach many investors take—often based on habit—is to write a check, drawing funds from whatever source of liquidity is most convenient. Whether it is for an investment in office real estate, a hedge fund of funds or a nephew's tech start-up, you may write a check for $500,000, drawing money from your bond portfolio because that's where the cash resides and that is the amount you are comfortable in committing. But is that the right amount to invest? The right place to draw the cash? The right asset category to be increasing?

Presumably you and your advisors have built a carefully balanced strategic asset allocation for your overall portfolio. So what you may have done, inadvertently or otherwise, is substantially alter the risk/reward metrics of your portfolio. You have re-deployed what may have been lower risk, lower volatility, income-generating assets into a very high risk alternative investment.

A DISCIPLINED APPROACH FOR INCORPORATING ALTERNATIVES

A better approach might be a model for incorporating alternatives that clarifies your overall strategic asset allocation.

What you may want instead is a disciplined approach that enables you to take advantage of these opportunities while understanding the tolerances within your portfolio for risk and return. One that enables you to know precisely how much to invest, where to draw the funds, and where this new investment fits within the higher volatility/total return and lower volatility/income generation framework of your portfolio.

INTRODUCING THE DUAL ASSET CLASS MODEL

Many investors believe that there are four asset classes: stocks, bonds, cash and alternatives. But there is another model that suggests that there are only two asset classes: high volatility and low volatility. And that alternatives are not an asset class at all. Rather, they are just another way to pursue alpha — outperforming the market. Versus traditional asset classes which, particularly over the long term, deliver beta — market performance.

With this type of Dual Class model, investments can be grouped into two subcategories: high volatility—which are assets that drive long term total return and may include stocks and some types of alternative investments. And low volatility, which includes capital preservation and income-generating assets, such as bonds and T-bills along with certain other types of alternatives.

What this model delivers is a fully inclusive asset allocation that accommodates all of your investment opportunities, including alternatives. One that gives you the ability to “right size” any new opportunities as they come along.

HOW THE PROCESS WORKS

As with any investment advisory process, the Dual Asset Class model begins with an in-depth interview. We explore your needs for income, tolerance for risk, comfort level with volatility and expectations for return on investment.

But unlike other approaches, the Dual Asset Class model includes alternatives — not only as a slice or surplus investment — but as a core component of your portfolio. In other words, with the Dual Asset Class model, we may look at how much a particular hedge fund, for example, should make up of the low volatility portion of your portfolio.

In addition, when it comes time for periodic rebalancing or finding funds to take advantage of new opportunities, the Dual Asset Class model indicates where these funds should come from and should go.

Much like a carefully planned recipe, if you change the amount of one ingredient, it will affect the proportions of all the others. For example, if you wanted to add $2 million to the higher volatility/total return portion of your portfolio, you would balance that with a proportional addition to the lower volatility/ income generation portion.

ADDRESSING BOTH YOUR PERSONAL AND "INSTITUTIONAL" NEEDS

The Dual Asset Class model has other advantages, too. It enables you to accommodate both the personal needs of your family for income generation and wealth preservation, as well as pursue your desire for institutional-caliber returns.

Because we often serve as the family office for wealthy families, we understand and accommodate a family's personal needs, whether it be for lifestyle management, philanthropic objectives, or longer-term dynastic and estate planning goals. We accomplish this in a diversified way, not only by investing in traditional low-risk securities such as bonds but by complementing these with multi-strategy hedge funds, funds of funds and other low volatility alternatives.

At the same time, we can build out the "institutional" side of the portfolio with higher volatility securities and alternatives that seek to outperform the market and are benchmarked according to institutional standards.

HOW ALTERNATIVES CAN REDUCE VOLATILITY

As the Dual Asset Class illustration below shows, it is possible to increase your exposure to alternative investments yet decrease the volatility of your overall portfolio. In this example, we moved $3 million out of high volatility, marketable equities (beta-led strategies in U.S. large cap and U.S. mid cap) and moved $2 million of that into a low volatility, absolute return alternative strategy. This move increased the overall percentage of the portfolio in low volatility assets from 34.22 % to 37.49 %. In effect, lowering risk.

CURRENT INVESTMENT OBJECTIVE: BALANCED

HIGH VOL ASSETS (TOTAL RETURN)		**Current Allocation**		**Changes**	**New %**	**New $**
Marketables (Beta-led Strategies)		**%**	**$**		**%**	**$**
US Large Caps		29.19%	17,826,059	(1,350,000)	26.98%	16,476,059
US Small/Mid Caps		17.01%	10,389,385	(1,650,000)	14.31%	8,739,385
Foreign Large/Mid/Small Caps		14.29%	8,728,418		14.29%	8,728,418
Foreign Emerging Markets		1.53%	936,900		1.53%	936,900
Real Estate		2.48%	1,517,393		2.48%	1,517,393
Commodities		0.00%	0		0.00%	0
High Yield Bonds (Tactical)		0.00%	0		0.00%	0
Style Tilts (Tactical)		0.00%	0		0.00%	0
Currency (Tactical)		0.00%	0		0.00%	0
	Beta-led	64.52%	39,398,155		59.61%	36,398,155
Alternatives (Alpha-led Strategies)						
Hedge Funds (Directional/Event-Driven/Sector Strategies)		0.00%	0		0.00%	0
Private Equity		1.26%	771,376	1,000,000	2.90%	1,771,376
(including distressed securities, buyout/ growth, equity, vc, real estate, natural resources, etc)	*Alpha-led*	1.26%	771,376		2.90%	1,771,376
Total High Vol Assets		**65.78%**	**$40,169,531**		**62.51%**	**$38,169,531**
LOW VOL ASSETS (CAPITAL PRESERVATION/INCOME						
Marketables (Beta-led Strategies)						
Bonds		29.99%	18,313,071		29.99%	18,313,071
Foreign Bonds (Tactical)		0.00%	0		0.00%	0
TIPS (Tactical)		0.17%	102,976		0.17%	102,976
Cash		3.14%	1,915,674		3.14%	1,915,674
	Beta-led	33.30%	20,331,721		33.30%	20,331,721
Alternatives (Alpha-led Strategies)						
Hedge Funds (Absolute Return Strategies)		0.92%	561,615	2,000,000	4.20%	2,561,615
	Alpha-led	0.92%	561,615		4.20%	2,561,615
Total Low Vol Assets		**34.22%**	**$20,893,336**		**37.49%**	**$22,893,336**
Total Assets		**100.00%**	**$61,062,867**		**100.00%**	**$61,062,867**

A NEXT GENERATION GLOBAL MACRO MODEL

The Dual Asset Class model builds on the Global Macro asset allocation model developed by Jack Ablin, Chief Investment Officer at Harris Private Bank. By Global Macro, we mean the process of identifying overvalued or undervalued asset classes and increasing or decreasing their respective weightings within an investor's long-term strategic allocation. This is important because on a year-over-year basis, the range of returns between the best-performing and worst-performing asset classes can be significant.

So our overall approach is to build a quantitatively-driven, strategic asset allocation model that has tactical tilts built into it, based on our research. The Dual Asset Class model is simply a way to refine a client's general strategic asset allocation to right size the inclusion of alternative investments within that asset allocation.

One of the main challenges facing high net worth families today is to appropriately incorporate all of the investment opportunities that are available. You want to accommodate alternatives in your portfolio. You would like the rigorous oversight of having an institutional-quality investment management committee. And you want to access top-tier investment managers and to do so in a way that is aligned with your income and liquidity needs. The Dual Asset Class model gives you a disciplined process for accomplishing all of these goals.

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