



*Knowledge for the
Sophisticated Advisor*

Yale's David F. Swensen held the unofficial title of investment genius for many years until his model nosedived with everyone else's in the 2008 crash. The concept, originally crafted for university endowments and later emulated by countless other institutional investors, espoused shifting money out of traditional stocks and bonds into higher-yielding alternatives such as hedge funds, real assets (commodities and real estate) and private equity.

Swensen's rationale was that private investments offer greater value than public markets. Private assets tend to be less inundated with capital, which makes them more attractive because the inefficiencies are theoretically easier to find than they are in public markets and the prices less frequently bid to extremes. Therefore, the theory goes, diversification into private alternatives simultaneously reduces risk and enhances return. Private assets also pay risk and liquidity premiums less available in public markets.

But even though private markets might be good for some diversification, there are two significant hurdles in this space.

One is that many private assets are illiquid. In bull markets, it's common to hear investment strategists advising clients to sell liquidity, believing it's worth the sacrifice to take the higher return on illiquid investments. That strategy can backfire, though, exactly as it did in 2008, particularly for investors lacking the financial stamina

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You Are Not Yale

Parting Shot | Paul R. Sanford

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to wait it out. Liquidity is rarely appreciated by investors until they don't have it.

The other hurdle is that private equity investments in particular generally depend on financial leverage and therefore on low interest rates- in other words, on what can be funded through a bank. In the LBO sector, for instance, investors use large amounts of debt to buy companies, hoping to make a few organizational or marketing tweaks, before re-entering the market via an IPO to payoff the debt and make a killing. That's only possible when a lot of cheap debt is available.

Thus, success with private equity investments is often more about the overall economic environment than it is about the particular deal. This is why the "vintage year" is so important in private equity investing.

LBO and mezzanine (essentially, debt restructuring) strategies generally have short time horizons. The only way to make big returns quickly is with leverage. If cheap financing is not available and/or the economic environment sours, these strategies can suffer greatly. Two other private markets, venture capital and angel investing, involve injecting private capital into new businesses to either start them up or advance them beyond the start-up phase. But neither of these has fully recovered since the tech bubble burst.

The terms and fees charged by private asset managers, meanwhile,

tend to be onerous. This means private equity investments must well outpace public equity markets on a gross basis to offset management fees and compensate the investor for taking the significant economic and liquidity risks.

You have big advantages, of course, if you are Yale. Your size and industry connections allow you to get the pick of the high-quality litter- a narrow space-and negotiate lower fees and more attractive terms. Yale also has the capacity (even if the university takes heat about it from media) to withstand a bad year or two of illiquidity. The university will likely go on in perpetuity and is only mildly susceptible to cash flow problems. If the economy is having a bad couple of years, the university can reduce its endowment's distributions for a while and wait for liquidity to return to the market. Because the portfolio is so large and diverse, the university can meet cash-flow needs, if it has them, by using other parts of its portfolio without doing too much harm.

Real People

But individuals- or even families with \$40 million to \$50 million in assets are not like Yale. It makes no sense for wealthy families, for instance, to add private equity to their portfolios when the bulk of their wealth is already in various forms of private equity: real estate and entrepreneurial business. They should be looking instead at something highly liquid to counterbalance their exist-

ing holdings, not emulating the Yale model.

Furthermore, wealthy families may not share Yale's major advantages in private asset investing. The model may indeed be advisable for individuals or families with an extended time horizon, those who are diversified enough to ride out market illiquidity. It might also be appropriate if they are not overly levered in their own businesses or properties or if they are in the right sectors at the right time. Equally important, they must recognize that Yale can do things they can't. Otherwise, these investors are better off seeking other strategies.

Many harness themselves to a traditional 60/40 or 50/50 asset allocation because of the historic performance of markets and asset classes. But past performance represents the average of all data points measured. Few years are average; most years are above or below, sometimes greatly so. If investors use the past performance of traditional asset classes (stocks and bonds) to project future returns, the only thing they can be reasonably sure of is that the "average" performance won't happen. Markets tend to move in "long waves," in secular trends and in shorter-term cycles, and investors who do not account for that in their asset allocation face disastrous results.

The accumulation period for most individuals is 15 to 20 years, the time between their peak earning years, when they are able to save and invest meaningfully, and their retirement, when they expect to live on the income from their investments. Secular markets (longer-term structural shifts), however, have historically lasted 17 years, plus or minus a couple of years. That means the duration of an entire secular bull and bear market cycle can last approximately 34 years!

Consider a couple in their late 40s or early 50s with a 60/40 asset allocation at the beginning of the secular bear market in the year 2000. That couple today may well be in deep financial

distress. Certainly, their retirement plans have taken a stomach punch. A similar couple implementing the same policy in 1982 fortuitously caught the start of the nation's greatest secular boom market and simply rode the surge to a secure retirement, even if their investment managers were mediocre or relatively poor. The only difference between these two couples may have been the years of their birth—a happenstance. Depending on when someone is born, his or her 20-year window may occur during the best or worst of times.

The role timing plays in the success or failure of traditional asset allocation strategy is enormous, and arbitrarily applying an investment policy that lacks the flexibility to adjust to secular or cyclical considerations reduces portfolio performance to little more than a coin flip.

The careers of financial professionals often parallel those of the investment portfolios they manage. Advisors and managers had to do little more than hang on to the reins during the two decades from 1981 through 2000. Since then, it has been anything but easy. Performance has ebbed, no matter how hard managers rowed upstream. Many have considered themselves successful during the past decade if they simply suffered less bad performance than others.

As a member of the investment committee for the City of Hope, I concern myself with the investment needs of an entity expected to continue indefinitely. With luck, the organization will be making medical breakthroughs to help humanity combat the worst diseases long after I am gone. Because the endowment has this limitless time horizon, we aren't overly concerned about year-to-year market conditions. We can ride out economic cycles and short-term market movements, whereas few individual investors have that advantage. Instead, their investment policies must account for these secular markets and cyclical movements.

Alternatives

Because the asset allocation strategy used by Yale and other endowments may not be practical or appropriate for most investors, and since traditional rebalanced "policy portfolios" are at the mercy of long and short market cycles, what strategies should be considered for those who are not Yale?

Portfolio management has become increasingly difficult in recent years as the capital markets have become dominated by hedge funds, the proprietary trading desks of large banks and professional "fast money" traders. These market players have several things in common. They frequently use volatile, short-term trading strategies, magnify their returns and their effect on the market through the use of leverage, and follow market technicals (such as momentum), leading to speculative bets that can be divorced from underlying fundamentals. Increasingly, these strategies are dominated by "quants," who manage money largely via computer models. Perhaps the most daunting aspect of this is that these players frequently race to be the first into the most speculative (highest beta) trades they can find when they believe market technicals support them.

The goal of these quants is not to be the first in but, as the momentum clearly begins to change, to jump in quickly to maximize the surge that follows. When the momentum begins to stall, they jump out and the rally collapses. Because so many strategies, particularly those used by quant managers, rely on similar technical indicators, billions of dollars can pile into and out of the same trades almost instantaneously, causing a roller-coaster ride of market volatility for the rest of the investment community.

How does this affect the average investor? Those lacking endowment-size portfolios are typically left staring at a harsh reality and a difficult set of choices. The reality that the capital markets have been largely co-opted by

short-term speculators leaves investors three main options, in my judgment.

They can regard investing as a game of musical chairs with these “fast money” traders, and either choose to dance or sit out at any given time.

They can participate by hiring their own short-term speculators (who ostensibly have the talent to compete) to handle some portion of their investment portfolios.

Or they can decide the game being played is the wrong one altogether and decouple themselves from the market’s traditional benchmarks, focusing instead on risk-adjusted returns.

The first option is attractive in its simplicity but fraught with timing risk. If investors sit out market periods entirely, they risk significant underperformance if their timing is wrong, which means they may miss their investment goals or have to scale them back. If they choose, instead, to be “fully invested” at all times and play the volatile trading game, they might see more dangerous outcomes and be left standing with nowhere to sit when the music stops. (Think of the stock market from 2000 to now.)

The second option, hiring one’s own managers specializing in shorter-term trading strategies (a la hedge funds) can also be attractive. Access to hedge funds (or hedge fund surrogates) has increased exponentially in recent years. People who could never have invested in these strategies before now have the opportunity. The downside is that the managers with the best track records tend to have very high minimums (and fees to match), plus onerous liquidity lockups, which realistically makes them accessible only to the super rich anyway.

The alternative is funds of funds, which allow investors to pool money to reduce investment minimums. But unfortunately, funds of funds give investors another layer of fees. Meanwhile, clients still face somewhat high investment minimums, and they haven’t eliminated the burdensome

liquidity lockups.

The newest option in this space is registered public products (1940 Act mutual funds and registered structured products). The advantage of these is that they are more accessible to smaller investors. The fees tend to be much lower and the liquidity significantly better than they are in the private space. The downside is that the return potential of these products can be less than that of their private peers.

The third option is to focus on risk adjusted returns, which means identifying the most attractive returns on an investment per unit of risk. It’s challenging for those not versed in this type of analysis, but it’s possible to measure risk-adjusted performance using tools such as the Sharpe ratio, the Treynor ratio, Jensen’s alpha and the Sortino ratio.

Most investors are not familiar with these and may have a tough time unlearning the “What’s the Dow doing?” mentality they’ve developed throughout their investing lives. They may not take much solace in knowing that their investment portfolios have much better Sharpe ratios than the Dow Jones Industrials Index during a bull market (even during a short-term cyclical spike or a bear market rally). This type of investing takes a steel will and fierce discipline.

Taking into account these risk-adjusted returns means looking forward rather than back, making forward-looking assumptions about asset classes rather than relying on past performance. The obvious question is, “What if my forward assumptions are wrong?”

But the choice doesn’t have to be either sitting it out or dancing to the music. Rather than taking anyone of these approaches, I believe in pursuing all three. Investors can apply some of their portfolio (perhaps 30% to 50%) to a “core” holding diversified for their long-term goals- a core whose goals could allow the investor to emulate the endowment model.

These assets may be subject to swift market movements, but an investor will not be worried here about market swings, interest rates or inflation.

The investor could then allocate the next portion of his or her assets to investments with a shorter time horizon (an allocation that can range from 20% to 40%, depending on the person’s circumstances and appetite for risk). This part of the portfolio could be allocated to “absolute return” managers, and investment vehicles such as hedge funds, funds of hedge funds, structured products or mutual funds, according to the investor’s unique parameters. The rest of the portfolio (up to 40%) could then go toward tactical investments according to the investor’s risk-adjusted return potential (not high beta speculation).

With all three components, the portfolio exposure to individual money managers and strategies should be thoroughly diversified.

Such a structure reduces the likelihood of investors being extremely wrong at any given time and simultaneously gives them exposure to much of the upside potential of market rallies. It’s much less likely that investors will find themselves on the wrong end of every bad market if they are pursuing all three of these strategies at once, even during those times when correlations rise amid market panic. It gives them better diversification, with much less volatility, and an even greater chance of attaining their goals.

It’s a practical strategy, unlike the Yale model, when investors lack a Yale-size portfolio.

Paul R. Sanford is chairman of the Investment Committee and chief investment officer for Tow Financial Advisors, Sherman Oaks, Calif. Paul is the third generation in his family to work in the investment business and serves on both the City of Hope and Little Company of Mary Hospital Investment Committees. He can be reached at psanford@tfainvest.com or 818-906-9301.



14724 Ventura Boulevard, Suite PH-1300, Sherman Oaks, CA 91403 · Tel. 818.906.9301 · Fax 818.784.3241
222 N. Sepulveda Boulevard, Suite 2000, El Segundo, CA 90245 · Tel. 310.335.2035 · Fax 310.335.2036
www.tfainvest.com