Unnecessary Evils

A Critique of Contemporary Wealth Management Norms

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Basic Test. New Providence is led by experienced professionals who view investment counseling as a profession, not a business, and are committed to the pursuit of excellence in all aspects of our work. Such work centers on the shaping and ongoing refinement of both comprehensive and specialized investment programs for a select group of wealthy families and endowed charities. Given the US-centric bias of portfolios stewarded by many recipients of this essay — a bias at odds with the very full current pricing of assets flattered by it — the time is ripe for such principals to undertake a thorough review of their investment policies and practices.

New Providence's principals have conducted many such reviews over the years, and are increasingly concerned that many fine families and trustee groups with whom we've compared notes of late don't recognize how sub-optimal their current investment programs are. For reasons rooted primarily in perverse incentives for investment advisors, consultants and other hired guns, many such programs are needlessly complex, costly and opaque. More to the point — one that cannot be overstated — many such programs flunk the most basic test to which any portfolio might logically be subjected: is the whole greater than the sum of its parts? As another legendarily successful investor — Seth Klarman — has observed, "The challenge of successfully managing an investment portfolio goes beyond making a series of good individual investment decisions."

While many principals sense that their current investment programs aren't likely to produce satisfactory risk-adjusted net returns in coming years and beyond, most have difficulty pinpointing with actionable precision the root causes of their discontent. In an effort to help readers gauge the potential utility of programmatic reviews of the sort alluded to above, we've assembled a list of the defects we encounter most frequently, rank ordered by their frequency of appearance.

Defect #1 — Unclear Aims. Examine any enduringly successful enterprise in any field of human endeavor — corporate, non-profit, military, etc. — and you'll likely find at its core a clear articulation of not only the metrics to be used in gauging success but the time horizon over which such metrics shall be gauged. Too many investors deploy wealth without achieving such clarity. As the age-old saying goes, if you don't know where you're going it doesn't matter what road you take to get there. Differently put, if a portfolio's owner hasn't articulated clear and achievable goals for the portfolio as a whole, it's hard to determine which assets and strategies the portfolio should favor and harder still to determine which it should avoid. The latter defect helps explain the depressing frequency with which we encounter the next two most common defects when conducting diagnostic reviews for wealthy families and endowed charities.

Defect #2 — Excess Costs. Given the growing visibility and commercial success of ultra-low cost rules-based approaches to equity investing in particular, few if any readers need a lecture from us on the virtues of reducing return slippage. That said, it's surprising how few stewards of substantial wealth have examined rigorously **all** forms of slippage to which their capital is subject — e.g., base fees, incentive fees, applicable taxes and (especially) appropriate measures of inflation; and it's shocking how few principals ponder carefully aggregate slippage they're likely to incur under not only normal or base case conditions but under abnormal conditions also, e.g., scenarios entailing very high nominal gross returns coupled with high rates of inflation.

Defect #3 — Myopic Methods. Overpaying is endemic to wealth management because self-interested advisors have induced many principals to engage in bucket filling — funding managers and strategies pursuant to pre-specified targets that essentially ignore such exposures' current price tags. The targets in question ignore current prices because they're typically derived by applying backward-looking asset allocation models to historical data, the operative premise being that historic returns, correlations and volatilities can serve as reliable prologues to the future. They can sometimes. But the history of investing is littered with examples of investors who extrapolated past phenomena into the future without adjusting such data to reflect the very labors in which they were engaged.

The poster children for such behavior are behemoth state pension funds whose mean-variance models produce gigantic allocations to niche strategies whose alluring past performance is attributable largely to a historic dearth of human or financial capital. Shift too much human and especially financial capital into such niches

and future returns gets pushed way down, often into negative territory. For lack of a better term, we call this phenomenon the fallacy of composition — the tendency of investors to pay insufficient heed to the actual or probable overcrowding of niches into which they themselves are shifting capital, typically on the basis of juicy historic returns. Putting the same point more plainly, by the time data supportive of outsize commitments to size constrained niches roll in, the big bucks have already been made.

Defect #4 — Faulty Structures. Many contemporaneous asset mixes include "asset classes" unworthy of the name: pseudo-classes like "Hedge Funds" and marketing gimmicks like "Infrastructure" that no sensible investor would fund if they knew they'd earn from them over time the average return of all investors engaged in such activities. To be sure, the securities or properties held within such portfolio segments or buckets might themselves have a logical place in well-diversified portfolios, provided that (a) the reasons underlying their purchase are clear and compelling and (b) the costs of acquiring and holding them are reasonable on an absolute basis and relative to competing alternatives.

In general, the criteria just mentioned preclude or better put **ought** to preclude the purchase of so-called structured notes: bespoke contracts between financial services firms — typically large, multi-line banks — and customers of their brokerage arms that provide the latter with exposures incompatible with a proper understanding of their long-term goals and that, even if compatible, can typically be acquired far less expensively by cutting out the middleman.

Defect #5 — Dicey Dynamics. We're surprised and alarmed by how many otherwise savvy principals we've encountered of late who can't furnish even minimally satisfactory answers to two basic questions respecting their portfolios: (1) what do you own and (2) why? We're not talking about detailed info on each and every holding; just a general sense of what's held and the reason(s) why.

The behavioral roots of such befuddlement are clear and plain. Lacking as they do the expertise needed to determine objectively whether a given potential investment's future is truly as bright as its past, many principals or hired guns employed by them commit capital on the basis of the only verifiable facts known to them: past returns, with an emphasis on the recent past. Eventually if not immediately, they become the beneficial owners of a mish-mash of securities and properties whose names let alone fundamental attributes are wholly foreign to them — assets selected typically by an unduly large cadre of external managers none of which is sufficiently well understood or trusted by the portfolio's ultimate owner to merit a potentially needle-moving allocation (5+%).

Of course, trust ought not be reposed in any manager to any degree unless the allocator involved has taken effective steps to determine whether the stellar past results animating their ardor are attributable to skill rather than luck. How can a prudent allocator determine whether a manager's past successes are indeed rooted in skill? The only truly reliable way to do so is to obtain and review critically *ex ante* rationales for a representative set of decisions, e.g., a verifiably time-stamped internal note outlining **why** an equity manager was accumulating Amazon shares as their price was bottoming after a big swoon in 2014.

Importantly, any allocator with at least a modicum of business experience and common sense can review such evidence and gauge reliably whether a given investment decision or series of decisions is suggestive of the repeatable application of skillful methods to a given manager's specified selection universe. Conversely, few if any allocators have the training and time to review the complex algorithms driving portfolio choices within many hedge fund shops stewarding collectively many billions of dollars for institutional investors at present.

Defect #6 — Dangerous Thinking. Most contemporaneous asset mixes entail sub-optimally low allocations to cash — a deceptively valuable component of successful investment programs given the ceaseless swinging of investor sentiment between greed and fear. Why is cash viewed as trash by so many investors, including but not limited to trustees of endowed charities whose investment time horizons are boundless in theory? Because their horizons are anything but long-term in practice — not when such horizons are defined as a given investment committee's tolerance for disappointingly poor results.

For reasons not discussed in this relatively brief piece, the typical investment committee (IC) tolerates such results for about 2.5 years on average before parting company with the investment pros who've produced them, with this leash shortened if the shortfalls in question entail sub-par gains in a strong bull market and especially if such deficiencies are rooted in material measure in a manager's maintenance of cash reserves.

The irritability that such cash-based shortfalls tends to spawn in ICs contrasts sharply with the equanimity that certain notably accomplished capital allocators have displayed during intervals when such impatience has been most intense — *cf.* what Warren Buffett and Seth Klarman, among other such accomplished pros, did and more importantly refrained from doing when US stock prices in particular were racing upward in the late 1990s and mid-naughts.

Seth explained well the logical underpinnings of such restraint in a client letter penned during the latter interval: "Every investment must be compared to the alternative of holding cash," Seth wrote. "If an investment is sufficiently better than cash —offering a more than adequate return for the risk involved — then it should be made. Note that the investment is made not because cash is bad, but because the investment is good. Exiting cash for any other reason involves dangerous thinking and greatly heightened risk."

Rightable Wrongs. What else is wrong with wealth management norms these days? Plenty — as discussed in other think pieces by members of the New Providence team that are available upon request. Which impoverished practices discussed therein would we be remiss in not mentioning at least briefly here? Two clear the bar. First, so-called "passive management" — an effective means of reducing investment-related costs but not necessarily an effective means of optimizing risk-adjusted net returns over the long term, especially for deep-pocketed investors able and willing to invest prudent portions of their capital in privately-traded assets. Truth be told, **every** portfolio (including an S&P 500 index fund!) is "active" when viewed through the lens most germane to long-term return generation: one that compares a portfolio's current holdings to the total universe of investable assets, including the vast sub-universe of such assets that are privately-traded.

The second wrong we'll flag in this context is related to the first: the potential for the tidal wave of capital flowing toward passive vehicles in general and S&P 500 index funds and ETFs in particular to reverse not gradually as their holders effect sales commensurate with spending needs but rather abruptly as such individuals scramble to exit crowded theaters in which smoke has become evident.

We're thinking particularly of baby boomers 70+ years of age who hope to live many more years but know they'll incur big tax penalties for failing to meet government-imposed floors for withdrawing funds from tax-sheltered retirement accounts — and suffer potentially even more pain if they postpone discretionary redemptions from such accounts until conditions get truly dangerous in the theaters they're so comfortably inhabiting at present.

An admittedly extreme but entirely plausible scenario in which now-cushy seats could get unbearably hot would be one combining (1) confidence-rattling declines in the S&P 500 with (2) large actual or proposed increases in marginal tax rates on wealthy baby boomers whose retirement fund withdrawals will be taxed at ordinary income rates.

Toss a few more perturbations into the mix — e.g., price insensitive portfolio moves consummated on behalf of robo-advised individuals and institutions and momentum-driven sales consummated by algo-directed hedge funds and high frequency traders — and you have the makings of a market in which wealth eventually gets transferred from jittery investors scrambling to convert longer-dated assets into cash to those who've been patiently awaiting opportunities to do the converse.

At Your Service. We're working hard to generate satisfactory risk-adjusted returns while also preserving our capacity to seize opportunities of the sort just described. Give a shout and we'd be pleased to elaborate.

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