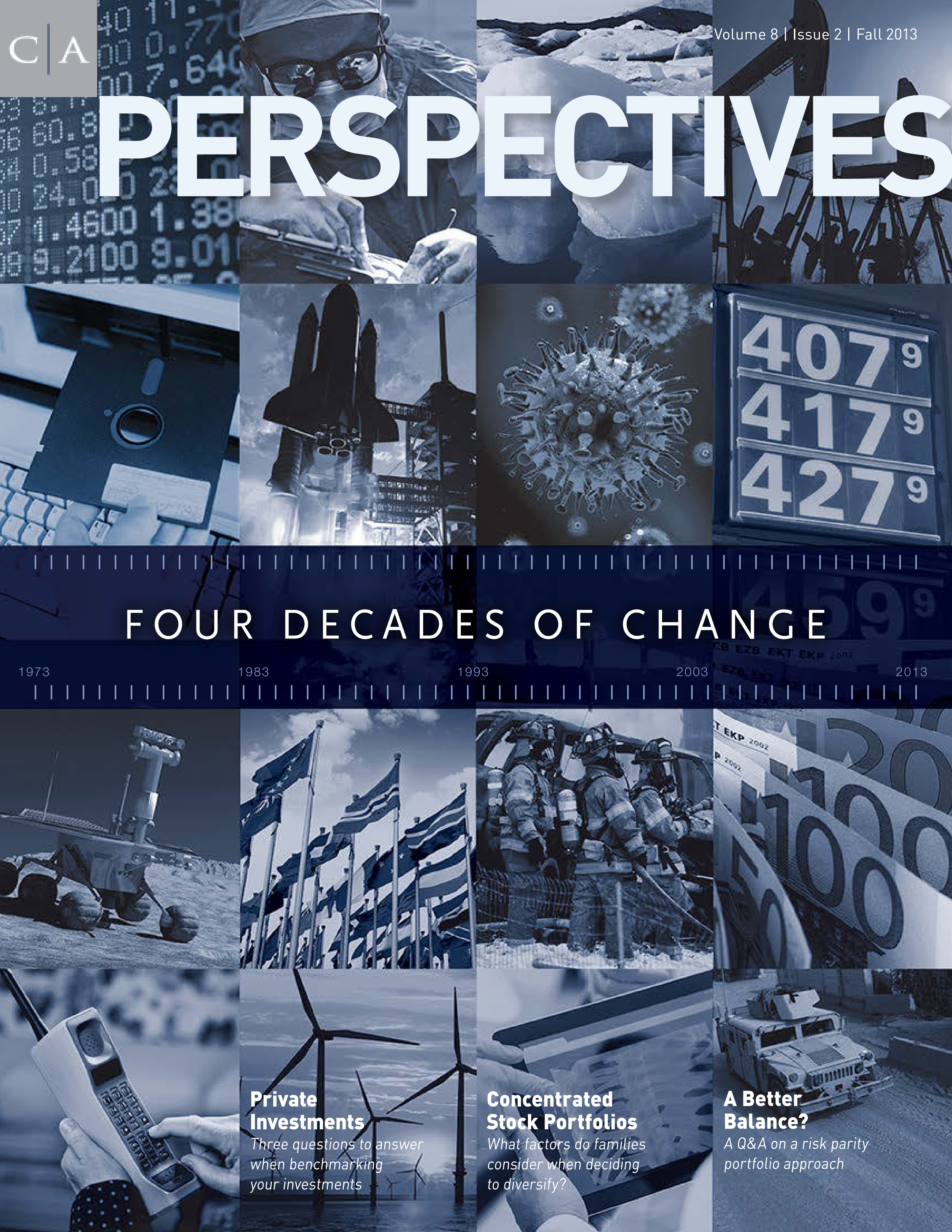


C|A

Volume 8 | Issue 2 | Fall 2013

PERSPECTIVES

FOUR DECADES OF CHANGE

1973 1983 1993 2003 2013

Private Investments
Three questions to answer when benchmarking your investments

Concentrated Stock Portfolios
What factors do families consider when deciding to diversify?

A Better Balance?
A Q&A on a risk parity portfolio approach

A Message from Sandy Urie

IT IS HARD TO BELIEVE 40 years have passed since Jim Bailey and Hunter Lewis, Cambridge Associates' founders, conducted the early investment research for institutional investors that would form the foundation of our firm.

The investment world and Cambridge Associates have evolved considerably since then. From the day we opened our doors, our focus has been on finding innovative and forward-thinking strategies with our clients to help them master a dynamic investment landscape. How we do that has changed dramatically as our clients' needs and global investment opportunities have expanded and grown in complexity.

In those early days, availability and analysis of investment information itself was the innovation. Our research on the then-emerging areas of alternative investments and the collection of peer data for institutional investors majorly contributed to our investors' portfolio management process. Today information is ubiquitous, available at the stroke of a few keys at our desktops.

But if information and data are now commodities, knowledge is not. We continue to challenge ourselves to find the best and most innovative approaches to portfolio management that will add the greatest long-term value to investors' portfolios. We have set a high bar for ourselves to provide innovative research in areas such as risk management, implementation strategy, and global investment opportunities.

Along with our strategic research, we must also evaluate how current events around the world impact investment portfolios. The pace of news leaves little time to digest changing world events. On October 1, 2013, the day the U.S. government shut down, our investment strategy research team shared an evaluation of the potential implications of the U.S. government shutdown with our investment professionals worldwide. They also provided observations on the debate surrounding the impending U.S. debt ceiling vote. When I started working at Cambridge Associates back in 1985, it would have been impossible to imagine that I'd be reading a just-published research note about the impact of an event that I was simultaneously watching unfold in real-time!

In this issue of *C|A Perspectives*, we explore a variety of topics that focus on changes in portfolio management. To start, we consider the evolution of portfolio construction in the 40 years since we were founded. We outline some key statistics from then and now and look at how portfolios have evolved in "Four Decades of Change" (*page 3*). A Question & Answer with Andre Abrantes and Timur Kaya Yontar, authors of our upcoming research report on risk parity, discusses the benefits and considerations of this approach to portfolio construction and implementation in "A Better Balance?" (*page 6*). Benchmarking private investments has long been a challenge for investors. In "Taking Measure," Jill Shaw and Carlos Herrera, two of C|A's private investment benchmarking experts, share insights on the comprehensive three-part approach we advocate to successfully monitor these types of investments (*page 11*). Many private clients must address whether and how to diversify a concentrated holding. In "Concentrating on Your Assets," Tony Wilson, a member of our private wealth practice, provides insight into the considerations families face when deciding to diversify away from a single security, often the one that created the family's wealth, and discusses various approaches to diversification for families who decide to diversify (*page 14*).

While we can never know what's in store in the coming decades, I do know that our clients will want to be investment leaders and early adopters of innovative advancements in portfolio management. That requires our firm to work with our clients to continually ask what's next, to identify and evaluate new strategies, and to find the best investment ideas around the globe. We are ready.

Sandy Urie

Sandra A. Urie
Chairman and CEO

THEN AND NOW:
FOUR DECADES OF CHANGE

By Andi Pollinger

UNTIL THE LATE 1960S, ENDOWMENTS SURVIVED ON INCOME. Capital preservation was sacrosanct. Investment committees focused on selecting bonds, preferred stocks, and other securities that would provide income to fund the institution's activities.

Nearly 40 years ago, Cambridge Associates' first college and university clients included 12 institutions: Amherst College, California Institute of Technology, Dartmouth College, Harvard University, Johns Hopkins University, Massachusetts Institute of Technology, University of Notre Dame, Princeton University, University of Southern California, Stanford University, Wesleyan University, and Yale University. In the late 1970s, the mean endowment size of these institutions was $342 million, their portfolios included an average of just three external managers, and they allocated their assets to a simple 60/30/10 stock, bond, and cash position. Contrast this to today's endowments and the shift is striking. What drove these changes in endowment management?

In 1969, the Ford Foundation published *Managing Educational Endowments*, the second of two influential studies that examined the funding and financial management of higher education. These studies concluded that the focus of endowment investing should be on total return rather than income and that endowments with perpetual time horizons should be far more heavily invested in equities.

Of course, by the time most institutions had digested these reports and implemented their recommendations, the great bull market of the post-war era was coming to an end. For U.S. colleges and universities, the 1970s were a horrendous decade of soaring costs and decimated endowments.

Nonetheless, over the long term, the focus on equity investing for total return has proven effective, and the impact on endowment management has been significant as evidenced in the charts on the following pages.

Systematic performance measurement is perhaps the most significant development in the last 40 years, according to Ian Kennedy, former Managing Director of Research at Cambridge Associates. "Once endowments had rigorous benchmarks against which they could evaluate their results, they had to assess the extent to which their portfolio management strategies and investment committee practices were adding value."

One thing that hasn't changed is that the most successful endowments continue to be those that look forward and avoid buying what did well yesterday, says Kennedy. "Research wasn't as available 40 years ago as it is today. Investors must continue to evaluate the questions they need to answer, what information they have to answer them, and what more information they need."

What is likely to change? According to Kennedy, the investment landscape will always evolve. Over the last few decades, we have seen equity investing branch out into private enterprises and frontier markets. And we should expect further innovations in risk management. But investors will never escape the necessity of making decisions under conditions of uncertainty. For that reason they will continue to see diversified portfolios as the best means to realize their goals.

Read about the evolution of the endowment model and the experiences of its early adopters in C|A's recent research report, The Endowment Model 2.0: A Success Story That Endures. *All of our research reports are available when you log on to our website.*

Then and Now

Mean Endowment Size

341.9M

9.7B

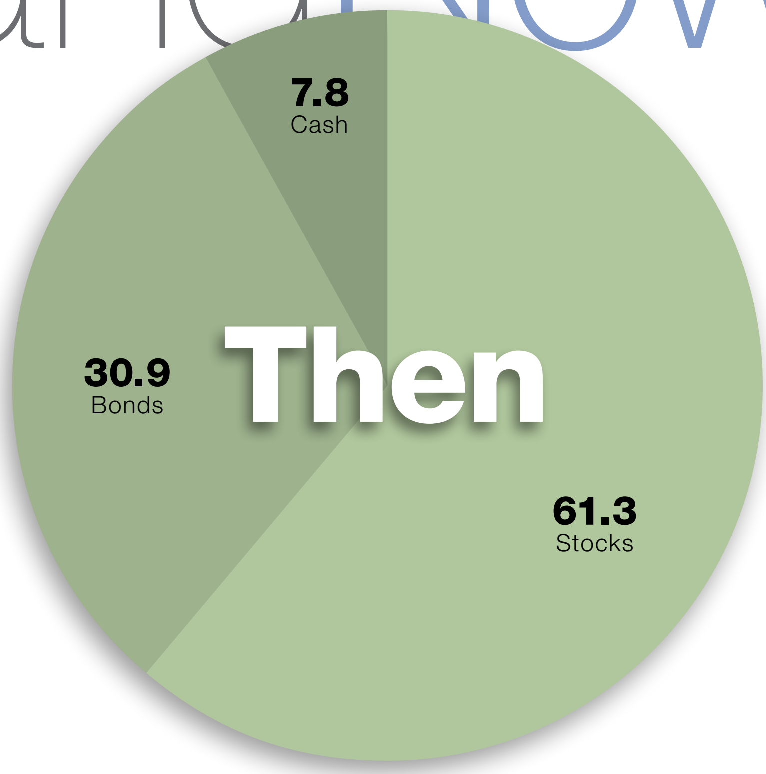
Mean Number of External Managers

3.1

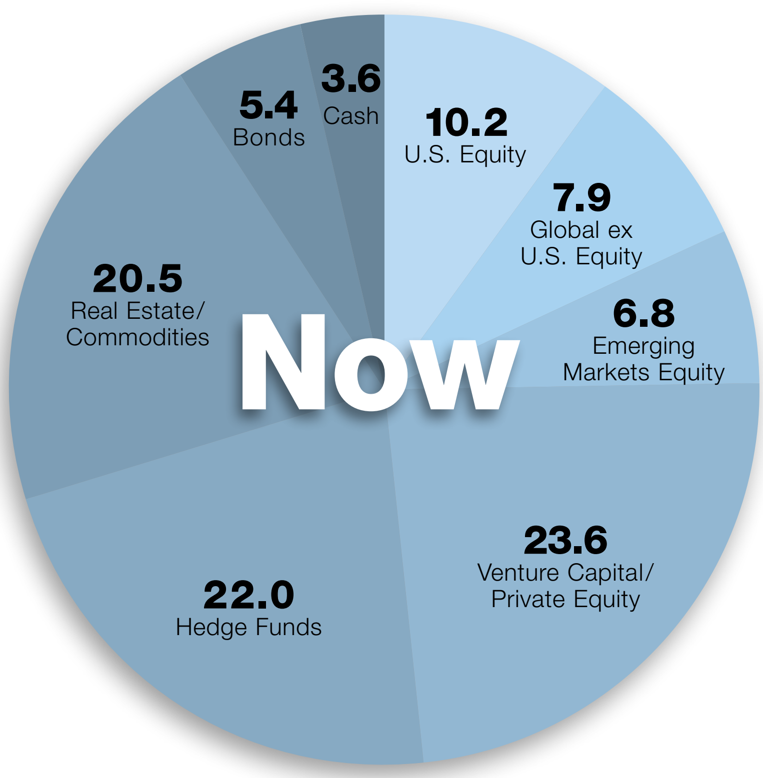
117.3

Source for Group Portfolio Data: Cambridge Associates LLC's Comparative Asset Allocation and Total Return survey data. "Then" portfolio information reflects data available as of June 30, 1977, when CIA started to systematically track peer data for clients' use. "Now" portfolio information reflects data reported as of June 30, 2012. Institutions in the universe include Amherst College, California Institute of Technology, Dartmouth College, Harvard University, Johns Hopkins University, Massachusetts Institute of Technology, University of Notre Dame, Princeton University, University of Southern California, Stanford University, Wesleyan University, and Yale University.

Sources for economic statistics: Federal Reserve and Thomson Reuters Datastream. "Then" data as of September 30, 1973. "Now" data as of September 30, 2013. Population statistics are as of June 30 for the respective years. U.S. inflation rate represents the annualized ten-year CPI from January 1973 to December 1982 and September 2003 to August 2013. GDP information available from International Monetary Fund, World Economic Outlook Database, April 2013. Data on GDP components prior to 1980 are not widely available. "Then" number reflects an approximation of the emerging markets percentage based on 1980 data.



Group Mean Asset Allocation (%)



Then and Now

Global Currencies

$1 =

British Pound	0.41	0.62
Australian Dollar	0.67	1.07
Japanese Yen	265.35	98.13
Singapore Dollar	2.34	1.25

Gold Price (US$/Ounce)

103

1,348

S&P Index Level

108

1,682

Oil Price

US$/Barrel

4

102

Nikkei Index Level

4,617

14,456

World Population

(Millions)

3,919

6,916

U.S. Inflation Rate

(Percentage)

8.7

2.4

Emerging Markets as % of World GDP

(Percentage)

31

51

A BETTER BALANCE?

EXPLORING THE MERITS AND CHALLENGES OF A RISK PARITY PORTFOLIO APPROACH

By Krista Anderson

C|A *PERSPECTIVES* sat down with Andre Abrantes and Timur Kaya Yontar, co-authors of C|A's upcoming research report *Sharpe*ning Your Beta*, to discuss a risk parity portfolio approach.

What exactly is risk parity?

Andre: The concept of risk parity is very simple. The approach seeks to build a more balanced, efficient risk/return portfolio than an equity-dominant portfolio. But a more balanced portfolio usually includes more fixed income, which results in lower absolute expected returns. Risk parity proponents propose that the investor then lever that balanced portfolio to the desired level of return or risk. The theory is, if you can build a portfolio that's more balanced from a risk perspective, your portfolio is not as vulnerable to the movements in equity markets, and you can have an approach that's more stable across a variety of market environments.

But if the concept is simple, implementation is not. It requires derivatives and leverage and some complicated portfolio management tools.

Timur: Right. The capital markets theory under-pinning risk parity is not different from that of the endowment model. Both build on the concept of diversification put forth in modern portfolio theory. But risk parity has some different constraints and objectives in terms of how the portfolio is constructed.

In the endowment model, achieving the desired return means weighting the portfolio more heavily toward higher-returning assets like equities, making the portfolio's volatility heavily tied to that of equities.

Risk parity instead says, lever up certain asset classes that otherwise would deliver too little in return so the volatility is spread out more evenly among the different broad asset groups.

How does asset allocation for a risk parity approach look different than a typical endowment model allocation?

Andre: When you look at the two allocations side by side, they use the exact same core asset classes for the most part. But they look completely different in the weightings.

Timur: Exactly. Typically, U.S. endowment portfolios have 50% to 70% equity exposure, and then the remainder is split in some proportion between bonds, hard assets, and more diversifying hedge funds.

In a risk parity portfolio, when unlevered, the equities would be more like 20%, bonds would be 40%, and inflation hedging around 40%. And then you apply leverage. In terms of total notional exposure, you're now looking at, say, 30% to 40% equities, 80% to 100% bonds, and 80% inflation hedging.

Another striking difference is the type of instruments investors use. In the endowment model, investors try to find alpha through active managers, particularly less-liquid alternative assets, so they have hedge funds and private investments. And they have active managers across much of the portfolio.

That's not how it works in risk parity. In this approach, levered exposure is applied through passive instruments, implementing as much as possible through derivatives on indices—for example, a futures contract on the S&P 500. You are not getting any manager alpha in this approach. All of your benefit is from taking a mix of betas and blending them in a more balanced way and then levering up the returns.

Some investors might say, can we somehow combine them? Can we have the best of both worlds and have risk parity on top of the endowment model?

We really don't think that would work. You would end up trying to lever your alternative investments, for example. And leverage plus illiquidity has often proven to be a very toxic mix. It's not reasonable to think that you can blend them in that sense. But, you can add alpha on top of your risk parity portfolio, we just wouldn't recommend doing so using illiquid investments. You need to keep adequate liquidity to manage the leverage in the portfolio.


Andre Abrantes *(l)*, **Timur Kaya Yontar** *(r)*

How do investors typically implement a risk parity approach? Is it done at the fund level or in-house?

Andre: The vast majority of risk parity assets are in funds. Very few funds have more than a three-year track record, so a lot of the money in this space is concentrated in the top "founding firms" that started doing this.

Timur: Implementation is tricky. To do it yourself, you need a team, with experienced traders, who can handle the derivatives piece in-house. And you will need the proper risk controls in place. That's why only the biggest investors are thinking of doing that.

Let's talk more about leverage. How do you reconcile risk parity's goal to reduce overall portfolio risk with its introduction of leverage to the portfolio?

Timur: It's important to remember that risk is one of those things you can't totally do away with. By trying to limit it in one place, it often pops up somewhere else. It's like that old arcade game, Whack-A-Mole. You are shifting from an unlevered portfolio with concentration risk to a portfolio that is more balanced in its volatility profile, but has now layered on leverage risk.

Andre: Right. Risk parity is not this magic bullet that has somehow eliminated risk. The argument is that it shifts concentration risk to leverage risk.

What risk parity managers would say is, well, we can manage the leverage risk, and we have a more balanced portfolio. While in the equity-dominant approach, you just can't manage that concentration risk. You have what you have.

And the risk parity managers say, we would rather diversify the concentration risk, take leverage risk, and work hard at managing it.

How exactly do they manage the leverage?

Andre: In all sorts of ways. And that's one of the differentiators among the firms: how they think about and manage that leverage risk.

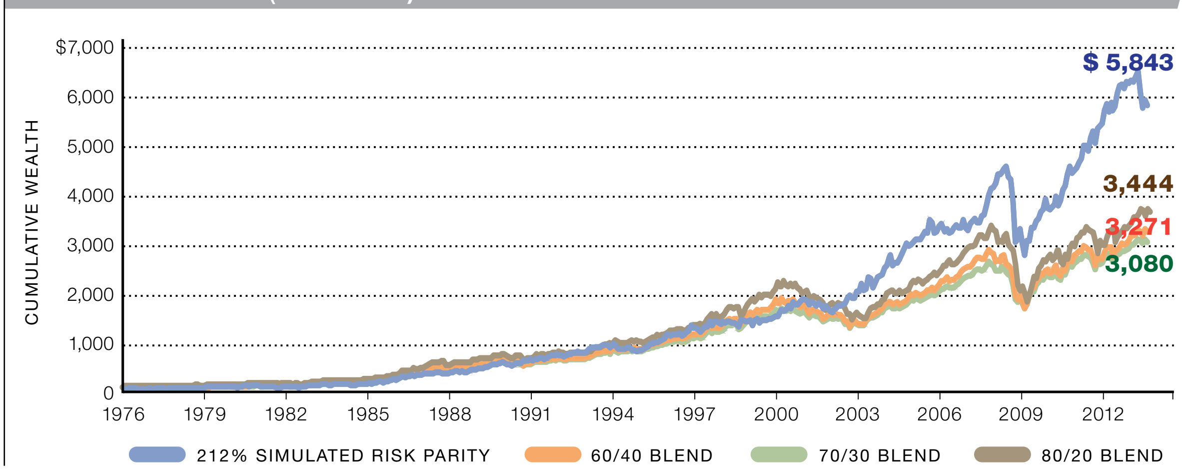
There are many options. Some have the "on and off" button. Either you have leverage or you don't. Other managers do dynamic approaches that continuously tune up or tune down the leverage amount. Some have hedge fund–style stop-loss limits that cut them out of positions if they lose a certain amount.

There are all sorts of ways to do it and it appears to remain a work in progress. As markets evolve, and derivatives markets change, the managers are constantly evaluating how to manage that leverage risk. We would say many are still figuring it out or refining their approaches to deal with leverage.

HOW DOES RISK PARITY LOOK OVER TIME?

Using the firm's long-term asset class assumptions, C|A created a simulated risk parity portfolio and back tested it to analyze how well it performed over time relative to simple blended indices.

FULL TIME PERIOD (1975–2013)



Sources: Barclays, BofA Merrill Lynch, Federal Reserve, MSCI Inc., Standard & Poor's, and Thomson Reuters Datastream. MSCI data provided "as is" without any express or implied warranties. **Note:** Calculations are based on monthly data. The equity/fixed income blends are a weighted average of the MSCI ACWI and Barclays Aggregate Bond Index from January 1, 1988 to present; prior to January 1, 1988, the MSCI World Index was used as the equity blend component.

What has been the marketplace appetite for these funds? Have many investors moved in this direction?

Andre: Industry-wise, the top three or four firms have collected more than $100 billion in assets. So it's not like there's nobody doing this. Significant capital has been allocated. But as a percentage of the overall institutional market, it's pretty small.

Timur: Among C|A clients, the adoption has been very low. And for the handful of clients using risk parity it's a small piece in the portfolio, roughly equivalent to what they give to any other well-sized manager—not more than 10% of the overall portfolio. Frankly, the jury is still out in terms of whether that size is really additive. It won't necessarily hurt the portfolio, and would probably enhance liquidity, but it remains to be seen whether having 5% or 10% of your portfolio in a risk-parity approach is going to move the needle in a meaningful way beyond what adding any type of "diversifier" manager would do.

And, as we talked about earlier, when investors use risk parity they also give up the potential alpha from active managers. It seems that most have not been willing to do that.

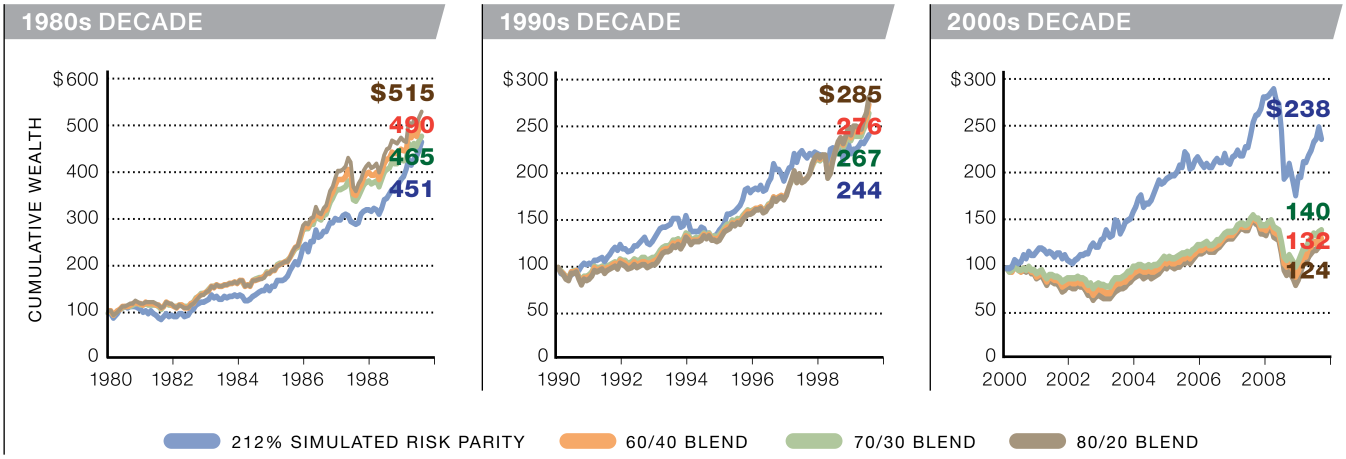
An institution adopting risk parity as its main approach to running a portfolio also faces huge maverick risk. The institution would look very different and have different patterns of performance relative to peers and broad markets. A period of underperformance versus peers and broad markets could create a lot of pressure from the institution's oversight body. This is probably part of the reason why people haven't adopted risk parity more widely.

If risk parity does gain more traction, is it an approach that works for all investors?

Andre: The concept of a balanced portfolio that can remain stable in a variety of environments has the promise of being something that's interesting and reasonable for everyone.

The cumulative wealth chart on page 8 indicates that over the long term, risk parity has produced very strong results. But it does not win during all market environments.

For example, while the risk parity portfolio performed significantly better than the blend during the challenging equity markets of the 2000s, it lagged during the bull market of the 1990s.



The "212% Simulated Risk Parity" represents the following blended index over time: Prior to January 1, 1981, 37% S&P GSCI/37% MSCI World Index/102% Barclays U.S. Treasury Bond Index/-75% 91-Day Treasury Bill Index. Between January 1, 1981 and January 1, 1988, 37% S&P GSCI/37% MSCI World Index/102% Barclays 10-Year Treasury Bellwethers Index/-75% 91-Day Treasury Bill Index. Between January 1, 1988 and March 1, 1997, 37% S&P GSCI/37% MSCI ACWI/102% Barclays 10-Year Treasury Bellwethers Index/-75% 91-Day Treasury Bill Index. Since March 1, 1997, 59% Barclays U.S. TIPS Index/28% S&P GSCI/37% MSCI ACWI/89% Barclays 10-Year Treasury Bellwethers Index/-112% 91-Day Treasury Bill Index.

But in reality, a couple of limits make it difficult for risk parity to be for everyone. First, the leverage risks may not be palatable. Second, it's complicated to implement. So if you are thinking of building in-house, it's probably not appropriate for most investors.

Then you might decide, I'm okay with leverage, and I can't do it at home, so I'm going to outsource. Well, the reality is that very few managers actually have a track record in risk parity. The few that do are more or less closed. And again, you have to make a decision: am I okay investing with newer managers that have not done this for very long?

In concept, it's a very interesting idea. It's actually quite attractive. But when you get to the implementation, it's tricky. Not impossible, but tricky. As investors make decisions around each of these questions, many will probably decide that it's not appropriate for them.

"Very few funds have more than a three-year track record, so a lot of the money in this space is concentrated in the top 'founding firms' that started doing this."

In essence, risk parity sounds like an attractive concept that has significant implementation limitations. Is the approach really viable?

Timur: It's important to remember that this is a long-term approach. Some people have argued that risk parity is a bad idea because of current bond valuations, but that doesn't invalidate the approach for all time. That would be analogous to people in 2000 saying, "The endowment model is bad because look where stock prices are right now." Well, when stock prices get that high the endowment model is probably going to take it on the chin in the short term. Although prudent investors might have reacted to valuations by dialing back their equity exposure, it's hard to do that enough in an equity-dominated approach.

Risk parity isn't going to look perfect in every short-term market environment either. Managers know that, and some, but not all, have offered products that take valuations into account, too. Regardless, both risk parity and the endowment model are long-term approaches and that's what our clients are looking for.

Andre: The concept of risk parity has been around for 50 years, and people actually began looking to implement the approach in earnest probably 20 years ago. It is absolutely viable and several early managers have run risk parity strategies for a significant time period, even if few institutions have moved in this direction.

Over the last decade, the equity markets dealt with the Internet bubble and the financial crisis. Equity-dominant portfolios took these two big hits, and as a result investors have been looking for alternative approaches that would not have been as affected by these massive equity market drops. And risk parity looked really good during that time.

We will continue to look at this model because we constantly look for innovative ideas and tools that can enhance the current approach. Risk parity has had a very good track record over the last ten to 15 years. And with the two events in equity markets over the last decade, other, potentially more balanced, ideas start to look interesting.

A lot of folks look for alternatives to traditional endowment approaches that will somehow solve all problems. The reality is, if such an approach existed, everybody would be doing it. Risk parity solves certain problems but it introduces new ones. And those new problems are just as tricky to deal with and require a bit of work. We don't yet have a full view of whether it's possible to completely address them or not. Risk parity is very interesting and a viable option for investors, but certainly it's not a slam dunk case that it is a superior approach.

Watch for the new C|A research report, Sharpe*ning Your Beta, *which explores the risk parity approach in more detail. The report will be available on our website soon.*

Taking Measure

It sounds like a simple enough question:
How well have my private investments actually performed?

By Katharine Campbell

THE ANSWER, it turns out, has been anything but straightforward. While private investments can be and have been highly additive to many investors' portfolios, a variety of performance methodologies and uncertainty about how (and when) to measure returns can produce a host of mixed messages about their performance.

C|A's private investment benchmarking team recommends that investors ask three questions when measuring the success of their private investments: (1) was the decision to allocate capital to private investments a good one?; (2) have we made good manager selection decisions?; and (3) have our allocation decisions been good with respect to timing, strategy, and commitment sizing?

To answer the first question, investors need to know how the program has performed against public markets. "Enhanced return in the growth part of the portfolio is, after all, the reason for including privates in the first place," explains Jill Shaw, a private investment consultant and co-head of Cambridge Associates' private investment benchmarking working group. "Comparing private investment returns to public market alternatives is the key metric investors should monitor consistently. This will answer the fundamental question: Was it worth taking on the illiquidity and other risks associated with various private investments?"

Comparisons of the two can be challenging. Private investments are best measured based on internal rates of return or multiples of value created relative to capital invested, while public investments are measured on a time-weighted basis. For this reason, there is no standard way to conduct a private-to-public performance comparison, explains Shaw. The most commonly used approach during the last two decades has been public market equivalent (PME). PME analyses convert public market returns to a series of cash flows that mimic those of the private investments being evaluated. In other words, the PME methodology assumes that public shares are invested at the same time that private investment capital calls are made, while public shares are sold

“Enhanced return in the growth part of the portfolio is, after all, the reason for including privates in the first place.”

Jill Shaw

when private investment distributions are made. The value of the PME’s public share holdings is based on the returns of the chosen public market index reflecting the investment timing of the private market cash flows, explains Shaw. Once investors create a set of PME cash flows (and PME NAV, based on the value of the public holdings), they can analyze performance using conventional private investment measures, such as internal rates of return and multiples, which are directly comparable to the private investment.

But there’s a downside. “When a private portfolio produces relatively strong distributions in a period when public market performance is weak, the PME NAV can become negative, implying that you are short the index,” explains Carlos Herrera, a senior research specialist focusing on private performance issues.

To address this flaw, a working group at C|A, led by Herrera, developed its own version—the C|A Modified Public Market Equivalent, or mPME. C|A began using mPME as a standard measurement in private investment due diligence reports last year. In the coming months, clients of the firm will be able to access the mPME tool when they log on to the C|A website. mPME capabilities will also be incorporated as a standard calculation in a new version of Cambridge Associates’ Benchmark Calculator to be released in mid-2014.

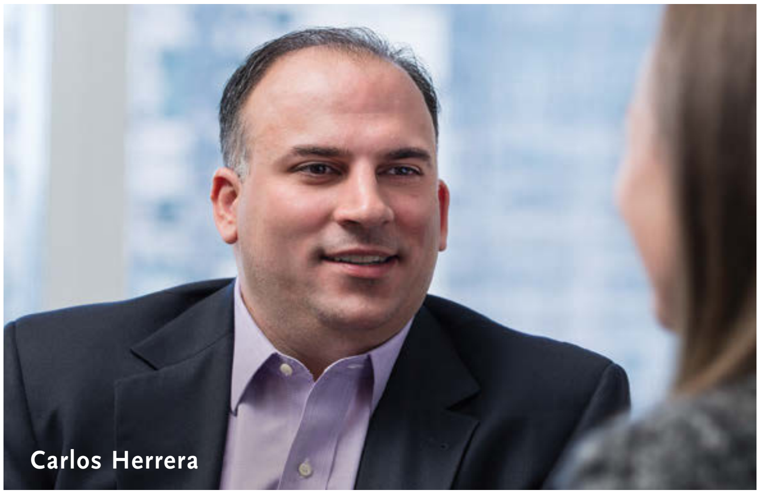
The second question investors should ask about their private investment performance focuses on manager selection. C|A benchmark medians and quartiles remain the best way to single out manager performance fund by fund, says Shaw. But beware. “The fact that one can calculate a median doesn’t mean it’s actually meaningful,” Shaw advises. According to Shaw, investors should pay little attention to any comparative benchmarking until an investment is at least five years old, making exceptions for obvious big early wins or losses.

Indeed, an analysis of more than 1,600 private investment funds raised between 1995 and 2005 revealed that it took, on average, more than six years for a fund to settle into its ultimate quartile ranking. Gauging performance relative to peers much earlier than five to six years into a fund’s life cycle isn’t particularly useful, Shaw concludes. “Investors are not doing themselves any favors by beating themselves up over poor early returns, or by congratulating themselves because a particular manager might employ a relatively aggressive valuation practice in their largely unrealized portfolios,” she says.

After the five-year mark, investors must decide whether to benchmark each fund across a broad set of alternatives or something more focused. Shaw explains, “For example, should a West Coast, IT-focused venture fund of a certain vintage be benchmarked against other West Coast IT-focused venture funds? Or should that fund be benchmarked against global venture funds? Investors should consider each fund’s intended role in the portfolio before assigning the most appropriate benchmark.”

To answer the final question regarding allocation, C|A recommends creating a custom pooled benchmark, Shaw says. In this approach, the investor creates a portfolio benchmark in the same way actual investments are made: by weighting and pooling transactions for the relevant benchmark universe. The portfolio benchmark mirrors the strategy and vintage year allocations of the actual portfolio. The investor can then compare that benchmark to another pooled benchmark that incorporates alternative allocation characteristics. This approach allows investors to determine how successful their specific allocation decisions have been during different market environments or scenarios, Shaw explains. Take vintage year allocation. Using this benchmarking approach, investors could model how successful they were at avoiding excessive commitments in the run-up to the technology bubble in 1999 and 2000. Conversely, they can look at how well they were able to soft pedal during periods with lower returns.

Investors can also use this methodology to gauge the effectiveness of specific strategy and sub-strategy allocations. "Suppose you had been investing in private equity since 1995 but had not allocated to venture until 2000. You might want to know what the drag on your performance had been," Shaw explains. Investors can perform similar analysis in terms of geographic choices, she continues, such as the impact of not allocating to European buyouts in the early 2000s and missing that period of outperformance.



Carlos Herrera

Shaw advises that addressing allocation questions is best reserved for periodic, in-depth portfolio reviews. The pooled custom benchmark analysis allows investors to evaluate performance in a dynamic way and provides insights into longer-term trends. However, it is less relevant as a defined benchmark that is monitored from quarter to quarter. ■

Does It Add Up?

Benchmarks are only as reliable as the calculations used to create them. When measuring private investments on a stand-alone basis, most investors use money-weighted internal rates of return and end-to-end returns. However, some also use time-weighted returns (TWRs) as that is the standard measure for nearly all other types of investments.

But private investments have a unique set of characteristics: the long lock-up (typically ten or more years) of capital, the impact of the J curve (as management fees and capital are called early in a fund's life) without offsetting increases in portfolio company value, and the wide latitude managers have in valuing their portfolios, to name a few.

For all of these reasons, TWRs are inadequate as a way of measuring private investments, insists Jill Shaw. "By definition, a TWR calculation handles each quarter of investment independently regardless of the amount of dollars at work. This methodology is reasonable for public investments as investors can choose to get in and out of the index at their desired pace and can choose to expose their capital to the returns of any time period. However, because TWRs ignore key characteristics of a private investment manager's performance, like realized net cash flows and capital deployment decisions, they can paint a distorted picture, and thus are not as useful a measure of private investment performance."

CONCENTRATING ON YOUR ASSETS

If a concentrated investment is often the key to creating wealth, it can also be a roadblock to preserving it. | By Krista Anderson

FOR MANY FAMILIES, a significant portion of their assets can be concentrated in a single listed stock holding. It is often the source of the wealth they have amassed. While it can sometimes be difficult for investors to sell the position, diversifying wealth can provide many long-term benefits, explains Anthony Wilson, a Managing Director at C|A and a leader in the firm's private wealth practice.

Why can diversification be so valuable? In short: volatility reduction and less risk of permanent wealth destruction.

C|A's recent research report *Concentrated Stock Portfolios* indicates that single stocks are, on average, 68% more volatile than a diversified portfolio. In fact, 92% of the S&P 500 constituents experienced a higher volatility than the S&P 500 Index itself in the annualized ten-year period ended June 30, 2013, according to the report. And while the equity *market* eventually recovers from adversity, not all individual companies do.

Still, there are many reasons why some families choose to retain a concentrated position. One common consideration is a desire to defer realization of capital gains tax on the position. But, if the family expects to sell the shares eventually, the difference between paying taxes now versus paying them a few years down the road may not be particularly large (especially when compared to the cost of hedging the shares for a multi-year period).

Another primary reason that families keep a concentrated position is control. In some cases, family members might still be deeply involved in or employed by the company the family owns. Selling the stock would likely result in a loss of decision-making power regarding the firm's strategy. For investors in a control position, some may prefer to hold the concentrated stock if they are highly confident that the stock will deliver market-beating returns.

But be careful of overconfidence. "The owner should have a deep knowledge about the real value of the company and some level of control over the firm to make that assertion," Wilson says. "A founder who is still actively involved in the company and has a strong level of influence over its direction can typically assess enterprise value more successfully than others."

Even an investor with intimate knowledge of the company needs to be realistic about how far into the future he or she can accurately assess the firm's prospects. "As the degree of uncertainty about the future increases, the investor should be more deliberate about considering the potential risks relative to the rewards of retaining the position," cautions Wilson.

Financial reasons for holding a concentrated position aside, the decision to diversify can often be an emotional one. Wilson says many clients have found it difficult to let go of the company that created their wealth. In some cases, the stock represents a legacy that the family wants to protect and pass on to future generations.

For these reasons, investors must weigh both financial and personal factors to make the right decision. "We can't value the personal aspect of owning the stock. The goal is for clients to have a clear picture of the fundamental factors needed to fully understand the benefits and risks that holding the position can have on their portfolio over time," Wilson advises.

If a single stock holding can be impactful on the portfolio, then how concentrated is too concentrated?

It's all relative. What an investor should retain depends in part on the individual's investment objectives and capacity for risk. "An investor should look at his or her own personal risk profile and ensure that it is aligned with the risk associated with holding the stock," explains Wilson. C|A's research report estimates the added portfolio risk associated with varying levels of concentrated stock, but stocks themselves have varying degrees of risk.

Once an investor decides to diversify a concentrated holding, the process can usually be as quick or as measured as the family decides. In cases where an investor sells a private company or fully liquidates a public holding, diversification can begin immediately, Wilson explains. For others, diversification might require a managed process that phases in the selling of the concentrated asset over a period of time.

"With one of my clients, we have been working together for nearly a decade to move from a portfolio that was virtually all concentrated in a single type of investment to a more traditional, diversified portfolio that includes a variety of core asset classes," Wilson shares. This deliberate approach has allowed the family to carefully manage the tax implications of the sale while gaining more risk protection through incremental diversification. It may be possible to hedge some of the remaining stock exposure during a multi-year divestment process, although hedges can be somewhat costly and complex.

To manage the impact of taxes when selling or trimming a holding, certain strategies may help offset some of the tax cost during the diversification process. Tax advisors can provide guidance on the impact that capital gains taxes will have on the assets in the short term and help create implementation plans best suited to the individual investor's needs. For investors who plan to eventually donate some assets to charity, gifting appreciated shares of the concentrated stock to a charitable investment vehicle such as a community foundation or donor-advised fund can be advantageous.

In cases where the single asset is diversified over time, Wilson suggests building the rest of the portfolio around the holding to ensure that the risk in the portfolio is managed appropriately. For example, if the investor's single stock is in a technology company, he or she would likely limit broad exposure to the technology sector elsewhere in the portfolio. "Build the rest of your portfolio around the concentrated position to ensure you are not doubling down on your risk," Wilson advises.

Parting with a single stock, especially one that has a personal connection to the family, can be a difficult decision for any investor. While it typically makes better financial sense to diversify, there are a host of financial and emotional factors that need to be considered as well. Working with an advisor, family members can create a plan that makes them comfortable both personally and financially.

Wilson concludes, "Ultimately, we always acknowledge that the decision rests with the family. Our job is to ensure that families fully comprehend the risk associated with holding a concentrated position so they can then make thoughtful and informed decisions about their overall wealth management strategy."

Read more about strategies that can help mitigate the risks of single-stock exposure in C|A's recent research report, Concentrated Stock Portfolios. *All of our research reports are available when you log on to our website.*

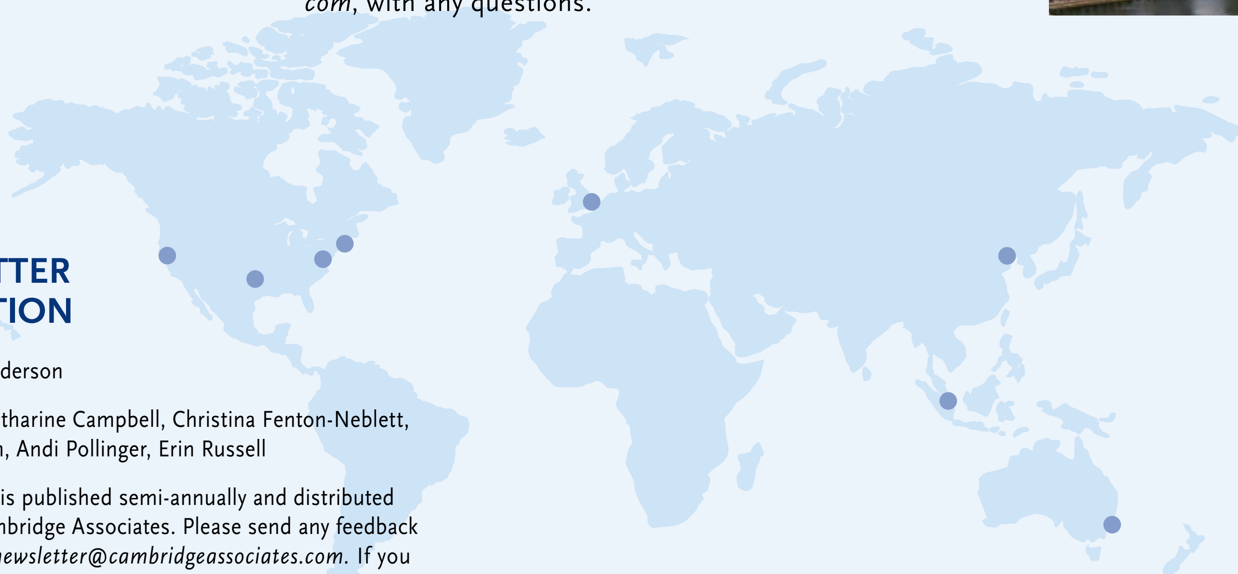
IN THE QUEUE

See Us in New York

Two members of Cambridge Associates' outsourced investment office business unit, C|A Capital Management, will present at the Endowment and Debt Management Forum organized by the National Association of College and University Business Officers (NACUBO). Bruce Myers and Rob Rodgers will lead a session that explores the continuum of investment outsourcing options, illustrating the topic through three actual case studies of institutions that outsource in different ways. The event will take place February 5–7, 2014, at the Waldorf Astoria in New York. For information on how to register for the event, please visit *www.nacubo.org*.

Join Us in Vancouver

Vancouver, Canada, will provide the backdrop for C|A's 11th Global Investment Workshop, held May 4–7, 2014. Attendees will explore the topic of real assets and hear on-the-ground perspectives illuminating areas of both investment risk and opportunity. Capacity is limited and seats are reserved on a first-come, first-served basis. A link to register for the event, and additional information, is available once you log on to the Cambridge Associates website, www.cambridgeassociates.com. Please contact Rebecca Hanson, *rhanson@cambridgeassociates.com*, with any questions.



NEWSLETTER PUBLICATION

Editor: Krista Anderson

Contributors: Katharine Campbell, Christina Fenton-Neblett, Rebecca Hanson, Andi Pollinger, Erin Russell

C|A Perspectives is published semi-annually and distributed to clients of Cambridge Associates. Please send any feedback or requests to *newsletter@cambridgeassociates.com*. If you prefer NOT to receive this newsletter in hard copy, please email *clientdirectory@cambridgeassociates.com* or contact Brian Green at 703.526.8500. This newsletter is also available electronically at *www.CambridgeAssociates.com*.

Cambridge Associates is a privately held global investment firm. We strive to help global institutional investors and private clients meet or exceed their investment objectives by providing proactive, unbiased advice grounded in intensive and independent research.

www.CambridgeAssociates.com