August 2015 Investment Publications Highlights

What Would Yale Do If It Were Taxable?

Patrick Geddes, Lisa R. Goldberg, and Stephen W. Bianchi, *Financial Analysts Journal*, vol. 71, no. 4 (July/August 2015): 10–23

The growth in assets among ultra-high-net-worth individuals has led many wealth managers to increasingly consider how to adopt best practices from institutional investors. In an effort to address this concern, the authors seek to adapt Yale's asset allocation to fit the needs of taxable investors, arguing that tax management is an essential element in the portfolio construction process.

For taxable investors, tax management considerations should not be an afterthought in the asset allocation process. Rather, family investors should consider differences in the tax treatment of asset classes and after-tax correlations of assets as they develop their asset allocation. To demonstrate how different an institutional portfolio would look if it were taxable, the authors examine the asset allocation of Yale's endowment.

Initially, the authors consider how the endowment would change using after-tax expected returns. Yale's sizeable allocations to active equity and absolute return strategies would be reduced due to the impact of taxes, and allocations to indexed equity and tax-advantaged equity would increase. With higher allocations to more tax-efficient strategies, investors would be able to tolerate some tax-inefficient investments, provided they deliver high levels of diversification to offset the impact of taxes.

The authors note that the degree in which Yale's allocation changes is dependent on the proxy chosen to represent the asset class. For instance, the hedge fund index used in the sample has a low correlation to equities, lower than many other indexes that track the class. As a result, using other hedge fund proxies would likely result in substantially different allocations.

The authors then consider how Yale's endowment would change using both after-tax expected returns and an after-tax covariance matrix. With these inputs they confirm their prior findings, noting that the allocation to tax-inefficient classes whose volatilities are more dampened by taxes increases at the expense of those whose volatilities are less impacted by taxes. While the introduction of an after-tax covariance matrix may be difficult for some wealth managers because of data estimation challenges, the impact of taxes on investment returns should be considered in allocation decisions.

A Multi-Family Office (MFO) 'Investment Manifesto'

Scott Welch and Jamie McIntyre, *The Journal of Wealth Management*, vol. 17, no. 4 (Spring 2015): 9-20

The authors highlight trends that can help MFOs successfully address the concerns of high-net-worth (HNW) clients. These clients have become increasingly more hands on, risk averse, tax sensitive, and interested in non-traditional investment strategies; a successful MFO should seek to simplify interactions and provide more tailored solutions to client wealth objectives.

The authors address the sophisticated demands of HNW clients by highlighting six distinct solutions that can help MFO professionals better address client needs.

Outsourcing. The growth in customizable investment advice has directly contributed to some MFO professionals outsourcing a portion of their investment management role so they can focus on financial, tax, and estate planning. The authors claim that focusing on areas other than investing has the potential to enhance productivity, efficiency, and possibly performance.

Thematic Portfolios. While modern portfolio theory aims to maximize a portfolio's risk-adjusted return, thematic investment strategies, such as goals-based portfolios, help align portfolio objectives with how investors actually think about their money. Incorporating these concepts into portfolio management allows MFOs to construct simplified, personal portfolios that address investor goals.

Fee Optimization. The authors believe MFOs should spend active management fees where they are most likely to be impactful. MFO professionals should employ a "top-down" approach on fees, which involves determining the total amount HNW clients are willing to spend, and then building a portfolio based on where those fees will deliver the best risk-adjusted returns.

Managed Accounts. In recent years, unified managed accounts (UMA) have evolved to better address the needs of HNW clients. Highly customizable and easy to implement, UMAs can improve MFO efficiency and help HNW clients access better managers and more efficiently manage costs and taxes.

Alternatives. MFO professionals have increasingly allocated capital to alternative strategies managed in liquid and regulated investment vehicles, such as a mutual fund or exchange-traded fund. The approach has gained a following in part because it has helped better address investor-specific trade-offs between return, risk, liquidity, and fees.

Performance Reporting. MFO professionals have frequently sought to use the client performance report as a business development and client retention tool. The authors emphasize how offices should rely on new technologies to visually illustrate factors driving performance and how their advice adds value.

The Influence of a Family Business on Portfolio Management: An Asset-Liability Management Approach

Stephen M. Horan and Robert R. Johnson, *The Journal of Wealth Management*, vol. 17, no.1 (Summer 2014): 14–30

Wealth managers often evaluate clients' non-financial assets, such as stakes in family businesses, to inform the portfolio construction process. The authors believe adopting this approach more broadly, using insights learned from an asset-liability management (ALM) framework, will help wealth managers to better account for client risk.

The authors believe a typical approach in wealth management, in which an advisor focuses primarily on managing financial assets, has shortcomings because it fails to consider liabilities and human capital, or expected future earnings. Adapting ALM techniques frequently used in pension fund management, the authors argue that wealth managers should comprehensively review client specifics, including potential future income from family-owned businesses and planned philanthropic goals.

Using a client with a family-owned business as an example, the authors suggest the wealth manager consider the business as equity when making asset allocation decisions, in part because of the uncertainty and size of potential future cash flows. This stands in contrast to a client with a traditional earnings stream, which would be more akin to a fixed income security. If a family business is funding high-priority goals, wealth managers should seek to understand the risks of the business and explore opportunities to mitigate those risks.

The authors highlight three approaches to managing risk, including investing in the risk-free asset, diversifying, and hedging. They note it can be difficult for wealth managers to convince clients who have amassed the majority of their wealth through a family business to hedge exposure to that company. An option for some may be to hedge only the portion of the business used to cover high priority goals. In that scenario, wealth managers would need to determine what hedge ratio would be appropriate and how closely aligned the hedging product is with the family business. Ultimately, taking a more holistic approach can help to better address risk in the portfolio construction process. ■

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