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Rethinking Everything: Building Your Client's 'Portfolio for the Future™'

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INVESTMENTS & WEALTH INSTITUTE®

Rethinking Everything

BUILDING YOUR CLIENT'S 'PORTFOLIO FOR THE FUTURE™'

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Record low interest rates and muted forward-looking return expectations have caused asset owners to look for better sources of growth, income, and inflation protection. Simultaneously, fee compression in traditional markets and an evolution of capital formation toward the private markets have caused asset managers to diversify their revenue streams.

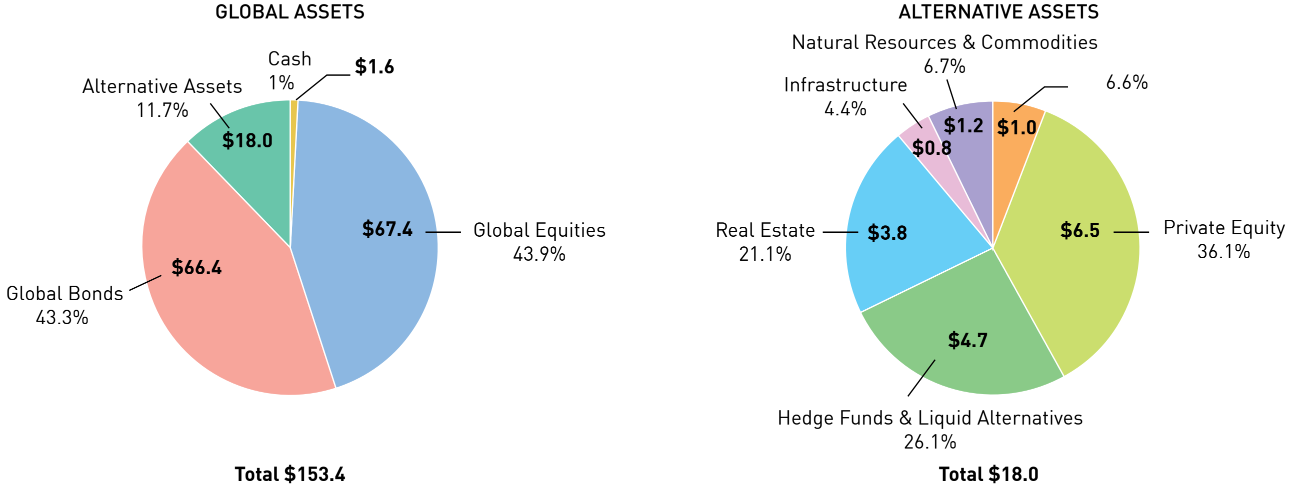
With such strong supply and demand forces at play, it is no surprise that alternative investments, which now represent less than 20 percent of assets under management, are expected to produce half of annual industry revenue in only a few years.

CAIA Association estimates that, as of the end of 2020, institutionally adopted alternative investments represented approximately $18 trillion in assets under management, or 12 percent of the $153-trillion global investable market, as shown in figure 1. With such strong supply and demand forces at play, it is no surprise that alternative investments, which now represent less than 20 percent of assets under management, are expected to produce half of annual industry revenue in only a few years.[1]

RETHINKING OUR FRAME OF REFERENCE

The 2010s were like a lost decade for investors in long-term diversified portfolios. Table 1 shows time-weighted returns, standard deviations, and maximum drawdowns of major public and private capital returns as of December 31, 2020, using quarterly returns. Until the COVID-19 pandemic, drawdowns in global public equity and fixed income markets were minimal. It really wasn't until the equity market

Figure 1 GLOBAL INVESTABLE MARKET ($ TRILLIONS) AS OF DECEMBER 31, 2020



Source: CAIA Association, Bloomberg, Preqin, FRED, MSCI, HFR, Bank for International Settlements Derivatives Statistics

Table 1

ANNUALIZED ASSET CLASS PERFORMANCE, RISK, AND DRAWDOWNS (AS OF DECEMBER 31, 2020)

	Annualized Returns				Volatility		Max Drawdown	
	1-Year	5-Year	10-Year	15-Year	10-Year	15-Year	10-Year	15-Year
Public Equity - MSCI World Index	18.5%	11.2%	8.7%	6.7%	15.3%	17.6%	−21.4%	−50.7%
Private Equity - Venture Capital	51.2%	20.7%	18.6%	14.4%	10.9%	10.7%	−3.0%	−18.2%
Private Equity - Buyout	20.7%	15.7%	13.7%	13.4%	7.9%	10.9%	−11.0%	−31.1%
Public Debt - Bloomberg Barclays Aggregate Bond	7.3%	4.4%	3.8%	4.5%	3.0%	3.2%	−3.0%	−2.4%
Private Debt - Senior	1.5%	6.7%	8.6%	8.2%	6.0%	8.8%	−10.7%	−24.3%
Private Debt - Mezzanine	7.2%	8.3%	8.7%	8.0%	4.5%	5.3%	−7.9%	−15.1%
Private Debt - Distressed	3.5%	5.6%	7.0%	8.0%	6.9%	11.2%	−11.7%	−34.7%
Hedge Funds - HFRI Fund Weighted Composite	13.0%	6.4%	4.4%	5.0%	7.7%	8.3%	−11.6%	−19.0%
Commodities - Bloomberg Commodity Index	1.1%	2.2%	−5.5%	−2.2%	15.1%	18.8%	−61.3%	−65.9%
Real Estate - Generalist	−3.9%	4.2%	7.2%	3.1%	3.8%	9.9%	−7.9%	−53.1%
Real Estate - Value-Added	1.3%	7.8%	10.1%	5.5%	3.5%	10.8%	−5.0%	−55.4%
Real-Estate - Opportunistic	−2.7%	6.9%	8.5%	6.4%	4.3%	13.3%	−7.5%	−57.8%
Natural Resources	−9.1%	0.8%	0.9%	5.2%	11.4%	11.4%	−34.4%	−25.6%
Infrastructure	4.2%	8.9%	8.2%	7.9%	4.2%	7.8%	−6.0%	−24.0%
Public 60/40 Portfolio	14.1%	8.5%	6.7%	5.8%	9.0%	10.4%	−11.6%	−31.2%
Alternative Assets Portfolio*	12.7%	9.3%	8.9%	8.1%	5.9%	7.8%	−9.3%	−24.4%
60% Alternative Assets Portfolio, 40% Public 60/40 Portfolio	13.3%	9.0%	8.0%	7.2%	6.9%	8.5%	−10.2%	−27.0%

Data is quarterly, annualized returns are computed using arithmetic mean. Data for private equity, private debt, real estate, natural resources, and infrastructure are computed using pooled time-weighted return statistics for funds with vintage years 2000 through 2016.

**Alternative Assets Portfolio is represented by an equally weighted portfolio of private equity, private debt, hedge funds, and real assets (real estate, natural resources, and infrastructure).*

Source: Bloomberg, Burgiss, CAIA Association

drawdown during early 2020 that investors rediscovered the benefits of diversification for the first time in more than a decade.

Most of us have never seen a secular bear market in bonds, and domestic stock indexes seemingly have done nothing but appreciate since the Global Financial Crisis of more than a dozen years ago—so why take client portfolios off autopilot when they've done so well for so long?

INDIVIDUAL INVESTORS ARE ON THE HOOK

Defined benefit plans are challenged with underfunded commitments and defined contribution plans have cemented their place among retirement savers in the United States. Excluding the minimal support that Social Security provides in retirement, individuals effectively bear most of the risk of securing and surviving their own retirements.

Those nearing or at retirement face public equity valuations near record highs, fixed income yields at record lows, and inflation that's the highest it's been in 40 years. Simultaneously, millennial and Gen-Z investors, projected to inherit $48 trillion of wealth over the next 25 years, are facing the daunting challenge of securing their own retirements—even if those retirements are 30 or 40 years from now.

Regardless of a client's life stage, many want to allocate differently and, importantly, think about risk differently. As advisors prepare for lower public-market returns, they need to reimagine the way they approach portfolio construction. In the trade-off between innovation and efficiency, we may need to choose innovation.

In this article, I propose that the wealth management industry rethink three major portfolio management factors:

- Asset allocation
- Risk
- Implementation

In coming decades, meeting investment outcomes and fulfilling our fiduciary responsibility will be a much taller order. Building the "Portfolio for the Future™"[2] will demand that investment professionals become more enterprising and work harder to construct diversified and creative portfolios anchored to client goals.

RETHINKING HOW WE BUILD ALLOCATIONS

WHAT'S AN ALLOCATOR?

An allocator is not a job title, it's a mental framework. To think like an allocator is to acknowledge that a healthy portfolio consists of different players needed to take on different roles to help achieve the client's objective. It means thinking through all the risks, not just in terms of statistical measures like standard deviation, but illiquidity risk, manager risk, and, importantly, shortfall risk. It means thinking through environmental, social, and governance factors, and how those factors influence cash-flow distributions and mark-to-market. Finally, it means thinking through a mosaic of allocation techniques, acknowledging that singular frameworks come in and out of favor.

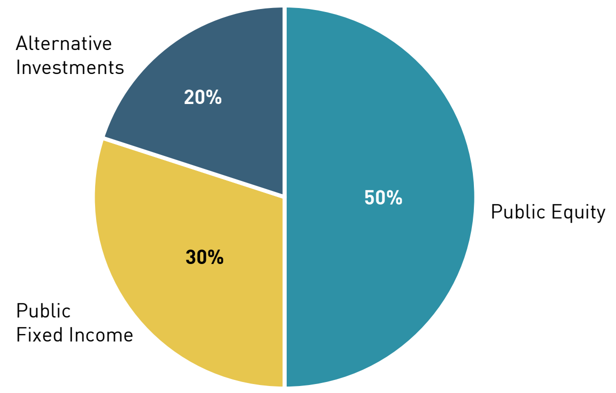
ALLOCATE ACROSS RISK EXPOSURES, NOT ASSET CLASSES

Pie charts are important narrative devices; however, as a mental framework they often handcuff us into making suboptimal portfolio decisions. The moment we give ourselves a quota for a particular asset class is the moment we have lost the point of allocating capital in the first place.

At first glance, the asset allocation in figure 2 makes intuitive sense. But on further inspection, we realize that each of these categories covers multiple styles, exposures, and risks. In particular, the 20 percent in alternative investments covers a lot of things that aren't even remotely related (e.g., does it make sense to have private infrastructure and hedge funds in one category?).

Figure 2

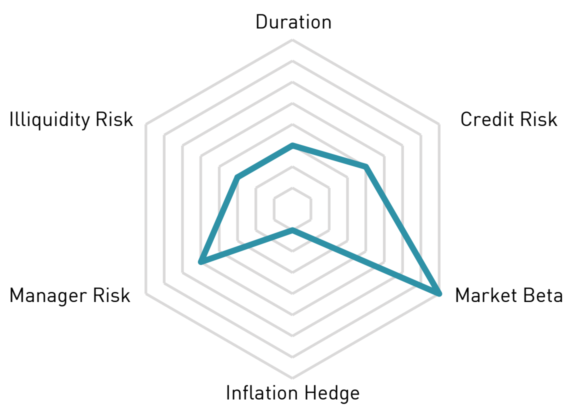
ASSET ALLOCATION PIE CHART



Source: Author's calculations. For illustrative purposes only.

Figure 3

RISK EXPOSURE ALLOCATION CHART



Source: Author's calculations. For illustrative purposes only.

Further, separating any asset or strategy from the rest of the portfolio does a disservice to explaining the true exposures of allocation. Technically, everything is an alternative investment—after all, isn't investing all about opportunity cost? Instead of thinking about dollar allocations, let's think a bit more about underlying risk drivers. Sure, we may end up with the same pie chart at the end of the exercise, but an allocation should be merely the byproduct of the necessary risk exposures to achieve an objective, as shown in figure 3.

WHAT IS AN ASSET CLASS, REALLY?

If we adopt a risk-exposure lens, we're required to think about asset classes differently. Sometimes, I think we get so caught up in the investment vehicle (exchange-traded fund, mutual fund, limited partnership, etc.) that we forget that many of these strategies have similar underlying economic drivers and risk characteristics. Public and private equity both represent equity stakes in a company, so why do we treat them as separate things in a total portfolio context? Sure, you are accessing different areas of the market at different stages of development, just like you would allocate to large- and small-cap public equities. However, that's just basic diversification within the larger risk exposure. Let's not forget the most basic elements of both.

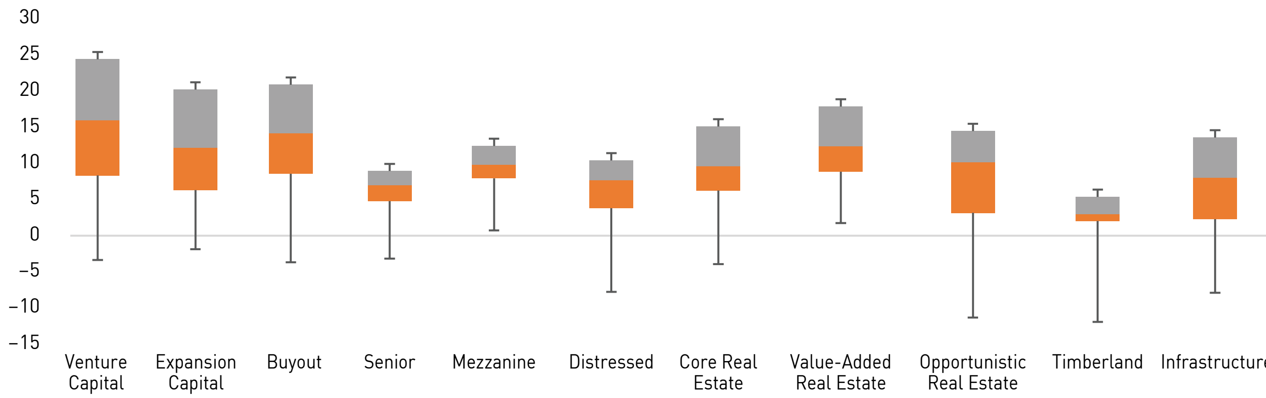
In fact, general partners (GPs) across many strategies are pushing against the artificial boundaries of public and private markets, no longer constraining themselves by investment vehicle. For example, the Sequoia Fund's announcement in 2021 shows that venture capital managers are willing to break the cycle of only holding portfolio companies until they go public, extending the venture capital-fund life cycle into perpetuity.[3] On the other end of the life cycle, hedge fund managers participated in 753 private deals, worth an aggregate $96 billion, in 2020— representing a new record.[4]

COMPENSATED RISK VERSUS COMPENSATING FOR RISK

The economic and systematic risk underpinning public and private capital may be more similar than we think, but private capital brings additional risks

Figure 4

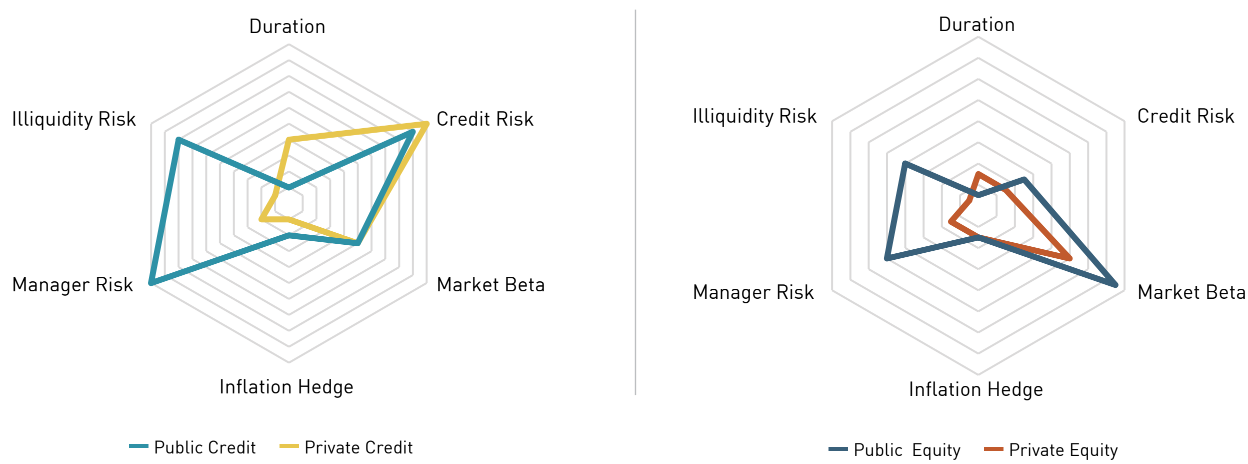
10-YEAR PRIVATE CAPITAL FUND PERFORMANCE DISPERSION



Note: Figures 4 and 5 show the performance differences among managers. From top to bottom, figure 4 identifies top 5 percent, top quartile, median, bottom quartile, and bottom 5 percent.
Source: CAIA Association, Burgiss. IRR data as of December 31, 2020

Figure 5

PRIVATE VS. PUBLIC MANAGER RISK EXPOSURE



Source: Author's calculations. For illustrative purposes only.

an investor should consider. In fact, unlike in public-market indexes, aggregated private capital fund performance data remains misleading and doesn't provide a look into what an average investor might experience by investing in a top, bottom, or average performing fund manager, as shown in figure 4. The skill required to select good managers is just as, if not more, important as having access to them in the first place. Although the underlying risk exposures may be familiar to a public-market participant (growth, income, and inflation protection), illiquidity and manager risk will drive a material portion of the outcome.

ARTICULATING RISK WITH ADDITIONAL VARIABLES

Figure 5 presents a simple visual framework for comparing public and private capital strategies. For illustrative purposes, I compare the risks of public and private capital. Notice a level of overlap in underlying risk drivers. Still, private capital clearly introduces two additional dimensions of risk—illiquidity and manager risk.

RETHINKING YOUR CLIENT'S RISK

Individuals in the accumulation phase define risk differently than institutions, which may have a multi-generational or perpetual time horizon. Individuals may have multi-decade time horizons, but they still face prominent risks such as permanent capital loss or failing to reach the goals within their financial plans.

Volatility becomes an even bigger liability to "asset distributors," or those living off their assets in retirement. Clients in this phase are subject to sequence-of-returns risk, i.e., poor performance for an extended period. Realizing this risk could prove detrimental to the financial plan as clients draw assets from their portfolios. Although we should encourage clients to take a longer-term perspective, the intermediate term is sometimes just as important. Attractive long-term returns

Table 2

ILLUSTRATION OF SEQUENCE-OF-RETURNS RISK

		Portfolio 1		Portfolio 2		Portfolio 3	
Starting Portfolio Value	Annual Withdrawal	Value	Return	Value	Return	Value	Return
Year 1	$(50,000.00)	$1,010,000.00	6%	$1,030,000.00	8%	$1,050,000.00	10%
Year 2	$(50,000.00)	$1,020,600.00	6%	$1,010,900.00	3%	$947,500.00	−5%
Year 3	$(50,000.00)	$1,031,836.00	6%	$950,791.00	−1%	$963,825.00	7%
Year 4	$(50,000.00)	$1,043,746.16	6%	$1,014,885.92	12%	$759,613.00	−16%
Year 5	$(50,000.00)	$1,056,370.93	6%	$1,005,481.36	4%	$937,496.90	30%
Year 6	$(50,000.00)	$1,069,753.19	6%	$ 1,056,029.49	10%	$981,246.59	10%
Final Portfolio Value		**$1,069,753.19**		**$1,056,029.49**		**$981,246.59**	
Arithmetic Average Return		6.0%		6.0%		6.0%	
Geometric Average Return		6.0%		5.9%		5.0%	
Standard Deviation		0.0%		4.9%		15.6%	

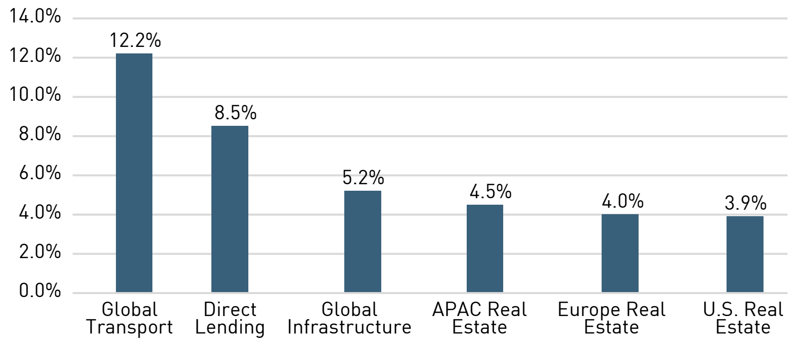
Source: Author's calculations

with poor short-term return streams could be just as bad as not achieving those returns in the first place.

Table 2 illustrates this concept with three hypothetical portfolios that generate the exact same arithmetic return of 6 percent per year, each in a different way. Portfolio 1 earns a 6-percent arithmetic return by generating the same return every year (a standard deviation of 0 percent), and portfolios 2 and 3 generate this return with differing, and more volatile, return streams. Each portfolio starts with US$1 million and requires $50,000 (or 5 percent of the starting portfolio) in withdrawal every year to fund retirement. Notice that the more volatile the return stream, the lower the geometric return—and the lower the ending portfolio value.

Figure 6

ALTERNATIVE ASSET CLASS YIELDS



Source: JPMorgan's Q2 2022 Guide to the Markets

ENTER ILLIQUIDITY

With this backdrop, it might be tempting to look for alternative sources of income, which often come with lower levels of liquidity, to help bridge the gap. Figure 6 shows the yields on alternative asset class yields available to investors in private capital. At first glance, most of these yields might solve the public fixed income problem an investor faces, and the mark-to-market would seem to solve the volatility problem.

Be wary, however, of running to private markets to chase yield. As shown in figure 5, these strategies introduce additional risk drivers to the portfolio. The introduction of illiquidity and manager risk brings further portfolio management considerations, such as more hands-on rebalancing and risk controls. Finally, introducing illiquidity may lower stated volatility, improving the portfolio's statistical optics, but later realized returns may be suboptimal due to permanent capital loss or poor strategy execution.

RETHINKING PORTFOLIO IMPLEMENTATION

Advisors who invest in alternative strategies, especially those with illiquidity attached, will be faced with additional factors when determining whether it is in a client's best interest. These factors include liquidity, time horizon, cash flow, and taxes.

LIQUIDITY AND TIME HORIZON

Many institutions can handle illiquidity, albeit to varying degrees. Endowments and family offices, for example, may be far more willing to invest a substantial portion of their capital in illiquid strategies and assets. Pensions, on the other hand, may need to be more selective about where they take on illiquidity because of funded status and future distributions.

Liquidity profiles for these institutions may change but, given most have perpetual time horizons, that change may be slow. Conversely, the liquidity

Table 3

AVERAGE LIFESPAN OF PRIVATE CAPITAL FUNDS

Fund Strategy	Average Lifespan (Years)
Core Infrastructure	14.1
Natural Resources	9.1
Direct Lending	5.7
Buyout Private Equity	8.8
Venture Capital	7.9
Core Real Estate	7.2

Source: Preqin

profile of private wealth clients may be more volatile due to changing circumstances such as health, marital status, or interests, all of which can create unexpected liquidity needs.

I always advocate for a comprehensive goals-based investment strategy, so a simple starting point to avoid a liquidity mismatch would be to align the time horizon of each asset with the client's cash-flow needs. For example, according to Preqin data shown in table 3, infrastructure funds can last upward of 15 years on average whereas direct lending funds may only last five. Each provides attractive levels of income but with different time horizons. On the other hand, venture capital may not provide any cash flow for many years.

Even if clients' circumstances don't change over time, their tolerance for illiquidity will. Therefore, an advisor may want to create a glidepath for a client, similar to that of a target-date fund, that accounts for illiquid assets and the client's cash-flow needs.

CASH-FLOW MANAGEMENT

Liquidity is a big consideration once the portfolio is invested, as well as while it's getting invested. Unlike investing in publicly traded securities, exchange-traded funds, or mutual funds, investing in private capital usually is not as simple as a point-and-click purchase. There are many different approaches to managing capital calls and distributions, including the following:

Money is set aside until the GP calls capital. This is the easiest approach operationally, but excess cash could be a drag on the overall portfolio's performance if capital markets perform well.

The portfolio remains fully invested in other assets until the GP calls capital. This approach would keep the client fully invested. However, the risk of this strategy is that GPs could call capital at a time when other asset classes are performing poorly, requiring poor timing on a sale.

Committed capital is invested in a public-market equivalent or replication strategy until the GP calls capital. This approach would keep the portfolio invested in an asset with a similar underlying economic risk profile. However, like a fully investable portfolio, your client runs the risk of the GP calling capital during a period of market stress.

TAX CONSIDERATIONS

A key difference between institutional investors and private clients is that many institutional investors are tax-exempt and a private client's investments may be subject to federal, state, and local taxes, including capital gains taxes, income taxes, and estate taxes. So, although tax-exempt institutions largely can ignore taxes, taxes are a key consideration for private wealth clients. The contents of a client's investment policy statement often are similar across regions and globally applicable. Still, effective tax planning is heavily dependent on local laws.

To respond to this, many advisors and consultants will opt for tax-location strategies, which attempt to optimize the location of investments across different accounts based on their tax structures. Tax-location strategies often will disqualify certain assets from certain accounts. For example, hedge fund strategies with high levels of turnover (and short-term realized gains) may not make sense for a client's taxable account; they may be better suited for a tax-deferred vehicle. In the United States, both the 1099 and Schedule K-1 forms are used to report income that doesn't come from an employer, including private investments. Often, clients are used to filing a 1099 but may be less familiar with the K-1.

RETHINKING EVERYTHING

I will end where I started: Investors face a very different world in the future, and therefore must re-imagine client risks and portfolio construction. We can all update our annual capital market assumptions and make slight shifts to our strategic allocations accordingly, but portfolio resilience can be achieved only if we let go of past methods.

CAIA Association's 2022 seminal piece, "Portfolio for the Future™,"[5] opened with the following quote from Ariel Babcock, CFA®, of FCLT Global:

> *The benefits of diversification are well documented, but how we define diversification is evolving. With the advent of indexed investing, everyone can own the market portfolio—diversification is cheap, and even free in some cases. Long-term investors define diversification differently, looking across asset classes and paying close attention to the interactions of investments in different parts of the portfolio.*
>
> *The top-down whole portfolio approach to diversification is even more important as portfolios become less liquid. Increasing allocations to private assets—private equity and venture capital, but also things like real estate, infrastructure, and timberlands—give long-term portfolios access to new sources of return. And those returns from private assets—alternatives—come with holding periods that are often better aligned with long-term investment objectives.*

Continued on page 25 →

RETHINKING EVERYTHING

Continued from page 18

For advisors embracing less-liquid markets for the first time, the top-down and holistic portfolio approach to diversification will become even more important than it was in the past. Thinking through risk exposures at all levels will only lead to better client outcomes in the long run.

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ENDNOTES

1. "Global Asset Management 2020: Protect, Adapt, and Innovate. Boston Consulting Group" (May 19, 2020), https://www.bcg.com/publications/2020/global-asset-management-protect-adapt-innovate.
2. CAIA Association, "Portfolio for the Future™" (2022), https://caia.org/sites/default/files/2022-03/CAIA_Portfolio_for_the_Future_24MAR2022_2.pdf.
3. "The Sequoia Fund: Patient Capital for Building Enduring Companies" (October 26, 2021), https://medium.com/sequoia-capital/the-sequoia-fund-patient-capital-for-building-enduring-companies-9ed7bcd6c7da.
4. "Going Private: Hedge Funds and the Convergence of Private and Public Equity Investments" (September 2021), Goldman Sachs, www.gs.com.
5. See endnote 2.

CONTINUING EDUCATION

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