BEST PRACTICES:
PRINCIPLES FOR ALIGNED INVESTMENT ADVICE

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After investing capital on behalf of families for decades, we've seen market ups and downs, bubbles and trends. Through it all, there are several fundamental principles which inform prudent investing for families. We call them our *Investment Best Practices:*

- Seek public market returns (beta) at low cost, through passive strategies. Though we consider active management in less deep or liquid markets, we believe active managers often fall short of broad market returns;
- Seek to beat public market returns (alpha) primarily through private, illiquid investments. But, be mindful that not all private investments are created equal, especially when it comes to the timeliness of a particular strategy, fees and expenses, and alignment of the manager with investors;
- Pay close attention to portfolio asset allocation and re-allocation;
- Be real about your portfolio, especially with regard to performance - measure returns only after fees and taxes, and the amount of risk you are taking to get a particular return – i.e., volatility;
- Make sure the interests of client and adviser are as aligned as possible, and in particular that the adviser's compensation is not linked to the adviser's investment recommendations.

How did WE arrive at these guiding principles? The twentieth century saw substantial growth in the financial industry of companies dedicated to active management. During the second half of the century, analysts would examine data from either first-hand visits or data gathered from market studies or regulatory filings. Those who had access and a disciplined methodology could make investment decisions that were ahead of the curve, achieving healthier returns, and compensating for their higher fees.

Given the massive increase in access to information because of the internet boom at the end of the 90's, as well as greater regulatory disclosures, such competitive advantage was reduced and the spread between the best and worst managers contracted. This is when the portfolio indexation process (ETF's and "passive") investments gained broad popularity. These changes brought an opportunity for investors to substantially reduce the costs for their portfolio management, with little or no reduction in returns.

Over the last few years, it has been shown that 85 to 90% of active managers are not able to consistently beat their benchmarks or reference index. More importantly, there is evidence that portfolio returns are impacted at least as much by asset allocation and accurate portfolio construction as they are by the selection of specific managers or securities*. Given these statistics and the higher fees (as much as 10x higher) of active managers vs. their passive counterparts, we must ask ourselves: Why do so many investors still entrust their assets to managers who do not achieve their goals consistently and who put their economic interests before their clients?

The main problem lies in the business model of most asset managers. Instead of focusing on meeting investors' goals, such as: liquidity, necessary cash flow, investment horizon, risk aversion, etc. most money managers are looking at how much compensation they will obtain by managing their clients' money.

As mentioned above, historically, the competitive advantage of managers lay in having access to information first. Nowadays, in most public markets, that differentiation does not exist, with the exception of the private markets. In recent years and in the foreseeable future, the best investment opportunities will likely be in instruments that are neither listed nor easily accessible by the general public. Currently, the access and ability to analyze these options are one of the greatest differentiators between managers. This has been an advantage for sophisticated investors, such as family offices, sovereign wealth funds, or portfolio managers of large universities, who, because they have longer time horizons and are not subject to short term performance rankings, have been able to invest differently and in most cases, with higher returns.

If an investor is willing to assume illiquidity and a longer investment period, there are very interesting opportunities in private debt, equity and venture markets, as well as in different niche markets of real estate and infrastructure. In the coming years, a combination of illiquid investments and a low-cost, liquid investments, may well offer investors a better chance of achieving higher overall portfolio returns than those in public markets, along with greater diversification, efficiency and likely with less volatility.

See e.g. RG Ibbotson, The Importance of Asset Allocation (2010)

Finally, it should be noted that active management must come from the appropriate distribution of assets, that is, in the "asset allocation." Historically, asset allocation has been the primary driver of a diversified portfolio's returns, along with high-value assets in the private market sector and indexing to public markets where great transparency lies. An exception to this may be in emerging markets where active management clearly continues to add value.

Given the current low interest environment and historically expensive asset prices, you have to evaluate what will generate value given the amount of risk taken and cost of owning these assets. Now more than ever, taking into account post-tax returns is essential since the management of profit and losses can be used to offset each other. After all, this greatly impacts what will be gained in the long term.

It is crucial to have a team that is paid only by the client, that avoids or minimizes any conflicts of interest, and whose business model and culture demonstrate a commitment to act in clients' best interests. In other words, it is crucial to have advisors who are true fiduciaries.

Our five investment principles follow from these conditions and realities, and provide the basis for what could be called aligned investment advice. We believe implementing these best practices is crucial to families and other investors who wish to preserve and grow their wealth enterprises to endure across generations.

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