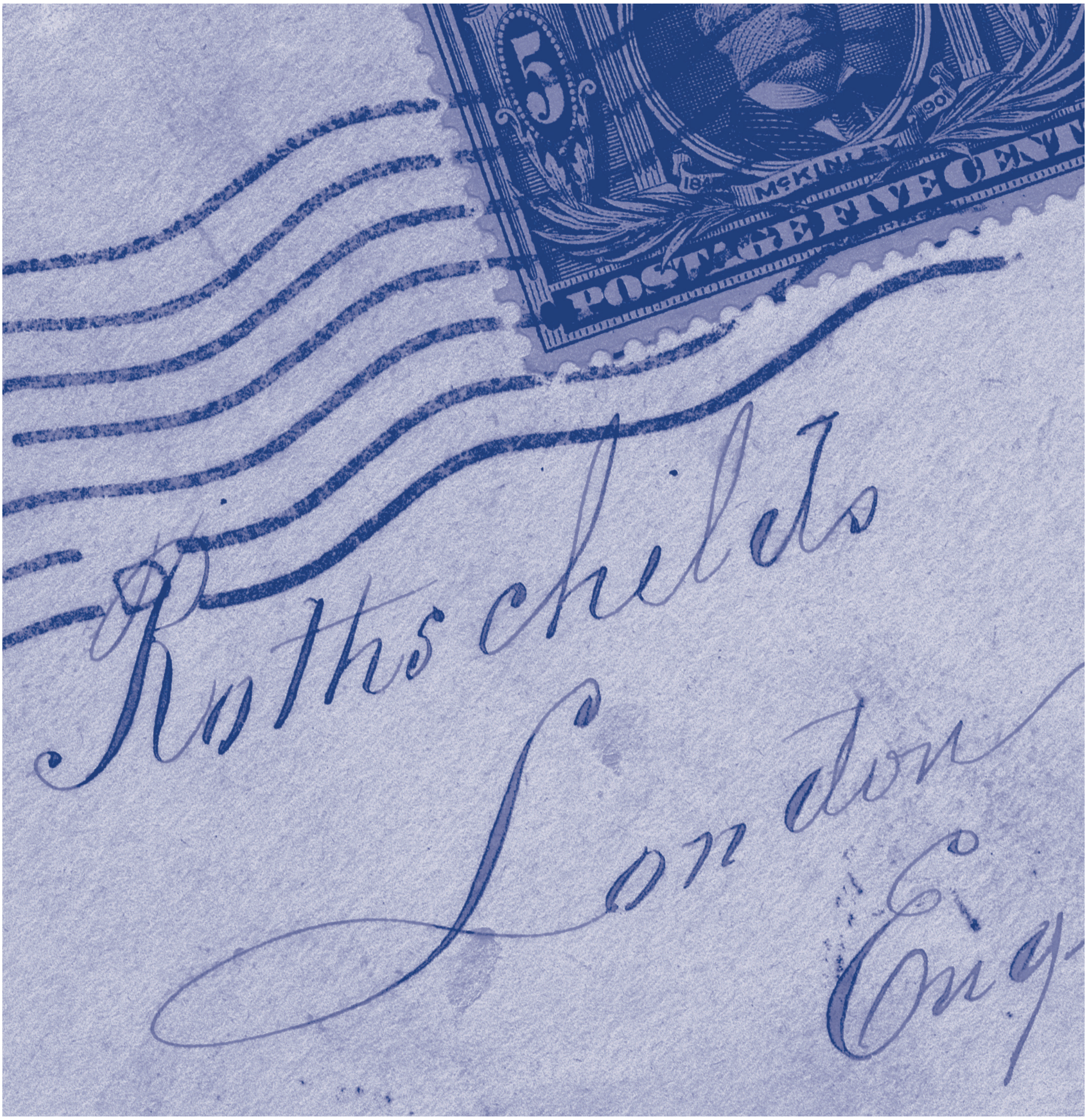
Cultivating good habits

Quarterly Letter

Issue 17 | January 2018



Rothschild
Private Wealth

Cover image:
Envelope from a Presidential 'Thank you' sent to Nathaniel 1st Lord Rothschild (1840–1915), Senior Partner N M Rothschild & Sons, from President Theodore Roosevelt (1858–1919) in 1904.
Courtesy of The Rothschild Archive

Rothschild Wealth Management
New Court
St. Swithin's Lane
London
EC4N 8AL
+44 20 7280 5000
rothschild.com

Publication date: January 2018.
Values: all data as at 27th December 2017.

Foreword

Our regular readers will have observed that our quarterly letters typically focus on one or two elements of our investment approach. In this letter, keeping with the festive spirit, we have taken a slightly different tack.

I joined Rothschild in 2010. My interview process, as you would expect, was rigorous. I met with more than 10 senior leaders within the bank, including Baron Eric de Rothschild. Eric has enjoyed a career spanning more than 50 years in finance, but has a second career, in wine, as head of Domaines Baron de Rothschild (Lafite).

One of the key reasons I joined Rothschild Wealth Management was the family ownership. In this letter we explore some of the parallel advantages the banking and wine businesses enjoy thanks to the family ownership, and in a banking context, what benefits we believe they bring to you, our clients.

Eric was Chairman of Wealth Management until 2014 and continues to take a very active interest in our business and clients. He kindly agreed to be interviewed by our team for this letter and has provided many of the wine related anecdotes.

I would like to wish you and your families a happy, healthy and prosperous 2018.

Helen Watson
CEO, UK Wealth Management

Cultivating good habits

A bit of history

In the early 1800s Mayer Amschel Rothschild sent his five sons to five different European cities to establish branches of the family's banking business. The youngest, James Mayer Rothschild went to Paris and enjoyed considerable success.

In 1868, shortly before he died, aged 76, he purchased Chateau Lafite in Bordeaux. Lafite was considered to be one of the finest vineyards in France – one of only four 'First Growth' wines, as classified in 1855. Today, under the leadership of Baron Eric de Rothschild (James's great great grandson) Lafite continues to be considered one of the very best (if not the best) wines in the world and the Domaines Baron de Rothschild (Lafite) group has vineyards across the globe.

Both the Rothschild banking and wine businesses continue to be owned and controlled by members of the Rothschild family. This family ownership is unusual and brings a number of benefits. In this letter, we are focusing on three: the ability to take a long-term approach; the forming of strategic partnerships; and the network effect.

Investing for the future

For many of our clients, their wealth was generated through a family business. Family ownership affords a time horizon to make long-term investments that short-term investors wouldn't necessarily have the patience for. This is exemplified by the family's recent venture in China. More than 10 years in the planning, this 'small' vineyard, in Eric's own words, is being run by the Lafite team, on a premier site, with vines transplanted from Bordeaux, but is yet to sell a single bottle. It takes time to build something great – even 'new' great businesses aren't as new as we might think, e.g. Amazon (est. 1994) and Google (est. 1998).

Perhaps what makes the wine business different to many other businesses is the requirement for an ultra-long term approach, necessitating something more than 'just' family ownership, but rather multi-generational family ownership. Eric says they "prepare for the harvest in 20 years' time" and this is illustrated by the fact that the average vine used for Lafite is 40 years old.

Short-term pain

In 1984, Chateau Rieussec – a Sauternes sweet wine – was acquired by Domaines Barons de Rothschild (Lafite), who redeveloped the estate. A new cellar was built, and new processes established to improve the wine making – "the whole thing is operationally state of the art". A remarkable trio of vintages ensued in 1988 to 1990, followed by an entire decade of very good wines from 1995 to 2005.

The vineyard was thriving, with Rieussec's position as an impeccable label increasingly well deserved. But such a reputation requires protection: in 2012, when holidaymakers were enjoying a dry August and September, the vineyard was suffering, with the harvest falling below standard, Eric and his team took the decision not to produce any Rieussec.

In the short-term this was expensive – zero revenue from the vineyard's main wine. However, in the long-term it was felt that customers would have greater regard for the wine, and the vineyard's reputation would be upheld.

Long-term family ownership alleviates the need to obsess about quarterly or even annual corporate results.

In a banking context, long-term family ownership alleviates the need to obsess about quarterly or even annual corporate results. As with the 2012 Rieussec, our team is encouraged to give their best advice to clients, even if there is a short-term cost to the bank. In recent years we have referred dozens of clients to National Savings and Investments (NS&I), a UK government owned savings institution. Rothschild & Co's financial position is strong and we do not need to pay high interest rates, whereas NS&I has been offering very competitive rates and comes with UK government support. These referrals earn Rothschild Private Wealth nothing but goodwill. We measure our success by the longevity and depth of our client relationships, not the last year's revenue.

Another benefit of long-term family ownership is consistency of strategy. In a private client context, M&A activity can be very unsettling, leading to higher levels of staff turnover. Eric observes that "you don't sell a business with your name on". We know our clients value consistency of relationship, and we enjoy one of the lowest levels of personnel turnover, and corresponding longest employee tenures, in our industry.

At the portfolio level, we invest from the 'bottom up'; this means selecting investments based on their own merits.

This multigenerational long-term approach also allows us to make investments in our team, systems and infrastructure, without worrying about immediate returns. In the last 5 years we have rolled out an entirely new set of systems and invested heavily in expanding our teams. These investments might not reap short-term rewards, but over time will deliver a better experience and results for our clients.

At the portfolio level, we invest from the 'bottom up'; this means selecting investments based on their own merits. If we don't like an investment we won't own it. In the short-term this can feel painful (e.g. no direct exposure to the mining sector in 2016), but like the 2012 Rieussec, we can afford to forego tactical gains in the interests of maximising long-term value.

Managing portfolios for the long-term

We devote a lot of thought to risk in client portfolios, and have discussed many of the risks we seek to protect against in previous letters. One risk we haven't discussed before is 'career risk'.

Numerous academic studies have shown that to deliver strong investment performance, investors must be genuinely active investors. This doesn't mean constantly making changes to investment portfolios, but rather positioning investments differently to the herd and taking a long-term approach to underlying investments. The challenge is that no matter how brilliant the investor, they won't get it right all the time. All of the world's best investors have had periods of disappointing performance, often lasting several years. This is true of the great Warren Buffett, but also others such as Seth Klarman and Sir John Templeton.

In professional investing, portfolio managers are typically employees. They have annual appraisals, are paid yearly bonuses, and have families at home to support. They worry that periods of poor investment performance will lead to them losing their jobs – career risk.

Whilst many investment houses may profess a long-term approach, their shareholders don't have the patience for the inevitable ups and downs of long-term active investing, portfolio managers follow the herd to avoid career risk and clients suffer weaker performance as a result. By contrast, at Rothschild & Co our shareholders have a genuinely longer horizon, allowing our portfolio managers to manage money as though it were their own. This is reflected in the way in which our portfolio managers are paid, with a meaningful part of their pay linked to long-term investment performance.

Bringing it back to wine, whilst one might assume that the sites and the vines are the main assets of a vineyard, Eric sees it differently, "the greatest gift to my grandchildren is the skilled staff".

Family partnership

One of the most treasured items in the Rothschild family's archive is an agreement dated 27th September 1810 establishing a partnership between Mayer Amschel Rothschild and his sons. Over more than two centuries the Rothschild family have entered into many strategic partnerships.

In 1999 the Rothschild and Catena families began discussions to form an alliance – to create a leading Argentinian winery. At a simplistic ingredients level, the wine, Bodegas CARO is a blend of the two families' signature grapes, Malbec for the Catenas and Cabernet Sauvignon for the Rothschilds, but the partnership was much deeper. The Mendoza region is one of the highest altitude wine producing areas in the world (600-1,100 metres, compared to almost sea level for Bordeaux), and the Catenas brought invaluable local knowledge. The Rothschilds brought centuries of experience and know-how of blending different grape varieties. The result is an award winning wine, considered by many as the leading wine of its type.

Investment partners

This partnership approach is also employed in a portfolio context. No matter how marvellous we think our team is, they cannot be experts in every field, and we cannot claim to employ all of the world's best investors. Where appropriate, we invest in third party funds, a relationship we view as a partnership.

For Return Assets (those investments we expect to drive long-term inflation beating returns) we want managers to think similarly to ourselves: they must carry out deep fundamental research; invest with conviction; adopt a long-term approach; and their interests must be aligned with their investors. One such example is the Ward Ferry Asian Smaller Companies Fund.

The team, led by Scobie Ward and Vineet Mitera, who have worked together since 2005, are based in Hong Kong. As the fund name suggests, the portfolio is invested in Asian smaller companies, potential stars of tomorrow. These businesses, due to their size, are below the radar of most investors. You need an experienced team with broad networks to unearth these opportunities.

The team needs to be local. In a region where corporate governance standards are typically less advanced, Ward Ferry emphasise 'on-the-ground' research to really understand the companies and management teams in their universe. They meet with hundreds of companies each year. It would be impossible for a London based investment team to replicate the work being conducted by our friends at Ward Ferry.

Whilst relatively young, the partnership has started well. Since first investing in January 2015, the fund has returned more than 50%, almost twice that of the comparable index.

For Diversifying Assets (investments which we hope will provide protection to portfolios against a major equity market correction), the third party funds we partner with employ highly differentiated strategies, typically skillsets we do not have in-house. For example, trend-follower hedge funds, such as CFM who have a team of 59 physics PhDs in-house, 13 of which fine tune their trading algorithms and execute their trades as efficiently as possible.

Network effect

Under Eric's leadership, the Domaines Baron de Rothschild (Lafite) group has expanded significantly. While Lafite continues to be the flagship, the family have extended their interests in France, through the purchase of Chateau Duhart-Milon, Chateau L'Evangile and Chateau Rieussec. Internationally, there are operations in China, Argentina and Chile.

In 1988 the Rothschild family, following extensive research to find the best site, with the right elevation and climate, purchased the Los Vascos estate in Chile, 200 kilometres south-west of Santiago.

In the years following the purchase, the family restructured the business. A new management team was appointed, led by Chateau Lafite's Technical Director. Processes were improved, leveraging the knowledge and experience gathered from the family's other wine operations – vineyards were replanted, grape yields were reduced and new processes were established. Substantial infrastructure investments were also made, ranging from water bore holes to weather stations. Nearly 30 years since purchase, Los Vascos has proven to be an exceptional investment, generating annual profits more than 10 times greater than the original purchase price.

Whilst the restructuring of Los Vascos might have succeeded under different ownership, Eric believes the scale of the success reflects the benefits of being part of a group, enjoying network effects. All of the family's vineyards benefit from network effects, even Lafite.

We believe that the culture of family businesses is more conducive to collaboration.

Synergies are not the exclusive domain of family owned companies. However, we believe that the culture of family businesses is more conducive to collaboration. This is also true of the family's banking business and it has positive impacts for clients.

Rothschild & Co has offices in 40 countries, more than 3,400 employees and three businesses: Global Advisory (M&A advice to corporations, governments and families); Merchant Banking (private equity and debt funds); and Private Wealth and Asset Management (with which you are hopefully familiar). Whilst always being mindful of privacy and regulatory imperatives, we often lean on the expertise of our colleagues. This can be formal, such as Wealth Management introducing an entrepreneur client to Global Advisory for corporate advice. More often than not it is informal, sharing insights, acting as a sounding board or opening up networks.

By way of recent example, a Wealth Management client's son is launching a technology business. Two weeks ago we arranged a meeting with the head of the Global Advisory technology team to constructively challenge his business plan.

We also benefit from the network effect in a portfolio context. Our investment analysts regularly engage with our Global Advisory and Merchant Banking specialists. In the context of our portfolio investment in Lloyds Bank, for example, our analysts regularly meet with our Global Advisory 'Financial Institutions Group' colleagues to hear their views from working with the UK's leading financial companies.

From their bases in Frankfurt, London, Naples, Paris and Vienna, Mayer Amschel Rothschild's five sons established an unrivalled network of agents, couriers and shippers.

This network was most famously used between 1813-15 by Nathan Mayer Rothschild (in London) to deliver gold to the Duke of Wellington's armies across Europe, almost single handedly financing the British war effort.

Mayer's five sons came to be known as the Five Arrows, a symbol of their successes in Europe's leading economic centres of the time.

Today, Rothschild & Co and bottles of Rothschild wine wear the mark of the Five Arrows – a reminder of the shared heritage and ownership of both these businesses.

Notes

At Rothschild Private Wealth we offer an objective long-term perspective on investing, structuring and safeguarding assets, to preserve and grow our clients' wealth.

We provide a comprehensive range of services to some of the world's wealthiest and most successful families, entrepreneurs, foundations and charities.

In an environment where short-term thinking often dominates, our long-term perspective sets us apart. We believe preservation first is the right approach to managing wealth.

RPW0003/12/17