

# Our investment approach





Cover:  
Detail of a French-style carriage  
clock, c.1880 by London  
& Ryder, New Bond Street,  
London. One of a number of  
antique time-pieces at New  
Court, the historic London  
address of the Rothschild  
business for over 200 years.  
Courtesy of The Rothschild  
Archive.

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Management

# Foreword

We believe it's important to ensure clients have a clear understanding of why we focus on wealth preservation, what can be expected from us and how we construct and manage portfolios to meet our clients' objectives.

Our investment approach is 'bottom up' and centred on the blend of only two aspects – return assets to produce growth and diversifying assets to provide protection and diversification. This allows us to focus on wealth preservation and the objective of delivering inflation-beating real returns. The following pages will take you through the thinking and commitment we apply when managing your wealth.

Our approach is designed to provide our clients with a smooth investment journey that lets them sleep at night.

A handwritten signature in black ink, consisting of a series of loops and a long horizontal stroke extending to the right.

**Helen Watson**

CEO, Wealth Management UK

# A brief what, how and why

## What are we trying to achieve?

Our objective is to preserve and grow the real value of our clients' wealth. This involves several related things: outpacing inflation, achieving prudent growth, and avoiding large losses, all while focusing on the long term.

Let's start with inflation. If we are to maintain and increase someone's purchasing power in the real world, we must produce investment returns for them that keep ahead of rising prices. To do so, we need to invest in assets that grow in value over time.

That part is relatively straightforward. The challenge comes when we add two qualifications. First, we want to achieve this growth without making large losses along the way. Second, we want to do this not just for a few weeks or months but for decades to come.

On paper, this recipe for real wealth preservation looks easy; the hard part comes when actually doing the cooking, consistently and well, through thick and thin.

## How do we go about it?

Having set our objective, we then focus our time and energy on meeting it, building portfolios for our clients with two distinct parts. One side of the portfolio is focused on *opportunities* for creating wealth. We call these *return assets*, because we expect them to grow in value and generate good returns over time.

The other side of the portfolio is focused on *risks*. Here, we hold *diversifying assets* – assets that we believe will help preserve capital and offer some protection. Collectively, these assets should help make the investment journey smoother, cushioning the impact of the inevitable bumps on the road.

Everything we invest in is selected on its own merits. That means we begin by finding individual securities and funds we might want to own, research them thoroughly ourselves, then decide if we should buy them, and at what price. We look for investments globally, rather than limit ourselves to one market or region.

Once we have found an attractive security or fund, we then apply context: an investment may look great in isolation, but what does it bring to the portfolio as a whole? This portfolio context – always linking back to our objective – determines whether or not we make an investment, and the size of the position we take.

By building portfolios like this from the 'bottom up', we avoid the characteristics of 'top down' investment models and templates (these models usually start by dictating set amounts that must be invested in a particular asset class, region or theme).

**We seek to be responsible  
custodians of our clients' capital,  
investing in a way that is sensible,  
focused and patient.**

## Why this approach?

Most of our clients are families and entrepreneurs who have worked hard to build their wealth. They are looking to us to preserve and grow this wealth, not to create a second fortune.

Equally important, we believe preservation-first is the right approach to take with the financial markets. If you experience an investment loss of 50%, you then have to double your money just to get back to where you started. If you lose 80% of your capital, the equivalent gain required is 400%.

By contrast, an investment that grows at an average of 7% annually will double in value over a decade and nearly quadruple over twenty years. Over time, regularly reinvesting gains has such a powerful cumulative impact that this 'compounding' has been called the eighth wonder of the world.

In short, successful investing over the long term is more about avoiding disasters than delivering great results in any one year.



# On opportunities and growth

We think and act as long-term owners of assets. The big economic picture is important, and its impact is continually reviewed by our Global Investment Strategist, Kevin Gardiner. We then concentrate our energy and resources on researching individual securities and funds, and bringing them together into a portfolio, because we believe this is the best way to deliver target returns.

Our return assets are mostly shares in individual companies or equity-related funds. They may also include corporate bonds, real estate and other assets. What these investments have in common is that their returns – and, crucially, their pattern of risks – all tend to be linked to the stock market. This means, when stock markets fall, we anticipate that the prices of our return assets will also decline.

**To meet our objective, we need to invest in assets that increase in value over time. These return assets occupy one side of our portfolios.**

Within a portfolio, we aim to keep the number of investments small and stable, and we are comfortable taking large positions in an investment where we have a high level of conviction about its prospects.

As the table on page 7 illustrates, our return assets can be split into two broad groups: core and special situations, each includes companies and external funds. First, we will focus on companies.

## **Companies – core**

These are some of the world's greatest businesses. Often they are over one hundred years old, with a proven, sustainable, competitive advantage that has endured through inflation, deflation, depressions, world wars, energy shocks and revolutions in transport, technology and communications.

These firms usually have a good record of allocating capital and have solid balance sheets, little debt, lots of free cash flow, and high returns on invested capital. Over time, these companies are well placed to raise their prices to outpace inflation and to compound their reinvested earnings at an attractive rate.

To quote legendary investor Warren Buffett, it is 'economic moats' that provide these firms with their sustainable competitive advantage: the profitability of a company is linked to "the width of its moat, the depth of its moat, and the size and the ferocity of its resident reptiles".

In our company research, we look for moats and reptiles that include entrenched consumer brands, hard-to-replicate systems for distributing products, legal barriers, patents, economies of scale and high switching costs for customers.

Once we have invested in a great business, we don't try to be clever by trading in and out of our position, although we may occasionally take advantage of pricing discrepancies.

## **Companies – special situations**

Put simply, these are investments that we believe will deliver good returns, but which don't meet the extremely high standards for a core holding. Again, special situations are mostly shares in individual companies, but they may also include other assets we hold for their return potential, such as real estate or high-yielding bonds.

To flesh out the distinction between our two groups, let's return to the moats. Most companies have no economic moat at all. They have no sustainable competitive advantage and so cannot defend their profits from competitive attacks.

Our special situations do have moats, and their fortifications are robust enough to ward off intruders, but the moats are not as wide as those of the core companies. As a result, at times when valuations are high, we are more willing to sell our shares in a special situation, whereas we would need to be offered an excellent price to part with our holding in a core company.

That said, special situations are definitely not second-class citizens. For example, a special situation may generate more free cash than

a core company, or profits may be growing more quickly. These factors can more than compensate for a narrower moat.

### **What else is important?**

The returns we experience as investors depend not only on the quality and profitability of a business but also the strength of that business' management and the price we pay for the company's shares.

A company may make lots of money, but do we trust the people in charge to use it wisely? In our experience, it is rare to find a management team that can allocate capital really well.

In theory, business leaders should make decisions in the best interests of shareholders. In practice, the corporate landscape is littered with ill-judged spending initiatives, failed takeovers and grand vanity projects as well as questionable governance practices.

Turning to price, if and when we are convinced from our research that a company can continue to produce good profits, we then determine a reasonable valuation, setting out how much we are prepared to pay for a stake in the firm.

Our approach here is rooted in the long term. If we are prepared to hold shares in a business for at least several years, then we will have the time to benefit from that business compounding its underlying earnings. High and sustained earnings growth means shareholders can enjoy very good returns, with a combination of great performance and a low risk of permanently losing money.

### **External funds**

As previously referenced, external funds sit within both core and special situations on the return asset side of the portfolio. Here, we are choosing to partner with fund managers who have skills and expertise that complement our own.

There are very few fund managers who consistently add enough value to justify paying their fees. Yet a small minority of managers do perform exceptionally well over time, earning their place in our portfolios.

Access can also be an issue, because many exceptional managers have closed their funds to new investors. Here, our long-term horizon and the strength of the Rothschild & Co brand and global network stand us in good stead, opening up opportunities that wouldn't otherwise be available.

### **Deciding to partner**

When we invest with a manager, we see it as a partnership, but not as a marriage. This means we go into the relationship backing the manager for the long haul. We do not tinker with our investment or attempt to micro-manage what they do. We know that if they are to deliver exceptional returns, they may have to go against the flow and invest with conviction, and this inevitably means there may be some stretches when their performance is weak.

**Our long-term horizon and the strength of the Rothschild & Co brand and global network stand us in good stead, opening up opportunities that wouldn't otherwise be available.**

All that said, we are never wedded to a manager or fund, regardless of their reputation. Our monitoring is active and our regular meetings with them are challenging. We are always on the lookout for red flags, and we will withdraw our clients' capital if we become convinced that better opportunities lie elsewhere.

### **Funds – core versus special situations**

A manager will typically start as a special situation and it is only after partnering with them for some time that they will be moved to core.

# On diversification and risk

In his *Seven Levels of Photographers*, Ken Rockwell awards the bottom rung to men (and they are all men) who are more interested in the theoretical performance of a camera than whether the camera actually takes good photos. Suffering from ‘analysis paralysis’, these photographers worry so much about trying to put numerical ratings on things that “they are completely oblivious to the fact that cameras or test charts have nothing to do with the spirit of an image”.

Similar characters lurk in the financial markets, and they are easiest to spot when you ask them about risk. People suffering from ‘analysis paralysis’ see investment risk as a number; their love for numerical ratings can make them oblivious to the true ‘spirit’ of the risks they are taking.

**To protect against risks, we hold what we call *diversifying assets*. These investments should give protection to the portfolio and help us all sleep soundly at night.**

Statistical models are their equivalent of the cameras and test charts. Of course, there is nothing wrong with models, in the same way that there is nothing wrong with cameras – it all depends on how you use them. With modelling risk, the danger usually comes with too little critical thought about what goes into the model, and too much confidence in what comes out.

## **How we think about risk**

When investing, we are more interested in managing risk than measuring it to four decimal places.

In our view, any loss of capital has two important dimensions: how much money is lost, and how long the loss lasts. Following from that, we make a distinction between what financial writer and historian William Bernstein calls ‘shallow risk’ and ‘deep risk’ (read our publication, *Why Wealth Preservation* for more information).

Shallow risk is temporary. It involves a loss of capital that recovers within anywhere from several weeks to two or three years. This risk comes from the regular swings in asset prices that are always present in the financial markets.

In a world of 24-hour news, shallow risk tends to be overemphasised. Events that will lose their investment significance in a matter of days or weeks often dominate the headlines.

By contrast, deep risk involves a permanent loss of real capital. This could come from a sustained rise in inflation that erodes purchasing power, an individual investment that collapses in price and never recovers, or an investment that is sold after a price collapse, preventing the investor from enjoying any subsequent rebound.

For an investment portfolio as a whole, deep risk would involve a large capital loss, and related negative real returns, that span ten, twenty, or thirty years.

## **Putting thinking into practice**

We are obviously trying to avoid deep risks, making sure we don’t permanently lose money for our clients. At the same time, we are also seeking to manage the shallow risks properly.

Shallow risks do matter. They are unnerving, and can be unpleasant to live through. This is where our diversifying assets come in, giving protection to the portfolio.

Although each diversifying asset performs a slightly different role, our general expectation is that they should perform well during a sustained downturn in markets, and at times when markets are volatile. If they perform as we expect, these diversifiers will help to offset falls in the return assets, reducing both the shallow and the deep risk of the overall portfolio.

Our approach here is distinctive. In the mainstream way of building portfolios, capital is spread across half a dozen or so asset classes, with investments in each asset class then split across multiple sub-sectors or regions. A pie chart showing the resulting asset allocation is a reassuring rainbow, with seemingly good diversification and eggs placed safely in lots of different-coloured baskets.

Unfortunately, adding new asset classes to a portfolio does not necessarily lead to more diversification. During times of stress in markets, many riskier bonds and so-called alternative investments move in the same direction as equities – they go down, at exactly the moment their owners most need them to go up.

In our view, the portfolio pie charts would be better split into just two segments – return assets for those securities that move in line with equity markets, and diversifying assets for those that do not.

### **Introducing the diversifiers**

#### **Cash**

Cash is perhaps the most unloved holding in our portfolios.

When cash levels are high, clients sometimes wonder why they are paying us to do something they can do themselves with a bank account.

Yet we see cash as the under-rated defensive midfielder on our football team, the kind of player who keeps the ball under pressure and makes the simple passes that move the team forward. The tougher the opposing investment climate, the more valuable cash is to our tactics.

In our view, the real cost of holding cash largely depends on the opportunities available elsewhere. When cheap assets are plentiful, sitting on cash is expensive, given the potential returns you are foregoing. Conversely, when opportunities are sparse, holding cash should be seen as much less expensive. When compared to the alternative of owning overpriced assets, cash is particularly appealing.

Another advantage of holding cash is the firepower it gives us, allowing us to buy good assets at depressed prices. When panic sets in, it can be difficult to raise cash quickly; having cash on hand is therefore very valuable.

#### **Bonds**

As with every investment, bonds must earn their place in our portfolios.

If we find a bond where the potential returns look compelling, we will own it as a return asset. If we find a bond that helps protect us against a particular risk, we will own it as a diversifying asset.

If a bond does neither of those things, we won't own it at all.

We have no mandatory allocation to any asset class or investment type.

#### **Portfolio protection**

Our investments under this heading usually involve a type of financial market contract known as an option. The analogy with an insurance policy isn't perfect, but it does a better job than a technical definition.

Instead of covering a risk like fire or burglary, the options we buy usually focus on protecting portfolios against a large drop in the equity markets. As with an insurance policy, we pay a premium up front, to give us protection for a set period of time.

If the equity market 'fire' doesn't take place, we have paid our premium without anything in return. However, if it does take place, we will usually receive back many times the amount we paid for the initial premium.

**We see cash as the under-rated defensive midfielder on our football team, the kind of player who keeps the ball under pressure and makes the simple passes that move the team forward.**

The cost of buying this protection varies greatly over time, as market sentiment swings from upbeat to downbeat and back again. Options are therefore not a permanent feature in our portfolios; we will only buy them at times when we believe prices are reasonable.

As well as buying options directly ourselves, we may also partner with external managers who specialise in option investing.

#### **Alternative strategies**

Our alternative strategies are funds run by specialist managers outside of Rothschild & Co. These managers invest in areas that should provide the portfolio with a different source of return, a source that doesn't depend solely on rising equity markets.

For example, some of these managers seek to benefit from sustained patterns and price trends in financial assets; others focus on identifying and profiting from macroeconomic events and themes.

Sometimes, these strategies will perform well in periods when equity markets are falling, but this is not always the case. They offer broad diversification, rather than perfect protection.



# How we construct portfolios

We think differently and focus on opportunities (Return assets) and risks (Diversifying assets)

## Return assets

- Assets that we expect to drive long-term performance
- Comprised of direct securities and funds likely to be correlated to equity (stock) markets, principally direct equities and equity funds
- May include property, corporate bonds and commodities

### Special situations

- Good businesses but perhaps fewer competitive advantages than Core
- Great managers with shorter track records
- More opportunistic holdings

### Core

- First-class businesses with sustainable competitive advantages
- Some of the best managers in the world, with long track records

## Diversifying assets

- Assets that we expect to provide true diversification by:
  - Protecting in challenging equity markets
  - Providing a source of returns that is different from the Return assets
- Comprised of direct securities and funds that display little (to varying degrees) correlation to Return assets, even in extreme conditions
- May include cash, high quality bonds, alternative strategies and portfolio protection

**“It takes a great deal of boldness and a great deal of caution to make a great fortune; and when you have got it, it requires ten times as much wit to keep it.”**

**Nathan Mayer Rothschild  
(1777–1836)**

# Conclusion

## Sensible stewardship

We seek to be responsible custodians of capital, preserving and growing wealth in real terms for decades to come.

With our long-term approach and commitment to patient investing, we are happy to own unpopular assets. At times when others are cautious, we may be confident. When others are chasing opportunities, we may be focused on managing risks.

As a result, there will be periods when we lag the stock market or underperform other wealth managers. This may feel disappointing at times, but we think it is a price that must sometimes be paid if we are to be sensible stewards of wealth over the long term.

## Playing to strengths

We could pretend to be the best in the world in every area, with mastery of every market and asset class, an opinion on everything, and a monopoly on good ideas and investment expertise. Yet we think it is much wiser to know our limitations, stick to our circle of competence, and to focus on what we do best.

Our core strength is building portfolios focused on wealth preservation. By combining return and diversifying assets in the way that we do, we believe our portfolios should outpace inflation, avoid large losses, and deliver good growth over the long term.

In particular, we try to recognise the limits of our knowledge about the future, and believe too much confidence in forecasting is a recipe for financial pain.

With perfect foresight, we could move a whole portfolio into diversifying assets at the very top of the market, then switch entirely to return assets before the next upswing.

Unfortunately, no investors (ourselves included) are clever enough to do this and to get it right all the time.

Rather than trying to predict the regular twists and turns in the market, we focus on coping with uncertainty and on meeting our investment objective over the long term.

## Standard integrity

The physicist Richard Feynman noted a contrast in cultures between advertising and physics.

In physics, the emphasis is on carefully presenting the evidence, laying out a theory's strengths and weaknesses, as objectively as possible. In Feynman's experience, scientists learn a "standard integrity and honesty".

**Having introduced our investment approach, we conclude with a few thoughts on what clients can expect from us as their wealth manager.**

In advertising, the emphasis is on persuasion. Arguments are presented to favour a particular conclusion or message. Instead of balance, there are prominent headlines with details in small print.

When selecting investments, managing portfolios, and communicating with our clients, we are striving for a physics culture. As a client, we will treat you as we would wish to be treated if our roles were reversed.



## Notes

At Rothschild & Co Wealth Management 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.

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