On sensible and genuine diversification

Quarterly Letter

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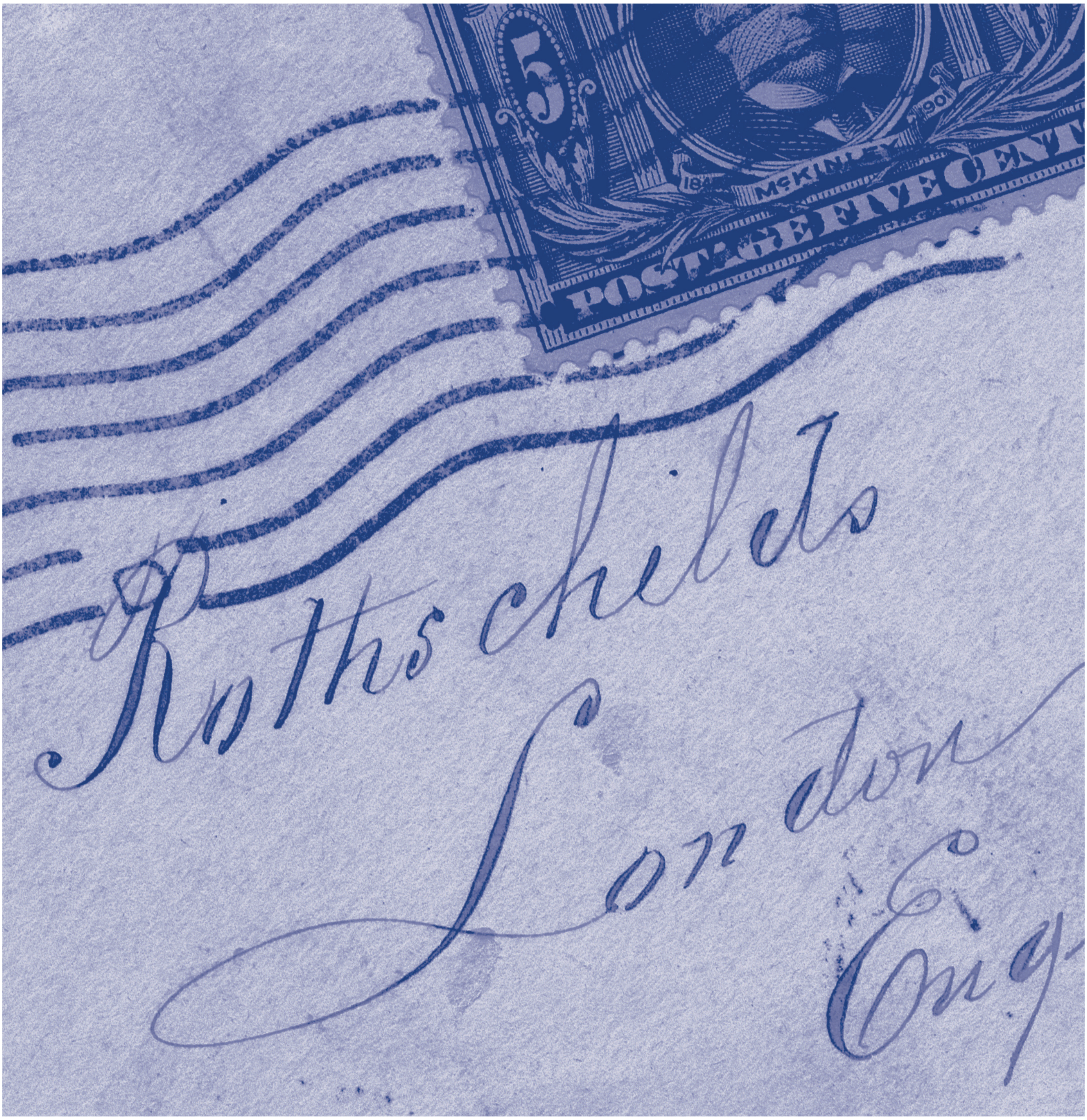

Rothschild
Private Wealth

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

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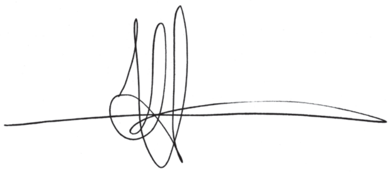
Foreword

The more observant and regular readers of our Quarterly Letters may notice the cover of this edition carries a different image to previous versions, and on closer inspection you will see it is, in fact, an envelope from The White House, which contained a personal thank you letter from President Roosevelt to Nathaniel 1st Lord Rothschild way back in 1904. This seems a fitting picture for our quarterly publication as it reminds me of how important regular communication is and how it underpins strong relationships.

In this edition, we turn our attention to the way in which we seek to preserve our clients' capital through genuine diversification. We avoid trying to predict specific events, instead preparing ourselves for any number of outcomes at any one time.

The concept of spreading risk goes far beyond simply not having all your eggs in one basket, and here we describe the way our approach seeks to preserve our clients' wealth over the long term.

I hope you enjoy receiving our regular Quarterly Letters, even if they are not sent from The White House.



Helen Watson
CEO, UK Wealth Management

On sensible and genuine diversification

A property owner, doing well, with a number of houses in various cities may believe that they are adequately diversified. After all, if one of the homes develops a leak or subsidence, they should feel it is unlikely that similar mishaps would occur throughout their portfolio.

But what happens when the entire property market tumbles? Such is the brittle illusion of diversification – it's easy to imagine we are diversified sensibly.

Nathan Mayer Rothschild (1777–1836) said, "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."

This is the situation in which many of our clients find themselves; they have made their fortune, often by being concentrated in their efforts. It is our job to ensure that they hold on to it, through genuine diversification.

In this Quarterly Letter, we discuss our views on the pitfalls of conventional portfolio diversification, and reveal how we take a distinctive approach to address risk for our clients.

Why diversify at all?
First, let us explore the rationale for diversifying investments.

To be sufficiently diversified means holding a variety of investments – to spread the risk. Therefore, if an event causes one or two of those investments to fail, it is hoped that other investments or assets in your mix may fare better and provide some protection.

There are two types of diversification to consider: protection against specific risk and protection against general risk. Specific risk, as the name implies, refers to risk which may only affect a single company or a small group of companies. The shortcomings of one airline, for example, may also influence share prices in other aviation companies. Or there may be no contagion.

General risk, on the other hand, such as inflation or a recession, is broader in reach and may affect whole markets or regions. This type of risk is almost impossible to predict and to completely avoid.

The philosophy that underpins spreading risk
The thinking and theory behind diversification and spreading risk has gained a great deal of traction since 1952, when the Nobel prize-winning economist Harry Markowitz first proposed what he labelled *Modern Portfolio Theory (MPT)*.

While we agree with the principles of Modern Portfolio Theory when we are in a 'normal market environment', we are less convinced of its merits when markets are distressed.

Markowitz's framework suggests that investment risk can be reduced by holding a diversified portfolio of asset classes and that to maximise a portfolio's expected return, one should vary the proportions in the portfolio. The theory assumes that investors are naturally risk averse and will only take more risk if they are rewarded to do so.

Yet the concept of diversification has potentially been understood for much longer. As Markowitz himself pointed out[1] in Shakespeare's The Merchant of Venice, the merchant Antonio is quoted in the first scene as saying:

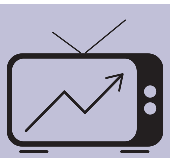
My ventures are not in one bottom trusted,
Nor to one place; nor is my whole estate
Upon the fortune of this present year:
Therefore my merchandise makes me not sad.

So philosophically, at least, we inhabit solid ground by diversifying given our focus on preserving and growing our clients' wealth for decades to come.

However, while we agree with the principles of MPT when we are in a 'normal market environment', we are less convinced of its merits when markets are distressed. Further, the theory demands some pretty big assumptions. For example, it assumes that a truly risk-free rate of return exists and that investors are rational – mountains of evidence indicates that investors are quite the opposite.

"My ventures are not in one bottom trusted..."
Antonio, The Merchant of Venice

[1] In a 1999 paper for the Financial Analysts Journal.



Shallow risk keeps dedicated financial TV channels in business.

Our team, here at New Court, favour building portfolios from the 'bottom up', comprised of return and diversifying assets, rather than a more typically MPT inspired 'top down' approach.

Our view is that adding new asset classes doesn't necessarily equate to more robust diversification. In fact, when equity markets are strained, many asset classes move in the same direction as equities. We only have to look back to the financial crisis of 2008 to witness a complete rout of most asset classes.

So diversifying successfully is much more complicated to achieve than simply not putting all of our eggs in one basket.

Our approach in focus

We build portfolios with a balance of return and diversifying assets. Return assets centre on opportunities for growing wealth, while on the other side of the scales, diversifying assets help preserve capital and offer some protection. In the following paragraphs we look more closely at what we describe as diversifying assets and how they play their part in covering a range of potential outcomes. After all, successful investing over the long term is more about avoiding disasters than delivering great results in any one year.

As much as we methodically seek out suitable return assets, we apply the same precision in our distinctive – albeit uncomplicated – approach to diversification.

When investing we are more interested in managing risk than measuring it to four decimal places. That is, while we accept that you can model risk to the nth degree, it is prudent to remain faithful to our primary investment objective: to preserve and grow the real value of our clients' wealth, while avoiding significant losses along the way.

This thinking informs our attitude towards capital loss and distils it into how much money could be lost and how long the loss lasts. We find it appropriate to further marshal these characteristics into what the financial writer and historian William Bernstein labelled 'shallow risk' and 'deep risk'.

Shallow risk keeps dedicated financial TV channels in business. It is risk that comes from regular swings in asset prices – for example, a share price fall following slightly disappointing quarterly results – and it involves a loss of capital that recovers anywhere from within several weeks to two or three years. It may be also summoned by the tweets of world leaders.

Deep risk has much more profound consequences; it involves a permanent loss of real capital. This could arise from assets collapsing in value and never recovering, or an investment sold too soon after a share price fall, preventing the investor from benefiting from any subsequent price recovery. A persistent rise in inflation – left untamed – may also involve a significant loss of real purchasing power that could take decades to recover.

Naturally, we want to avoid deep risk and permanent loss for our clients. Yet we also seek to manage shallow risk appropriately; while it is not as serious, it can be troubling. And it pays to be mindful of an uncomfortable fact: most deep risk begins life looking shallow.

To achieve consistent growth for our clients we can't avoid the ordinary fluctuations of markets. Some risk is necessary. So as much as we methodically seek out suitable return assets, we apply the same precision in our distinctive – albeit uncomplicated – approach to diversification.

Given our approach, we don't have a mandatory allocation to any asset class. If we feel an asset class, sector or region is unattractive, then we won't own it. This thinking acts as a cornerstone for our diversifying assets as much as our return assets. We find it pays to keep things simple.

We target assets and instruments which move independently of one another.

Introducing our diversifiers

Our diversifying assets fall under four categories: cash; bonds; portfolio protection; and alternative strategies.

Cash

We understand that when we hold cash we come under close scrutiny. Clients sometimes wonder why they pay us a fee to hold what they can keep in a bank account. Yet cash gives us freedom; it allows us to make the most of good opportunities in the market when asset prices are depressed – particularly when panic sets in and it can be difficult to raise cash quickly. When assets become overpriced cash is an attractive holding, but when cheap assets are plentiful, it makes sense to target higher returns and move somewhere else.

Bonds

Sometimes bonds produce attractive returns compared to equities – as seen in the years following the financial crisis when we were able to buy high yielding bonds at depressed prices and bonds behaved more like equities.

On the other hand, some bonds can provide a safe haven, such as short-dated government bonds (gilts) that, in fact, act more like a substitute for cash.

If a bond neither acts as a diversifying nor return asset, we won't hold it at all. As with every investment, bonds must earn their place in our portfolios.

Portfolio protection
At certain times we may incorporate equity 'put' options in portfolios. These options perform well when equity markets are stressed and give us another chance to reduce losses in our portfolios.

In many respects, put options are similar to insurance policies – we pay a premium to give us protection for a set period of time. We may pay this premium without receiving anything in return. But if an event that we 'insure' against does occur, then we generally get back many times the sum we paid for the initial premium.

The cost of this insurance can vary widely. We exercise our judgement and buy such options when we feel that they are cheap. This tends to be after long periods of rising equity markets, with only modest setbacks.

Alternative strategies
Among the ways we aim to protect our clients' wealth is through alternative strategies, funds run by specialist external managers.

These managers aim to provide sources of return that don't depend solely on rising equity markets. For instance, some may focus on identifying and profiting from macroeconomic events and themes. Other alternative strategy managers may look to benefit from persistent trends and patterns in financial markets.

Trends may become attractive due to how humans are wired and subsequently, how we behave. It is not uncommon for markets to rise or fall based on what psychologists call 'herd behaviour' – a tendency to copy others which is driven by the influential force of social proof. If assets are rising people are inclined to buy and when they fall they are persuaded to sell; these actions often ignore the fundamental strengths or weaknesses of an investment. (Remember, we mentioned earlier how MPT assumes investors are rational!)

Where appropriate we will deploy a fund that uses a trend-following strategy. The advantage of such a fund is that it can perform well when equity markets are distressed as stronger trends emerge.

Trend-following funds, therefore, provide another way to offer broad diversification, rather than perfect protection.

Preparing for unknown unknowns
While we act diligently when managing portfolios we can't guarantee complete capital protection. However, we anticipate that our diversifying assets should, over the long term, perform well.

While we agree with the futility of trying to predict future events, we can assign a certain confidence that unpredictable incidents will occur – and plan accordingly.

Our commitment to deep research helps us to systematically unearth the facts, whether they relate to our return or our diversifying assets. Only by reading widely and assessing these facts carefully can we design our diversifying assets so we have cover for a range of unknown outcomes.

Of course, we don't know what these unknowns will be, but it is prudent to be ready for what are called 'black swan' events, a term popularised by finance professor and author Nassim Nicholas Taleb. Black swan events are unexpected events or occurrences which are unprecedented at the time. We should accept, nonetheless, that they may happen.

While we agree with the futility of trying to predict future events, we can assign a certain confidence that unpredictable incidents will occur – and plan accordingly. Rather than prepare for a particular outcome, we prefer to prepare for a range of outcomes.

Conclusion
The renowned investor (and co-founder of investment manager PIMCO) Bill Gross once said, "good investment ideas should not be diversified away into meaningful oblivion."

We agree, to a point. But we maintain that while it requires concentration to build wealth, to preserve it demands genuine diversification.

By combining return and diversifying assets in the way that we do, we set ourselves apart from the hullabaloo associated with investing and managing risk. Instead we seek to calmly conduct our primary objective: to be responsible wardens of our clients' capital, preserving and growing wealth for the long term.

Black swan events are unexpected events or occurrences which are unprecedented at the time.

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.