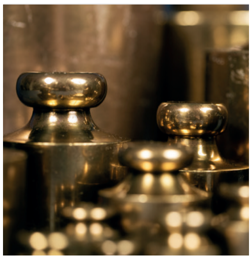
What to expect

Rothschild
Private Wealth



Cover:
These brass balances were used for precise weighing of the Rothschild branded gold bars produced at the Royal Mint Refinery in east London from 1852, which was set up as part of the firm's role in shipping newly discovered gold from Australia and America.
Courtesy of The Rothschild Archive.

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Foreword

I had a useful reminder of the importance of expectations in the days after my daughter collected her A-Level results. She had met her objective – securing a place at the university she wanted to go to. But, relative to the results she'd expected to achieve, she was disappointed.

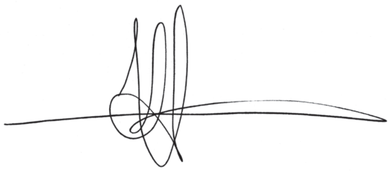
As someone who didn't go to university, I was delighted my daughter had achieved her goal. Unfortunately, my delight couldn't compensate for her sense of unmet expectations.

Our expectations shape how we feel about everything from the products and services we buy to exam results and the commute to the office. These expectations rarely stand still. They can fluctuate daily, and shift in an instant.

As a wealth manager, setting and managing expectations is an important part of our role. We believe we have a strong and distinctive approach to investing. We're clear on our objectives, and how we go about meeting them. We also recognise that our approach may not be right for everyone.

In the following pages, we set out what our clients should expect from us. We outline what we are trying to achieve, how we are different, and the pattern of performance we might deliver. We also highlight how we would like to be judged.

If we are doing our job well, much of what follows should sound familiar, with few shocks or surprises.



Helen Watson
CEO, UK Wealth Management

What to expect

“Happiness equals reality minus expectations.” Tom Magliozzi

What are we trying to achieve?
We invest for entrepreneurs who have sold businesses and then trusted us with the proceeds. For successful businesspeople approaching or in retirement. For charities who have received wealth as donations, gifts and legacies. For the families and descendants of wealth creators.

Their capital is precious. And it’s usually irreplaceable.

Many of our clients are actively starting and building new businesses, or leading established firms. Yes, they are still creating new wealth, but their capital remains precious. When investing, they need diversification, and a portfolio they can depend on.

As a wealth manager, we’re not in the business of creating second fortunes for our clients. Instead, we focus on keeping them wealthy – for years and decades to come, through good times and bad.

Remaining wealthy means at least maintaining, and ideally increasing, purchasing power in the real world. To achieve that, our clients’ portfolios need to beat inflation. We must deliver investment returns that outpace rising prices and a higher cost of living.

To beat inflation, we need to invest in what we call return assets. These are mostly shares in companies and specialist equity-related funds. They are assets that we believe will increase in value over time, delivering returns that outpace inflation by a good margin. These return assets occupy one side of our clients’ portfolios.

If your main aim is to beat the equity market or a market benchmark, our approach may not be for you. Our first and overriding goal is to keep our clients wealthy over the long term.

Our second goal is to meet this first goal, while avoiding large losses along the way. We focus on avoiding what we call ‘deep risk’[1] – permanent and irrecoverable losses of capital.

We have quoted these numbers before, but they are worth repeating. If an investment loses 50% of its value, it subsequently has to double to get back where it started. An 80% loss must be followed by a 400% gain just to return to square one. By contrast, an investment that grows at an average of 7% annually will double in value over a decade and nearly quadruple over 20 years.

To give protection to the portfolio, we hold diversifying assets alongside our return assets. Although each of these diversifiers performs a slightly different role, our general expectation is that they should perform well during a sustained downturn in markets, and at times when our return assets are weak.

As a group, the diversifying assets should help us avoid large losses.

Our clients’ capital is precious, and usually irreplaceable.

How are we different?
We don’t set out to be different or unique. Instead, difference for us is a by-product, something that has flowed from our focus on meeting goals for our clients.

In the following areas, we may be different from others:

Portfolio composition
Every investment we own is selected on its individual merits. Once we have identified an attractive security or fund, we consider its risks and the long-term returns we expect it to produce. We then view it within the portfolio context, assessing what this investment might bring to the portfolio as a whole, either as a return or a diversifying asset.

It is this decision-making process that determines whether or not we make an investment, as well as the size of any position we take. We have no fixed, mandatory or target allocation to any asset class, region, or

1. The term comes from William Bernstein, a financial theorist and neurologist.

theme. There are no underweight or overweight positions in our portfolios, because we are not trying to match or beat any benchmarks or market indices.

For example, a large portion of our return assets are invested in companies that sell their products or services directly to ordinary consumers – everything from beer and chocolate to car insurance, credit cards and short-haul flights. By contrast, we own no long-dated government or corporate bonds. We have no direct exposure to real estate, mining firms or utilities.

We can be confident when others are cautious.

From another angle, consider our exposure to the Japanese equity market. Beginning in 2012, we built a large investment in Japan via a specialist fund. We sold part of this holding in late 2014 and the remainder in summer 2015. Since then, we have had no direct exposure to Japanese equities even though the country is the second-largest in the MSCI World index, representing over 7% of the total market capitalisation.

Our approach meant we were free to book strong profits from our holding in Japan, and to invest the proceeds in more attractive opportunities elsewhere.

Buying investments in difficult markets
We can be confident when others are cautious and are prepared to buy things that are unfashionable and out of favour, including during periods of panic in markets. We may increase our exposure to return assets after a market fall, when the headlines are negative, and when all the pundits agree the outlook looks bleak. Times of distress tend to throw up the best bargains.

Our focus is on the fundamentals, rather than prevailing investor sentiment. Say the price of one of our investments falls sharply, but its fundamentals remain strong. We will be happy to hold on to our position, and may decide to buy more. Admiral, American Express, Deere, Lloyds, Praxair and Wells Fargo are all examples of positions we have previously added to the portfolio following a price fall.

2. There are some exceptions, such as short-dated bonds, and the options we buy to help protect our portfolios.

No market forecasts
We make no forecasts about short-term market movements, nor do we pay much attention to people who do.

Prakash Loungani, an advisor in the Research Department of the International Monetary Fund, has studied the accuracy of economic forecasts, concluding that "the record of failure to predict recessions is virtually unblemished". There is a similar lack of foresight when it comes to forecasting inflation and movements in the bond and currency markets.

In our view, financial forecasters misunderstand the nature of the system.

Dave Snowden, founder of the decision science consultancy Cognitive Edge, makes a distinction between complicated systems and complex systems. To illustrate, he contrasts a Ferrari with the rainforest.

A Ferrari is a complicated system. An expert mechanic can take a Ferrari apart, and then reassemble it, without changing anything. The car is static, and the whole is equal to the sum of its parts. In a complicated system, there is a clear relationship between cause and effect.

By contrast, the rainforest is a complex system. It is in constant flux and unpredictable, the sum of millions of intricate relationships and interdependencies. If a species becomes extinct, or someone reroutes a river, the results for the rainforest will be hard to know in advance. Snowden argues that in complex systems there are instructive patterns, but we can understand why things happen "only in retrospect" and "right answers can't be ferreted out".

The application: forecasters seem to work from a mechanistic assumption that economics and markets are orderly, linear and predictable, with knowable links between cause and effect. In reality, this is not the way the economy works: it is a complex system, in constant flux, more rainforest than Ferrari.

Low turnover
When we buy an investment, we do so with the intention of keeping it for the long term[2].

Frequent trading is not part of our investment style: we believe it would incur unnecessary costs for clients and reduce our chances of success.

Once we have assembled an attractive portfolio of assets, we seek to be patient, limiting our buying and selling.

Some sizeable positions
Where our level of conviction is high, we are prepared to take sizeable positions in individual securities and funds (within sensible risk limits).

As an alternative, we could double the number of positions in a portfolio. Superficially, this would look more diversified. But we think the change would be mainly cosmetic.

This view is supported by academic research. In their book *Modern Portfolio Theory and Investment Analysis*, Ed Elton and Martin Gruber analyse the analyse the correlation of different equity returns. Their work suggests that, in a hypothetical equally-weighted portfolio, the benefits of further diversification are small once you get beyond around 25 positions.

Use of active funds
Typically, we will invest somewhere between one third and half of a client's capital with actively managed external funds. This will increase the total cost of the portfolio.

Investment expenses are important, and we seek to avoid all unnecessary costs. We therefore only partner with other managers when we are confident they will more than justify their fees. They must earn their place in our portfolios.

Rather than look at the total cost of a fund in isolation, we ask clients to look at net returns, after all fees, over the medium and long term. It is these net results that should matter most, because they are results you can spend.

What are the implications for performance?
Clear goals and a distinctive investment approach make for a different pattern of performance. Our performance is likely to be different from bond and equity markets, from market benchmarks, and from other wealth managers.

Our returns can be lumpy. For example, one quarter of great gains may be followed by a quarter when performance goes sideways.

When the overall equity market rises, our portfolios might still fall. When the market falls, our portfolios might rise. It all depends on what is driving the market.

In general, we do not expect to keep pace in strongly rising equity markets (because our diversifying assets can be a drag on performance). But when equity markets fall, we do expect to outperform, protecting our clients from the full impact.

Protection in practice
In investing, there is always a trade-off between capital growth and capital protection. Managing this trade-off in a way that is right for our clients, requires skill, balance and good judgement.

When thinking about protection, we make an important distinction – between drawdowns (peak to trough declines in portfolio value) that are amber, and those that are red.

An amber drawdown is one where a portfolio drops in value by anything up to around 10%[3]. Our clients should expect some amber periods from time to time. Why? Because when equity markets fall, so too will the quoted market prices of many of our return assets.

To avoid all amber drawdowns, we would need to construct portfolios with a very different mix of assets. We believe this mix would deliver much lower returns over the long term. In a world of low interest rates and record low bond yields, any portfolio built for complete capital protection would struggle to meet our first objective of keeping our clients wealthy.

Clear goals and a distinctive investment approach make for a different pattern of performance.

Put another way, avoiding all amber drawdowns is expensive – to get guaranteed capital protection, you usually have to give up a large portion of your returns. By tolerating some amber, clients should experience better long-term performance from us.

A red drawdown is different. It involves a drop in portfolio value of more than 10%. We build portfolios, and hold diversifying assets to help protect clients from these red times. Avoiding these drawdowns is a major focus for us – it's our second goal. The deeper the red, the more we want to avoid it.

In extreme or very difficult markets, red drawdowns may still occur. This might be during a collapse in equities or currencies. Rapid sharp shocks – such as Black Monday in October 1987, when the US stock market fell by 22% in a day – are particularly hard to protect against.

3. The figures we use here are illustrative for a representative balanced portfolio. The numbers would be lower for clients with a lower appetite for risk; they would be higher for clients with a higher appetite for risk.

Nevertheless, when major falls do occur, we'd expect to provide substantial protection from the impact.

By combining return and diversifying assets in the way that we do, we believe our portfolios will outpace inflation, avoid large losses, and deliver solid growth over the long term.

How should we be judged?

We expect to be held to account, and ask our clients to judge us in three ways:

1. On the long-term returns we deliver
To us, long-term performance means periods of at least five years. It is over these periods that we aim to meet our clients' objectives.

At times, this may require patience. Some quarters will be strong, others will be weak.

2. On the performance of the overall portfolio
We encourage clients to focus on the performance of their portfolio as a whole, not on the individual investments in isolation.

With some individual investments, we will make mistakes. When we do, we try to be open and frank about them. Individual return and diversifying assets will be volatile, and some may perform poorly.

Yet what matters most are the returns from the whole portfolio, not the performance of its component parts.

3. On the quality of the service we provide
People rightly have high expectations for service from us, and we seek to meet and beat those expectations.

Clients should expect to interact with engaged and experienced individuals and teams, and people who act in a way that is clear and transparent.

Communication is central, particularly in challenging markets, and we don't shy away from difficult conversations.

Conclusion

By combining return and diversifying assets in the way that we do, we believe our portfolios will outpace inflation, avoid large losses, and deliver solid growth over the long term.

Our approach is different, and our pattern of performance will be too. We are determined to be good custodians of our clients' capital, delivering expected returns for decades to come.

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.