Rothschild & Co
Wealth Management

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Why wealth preservation matters

Foreword

‘Why focus on wealth preservation?’ is a question we’re often asked, and it’s a fair one.

When stocks are thriving, and people are feeling bullish, an investment approach that prioritises preservation may seem timid and unambitious. During those times, we like to revisit the words of economist John Kenneth Galbraith, who warned against falling victim to “the extreme brevity of the financial memory”.[1]

With every market rise, there is an eventual, inevitable fall. And while the merits of a preservation-first approach suddenly become clearer during a downturn, investors are at risk of overcompensating and showing too much caution in response.

Instead, our aim is to look beyond the market fluctuations of today or tomorrow by building portfolios that preserve and grow wealth for generations to come. Growth is essential, but we want to achieve this in a way that is prudent and avoids irrecoverable losses along the way.

Our investment approach is just one piece of the wealth preservation puzzle though. As a wealth manager, we also want to help our clients prepare for the future however we can, and in this *Quarterly Letter*, we discuss some of the ways we try to do that.

I hope the insights shared here prove valuable. I would also like to wish you and your loved ones a year filled with health, happiness and success in 2025.

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[1] A Short History of Financial Euphoria, John Kenneth Galbraith, 1990

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Why wealth preservation matters

Arie de Geus, a Dutch business theorist, once wrote that companies either behave like puddles or rivers.

Businesses that focus only on producing profits for the current crop of managers and investors are the puddles. When rainfall is plentiful, they enjoy healthy expansion and growth. Unfortunately, even a short spell of intense sunshine can lead to complete evaporation. A puddle's survival depends on favourable conditions.

On the other hand, companies that build strong foundations for the future resemble rivers.

"Unlike a puddle, a river is a permanent feature of the landscape. Come rain, the river may swell. Come shine, it may shrink. But it takes a long and severe drought for a river to disappear."[2]

While De Geus was referring to the fortunes of businesses, it's also an apt analogy for wealth. When poorly managed, it can dry up like a puddle on a hot summer's day. However, taking a long-term perspective helps to create a river of wealth – one that doesn't just flow today, but continues to flow well into the future.

As De Geus so elegantly puts it, with a river "new water drops succeed old ones, and they are all carried forward".

We begin with this analogy because it captures the essence of what wealth preservation seeks to achieve – security for you, your loved ones and future generations. But before we delve deeper into the why of wealth preservation, we must first be clear about who the wealth belongs to.

[2] The Living Company: Growth, Learning and Longevity in Business, Arie de Geus, 1997

STARTING WITH THE OWNERS

In broad strokes, most of our clients have either already created their wealth or they are still actively building it.

To expand on De Geus' meteorological metaphor, the first group typically have a finite pool of wealth – less a puddle, more a lake. As a result, their capital is precious, and usually irreplaceable. They may be an entrepreneur who has sold their main business, a professional on the verge of retirement, a charity that has received wealth as a gift, or the families and descendants of wealth creators.

Other clients, meanwhile, still have a free-flowing source of income. A 'stream' of wealth, if you'll pardon the pun. Although most of their money will usually be tied up in their business, some is available for investing and they are keen to prepare for the future.

Everyone's circumstances are different, but in our experience, what our clients usually want most from their investments is peace of mind. In practice, this means a portfolio focused on real wealth preservation. But what does that look like?

Our view is that a wealth manager's role is not to deliver striking 50- or 100-fold gains. That is the domain of entrepreneurship. Similarly, betting on promising new businesses or the next big thing is best left to venture capitalists.

That's not to suggest you should avoid these types of investments – they can (and often do) sit happily alongside a wealth preservation portfolio. Nevertheless, we believe in preservation first, and as a result, our portfolios are balanced between 'return' and 'diversifying' investments.

Our growth-oriented return assets aim to provide above-inflation returns over the long term, while our diversifiers seek to offer important protection against large losses as well as generating alternative sources of returns away from equity markets.

It's an approach that may feel pedestrian when compared with the excitement of founding a business or investing in what might become the next Amazon or Nvidia. However, we are confident that prioritising preservation is the right objective for every wealth owner, for some or all of their liquid assets.

In the words of Nathan Mayer Rothschild in the early 1800s, while it requires "a great deal of boldness and a great deal of caution to make a great fortune", keeping that fortune "requires ten times as much wit".

WHY WE DIVERSIFY

One alternative to a preservation-first portfolio is to fully invest in equities. At first glance, the case for this seems strong: $100 invested in the S&P 500 in 1928 would have been worth more than $787,000 by 2023.[3]

By contrast, $100 placed in corporate bonds would have grown to just $49,500 – roughly 94% less over the same period. With 10-year Treasuries the performance is even worse, returning a mere $7,300 on the original $100.

Which begs the question, if equities deliver superior returns over such long time horizons, why diversify at all?

First, we should stress that we are big believers in long-term equity ownership. The bulk of our portfolios is invested in return assets, the vast majority of which are linked to the stock market. We view equities as essential to outpacing the eroding force of inflation, which would likely eat away at a client's wealth over the long term if they placed their money solely in ostensibly 'safe' investments or cash.

So the issue as we see it is not whether to own equities, but instead what percentage of a portfolio should be invested in them. For us, this is always a function of the available opportunities, and never determined by a fixed allocation.

When we invest, our investments are selected on their merits, looking not only at the forward returns we expect them to produce, but also any risks they may present. We do not attempt to 'buy the market', as it were.

Our allocation to equities will therefore vary over time; setting it to 100% might force us to buy equities at times when we believe they don't provide real value.

Moreover, equities do not always deliver the best returns, even over long periods.

Consider Japan. Someone who invested 100% in the Japanese stock market during the late 1980s would have enjoyed spectacular growth – until the bubble burst. From January 1990 to January 2000, this investor would have lost 35%, even when allowing for the reinvestment of all dividends (using data from the Topix Total Return index).

[3] NYU Stern School of Business. Historical Returns on Stocks, Bonds and Bills: 1928-2023.

> "Profit in the share market is goblin treasure: at one moment, it is carbuncles, the next it is coal; one moment diamonds, and the next pebbles."
>
> *Confusion of Confusions* (1688), the earliest known book about stock markets

By January 2010, after 20 years, the situation would actually be worse rather than better: the fully invested Japanese equity portfolio would be down 61% from the reference point in 1990. What's more, it took until February 2021 for the Topix index to close higher than it did in June 1991 – almost 30 years.[4]

Opportunity cost must also be factored in; the gains one could have enjoyed by being invested elsewhere instead.

With this in mind, it's perhaps not surprising that many people feel uncomfortable with both the instability and periodic large falls in portfolio value that inevitably come with an equity-only approach.

The Japanese experience has been rare, admittedly, but similar scenarios are not outside the realms of possibility. After all, any meaningful discussion about wealth preservation should always carefully consider risk.

RISK IN REVIEW

In his book *Mastering the Cycle*, American investor Howard Marks provides a good working definition of investment risk: the likelihood of permanent capital loss.

From a practical perspective, we would consider any significant loss of capital, and related negative real returns, that span 10, 20 or 30 years as meeting this criteria.

A permanent loss may occur when an individual investment collapses in price and never recovers, or when investments are sold during a drawdown, preventing the investor from enjoying any subsequent rebound.

Importantly, we must make a distinction here between the above scenarios, and the regular volatility in asset prices that are an inescapable feature of financial markets. After all, stock markets are inherently cyclical; they have peaks and troughs, upswings and downswings, ebbs and flows.

It is not our intention to be glib when we describe the losses experienced during a typical downswing as 'temporary'. Some may last up to two or three years, which we recognise is a deeply discomforting amount of time for any investor. Nonetheless, this rarely represents an existential threat to a portfolio.

"Every once in a while, an up- or down-leg goes on for a long time and/or to a great extreme, and people start to say, 'this time it's different'," Marks says.

"But then it usually turns out that old rules do still apply, and the cycle resumes. In the end, trees don't grow to the sky, and few things return to zero."

However, 'usually' is not 'always'. Some risks that appear temporary may develop into something more enduring. How does this affect our approach to wealth preservation?

Our goal is to soften the impact of temporary losses in a way that, we hope, doesn't deprive our clients of sleep. At the same time, we want to entirely avoid the more severe investment risks that could result in permanent, irrecoverable losses.

We seek to do so by being thorough and robust in our research before adding any investments to our portfolios. Only resilient companies and third-party managers, with skilled leadership teams and sustainable competitive advantages, make the cut.

Is a business built on strong foundations that ensure its long-term survival, like a river, or is it too vulnerable to external forces that could evaporate its attractive returns, like a puddle? Like De Geus, we have far more confidence in the long-term success of companies that behave like rivers.

Lastly, risk often has negative connotations. In one study, 'loss', 'fear' and 'danger' were among the top words that banking customers associated with the concept of risk.[5] This is understandable, and we hope that we have allayed any concerns that our readers may have about our approach to risk.

One word which was missing from the study's responses, however, was 'opportunity'. During a market downturn, being overly risk averse can prevent investors from taking advantage of price drops in companies that otherwise have strong fundamentals. It is therefore crucial to balance risk and return appropriately.

To quote American investor Cathie Wood: "The strongest bull markets I've been in are built on walls of worry."[6]

[4] Financial Times: Japan's Topix stock index closes at highest level since 1991, 8 February 2021.

[5] Risk Savvy: How to make good decisions, p99, Gerd Gigerenzer, 2012.

[6] Bloomberg UK. Cathie Wood Buys the 13% Dip in Tesla as ARKK Slips Again. 23 February 2021.

STRAYING FROM THE HERD

For Adélie penguins, swimming in the Antarctic Ocean is a double-edged sword. While the ocean is home to the krill that form a big part of their diet, its chilling, murky waters also conceal leopard seals that prey on them in turn. Eat or be eaten.

According to behavioural economist Michelle Baddeley, penguins use social learning to judge the best course of action when it's feeding time. In other words, they wait to see what their pals do – once one hungry penguin plunges into the icy depths and breaks the surface unscathed, they all quickly follow suit.

This behaviour is called 'herding', and humans are just as prone to it as penguins.

"We herd because it is quicker and easier just to follow others, even if there is a chance we are simply copying their mistakes," Baddeley explains.[7]

Herding is common among investors, especially when markets are either at their peak or bottoming out. This is usually a result of the 'affect heuristic', a mental shortcut the brain uses for making decisions based on a person's current mood.

And while most of us would like to see ourselves as rational, objective decision-makers, this is not often the case. In fact, herding is just one example of behavioural biases that can affect investors, but there are many others, including confirmation bias, loss aversion and the endowment effect.

People's emotions tend to act like a pendulum, swinging from wild euphoria to abject despondency in lockstep with the fluctuations of the market cycle.[8]

In periods of market exuberance, investors often succumb to greed, chasing stocks at lofty valuations in fear of being left behind as others profit. Similarly, when prices plummet, panic often overpowers prudence, driving investors to sell in haste, desperate to stem their losses.

Although it may seem counterintuitive, investment risk is often highest when it feels lowest and vice versa. Speculating on the perfect moment to enter and exit investments can invite the very losses one hopes to avoid, particularly for those who buy at the market's peak and then crystallise temporary price drops by selling at its nadir.

Our firm belief is that time in the markets is far more effective than timing the markets. That's why, during periods of turbulence, when emotions are running high, the true advantage usually lies in resisting the pull of the crowd.

This is easier said than done. Artist Vincent van Gogh rightly identified the "little emotions" as the "great captains of our lives", captains we obey without knowing it. And to cut through the noise, it helps to have a clear focus on wealth preservation.

[7] Copycats & Contrarians: Why We Follow Others … and When We Don't, p 92, Michelle Baddeley, 2018.

[8] Mastering the Market Cycle, p83, Howard Marks, 2018.

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BEYOND INVESTING

We hope that we have made a compelling case for why we believe wealth preservation is the right approach from an investment perspective. But it is also important to address the more personal aspects of wealth management.

Whether wealth has been passed down over multiple generations or it is a more recent acquisition, most families want to protect their legacy and prepare the next generation to be responsible custodians.

Many people also appreciate having a sounding board for their ideas, or are keen to play their part in preserving the environment and communities that their children and grandchildren will live in. Preserving a legacy can mean many different things to many different people.

Put simply, a wealth manager's role isn't solely to maximise investment returns. That is the domain of asset management. We aim to take a broader, more long-term view of your goals for the future, and work closely with you on how to achieve them.

For some, that may include choosing the right time to sell a business or planning how much money is needed for retirement. Others may be keen to prioritise investing more sustainably, such as through our Exbury portfolio.

That being said, we do not pretend to be all things to all people. As the Chinese philosopher Confucius said, "the person who chases two rabbits catches neither". For this reason, we're always pleased to introduce our clients to trusted contacts within our wider network who may be better positioned to help them.

Ultimately, it is always our hope that we will be working with our clients for decades, and ideally generations. Which is why a focus on real wealth preservation is our guiding principle at Rothschild & Co.

The challenge comes with actually delivering it, consistently and well, over the long term. We remain grateful to you, our clients, who continue to trust us to do that.

KING OF SWING

The S&P 500's annualised average real returns have been approximately 10% since its inception in 1957. However, the index has only returned between 8 and 12% on five occasions during that time – and only once in the last three decades.

Conversely, returns have been more than 20 percentage points either side of the average (beyond +30% or -10%) 16 times over the same period, or roughly once every four years. In the words of Howard Marks, "the average certainly isn't the norm" with stock market performance.[9]

[9] Ibid, p86

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.

Important information