MANAGING LONG-TERM CAPITAL: A FEW BEST PRACTICES

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The recent market volatility has made many investors anxious (and sometimes panic). It has also given them the opportunity to give additional thought to the construction of their portfolios. Sharp moves in markets will reveal the weak points in portfolios, and these rare events are both a wakeup call and an opportunity for investors to reassess their levels of risk, their portfolio construction and objectives. In other words, it is an ideal time to understand how you are invested and why. We have found this process not only helps investors sleep better at night but also helps them recognize opportunities amid the chaos.

When thinking about managing long-term capital, I can draw many parallels between managing an endowment fund and managing family wealth. Many of the methodologies, practices and processes I developed for the endowment fund I managed for many years I also use to benefit families here at Omnia. It turns out that how our families are invested and why is not unlike how some of the large endowments are invested, often to address similar goals and challenges.

CHALLENGE #1: CONFLICTING TIMEFRAMES

In an endowment, each year, ideally 5% of the endowment's assets are distributed to support the organization's day-to-day activities. At the same time, there is a focus on growing and preserving the real value of the wealth for generations to come. Practically speaking, this means achieving long-term returns that outpace the 5% distribution plus inflation. **This simple concept is very important, because it changes the way we think about the construction of the portfolio, the asset allocation, the assets we invest in, the diversification level and the portfolio's liquidity profile.**

Like endowments, families must be able to support their day-to-day operations and objectives but also ensure future generations are taken care of. Investing on behalf of family members who are not yet born is hard to comprehend, but yet, this is exactly how we think when managing intergenerational wealth. Our goal is always to preserve the real value of wealth accumulated over many years of hard work and support short-term distributions for a very long time.

CHALLENGE #2: LONG-TERM PORTFOLIO CONSTRUCTION AND PLANNING

Portfolio construction should be a process. Rather than chasing a few 10x investment opportunities, the process must be sustainable and repeatable, focused on lowering volatility and thereby enhancing long-term returns. We review new investment opportunities on a daily basis, and many times, we pass on even the most compelling opportunities because they do not fit our specific investment criteria. We believe sticking to a long-term investment strategy is critical. Staying the course, even when faced with market swings and investment trends, has proven to be successful over time.

Best practice: Lay the groundwork

Long-term investing requires long-term planning, and long-term planning means knowing which opportunities are on the horizon for the markets in the next few years. Researching those coming opportunities in the present to lay that groundwork means knowing ahead of time what changes will be made in the portfolio at different market scenarios (including taking advantage of large and swift market dislocations) and what capital distribution the family might need in these scenarios, balancing current needs with future investment objectives.

Best practice: Invest, don't speculate

Without a process driven by an objective view on the most important aspects of investing, such as asset valuations, risks in markets, macro factors, market cycles and geopolitics, investing becomes speculating.

Investing for many years brought me to realize how much randomness there is in markets that we just can't explain, often not even in hindsight. Trying to find an explanation for what happened in the short term is usually a waste of time. Avoiding the trap of randomness and building discipline requires a robust investment process for assessing opportunities and risks, portfolio rebalancing, tax harvesting, and of course, decision making. The process has to be repeatable and understandable to everyone on your team. But most importantly, it has to evolve over time. We cannot assume that what worked in the past will continue to work in the future (i.e. 60/40 stocks and bonds portfolios).

Best Practice: Use alternative investments

When building portfolios, for endowments and families alike, it is key to find sources of returns that are not dependent on the same factors. For this reason, many investors turn to alternative investments to achieve greater diversification and soften portfolio volatility, especially as equity and fixed income markets become more correlated over time. Alternative strategies require the advisor to have the expertise and the capabilities to conduct rigorous due diligence. The dispersion in returns between top tier managers and the rest is significant, which makes the access to these managers the only way we can justify an investment in alternative strategies. Like any investment, it is important to consider what role a particular alternative investment plays in the overall portfolio.

Best Practice: Accept that you will be wrong at times

Long-term investing does not always agree with the short term and can often conflict in terms of asset pricing. This short-term pricing disconnect can make an investor appear "wrong," even if an investment decision is prudent in the long run. A fear of looking wrong can drive many bad decisions. If we fear looking wrong or missing out and, as a result, chase performance, it is unlikely we will have the desired outcome. **This cycle of fear and greed is the biggest enemy to successful long-term capital management.**

Best practice: Risk management

For endowments and families alike, risk management is one of the most important aspects of investing. But it is also one of the most misunderstood. Because risk management can be subjective at times, it's important to be defined in advance. While this topic requires a lengthy explanation to properly understand it, in a nutshell, we view it in two timeframes: short and long.

In the long term, we use risk management to actively identify and protect against long-term tail events, loss of principal and eventual disruption to a family's lifestyle. In the short term, we use risk management to monitor whether or not individual investments are playing their expected role in the overall portfolio.

Risk management is an integral part of the investment process and one of the main contributors to strong long-term performance.

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Best practice: Ensure objectivity and alignment of interests

It may sound basic, but it is surprisingly rare to find objectivity, particularly in large wire houses where the advisors are compensated on the sale of "products." Endowments make investment decisions based on the goals and financial circumstances of the non-profit for which it was created. In the same way, families should follow investment advice based on their interests and goals.

It is our belief that families deserve the same objective investment advice that endowments receive, and the independent, un-conflicted advisor model can help mitigate this risk and ensure a family's investments are truly serving their best interest.

WATCHING PAINT DRY

Most advisors hate to admit it, but managing an endowment and family's capital is often like watching paint dry. With 90% of the time assessing risks, markets and opportunities, and only 10% of the time managing the portfolio, it can seem like a portfolio manager is not "doing enough." From decades of experience, we know that activity for activity's sake can lead to poor decisions and results.

This approach requires discipline on both sides of the equation: the advisor and the family. The advisor can't feel the pressure to show activity only to justify his existence, and the family needs to understand that prudent portfolio managing doesn't require many transactions; in reality, it can be the opposite.

This reminds me of an old joke about two piano students, one is playing a complicated symphony, and one keeps hitting the same key over and over again. When the teacher asked him why he's not playing like the other student, he replied that the other student is still looking for the right key, but he already found it!

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