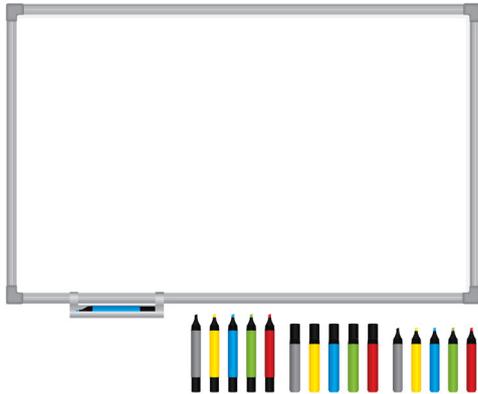


Whiteboarding 2.0: Diversification ... The Report

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FOREWORD

In 2014 Brookvine ran a half-day workshop modestly entitled 'WhiteBoarding 1.0'¹. At that time a select group of private wealth advisors and CIOs to High Net Worth (HNW) clients and Family Offices (FO) challenged the principles, models and beliefs of institutional investing. They discussed the extent to which these principles may not apply to smaller Australian private wealth funds. By design WB1.0 sacrificed depth for breadth with the promise that WB2.0 would focus on a single topic in greater depth. *Diversification* stood out as that topic.

WB2.0 saw a group of advisers and CIOs to HNW/FOs take on the challenge of critically assessing the role of diversification in their thinking and practice.

ABSTRACT

The wisdom of diversifying an investment portfolio is ancient. Buffett's claim is no more than a modern version of the biblical instruction to "divide investments among many places, for you know not what risks might lie ahead." A millennium later the Talmud offered a more explicit instruction that wealth should be divided equally between "buying and selling things" (equity), "gold coins" (cash) and "land" (real estate). It was a naïve but quite reasonable asset allocation.

Until Markowitz' Modern Portfolio Theory, some 60 years ago, diversification was justified by the slogan "don't put all your eggs in one basket". This stood in opposition to the less common but for some equally valid, "put all your eggs in one basket but watch it very carefully." By quantifying portfolio construction Markowitz transformed diversification from a slogan to an operational tool that explained why and how diversification works.

The transformation was remarkable. Diversification moved from theoretical insight to black letter law in a mere 20 years. It became an investment truism, typified by hedge fund manager Paul Tudor-Jones' claim that it is the "single most important thing" in portfolio construction.

By law superannuation funds must "have regard to" diversification. For MySuper² it is compulsory. Yet WB1.0 revealed many private wealth portfolios (especially Self Managed Super Funds³) are less than 'optimally' diversified ... often for sound reasons.

"Diversification is a hedge against ignorance."

Warren Buffett

VOICES, IDEAS, COMMENTS AND CRITICISMS

"Diversification is not about trying to get rich quick."

WB2.0 Participant

WB2.0 began with a flow of comments on portfolio diversification. The consensus view was that its primary purpose is to reduce the risk of capital loss, improve the likelihood of meeting investment

1. See 'Re-thinking an Investment Model for HNW and FO Investors' at www.brookvine.com.au/58/Recent-Presentations-Papers.

2. MySuper funds are the defaults offered by Australian superannuation funds, legislated to "... create a range of easily comparable, relatively simple products, which ... will focus competition on net costs and returns."

3. A Self Managed Super Fund (SMSF) is an Australian trust structure that is used by individuals and families to manage their retirement savings.

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objectives and smooth returns (i.e. lower volatility). By way of contrast most wealth is created by *not* diversifying. Rather it is made by concentrated direct investment in a single undiversified business. That makes it hard for some wealth creators to appreciate the logic of diversification in their investment portfolios.

Moreover, any one individual's experience, investment style and personality may be quite different from someone else's. One investor's diversification can be another investor's concentration.

WB1.0 highlighted the importance of sensitive advocacy skills in managing HNW families. This is nowhere truer than in the need to convince HNW families (particularly founders) of the benefit of diversification as an effective way of preserving capital.

“You can accumulate an extraordinary amount of wealth by not diversifying.”

WB2.0 Participant

As the putative benefits of diversification are often not apparent for some time, advisor advocacy is particularly demanding. Nevertheless participants saw extra benefits to engaging in discussion about diversification. It helps clients better appreciate and cope with uncertainty. Importantly it exposes mutually exclusive objectives clients sometimes have and leads them to a better understanding of trade-offs.

Diversification is often misunderstood. This is partly because abstract notions of optimality, efficient frontiers and covariance demand sophistication most clients do not have. However without *some* level of investment understanding clients can be seduced by the simplicity of “naïve diversification” that is unlikely to deliver diversification's full benefits. An example is the “1/n” Talmudic heuristic mentioned in the Abstract.

“One needs to step away from convention to find truly diversifying assets.”

WB2.0 Participant

Participants saw a special challenge in explaining how those full benefits require stepping outside conventionally accepted asset classes. There is a need to move into unfamiliar assets that offer a greater chance of low correlations and genuine diversification.

However participants claimed the unfamiliarity of these asset classes, and difficulty of gaining access to them, make it difficult to allocate sufficient capital to have a material impact. Examples discussed included different types of hedge funds, private lending strategies like real estate lending, niche strategies like catastrophe bonds, real assets like agriculture and timber, infrastructure, oil and gas, and collectibles such as art.

Of particular concern was the paucity of opportunities that offer genuine diversification within an income oriented portfolio (this creates an opportunity for both managers and advisors).

Participants broadly agreed that they can readily explain the underlying ideas of diversification. They can use concrete examples and intuitive notions such as spreading across asset classes, industries, countries and currencies; as well as across liquid and illiquid assets, across privately held direct assets and investments in publicly held securities.

It is more challenging to explain the concept of diversification by investment strategy and approach within asset classes.

Some also distinguished between traditional portfolio notions of diversification and a somewhat different type in which portfolios are structured around familiar and purposeful ‘themes’ with different time horizons from which a diversified portfolio almost falls out. For example a diversified portfolio would fall out of one including themes such as income, aspirational/opportunistic, security, legacy/philanthropic, and fun/trading.

A point was also made that, even if one is not expecting particularly strong investment returns, a diversifying investment serves an important purpose in any portfolio construction process.

Some participants suggested that private wealth investors have some advantages over institutional investors, perhaps due to differences in their *motivations*. Although the latter can more easily access exposures to infrastructure, hedge funds and other alternative assets that offer genuine diversification, it was argued that they also focus excessively on costs, benchmarks and peer groups at the expense of *improved* diversification.

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For instance, institutional investors often favour highly diversified (low conviction), long only portfolios that closely mimic equity and bond market indices. Some HNW/FOs on the other hand are biased towards less diversified (high conviction) portfolios but may also include greater exposure to absolute-return oriented funds and niches in mainstream markets that offer better diversification to broad-based indices.

The limited inclusion of hedged equity and bond strategies by most institutional investors is a real limitation to their diversity. These strategies accommodate shorting, (albeit with a net long position) and dynamically adjust their exposures to the market.

“No one has ever been sacked for over-diversifying.”

WB2.0 Participant

Participants agreed with institutional investors that the tools of diversification apply across asset classes and across investment approaches provided the focus is on intrinsic investment characteristics and strategy, not merely on ‘style-labels’ such as value and growth.

There was little discussion on diversification across risk factors, a topic that dominates institutional thinking if not practice. This was not surprising given the lack of agreement on what constitutes a risk factor and the difficulty of modelling the often idiosyncratic risks in private wealth portfolios.

Yet participants were concerned that, even in conventional ‘70/30’ portfolios despite being diversified across international, domestic and emerging equities, real-estate, bonds and credit, around 90% of portfolio risk remains equity risk.

“Diversification is a veil to hide behind.”

Charlie Munger

Strong comments were made on the risk of over-diversifying (‘diworseifying’), consistent with Charlie Munger’s admonition, a common result of advisors and other agents (subliminally?) minimising career and business risk.

Agency issues led to the query: are there material differences between diversification in advisors’ personal accounts (PA) and those of their clients? The consensus was that often there are differences that can be justified by different objectives, liquidity needs and risk tolerances. One participant claimed that “most” investment professionals under-diversify their PAs on the grounds that “it’s my money so I can have more of a punt.”

Whether diversification is the oft-touted free lunch led to vigorous discussion. Participants saw the main ‘cost’ as the added complexity of more asset classes, demanding more advisor time, thus making fees an issue.

Related to cost was an engaging debate about the *perceived* failure of diversification. This was seen as a consequence of economic and portfolio globalisation and of post-crisis central bank policies. High correlations between asset classes makes diversification less attractive, except perhaps for very long-term investors. This view is re-enforced by the one-way path in asset prices clients have experienced for almost a generation.

There was some agreement that a more dynamic approach to diversification is now needed to replace the more common quasi-static approach. This suggested to some advisors to HNW clients that the pricing models for services needed to be scaled to accommodate different levels of value add.

DIVERSIFICATION IN PRACTICE

Following this discussion participants separated into groups to discuss a hypothetical case study designed to challenge the way we think about diversification through two distinctly different investor types with different goals and objectives⁴.

The case involved two brothers who inherited wealth from their businessman father. Klyde, an entrepreneurial businessman and decision-maker who created wealth by building a narrowly focused business, sets up a family trust for the benefit of his immediate family and future generations. Because his passion is for building businesses he probably does not wish to relinquish control. That makes the trust’s implicit purpose and objectives somewhat ambiguous and therefore challenging for an advisor/CIO wedded to the tenets of Modern

4. The full case study is available from Brookvine on request.

Portfolio Theory.

His brother Cerry, a delegator with minimal interest in investing, sets up a philanthropic trust to support the arts. The trust has an explicit purpose and objective: to spend 5% pa to maintain its tax-free status. Currently it is heavily weighted to property and art.

Both Klyde and Cerry chair their trusts and seek advice on diversification from the participants.

DIVERSIFICATION SHAPED BY FINANCIAL CONSTRAINTS AND EMOTION

It was immediately apparent that diversification would remain an abstract notion in the absence of an appreciation of the family's experiences, expectations, idiosyncrasies and the trusts' purposes and objectives.

Participants did not feel inclined to presuppose a model for diversification. They sought answers to questions with both financial and emotional/ psychological dimensions.

Questions asked included the following: What do the principals of the families hope to achieve from the investments? To what extent are unrealised taxable gains an impediment to change? Is there any disgruntlement amongst family members? What might emerging success and failure look like? What do they worry most about? What time horizon do they think in terms of? What level of control do they want? What role do they want to play in day to day investment decision making? What are their biases and predispositions and how strong are their convictions? What are their personality types? How do they think about and describe risk? What is their attitude to leverage? What competitive and comparative advantages might the trusts have?

"I used to be in the *get rich* business; now I'm in the *stay rich* business."

Anon

TENSION BETWEEN ENTREPRENEURIALISM AND PORTFOLIO DIVERSIFICATION

Investment issues around the entrepreneur Klyde's approach generated disagreement and debate about the trust's purpose, a challenge (likely) exacerbated by his forceful and (over-) confident personality.

Like many who create substantial wealth, Klyde achieved this through an unrelenting focus on a single business in a single industry. He kept all his eggs in one narrow basket and watched it very carefully. In fact his experience with diversifying his businesses (a fact made plain in the case study) had diminished his wealth. He may well argue with justification, to continue to keep his eggs in the basket he knows very well. Participants expected his refrain to be "leave my businesses alone and don't lose my money".

To someone like Klyde, it makes sense that you limit your investments to those situations where you are knowledgeable and confident. The less experienced you are, he might say, the more investments you should hold.

All participants saw the initial configuration of Klyde's trust, with a dominant exposure to the idiosyncratic risk of a single business, as inadequately if not dangerously under-diversified. The portfolio is exposed to a meaningful risk of a sizeable capital loss that could be materially reduced through effective diversification.

The exact form of that diversification and how it should be implemented was discussed. The consensus was to reduce the weight of legacy assets over time in a tax-effective manner. Participants generally favoured a portfolio with (by institutional standards) more calculated bets, a concentrated set of investments, a still sizeable interest (at least at the outset) in the legacy business and direct ownership of (at least some) other assets. They also favoured a program of sizeable shifts in allocations over time and recognised cash as a very active part of the overall portfolio mix.

Two competing investment models gave effect to this preference; the *entrepreneurial model* and the *transitional model*⁵

5. Labels of different investment 'models' were devised by the authors to best fit the description of the respective models given by participants.

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The *entrepreneurial model* favoured (but not exclusively so) a concentrated set of investments with which Klyde is familiar, and interests in operating businesses and assets aligned to his experience and networks and those of his investment team. There was a strong preference for direct ownership of assets and a reluctance to invest in commingled funds except in exceptional circumstances. These other assets added some diversity to the overall mix, albeit they were sizeable individual commitments. The *model* (likely) needs to be managed by an exceptionally talented in-house team, perhaps supplemented by outside investment advisors. What it lacks in diversity may (at least in part) be compensated for with the benefit of time and the trust's unique advantages in deal flow.

The *transitional model* more determinedly reduced the weight of the 'legacy' business. It favoured a far higher weight to non-operating assets and adopted more conventional notions of diversification. It adopted a plan to transition to a (somewhat) broader and more balanced array of assets over time. It was more accommodative of commingled fund investments, and more explicitly adopted an investment policy that included investments in public markets and alternative assets, but remained avowedly opportunistic. It will work with Klyde to vet opportunities originated via his networks.

Given the breadth of its activities the *transitional model* was expected to be more demanding of very sophisticated outside investment advice. This was needed for the origination, due diligence and monitoring of investment opportunities, working with an engaged chairman-entrepreneur, accommodating a mix of operating companies, direct investments in other assets and fund investments, and maintaining investment discipline.

The structure and function of the investment model was tailored to the needs of Klyde's family. By helping Klyde choose the right structure first – whether *entrepreneurial* or *transitional* – all the key investment pieces fell in place more quickly and efficiently. Given a plethora of factors from family dynamics to economic conditions, there was also recognition that the chosen *model* and its approach to diversification need to be as flexible as possible over time.

It was nonetheless a challenge to convince Klyde of the need for (at least) some diversification and to maintain investment discipline. Participants were of a common mind that there is nothing like the power of a good idea properly presented and well argued. But it must recognise the client's financial and emotional/ psychological dimensions.

There was also agreement on the need for a "family governance document". This was to deepen the meaning and expectations underlying the trust's purpose "for the benefit of current and succeeding generations." It would also help link any proposed investment strategy to Klyde's (and his family's) sense of financial and emotional well-being.

CLARITY OF PURPOSE LEADS TO DIVERSIFICATION

For a number of reasons Cerry's philanthropic trust was less problematic. On the financial side, its purpose and goals are relatively clear and explicit and tax plays a marginal role. On the psychological/ emotional side Cerry has no interest in the existing financial assets so it is unlikely he will argue for greater concentration. His personality and character are more benign with a more charitable world-view.

Naturally, participants saw the initial configuration with dominant exposure to Australian real-estate, as inadequately if not dangerously under-diversified. The portfolio is exposed to a meaningful risk of a sizeable capital loss. This could be materially reduced through sales, with the proceeds directed towards effective diversification. Cerry's trust has other legacy assets to which he has a strong emotional attachment. But these are of an unusual form – paintings. As some participants argued, such collectibles should be an effective diversifier.

There was agreement on the preferred investment model - the *outsourced model*, albeit one with oversight by Cerry. As decision-making would not be highly constrained by Cerry's preferences the model favours a more balanced mix of assets. It was primarily delegated to the investment advisor.

This suggested a blend of traditional public markets investments and a heavy mix of alternative assets. There was no direct interest in operating assets given Cerry's lack of interest in these assets. Benchmarks and tracking error were, by institutional standards, irrelevant. As the trust is perpetual, participants generally felt it should have considerable tolerance for short-term variation in performance and for long-duration assets (particularly real assets like agriculture, infrastructure and timber).

Cerry's paintings were accommodated, but only on the proviso they make up a small part of the overall allocation. Participants recognised the important role that such non-traditional assets can play in the wealth of a family and its bequests.

"Diversification is harder to deliver, but the results are better and you have happier clients."

WB2.0 Participant

As with Klyde's investment program, participants favoured making sizeable shifts in allocations over time and recognised cash as a very active part of the overall portfolio mix. However participants noted a considerable challenge in finding and accessing individual investments aligned to the program's objectives - investments that offer inflation protection, a high current cash yield and portfolio diversification benefits.

CONCLUSION

Diversifying investment portfolios remains an (the most?) effective way of reducing the risk of loss of capital and of lowering volatility. It is *almost* the proverbial free lunch. For large institutional funds it is a key characteristic that should be weakened only under special and justifiable circumstances.

"Blind diversification won't deliver the outcomes you want."

WB2.0 Participant

Today, most investors need more *real* diversity, more scope to derive active returns and better protection against significant market downturns.

Yet for smaller Australian private wealth funds the full benefits of diversification are harder to achieve due to tax, liquidity needs, lack of access to unfamiliar

diversifying assets and the technical nature of supporting arguments. It is challenging for advisors to convince clients of the need for some diversification given the concentrated approach many have relied on to accumulate wealth and their strong emotional attachment to the businesses they have built. Good advisors are sensitive to these issues and can be positive advocates for levels of diversification that are 'optimal' given these constraints.

Overall WB2.0 re-enforced the view that for all investment professionals, not just the participants, the nuances of diversification are not fully understood and can lie hidden behind correlations that lack causal explanations. Diversification's value will be questioned again if the next crisis sees all assets go down together. Nonetheless, participants' thinking and practice have evolved. They are most concerned with the possibility of not meeting client objectives and protection of capital. While recognising there are no conclusive answers they are:

- Seeking assets that offer genuine diversification benefits
- Asking more questions about how much diversification is enough (and how much is too much)
- Thinking about diversifying across risk factors
- Exploring more dynamic approaches to asset allocation.

AFTERWORD

Investment decision-making was a crucial topic implicit in all Whiteboarding 1.0 and 2.0 discussions. How do (and 'should') we make decisions about ... asset classes, diversification, strategies, managers, ...? How and why do we select from the myriad of investment opportunities competing for our attention? How can we assess and improve our individual and group decision-making?

In 2016 Whiteboarding 3.0 will (courageously) address this most demanding of all investment topics: The quality of our decision-making under uncertainty – surely *the* primary determinant of longer-term performance.

ABOUT WHITEBOARDING⁶

All our thinking, decision-making and actions are heavily influenced by conventions, by what is broadly acceptable, by what has been done previously. Keynes called this latter behaviour – our extrapolating the past into the future – a convention.

Brookvine's *Whiteboarding* initiative aims to remove the constraints of convention and legacy to allow genuinely fresh ideas and thinking to surface. *Whiteboarding* participants are stimulated to develop fresh approaches and solutions to investment problems relevant to their business. Each session culminates in the preparation of a white paper containing all ideas and specific pragmatic recommendations.

ABOUT BROOKVINE

Brookvine helps investors challenge convention by introducing them to exceptional funds managers and to fresh investment thinking. We are passionate about the benefits of both alternative investments and unconventional approaches to mainstream asset classes.

Brookvine was established in 2001 and has raised over \$10 billion for select managers from institutional and private wealth investors. Our skills lie in selecting a small number of opportunities and bringing them to market. Brookvine also invests in and supports the development of emerging managers.

For further information see www.brookvine.com.au. For access to Brookvine's newsletter, *The Vine*, please contact thevine@brookvine.com.au.

WHITEBOARDING 2.0 PARTICIPANTS

Whiteboarding 2.0 participants included representatives from the following organisations (in alphabetical order), as well as representatives from several family office and multi-family office organisations who declined to include their logo in this report.



6. The idea of starting from scratch has an ancient lineage in the history of ideas. In investing it was first suggested by George Soros in the 1970s and first implemented by David Swensen at the Yale Endowment in the 1980s. Our approach was further influenced by 'The Portfolio Whiteboard Project', produced by Cathleen Rittreiser in 2013.

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