October 15, 2015

You have Won the Game; Now What?

We very much understand that many fortunes come from having capital concentrated. Indeed the source of wealth for most families that I have had the privilege of advising has usually had one of four origins, namely --

1. Ownership of one or more closely held businesses,
2. Compensation often in company stock of senior executives of public companies,
3. Compensation received through partnership in a law or accounting firm or as an M.D., or
4. Privately owned real estate.

Of course this does not mean that the majority of business owners amass fortunes, nor does it mean that all professionals become wealthy. In the case of highly successful business and real estate owners, most have been disciplined about reinvesting their profits back into the closely held businesses and real estate over decades. Over time the sales, earnings and cash flow of the underlying businesses, nurtured by reinvested capital, increase to the point that they have amassed considerable wealth. In the case of highly successful executives and professionals, they usually have done a great job of saving and reinvesting significant portions of their compensation into their company stock or a portfolio of stocks.

As an investor, I like to see management having significant "skin in the game" and we certainly appreciate how and why business owners plough capital back into "what they know". However, after working diligently, many successful people face very difficult choices about how to invest their capital to achieve their individual or family's goals. This can be even particularly daunting if, and when, a closely-held business or real estate is sold or when the executive or professional practitioner retires. Much of that decision comes down to personal preferences with respect to capital gains taxes and how they might best navigate the risks inherent in the stock and bond markets.

The first question many people face when they approach their retirement years is whether or not they should continue to hold concentrated interests or whether they should pursue diversification strategies. First, we appreciate the feeling of pride and sense of loyalty that stems from a successful career where the company's stock has been rewarding. Nevertheless in this letter, I want to highlight some of the things to consider with respect to owning wealth in publicly traded securities and in particular, stocks.

There are many potentially viable approaches that one can take after selling a business or retiring from a career as an executive or professional. As advisors, ***our chief responsibility is to provide advice and solutions that our clients can adhere to that have a relatively high likelihood of long-term success vis-a-vis their financial needs, wants and aspirations.*** Much of the decision boils down to our having a proper understanding of what is most important to and comfortable for our clients. However, we also need to help ensure that each of you has an understanding of the potential benefits and risks inherent in common approaches to investment management for wealthy individuals and families as well as endowments & foundations.

Which Risks do You Want to Bear?

As we all know, life is all about tradeoffs and this is certainly true of investment strategies and portfolios. If, on the one hand, you want to *attempt to* earn really high rates of return across your entire portfolio you could either concentrate your capital into a relatively small number of holdings and/or you could engage in market timing. Either *could* open up the possibility that your results will be particularly good. Most importantly, there are also substantial risks that those approaches will **not** generate favorable outcomes. In addition, ***since no strategy, sector investment manager, let alone individual stock always performs well, your resolve and conviction will almost certainly be tested along the way.*** An alternative is to allocate capital more broadly as means to reduce selection and timing risks.

Usually under a "buy and hold" approach, a relatively small portion of the underlying stocks in a diversified portfolio will drive the lion's share of the aggregate growth in the portfolio over the course of many years. For example, if the compound annual growth rate (CAGR) for an entire portfolio averages 7% annually over time, the majority of the underlying stocks will **not** perform nearly as well. In other words, the "average" return for the underlying stocks will track below the aggregate return. The table below shows the impact that different rates of return have on the change in portfolio value over time.

Growth of each $1.00 invested over 30 years

	Scenario 1				Scenario 2			
Performance rank	30 year ann. return	Growth of $1.00	% of tot. value	Cumul. % of value	30 year ann. return	Growth of $1.00	% of tot. value	Cumul. % of value
Top 10%	***14.0%***	***$50.95***	***46.9%***	***46.9%***	***14.0%***	***$50.95***	***55.7%***	***55.7%***
next 10%	11.5%	$26.20	24.1%	71.0%	11.0%	$22.89	25.0%	80.7%
next 10%	9.0%	$13.27	12.2%	83.3%	8.0%	$10.06	11.0%	91.8%
next 10%	6.5%	$6.61	6.1%	89.4%	5.0%	$4.32	4.7%	96.5%
next 10%	5.0%	$4.32	4.0%	93.3%	0.0%	$1.00	1.1%	97.6%
next 10%	3.0%	$2.43	2.2%	95.6%	0.0%	$1.00	1.1%	98.7%
next 10%	2.0%	$1.81	1.7%	97.2%	0.0%	$1.00	1.1%	99.8%
next 10%	0.0%	$1.00	0.9%	98.2%	-5.0%	$0.21	0.2%	100.0%
next 10%	0.0%	$1.00	0.9%	99.1%	-15.0%	$0.01	0.0%	100.0%
Bottom 10%	0.0%	$1.00	0.9%	100.0%	-25.0%	$0.00	0.0%	100.0%
Average/total	***5.1%***	***$108.59***			***-0.7%***	***$91.45***		
CAGR		***8.8%***				***7.9%***		

Imagine, for instance, that you purchased 100 stocks with a starting allocation of $1,000 or 1.0% each. The table above shows what happens to the aggregate change in value of the top performing 10 stocks, the next 10 and so on. As the table reveals, ***under buy and hold a small percentage of your initial capital will constitute the lion's share of total capital in the future***. I provided two hypothetical examples. In the first, all stocks at least maintain their initial value over the ensuing 30 years. The second may be more realistic as sadly, it is quite likely that some significant number will lose all or most of their value. Nevertheless, it is clear that the 80/20 rule or something along those lines is in effect here. Specifically under the two scenarios, the best performing 20% (best 20 out of 100 stocks) grew to become 71.0% and 80.7% of the total portfolio value in 30 years, respectively. Please note that under scenario one, the arithmetic average for the 10 deciles is 5.1% but over the 30 years, we find the capital has actually grown at a compound annual growth rate (CAGR) of 8.8%. The "above average ***minority"*** drive growth for the entire portfolio. The plot thickens.

These illustrations make clear that in retrospect, we will be able to conclude some stocks today are significantly overvalued and vice versa. After all, a relatively small number will deliver truly handsome returns while many more will prove disappointing. If the market was "all-knowing" this would not be the case as some would carry much higher market values today whereas many others would have appreciably lower values. Okay, so the market is mispricing things; doesn't that mean there is huge opportunity for us? Indeed if an investor were fortunate or skilled enough to just invest in the top 20 and nothing else she would have nearly 5x the wealth of owning all 100. Perhaps we should then focus hard, identify the future winners out of the herd and confidently invest accordingly. However, determining which small number of companies today will "ring the bell" in the decades to come has been the quest of "active" management from time immemorial. The obvious questions are: 1) how do we capture those "outliers"? and 2) what risks do we incur in taking this approach?

The potential for outsized gains is tantalizing. For instance, any investment that compounds at 14% for 30 years will experience a nearly 51-fold increase in value. However, notice that the majority of the stocks in both illustrations underperform the compound annual growth rate for the whole portfolio by a wide margin. In other words, ***the majority of the capital in both hypothetical portfolios is invested in securities that do not perform well.*** By concentrating, investors expose themselves to risks of owning too much in stocks that perform poorly and too little in those that delight. Indeed in my experience, many investors opt to concentrate their capital or stay in concentrated positions to their peril. Also because leadership among stocks changes rather dramatically over time and therefore no stock, manager or sector always does well, concentration means enhanced risk but also periods or heightened stress along the way. Therefore when some of your securities or managers are not performing well, what do you do? Sell them? Buy more?

To be clear, I am quite certain that in the benefit of 20/20 hindsight 10, 20 or more years from now, we will be able to identify stocks, sectors and managers that performed quite well compared to the overall stock market. That is a given. However, it is very difficult to make those judgments before the fact. We know that friction wears down the brake pads on our cars. Similarly, investment fees and taxes erode the returns that investors actually realize. Therefore, net of fees and taxes it is impossible for most managers or investors in the aggregate to do better than average over the long-term. Please go back to the table on the previous page. Imagine that your concentrated portfolio contains too few of the winners and too many of the ho-hum stocks that are more the norm. Do you find the risks that accompany concentration of capital to be more important than the potential reward?

With respect to trying to time in-and-out-of the market, I sincerely understand the desire to avoid losses. However when you sell stock there is a chance (not a certainty) that you will be able to invest it sometime later and at a lower price. If this proves to be the case, you will also need to capitalize by actually reestablishing the position. On the other hand, the market may surprise you by advancing appreciably higher. With markets there are always myriad potential outcomes and predicting the near term net of taxes and trading costs is a difficult challenge for many, if not most, investors.

Slow and Steady Wins the Race

Both scenarios reveal good news. With no prior knowledge of which stocks will and will not perform well, the investor who purchased and subsequently held either of these hypothetical portfolios would still likely realize a good outcome. Specifically for every $10 invested, the investor would have $108.59 or $91.45, respectively in 30 years' time. The market is a price discovery mechanism and whereas they were each equal sized positions in your portfolio, the best 20 stocks (20%) enabled a nearly 11-fold to 9-fold increase in aggregate value of the diversified portfolio.

Our approach is **<u>not</u>** designed to maximize upside because strategies that afford that potential also carry significant risks and higher probabilities of realizing unacceptable outcomes. A look back at the past 20 years (or indeed much longer) reveals a world and financial markets that are hard to predict. Because I truly do not know which market segment: "Growth" vs. "Value", U.S. vs. international, large vs. mid vs. small, developed world vs. emerging, let alone tech vs. financials vs consumer staples vs. energy, etc. will perform best over any particular time frame; we diversify. Indeed if I did know these things, we would not diversify; we would capitalize on our knowledge of the future and concentrate our holdings accordingly. That sounds eminently sensible. However we have to ask: How are we able to identify the market's mispricing of individual sectors, industries and stocks by say 20% or more? In other words, how do we see clearly what others (the market's current consensus) do not?

We leave market timing, manager selection and concentration risks to others. These other approaches are generally saddled with other hurdles like higher investment costs, lower tax efficiency (e.g. higher short and long-term gains realization) and the inherent difficulty of knowing what risk factors underlie the positioning by all of the managers that compose the overall investment portfolio. With respect to taxes, it is worth remembering that assets receive a "step-up" in cost basis when the account holder dies. So under buy and hold, it is possible to avoid paying much in the way of capital gains taxes.

We don't want to guess nor do we want to superimpose our biases (whatever they may be). Instead we want to follow the logic and history of the benefits of diversification. The first rule is to avoid unacceptable outcomes via incurring risk that can be prudently and effectively reduced. In hindsight, will incorporation of risk measures mean that some investors will end up with less than if they had just concentrated their holdings? Undoubtedly yes, but that is the same for fire, auto and life insurance. You can look back and say, 'that was a waste of money to buy insurance'. Or you could say, 'that provided the peace of mind to take prudent risks to build my business and I could not face the loss of my building or house to a major fire, nor could I have run the risk of being without car insurance.' ***When it comes to investing, we cannot consistently predict, let alone control, the movements of the markets, but we can prepare for the unknown.*** In other words, avoiding a catastrophe is job one.

In sum, our approach is to allocate capital broadly in order to reduce concentration risk and to simultaneously help ensure that meaningful amounts of the portfolio will always perform well, at least on a relative basis. Of course this also means that at all times some parts of our portfolio will not be performing as well as others will. In other words, there will inevitably be times when we will be able to conclude that our inclusion of small and mid-caps, or international market equities is not helping but rather they are hampering results. At these times some more concentrated approaches will likely appear more sensible. However, the game is not over in the first inning. Most importantly over the long-term, we believe diversification provides distinct advantages over most strategies.

W. Richard Jones, CFA
Senior Vice President, Investments

Opinions expressed are not necessarily those of Raymond James & Associates. Opinions are subject to change without notice. Information was received from sources believed to be reliable, but accuracy is not guaranteed. Past performance is not indicative of future results. Investing always involves risk and you may incur a profit or loss. No investment strategy can guarantee success. International investing involves additional risks such as currency fluctuations, differing financial accounting standards, and possible political and economic instability. These risks are greater in emerging markets. Investing in small and mid cap stocks are riskier investments which include price volatility, less liquidity and the threat of competition. Diversification and strategic asset allocation do not ensure a profit or protect against a loss. Investments are subject to market risk, including possible loss of principal. The process of rebalancing may carry tax consequences. Changes in tax laws may occur at any time and could have a substantial impact upon each person's situation. While we are familiar with the tax provisions of the issues presented herein, as Financial Advisors of Raymond James & Associates we are not qualified to render advice on tax or legal matters. Examples provided are hypothetical examples for illustrative purposes only. They are not intended to reflect the actual performance of any security. Investing in stocks involves risk, including the possibility of losing one's entire investment. The market value of securities fluctuates and you may incur a profit or a loss. This analysis does not include transaction costs and tax considerations. If included these costs would reduce an investor's return. Raymond James & Associates, Inc., Member New York Stock Exchange/SIPC