HEIRLOOM
INVESTING

DE-RISKING YOUR PORTFOLIO IN UNCERTAIN MARKETS

Heirloom Breakfast Seminar - September 2019

On September 18th, Heirloom hosted a breakfast seminar exploring the risks of the late stage in the investment cycle – particularly as they relate to correlation between traditional asset classes and the need for enhanced diversification in a family office portfolio. We were delighted with the level of interaction as the participants used this interactive forum to discuss and share their investment ideas and diversification strategies as well as network with their family office peers.

For those who were not able to attend, below is a summary of the general topics discussed.

SEMINAR GENERAL OVERVIEW:

A long period of monetary stimulus has caused great inflation in asset prices, particularly the traditional asset classes of equities, fixed income and real estate. As the market cycle is clearly in its later stages, many family offices are taking unnecessary risk by having their portfolios over-exposed to these asset classes, which cannot be expected to be uncorrelated in the next market downturn. The breakfast session explored the risk of the current market, the importance of diversification through truly uncorrelated investments, and how families can replace traditional asset classes with more attractive, and less correlated, alternatives.

THE MIXED MACRO-ECONOMY:

Since the 2008 financial crisis, economic structures and financial systems have been dramatically altered in a way that academics and market practitioners are struggling to grasp. The evidence of this distortion is everywhere. An unprecedented period of quantitative easing has led to massive asset price inflation and debt accumulation against a backdrop of flat real economic factors such as real wage growth. Developed countries in particular face headwinds due to aging demographics, slow-growth in productivity and record-high debt levels, leaving no room for further spending and investment. US corporate profits as a percentage of GDP are at all-time highs.

This all results in a massive transfer of wealth from the young and poor to the rich and old, which is not only economically unproductive, but also leads to rising social tensions.

In contrast, developing markets are seeing wages rising, exports expanding, labour participation increasing and productivity accelerating, all with a strong demographic tailwind.

THE CHANGING INVESTMENT CLIMATE:

Despite the favourable economic situation in developing markets, earnings multiples of listed companies in the developed world (particularly the US) are near all-time highs, while developing markets are below-average. This is even more prevalent in the private markets, as venture capitalists fund “unicorns” at multiples exceeding the “dot com boom”, while private equity buyout multiples are at all-time highs.

Not only are equity valuations in the West at all-time highs based on measures such as the Dow-to-GDP ratio and the Cyclically Adjusted Price to Earnings ratio, but the average yield on government bonds, the credit spread premium for lower-quality debt, and the volume of government bonds offering a negative yield suggest that fixed income is overvalued relative to history. In addition, real estate in many developed markets (although the US remains an exception) is trading near all-time low cap rates and housing affordability is near all-time lows. Commercial real estate is also under threat as online shopping is decimating regional / high street retail (albeit not local retail as of yet), and offices in prime urban centers see less demand as companies shift workers to cheaper centers or encourage telecommuting.

Meanwhile, the correlation of major asset classes has increased dramatically over the past decades, leaving little room for investors to diversify and protect their assets using traditional methods of diversification[i]. Family Offices in US, Europe and Asia have embraced a much heavier allocation to alternative investment strategies in an attempt to diversify. However, Canadian and Middle Eastern families remain materially over-exposed to real estate, fixed income, equity and home-country investments, which creates a risky portfolio and presages heavy losses in the next market crash.[ii]

NON-TRADITIONAL SOURCES OF RETURN:

Academic research, helpfully summarized by McKinsey[iii], has indicated that >90% of portfolio return comes from macro-exposure and only ~5% comes from individual security selection. In other words, focusing on how one’s portfolio is allocated on a big-picture or top-down basis is significantly more important than attempting to pick the best stock or manager within a certain allocation. However, most family offices (and indeed many institutions) spend the majority of their time and resources on security selection and very little on allocation.

Unfortunately, the investment industry has been built around the traditional asset classes, and it requires significantly more effort and expertise to identify and implement investments in non-traditional areas. Thus, despite the relative nimbleness of family office portfolios, the shift must be planned in advance, and fees (that word no one likes to talk about) must be paid to acquire the necessary expertise and partners.

HEIRLOOM'S IDEAS:

Heirloom has been shifting its clients' portfolios away from traditional asset classes and towards greater diversification and lower correlation for 2-3 years. This lower risk can be accomplished without compromising on return, and often can be accompanied with a moderate increase in overall portfolio return. We discussed specific examples of how Heirloom is replacing traditional asset classes with more attractive and lower-risk alternatives, such as the following:

TRADITIONAL ASSET CLASS	HEIRLOOM REPLACEMENT ASSET CLASS
TRADITIONAL REAL ESTATE	NON-TRADITIONAL YIELDING HARD ASSETS Real estate is attractive because it is a hard asset that earns yield. As cap rates have fallen, Heirloom has shifted its focus to other hard assets that generate yield. One example that was discussed was Dry Bulk Vessel Chartering. The demand for dry bulk vessels is very stable and growing, a liquid market for resale of vessels exists, current yields are expected to outperform most real estate, and market dynamics are expected to materially increase lease rates, providing an expected greater appreciation potential versus real estate.
PRIVATE EQUITY	LITIGATION FINANCE As society becomes more litigious, and legal cases more complex, litigation finance has become an important vehicle to fund a plaintiff's lawsuit in return for a portion of the settlement if successful. Net returns are expected, in Heirloom's estimation, to eclipse private equity, durations / lockups are shorter, and correlation to the market is significantly lower than private equity.
INVESTMENT-GRADE BONDS	ASSET-BACKED PRIVATE DEBT Since the Global Financial Crisis, regulators have implemented numerous new requirements and regulations that have led to banks vacating entire areas of lending. Though substantial capital has entered this space, there is still plenty of opportunity to lend against saleable assets at rates ranging from 8-15%. Depending upon the underlying security, Heirloom estimates that this can offer 3-4x the return of investment-grade bonds without taking additional risk. These opportunities are particularly attractive at the <$25mm loan size, which is perfect for family offices in our opinion.

Chart Continues...

TRADITIONAL ASSET CLASS	HEIRLOOM REPLACEMENT ASSET CLASS
HIGH-YIELD BONDS	MUSIC ROYALTIES Following two decades of disruption, music royalties are experiencing strong growth through streaming versus illegal downloading of music. Royalty streams produce cash flows that are protected against inflation and are uncorrelated to other assets. Heirloom has focused on managers that acquire iconic songs that provide solidly-forecastable revenue streams. It is Heirloom's opinion that these are expected to deliver 10-15% net returns at substantially lower risk than high-yield bonds.
HEDGE FUNDS	LIFE SETTLEMENTS Hedge Funds (as in the traditional stock-picking type) have continued to underperform benchmarks for years, and past market downturns have shown that they remain largely correlated. Instead, Heirloom is investing in life settlements (life insurance policies from healthy people that wish to sell their policies to fund their retirement), which offers a return profile that is largely uncorrelated to traditional asset classes.
DEVELOPED MARKET EQUITIES	DEVELOPING MARKET EQUITIES Shifting equity allocations to either non-US Developed Markets or Developing Markets is anticipated to yield far stronger returns than US Equity Markets, even assuming only partial reversions to historical earnings multiples. These equities may have higher volatility during flat to good markets but are expected to outperform US equities during a market crash.

Seminar participants contributed their own views to each of the above. In particular were families that indicated they have been allocating to Private Credit and Litigation Finance. An interesting debate was had around Life Settlements, with some expressing displeasure in the moral aspects of investments related to sick or dying people, but with a general agreement that a focus on purchasing policies from healthy people as a socially-positive approach. Interest in Non-Traditional Yielding Hard Assets was strong, and a good debate was held around the best means for obtaining non-US equity exposure.

In addition, a few participants offered some interesting ideas on agriculture or agri-related investments that they have made recently. These opportunities were specialized and offered not just attractive yields, but strong future growth potential as well – a good discussion was held around the attractiveness of these approaches versus the simple "buy farmland" that constitutes the majority of family office agriculture allocation.

Many of the above strategies are complex, have a degree of illiquidity, and require specialized expertise to understand and invest in. However, spending the effort and resources to shift your portfolio to even a few of them could add materially to your expected return, while reducing your portfolio risk substantially.

Heirloom is currently investing in all the above strategies, having spent approximately 2-2.5 years researching each. If you would like to discuss or learn more about any of these above-mentioned alternatives, please contact Beth at beth.hirshfeld@heirloominvesting.com.

ABOUT HEIRLOOM:

Originally the in-house investment management function for a Canadian single family office, Heirloom offers flexible institutional-quality investment solutions designed specifically to help family offices and high net worth individuals achieve their goals. Its services include advisory over the entire portfolio as a full Outsourced Chief Investment Officer, to offering advice or managing investments in specific themes or asset classes, to offering co-investment opportunities in specific opportunities or themes.

Heirloom's macro-thematic investment strategy invests across assets classes and geographies, focusing on allocating capital to long-term trends and market dislocations with a heavy focus on risk understanding and control.

Its approach has been used by leading pension plans and sovereign wealth funds for 20+ years. This strategy is supported by extensive academic research and has been advocated by McKinsey as how all investors should manage their money to generate the best risk-adjusted returns over the long-term.[iv]

DISCLAIMER:

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[i] Financial Times and various
[ii] UBS, Campden Wealth. Heirloom Opinion.
[iii] McKinsey & Company. "From Big to Great".
[iv] McKinsey & Company. "From Big to Great".