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Editor's Letter

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1120 Avenue of the Americas, 6th floor,
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This issue of *The Journal of Private Portfolio Management* takes a special look at the topic of alternative assets and, in particular, at the way in which individual taxable investors can make use of them. Over the last several years, an increasing number of wealthy individual investors have raised or made an initial commitment to that asset class. And yet it remains broadly misunderstood, in particular with respect to the impact that hedge funds, private equity funds, or other similar strategies can have on the after-tax returns of an individual portfolio.

Alternative assets also raise a question that is not addressed specifically in any of the articles in this issue of *The Journal of Private Portfolio Management*, and that applies equally to alternative and traditional assets: manager selection. Tradition has it that the idea of having an external manager started when a large pension fund found so many individual stocks in its portfolio that it could no longer keep track of them. The anecdote further has it that the trend toward increasingly diversified manager stables ended when that same pension fund found that it then had more managers than it had had individual stocks half a century earlier!

More seriously, the issue of the optimal size of a manager stable has been at the forefront of the debate for many years. Unfortunately, as has traditionally so often been the case in our industry, the debate has focused on the problems of large, tax-exempt institutions. It has therefore not incorporated many of the specific issues that taxable wealthy individual investors must consider. This has led to situations where individual investors have found themselves holding hard to administer and manage extended stables of managers.

In many ways, constructing a stable of managers is very much like constructing a portfolio. The most significant difference, in fact, may well be that the case for manager diversification can be stronger than the case for portfolio diversification. The evidence indeed is stronger that, particularly in the world of alternative assets, correlations among managers are typically lower than they would be among stocks in an individual market, or individual equity market within the developed equity market universe. Thus, just as is the case in the world of equity portfolios, the law of diminishing returns is certainly at work. This is

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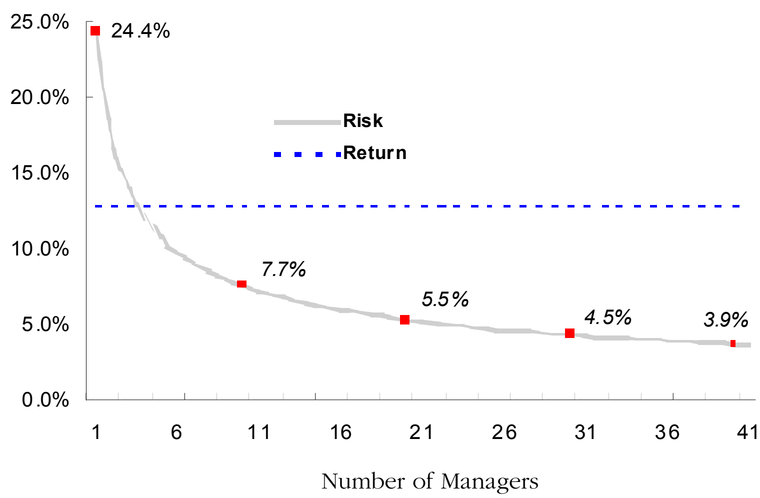
illustrated in the Exhibit below. It shows the expected return and risk characteristics associated with portfolios comprising varying numbers of alternative asset managers, whose returns are assumed to be perfectly uncorrelated to one another. Note how quickly risk reduction is achieved and how little risk reduction is available beyond the twentieth manager!

EXHIBIT
Multimanager Portfolio Risk and Return Trends



The issue is even more important when dealing with individual investors for two main reasons:

- Even when they are very wealthy, individual investors rarely have the "buying power" of large institutions. Spreading their assets over too many managers can significantly raise their overall management costs.
- Although many wealthy individuals and families have family offices or staff to administer their assets, the arguably unnecessary complexity associated with too large a manager stable can prove overwhelming, and claim too large a share of their

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resources. Too large a stable can apply too much pressure on the custodians who are responsible for administering the assets, on the investment consultants who are responsible for keeping track of each of these managers, on the accountants who must keep track of transactions and prepare tax returns, and even on themselves as they try to keep current on the diverse strategies and their results.

A few simple principles can help wealthy individuals and families deal with the problem.

- The often quoted but rarely used "keep things simple" principle applies here as much as anywhere. While manager diversification is indeed quite important, it is worth remembering why one is seeking diversification and thus avoid overdiversifying.
- Investors should focus their diversification efforts where they are likely to pay off most handsomely. Private equity investments are typically considerably less liquid than others, whether they involve traditional assets or alternative strategies. It is therefore arguably much more important to create a diversified private equity portfolio than it might be to create a diversified portfolio of U.S. large-capitalization equity managers.
- Investors might also focus their diversification efforts on the investment areas in which they are most interested. Market research has demonstrated that the degree to which each investor needs to feel involved in the management of their assets can vary dramatically from one to another. Although this might be misinterpreted to mean that wealthy individual investors seek to direct most of their investment transactions, it does seem to mean that the degree to which they are involved in the selection and management of their managers can vary. Someone interested in alternative investment strategies could satisfy their desire for involvement by having a more diverse stable than another who seeks more of a hands-off approach.
- Finally, and probably most important, it is worth remembering that the decision to hire a manager may well be only half the battle. More important, in the long term, is the attention needed to monitor each manager closely and ensure that peo-

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ple and strategies remain in place, and thus that the nature of the investment one made remains broadly in line with the strategy of the whole portfolio.

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In this issue, we offer four articles broadly focused on the topic of alternative assets, and two more general pieces.

Our focus on alternative assets starts with Jean Brunel's article, which looks at the role alternative assets can play in a diversified taxable portfolio, and particularly at their impact on overall portfolio efficiency. Next, Katherine Cattanach discusses the world of private equities and lifts the veil on that still somewhat mysterious asset class, tracing its origins and evolution and concluding with a discussion of why investors continue to find private equity attractive. Marc Sharpe's article considers the broad array of possible alternative — or hedge fund — strategies and shows the importance of diversification across styles and managers. Finally, Sandra Manzke describes private placement variable life insurance as a means of improving tax-efficiency.

Michael Christensen addresses the issue of benchmark selection, a particularly important topic for taxable investors, as there is no clearly obvious after-tax benchmark against which to assess the performance of managers or, more importantly, overall portfolios.

Jim Musumeci revisits the issue of international diversification, but looks at it from a somewhat different point of view: He considers the interaction of human capital and diversification, and concludes that the main argument for international diversification remains one of overall portfolio risk reduction.

Jean L.P. Brunel
Editor

Nancy L. Jacob
Editor