Change – The Only Constant

By Christina Ho
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"I am trying to figure out what it means to be long-term in a world with extreme short-term volatility and the potential for seismic change in the next few years." ~ Anonymous Private Investor

When faced with change, investors often struggle to know how to react – are the new circumstances welcome relief, or do they pose a threat? For most investors, the past twelve months have been a grueling test of their ability to respond to changing markets, changing risks, and – perhaps most frightening – changing "investment truths."

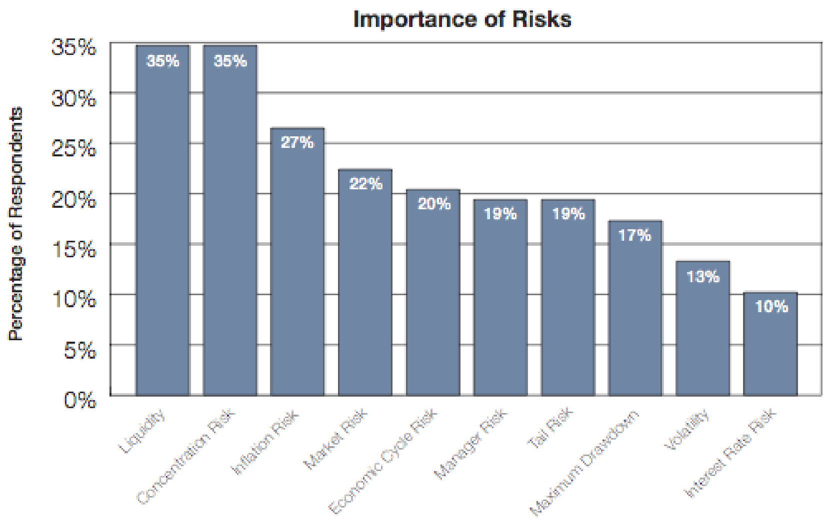
As our data show, many wealthy investors have responded by increasing their use of tactical asset allocation and positioning their portfolios to defend against liquidity, concentration and inflation risk. As many have adapted and formed fresh perspectives on risk, advisor relationships, and investing in general, an enduring lesson has emerged: change is the only constant.

Our organization, the Institute for Private Investors (IPI), was founded in 1991 as an educational and networking resource for families with substantial assets and their advisors. Today, we count 1,100 individual private investors among IPI's members, 80% of whom oversee in excess of $50 million. We survey members quarterly to ascertain their views of the capital markets, their perceptions of risk, and their asset allocations.

Investors grapple with risk

Three quarters of the members who responded to our November 2009 survey[1] said they have changed the way they view and manage risk in their portfolio since 2008.

Two years ago,[2] when asked about the risks that concerned them, IPI members cited manager risk as the single most important risk they needed to monitor. At the time, members viewed interest rate risk and inflation risk as the two least important risks. But now members list liquidity and concentration risk as top concerns, with 35% of respondents describing them as "extremely important." Inflation risk has also returned to the fore – 27% of respondents called it "extremely important." Investors may be viewing risk in a different light, but what metrics will they use to monitor and manage these risks? Volatility is the traditional risk metric used in the industry, but IPI members now list it among the least worrisome risks.



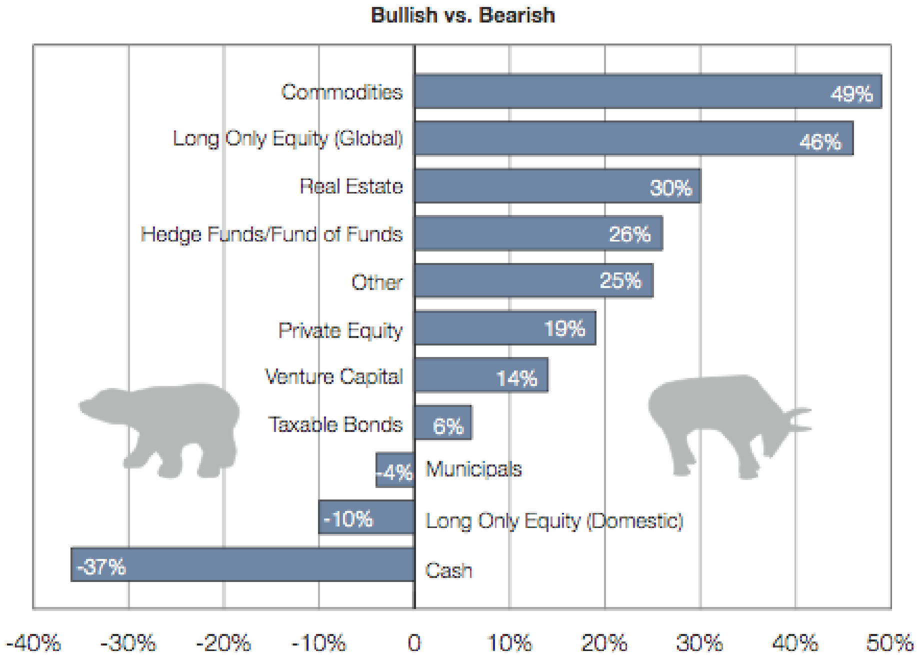
Tactical asset allocation gains ground

The financial crisis altered other views as well. Of the 62% of respondents who reported having a formal, written investment policy in the spring of 2009,[3] over half said that they were making, or considering making, changes to their policy in light of their 2008 experience.

In 2008, IPI members cushioned the fall with cash, reporting an all-time-high average allocation to cash of 16.7%,[4] nearly double their allocation in 2007 (8.6%).[5] Not surprisingly, members who had a higher percentage of their portfolio allocated to cash in 2008 fared better than their peers. On average, those with 41% or more in cash returned -13.80% compared to -18.72% for those with less than 10% in cash and -28.86% for the eight investors who had 0% in cash. Perhaps this experience emboldened members to change their investment policy to allow for more tactical asset allocation.

More allocation adjustments ensued at the end of 2009,[6] and the chart below shows the overall bullish vs. bearish sentiments of IPI investor members based on survey results obtained in November 2009. The figures in the chart represent

IPI investors' net sentiments: we subtracted the percentage of respondents who intend to reduce their allocation to an asset class from the percentage who plan to increase their allocation. Cash, for example, has a net value of -37%, because 17% plan to increase and 54% plan to decrease their cash holdings.



In a shift in focus from previous years, commodities and global long-only equity now appear to be the most popular asset classes among IPI members, with a 49% planned net increase to commodities and a 46% planned net increase to global long-only equity.

Many investors are also increasing, or plan to increase, their use of certain strategies or investment products, such as Treasury Inflation-Protected Securities (TIPS). Of those surveyed, half say they currently have TIPS in their investment portfolio; a quarter (of those surveyed) plan to increase their allocation to TIPS in the next twelve months.

International investment saw a modest uptick, with respondents reporting on average that 28.7% of their overall portfolio is invested outside of their domestic market. In 2007,[7] the average was just under a quarter. More importantly, one in five have invested 50% or more of their overall portfolio outside their domestic market, up from the 12% who did so in 2007.

Investors are also making use of other opportunistic strategies, with 44% planning to increase allocations to distressed securities, 39% to distressed real estate and 24% to secondary private equity.

Looking to the year ahead, these changes may reflect investor fears about inflation and dollar debasement.

While manager turnover continues, advice gains respect

IPI members continued to adjust their roster of managers this year, with almost three quarters either hiring or firing; 43% did both. But the median number of managers employed by IPI members has stayed relatively constant – five traditional managers out of a total of 15 that includes hedge funds and other alternative managers.

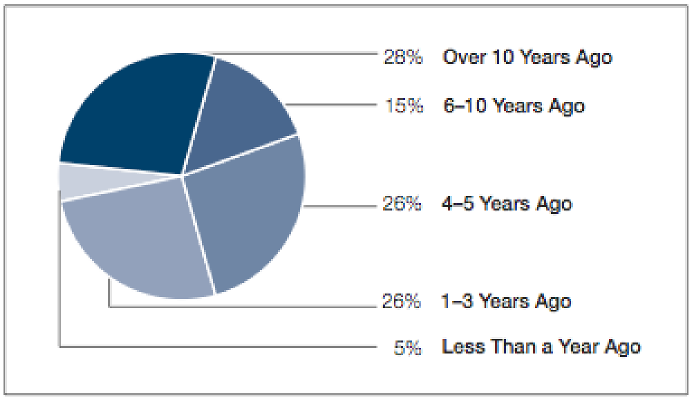
Times appear to have changed from the days when the ultra-wealthy relied on networks and word of mouth to find money managers or hedge funds. For those who hired managers this year, more than half (53%) found their new manager through a consultant or advisor. This suggests that consultant-advisors have gained ground since 2001,[8] when 31% relied on their advice in hiring decisions.

In fact, in a year that has been tough for investors and advisors alike, 81% of respondents agreed or strongly agreed with the statement, "I trust my advisor to act in my best interests." When asked if the industry as a whole had served them well, 61% of investors said it had.

Investors also continue to rely on their advisors to help them plan and consider new strategies in their wealth management and estate planning. To prepare for anticipated tax changes in 2010 and beyond, 41% of investors are enlisting the help of their current advisor(s), compared to the 6% who are hiring (or recently hired) a specialist in tax advice.

Just over half (55%) of the respondents indicated they rely on a single firm as their primary advisor for the bulk of their investment advice, which is roughly in line with reports from prior years. The tenure of these firms is impressive. Only 5% were hired within the past year, and close to one third were hired over 10 years ago. A little more than half were hired in the past five years.

Primary Advisor Tenure



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[1] IPI survey, "New Thinking" (November 2009).
[2] IPI survey, "Absolute Risk and Relative Return" (January 2007).
[3] IPI survey, "Fight-or-Flight (or Freeze)" (May 2009).
[4] IPI survey, "Family Performance Tracking® Survey 2008" (March 2009).
[5] IPI survey, "Family Performance Tracking® Survey 2007" (June 2008).
[6] IPI survey, "Change Is The Only Constant" (December 2009).
[7] IPI survey, "Family Performance Tracking® Survey 2006 – Part II" (August 2007).
[8] IPI survey, "2001 Survey on Hiring Managers" (August 2001).

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