ADVISOR PERSPECTIVES

Patience and Diversification 2.0: How the Ultra-Wealthy are Responding to the Current Market

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The recent collapse of several of the world's most venerable financial institutions and the concomitant loss of trillions of investment dollars have sobering implications for investors of every type and size. The financial industry's upheaval, coupled with the dramatic downturn in the overall market which has sent the S&P's trailing 10-year returns into negative territory, have advisors and their clients seeking information to better understand the current environment and its impact on various investor segments, particularly the very wealthy.

As a provider of comprehensive portfolio reporting information exclusively for the ultra-high-net-worth market, my company is uniquely positioned to observe investment performance and behaviors across numerous high wealth investors and their advisors. Hence, the question I have been most frequently asked in recent months is, "how are these economic conditions impacting the ultra wealthy?"

For starters, "ultra-high-net-worth" individuals and families — those with more than $30M in net investable assets — are benefiting from two important attributes: patience and diversification. In the midst of the present economic crisis, one of their most critical assets is the ability to look - and invest - beyond the near term by taking a patient, deliberative approach focused on longer term outcomes. But the super wealthy are also helped by having highly diversified portfolios, large holdings in cash, and varied investments in recession- and shock-resistant assets. On average, over 50 percent of their portfolios is in "alternative assets," including private equity, venture capital and hedge funds, real estate, as well as large private collections of homes, private jets, automobiles, art and other lifestyle assets. As these alternatives have largely held their ground, our clients have generally navigated the precipitous market drop with comparatively minor losses to date.

It is likely, however, that as the recession takes tighter hold it will ultimately push down the value of these alternative assets too — particularly hedge and private equity funds. Yet despite this continued uncertainty and risk, many of our clients are seeing significant investment potential in this tumultuous environment, which is fueling their desire to further diversify. In fact, the increased number of opportunities to buy “distressed assets” has recently provided an incentive for a number of family offices to hire new private equity managers to build their own internal deal teams. The combination of entrepreneurial instinct, available cash, deal flow, and reduced asset prices, coupled with patience, holds real potential for the families to garner substantial future returns.

Another interesting trend precipitated by the recent market upheaval is the flight to institutional safety and a move away from global custodianship. When Bear Sterns was sold to JP Morgan, it triggered a torrent of custodial changes among our high wealth clients that has yet to subside. Many are rapidly moving to institutions perceived to be “safe”, such as those with strong retail deposits, reasonable leverage, and little evidence of subprime infection. In particular, we are seeing a major flight to quality with pure play custodians such as State Street, Pershing and Schwab, who are winning a great deal of market share in the current environment.

Interestingly, however, these custodians are not necessarily receiving *all* of an ultra-high-net-worth family’s migrated assets. Instead, we are frequently seeing families leave one platform and migrate to two or three. As diversification is now extending into even custodianship, we are hearing increasingly from family offices and advisors who are facing serious reporting challenges. They do not have efficient, effective methods to manage, process, and report on the wide diversity of financial data from numerous sources, and are seeking our comprehensive aggregation services to address the problem.

Beyond the trend towards portfolio and custodial diversification, the instability of the market has also prompted ultra-high-net-worth families to begin taking much tighter control over their financial choices. As a result, the dedicated family office is more important than ever before. Wealthy investors believe they need to make decisions more proactively and selectively to prevent, for example, certain advisors from driving them to purchase sub-optimal products. Consequently, it is crucial to have an in-house “alpha advisor” who has a genuine, trusted relationship with the family and a full, accurate understanding of their total wealth picture and investment objectives. Placing Chief Investment Officers in-house will strengthen the role and central position of both single-family and multi-family offices and further formalize this growing industry.

In conjunction with the assertion of greater control, we are also seeing families take a much more active role in understanding the details of their financial lives. To this end, many families and individuals are directly accessing their online portfolio reports on our system more frequently and in greater depth that at any other time since 9/11. This activity is further facilitating the communication and decision-making process between the ultra wealthy families and their advisors.

Despite present market conditions, the investment activity and behaviors of the ultra-high-net-worth appear likely to support the old adage that “money makes money”. By continuing to diversify existing investment portfolios, along with custodians, while maintaining strong cash positions the ultra-wealthy have significantly mitigated their downside risks today. At the same time, they have evidenced a patient investment eye directed toward the longer term and are taking deliberative steps to position themselves for significant upside returns tomorrow.

Norman Jones is the CEO of WealthTouch, a comprehensive reporting solution provider for ultra-high-net-worth families and their advisors. WealthTouch serves hundreds of ultra-high-net-worth clients with wealth ranging from $50M to $1.5B.