

# What to expect



Quarterly Letter

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# Foreword

“History doesn’t repeat itself, but it does rhyme.”

Mark Twain

When investing your wealth, it sometimes helps to be reminded that markets are cyclical: they rise, they fall, they peak, they trough. And they rarely do so in such a predictable order.

I mention this because, as you will no doubt already know, our portfolios continue to perform well this year, with positive tailwinds providing ample reasons to stay optimistic as we head into the second half of 2021.

This is, of course, great news and extends our run of strong portfolio performance in recent years.

However, I believe it’s important for us as wealth managers to rein in expectations, particularly at times like this. During a market upturn, it can be easy to forget that prevailing conditions won’t last forever.

Eventually, regular service resumes, and clients need to be prepared for a future where performance reverts closer to the long-term average. After all, it is over the long term that we want our investment approach to be judged.

Managing expectations is a topic we have covered before in a previous *Quarterly Letter*. We outlined what we are trying to achieve, how we are different, and the patterns of performance this may deliver.

After dusting off a copy from our archives, I was struck by how much remained relevant today, nearly five years later. So, in keeping with the theme of market cycles, we’ve decided to republish the original, albeit with a few updated tweaks.

In doing so, we hope you learn something new, whether you’re reading it for the first or second time.



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Cover image:  
Envelope from a Presidential  
‘Thank you’ sent to Nathaniel 1<sup>st</sup>  
Lord Rothschild (1840–1915),  
Senior Partner N M Rothschild &  
Sons, from President Theodore  
Roosevelt (1858–1919)  
in 1904. Courtesy of The  
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# What to expect

“Happiness equals reality minus expectations.”

The above quote is often attributed to Tom Magliozzi, the late co-host of NPR’s award-winning radio show *Car Talk*. Like many great quotes, it’s astute, pithy and easy to remember.

It also happens to be true. In 2014 – the same year that Magliozzi sadly passed away – researchers tested this formula for happiness and found it holds up well to scientific scrutiny. Expectations are key to our happiness.

In the University College London (UCL) study, 24 participants were asked to complete decision-making tasks that led to financial gains or losses.<sup>1</sup> Each person could either choose a certain outcome or a 50/50 gamble.

Successful gamblers won more (or lost less) than those who played it safe, but they also risked far greater losses when fortune didn’t favour them. Throughout the study, each subject was regularly asked “how happy are you right now?”.

**To ensure our clients have realistic expectations of us, we must be clear about our objectives and how we go about meeting them. We’d like to take the time to do that now.**

People were generally happier when they were winning money rather than losing it. No surprises there. But researchers discovered that a person’s total winnings weren’t a major factor in how satisfied they were at the end of the experiment.

Put simply, the biggest earners weren’t necessarily the happiest.

In fact, how well things went didn’t really matter. A person’s happiness depended far more on whether the experiment had gone better or worse than they had believed it would.

## Managing expectations

The UCL study wasn’t a one-off. The team has replicated the results across more than 18,000 participants in other experiments and even formulated a ‘Happiness Equation’, which they claim can predict how pleased someone will be with an outcome.

What lessons can investors learn from this research? For one, it would seem that high expectations often lead to disappointment. If a portfolio is delivering record returns, managing expectations can help you prepare for any nasty surprises when performance inevitably regresses towards the mean.

Are low expectations better? Not quite. Dr Robb Rutledge, cognitive and computational neuroscientist and author of the UCL study, said people with low expectations might be happier, but there’s a significant downside.

“Expectations are really important for decision-making. If you always expect the worst, it’s difficult to make good choices,” he explained. “Realistic expectations are generally best.”<sup>2</sup>

We tend to agree. And to ensure our clients have realistic expectations of us, we must be clear about our objectives and how we go about meeting them. We’d like to take the time to do that now.

## What are we trying to achieve?

Our first and overriding goal is to keep our clients wealthy over the long term. Our second goal is to meet this first goal, while avoiding some of the large losses along the way.

<sup>1</sup> [www.pnas.org/content/111/33/12252.full](http://www.pnas.org/content/111/33/12252.full)

<sup>2</sup> <https://theconversation.com/is-there-a-happiness-equation-heres-how-were-trying-to-find-out-161025>

### UCL’s ‘Happiness Equation’

For those of you who might be particularly interested, UCL’s ‘Happiness Equation’ expressed is:

$$(t) = w_0 + w_1 \sum_j = 1t\gamma_t - jCR_j + w_2 \sum_j = 1t\gamma_t - jEV_j + w_3 \sum_j = 1t\gamma_t - jRPE_j$$



We have quoted the following numbers before, but they are worth repeating. If an investment loses 50% of its value, it subsequently has to double to get back where it started. An 80% loss must be followed by a 400% gain just to return to square one. By contrast, an investment that grows at an average of 7% annually will double in value over a decade and nearly quadruple over 20 years.

If your main aim is to beat the equity market or a market benchmark, our approach may not be for you.

We invest for entrepreneurs who have sold businesses and then trusted us with the proceeds. For successful businesspeople approaching or in retirement. For charities that have received wealth as donations, gifts and legacies. For the families and descendants of wealth creators.

Their capital is precious. And it's usually irreplaceable.

Many of our clients are actively starting and building new businesses or leading established firms. Yes, they are still creating new wealth, but their capital remains precious. When investing, they need diversification, and a portfolio they can depend on.

We are not in the business of creating second fortunes for our clients. Instead, we focus on keeping them wealthy – for years and decades to come, through good times and bad.

Remaining wealthy means at least maintaining, and ideally increasing, purchasing power in the real world. To achieve that, our clients' portfolios need to beat inflation.

We must deliver investment returns that outpace rising prices and a higher cost of living. In a post-pandemic world, where pent-up consumer spending could soon be unleashed, inflation remains a growing cause for concern.

To beat inflation, we need to invest in what we call return assets. These are mostly shares in companies and specialist equity-related funds. They are assets that we believe will increase in value over time, delivering returns that outpace inflation by a good margin. These return assets occupy one side of our clients' portfolios.

To give protection to the portfolio, we hold diversifying assets alongside our return assets. Although each of these diversifiers performs a slightly different role, our general expectation is that they should perform well during a sustained downturn in markets, and at times when our return assets are weak.

As a group, the diversifying assets should help us avoid very large losses.

### **What are the implications for performance?**

Clear goals and a distinctive investment approach make for a different pattern of performance. Our performance is likely to be different from bond and equity markets, from market benchmarks, and from other wealth managers.

When the overall equity market rises, our portfolios might fall. When the market falls, our portfolios might rise. It all depends on what is driving the market.

Our returns can also be lumpy. For example, one quarter of great gains may be followed by a quarter when performance goes sideways.

That's why we seek to manage expectations when investment returns are unusually high, recognising that market weather can be fickle, even if it looks like clear skies ahead.

In general, we do not expect to keep pace in strongly rising equity markets anyway (because our diversifying assets can be a drag on performance). But when equity markets fall, we do expect those diversifying assets to protect our clients from the full impact.

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### **Protection in practice**

When investing, there is always a trade-off between capital growth and capital protection. Managing this trade-off in a way that is right for our clients requires skill, balance and good judgement.

When thinking about protection, we make an important distinction – between drawdowns (peak to trough declines in portfolio value) that are amber, and those that are red.

An amber drawdown is one where a portfolio drops in value by anything up to around 10%.<sup>3</sup> Our clients should expect some amber periods from time to time. Why? Because when equity markets fall, so too will the quoted market prices of many of our return assets.

<sup>3</sup> The figures we use here are illustrative for a representative balanced portfolio. The numbers would be lower for clients with a lower appetite for risk; they would be higher for clients with a higher appetite for risk.

To avoid all amber drawdowns, we would need to construct portfolios with a very different mix of assets. We believe this mix would deliver much lower returns over the long term. For example, any portfolio built for complete capital protection in a world of low interest rates and record-low bond yields would struggle to meet our first objective of keeping our clients wealthy.

**It is this decision-making process that determines whether or not we make an investment, as well as the size of any position we take. We have no fixed, mandatory or target allocation to any asset class, region or theme.**

Put another way, avoiding all amber drawdowns is expensive – to get guaranteed capital protection, you usually have to give up a large portion of your returns. By tolerating some amber, clients should experience better long-term performance from us.

A red drawdown is different. It involves a drop in portfolio value of more than 10%. We build portfolios and hold diversifying assets to help protect clients from these red times. Avoiding these drawdowns is a major focus for us – it's our second goal. The deeper the red, the more we want to avoid it.

In extreme or very difficult markets, red drawdowns may still occur. This might be during a collapse in equities or currencies. Rapid sharp shocks – such as Black Monday in October 1987, when the US stock market fell by 22% in a day – are particularly hard to protect against.<sup>4</sup>

Nevertheless, when major falls do occur, we'd expect to provide substantial protection from the impact.

#### **How we are different**

We don't set out to be different or unique in our approach. Instead, difference for us is a byproduct, something that has flowed from our focus on meeting goals for our clients.

In the following areas, we may be different from others:

#### **Portfolio composition**

Every investment we own is selected on its individual merits. Once we have identified an attractive security or fund, we consider its risks and the long-term returns we expect it to produce.

We then view the investment within the wider portfolio context, assessing what it might bring to the portfolio as a whole, either as a return or a diversifying asset.

It is this decision-making process that determines whether or not we make an investment, as well as the size of any position we take. We have no fixed, mandatory or target allocation to any asset class, region or theme. There are no underweight or overweight positions in our portfolios because we are not trying to match or beat any benchmarks or market indices.

For example, we invest in many companies that offer niche business-to-business services, such as credit ratings, laboratory testing and vertical market software. But an appreciable portion of our return assets are also invested in companies that sell everyday products or services directly to consumers – everything from broadband and car insurance to credit cards.

By contrast, we own no traditional long-dated government or corporate bonds and we have no direct exposure to assets like real estate or mining firms.

#### **Some sizeable positions**

Where our level of conviction is high, we are prepared to take sizeable positions in individual securities and funds (within sensible risk limits).

As an alternative, we could double the number of positions in a portfolio. Superficially, this would look more diversified. But we think the change would be mainly cosmetic.

This view is supported by academic research. In their book *Modern Portfolio Theory and Investment Analysis*, Ed Elton and Martin Gruber analyse the correlation of different equity returns. Their work suggests that, in a hypothetical equally weighted portfolio, the benefits of further diversification are small once you get beyond around 25 positions.

#### **Buying investments in difficult markets**

We can be confident when others are cautious and are prepared to buy things that are unfashionable and out of favour, including during periods of panic in markets. We may increase our exposure to return assets after a market fall, when the headlines are negative, and when all the pundits agree the outlook looks bleak.

<sup>4</sup> More recently, our portfolios briefly experienced a red drawdown when they fell more than 10% peak to trough across February and March in 2020.

Times of distress tend to throw up the best bargains.

Our focus is on the fundamentals, rather than prevailing investor sentiment. Say the price of one of our investments falls sharply, but its fundamentals remain strong. We will be happy to hold on to our position and may even decide to buy more. Admiral, American Express, Deere, Lloyds, Linde and Wells Fargo are all examples of portfolio positions we have previously added to following a price fall.

#### **Low turnover**

When we buy an investment, we do so with the intention of keeping it for the long term.<sup>5</sup>

Frequent trading is not part of our investment style: we believe it would incur unnecessary costs for clients and reduce our chances of success.

Once we have assembled an attractive portfolio of assets, we seek to be patient, limiting our buying and selling.

#### **Use of active funds**

Typically, we will invest somewhere between one third and half of a client's capital with actively managed external funds. This will increase the total cost of the portfolio.

Investment expenses are important, and we seek to avoid all unnecessary costs. We therefore only partner with other managers when we are confident they will more than justify their fees. They must earn their place in our portfolios.

Rather than look at the total cost of a fund in isolation, we ask clients to look at net returns, after all fees, over the medium and long term. It is these net results that should matter most because they are results you can spend.

#### **No market forecasts**

We make no forecasts about short-term market movements, nor do we pay much attention to people who do.

Prakash Loungani, an advisor in the Research Department of the International Monetary Fund, has studied the accuracy of economic forecasts, concluding that "the record of failure to predict recessions is virtually unblemished". There is a similar lack of foresight when it comes to forecasting inflation and movements in the bond and currency markets.

In our view, financial forecasters misunderstand the nature of the system.

Dave Snowden, founder of decision science consultancy Cognitive Edge, makes a distinction between complicated systems and complex systems. To illustrate, he contrasts a Ferrari with the rainforest.

A Ferrari is a complicated system. An expert mechanic can take a Ferrari apart, and then reassemble it, without changing anything. The car is static, and the whole is equal to the sum of its parts. In a complicated system, there is a clear relationship between cause and effect.

By contrast, the rainforest is a complex system. It is in constant flux and unpredictable, the sum of millions of intricate relationships and interdependencies. If a species becomes extinct, or someone reroutes a river, the results for the rainforest are hard to know in advance. Snowden argues that in complex systems there are instructive patterns, but we can understand why things happen "only in retrospect" and "right answers can't be ferreted out".

The application: forecasters seem to work from a mechanistic assumption that economics and markets are orderly, linear and predictable, with knowable links between cause and effect. In reality, this is not the way the economy works: it is a complex system, in constant flux, more rainforest than Ferrari.

#### **How should we be judged?**

By combining return and diversifying assets in the way that we do, we believe our portfolios will outpace inflation, avoid very large losses and deliver solid growth over the long term.

Our approach is different and our pattern of performance will be too. We are determined to be good custodians of our clients' capital, delivering real returns for decades to come.

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As such, we expect to be held to account, and ask our clients to judge us in three ways:

#### **1. On the long-term returns we deliver**

To us, long-term performance means periods of at least five years. It is over these periods that we aim to meet our clients' objectives. At times, this may require patience. Some quarters will be strong, others will be weak.

<sup>5</sup> There are some exceptions, such as short-dated bonds, and the options we buy to help protect our portfolios.

## **2. On the performance of the overall portfolio**

We encourage clients to focus on the performance of their portfolio as a whole, not on the individual investments in isolation. With some individual investments, we will make mistakes. When we do, we try to be open and frank about them. Individual return and diversifying assets will be volatile, and some may perform poorly. Yet what matters most are the returns from the whole portfolio, not the performance of its component parts.

## **3. On the quality of the service we provide**

People rightly have high expectations for service from us, and we seek to meet and beat those expectations. Clients should expect to interact with engaged and experienced individuals and teams, and people who act clearly and transparently. Communication is crucial, particularly in challenging markets, and we don't shy away from difficult conversations.

**As a wealth manager, setting and managing expectations is an important part of our role. We aim to be clear, prudent and realistic in our investments and with our clients.**

### **Conclusion**

We believe we have a strong and distinctive approach to investing. We also recognise that our approach may not be right for everyone.

As a wealth manager, setting and managing expectations is an important part of our role. We aim to be clear, prudent and realistic in our investments and with our clients.

If we are doing our job well, much of what we have said in this *Quarterly Letter* will be familiar, with few shocks or surprises.

## Notes

At Rothschild & Co Wealth Management we offer an objective long-term perspective on investing, structuring and safeguarding assets, to preserve and grow our clients' wealth.

We provide a comprehensive range of services to some of the world's wealthiest and most successful families, entrepreneurs, foundations and charities.

In an environment where short-term thinking often dominates, our long-term perspective sets us apart. We believe preservation first is the right approach to managing wealth.

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