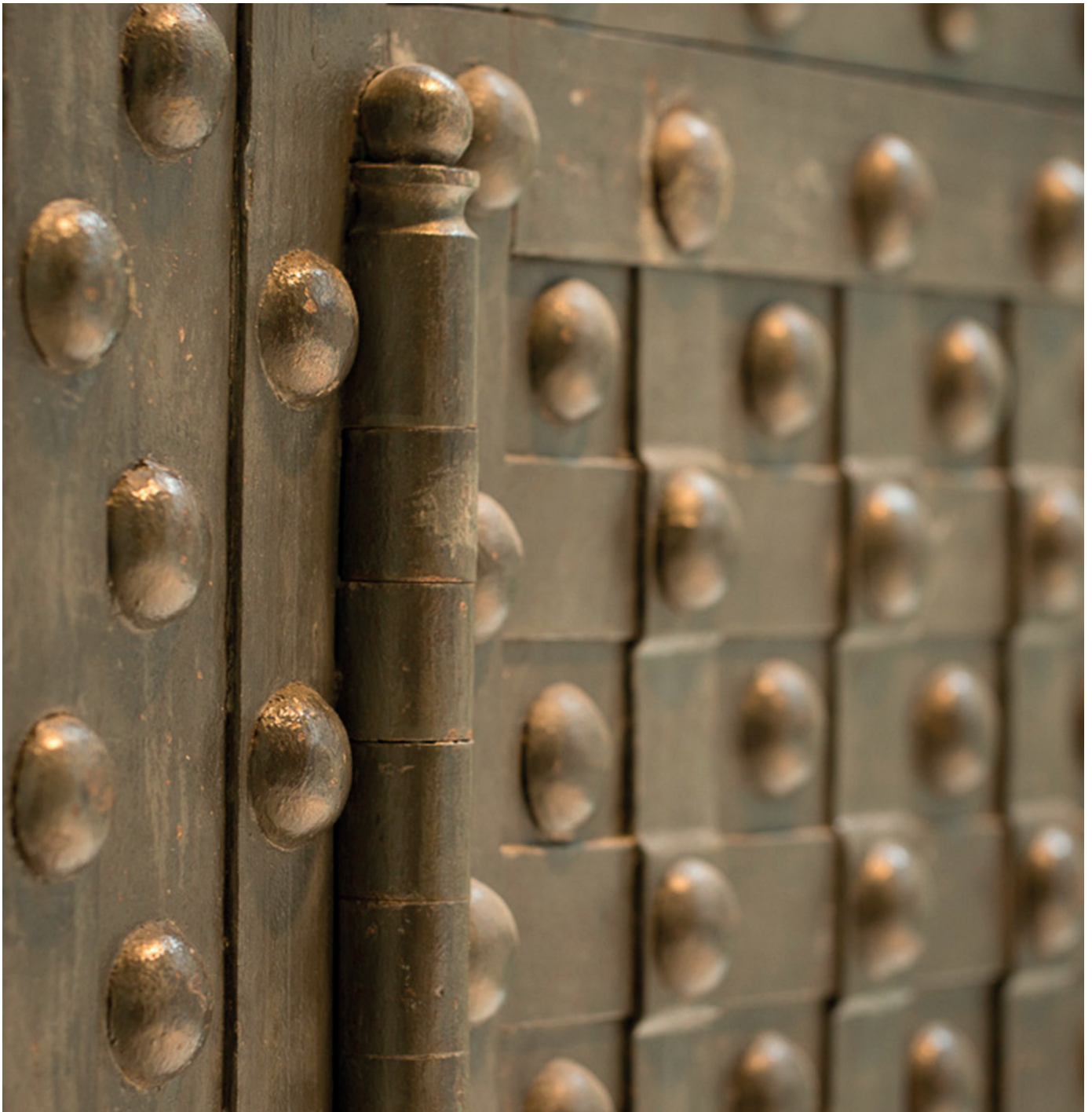
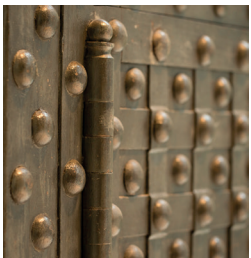


# Why wealth preservation





Cover:  
The original safe from the Paris  
branch, rue Laffitte. It currently  
sits in the reception of our  
London office, New Court – as a  
symbol of enduring security and  
strength.  
Courtesy of The Rothschild  
Archive.

Rothschild & Co Wealth Management  
New Court  
St. Swithin's Lane  
London  
EC4N 8AL  
+44 20 7280 5000

© 2017 Rothschild & Co Wealth  
Management

# Foreword

In caricature, wealth preservation is a close cousin of stuffing money under the mattress. An investment strategy that is dull, and lacks ambition.

The reality is different. When investing, we are seeking to preserve and grow wealth for decades to come. This means keeping ahead of inflation, so that we maintain and increase our clients' purchasing power in the real world. To do that, we need to achieve growth. But we want to achieve this growth in a way that is prudent, avoiding irrecoverable losses along the way.

From that brief sketch, we can pull out four parts: *outpacing inflation*, *achieving prudent growth*, *avoiding irrecoverable losses*, and *investing over the long term*.

If these were four items on a menu, it would be easy to serve up just one or two of the dishes. Anyone with a bank account can avoid the losses without beating inflation. An amateur investor can achieve growth that seems prudent for five years but turns out to be reckless in the sixth.

To vary the metaphor, the challenge comes when bringing the four ingredients together. The wealth preservation recipe looks easy, but the skill comes when actually doing the cooking.

On the following pages, we set out why we focus on real wealth preservation. This article was first published as a letter to our clients in early 2015, and the approach remains at the core of our business. It's a message we believe is worth repeating.

A handwritten signature in black ink, consisting of several loops and a long horizontal stroke extending to the right.

**Helen Watson**

CEO, Wealth Management UK

# Looking after the goose

## Making the case for prioritising real wealth preservation

Once upon a time there was a countryman who owned the most wonderful goose you can imagine. Every morning the countryman visited its nest to find the goose had laid a beautiful, glittering, golden egg.

In Aesop's fable, the countryman takes the eggs to market, and soon becomes rich. Life is going well, until he becomes impatient. The goose is *only* laying one golden egg a day. The countryman is hungry for more and has an idea: kill the goose, cut it open, and get hold of all her golden eggs at once.

At this point in the tale, engaged children cry out to the countryman urging him not to do it. But Aesop moves swiftly to the denouement: the countryman cuts the goose open and finds no golden eggs. His once precious goose is now dead.

We have started with Aesop because he makes our point well for those who like a quick read: if you have a golden egg laying goose, your main goal should be to keep her healthy and safe for many years to come. Optimising her output for short-term gains, or outperforming a peer group of other mythical creatures, should take a back seat.

### Starting with the owners

To answer the question 'why wealth preservation?' we first need to be clear on who the funds belong to.

Put simply, for some of our clients, their wealth has already been created; others are still actively creating it.

To expand on our fable, some of our clients have already bred their geese and are no longer engaged in avian alchemy. As a result, their capital is precious, and usually irreplaceable. This could be an entrepreneur who has sold her main business, a businessman approaching retirement, a charity that has received wealth as a gift from others, or the families and descendants of wealth creators.

By contrast, other clients have a goose farm that is still in full operation. While most of their wealth will usually be tied-up with their business, some is available to be invested.

What these clients tend to need most from their investments is diversification. To stretch our

fable to breaking point, they need investments they can depend on in the event that their geese get struck down by a nasty bout of avian flu. In practice, this means a portfolio focused on real wealth preservation.

### Risk in review

One way to understand our approach to wealth preservation is through the perspective of risk. Financial writer and historian William Bernstein gives a good working definition of investment risk as the *size of loss of real capital* multiplied by the *duration of the loss of real capital*. For those who don't like equations, even thematic ones without any numbers, this is really just stating that there are two main dimensions to a capital loss: its depth (how much is lost) and its duration (how long the loss lasts).

Flowing from that definition, Bernstein makes a valuable distinction between shallow risk and deep risk. Shallow risk is temporary. It involves a loss of capital that recovers within anywhere from several weeks to two or three years. This risk comes from the regular and inevitable swings in asset prices that are a permanent feature of the financial markets.

In a world of 24-hour news, shallow risk tends to be overemphasised. Events that will lose their investment significance in a matter of days or weeks often dominate the headlines, capturing a lot of attention and creating unhelpful distractions.

By contrast, deep risk is permanent. It involves an irrecoverable loss of real capital. This could come from an individual investment that collapses in price and never recovers, or an investment that is sold after a price collapse, preventing the investor

**There are two main dimensions to a capital loss: its depth (how much is lost) and its duration (how long the loss lasts).**

from enjoying any subsequent rebound. At a portfolio level, deep risk would involve a large capital loss, and related negative real returns, that span ten, twenty, or thirty years.

In Bernstein's words, shallow risk, if handled properly, "deprives you only of sleep for a while; deep risk deprives you of sustenance."

What does this mean for our approach to wealth preservation? First, we are seeking to manage the shallow risks properly for our clients, in a way that, we hope, doesn't deprive them of sleep. At the same time, we want to avoid deep risks and the related irrecoverable losses.

There are some important nuances here and we seek to be as clear as we can with our clients about what to expect from us.

**In Bernstein's words, shallow risk, if handled properly, "deprives you only of sleep for a while; deep risk deprives you of sustenance."**

For example, some of the individual assets we own will, at times, fall heavily in price. Within a portfolio, we might own shares in an individual company or fund that could drop in price by 40%, 50%, or more. Is this shallow or deep risk? That depends on what happens after the price fall. If the fall is permanent, and the loss is irrecoverable, then it is deep risk. If the fall is sharp, but we believe the investment will recover, then we would class the risk as shallow. Unnerving and unpleasant, yes – but on Bernstein's definition a large temporary fall is still shallow risk. Whenever an investment has plummeted, the word shallow may jar, but we believe it is an improvement on volatile, which is the usual euphemism in the investment jargon.

At the level of individual investments, our task is to be thorough and robust in our research, to minimise the chance of a temporary loss becoming permanent. We must also remain proactive and avoid complacency, because most deep risk begins life looking shallow.

In understanding our approach, context is everything. This is why we encourage clients to focus on the performance of their overall portfolio. The diversified whole is designed to be more stable than the component parts; risks which could be worryingly deep on their own can be made shallower in the context of a well-

diversified portfolio where no one position should threaten the whole.

### **Apples and pears**

Having outlined who we are investing for and how we understand wealth preservation, it is also worth considering some of the main alternatives to a preservation-first investment approach.

This must begin with the business we're in. In our view, the role of a wealth manager is not to deliver striking fifty or hundred-fold gains: that is the realm of entrepreneurship. Similarly, betting on promising new businesses or the next big thing is best left to venture capitalists.

As part of a broad allocation of wealth, these entrepreneurial and venture capital investments can (and often do) sit happily alongside a wealth preservation portfolio. However, the objectives, risks and potential returns in each area are very different, and so are the levels of excitement.

Our approach may feel pedestrian when compared with founding a business or investing in what might become the next Twitter or Tesla. Yet we are convinced that wealth preservation is the right objective, for every wealth owner, for some or all of their liquid assets.

In the words of Nathan Mayer Rothschild in the early 1800s, while it requires "a great deal of boldness and a great deal of caution to make a great fortune" keeping that fortune "requires ten times as much wit."

It is interesting to note that versions of the phrase "from sandals to sandals in three generations" crop up in many languages and cultures. It seems to describe a near-universal experience: a fortune is made, but not safeguarded. Because wealth preservation is neglected, the grandchildren return to the poverty their grandparents started out in.

### **Buying the market**

Within the public financial markets, an alternative to a wealth preservation portfolio is to be fully invested in equities all of the time. At first glance, the case for doing this can seem strong: if equities deliver the best returns over the long term, why not invest 100% of a portfolio in stocks? Why would a long-term investor need diversification?

First, it is worth noting these questions tend to be highly cyclical. In 2002 after the dotcom bubble burst, or in 2008 at the height of the financial crisis, these questions were on mute. As equity markets recover, the volume tends to rise. When stocks are booming, and irrational exuberance takes hold, the chatter often reaches a din.

In addressing the questions, we should stress that we are big believers in long-term equity ownership. The bulk of our portfolios are invested in wealth-creating return assets, the vast majority of which are linked to the stock market. We see these investments as an essential part of delivering real wealth preservation and growth.

The issue as we see it is not whether to own equities, but instead how much of a portfolio should be invested in stocks. This, for us, is always a function of the available opportunities, and never determined by a fixed allocation set by a template. We select investments on their merits, looking both at the risks and the long-term returns we expect them to produce. Our allocation to equities will therefore vary over time; setting it to 100% might force us to buy equities in periods when we believe they are very expensive.

### **Appetite for losses**

Over the very long term, a portfolio invested 100% in equities may outperform our approach. Yet equities do not always deliver the best returns, even over long periods, and most investors prove to be deeply uncomfortable with both the instability and periodic large falls in portfolio value that inevitably come with an equity-only approach.

Consider Japan. Someone who invested 100% in the Japanese stock market during the late 1980s would have enjoyed spectacular growth – until the market bubble burst. From January 1990 to January 2000, this investor would have lost 35%, even when allowing for the reinvestment of all dividends (using data from the Topix Total Return index). By January 2010, after twenty years, the situation would actually be worse rather than better: the fully-invested Japanese equity portfolio would be down 61% from the reference point in 1990.

By any sensible measure, this is deep risk, particularly when you factor in the opportunity cost, the gains this investor would have enjoyed if he or she had spent these two decades invested elsewhere.

In recent memory, the Japanese experience has been rare, but at the risk of sounding like a financial disclaimer, past performance is no guarantee of future results. Recent memory is not a good guide to financial history.

Looking ahead to the next twenty years, there is no guarantee that investing solely in equities will deliver the best results. To offer a question back to the questioner: if your capital is precious and irreplaceable, do you really need to take on such a high level of risk?

### **The emotional factor**

The psychological aspect of investing also speaks for wealth preservation. Van Gogh rightly identified the “little emotions” as the “great captains of our lives”, captains we obey without knowing it. *Homo economicus* – the Spock-like super rational, utility maximiser – is a fictional character, existing only in basic economics textbooks.

Without getting into the minutiae of prospect theory, it is worth noting that, as humans, we tend to be asymmetrical in our responses to financial gains and losses. In simple terms, the pain we feel from a 10% loss exceeds the pleasure we experience from a 10% gain. In fact, some studies in behavioural economics suggest that losses have more than twice the psychological impact of equivalent gains.

More broadly, we see psychological and emotional discipline as one of the essential traits for investing and wealth preservation, a trait that has no correlation to intellect.

Isaac Newton illustrates this well. In 1720, Newton owned shares in the South Sea Company. As popular enthusiasm for the stock exploded, he sold his shares, making a 100% gain and a profit of £7,000. This was a substantial sum for Newton, and equivalent to roughly £1 million today.

So far, so good. But after Newton sold his holdings, the market euphoria continued. Shares in the South Sea Company continued to surge higher. Newton then re-entered the market, buying a much larger position at a price three times higher than he'd paid for his initial stake. Shortly afterwards, the bubble burst. Newton sold his shares again, but this time losing around £20,000.

Reflecting on his experience, Newton said he could “calculate the motions of the heavenly bodies, but not the madness of people.” In failing to prioritise preservation over growth, and to master the emotional side of investing, Newton lost almost all his life savings.

**“Investment is an effort,  
which should be successful,  
to prevent a lot of money from  
becoming a little.”**

**Fred Schwed, 1940**

### **No mood to party**

Let's now return to a fictional couple 100% invested in equities. Their investment journey hasn't been as wild as Newton's, but let's say it is New Year's Eve 2008 and instead of going out to a party they've decided to stay home to work out what to do about their investments.

The financial crisis is raging, the banking sector seems to be on the edge of collapse, and their portfolio is down 40% on the year. They feel they have lost nearly half of their wealth and are understandably nervous about what 2009 might bring. In this scenario, almost everybody presses the panic button, deciding to sell some or all of their equity holdings. In doing so, they experience an unforgettably painful deep risk.

### **Conclusion**

Given the business we are in, the clients we are serving, the history of financial markets, human psychology and the perennial need for discipline when investing, we believe our focus on real wealth preservation and growth is wise and prudent.

Conceptually, real wealth preservation is simple. The challenge comes with actually delivering it, consistently and well, over the long term.

**“How goes the Stock, becomes  
the gen'ral Cry. Rather than  
fail we'll at Nine Hundred Buy.”  
Alexander Pope, on the South  
Sea bubble.**

To quote William Bernstein again, without “the liquid and safe reserves” that are an essential part of a wealth preservation portfolio “you will not have the wherewithal to weather the... setbacks that come with turbulent markets, to purchase stocks at low prices, and to keep your courage up when it's needed most.”

### **The nature of investing**

The final part of our answer to the question ‘why preservation’ is perhaps the least surprising: we believe it is the best investment strategy.

A focus on wealth preservation and having a ‘margin of safety’ has been a feature of the investing styles of many of the great investors we admire, from John Maynard Keynes to Benjamin Graham to Warren Buffett.

Maths is also on the side of preservation. If you experience an investment loss of 50%, you have to then double your money just to get back to where you started. If you lose 80% of your capital, the equivalent gain required is 400%. By contrast, an investment that steadily compounds at an average of 7% annually will double in value over a decade and nearly quadruple over twenty years. Harnessing this cumulative power of compounding – the regular re-investment of gains over time – has rightly been called the ‘eighth wonder of the world’.

## 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.

## Important information

This document is strictly confidential and produced by Rothschild & Co for information purposes only and for the sole use of the recipient. Save as specifically agreed in writing by Rothschild & Co, this document must not be copied, reproduced, distributed or passed, in whole or part, to any other person. This document does not constitute a personal recommendation or an offer or invitation to buy or sell securities or any other banking or investment product. Nothing in this document constitutes legal, accounting or tax advice.

The value of investments, and the income from them, can go down as well as up, and you may not recover the amount of your original investment. Past performance should not be taken as a guide to future performance. Investing for return involves the acceptance of risk: performance aspirations are not and cannot be guaranteed. Should you change your outlook concerning your investment objectives and/or your risk and return tolerance(s), please contact your client adviser. Where an investment involves exposure to a foreign currency, changes in rates of exchange may cause the value of the investment, and the income from it, to go up or down. Income may be produced at the expense of capital returns. Portfolio returns will be considered on a "total return" basis meaning returns are derived from both capital appreciation or depreciation as reflected in the prices of your portfolio's investments and from income received from them by way of dividends and coupons. Holdings in example or real discretionary portfolios shown herein are detailed for illustrative purposes only and are subject to change without notice. As with the rest of this document, they must not be considered as a solicitation or recommendation for separate investment.

Although the information and data herein are obtained from sources believed to be reliable, no representation or warranty, expressed or implied, is or will be made and, save in the case of fraud, no responsibility or liability is or will be accepted by Rothschild & Co as to or in relation to the fairness, accuracy or completeness of this document or the information forming the basis of this document or for any reliance placed on this document by any person whatsoever. In particular, no representation or warranty is given as to the achievement or

reasonableness of any future projections, targets, estimates or forecasts contained in this document. Furthermore, all opinions and data used in this document are subject to change without prior notice.

This document is distributed in the UK by Rothschild & Co Wealth Management UK Limited. Law or other regulation may restrict the distribution of this document in certain jurisdictions. Accordingly, recipients of this document should inform themselves about and observe all applicable legal and regulatory requirements. For the avoidance of doubt, neither this document nor any copy thereof may be sent to or taken into the United States or distributed in the United States or to a US person. References in this document to Rothschild & Co are to any of the various companies in the Rothschild & Co Continuation Holdings AG operating/trading under the name "Rothschild & Co" and not necessarily to any specific Rothschild & Co company. None of the Rothschild & Co companies outside the UK are authorised under the UK Financial Services and Markets Act 2000 and accordingly, in the event that services are provided by any of these companies, the ns provided by the UK regulatory system for private customers will not apply, nor will compensation be available under the UK Financial Services Compensation Scheme. If you have any questions on this document, your portfolio or any elements of our services, please contact your client adviser.

The Rothschild & Co Group includes the following wealth management and trust businesses (amongst others): Rothschild & Co Wealth Management UK Limited. Registered in England No 04416252. Registered office: New Court, St Swithin's Lane, London, EC4N 8AL. Authorised and regulated by the Financial Conduct Authority. Rothschild & Co Bank International Limited. Registered office: St Julian's Court, St Julian's Avenue, St Peter Port, Guernsey, GY1 3BP. Licensed and regulated by the Guernsey Financial Services Commission for the provision of Banking and Investment Services. Rothschild & Co Bank AG. Registered office: Zollikerstrasse 181, 8034 Zurich, Switzerland. Authorised and regulated by Eidgenössischen Finanzmarktaufsicht FINMA.