How We Invest

As an investment advisor and a fiduciary, one of BWA's primary responsibilities is to help our clients build better portfolios. A big part of this job is to identify, review and then recommend an appropriate combination of independent money managers for each client's portfolio. This is more challenging than it might seem at first blush: There are many thousands of available financial products and money managers that we must hone down to a select list of those we believe will provide exceptional long-term value to our clients.

The purpose of this article is to describe how we sift through the tsunami of incoming data about potential investments. We also proactively seek out attractive investment opportunities, reaching out to promising managers and strategies.

Our process has worked: Since the inception of Beekman Wealth Advisory in 2003, we have recommended to our clients approximately 65 distinct investment opportunities across a wide variety of asset classes (including private investments such as hedge funds and private equity funds). About 90% of the strategies and funds we've recommended are still held in client portfolios. Among the "dropouts", several were term-limited investments that simply reached the end of their targeted investment lives.

BWA's Guiding Principles

At BWA, our approach to investing is based on the following principles and values:

1. We construct portfolios designed to generate attractive *absolute returns* – not just beat a benchmark – after fees and taxes.
2. We believe the best way to win is *not to lose.*
3. We invest in *people*, not just asset classes (most of the time)[1].
4. We favor *broadly-mandated core funds, supplemented by specialists.*
5. We never recommend for a client anything we wouldn't invest in our *own portfolio.*
6. We don't invest in anything we don't *understand*.

These principles and values drive the multi-step process BWA uses to winnow the opportunity set. The key steps are summarized below.

Step 1: Get Rid of the Chaff

BWA's first screen eliminates anything we consider too risky, too expensive, or too illiquid to recommend to clients, such as:

- Load mutual funds
- Highly leveraged funds
- Private equity funds with excessively long terms or high fees
- Hedge funds with excessively long lockups or high fees
- Funds with excessively tax-inefficient strategies
- Funds sold by firms with a history of conflicts of interest versus clients
- Funds based on "black box" strategies
- Funds lacking verification by trustworthy third parties, e.g., auditors, custodians, and counsel

Next, we discard passive (index-hugging) products designed to replicate the returns of a benchmark index. We prefer actively-managed investment funds, which attempt to outperform the index (typically over a full market cycle).

These first two screens enable us to eliminate, very quickly, more than 90% of the investment products that come across our desks for review. We can then concentrate our efforts on more intensive analysis of the rest.

A word about active management: We are well aware that our active investment philosophy runs against current investment

[1] We occasionally make a top-down recommendation at the asset-class level, particularly in times of severe misvaluations of entire markets or market segments. For example, in the first quarter of 2009, we recommended that clients invest in convertible securities, which had been unduly marked down as a result of U.S. government actions taken to contain the financial crisis. In more normal times, our recommendations are based on bottom-up reviews of managers.

fashion, at least in some circles. It is a mathematical truism that the sum of all managers equals the market, and therefore the return to all active managers collectively must be the return to the market, less the fees charged by the managers. Logic would then dictate that active managers collectively must underperform the broad market.

It is also true that many—perhaps most—investors lack the experience, temperament, and/or investment expertise to determine likely future winners and losers among active managers, and would be better off if they stopped attempting to do so.

However, we think it's a step too far to believe this means that *no one* can judge likely future winners and losers, and therefore *everyone* should index *everything*[2]. In our experience, such all-or-nothing thinking rarely leads to optimal outcomes. Instead, we apply the investment analytics, disciple, and judgment we have gained from our decades of evaluating money managers and products.

Step 2: Seek the "Wheat"

After we have discarded most of the investment products we see, on the basis that they fail one or more of our tests of investment quality, we can then do more detailed analysis of the rest. This takes the form of a two-stage analysis. We typically investigate qualitative factors first, and then, if warranted, move on to quantitative analysis. We work in this order because we can discard, without the more time-consuming quantitative analysis, any prospective investment that does not pass BWA's quality test criteria[3].

As we pursue our qualitative due diligence, we seek a definable, replicable, sustainable **investment "edge"** in the marketplace. This might be, for example, specialized expertise, an inefficient or less-crowded market niche, or an unusual source of deal flow.

In this stage of analysis, we look for answers to key questions such as:

- What is the source of this manager's edge?
- What special skills or knowledge does this investment team bring to bear?
- What market anomalies does this strategy capitalize on?
- What has to happen for this strategy to succeed?
- Conversely, what could happen to derail the strategy?
- What are this manager's comparative advantages versus other market participants?
- What is the evidence that the outcome achieved results from skill, rather than luck?
- What mistakes has this manager made, and what has s/he learned from them?
- What are the primary risks in this strategy?
- What has changed that could make the future look different from the past?
- What do others say about this manager, and what kind of company does s/he keep, in terms of both other investors and professionals (auditors, custodians, counsel)?

An attractive investment premise is necessary but not sufficient. In order to earn a recommendation for clients' portfolios, attractive investments must also either (1) be objectively better than, and therefore displace, an existing investment; or (2) bring something new and desirable to the portfolio, and therefore enhance expected risk-adjusted returns for the portfolio as a whole.

Our bottom-line qualitative question, as we consider adding a manager to our roster, is, ***"Is this better than the best of everything we've already turned down?"***

The "Numbers" Really Matter

For the few investments that do pass our qualitative analysis, we then begin our quantitative analysis, based on a proprietary toolset developed by BWA's founder. The "raw material" for the analysis is the historical track record, in the form of quarterly returns net of fees, typically for at least ten years or the full period since inception. The quarterly return time interval coincides with the performance reporting cycle to clients, and represents a reasonable period for evaluation.[4]

[2] And if everyone indexed everything, this would merely magnify exploitable inefficiencies for the first intrepid person who stepped forward as an active manager.

[3] It works the other way around when, as sometimes happens, we can tell at a glance that returns are not compelling. We don't work through the qualitative analysis when it's clear the numbers will quash our interest.

[4] We don't think it's wise to evaluate money managers over much shorter periods. What happens over days or weeks tends to be more indicative of market noise than of manager skill.

Our proprietary tools take these return histories and produce, as output, analyses of:

- **Returns:** How much money does this investment make?
- **Volatility:** How much risk does it take?
- **Correlations:** How would this fit with the rest of a portfolio?

With respect to returns, another truism is that, *If you want to be better, you have to be different.* There are four basic ways an investment can be better (that is, earn higher returns) than markets and competitors:

1. It can make money more often (i.e., a higher proportion of the quarterly periods reflect gains);
2. *When* it makes money, it can make more (i.e., earn higher average gains);
3. It can lose money less often;
4. *When* it loses money, it can lose less.

BWA seeks investments that outperform along two or more of these four dimensions.

Step 3: Assess the Risks

With respect to risk, we calculate volatility using standard deviation as one measure, even though this industry-standard number is often a poor proxy for actual investment risk. BWA's clients generally do not worry much about shorter-term fluctuations in a return pattern; they tend to worry more about the risk of *permanent capital impairment* (losing money). In our view, the main benefit of reducing volatility is that it helps investors stay the course during the interim declines that inevitably happen along the way.

With respect to correlations, we — and perhaps many of you — are marketed a steady stream of supposedly "non-correlated" investment products. In our experience, this is rarely true: Most of the time, correlations to markets and other assets are significant and positive. They're just less than 100% correlated. Moreover, experienced investors have seen time and again that asset class correlations tend to move sharply higher during times of extreme stress.

Once we have the output of our analytical tools in hand, we are ready for the next stage of our investigation of a prospective manager. This is the critical evaluation of the numbers we see. In general, we are on the lookout for numbers that seem suspect, unrepeatable, or out of keeping with our qualitatively-based expectations, and we ask questions such as:

- How much is the track record influenced by outliers (very big gains or losses)?
- Is any part of the track record based on hypotheticals and simulations, as opposed to live money? If so, how much, and what happened after the strategy "went live"?
- Has growth in assets managed changed the investment strategy? Will it do so in the future?
- Does the track record look reasonable, given the strategy described?
- Does any aspect of the return history look too good to be true?

Those strategies that appear to be compelling investments based on our quantitative and qualitative analysis undergo a final set of checks in which we evaluate key aspects of the managers' operations. Our primary goal is to assure that each manager selected operates in a trustworthy and ethical manner, and hews closely to industry "best practices".

Our operational due diligence includes, but is not limited to, the following:

- Confirming the key service providers to the manager, including the auditors, counsel, administrators, tax preparer, custodians, and banking relationships. We expect to see well-known, high-quality providers in each of these roles.
- Discussing the use of outsourced providers of compliance, IT, portfolio-accounting and other key services, where this is applicable.
- Reviewing compliance, trading operations, disaster recovery, and ethics practices and procedures.
- Discussing AML (anti-money-laundering) and KYC (know your client) practices.
- Understanding each firm's management company structure and ownerships, and roles and compensation practices for key personnel.

Significant unresolved questions about any of these areas will cause BWA to discard an otherwise-attractive manager.

Step 4: Create the Portfolio

At BWA, there is no single "magic bullet" portfolio or standard manager selection that works for all clients, all of the time. Instead, portfolios are constructed one at a time, using funds and managers in which we have high confidence. These funds and managers generally appear across many client portfolios, but with somewhat different allocations from one client to another, based on factors such as:

- The individual client's time horizon, risk tolerance, tax situation, needs for cash flow, and other personal factors.
- The other assets in place and to be retained within each client's portfolio. We strive to avoid duplication or overlap with pre-existing assets.
- Which assets or asset classes look particularly compelling as each new portfolio is being constructed, and as reinvestible cash is generated within existing portfolios.
- Which funds are open and available for investment at the time cash is being invested.

A Proven Approach: "Core and Satellite" Portfolios

Once all of the above is determined, portfolios are generally built on a "core and satellites" basis. The "core" of each portfolio generally consists of broadly-mandated funds of liquid securities selected by generalist value managers. These funds are intended to be held indefinitely. We recommend relatively cheap and transparent public mutual funds where appropriate.

A key part of BWA's investment approach is that these generalist managers are the primary source of opportunistic asset shifts. That is, they are the funds that have the ability and authority to move assets from one geography to another (for example, buying Japanese stocks and selling European stocks), or one asset class to another (for example, selling stocks and holding cash) as valuations change. This is because BWA has found that it is much more efficient to have "close-to-the-action" players respond to changing market conditions than it is to hire and fire a series of narrowly-mandated managers to do so.

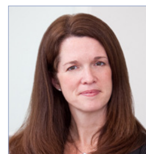
The "satellites" are often less-liquid funds, such as private equity and hedge funds; sector specialists, such as health-care or technology funds; or single-asset-class funds, such as convertible bond funds. These funds generally receive smaller allocations than the core funds, and are the categories within the portfolio for which we may recommend "paying up" for access to particularly talented managers. Examples of such funds recommended by BWA have included long – short sector hedge funds in the media/technology, health-care, and financial/banking sectors; one of the nine U.S. government-supported Public – Private Investment Funds launched in the wake of the 2008 financial crisis to help clean up bank balance sheets; and a specialist hedge fund making activist investments in mismanaged small- and microcap public companies.

In Conclusion

Choosing investments and money managers wisely is hard. Pretty much every financial product comes with a marketing pitch designed to make it sound attractive. Most private investors need help with this critical task, because it is time-consuming, and requires a high level of expertise to be able to sort through the investment "haystack" successfully to find the "needles".

If there is one common denominator among BWA clients, it's that they are seeking "peace of mind" about their investment portfolio, and have hired us to provide it. We hope this explanation of "How We Invest" helps explain our approach. If you have any questions or would like to learn more about this important topic, please contact us directly.

Elizabeth P. Anderson, CFA, is the founder of Beekman Wealth Advisory LLC, a boutique financial consultancy providing highly customized services to families and individuals. Founded in 2003, Beekman Wealth Advisory's business model reflects its unwavering commitment to the best interests of its clients.



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