Gresham's Refined Approach to Portfolio Construction and Improved After Tax Outcomes

Background

Sound portfolio construction has been foundational to our clients' long-term success. In 2012, we published a white paper titled *Challenging the Conventional Wisdom of Portfolio Construction* that focused on the principles of our approach and how conventional frameworks have failed investors by creating an illusion of diversification and a false sense of portfolio protection, particularly during significant market declines such as 2022, when it was needed most. That white paper still serves as a foundational document for describing Gresham's differentiated approach to portfolio construction.

This article describes how we have refined and reorganized our portfolio construction framework to help contextualize the choices and trade-offs Gresham explores with clients for each portfolio decision, and from this refined foundation, how we will begin building tools to enhance how we work with our clients in building their portfolios.

Portfolio Construction Framework

Gresham's portfolio construction approach segments decisions into a three-level hierarchy that helps achieve client-specified investment objectives.

- Level 1 - Focuses on what is most important: our clients' objectives and preferences. Once we understand those objectives and preferences, we use them as inputs to Level 2 of the hierarchy.
- Level 2 - States why we rely on a strategic purpose-based allocation approach to determine broad weights to different assets classes that are diversified by their performance outcomes in various economic regimes. This step helps clients understand why they own certain assets and has resulted in portfolio allocations that protected capital better than conventional approaches.
- Level 3 - Implements client specified allocations by weighing secondary considerations that inform tradeoffs and provide choices in areas such as active vs. passive management and geographic mix.

This three-level hierarchy leads to the construction of an economic regime diversified portfolio that reflects client preferences and which should allow clients to remain invested in adverse markets, thereby avoiding the permanent impairment of their capital.

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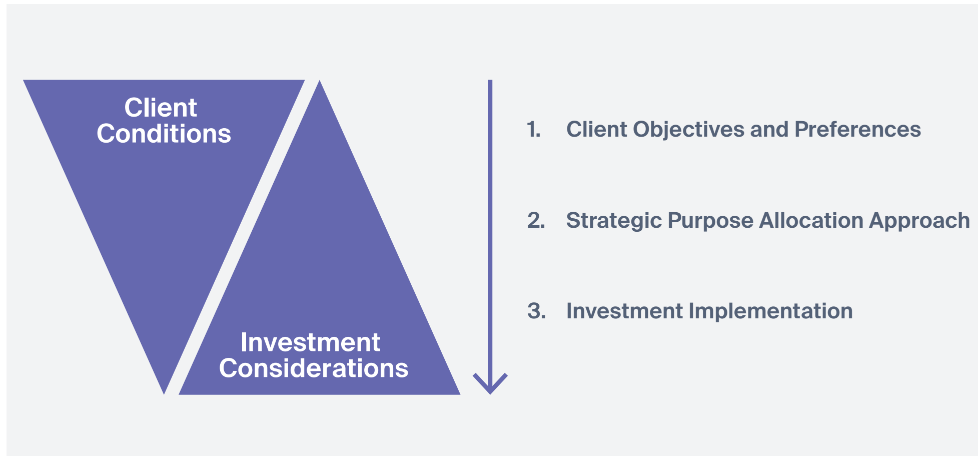


Client Objectives and Preferences

Each investment decision should be supported by a clear understanding of client objectives and preferences. At the outset of a new client relationship, we conduct an in-depth goals and objectives meeting to ensure we have captured the necessary information for building portfolios that are customized to our clients' needs. The importance of this initial phase remains unchanged, but we believe a more explicit emphasis on where clients fit within the three dimensions described below is an important refinement to our approach to portfolio construction.

Risk Reduction vs. Growth

Understanding the amount of risk an investor is willing to take to achieve their desired return objective is central to constructing an investment portfolio. The conventional approach to measuring risk typically revolves around backward-looking statistical measures such as volatility and correlation, but for most investors, particularly individual investors like our clients, the more appropriate measures relate to downside risk. Recall that the most important element of building portfolios for individual investors is to allow each investor to withstand adverse market conditions and remain invested to avoid a permanent impairment of capital that could arise from selling during severe market declines. Balancing a client's allocation between more volatile "growth" assets that typically have correspondingly larger drawdown potential and assets that help "preserve" their wealth can be challenging to calibrate.

Families with multi-generational wealth have another challenge as part of their goal-setting process. Often these families are faced with bifurcated goals for their assets since certain assets may be intended to provide for the current generation while others are set aside for the benefit of future generations. The objectives and constraints of these various pools may differ considerably and typically require different allocations. For example, a portfolio set aside for the benefit of future generations is likely to have a much greater emphasis on long-term growth with less regard for volatility or drawdowns and will typically have a higher tolerance for illiquidity since these assets rarely support current lifestyle needs.

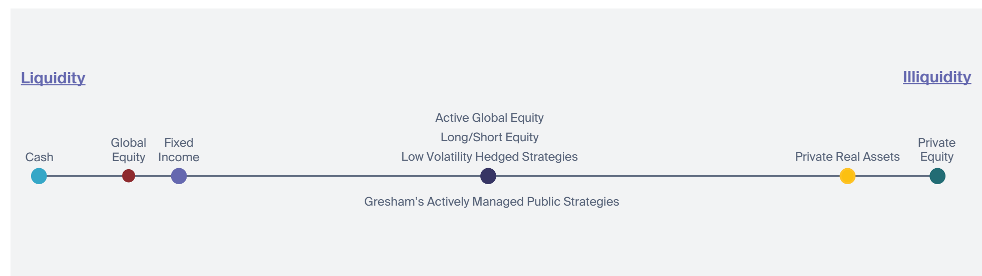
The building blocks for a growth-oriented portfolio typically include equity-based strategies such as public and private equities that are expected to generate a premium return over inflation, but also come with a higher potential for larger declines.

Conversely, investors focused on capital preservation or risk reduction will prioritize stability of capital at the cost of long-term growth. These investments tend to reside at the opposite end of the risk spectrum and include cash, high quality fixed income and more complex strategies like market-neutral hedge funds. Determining the allocation mix between growth and risk reduction strategies requires balancing the inherent risk/reward tradeoffs in conjunction with a client's goals and preferences to establish and maintain long-term target allocations.

Liquidity vs. Illiquidity

Liquidity is the ability to convert investment assets into cash and control the timing of this conversion. We help clients quantify their required level of portfolio liquidity to satisfy recurring cash needs like living expenses, income tax payments, and capital calls related to private investments plus liquidity beyond what is necessary over short-term periods that may be desirable for comfort or for other strategic purposes (e.g., maintaining "dry powder" to invest in the future).

Investors typically face trade-offs for liquidity. Highly liquid assets often have lower expected returns, whereas illiquid investments have historically provided a return premium to compensate investors for their willingness to lock-up capital or preserve capital during market decline in the case of less liquid long/short equity and other hedged strategies.

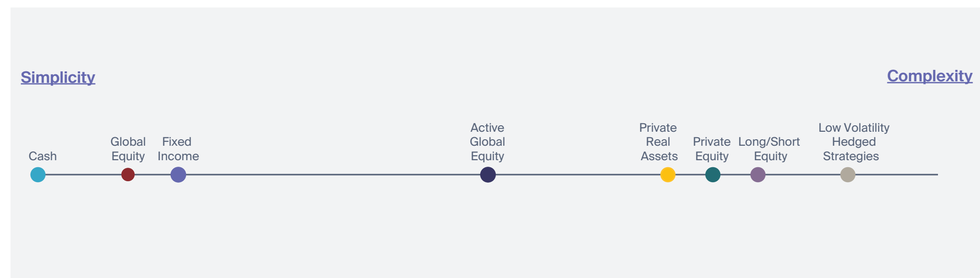


Simplicity vs Complexity

Complexity, which comes in many forms, is typically subjective, eliciting varied responses from clients. For example, a multi-strategy hedge fund that offers limited transparency into their long-short investment portfolio might be considered complex by many investors. However, this same strategy, particularly if it is well hedged from a risk perspective, might also be considered lower volatility and a risk reducing asset for those seeking to reduce the risk of loss. In our framework, elements that contribute to complexity include lack of transparency, leverage and complexity of investment strategy.

The exhibit below illustrates how we frame complexity across strategies. Cash and traditional, passive or quasi-passive equity strategies are relatively simple and reside at one end of the spectrum. At the other end are strategies such as multi-strategy hedge funds with complex robust risk management programs that are critical to reducing volatility, but also increase the complexity and reduce an investor's ability to understand what they own. Actively managed equity strategies lie somewhere in the middle while private equity, which includes venture capital, own a portfolio of non-public companies that are not quoted on markets and are more difficult to gather information on and understand. All else being equal, most investors prefer simplicity but might be willing to accept complexity if their portfolio will benefit in the form of increased return or reduced downside risk.

Historically, our clients have accepted some measure of complexity to enhance portfolio outcomes, and in some cases significantly complexity. For example, more complex strategies such as hedge funds, if executed well, can improve the downside performance of a portfolio, and sacrifice less return when compared to simpler, risk reduction strategies such as cash or fixed income. This approach pushes the onus for achieving these diversification benefits from the portfolio construction level down to the execution level (i.e., our ability to find managers and construct a diversified collection of return drivers).



Strategic Purpose Allocation Approach

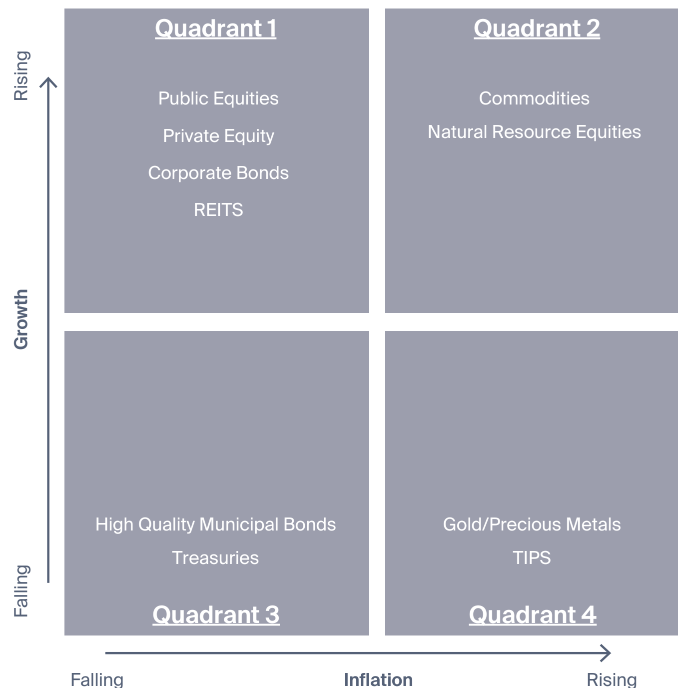
With a clear understanding of our clients' goals and preferences in Level 1 of our framework, we transition to Level 2, where their preferences are reflected across broadly defined asset categories. The conventional approaches to portfolio construction rely on historical returns and correlations to build portfolios that are seemingly diversified across different asset classes. These approaches have often failed to protect client portfolios during significant market declines when correlations of certain asset classes tend to converge causing assets to decline together and offer little portfolio protection. The flaw lies in the definition of asset classes that tend to parse asset along market characteristics but in reality, have similar performance drivers and hence downside risk. For example, many asset allocation models separate small, mid and large-cap stocks as diversifying exposures. While less egregious, others often will distinguish between U.S. listed stocks and international stocks. The flaw is that these are all forms of equity ownership that will tend to decline together in certain economic regimes and during severe market declines.

On the other hand, if we group asset classes by how they perform in various economic regimes this process also tends to group assets with similar downside characteristics.

While this generalizes a more nuanced approach, this framework seeks to eliminate the illusions of diversification and investors' false sense of protection.

If we can classify the best performing asset within various economic regime, why not just allocate to assets that perform best during a particular economic regime rather than diversifying across these regimes? First, predicting economic regime shifts is difficult and the cost of being wrong can be quite high. Second, the duration of a particular regime can be short and the transitions between them rarely follow an orderly pattern and are often accompanied by highly volatile markets. As a result, we are regime agnostic and attempt to build balanced portfolios that perform well across regimes while emphasizing growth-oriented strategies that have a greater chance to maximize long-term wealth creation.

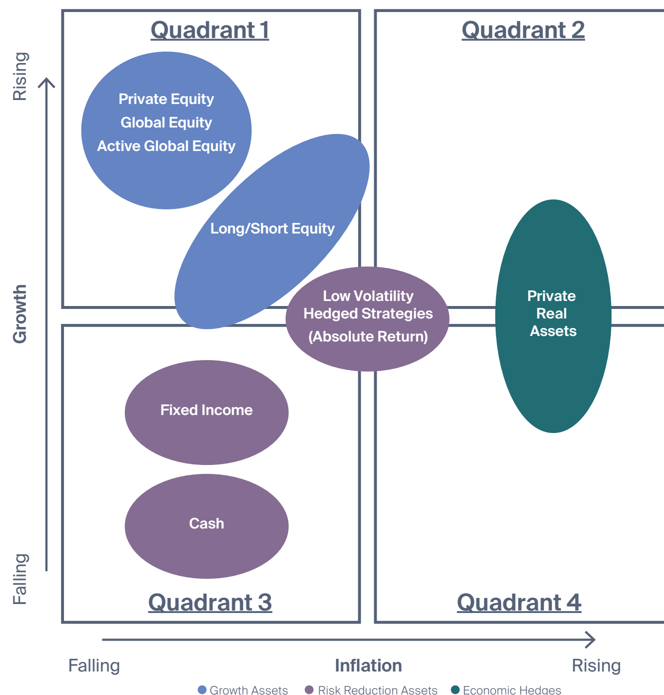
Many factors define an economic environment, but those with the strongest impact on capital markets are economic growth and inflation. It is not surprising that certain asset classes tend to perform better than others depending on the scenarios for growth and inflation. By combining these inputs, we can define four discrete economic regimes, which are shown in the chart below. We have included examples of traditionally defined asset classes that tend to perform well in each economic regime although they may not be part of our recommended solution for various reasons.



For example, Quadrant I is a high growth/low inflation environment. Until very recently, this has been the dominant environment over the past 40 years, as workforce globalization created strong disinflationary forces and technological innovation drove a productivity boom leading manufacturers to produce better goods at cheaper prices. Equities have historically performed best during periods of high (or increasing)

growth, particularly when it coincides with falling inflation (Quadrant I). However, this is not always the case as other types of equities (e.g., commodity producers) can perform well when growth and inflation are high (Quadrant II). The high/rising growth environment in Quadrant I may also benefit corporate bonds as higher growth tends to improve the financial strength of corporations. In contrast, fixed income securities issued by governments and municipalities have historically performed better in declining inflation environments that typically correspond with declining interest rates (Quadrant III). An allocation to precious metals would perform well in a low growth, rising inflation environment (Quadrant IV), particularly if the response is stimulative fiscal and monetary policies that result in currency debasement.

The chart below incorporates the strategic purpose building blocks and moves one step closer to the implementation level by plotting Gresham's primary implementation solutions across economic regimes. Long-term investors should hold significant exposure to public and private equities (Quadrant I) as core growth drivers, balanced with assets that typically perform better during other economic regimes. Risk reduction assets, that include high-quality fixed income investments like municipal bonds (Quadrant 3) can be a strong diversifier as they tend to perform well or exhibit some resilience when economic growth and corporate profits are weaker. As shown in the middle of the chart, non-correlated, absolute return-oriented strategies can do well regardless of regime, acting as a risk reducer in client portfolios. Private real assets tend to perform best in environments characterized by high growth and inflation, serving as an economic hedge, when many public equities may not perform as well.



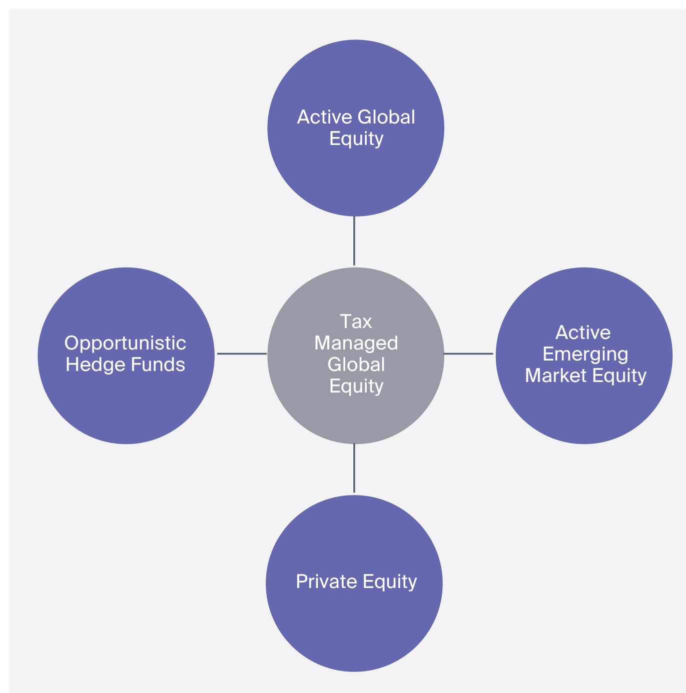
Investment Implementation

Core-Satellite Approach

Level 3 focuses on how we implement portfolios. We could devote an entire article to implementation; however, here we concentrate on growth assets given the prominent role these play in our client portfolios and the advent of tax-managed equity strategies.

A core-satellite framework allows investors to balance "core" equity exposures, which tightly track equity markets, alongside alpha seeking "satellites" whose performance will intentionally deviate (sometimes significantly) from equity markets in pursuit of higher long-term returns. While Gresham has historically recommended modest core (i.e. ETFs, tax-managed index tracking strategies) solutions, our recent work to co-develop an enhanced tax-managed strategy which will improve the after tax outcome for our clients may shift our recommended core-satellite balance. While the enhanced strategy is more expensive due to higher management fees and the cost of leverage and may have slightly larger deviations from equity benchmarks, the tax benefits to an investors entire portfolio make this tradeoff well worth considering.

The allocations between core and satellite growth exposures will vary by client, reflecting their personal preferences as described earlier. Gresham's actively managed satellite solutions include concentrated global equity, emerging markets equity, opportunistic growth (primarily equity based hedge funds), private equity and venture capital. These satellites are likely to make up the majority of clients' growth assets, as most clients will accept the lessor liquidity, added complexity and higher benchmark deviation in pursuit of higher returns and long-term wealth creation. It is also important to remember that these strategies are heavily reliant on our manager selection process, which has been successful for our clients over time, but doesn't happen consistently through time. A long-term perspective is required to reap the benefits of investing in these satellites.



Conclusion

Gresham's unconventional approach to portfolio construction, which remains rooted in understanding the role assets play in different environments, has served clients well for more than 25 years and throughout the different regimes it was designed to address. Not only has it helped us better understand and meet clients' long-term objectives and preferences, but it has also been a source of downside protection during periods of significant market decline and provided diversification when it was needed most. Like anything, we must continually evolve and refine our framework and the allocations within it to meet changing needs of our clients and the changing opportunities presented by capital markets and new investment solutions. In the near-term, this refinement of our portfolio construction framework will likely not result in higher-level allocation changes for client portfolios, but merely a change at the implementation level as the enhanced tax-managed solutions will tend to increase our allocation to core, tax-managed solutions.

About Gresham

Gresham Partners is an independent investment and wealth management firm that has been serving select families and family offices as a multi-family office and an outsourced chief investment officer for a quarter of a century. Today, we manage or advise on approximately $8.6 billion* and for about 110 families* located nationally.

We are committed to providing superior investment performance by utilizing select, difficult-to-access managers that are located globally in a full range of asset classes and are not affiliated with Gresham. We make these managers available to our clients in a flexible format well suited to achieving a broad spectrum of investor goals. We integrate this investment approach with comprehensive wealth planning and management services to address the full range of each client's financial needs, often avoiding the need for them to maintain a family office.

Gresham is wholly owned by its senior professionals, client fees are its sole source of compensation, it avoids conflicts of interest that affect many other firms and it acts as a fiduciary dedicated to serving its clients' best interests.

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**Approximate AUM and client families as of 12/31/21*