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Building and maintaining

family office share portfolios

In these uncertain times, how family offices manage their share portfolios is increasingly important. Family office management has to take into account key requirements that go beyond what is needed for other large portfolios. It is not that the requirements are unique to family office portfolios; rather, they have to be implemented with more care and rigor because of the need to preserve and grow the wealth over generations.

The first requirement of family office portfolios is that they have a clear, rational and objective basis for their development and maintenance. Warren Buffett, chairman and chief executive officer of Berkshire Hathaway, made this clear for his own investing when he wrote that the basis of his success was having “a sound intellectual framework for making decisions and the ability to keep emotions from corroding that framework”.

When Buffett started his investment partnerships in Omaha in 1956, his net worth was US$174,000. Today it is around $50 billion, an average annual return of over 25 per cent.

Adopting such a methodology is even more important for portfolios held by family offices, for four reasons. First, a clear decision-making methodology allows those who are responsible for the share portfolio to properly communicate and collaborate with each

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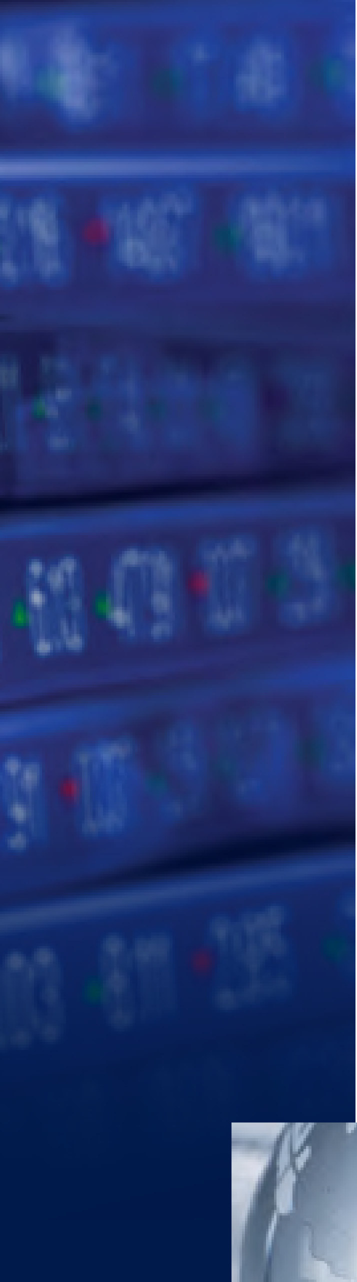

other, whether they are actually members of the family or outside managers.

Second, it allows the methodology to be presented objectively to the other family members. Properly presented (and this is really only possible when the basis is clear and rational), it allows the other family members to understand the rationale behind the investment decisions.

The third reason is that it gives the members of the family a sense of responsibility and ownership of the investment decisions along with their actual ownership of the portfolio itself. The fourth reason is that it reduces the potential for conflict between members, so often responsible directly and indirectly for sub-par performance.

The second requirement for family office share portfolios is the preservation of capital. Even though performance is important, more important are strategies that preserve the wealth within and between generations and avoid it slipping away through misguided, ill-informed or short-term decisions.

The obvious reason to preserve capital is that there is no loss of wealth for the current generation. A second and more important reason is that it prevents an even greater loss of money for future generations. A loss of wealth now can become magnified in the future because of a smaller base to take advantage of the effect of compounding.

Of course, Buffett has done much more than not lose money, and the same would be anticipated for family office portfolios using the methods described below.

Even though the methods are aimed at implementing the requirements of a rational basis for the investment methodology and the preservation of capital, they also provide a foundation for generating not only an attractive return, but one with high safety as well.

Rational basis for share selection and portfolio management

Let us start with an outline of a rational basis for selecting shares and managing a portfolio. There are four aspects to this.

Financial requirements

Start with the earnings of a company. It comes as a surprise to most investors to learn that over any 12-month period, only around one third of companies on the ASX make money. Putting it another way, over any 12 months, well over 1400 companies make no money for their shareholders, with most losing money for them. It is no wonder that the prices of so many shares never meet their touted expectations. Most turn out to be outright capital-killers, with huge crashes in share price. Or they are capital-killers by stealth and dribble your capital away. The first financial requirement is strong, steady growth in earnings per share. The same applies to sales per share, the bedrock of earnings per share.

Next look at return on equity, the earnings of a company divided by its equity. It is an important measure of the economic success of a business. Unless management scores well in this regard, it makes little sense to invest in the company. With this in mind, a

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basic requirement is that ROE should be consistently above 10 per cent – ideally above 15 per cent.

Another requirement is that there should not be too much debt. Recall Babcock and Brown. Just before it collapsed, it had a debt to equity ratio of 450 per cent. Almost 80 per cent of the net profit was used to pay the interest bill. Yet it was being promoted by most analysts and financial commentators as a desirable investment. In looking at companies, we are wary of those with debt to equity above 50 per cent, and of those who use debt in ways that appear to be more for the benefit of management than shareholders.

Future risks of the company

It is easy to find reasons to invest in a company. Simply read any of the press releases by the CEO or chairman, who have a vested interest in describing the company in a positive light. It is not so easy to find reasons not to invest in a company. Yet from an investor’s perspective, knowing about the risks involved could be the difference between a winner and a capital-killer. A methodology like that utilized by Teaminvest works well: start by developing a list of the risks of a business, then gauge the likelihood of these risks occurring in the next economic cycle and the severity of the damage should they occur.

Board and senior management

About 50 years ago, Philip Fisher, one of the pioneers of investment analysis, wrote that the final question every investor should ask was whether the company had management of unquestionable integrity. He continued: “If there is a serious question of the lack of a strong management sense of trusteeship for stockholders, the investor should never seriously consider participating in such an enterprise.”

It isn’t always easy to see from the outside whether management has unquestionable integrity. There are, however, pointers that cause us to shy away from particular companies. One is through a careful reading of the section in the annual report on related party transactions. If there are a large number of related party transactions or if they are of considerable size, it is generally best to move on.

Another pointer can come from the remuneration report. The levels of the salaries and incentives given to senior management, particularly the CEO, are important. Even more important is whether the incentives are properly aligned with the goals of the shareholders. As an example, a close analysis of some incentive packages show that management is rewarded for the activity of making acquisitions instead of whether any acquisitions genuinely increase the earnings per share.

Economic moat

An economic moat, or sustainable competitive advantage, protects a company against changes in the buying habits of consumers, existing and new competitors, government legislation and the general economy. Types of economic moats include geographical, location, brand name, licenses or patents, cost of entry and management expertise.

We measure an economic moat in terms of its type, strength and durability. It is vital that a company has a strong economic moat and that there is evidence that the company is focused on maintaining it. Otherwise the company may move from a profitable market leader to an also-ran contender.

Family values

Another consideration for some families is to choose companies with products and services that are aligned with the values of the family. This is one of the aspects of being a conscious investor; the other is having a clear awareness of why particular investment and portfolio decisions are made.

Preservation of capital using stress testing

The key to preserving capital is stress testing. When an architectural engineer gives approval for the construction of a new building, they must give assurances not only that the building will meet the requirements of the new owner; it will also pass a range of safety requirements. Before any building work starts, the design has to be stress-tested for everything from the ability of the floors to carry specified loads to the building being able to withstand extreme winds.

15%

THE BENCHMARK RATE OF RETURN ON EQUITY WHICH IS A DETERMINANT OF A COMPANY’S INVESTMENT POTENTIAL

Similarly for the share market, before a purchase is made, the investment needs to be systematically stress-tested. In this way, stress testing goes far beyond the general idea of asking that an investment has a margin of safety. Precise stress testing is the key to ensuring that a purchase meets the needs of a successful investment, ranging from preservation of capital through to a healthy, secure return. There are three specific tests that should be applied.

Stress test 1: growth of the business

Professional analysts make forecasts of the growth of businesses. Unfortunately, despite all the publicity about these forecasts, many large-scale academic studies show that they are generally not accurate enough for responsible investing.

Fortunately as investors we do not need to make accurate forecasts – we just need to avoid results that are less than projected, so-called negative surprises. In other words, we want to make forecasts that the actual growth rate is very unlikely to fall below, and highly likely to exceed. This is what is meant by a stress-tested forecast. It can be interpreted as a worst-case scenario.

Stress test 2: market recognition

When Benjamin Graham introduced the mythical character Mr Market, he wanted to emphasize that stock markets have moods. Some days shares in a particular company will only be available at high prices. Other days, with no further information, they will be available at much lower prices. The easiest way to see these swings is via the price-earnings or P/E ratio. The P/E ratio tells us how much Mr Market is willing to pay for the projected stream of earnings being generated by a company.

Even for stable iconic companies such as Woolworths, this can vary considerably over a financial year by 50 per cent or more. What we need is a stress-tested P/E ratio at a level that we can be confident will be exceeded in the future.

Stress test 3: dividend policy

What has been the level of dividends in the past compared to earnings per share? Has the board given any indication about the future dividend payout ratio? If the payout ratio were cut back, what would be the impact on the expected return on an investment? These are the types of questions that can be included in making forecasts of payout ratios. Once more we are stress-testing the particular forecasts and their outcomes.

It is vital that such stress tests be objective – otherwise it is too easy to be led astray by behavioral biases into thinking that an investment is more robust than it really is. Objective computational methods are available that isolate weaknesses in the historical financials of a company and make these stress-tested forecasts. These methods are contained within Conscious Investor® as part of the Teaminvest approach to finding superior investments.

Calculation of the expected return

In light of the above, what minimum return would be required to compensate for the risks associated with it? For example, suppose the risk-free bank rate is five per cent. What extra return would be required to compensate for the risks associated with investing in a particular company? Without answering this type of question, we are really just speculating with the hope that we are going to get a profitable return but no real idea whether we will or not.

Again there are products such as Conscious Investor® that will perform this analysis. After activating the above stress-tested forecasts, the software calculates the return that can be expected with confidence from purchases made at the current price. If the return that is calculated exceeds the required return, it may be time to buy; if not, further calculations show what would be the appropriate purchase price.

Conclusion

Portfolios held by family offices have special requirements. The steps described above provide a clear pathway to meet these requirements to maintain wealth over generations and to grow it prudently.

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