Enodo.

Briefing
November 2020

Business owners - the asset allocation in your investment portfolio should be different

For
Your family ✓
Your firm ✓
Your society

Reading time
8 minutes

Enodo can help

By reviewing your portfolio of liquid investment positions and their interplay with your business assets

By building a strategic asset allocation that suits your needs and your personality

By selecting appropriate investment managers to implement your strategic asset allocation

Executive summary

As a business owner, it is essential that your investment decisions regarding your asset allocation take into account the potential interplay between your business and your investment portfolio, as economic uncertainty may impact your firm potentially in different ways than your investment portfolio. And before you can even formulate the right allocation, you need to be clear on your own and your family's situation and future needs, as they will impact your ability and desire to take risks in your portfolio.

Despite claims to the opposite, business owners regularly are being advised on their portfolio strategy without having gone through an in-depth analysis of their situation that is typically far more complex than that of the average client. Unsurprisingly, inconsistencies in outcomes and a feeling of deep dissatisfaction can come to the fore when markets are more volatile and portfolio returns dip beyond what investors were willing to stomach.

By taking a comprehensive look at the client's situation and determine a customised investment strategy for them can mitigate these issues markedly. Backed by the latest academic research in this field, we adopted some the best ideas and developed them further to create a tailormade solution that formulates an individually optimised asset allocation for entrepreneurs - the *Goal-based Asset and Liabilities Allocation* (GALA) approach. The results show that by incorporating the client's business activities as well as her liability positions into our assessment, we may propose an ideal risk/return profile that is different from what the client may have previously received.

We will go through an example case in order to illustrate the benefits of this novel approach to strategic asset allocation. As everyone's situation is different we have developed an online, fully customisable version of the Enodo GALA Modeller™, which can be accessed here.

In the morning, when you read the news on your tablet or phone, or simply browse through your favourite newspaper the good old-fashioned way, you probably cannot help but wonder how and why global equity markets have had such a good year so far. Numerous challenges, ranging from unstable geopolitical situations in a number of regions, the ongoing threat of trade wars, the historic levels of government debt and of course the longer-term structural impact of Covid-19, paint a rather sobering macro-economic outlook. With market valuations trading well above their long-term averages, it doesn't require a pessimist to expect rather turbulent times ahead.

As a business owner, economic uncertainty will also impact your firm, albeit potentially in different ways than your investment portfolio. It is therefore essential that your investment decisions regarding your asset allocation take into account the potential interplay between your business and your investment portfolio. And before you can even formulate the right allocation, it is well worth spending time on your own and your family's situation more generally.

Do you have a good understanding of what goals are important for you to achieve in the near future, but also in the long term? Will they constrain your ability to take on more risk in your business and in your investment portfolio? What about your general inclination to take risk? Differences in personal character traits may lead to marked differences when defining your optimal allocation of your assets.

Is your portfolio ready for the next downturn?

Assessing and choosing the optimal strategic asset allocation (SAA) for your investment portfolios features some unfortunate similarities with a visit at your dental hygienist – it is usually a rather lengthy and at times painful matter and at the end of process you may wonder whether it was at all necessary.

SAA is crucial for investors as it will drive about two thirds of a portfolio's total return over time. However, its derivation is rather laborious and yet unclear given the plethora of scientific and heuristic approaches that exist. Furthermore, it also doesn't seem to matter a great deal given that the advertised diversification benefits have not proven to be present during periods of market distress, i.e. when they are needed most.

Having recently lived through an extraordinary episode in the financial markets in March 2020, reinforced this feeling, particularly with those that have suffered severe losses in their portfolios. An exacerbating factor can be the fact that an investor's circumstances were not fully understood at the outset, leading to unnecessary frustrations once markets become less benign.

This is also the context where assurances by financial advisors that their advice is 'truly holistic' and takes one's personal circumstances fully into account have to be taken with a pinch of salt. The advice - more often than not – actually remains piece-meal and critical elements are not fully understood, let alone considered.

Business activities need to be reflected in the client's risk appetite assessment

Business owning investors will be particularly prone to suffering the consequences from over-simplifying assumptions regarding their personal circumstances as theirs are unusually complex. On the most basic level, their business activities need to be factored in appropriately. Operating businesses are a substantial source of current and future income for owners and, unlike the income of an employee that is fairly steady and certain, they move much more cyclically and therefore behave more akin to equity markets.

Treating the client's business as equity will therefore have a major bearing on the client's ability and willingness to take financial risks. Wealth advisors that do not explicitly build the client's business into their calculations are bound to arrive at a suboptimal SAA.

Liabilities and critical lifetime goals need to be accounted for

Even if the client's advisor does take the business into account appropriately, the assessment of the optimal SAA will typically be based on the client's assets alone. Incorporating both the business owner's assets as well as liabilities will give a much more complete picture when determining the client's risk propensity.

What sort of liabilities are relevant here? There are explicit liabilities such as the company's outstanding bonds or the client's personal mortgage on properties or a Lombard loan in the invested portfolio. Without taking into account the interplay between the client's assets and these liabilities, the client will not be aware and react to the reinforcing or counterbalancing nature of her assets, leading again to suboptimal choices when building the portfolio.

There are, however, also implicit liabilities on the client's balance sheet that need to be planned for. Most of these liabilities relate to the client's long-term goals for her money that - in her opinion - must be achieved with her savings. This can range from basic security needs, such as maintaining a certain lifestyle until her and partner's death, the desire to fund a certain lifestyle for her children, or simply the ability to donate a certain amount to charity.

Objective assessment measures help avoid subjective misjudgements in risk appetite

The assessment of a client's risk appetite is typically qualitative in nature and depends largely on the type of questions being asked, but also by how they are being positioned. The same questionnaire for the same client may lead to significantly different conclusions depending on how the questions are being framed by advisor. Small differences can then result in starkly different SAA preferences, which will have significant implications for the client's long-term returns. The risk profiling process with the client therefore needs to be based on a solid, research-led framework that allows for an objective determination of the client's risk score that is subsequently adjusted for behavioural characteristics.

The GALA approach provides a specific framework for entrepreneurs

Recent academic contributions have made helpful proposals in order to capture some of the complexities witnessed in reality. Asset Liability Management based solutions, which are more commonly used in the pension industry, have recently been adopted to address the wealth situation of individuals, in particular those of entrepreneurs.

We have adopted and expanded these in order to adjust them to the situation of our clients. We have summarised its building blocks in what we call the *Goal-based Asset and Liabilities Allocation* (GALA) approach. The results show that incorporating the client's business activities as well her explicit and implicit liability positions can alter the client's ideal risk/return profile significantly. [1]

In a recent discussion with a client - a successful Hungarian entrepreneur with a nationwide retail chain - we learned that her strategic asset allocation was heavily tilted towards fixed income investments based on the risk profile assessment by her advisor. It further transpired that neither her business operations, nor her longer-term goals were discussed in great detail. The advisor's conclusion on the client's risk profile appeared to be based on a limited number of qualitative questions and the notion to 'play it safe'.

However, this may not necessarily be the optimal portfolio solution for our client as the result will vary markedly depending on the client's liabilities or - put differently - the 'leverage ratio' on her balance sheet. Additionally, it will vary depending on the extent to which her business is correlated with the equity market, a measure called 'beta' factor where higher values show a greater synchronisation of company returns with the equity market.

During an in-depth conversation with the client, we established that the client had the desire to fund a number of long-term goals, ranging from supporting her parent's substantial medical bills over the next 15 years to setting up a trust for her three children and funding it adequately over the coming years. These goals were incorporated as 'liabilities' into her balance sheet and fed directly into our risk profiling model.

Following the discussion of various model scenario outcomes, the client decided to rebalance her portfolio towards a larger equity composition. In addition, her investments were split into goal-based buckets in order to be better able to track each goal's progress. This had the added benefit that certain higher priority goals could deploy a low-volatility asset portfolio (e.g. the bucket dedicated to the medical coverage for her parents), whilst other goals could be assigned riskier assets, balancing back to the overall agreed risk/return profile for the client.

---

[1] Our GALA approach borrows from recent academic contributions of (Horan & Johnson, 2014) and (Brunel, 2011) regarding their advancements in managing portfolio with an asset and liabilities perspective. However, the GALA approach expands on the number of asset classes in order to model a more realistic investor portfolio scenario. In addition, in contrast to (Horan & Johnson, 2014), we do not incorporate business assets into the overall asset allocation using their approach. Instead, we developed our own approach which includes an estimate of the company's return, volatility and correlation profile based on the companies estimated beta relative to the equities market. This allows us to fully incorporate the business into the strategic allocation calculation.

Finding the right mix for you – try the Enodo Goal-based Asset and Liabilities Allocation (GALA) Modeller™

Your situation may vary markedly from our client above. Perhaps, in your circumstances will require to take risk off the table, or, more likely, ensure that your investment portfolio displays a low correlation with your other business interests.

In order to help you to understand your objective risk position, but also your subjective preferences based on your personality, we would like to invite you to try out our approach today, through this shortened version of the Enodo **G**oal-based **A**sset and **L**iabilities **A**llocation (GALA) Modeller™ (click here). You will need to answer 21 questions about your financial situation, your life goals and your personality. It will take between 7 and 10 minutes to complete, and you will not need to provide any personal contact information to view the results. At the end, we will provide you with your own personal strategic asset allocation.

This is an opportunity to really think about the purpose of your wealth, so find somewhere quiet and relaxed to complete the questionnaire. We hope that you will find our philosophy both distinctive and disciplined – and the results insightful and challenging. We would very much like to discuss them with you.

References

Brunel, J. L. (2011). Goal-Based Wealth Management in Practice. *Journal of Wealth Management*, 17-26.

Horan, S. M., & Johnson, R. R. (2014). The influence of a Family Business on Portfolio Management: An Asset-Liability Management Approach. *Journal of Wealth Management*, 14-30.

About the authors

Nick Perryman MSc MBA CharteredFCSI FRSA MBPsS
Co-founder and Managing Director
nick@enodo.capital

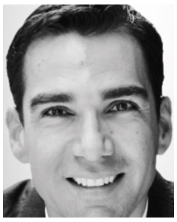
Nick has over 20 years of experience in wealth management, predominantly spent at UBS where he was a Managing Director. He held a number of senior leadership roles, including Head of Wealth Management for Global Emerging Markets in London, where he led a sizable business advising wealthy families in Central & Eastern Europe, Middle East, Turkey, Israel, Africa, Latin America and Asia-Pacific.

For six years, Nick was Head of Investment Products and Services where he led the investment management, capital markets, alternative investments, lending and wealth planning functions, responsible for over USD50 billion of client assets, and a sizable lending book. He also founded the client philanthropy unit in the UK, which supported clients in maximising the strategic impact of their giving. He has been a regular media commentator. Over the years, he has also maintained a strong academic interest in business psychology.

He has served on numerous non-profit boards and is currently Vice Chairman of the governing body of Royal Holloway, University of London, amongst the top 25 in the UK and 250 globally. He also chairs the committee overseeing the university's USD100 million endowment.

He holds MSc in Organizational Psychology and MBA in Finance degrees from the University of London, is a Chartered Wealth Manager, Chartered Fellow of the Chartered Institute for Securities & Investment and Member of the British Psychological Society. He was elected Fellow of the Royal Society of Arts for his work in philanthropy. He is also a part-time Doctoral researcher in organizational psychology and family-owned business at Durham University.

Dr Baris Serifsoy Dipl-Kfm MBA CFA FRM
Co-founder and Managing Director
baris@enodo.capital



Baris has over 15 years of experience in wealth management and investment banking in London, Zurich and Frankfurt. Between 2006 and 2020, he worked for UBS, where he was a Managing Director.

He served as Head of the Global Family Office, Ultra High Net Worth Emerging Markets and Financial Intermediaries units for UK and Jersey, offering wealth management, structuring, lending and investment banking solutions to the largest clients of the firm. His team was entrusted with over USD12 billion of client assets.

Prior to this, he was responsible for various significant teams serving wealthy families in Central & Eastern Europe, Middle East, Turkey, Israel, Africa, Latin America and Asia-Pacific.

Before joining UBS, Baris was a research assistant to the Chair of International Banking and Finance at the Goethe University Frankfurt and a visiting scholar in Finance at the Wharton School, University of Pennsylvania.

He published papers on global stock exchanges in peer-reviewed academic journals, including the prestigious Journal of Banking & Finance, and was a regular commentator in the media.

Baris holds a Doctoral degree in Finance from Goethe University Frankfurt and the Diplom Kaufmann degree from the University of Regensburg, as well as an MBA degree. He has completed the Chartered Financial Analyst and Financial Risk Manager programmes.

The story of Enodo

Enodo is the Latin word to explain, literally to *unknot* or *untangle*. This encapsulates our vision – to bring clarity to the complexity of being wealthy.

Our founders have had the privilege of advising some of the world's wealthiest families. They've observed first-hand the liberation and opportunity that wealth can bring – unifying families around a common purpose, creating real economic impact via a family business, or contributing to wider society through audacious philanthropy.

At times, they've also seen the stress and confusion that can result. They've witnessed family disharmony, miscalculations in family business or investment strategy, and the hugely detrimental impact of working with advisors who put their own interests first.

Our founders have engaged in the discipline of advanced academic research. Their own analysis of peer-reviewed academic literature across the disciplines of finance, economics and business psychology, combined with their deep professional experiences, have allowed them to arrive at new perspectives on how *to be wealthy* and how *to manage wealth*.

The result of their thinking is the Enodo Leadership in Wealth™ advisory framework which supports wealthy families in using their wealth to lead across all the dimensions of their life – *family, firm* and *society*. Amongst other things, their framework includes:

For your family

- Family governance and family office set-up
- Investment risk and asset allocation – including family business assets and debt
- Chairing a family investment committee
- Selecting the best investment managers
- Analysing investment opportunities, including alternative investments and recent innovations (e.g. cryptocurrencies)
- Understanding the impact of investing in your passions, such as art and collectibles
- Monitoring of performance and risk
- Guiding and analysing where you are in dispute with your investment advisor

For your firm

- Organizational culture and performance
- CEO / founder succession and role of family members
- Financial optimisation – including debt, hedging and foreign exchange
- Reviewing your equity and debt capital market opportunities
- Corporate and social responsibility

For your society

- Philanthropy and impact investing
- Establishing a family foundation

The Enodo Goal-based Asset and Liability Allocation (GALA) Modeller™ offers ground-breaking insights into optimal strategic asset allocation – examining the risk characteristics of a family business shareholding and analysing tolerance for risk from psychological personality profiling. You can experience a shortened version of this powerful tool here.

At Enodo, we offer rigorous, independent and intelligent advice to wealthy families around the world. We aspire to be your trusted partner, wherever life leads you.

Enodo Capital Limited
39 - 40 St James' Place, London SW1A 1NS, UK
+44-20-7717-9700
www.enodo.capital