The Skorina Letter

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The Family Office: where cash is king

All I ask is the chance to prove that money can't make me happy.

-- Spike Milligan

Something caught our eye last week as we leafed through a recent Harvard Business School case study, "Modern Endowment Management: Paula Volent and the Bowdoin Endowment."

The investment team has kept almost no cash or fixed income on hand for over fourteen years. Three-quarters of the portfolio runs on private equity and hedge fund moxie, the rest in stocks.

That's not how most ultra-high-net-worth (UHNW) family offices do it. In our experience, these offices hold substantial amounts of cash and bonds, adding stocks and real estate for the long haul. Why such a divergence?

According to the HBS study, Bowdoin's allocation to bonds and cash shrank from 18 percent in year 2000 to essentially zero by 2008 and apparently there hasn't been a dime added to liquidity since.

Granted, it certainly hasn't hurt Bowdoin's performance. Ms. Volent and her team led our ten-year performance rankings in our last endowment report.

Furthermore, the school has sizable reserves. We looked up the College's financial statements, which listed cash and equivalents of about $80 million against operating expenses of $176 million as of June 30, 2020. So the bursar made sure there was cash in the kitty. And, for the Ivys and elites, Bowdoin included, there are hefty credit lines and wealthy donors to lean on in a pinch.

Bowdoin is not alone, of course. Many large university chief investment officers have managed their endowments for years with a cash-is-trash attitude.

And, as most CIOs have learned the hard way, it's a brave investment manager indeed who breaks from the herd.

Marks to make-believe

As we wrote last December, endowment returns for 2021 approached the realm of fantasy. Institutional investors delivered once-in-a-lifetime performance, from about 25 percent at the most tentative public pensions to 65 percent at Washington University, St Louis.

Bowdoin, for example, posted an astonishing 57.4 percent return.

We opted not to do our usual performance study last year because we felt the private market marks were too far off the mean – and reality – to fairly assess skill. Given this year's collapsing valuations, we think we made the right call.

However impressive those investment returns eventually turn out to be once marks convert to hard cash, we can't help but recall what my first-year finance professor (Robert S. Hamada) at The University of Chicago emphasized in class.

He said that exceptional money managers seem to have the touch. And we can theorize, not always correctly, about how they do it. But most of them have a run bracketed by a certain period or a set of conditions, and then they are gone.

Families think differently

Family offices have been around for centuries and weathered every conceivable storm. They prefer not to fly so close to the sun.

From the major-domos in ancient Rome to Rockefeller and Microsoft heirs, cash has always been king. Liquidity meant power and the means to act in good times and bad.

Maybe it's also because family founders are usually operators who run businesses and in business, running out of cash is original sin.

The latest UBS Global Family Office Report 2022 breaks out UHNW family asset allocations and their preference for liquidity. The bank polled two-hundred-twenty-one single family offices with total wealth of almost half a trillion dollars and average assets under management of over two billion dollars.

UBS found that large family offices hold substantial cash and fixed income, about a quarter of their wealth all told. Families seldom bet the house.

There have been a few spectacular exceptions of course, Bill Hwang's Archegos Capital Management for one; the Hunt brothers Herbert and Nelson's run on the world's silver supply for another. What were they thinking?

Fortunately the youngest of the three Hunt brothers, Lamar, kept his head and his money and, among other honors, became a Culver Academies Athletic Hall of Fame Inductee in 2006. Funny thing about high school, I couldn't wait to graduate and yet, most of my closest friends come from our Culver days.

But I digress.

UBS noted a slight decline in allocations to fixed income and cash in 2021, but this reduction drew from a fat cushion to begin with. And families can change course in a heartbeat when the wind shifts, as has happened this year.

According to the UBS survey, UHNW portfolios allocated approximately 32 percent to stocks, 21 percent to private equity, 15 percent to fixed income, 12 percent in real estate, and 10 percent in cash. The remaining 9 percent includes a grab bag of hedge funds, private debt, gold, commodities, and art.

Compare this to Bowdoin’s portfolio of roughly 24 percent public equity, 38 percent private equity, 28 percent absolute return, and 10 percent real assets, all managed by a gaggle of one-hundred-twenty managers. The HBS study did uncover, however, one heretical fixed income investment. A lonely renegade.

So, bottom line? While UHNW family offices socked away cash and equivalents during America's glorious bull run, Bowdoin and other endowments kicked bonds and bills to the curb.

Owner or agent?

Why this stark risk-off, risk-on clash of sentiments? Arguably both family office and endowment investors are smart, savvy veterans of boom-and-bust cycles. Why does one side take Carmen M. Reinhart and Kenneth S. Rogoff's warning about inevitable financial fallouts to heart, while the other side goes all in on momentum trades?

In the end, it probably just comes down to the age-old principal-agent problem of aligning incentives with interests.

KPMG principals Catherine Grum and Edward Groves wrote about investment incentives in Rewards in family offices, published in The International Family Offices Journal.

Such plans often include real and phantom stock options, carried interest and co-investment vehicles, matched investment, and forgivable loans.

But nothing happens overnight. That's why top family office CIOs have excellent interpersonal skills and communicate well with multiple generations. It takes time and effort to understand family dynamics and negotiate compatible incentives.

We don’t care how much CIOs and board members at nonprofits love the mission or school, what’s the worst that can happen if it all goes sideways? It’s OPM. They move on.

But family money is the lifeblood that maintains their prosperity and purpose. No one cares more about the legacy than those who built it.

A family office perspective

Charles, I serve on several institutional investment committees (as well as head our family office) so have a bit of perspective.

I think your theory of risk-averse founders of businesses has something to do with keeping a larger cash cushion, but…

Every family office is different, with a different mix of generations, cash spending needs and philanthropy needs. From our experience these can change quite rapidly – one family member starts a business and needs capital, a business embedded in the family office sells requiring a large tax bill, an estate settles and the beneficiaries want cash…lots of scenarios.

Endowments typically have a spending policy set annually by a governing board in response to budget needs and my impression is this doesn’t change very often. They can predict the cash coming off of their allocations to meet the spending policy without carrying a large cash cushion.

Rather, the host institution may be the entity that carries a cash cushion or “rainy day” fund, as the operating managers of, say, a college likewise never want to run out of cash, and they may want to avoid asking the endowment or foundation to come through with support above that mandated by spending policy.

Asset allocation in family offices is quite varied depending on the owners' business experience, particular risk aversions, in-house expertise and so on.

We consider ourselves opportunists rather than allocators; we are not driven by an allocation-based investment policy statement (IPS). So we always want to have sufficient cash (or borrowing capacity) to meet opportunities as they arise.

Asset allocation in endowments is set by the IPS and targets may be tweaked quarterly or less often, but the mandate typically is to stay fully invested, or have a small cash allocation target (0-10% is common in my experience).

Finally, family offices are taxable investors. We find that estimating the cash needed to pay estimates and include with returns is difficult, so this requires a larger cash cushion for unexpected tax payments.

There is also the IRS safe harbor rules, so a conservative investor, not knowing what the final bill will be, will typically overpay and generate refunds later.