A few simple choices can improve returns and have an extraordinary impact on families down the line.

From Star to Founder

EastRock

Don’t Settle: Mediocre Returns Are Not OK

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WE HEAR IT ALL THE time: “It’s a stay-rich strategy.”

What it usually means: “My portfolio is underperforming, but I’m not concerned enough to make a change.”

For some families, this attitude makes sense. Those whose wealth exceeds what they spend and donate by an extraordinary amount (roughly 50x or more), and those that don’t believe in generational transfers of wealth, need not change a thing.

But the rest really ought to pay more attention, for two reasons:

First, we’ve done the math. Return differences that look small can have a big impact on families down the line.

Second, a few simple choices can change the return outlook quite a bit.

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Are a few percentage points of performance really a big deal?

YES.

To see why, consider a hypothetical family as follows:

- 2 parents, 3 children
- $100 million in investable assets
- $4 million in annual expenditures that inflate at 5% per year

Let's analyze asset accretion or depletion based on three return scenarios from real life—performance over the past 20 years among the endowments of Yale (the pioneer in modern endowment management), Stanford (the leader in tech access) and Harvard (the laggard, and yes, as a Yale grad, that is fun to say).

Here is the history through June 2023:

		MANAGER	
20-YEAR PERFORMANCE	10.9%	9.7%	8.8%
	Yale	Stanford	Harvard

They look pretty similar, right? You'll see below how much these small differences matter. But to add more dispersion, I'll include a classic 60/40 portfolio (60% stocks, 40% bonds), which produced a roughly 6.5% annual rate of return in this time period.

Since we are talking about family assets, we'll assume that a 35% tax rate applies in all cases.

How much nest egg will be left at the end of 20 years at these performance rates? Try to guess before reading the results.

Here they are:

	MANAGER			
20-YEAR PERFORMANCE	10.9%	9.7%	8.8%	6.5%
ASSET BALANCE IN 20 YEARS	$148M	$112M	$88M	$40M
	Yale	Stanford	Harvard	60/40 Portfolio

But there's more. Remember there are three children. Typically, that means 20 years later there will likely be four nuclear families living off the new asset balance (the original parents, three new adults, and potentially spouses and grandchildren). So let's divide that asset balance by four:

	MANAGER			
ASSET BALANCE PER NUCLEAR FAMILY, 20 YEARS LATER	$37M	$28M	$22M	$10M
	Yale	Stanford	Harvard	60/40 Portfolio

Obviously, $10 million per nuclear family is hardly a situation to scoff at. But one thing we know about families is that they hate to go backwards. And $100 million to $10 million is quite a step backwards.

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So why do many families choose to stick with an underperforming strategy?

First answer: Inertia, loyalty, and, often, a dependence on services that are unrelated to investment quality. These forces combine to make investment management a business that is far more sticky than it ought to be.

But I think there is more to it.

To explain why, I need to first tell a story and debunk a common perception that investing is a mature sector that's been fully picked over for advantageous opportunities.

In 1998, I was working in my first investing job and a senior member of my team said: "Well, we used to think coffee was a mature sector, but look at this Starbucks company. They've gone out and built 2,000 coffee stores. Now we KNOW it's mature."

That was about 32,000 stores ago.

The point is that it can be hard to picture what an already sophisticated sector can become. Today, there are 10,000 hedge funds and several thousand private equity firms. Firms are using armies of engineers and AI experts and all sorts of innovations as they compete for a shrinking pool of alpha. There are special managers out there, but in the context of so much competition they are increasingly difficult to identify and access.

And it doesn't help that the landscape of advisors is increasingly dominated by behemoth incumbents that look and invest alike.

In this context, it's not surprising that families feel discouraged from seeking new solutions.

But there are two strong reasons to think differently.

First, and most simply, look at small manager returns. There wouldn't be a systematically superior strategy, like focusing on small funds, if investing was a mature sector. Sure, Harvard's $53 billion endowment is too big for most smaller opportunities. But very few families have that kind of "problem."

Second, families can gain significant ground by simply improving their portfolio construction. As a sector, investment management has stuck with old models for too long. It started with the 60/40 portfolio, then graduated to the Yale model, but there's a lot of improvement ahead of us. Much can be gained through an updated approach to portfolio construction. Business schools such as Yale and Columbia agree and are starting initiatives to ramp up research and teaching in this area.

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Not convinced that mediocre returns are worth sounding alarm bells?

Well, every case is different.

Our advice: Do your own math and please, don't settle.

East Rock Capital

NEWSLETTER
From Star to Founder
Insights from partnering with exceptional investment managers as they launch and build new firms

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