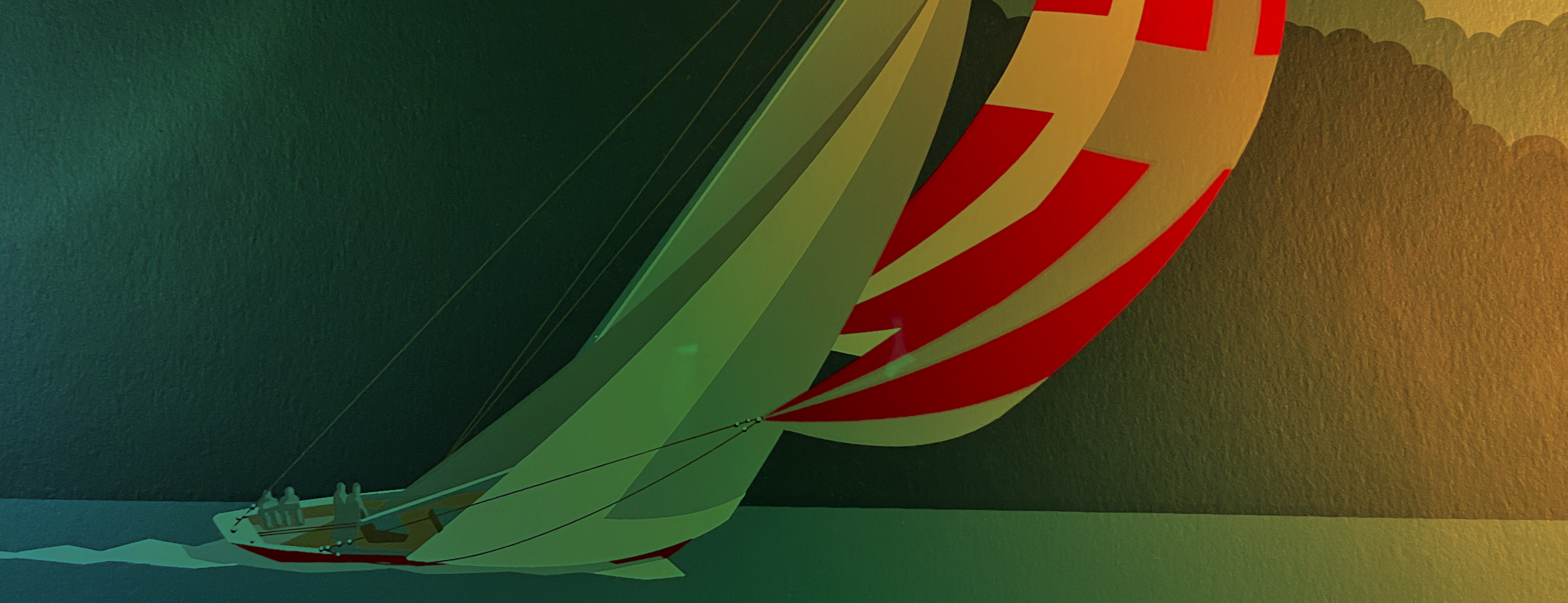

Private Investors, Carpe Diem!

Jonny Lach

Private investors including family offices can be great investors, but many are not. They have some big competitive advantages over institutional investors which live with significant constraints imposed by law, stakeholders, media and regulators. Private investors are usually less constrained, but often fail to recognize and exploit their competitive advantages. The advantages should be seized upon; fortune favors the bold.

Private investors' competitive advantages stem from two things:

- **Independence**. The private investor can watch the herd but avoid the impulse to follow it. They can be conservative when that is wise, and bold when that is sound.
- **Alignment**. Private investor principals are identified, present and interested, so their goals can be clear and their staff and investment committee can be well-aligned with good incentive structures. This opportunity is often missed.

Private investors can be entirely free of institutional pressures. They invest largely in private, free from the criticism and malincentives that institutions must endure. Family office investors can seize attractive new opportunities at will. They can freely invest according to their goals, risk tolerance, horizon and personal preferences. Wealthy folks can be pioneers, having initiated international exploration, venture capital, hedge fund investing and impact and private equity investing. Wealth is freedom, including to invest as one wishes. One example: institutional investors have no choice but to invest significantly in fixed income and cash today, with certain negative real returns to come. Private investors have no such compulsion or preference.

Many institutional investors suffer from having disengaged, distant and even unidentified principals, which makes managing the natural conflicts of interest with their agents, especially staff, difficult. For example, a school endowment's principals are primarily students (especially future ones) and present and future faculty and alumni -- a diffuse and detached lot. A pension plan's principals are mostly numerous pensioners, present and future, with diverse investment goals. A foundation's principals include unidentified future charitable projects, donors and the community at large. In contrast and to great advantage, the private investor's principals are present and often, engaged. The wealth owner can readily create compensation structures, governance structures and an investment office culture to align staff and committee objectives with those of the owners.

One should expect investment staff members (and everyone else) to generally put their own family and self-interests first, so wealth owners should shape those self-interests to align them with those of the owners. For

example, a family office can pay staff based on performance of an appropriate benchmark designed to reward staff performance (i.e. not legacy investments and not market betas). Investing has the advantage of having tools (indices and tunable metrics) for calibrating staff alpha fairly well. But studies and experience suggest that key executives are largely paid fixed or subjectively determined compensation that varies little with their contribution to portfolio performance. As a result, salaried staff behaves as such, with the downside risk of termination often the foremost incentive and with little incentive for sound risk-taking in the portfolio.

Jeremy Grantham put this forcefully: "The central truth of the investment business is that investment behavior is driven by career risk. . . . The prime directive . . . is first and last to keep your job. To do this . . . you must never, ever be wrong on your own."

Misalignment of objectives between wealthy principals and their staff and investment committee can often be significant but is hard to measure. Many families ignore rather than address these conflicts at the expense of investment performance. The staff may feel it more keenly than the principals, who may not see it at all. It's the elephant in the room, the principal-agent problem.

The light is low, so it's hard to see the elephant. It's the investment committee which, lacking any financial upside, is overly conservative. Over time, this might cost the family significant opportunity loss in performance. It's the investment officer who is the last to the best investments because they too have little upside exposure to investment outcomes. It's the Chief Investment Officer who fears most being "wrong" and alone having invested in an early-days or out of favor strategy, so she is years late to promising new strategies and misses the lucrative early years. It's the investment consultant whose fund ratings conflate risky investments and poor ones (i.e. the safe course for the consultant is to label even excellent risky investments unattractive).

Private investors on the other hand can support smart risk-taking (i.e. good investing), focus on portfolio rather than position-level results and set compensation to appropriately reward performance.

If you want your staff to invest like partners, you must reward them as such. Consider this: you pay your elite funds management fees and potentially big incentive fees (very often on beta sadly). But you might pay your CIO a salary and a relatively modest discretionary bonus; i.e. with big downside (risk of termination) and little upside. Simon Ruddick aptly calls the former "outsourced guts" (e.g. your hedge fund manager invested in crypto, but your CIO wouldn't dare). The latter simply chills risk taking.

An interesting example concerns investment in China. On a recent call with many institutional investors, it seemed clear that many or most had *no* investment in China and not for understandable moral/policy (human rights) or SRI (socially responsible investing) reasons. These investors were apparently avoiding China *en masse* because of political and economic risk (this was when Evergrande fears ran high). This may have been the right bet; i.e. perhaps the historic, outperformance of China and Chinese markets ends now. But China, that absurdly still called "emerging market," is well on course to become the largest economy in the world. Yes, China is an autocracy, police state and human rights abuser. But China has risen like no country ever has for decades now. Maybe it plateaus like Japan did, but maybe this is just the seventh inning of its rise. Many institutional investors and especially US ones avoid China out of condemnation, American pride and denial. China is a continuing difficult investment decision, but the private investor is free to make it as they wish; institutions watch and usually follow the herd.

Private investors, including family offices, can be world-class investors. Some seem not to appreciate the competitive investment advantages they have and fail to seize them. Selective boldness, patience, alignment with agents; these are unique advantages of private investors available for exploitation.

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