MANAGING FAMILY WEALTH THROUGH FIRST PRINCIPLES THINKING

YAMINI SOOD

Head Institutional and Family Office Business

DSP ASSET MANAGERS

India has seen a secular rise in the number of family offices. While we use the term a bit loosely to describe any UHNI who has wealth, in real terms the structure and objective of having a family office setup is well defined. They have graduated as a separate investor class today. As per the Hurun List 2023, India today has 260 USD billionaires; the list has 1252 participants with wealth over 1000 crs spanning 30 industries and 61 cities reflecting a dynamic and diverse landscape. 67% of the new entrants are first generation entrepreneurs holding 57% of cumulative wealth. It reflects the increasing impetus on skillset this investor class demands in terms of managing their wealth.

A family office can have multiple objectives like succession planning, tax planning, family wealth segregation, charity, wealth management, estate planning amongst others. Here, I will focus on **wealth preservation and its growth;** the **investing tenets** one needs to follow based on some timeless **first principles thinking.**

Your Values and Objectives

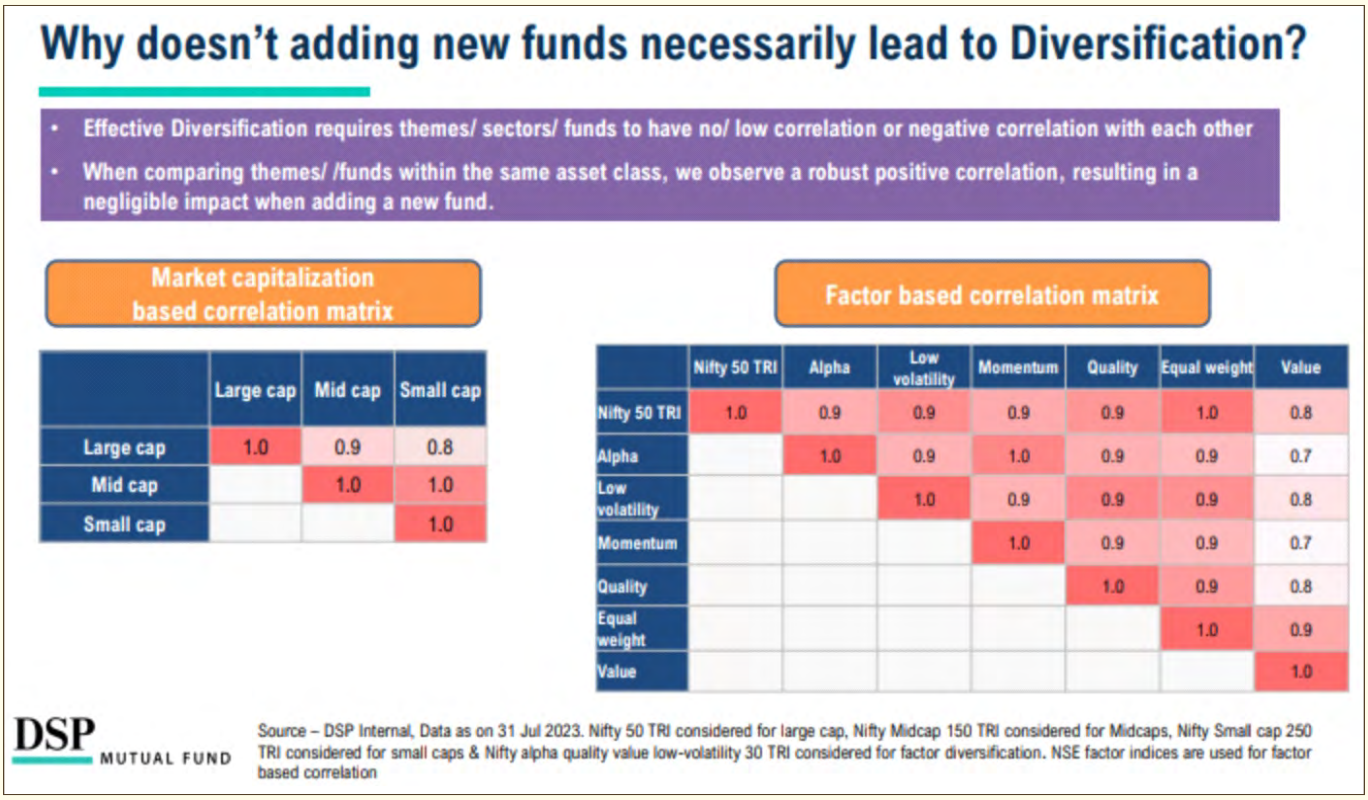
A well-documented framework popularly known as the investment charter akin to a blueprint of a house which we put in place before construction which outlines the fundamental design and structure of the house. A document that captures the value system and objectives of the family; its risk tolerance, asset allocation, decision making process. Charlie Munger was famously quoted as saying "Tell me where I am going to die and I won't go there". It is critical to know what we want to do with our money, where we want to invest it. It is equally critical to know what we shall not do and where we won't invest; the areas, sectors, investments to be avoided based on our ethos and comfort. Setting up of concentration limits, thresholds across sectors and asset classes. All corroborating with the broader family principles. Writing down your charter allows you to find rationale when a myriad of market activities can create a FOMO because of multiple biases playing out in a Lollapalooza effect. Let us take an example: The investment charter says that we will not invest in high debt companies which have a debt equity ratio of more than 2:1. If stocks with high leverage rally for a sustained period of time, then the family portfolio exposure shall underperform to that effect but it should not perturb the investor as one is being true to their charter.

Liquidity Need

Different family members can have different liquidity needs. It is a fine balance between meeting long term investment goals and providing for planned/unplanned expenditure of the members. Real estate and Alternate investments through private market exposures in the form of private debt, private equity, venture funds can build significant illiquidity via lock ins over pre-defined periods. Exits can get postponed depending on underlying portfolio quality. On the other hand, public market exposures via direct stock/bonds are liquid. Mutual funds score even better on transparency, liquidity and on the concept of impact cost which is not widely understood. It is the cost of purchase and selling of securities when an individual executes versus any large financial institution which benefits from economies of scale. Build exposure being cognizant of liquidity.

Diversification Need

Ever heard Beethoven's symphony? Did you know he was partially deaf when he produced some of his best work? The beauty of symphony is that even if you get some notes wrong somewhere it still sounds beautiful to the listener. Diversification is like creating a symphony of one's investment portfolio. The activity to segregate family wealth away from primary business into other assets is largely driven by the need to reduce concentration risk and dependability on one source of income. Thus, building low correlated portfolios with asymmetric return and risk payoffs becomes the cornerstone of investment. Can this be achieved by investing in a diversified equity portfolio or PMS? No, that shall address one's exposure to unsystemic or company specific risk. Adding strategies across different market caps, or different styles still have a high positive correlation.



Why doesn't adding new funds necessarily lead to Diversification?

- Effective Diversification requires themes/ sectors/ funds to have no/ low correlation or negative correlation with each other
- When comparing themes/ /funds within the same asset class, we observe a robust positive correlation, resulting in a negligible impact when adding a new fund.

Market capitalization based correlation matrix

	Large cap	Mid cap	Small cap
Large cap	1.0	0.9	0.8
Mid cap		1.0	1.0
Small cap			1.0

Factor based correlation matrix

	Nifty 50 TRI	Alpha	Low volatility	Momentum	Quality	Equal weight	Value
Nifty 50 TRI	1.0	0.9	0.9	0.9	0.9	1.0	0.8
Alpha		1.0	0.9	1.0	0.9	0.9	0.7
Low volatility			1.0	0.9	0.9	0.9	0.8
Momentum				1.0	0.9	0.9	0.7
Quality					1.0	0.9	0.8
Equal weight						1.0	0.9
Value							1.0

DSP MUTUAL FUND

Source – DSP Internal, Data as on 31 Jul 2023. Nifty 50 TRI considered for large cap, Nifty Midcap 150 TRI considered for Midcaps, Nifty Small cap 250 TRI considered for small caps & Nifty alpha quality value low-volatility 30 TRI considered for factor diversification. NSE factor indices are used for factor based correlation

Now add, other assets like Debt, Gold, International Equities and check the negative correlations:

	India Debt	India Equities	Gold in INR	International Equities
India Debt	1.00			
India Equities	-0.06	1.00		
Gold in INR	-0.13	-0.04	1.00	
International Equities	-0.09	0.47	0.03	1.00

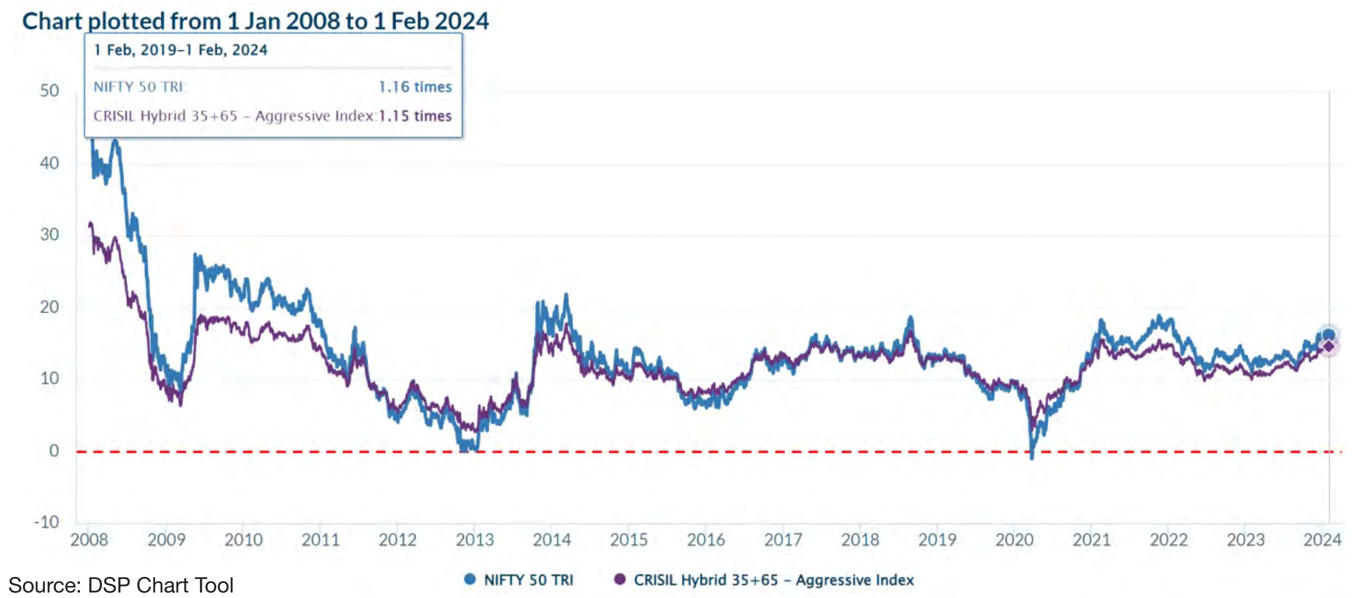
Source: DSP Internal, Bloomberg. Data as on 31 Jul 2023.Nifty 50 TRI, CRISIL Ultra Short Duration Debt B-I Index, XAU/INR, MSCI ACWI TRI considered for Indian Equities, Indian Debt, Gold & International equities, respectively.

Large and evolved family offices understand and execute this well. They have further added asymmetricity through geographical diversity, alternate investment bucket. But a lot of smaller families, unstructured ones, UHNIs, Budding entrepreneurs, small and mid-sized business owners who do not yet have a defined structure to manage their wealth rely on external advice for the same. To those, multi asset allocation funds can make a big difference. Let us take some random periods and check asset class returns to validate the point:

Period	Debt	Equity	Gold
Jan 2013 to Dec 2016	40%	45%	-9%
Jan 2005 to Dec 2009	35%	175%	170%
Jan 2008 to Dec 2013	35%	10%	175%

(Nifty 50 TRI has been taken for Equity return, Gold in INR for gold returns and Crisil 10-year Gild Index for debt return. All returns are depicted in absolute)

If one doesn't have the bandwidth to allocate across assets, just buying and holding a multi asset allocation across cycles can be an efficient fix. Another uncomplicated way of achieving a conventional 60/40 Growth portfolio is just by buying an Equity-Bond Fund which practices the buy low and sell high through rebalance.

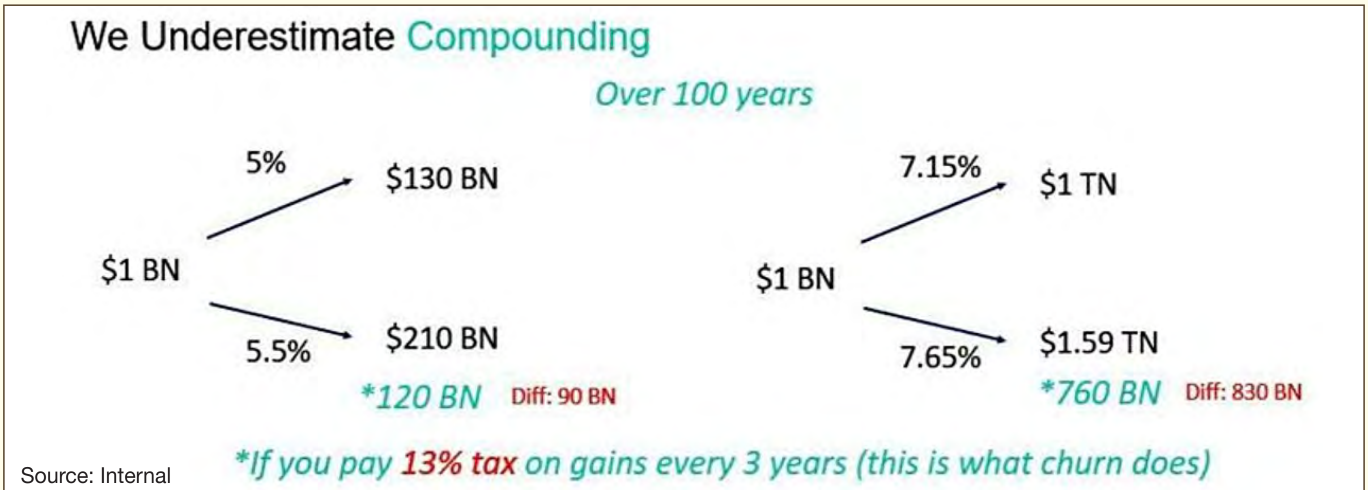


Source: DSP Chart Tool

The above chart depicts 5 year rolling returns over a 15 year time period. The Nifty 50 TRI has a standard deviation of 7.25 vs 4.42 in the balanced strategy. If you study the data available, actual returns by balanced funds are mostly superior to Nifty 50 TRI over a 10 year + horizon with lower volatility.

Tax Optimisation

Irony when I see multi-generational wealth tracking quarterly and annual returns. Investors often demonstrate recency and herd mentality bias. They tend to add on exposures which show better notional gains and panic sell during short term fluctuations. Too much of churn which looks accretive in nature can prove destructive. In the wake of compounding returns, one ends up compounding taxes paid. Look at this chart, just a 13% tax over a 3-year period drastically alters the end corpus over 100-years.



Source: Internal

Moral: Percentages may seem insignificant but as the base corpus increases, the adverse impact of churn on end AUM magnifies drastically.

Strive for Low Costs not necessarily Lower!

Over the last decade, cost consciousness has increased amongst the investor community. Passive low-cost strategies AUM has grown from a humble 55,954 crs in Dec' 17 to a whopping 8,46,528 crs by Dec'23. This is 1412% increase mirroring global trends. Being cost conscious is great if one does not lose sight of the real objective which is to generate alpha on the overall portfolio. An indexed strategy can only yield index minus cost minus tracking error. We are witnessing increased large cap flows into passives while investors prefer active management in the small and midcap bucket. A prime reason for underperformance of large cap active funds is having a low active share as most end up doing closet indexing. Investing is probability driven. Any endeavour to deviate majorly from the index can yield drastic outcomes in any direction. An investment manager with well documented framework which helps the investor understand what he is buying is more important than mere cost as a variable. Similarly alternates and PMS need to be evaluated via fixed and variable cost dimension which is altogether a separate topic. Costs must be low, not necessarily lower.

Value professional expertise

A common trend across unorganised setups is to have the trusted long-standing man handling finances for the family as the investment decision maker. Many a times unlisted exposures are identified based on word of mouth or 'gutfeel', both of which have more odds of going wrong than right. Investment is a specialised function. For any investments in public/ private market one has experts in the field and it is advisable to use them. Internally hiring your own 'no-man' who has seen market cycles, can filter noise and ideas is appropriate.

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Buddha Principle

A popular quote generally ascribed to Buddha:

When you have to say something, think: Is it Kind? Is it True? Is it Necessary? If I propose to speak, will it improve on my silence?

This operating principle can be applied to the world of investing. Maybe someone made disproportionate wealth through a listed exposure, someone got the commodity cycle right, someone today has a Unicorn which was seed funded by them years back. Whenever one is tempted to act on an exotic pitch, new great idea just think before you act: **Is this unkind; catering to my emotion over need? Is it necessary to change my current allocation? Is this true to my investment charter? Is the trade positively accretive versus not doing anything?**

Disclaimer: The author works for DSP Asset Managers and views here are personal.

Yamini Sood is Senior Vice President at DSP Asset Managers. She heads the Institutional and Family Office Business nationally. She has more than 20 years of rich experience in the financial services industry. Her professional experience evolved through advisory and sales roles in mutual funds, dealing with varied segments of institutional investors and family offices. She has a strong domain knowledge of capital markets and investor behavior. A fanatic of personal finance, she has authored articles on this topic for Economic Times. She likes to sometimes blog or micro blog her thoughts as well.