WINDHORSE

# There Must Be a Better Way
## Wealth Management in 2017 and Beyond
## April 2017

**Actionable Analysis and Advice.** The aims of this piece are to assess critically prevailing norms in money management and describe how Windhorse helps clients build and implement effective investment programs. To make the discussion below as user-friendly as possible, it comprises an invented chat between Windhorse CIO David Salem and a pleasingly pushy principal facing a happy problem: she (Eliza Bennet) recently sold for $1 billion a healthcare firm she founded and seeks help developing investment policies and practices for a multi-generation trust and private foundation that together will garner most of the proceeds. The principal in question is fictional, but her concerns are real and weighty, as confirmed by conversations that David and his partners have had of late with many wealthy families.

**Why Read This?** This question is best answered with another question — Why Windhorse? — and a concise answer thereto. The outgrowth of a single family office focused on long-term wealth management, Windhorse is led by experienced principals who view investment counseling as a profession, not a business, and are passionately committed to the pursuit of excellence in all aspects of their work. Such work centers on the shaping and ongoing refinement of both comprehensive and specialized investment programs for a select group of wealthy families and endowed charities, with each client deciding the types and degrees of discretion ceded to Windhorse. As the discussion below confirms, Windhorse finds much fault with current norms in money management, favoring instead methods geared specifically to the generation of pleasing long-term returns net of **all** forms of slippage.

**Highlights.** Here are noteworthy takeaways from the dialogue below:

• **Busted stuff.** In their zeal to be "like Yale," many wealthy families and non-profits have built investment programs that are needlessly complex, opaque, and costly.

• **Cardinal concern.** While taking due heed of growing economic imbalances and geopolitical strains that could cause most "endowment model" portfolios to produce disappointingly low net returns in coming years, principals seeking to prosper regardless of how such tensions get resolved should focus on one abiding concern: not overpaying.

• **Bucket-filling foolishness.** Overpaying is endemic to wealth management *circa* 2017 because self-interested advisors have induced many principals to engage in bucket filling — funding managers and strategies pursuant to pre-specified targets that essentially ignore such exposures' current price tags.

• **Pseudo logic.** Many contemporaneous asset mixes include "asset classes" unworthy of the name: pseudo-classes like "Hedge Funds" and marketing gimmicks like "Infrastructure" that no sensible principal would fund if she knew she'd earn from them over time the average return of all investors engaged in such activities.

• **Cash is king.** Most contemporaneous asset mixes entail sub-optimally low allocations to cash — a deceptively valuable component of successful investment programs given the ceaseless swinging of investor sentiment between greed and fear.

• **Self-negating notions.** The Oracle of Omaha may be ignoring self-negating aspects of his belief that US stocks remain the asset of choice for long-term investors: quite apart from wealth-corroding changes in societal norms that an excessively complacent electorate could unleash, unbridled enthusiasm for US stocks in general and S&P 500 constituents in particular could doom current purchasers of them to abnormally poor returns for many years to come.

• **Passive management is a mirage.** Determined though Windhorse's principals are to help clients optimize investment-related costs, they're under no illusions that "passive management" is a panacea to ills bedeviling most investors. Truth be told, **every** portfolio is "active" when viewed through the lens most germane to long-term return generation, i.e., one that compares a portfolio's current holdings to the total universe of investable assets.

• **What to do?** Among other actionable work products provided to clients, Windhorse makes available Illustrative Portfolios (IPs) comprising regularly updated allocations to asset classes, strategies, and external managers that the firm's principals deem choiceworthy, with due attention paid to tax factors in constructing IPs for taxable investors.

## Getting Acquainted

**Bennet.** I'm not an investment pro like you but I know enough about money management to start chats like this with a simple question.

**Salem.** Judging from the book you brought along — *Poor Charlie's Almanack*[1] — I can guess your question: "What's in this for you?".

**Bennet.** How'd you know?

**Salem**. Mrs. Bennet —

**Bennet.** Call me Eliza, please.

**Salem.** Will do. Eliza, I know Charlie Munger; the editor of that book about him is a friend of mine; and I, ma'am, am no Charlie Munger.

**Bennet.** You're no Lloyd Bentsen either! But I appreciate your attempt at humor and would appreciate too your answering my question.

**Salem.** It's the right starting point for get-acquainted chats like this. As Munger says —

**Bennet.** "Show me the incentives and I'll show you the results."

**Salem.** Exactly. Cutting to the chase, Windhorse provides investment counseling to a select group of wealthy families and foundations, in exchange for fees based typically on the dollars each client puts under advisement with us. The more effective we are in helping clients grow their capital over time, the more we make. Of course, we have other incentives to exert best efforts for clients — payoffs rooted in our custom of investing our own capital alongside clients', plus intangible rewards accruing to those who work hard and honor the Golden Rule.

**Bennet.** All fine and well, but what specifically can Windhorse do for my family?

**Salem.** Two things, not mutually exclusive, with you deciding how much or little discretion to give us when electing one or both options. First, we can provide comprehensive investment counseling, helping your family and foundation fashion and implement investment policies and practices responsive to agreed-upon wants and needs. Second, we can provide cost-effective access to specialized strategies — targeted investments we've green-lighted for use by our comprehensive counseling clients as well as our own families. [*See back page.*]

**Bennet.** What do you do when someone like me shows up — with a mishmash of existing investments, including perhaps a big wad of newly acquired cash?

**Salem.** Been there, done that — for clients with less investable wealth than yours and for folks with larger sums to deploy. In each case, we typically tackle two tasks up front — simultaneously if possible so we can curtail return slippage of all forms with all deliberate speed. *See Figure 1 at page 3.*

**Bennet.** Sounds good, but what exactly do you mean by return slippage? Something along the lines of what Munger had in mind when he howled about "the croupier's rake"?[2]

**Salem.** Yes, although our working definition of slippage is arguably broader than Munger's, encompassing as it does not only manager fees but taxes and inflation also.

**Bennet.** Makes sense, although our family foundation doesn't pay taxes — and we've effectively shifted at least half of the billion we received for the company into the foundation, per my promise to Charlie's partner.

**Salem.** I applaud your signing The Giving Pledge: the families we advise tend to be generous donors, with uncommonly long-term perspectives on societal problems as well as portfolio performance. That said, the incentive fees you're paying to the medley of managers you referenced earlier constitute a form of taxation, whether paid by a foundation, a taxable trust, or both.

**Bennet.** I take your point — and would be thrilled if Windhorse could find a deep-pocketed investor to take the entire mishmash off our hands, so we can start over.

1 *Poor Charlie's Almanack: The Wit and Wisdom of Charles T. Munger*, edited by Peter D. Kaufman, published initially in 2005.

2 "The croupier's rake" underwent withering criticism in Mr. Munger's 1998 address to the Foundation Financial Officers Group (FFOG), posted here.

**Figure 1**
**Initial Tasks Undertaken for Most New Clients**

**Policy Review.** Policy reviews are designed to help new clients get structured for investment success: to examine critically current policies and revamp them as needed to enhance their responsiveness to a client's wants and needs. Among the many questions addressed in such reviews, the following typically prove most central:

- What types and degrees of risk is the client willing to incur? Hazards considered typically include (among others) illiquidity, drawdowns, permanent capital impairment, and underperformance of relevant benchmarks including market indices and/or designated peer groups.
- Given agreed-upon risk parameters, what return goal(s) should be pursued? Over what horizon(s) and with how much sensitivity to fees, taxes, and/or inflation?
- What guardrails if any should govern portfolio construction (i.e., minima, norms, maxima), pursuant to what asset allocation taxonomy?
- What criteria should be employed in selecting and evaluating external managers and other vendors?

**Investment Program Review.** Using materials supplied by a new client plus extensive data bases, professional networks, and market- and manager-specific insights the Windhorse team has developed over many years, Windhorse examines exhaustively all aspects of a new client's existing investment program, including but not limited to:

- What precisely does the client own at present, on a truly look-through basis?
- What is, or might logically be, the reason for maintaining each current exposure?
- What are the all-in costs for maintaining each exposure, including but not limited to actively managed portfolios or funds?
- How readily can exposures not worthy of retention be eliminated and at what costs?

**Salem.** I'm not sure we could. And I'm not sure it'd be wise to do a complete re-set. What makes you think it would be?

**Bennet.** Because I look at what we already own; I look at what's going on in the world; I think about lessons learned from Munger, Buffett, and — last and perhaps least in your view — from the primer on wealth management that you yourself penned,[3] and I'm left with the nagging sense that our current policies and practices are sub-optimal at best — and that I certainly wouldn't deploy our large pile of newly acquired cash along lines mirroring our pre-existing investments.

**Salem.** Why not?

**Bennet.** Too many noses in the fee trough, some snarfing surreptitiously via opaque fee constructs; too many holdings, some of which are also maddingly opaque; too much turnover; too big a tax drag on our taxable trust: the whole construct is sub-optimal — even if my growing fears about the economy, markets, and geopolitics prove unfounded.

**Salem.** What are those fears, in a nutshell?

**Bennet.** Actually, counselor — or more precisely counselor-in-waiting — I'd like to know what **you** think I should worry about now that we've sold the company. What **should** someone like me — wealthy beyond my wildest dreams, keen to maintain my family's current standard of living, and keener still to transfer substantial sums to deserving non-profits and progeny over time — what **should** I worry about?

**Salem.** Fair question — one I could spend hours answering. That said, to underscore Windhorse's commitment to keeping things as simple as possible without oversimplifying, I'll say this: from a strictly **investment** viewpoint, your sole concern should be to avoid overpaying.

**Bennet.** Overpaying for what? Assets? Managers? Investment counseling?!

3 *A Candid Conversation about Capital Management*, posted at www.windhorsegroup.com. While also structured in dialogue form, *A Candid Conversation* discusses far more comprehensively than does the dialogue furnished here **what** Windhorse stands prepared to do for clients, **how**, and — perhaps most importantly — **why**.

**Salem.** All of the above, with special focus on not overpaying for assets or strategies whose potential returns are disproportionately low in relation to their inherent risks.

**Bennet.** Disproportionately low because the exposures you're warning about have been bid up in price by other investors?

**Salem.** Exactly — often but not always because individuals or institutions doing the bidding want or need to own certain assets **regardless of price**. State pension funds, for example —

**Bennet.** Piling into long-dated treasuries to match assets with liabilities?

**Salem.** Indeed: so-called LDI or liability-driven investment schemes tend to be stunningly price insensitive. But so too are many investors with less readily identifiable liabilities to defray.

**Bennet.** For example?

**Salem.** With all due respect, wealthy families not unlike yours — folks who've been persuaded by product-pushing advisors that they need to be "like Yale," allocating funds among a jumble of managers with the aim of reaching pre-specified target weights for a variety of asset classes and strategies, many of which aren't worth funding materially, if at all, on a truly permanent basis.

**Bennet.** Like the line item in our targeted asset mix labeled "Hedge Funds"?

**Salem.** That's an obvious example among many I could cite of pseudo-asset classes: forms of investing that no sensible principal would employ if she knew she'd receive over time merely the average return of all players engaged in such activities.

**Bennet.** I certainly wouldn't use hedge funds if I thought I'd earn no more than the average of what hedge fund investors as a group will earn over time. Of course, we always want to have an irreducible minimum commitment to cash, don't we, even if the income it generates is paltry?

**Salem.** Correct — because even passively managed subportfolios of ultra short-term T-bills can be hugely valuable to long-term investors. After all, most everything in markets if not life generally is cyclical, or more precisely **lumpy**, with stocks as a group presumably producing positive long-term real returns but with individual stocks as well as broad stock indices nosediving or soaring at irregular and unpredictable intervals. Accordingly, it helps lots to have cash at hand to buy choiceworthy assets when other investors want or need to unload them in a hurry. And it helps also to adopt policies permitting if not promoting the stockpiling of cash when other investors are clamoring to buy assets you own at acceptably high prices.

**Bennet.** True, though it's stunning how disinclined investors as a group are to hold cash these days, even when shares of well-managed firms trade at nosebleed valuations as many do at present. Of course, it's precisely the rampant bullishness to which I'm alluding that produced the proverbial offer we couldn't refuse for the company we just sold — an offer whose acceptance has left us sitting on a mountain of uninvested cash. I know we'll need to put it to work in longer-dated assets eventually, but I've read too much Buffett and Munger to be buying when investors as a group are manifestly greedy, as many seem to be today. That said, I worry that sitting on so much cash contravenes a pearl of investment-related wisdom you've cited approvingly in your own writings: "Diversification is the only rational deployment of our ignorance."

**Salem.** That quote from Peter Bernstein is my second favorite pearl about investing — one I had the privilege of hearing Peter utter not a few times during interactions with him when I was running TIFF. Ironically, Peter himself did some pretty conspicuous flip-flopping on the policy challenge you implicitly flagged just now: whether long-term investors should maintain at all times minimum allocations to specified asset classes and subclasses — US stocks, sovereign debt, realty, commodities, and the like. I won't burden you with the whys and wherefores here, except to say that Peter himself conceded not long before he died in '09 that he'd gotten whipsawed by markets in addressing this challenge.

**Bennet.** Where do you yourself come out on the question at hand: whether long-term investors should maintain non-zero allocations to certain types of risky assets at all times?

**Salem.** I'm fine with such guardrails, generally speaking, so long as they're applied to legitimate asset classes. Pseudo-classes like "Hedge Funds" and "Alternative Assets" as well as marketing gimmicks like "Infrastructure" need not apply.

**Bennet.** You've seen our current holdings as well as the taxonomy our current advisor uses to make sense of things, at least in his own mind. What say you about the picture that emerges?

**Salem.** Not much, because I don't know enough about your holdings to furnish an informed answer to the question you just posed. More specifically, I don't know what's actually held by managers sorted into certain buckets your current advisor fancies — Hedge Funds and Private Investments, for example — nor do I know the fees and terms governing each of the many manager relationships you've consummated.

**Bennet.** I hate that verb in chats like this — consummate —because it suggests we're married to the managers we employ. I wouldn't want to be married to most of them, figuratively or literally, especially ones that have done poorly.

**Salem.** Using what metrics? Over what time period?

**Bennet.** I know where you're headed with those questions. Let's not go there. Remember: I've studied carefully what Buffett and Munger have written on the need for patience in investing and need no further tutoring on that topic from you.

**Salem.** Nor did I need a private tutorial on Roman tax protocols from Charlie when we were introduced at a cocktail party years ago. But that's what I got — an hour-long version — with nary a word that I could put to immediate use in my day job managing money. No matter: I took the treatment Charlie gave me as proof positive that the form of patience most needed for successful investing isn't the oft-discussed patience to wait for hoped-for returns to roll in. Rather, it's the patience to wait for opportune times to buy things at the right price, even and indeed especially if one plans to hold them long term.

**Bennet.** When did you get your tutorial from Munger?

**Salem.** That's my point: in '99, at what proved to be the tail end of an interval during which Charlie and his friend Warren made very few new stock investments, preferring instead to maintain dry powder while presumably getting caught up on their reading, including — for Charlie — Cicero.

**Bennet.** I wish my family had waited a while before going whole hog with the investment policies our current advisor recommended when we hired him back in —

**Salem.** Lemme guess: 2006.

**Bennet.** Actually, it was 2005, but close enough. How'd ya know?

**Salem.** Because the framework your advisor uses and the funds he's put you into tell me that what you've rightly labeled a mishmash was intended to help your family and especially your foundation do one deceptively difficult thing: be like Yale.

**Bennet.** If "like Yale" means we earn returns like what Swensen and his team have produced for Yale over the last three decades — 13+% per year, if I'm not mistaken — count me in.[4]

**Salem.** If Swensen *et al.* were willing to manage your foundation's assets alongside Yale's, I'd counsel you to go for it, depending on the fee, of course. But Yale won't accept such an assignment — because it has ample if not excessive capital to deploy via strategies and managers that Swensen favors, most of which are inherently size-constrained and many of which Yale has employed for ages. And even the hefty fees you'd presumably be willing to pay Yale to invest your foundation's capital alongside its own could never offset the dilution Yale itself would suffer by sharing its best ideas with a large foundation like yours. As for your family's taxable wealth, it's hard to say whether it'd be wise to invest such wealth alongside Yale's because your singular focus in deploying such capital should be to optimize returns net of **all** forms of slippage — including taxes from which Yale is exempt. Moreover, the conditions that have enabled Swensen and his team to post such impressive returns over such a long interval — despite setbacks like the 25+% decline in Yale's endowment during the Global Financial Crisis — well, such conditions may not hold over the multi-decade horizon germane to deployment of your family fortune.

**Bennet.** "Conditions?" As in the overcrowding of virtually all identifiable corners of the money management business in the US? Or do you mean "conditions" as in growing economic imbalances and political tensions — domestically and globally —

4 Source: www.investments.yale.edu

conditions that seem frighteningly similar to those investors confronted in the 1930s?

**Salem.** Both, actually, though I'll hasten to add that there **are** ways to deploy capital, today no less than in the past or the future, entailing potentially asymmetric payoffs: pleasing total returns net of all forms of slippage if the world in general and America in particular undergoes a relatively benign "Fourth Turning," and discernible but tolerably muted losses if such a "turning" proves as miserable as some such paradigm shifts have in the past.

**Bennet.** "Fourth Turning" as in the generational change model devised by Strauss and Howe?

**Salem.** Exactly — perhaps the only model I've encountered in 35 years vetting money managers that's working as well in real time as it did when back-fitted to historical data at the time of its creation.

**Bennet.** If I have my Strauss and Howe correct, what you've just said concerns me — that we're headed for a crisis leading to destruction of existing institutional arrangements and ultimately the creation of a new order. Is that what you're expecting? More to the point, is Windhorse counseling clients to assume a "Fourth Turning" is nigh, your friend Buffett's opposing views notwithstanding?

**Salem.** I've never met Buffett, so I wouldn't presume to call him a friend. Nor have I ever deployed clients' capital on the assumption that any single scenario, economic or political, is **certain** to unfold. Of course, that's essentially what Buffett has done by arguing forcefully that America is not only an enduringly great country but that its citizenry **will** grow steadily richer in per capita terms over time. As a corollary, Buffett has suggested that US stocks as a group comprise attractive hunting ground, if not **the** asset of choice, for investors seeking to preserve and enhance real wealth over multi-decade horizons.

**Bennet.** You disagree?

**Salem.** Yes and no. America **is** great: always has been — great though not unqualifiedly good — and likely always will be. But let's not kid ourselves, nor deploy long-term capital on the potentially mistaken assumption that America's enduring superiority as a place to live, work, and invest is guaranteed. After all, if enough Americans take for granted the personal and societal virtues that make America great, the nation's best days are surely behind it. Also, even if core American values such as probity, empathy, and self-sacrifice trump reality TV mores in coming years, investors heeding Buffett's advice might bid up US stocks to levels that guarantee not pleasing real returns but the opposite.

**Bennet.** Given how pricey US stocks are relative to most non-US counterparts at present, that sounds like a clarion call to shift capital overseas.

**Salem.** That's one way among several to position capital for asymmetric payoffs of the sort we discussed earlier, and it could be a sensible step to take — assuming one moves selectively and patiently — to combat the overcrowding of US capital markets we also flagged earlier: the excess of human as well as financial capital that's shifted into such markets since the Volcker-led Fed broke the back of inflation in the early '80s.

**Bennet.** Hold on. Didn't you say a moment ago that you've been investing professionally for 35 years?

**Salem.** Yes, and I have the scars to show for it.

**Bennet.** Scarred, perhaps, but blessed too: blessed to have entered your profession just as strong tail winds began blowing in its favor — winds that have continued to blow, strongly if not irregularly, ever since. What I wonder is whether someone who's been sailing downwind for so many years can help my family and our foundation **tack** as needed, especially if storms of the sort that Strauss and Howe are predicting erupt.

**Salem.** Strauss died in 2007, sadly, not long after I had the privilege of participating in a retreat he helped conduct for a college board on which I sat — a pivotal moment in my career, coming as it did not long before a financial crisis and consequent political upheavals that sync splendidly with theories conceived years earlier by Strauss and Howe. For what it's worth, Howe denies that such theories leave no room for the exercise of free will — that citizens in general and political leaders in particular can't bend generational cycles in a manner more conducive to happiness than misery. That said, I don't think there's much that many financial intermediaries can do to maintain the lifestyles to which they've become accustomed as their industry and mine undergoes an inelegant "turning" of its own — a shakeout catalyzed by the ascendancy in financial services of three imperatives that have transformed retailing, among other sectors — radically and permanently: transparency, ease of use, and shared economies of scale.

**Bennet.** You look nothing like Jeff Bezos, but you sure sounded like him just then. Is that what Windhorse wants to be — the Amazon of investment counseling?

**Salem.** Transparent, user-friendly, and cost-effective? By all means. Amazon-like in scope and scale? By no means — not given the diseconomies of scale most investment counselors confront as their asset and client bases grow.

**Bennet.** Rings true to me, though I haven't heard much about disceonomies of scale in the recent swirl of investor chatter about indexing — an elephant that, truth be told, is in this very room if not all rooms in which advisors like Windhorse pitch their wares these days.

**Salem.** Indexing is indeed the topic *du jour* in money management these days — that and the related phenomenon of rapid growth in assets stewarded by so-called robo-advisers. Today isn't the day to explore investor confusion about indexing, but my professional colleagues and I have spent much time pondering it and I'd be pleased to discuss our thoughts on it in due course.[5] You can get a sneak preview with this exhibit (*see Figure 2 at page 8*).

**Bennet.** Interesting. Listen, you're being pretty candid with me in this get-acquainted session, so I'll return the favor by admitting I've had similar sessions of late with higher-ups in the robo-adviser world. Quickly, because we're almost out of time: what's your take on robo-advising?

**Salem.** Deploying long-term capital on a mass scale with minimal return slippage and maximum sensitivity to the lumpiness we discussed earlier — the endless array of investment opportunities and perils that democratic capitalism spawns on a highly irregular basis? My take on that notion echoes Gandhi's reply when the great man was asked what he thought of Western civilization: "I think it would be a good idea."

**Bennet.** Good but fanciful?

**Salem.** As I hinted earlier in discussing looming threats to existing institutional arrangements, prudent investors almost never say never. That said, in answering your question about robo-advisers, I personally need look no farther than a recent email I received from a leading robo — a firm whose services I've been test-driving to get a better sense of how robo-advisors or more precisely their clients might behave under a variety of market scenarios. Keen as I am to behave dissimilarly from the world's best-known reality TV star, I was truthful when building my investor profile for the robo-advisor in question and indicated that 100% of my available capital — relatively small sums not invested via Windhorse — was parked in cash. A few days later, I got an email entitled "Alert: 100% Idle Cash" that contained these words: "Much of that 100% could be invested in the markets to help you earn better returns on your portfolio, *without changing your risk profile*." [Emphasis added.] Gimme a break. As I said, I think the aims of such services, as with Jack Bogle's aims when he launched Vanguard's now-gigantic S&P 500 index program, are noble. But there's no higher a probability that such aims will be achieved than there is that countless investors now using the so-called endowment model will achieve returns meeting their own foolishly lofty expectations, especially with taxable capital.

**Bennet.** I hear you, or rather I appreciate the distinctions you've drawn between the so-called endowment model and the Yale version of same in your schematic on long-term investment paradigms. *See Figure 3 at page 9.* What about the third model outlined in that schematic — The Principal Solution? What's up with that?

**Salem.** You said a minute ago that we're almost out of time. How 'bout if I ping you with potential dates for a follow-up chat, so we can discuss the schematic and related topics at greater length?

**Bennet.** Deal, but before you go ... you mentioned earlier that the Bernstein quote about diversification was your **second** favorite quote about investing. What's the first?

5 Never wanting to reinvent soundly designed wheels, Windhorse's principals haven't attempted to improve upon perhaps the best recent examination of the ongoing shift of capital toward passive investment strategies: Rusty Quinn's March 2017 post to the Epsilon Theory website. As noted therein, **every** portfolio is "active" when viewed through the lens most germane to long-term return generation, i.e., one that compares a portfolio's current holdings to the total universe of investable assets.

**Salem.** Truth be told, it's not about investing *per se*. But it reminds me of all great investors I've met or read about. It comes from an interview that baseball Hall of Famer Tim McCarver gave after catching for fellow future Hall of Famer Bob Gibson in a World Series win for their Cardinals team in the 1960s. "Gibson," McCarver said, "is the luckiest pitcher I've ever seen. He's always pitching on days when the other team scores no runs."[6]

**Bennet.** I'll see you a McCarver, and raise you a Rickey.

**Salem.** You mean Branch Rickey's quote about luck being the residue of design?[7]

6 As recorded here in *Baseball Almanac.*

7 Branch Rickey (1881–1965) was a baseball executive who, among other pearls of wisdom, observed memorably that, "Luck is the residue of design." The *Yale Book of Quotations* attributes this gem to the February 21, 1946 edition of *The Sporting News.*

**Bennet.** Very good. Listen, this chat has been fun — and leaves me thinking my family might indeed be able to improve our luck by re-thinking the way we deploy capital — with Windhorse's help, of course. Can you push more background info my way?

**Salem.** Will do, including the Illustrative Portfolios that my partners and I use — one set for taxable investors, another for tax-exempts — to help folks we're advising grasp readily what we're recommending and why.

**Bennet.** Happy to take a look. Send me anything you deem worthy of my time — except Cicero. I got enough Cicero as an undergrad at St. John's. SJC – Annapolis, that is.

**Salem.** Munger would approve. So do I. Cheers.

*End*

## Figure 2
## Passivity Lies in the Eyes of the Beholder

**Let's Be Honest.** Many indexed portfolios aren't truly passive — not if passive is defined as buying automatically all investable assets in proportion to their capitalizations. After all, stocks in the Standard &Poors 500 comprise not more than 40% of the world's publicly traded equities nor more than 10% of its total investable assets measured by market values. Who decides the S&P 500's composition? A committee within S&P tasked with keeping its fabled index "representative" of US industry. Who shapes other portfolios profiled in the stylized diagram below? Hired guns have played a key and oft-counterproductive role in constructing "Yale wannabes" for many investors, taxable as well as tax-exempt. Vastly fewer investors pursue "The Principal Solution" — Windhorse's preferred approach to long-term capital deployment.

| | S&P 500 Index Fund | Yale Wannabes a/k/a The Endowment Model | The Principal Solution |
|---|---|---|---|
| How diversified relative to global investable universe? | Highly concentrated | Highly (overly?) diversified | Relatively concentrated |
| How price sensitive are buy decisions? | Not at all | Varies | Highly price sensitive |
| How tax sensitive are sell decisions? | Irrelevant to S&P's index choices | Taxes seldom considered | Highly sensitive vis taxable capital |
| Are base management fees reasonable? | Yes — rock bottom | Punishingly high historically | Yes — and trending lower |
| Are manager incentive fees reasonable? | Yes — because nil typically | No — low or no hurdles | Yes due to sensible hurdles |
| How costly is it to withdraw capital on short notice? | Virtually nil under normal conditions | Very costly | Low assuming proper planning |

**Figure 3**
**Long-Term Investment Paradigms**

| | The Yale Model | Yale Wannabes a/k/a The Endowment Model | The Principal Solution[SM] |
|---|---|---|---|
| **Life Span** | | | |
| Birth | Late 1980s | Early 2000s | Early 1900s [sic] |
| Death | Immortal? | Mid-2010s | Never (hopefully) |
| Declared dead | Never? | Not soon enough | TBD |
| **Key Characteristics** | | | |
| Initial user(s) | Yale | Large US educational endowments | Certain private investors |
| Initial champion(s) | Swensen | Consultants and business media | Family offices including Windhorse |
| Dominant mindset | Prophet | Acolyte | Principal |
| #1 Prerequisite for success | Risk being wrong and alone | Tolerance for illiquidity | Clearly articulated risk parameters |
| #2 Prerequisite for success | CIO-centric management | Steady cash inflows | Long performance measurement horizons |
| Transparency | Medium | Very Low | High |
| Complexity | Medium | Very High | Low |
| **Goals (actual even if unstated)** | | | |
| Primary | 5+% real returns | Keep pace with peer investors | Maximize returns without undue risk |
| Secondary | Beat Harvard and Princeton | 10+% annualized pre-tax net returns | Sustainable cash yields |
| **Typical Portfolio** | | | |
| True asset classes | Some | Many | Few |
| Pseudo asset classes | None | Many | None |
| Average allocations | | | |
| Marketable managers | >5% | <3% | >10% |
| Private investment managers | >3% | <1% | >5% |
| Managers abide AUM limits | Common | Rare | Essential |
| Publicly owned managers | Never | Why not? | Never |
| Liquidity | | | |
| < 1 week | <25% | <25% | >25% |
| < 3 years | <60% | <60% | >50% |
| >3 years | >40% | >40% | <40% |
| Potentially indefinite holds | Rare | Very rare | Common |
| **Costs** | | | |
| Shared scale economies | Rare | Very rare | Common |
| Annualized base expenses | Optimized | High | Optimized |
| Realization-based incentives | Common | Near-universal | Rare |
| Client-oriented hurdle rates | Rare | Very rare | Common |

The above diagram is for illustrative purposes only and does not include assurances respecting future outcomes that each of the three approaches examined may produce. Investment counsel furnished by Windhorse is customized to meet client-specific needs and may differ materially from the approaches examined above, including The Principal Solution. Future returns may be volatile. Past performance is not a reliable predictor of future results.