

WINDHORSE

Top of Mind — 1Q 2017

David A. Salem, Managing Partner and Chief Investment Officer

Open but Unchanged. Sticking stubbornly with long-held beliefs or goals even as passing events render them unsound or unachievable is inimical to success in many fields of human endeavor, including two in which many famed practitioners have been failing of late: investing and legislating. Of course, at the national level in America, effecting statutory changes typically requires focused and sustained action by the president as well as Congress — behavior of the sort that post-election increases in the value of many US stocks suggest are near-certainties as the Trump presidency unfolds. For reasons discussed in my last few *Top of Minds* (ToMs), I continue to assign a much lower probability than most investors to actual as distinct from promised policy changes that will validate such values. Not a zero probability, mind you, as it's seldom if ever prudent to say never when deploying capital, especially when one's goal is to compound it at pleasing rates over many years net of all forms of slippage, including inflation and applicable taxes as well as fees. Thoughtful pursuit of this goal against a backdrop of observable or looming changes in geopolitical, commercial, and social norms is the focus of a recent think piece by yours truly entitled *There Must Be a Better Way: Wealth Management in 2017 and Beyond*. This piece (henceforth *A Better Way*) is posted on our [website](#) and is properly viewed as an essential companion to this necessarily brief note on evolving market conditions.

Cautiously Optimistic. Having telegraphed above and in prior ToMs my deep skepticism that so-called unified government at the national level in America will spawn a material and **sustained** advance in the real or inflation-adjusted prices of US stocks as a group, I'll note anew that I'm more optimistic than most of my professional peers respecting achievable real returns on appropriately diversified portfolios over the next decade. The operative word in the prior sentence is "appropriately," which in this context means an array of assets likely to perform satisfactorily under all plausible scenarios and uncommonly well under conditions to which we at Windhorse assign higher probabilities than investors as a group. While much has happened in geopolitics as well as national politics during the interval since publication of the prior ToM ([for 4Q 2016](#)), asset prices and factors we deem germane to thoughtful assessment of same haven't changed materially enough to warrant a re-do of last quarter's compendium of noteworthy investment opportunities and perils. Rather than republishing it here, we'll commend it to readers' attention while confirming anew that Windhorse is verifiably walking the talk telegraphed in it, via means that we're making available to qualified parties on either a comprehensive or specialized basis. Comprehensive as just used means a mandate entailing thorough up-front review and revamping as needed of a client's investment policies and practices followed by ongoing deployment of capital pursuant to the client's preferred governance protocols.

Road Less Traveled By. As noted in *A Better Way*, many families and foundations with which Windhorse has interacted of late employ at present policies and practices suggestive of natural if misguided longings to "be like Yale" — to earn uncommonly high returns by deploying capital via demonstrably skilled and properly incentivized managers operating in corners of global capital markets in which manager returns tend to be highly dispersed. Borrowing from *A Better Way*, we've appended here a table from it contrasting (a) Yale's time-tested investment methods with (b) the overused *modus operandi* known as "the endowment model" and (c) Windhorse's preferred approach for deployment of long-term capital. Admittedly, the latter approach — what we've dubbed The Principal SolutionSM — isn't everyone's cup of tea. Readers who view this attribute as more virtue than defect and bear ultimate responsibility for the deployment of substantial long-term capital are encouraged to contact one of my partners or me to discuss ways in which Windhorse might be of help in fulfilling that responsibility. Though we expect many assets and strategies available for investment to produce offputtingly low if not negative returns over the next decade or so under our base case scenario, we're also seeing a steady flow of interesting opportunities, with a satisfyingly **small** number of them clearing our high curatorial bar.

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.