The Use of Pooled Investment Vehicles for Ultra High Net Worth Investors

By Mark W. Castelin
Director, Senior Investment Advisor

HARRIS myCFO®

A major challenge for a large segment of today's Ultra High Net Worth (UHNW) investors is gaining diversified access to the world's best managers at competitive fees.

Likewise, a related challenge for investment advisory firms catering to the UHNW market is the inefficiency with which their best manager ideas and investment opportunities are implemented across client portfolios. This paper explores pooled investment vehicles as a potential solution to these challenges and as a structure that may offer improved risk-adjusted returns for UHNW investors.

There are two ways investors typically access investment products: through either a mutual fund or a separate account. A mutual fund is "a company that brings together money from many people and invests it in stocks, bonds or other assets. The combined holdings of stocks, bonds or other assets the fund owns are known as its portfolio. Each investor in the fund owns shares, which represent a part of these holdings."[1]

A separate account is managed for an individual by an investment manager, and holds only the assets of that single investor. A separate account allows the investor to customize investments according to criteria such as market benchmarks, socially responsible investments, etc.

Assembling an array of mutual funds or separate accounts, especially those holding newer speciality asset classes, into a comprehensive portfolio and managing that portfolio on an ongoing basis can be daunting even for accomplished investors. A specialized pooled vehicle can simplify this process.

Using a pooled vehicle which is actively managed by a professional advisor to hold multiple investments in an asset class may make sense. By aggregating multiple clients' assets, a pooled vehicle allows a greater number of strategies to be represented in a more manageable single portfolio; allows investors access to managers/funds whose higher minimums their separate account may not have met; and generally results in lower overall fees due to the larger asset placements with a group of investors. Even the largest investors can benefit from this more diversified, professionally managed, and less expensive approach to investing.

[1] Investopedia, "Mutual Funds: What Are They?"

HISTORY OF POOLED FUNDS

Pooled, or managed, funds come in many forms. In general terms, they can be described as an investment where a number of investors pool their funds together in a vehicle that allocates among a variety of other investments.

One source says these funds first began when "a Dutch businessman named Adriaan van Ketwich created an investment trust whose name when translated meant 'unity through strength.' This form of pooled investment was created in 1774..."[2] This concept soon caught on in other European nations, and arrived on American shores in the late 1800s.[3]

Pooled funds are available today in such forms as mutual funds, closed- and open-ended funds, as well as "private label" funds available to clients of investment management firms. They all share the same general principle, however, which is that by pooling assets, investors can gain greater diversification, and potentially better investment results because professionals are managing the investments on their behalf.

IMPLEMENTING A POOLED FUND STRATEGY

How the various types of pooled funds differ is of great importance to investors. Most mutual funds specialize in one category of the securities markets such as high-yield bonds, large-cap growth stocks, etc. Morningstar's database now classifies funds in over 65 categories. So while a mutual fund is a pooled fund, most still invest in just one narrow segment of the market.

For many years, large US pension plans and other institutional investors have used a diversified variation of the pooled fund approach to simplify their investment structures. These investors focus on asset allocation as their primary duty, and utilize a fund manager or consultant to manage a portfolio of diversified styles or asset exposures within asset classes to implement their strategies.

By the mid-1980s, pooled funds began to get wider notice and use, and since then the institutional world has continued the use of this type of pooled fund more and more, especially in smaller asset classes (e.g. global small-cap). There, a fund using several managers with different investment approaches in the asset class allows the client the opportunity to generate better long-term returns in what is generally too small a component of the total portfolio to warrant holding more than one or two managers alone.

This professional management and superior diversification at a lower cost makes a pooled approach especially attractive when investing in areas such as small-cap equities or real assets, which are generally a small portion of most portfolios.

For example, when investing in real assets in a traditional manner, investors face several hurdles: 1) there are many categories of real assets — commodities, metals, grains, TIPS, REITs, infrastructure etc.; 2) they may not be easy to invest in directly; 3) it is not always intuitive to determine how much to allocate to each of the available strategies; and 4) there is little guidance about how to actively manage the allocations based on traditional fundamental or valuation measures.

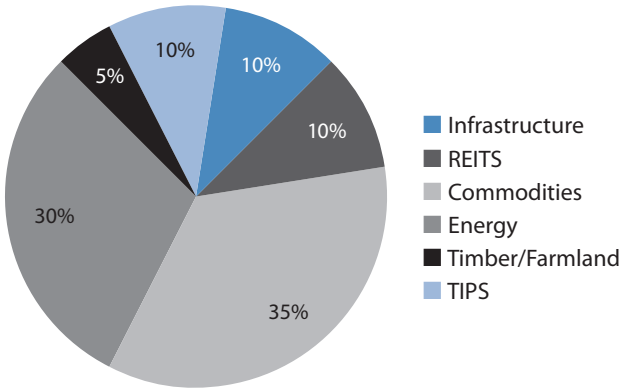
Let's look at an investor with a $50 million portfolio and an asset allocation of 40% low risk (fixed-income oriented) investments and 60% higher risk (equity and equity-like) investments. The investor decides to allocate 5% of his high-risk allocation, or $2.5 million, into the real asset portfolio shown in *Exhibit 1*.

Within the real asset portfolio there is a 35%, or $875,000, allocation to commodities. We reviewed five well-known firms that offer commodity- and natural resource-oriented funds. Assets managed in these strategies varied from $177 million to over $4 billion. We found that their minimum account sizes varied from $1 million to $2 million, which would preclude the use of any of them in this investor's portfolio.

[2] "History of Managed Funds," by Lyn Bell, EzineArticles.com, January 20, 2011
[3] Ibid.

EXHIBIT 1

Sample Real Asset Pooled Fund Allocations



But by pooling assets with others, the investor could not only access these commodity managers and achieve better diversification in this portfolio segment than he could on his own, he could also access other strategies such as REITs, infrastructure, etc.

In addition, active management of specific strategies is part of the value-add when using a professional advisor to guide investment in a pooled fund. This is especially true when a firm has an experienced research staff to review the various managers and portfolio options available; is better suited to adjust the allocation mix between the various categories as well as the underlying manager; and has more resources to perform the research and monitoring necessary to actively manage the portfolio on a day-to-day basis.

COMPONENTS OF A DIVERSIFIED POOLED FUND

There are a variety of investment options that may make up a portion of a diversified pooled fund:

1. Mutual Funds
2. REITs
3. Separate Account managers
4. Private partnerships
5. Exchange Traded Funds (ETFs), based on an index or single commodity
6. Exchange Traded Notes (ETNs), which are similar to ETFs but with some unique properties

With so many alternatives available, determining the best vehicles to use and how to allocate among them can be difficult for any investor managing his own portfolio. An investor is faced with some crucial decisions:

1. **How diversified do I want to be?** The investment options discussed above will provide targeted exposure to specific segments of the asset class involved, but none will generally cover it all.
2. **What tradeoffs do I have to make?** In an area like commodities, mutual funds investing in derivatives are exposed to such things as contango.[4] However, the only way to get broad exposure via holding physicals is to buy specific metals funds, which require the investor to decide what to hold, when, and makes him responsible for the allocation decision across a number of funds.
3. **How do I manage the re-allocation between investments?** As macro- and micro-economic events change the investment landscape, investors building their own diversified portfolio of strategies will have the daunting task of determining how to manage the allocation between all of them.
4. **How do I know what I am paying for my total allocation to the asset class?** The individual fees for each option vary widely, and some preferred strategies that may cost less may only be available via a separate account that requires a higher minimum asset placement than the individual investor can afford.

"With so many alternatives available, determining the best vehicles to use and how to allocate among them can be difficult for any investor..."

[4] Contango occurs in a climate of rising prices, when longer-term futures contracts carry a higher price than near-term contracts. Rolling over a near-term to a longer-term contract can lead to a slippage in return to an investor.

The use of a pooled fund managed by a professional advisor provides an attractive solution and addresses these issues, allowing the client's focus to remain on asset allocation decisions rather than specifics of portfolio implementation:

1. A pooled fund can hold multiple investment options in one fund, relieving the client from having to select the real asset categories in which to invest and simplifying the overall investment structure.
2. A pooled fund managed by a professional advisor means there is a responsible party researching the managers and vehicles used in the fund, overseeing the allocation to the real asset categories, and managing shifts between them as economic and investment circumstances warrant.
3. By pooling assets from a number of individual investors, break points or lower fees can often be negotiated with mutual fund and separate account managers, lowering the overall cost structure of the client's investment.
4. A pooled fund manager will be performing periodic due diligence on the underlying managers, seeking out more attractive investment vehicles, researching the suitability of including other real asset categories over time, and providing aggregated performance reporting on the entire set of investments.

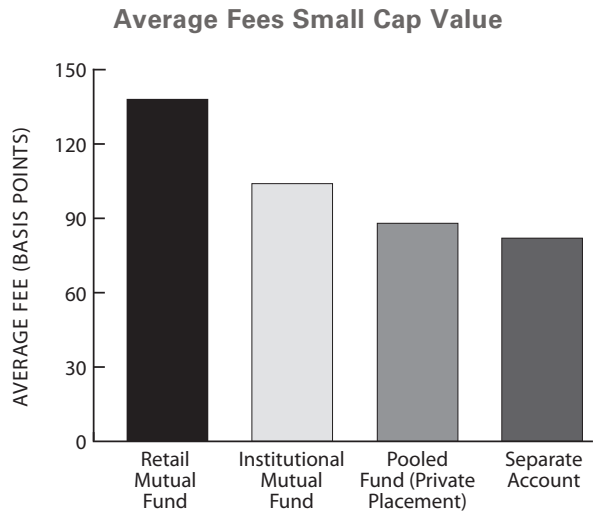
THE PRICING ADVANTAGE OF POOLED FUNDS

In addition to investment-related reasons for using pooled funds, lower fees are also a considerable attraction. Advisers should always be seeking ways to minimize the fees their clients pay for any investment-related function. Using pooled funds is one way an advisor can contribute to lowering the overall costs of an investment program.

The Harris myCFO Investment Advisory Services, LLC research team reviewed the fee schedules for small-cap value managers accessed through three different approaches: separate accounts, pooled funds, and mutual funds (see *Exhibit 2*).

For the 160 separate account managers in the study, the minimum asset placement was $5 million, with an average fee of 100 basis points (or bps), ranging from 50-130 bps. Sixteen managers offered pooled funds (at a lower $1 million minimum) with fees averaging 94 bps (ranging from 35-115 bps). Lastly, for institutionally priced mutual funds, the 63 funds analyzed had an average expense ratio of 105 bps (ranging from 45-139). Retail mutual funds were substantially higher.

EXHIBIT 2



Source: Zephyr, Morningstar, Investworks

IMPORTANT CONSIDERATIONS WHEN USING POOLED FUNDS

While there are several attractions to the use of pooled funds by UHNW investors, there is one notable caveat: the loss of control over specific asset allocation and investment decisions.

A pooled fund with a diversified structure removes the ability of the investor to determine exactly what he is invested in. Many investors might appreciate having exposure to some elements of a pooled fund strategy, but not others. Using the real assets example, perhaps exposure to oil and other energy stocks is something the investor might not desire, but he cannot escape it if the underlying managers in the fund are investing in that market segment.

There are also tax implications for pooled funds. Unlike a separate account, where investments can be managed on a tax-advantaged basis for the individual investor, in both mutual and pooled funds, investors are exposed to capital gains and income that may have been booked prior to the individual's investment. However, realized tax losses can be passed out to investors in a pooled fund via the K-1 reporting structure under which they operate, while a mutual fund can only offset gains within the fund, and the investor reports such gain from Form 1099.

A benefit to mutual funds, however, is that management fees can offset ordinary income within the fund, while a pooled fund reports income and management fees on a gross basis. In addition, mutual funds have higher investor cash flow than a separate account, with resulting higher turnover and fees.

Because most pooled vehicles are structured as an LLC or LP, there may be delayed tax reporting issues, as well as liquidity constraints that mutual funds typically do not have. Last, in order to manage the underlying managers in a pooled vehicle, there generally will be some level of administrative fee charged for custody and related expenses.

"Actively managed by a professional advisor, pooled funds can offer many benefits to the UHNW investor."

CONCLUSION

The use of diversified pooled funds can be a challenging undertaking for the individual investor. There can be many moving parts that go into structuring a portfolio to leverage the many advantages of pooled funds. Using the services of a professional investment advisor may create several advantages including:

- Access to a broader range of strategies than may be available to the individual investor.
- Active management of the portfolio to maximize tactical opportunities.
- Continual oversight of the manager and his strategy.
- Lower fees due to the aggregation of assets.

Actively managed by a professional advisor, pooled funds can offer many benefits to the UHNW investor. As the investment landscape continues to evolve and become more complex, by utilizing these vehicles and the resources and capabilities of a trusted advisor to manage them, clients can maintain control of key asset allocation decisions while capturing the benefits of a highly diversified, well-constructed, lower-cost portfolio of complementary strategies.

Mark W. Castelin is Director, Senior Investment Advisor with Harris myCFO, Investment Advisory Services, LLC for the organization's Seattle office. He works with clients in the development and management of investment allocations that reflect the goals and objectives for those assets. Mr. Castelin assures allocation mixes and specific portfolio manager assignments reflect the time horizon, risk tolerance, tax sensitivities and other considerations of the client. He has over 25 years of global investment experience.

Harris myCFO® is dedicated to managing the complex issues that face individuals and families of significant wealth by delivering the guidance and services of a comprehensive family office, along with the freedom to use your own trusted advisors and other best-in-class service providers.

Harris myCFO offers expertise in all areas of wealth services: Income Tax Planning and Compliance, Investment Advisory, Estate and Trust Planning, Risk Management and Insurance, Philanthropy, and Expense Management and Financial Reporting.

This presentation is for informational purposes only and is not sufficient to form any basis or financial planning decision. **Please consult with your advisor in regards to your own personal situation.**

Please contact us for more information and/or for additional white paper titles or copies.

We look forward to the privilege of serving you.

For more information, visit us at harrismyCFO.com or call 1-877-692-3611.

HARRIS myCFO®