

Handling Concentrated Specialty Assets* – Strategies to Mitigate Risk and Complexity

* Every asset exists in an account context and can't be looked at in isolation. Account type, investment objectives, account needs & limitations, account lifecycle and other factors must be considered to make an informed decision.

FIRST QUARTER

Foundational Question: What do PM's do? **

- A. Construct custom portfolios of stocks, bonds, funds & alts after getting to know the client.
- B. Plays financial chess: monitor asset allocation, concentrations, liquidity, taxes, volatility, and maintain IPS
- C. Read the WSJ, attend investment calls, play golf in bull markets, take regular beatings in bear markets
- D. A & C but not B

** In most mid-to-large banks with centralized investment research groups

A Primer: What do PM's do?

QUIZ

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IPS – Investment Policy Statement - RRTLLU

Quantitative

- Return Requirements
- Risk Tolerance

Document

- Timing
- Legal

Client/Bene

- Tax
- Liquidity

X-factor

- Unique
Circumstances

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In an Ideal World

Asset Review would...

- Discuss returns & types
- ID asset-related risks
- Highlight TTLUs
- Signal sector/industry
- Discuss marketability

PM Role

- A/R would actually be read
- High level understanding of asset
- Integrate into the IPS based on impact
- Flag any downstream collisions

Optimally

- Realtime conversation when warranted
- Get ahead of issues/potential assets
- Adopt a general outlook on retention
- Agreement on rightness of fit

Foundational Question:

What is the objective of every author?

Asset Review would...

- Discuss returns & types
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Asset Name	Asset Manager	F/S Date	Review Date
Financial Spreads		Narrative	
XXXX	Valuation	Company Info	
XXXX	Methodology Selection	Balance Sheet	
XXXX	Quantatative Analysis	Income Statement	
XXXX	Adjustments	Management	
	Discounts	Performance	
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Ratios Distributions			
Trends Liquidity			

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Less is MORE

- 1 Page
- 1 Format
- Clear/Concise
- Informative
- OCC 2008-10

Asset Name				Asset Manager	F/S Date	Review Date
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XXXX	XXXX	XXXX	XXXX	Methodology Selection	Company Info	
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Ratios Trends Distributions Liquidity						

What's the point of an asset review that doesn't inform the Investment Review Process?

What is a concentration?

	<u>Asset Over Account</u>
123 Main St LLC	\$250,000
Other Assets	\$750,000
Other LIKE accts	n/a
Other Wealth	<u>n/a</u>
Total	\$1,000,000
Concentration	25% - Account Concentration

- Most conservative approach
- Easiest to compute
- May be too narrow an approach

N.B. – A concentration is simply a quotient. It must be understood in context.

What is a concentration?

Account Concentration

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Portfolio Concentration

Asset Over Portfolio

\$250,000
\$750,000
\$1,500,000*
n/a
\$2,500,000

- ONLY include applicable assets
- If trust, like provisions & dispositives
- Denominator is now AGGREGATE
- Probably the most accurate view
- TO + PM should determine this jointly

*PORTFOLIO VIEW

	2020 Trust for Bill	2022 Trust for Bill	Total for Bill
123 Main	250	-	250
Securities	750	1,500	2,250
Total	1,000	1,500	2,500

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*** PORTFOLIO VIEW**

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***NB: The 2020 & 2022 trusts have...**

- Identical beneficiary structure**
- Identical dispositive structure**
- Other trust provisions substantially similar**

What is a concentration?

	Account Concentration	Portfolio Concentration	Comprehensive View
123 Main St LLC			<u>Asset Over Everything</u>
Other Assets			\$250,000
Other LIKE accts			\$750,000
Other Wealth			\$1,500,000
Total			<u>\$7,500,000</u> EXTERNAL
			\$10,000,000
Concentration	25%	10%	2.5% of TOTAL New Worth
			• While the most comprehensive view • Often inapplicable as fiduciaries

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What is a concentration?

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Concentration	25% - Account Concentration	10% - Portfolio Concentration	2.5% of TOTAL New Worth
	• Most conservative approach • Easiest to compute • May be too narrow an approach	• ONLY include applicable assets • If trust, like provisions & dispositives • Denominator is now AGGREGATE • Probably the most accurate view • TO + PM should determine this jointly	• While the most comprehensive view • Often inapplicable as fiduciaries

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SECOND QUARTER

What are the relief valves?

1. Sell the asset OR adopt a plan of diversification
2. Reduce the holding
3. Legitimately expand the denominator (see previous slide)
4. Identify unique asset contribution
 - Outsized income contribution
 - e.g. 15% of assets but 45% of distributable income
5. Non-judicial relief – **Non-Judicial Settlement Agreement**
6. Judicial relief – Court Order

Beware the two-edged sword: Actionability

More actionable = More risk

Completely Liquid,
fractionable assets

PublicCo	Shares	Concen
Original	600	15.0%
Sale	-100	-2.5%
Sale	-100	-2.5%
Current	400	10.0%

Semi-Liquid,
somewhat fractionable

- Some closely held assets
- Oil & Gas royalties
- Some farm/timber assets
- Most Comm/Residential RE

Completely illiquid,
indivisible assets

- Large Commercial RE
- Many closely held assets

CONTINUUM OF RISK

Investment Risk

Fiduciary Risk

QUESTIONS TO BRING BACK TO THE OFFICE

1. Do your asset managers ask the company about marketability annually?
 - Have there been any sales of equity in the last year?
 - Is there a redemption program?
 - Hypothetically, “if we were to seek to sell all or some”, what’s next?
2. Do you document marketability in your asset reviews?

Investment, Legal & Fiduciary landscape?

- Modern Portfolio Theory (MPT)
 - Not going into the weeds on this, but...
 - Well established investment principle
 - Standard against which investment professionals are judged
- Multiple legal precedents in multiple judicial venues
 - In general, this is settled fiduciary principle and settled law
- Exculpatory language deemed unreliable as foundation to ignore MPT
 - Beware: There is exculpatory language and then there is predatory language
 - e.g. “Trustee has no duty to diversify *unless the asset really tanks*”



Never fall in love with any asset, it has no capacity to love you back!

Tanner's Tangent

- Modern Portfolio Theory (MPT).....i lied.
 - We are taking a few steps into the weeds on this!

**Markowicz brought us the efficient frontier which says
Every unit of incremental risk must come with incremental return OR
You back away from the efficient frontier.**

**If Closely Held Assets
present more risk than
marketable securities.**

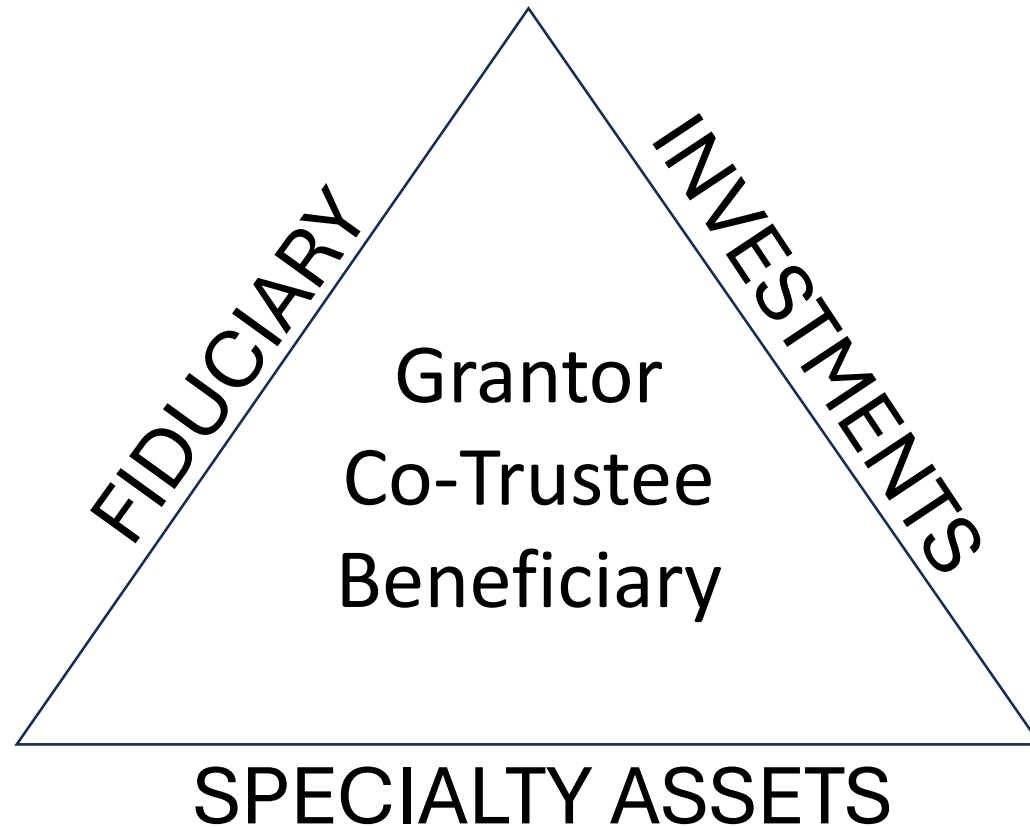
AND

**An opportunity presents
itself to sell at or above
fair market value**

THEN

**There should be a compelling reason
not to sell the closely-held asset
turning proceeds over to PM.
N.B. Check restrictions & tax!**

Are we speaking to each other...
...or AT each other?



Oh my!

The beneficiaries have made clear that their grandparents founded this company and... that it must remain in the family.

- Dedicated Trust Officer

Look everyone, you're long an ultra concentrated, micro-cap equity in the transportation sector and it won't stop flashing on my screen.

- Analytical Portfolio Manager

That's funny, my deceased husband told me it was a trucking company.

- Beleaguered Surviving Spouse/CoTrustee

The financials, when we get them, aren't audited, reviewed or even compiled and the state has administratively dissolved the company for non-filing of the status return.

- Nervous Asset Manager

Seriously.....Who are We?

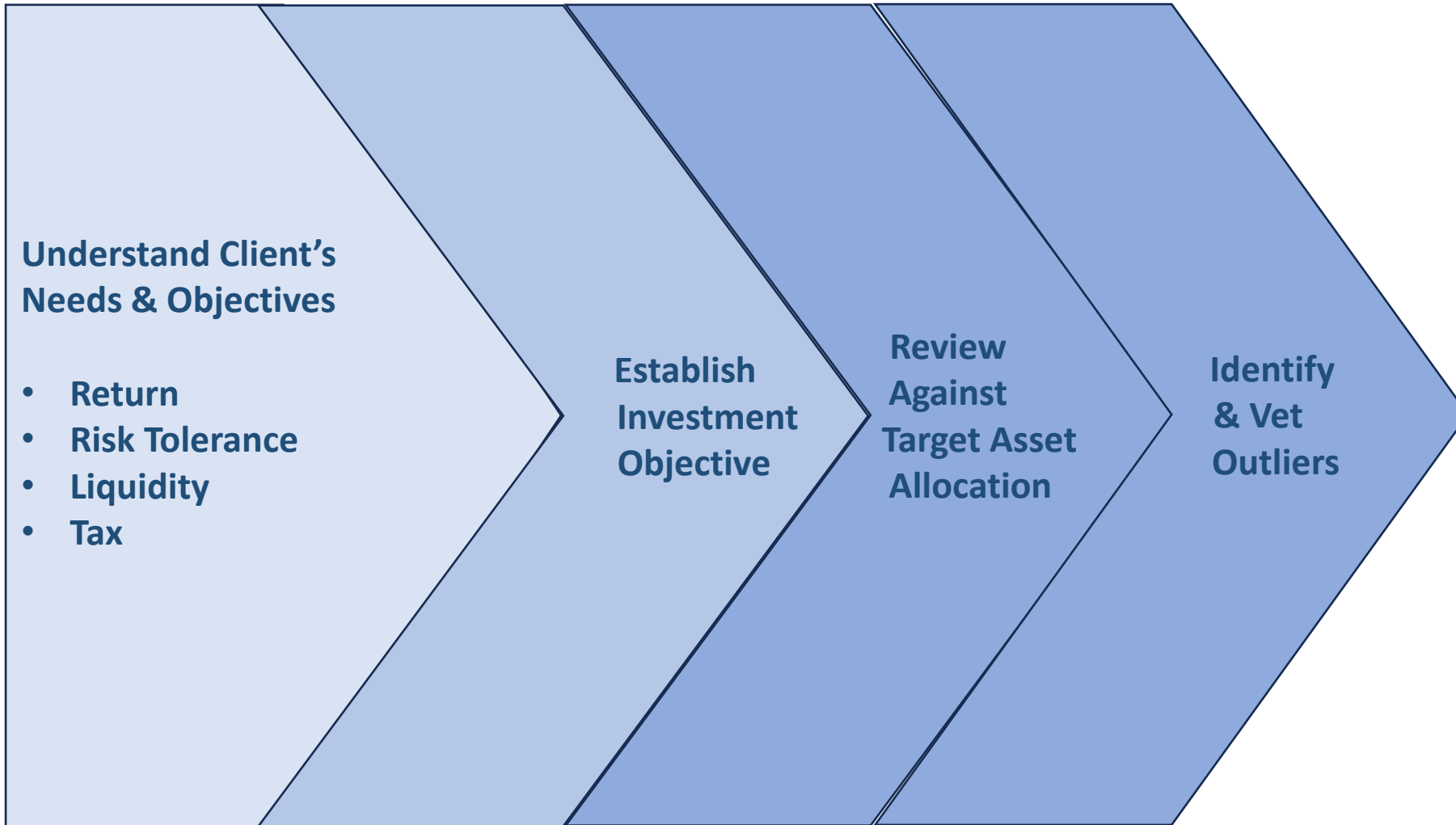
- Corporate fiduciary...with all the duties appurtenant thereto!
- Held to a higher standard
- What are the Standards
 - Prudent Person....each asset had to fit
 - **Prudent Investor...focus on portfolio view**
 - Prudent Expert...applies mostly to ERISA
- Corporate Trustee ≠ Uncle Jimmy who may be held to a lesser standard
- Investment Policies – two-edged sword
 - Peril for not following investment policies
 - Peril for blindly following investment policies...
...if compelling context exists for alternative considerations

Is a certain percentage sacrosanct?

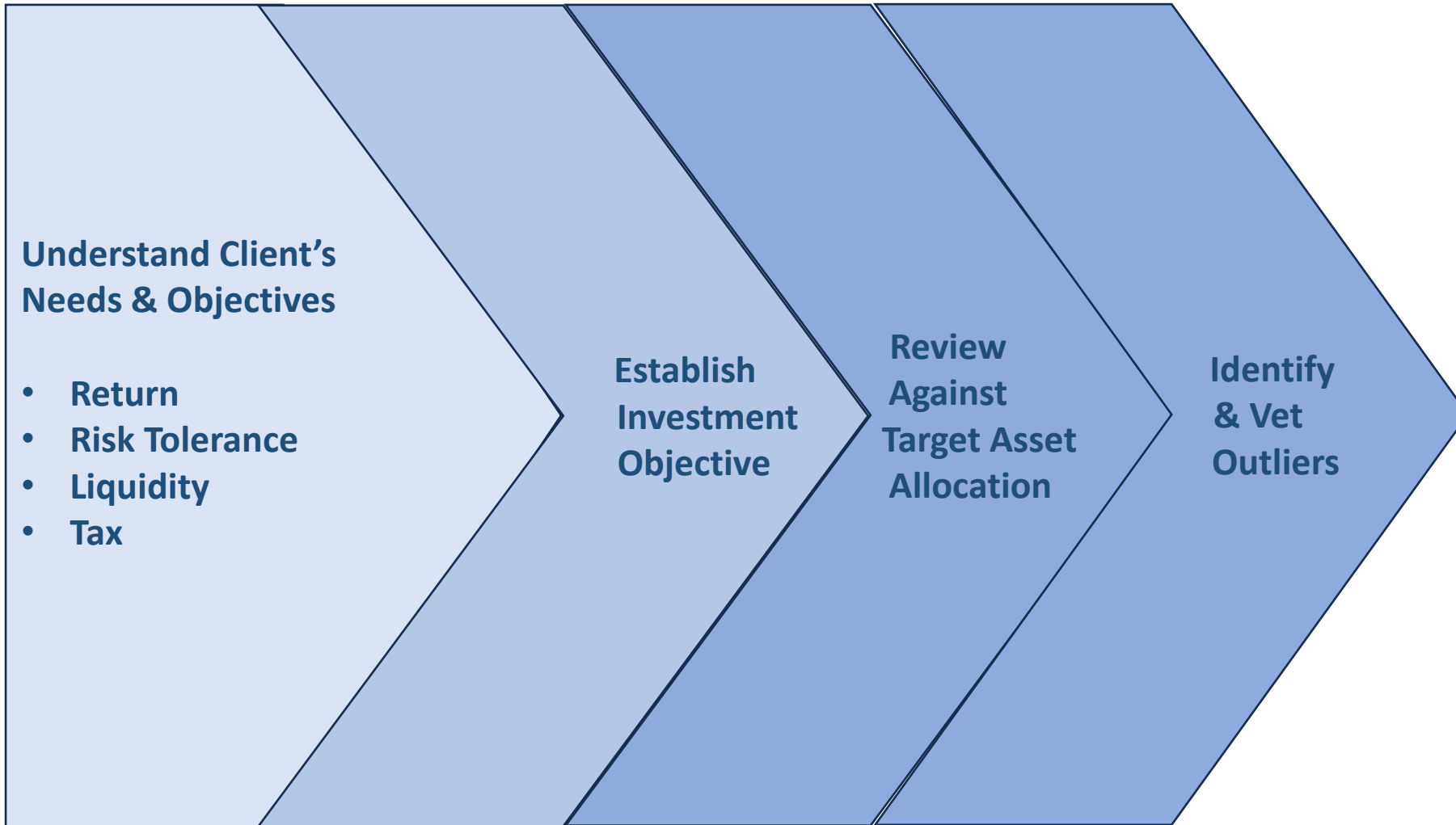
- In a word, no. Context matters
 - 9% isn't always perfect and 11% isn't always concerning
- Denominator thresholds
- **Investment objectives** linked to **Asset Allocation Targets**
- Available alternatives – sell, retain, trim, NJSA, court order
- D-word: Diversification

THIRD QUARTER

Concentrated Asset meets Investment Process



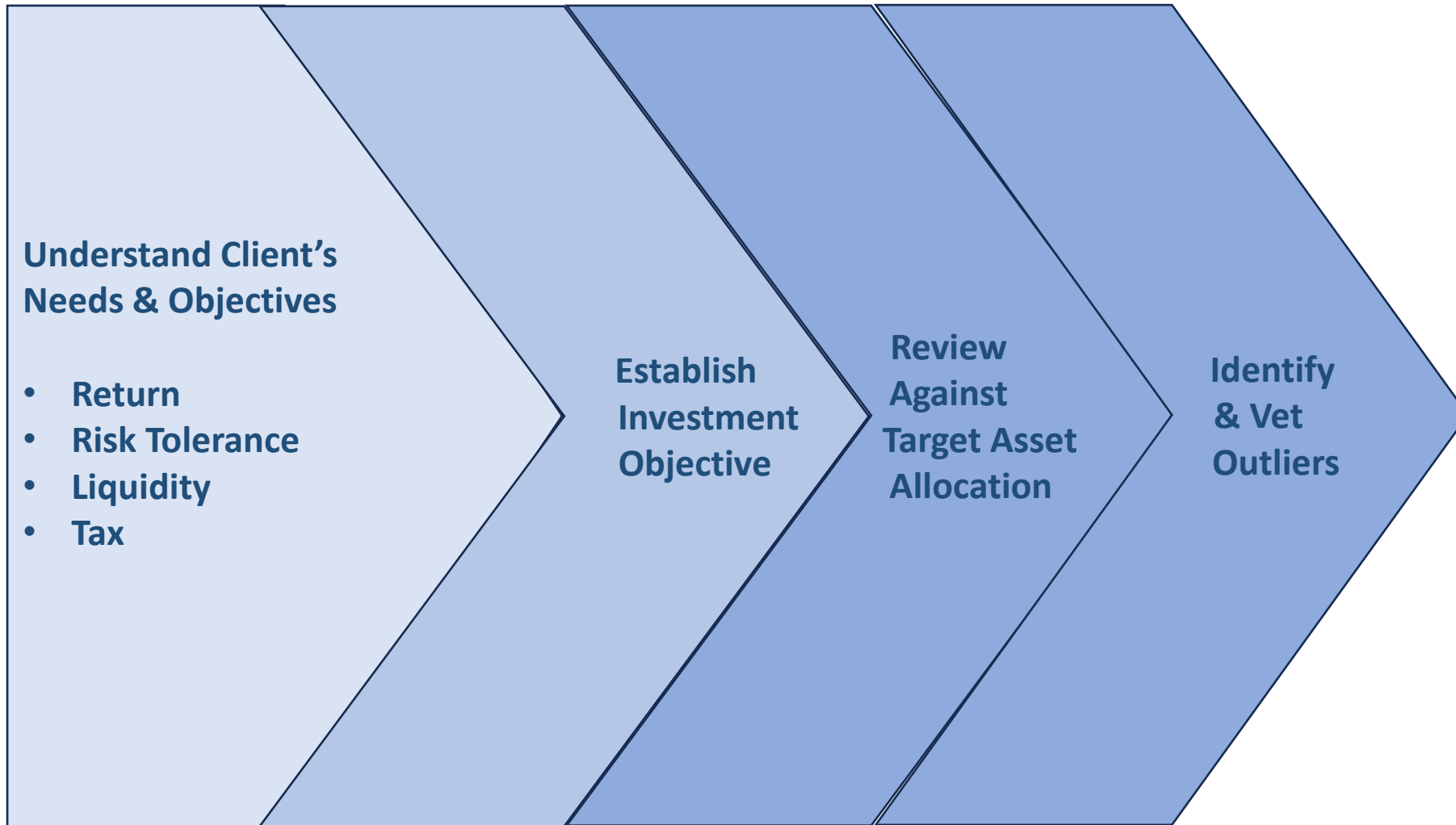
Concentrated Asset meets Investment Process



The surest way to miss a target, IS TO FAIL TO SET ONE!!!!!!!!!!



Concentrated Asset meets Investment Process



Generally speaking...

- A concentrated asset will often put stress on target asset allocation thresholds
- This stress is compounded if the concentrated asset runs contra to the investment objective
- Very large concentrations prove the adage:

**“As goes the asset,
so goes the account.”**

The surest way to miss a target, IS TO FAIL TO SET ONE!!!!!!!!!!



What are the hazards?

#5 Blind obedience to trust document

Always remember & never forget – the highest risks lie in the extremes!

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#3 Over-reacting (falling for) volatility

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#2 The peril of \$1 assets

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- #4 Over-reliance on exculpatory language
- #3 Over-reacting (falling for) volatility
- #2 The peril of \$1 assets
- #1 The Binary Option Trap – Sell it ALL/Keep it ALL

What are the hazards?

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- #3 Over-reacting (falling for) volatility
- #2 The peril of \$1 assets
- #1 The Binary Option Trap – Sell it ALL/Keep it ALL

*Always remember & never forget...
the highest risks lie in the extremes!*

What are the mitigants?

- Update information
 - MV, Marketability, Appreciation, Income
 - THOUGHTFUL documentation & communication
- Act prudently
- Act incrementally
 - Way too often, the dialogue hinges on ALL IN or ALL OUT –
- Identify unique asset contribution
 - 15% of assets, 40% of income
 - This isn't an absolute, sometimes the outsized income is driven by outsized risk
- Selective trimming is how concentrations are handled for marketable securities
 - WHY NOT FOR specialty assets?
 - Many specialty assets can be selectively trimmed
 - Commercial RE – It's hard to sell part of a building

A note on concentration committee vocab...

- It's a concentration, sell it! (Booms the committee chair)
 - “Yes, but we also have a **duty to diversify**, but we also have a **duty to be thoughtful**”.
 - “If we were to sell, how would we replace the income currently being generated?”
 - “I think it would be more prudent to be incremental in this decision.”
- Special note for oil & gas assets, especially after new wells begin producing:
 - rate volume variance (production spikes, price spikes, or even both)
 - Temporary, substantial spike in value/concentration
 - energy assets asset as self-diversifying (when high principal allocation is present)

FOURTH QUARTER

Final Exam – One Question

Is this a good asset?

Asset

- 35,000 SF office building in Nashville, TN
- Fully leased to State of TN for multiple departments
- 15 years left on a 25 year triple net lease
- Escalations: Market + 2% escalation on the 5s

Exam Question: Is this property a good asset?

Final Exam – One Question

Is this a good asset?

Current Context

- Survivors trust
- 15% concentration in the trust, nothing else in ALTS
- Generates 40% of distributable cash to income bene
- Investment object is Current Income
- Property was an original asset of the trust
- Language in trust supports retention of property to generate income for spouse
- **BUT THEN.....**

Final Exam – One Question

Is this a good asset?

Next Context

- Income beneficiary dies
- Trust remains for another 20 years
- 3 Remainder benes, all successful professionals
- New Investment Objective – Tax Sensitive Appreciation

Exam Question: Is this property **STILL** a good asset?

Final Exam – One Question

Is this a good asset?

Exam Question: Is this property still a good asset?

- Of course it is!!!
- Just not for this account in light of change in Investment Objective
- This property is still strong, but it is now inconsistent with account needs

Note:

- But be thoughtful in making the adjustment
- Respect all of the new Investment Objective

Final Exam – One Question

Is this a good asset?

Exam Question: Is the property still a good asset?

IDEAS PLEASE???

Final Exam – One Question

Is this a good asset?

Exam Question: Is the property still a good asset?

Of course it is.

It has, however, become toxic to the account.

Final Exam – One Question

Is this a good asset?

Sell the property, but pursue a partial 1031

- Take some chips off the table
- Defer recognition of capital gains
- Use replacement real property to maintain diversification

What might this look like?

Sell the property with transaction proceeds going to:

- Underallocated parts of the target asset allocation
- Replacement property via 1031 deferring gains
- Tax on recognized capital gains

What kind of target property?

- Purchase clear-cut timber tracts
- Replant across timber basins and species
- Focus on longer-term growth patterns
- Returns come from:
 - Eventual harvesting – capital gain treatment ●
 - Appreciation through biomass and value of underlying land
 - Timber, unlike row crops, allows you to pick your harvest time
- Respects new investment objective

OVERTIME

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Handling Concentrated Specialty Assets – Strategies to Mitigate Risk and Complexity

FINAL

NTCHBA 60

SPEAKER 0