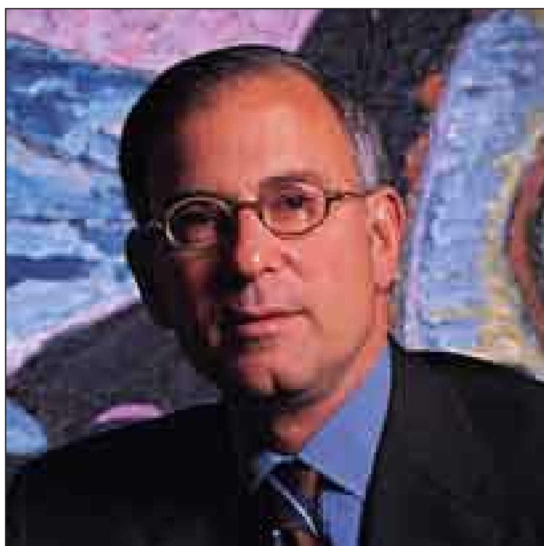
Interview

Behavioral Wealth Management

An Interview with Andrew Rosenfield, Managing Partner, Guggenheim Partners, LLC, Chicago



Andrew Rosenfield

EDITORS' NOTE *Andrew Rosenfield was educated at Kenyon College, Harvard University, and at the University of Chicago and its Law School, where he has served on the faculty as a Senior Lecturer in Law for 20 years. In 1977, Rosenfield, with University of Chicago Professors William Landes and Richard Posner, founded Lexecon Inc., an economic consulting firm that he ran for more than 22 years. He was also the Founder, Chairman, and CEO of UNext Inc., an education firm he created in 1997. In 2004, Rosenfield joined Guggenheim Partners where he is currently Managing Partner and Chairman of Guggenheim Investment Advisors, the firm's wealth management and institutional advisory businesses. He is also Founder, President, and CEO of the advisory firm Leaf Group LLC, which is affiliated with Guggenheim. He is a member of the board of trustees of the University of Chicago, a national member of the board of directors of the Lyric Opera of Chicago and Vice Chairman of the board of trustees of the Art Institute of Chicago.*

COMPANY BRIEF *Guggenheim Partners, LLC (www.guggenheimpartners.com) is a diversified financial services firm founded in 2000. One of its principal activities is to provide the Guggenheim family and other high-net-worth clients, as well as foundations and other endowment managers, with wealth and investment management services. With nine offices in the United States, along with London, Hong Kong, Dublin, and Geneva, Guggenheim embodies a century-old family tradition that emphasizes wealth preservation with sustainable capital growth grounded in pioneering academic research and proven investment strategies.*

Is yours a secret business?

Not really, but we do not advertise or promote much.

And you don't say who your clients are.

Right. That will never change. We respect their confidentiality – a paramount issue for them and for us.

There are plenty of excellent companies that do what you do. What sets you apart from them?

Let me tell you a little about what we do, which is idiosyncratic. We started a wealth management business a number of years ago unfettered by affiliation with a large global investment bank. And we asked ourselves a very simple, straightforward question, which is: If we were building a wealth management business to serve ourselves as clients, what would we want? The things we wanted were really quite basic, but largely unavailable in the market. First, we wanted a business that was completely loyal to its clients. Although this seems obvious, it's not the case with most wealth management businesses. We exist solely to serve the interests of our clients. That means our business is completely open and unconnected to any other products or services at Guggenheim. Unlike the major investment banks and universal banks, we do not have a wealth management business in order to sell products of the firm. It's a pure service business. We sit on the same side of the table as our clients and we represent their interests exclusively.

Second, we consider the total wealth – liquid and illiquid – of each of our clients, which is quite unusual since almost all of our competitors would treat two people with $100 million of liquid assets identically, irrespective of the possibility that one has another $100 million in timber in Indonesia and the other has $100 million in oil and gas in Texas. The reason for that, I think, which took me a while to realize, is that the industry charges fees only on the money they manage – that is the liquid portion. So to most banks, a $100 million account is just like every other $100 million account. We say that's the wrong way to think. We look at the whole picture before constructing an asset allocation.

Do you take fees, or percentages, or both?

We have no source of revenue other than the fee we charge clients and we do not get paid by any fund managers or product managers. If someone were to give us a discount, which is extremely rare, then we would pass that saving directly on to our clients. Usually we just charge a simple service fee. In some cases we will negotiate a performance fee with our clients, but that's not something we require.

How much is the service fee?

Typically about 100 basis points to provide a whole range of services, from family office services to investment advisory services. Often clients will need someone who knows everything about procuring fractional interests in aircraft, or the purchase of second homes, or the obtaining of a special loan facility. Other times you need people who know a lot about private equity, or hedge funds, or venture capital. No families, save for the rare exceptions, really can afford to have all of those services provided by people who work exclusively for them. So we've created a multi-family office structure where we provide all those services and more for a fee. Another distinction is in the approach we have toward investments. And this relates to Danny Kahneman. He is a remarkably talented person, a Professor at Princeton, a Psychologist, and the only Psychologist ever to win a Nobel Prize. There is no Nobel Prize in psychology – Danny won the prize in economics in 2002. Starting in the '70s, with his colleague, Amos Tversky, Danny began to think about questions that economists had long thought about, including how people react to and deal with risk. But he thought the way most economists were thinking about risk was largely wrong. What he determined was that people voluntarily take equal probability prospects only when the payoff for winning is about twice the cost of losing, which was inconsistent with the way economists then thought about risk taking. And so Danny and Amos built a very thoughtful approach to risk, called Prospect Theory, in the late '70s.

Prospect Theory?

Basically what they concluded was that the carriers of utility were changes in wealth, not levels of wealth. Increases from some reference point or level had one utility implication and decreases from that point had another, and that on average a dollar of loss is twice as "bad" as a dollar of gain is "good." People dislike losses

terribly, much more than they like gains. This has a number of implications and it has an impact on how we manage money. We don't use words like risk averse, risk neutral, and risk preferred because you have to separate the domain of gains from the domain of losses. Danny said the first thing you do is avoid loss, the next thing you do is seek gain. This different way of thinking brought forth a battle in economic circles for 30 years, resulting in the emergence of a new and thriving discourse: behavioral finance. The conflict arose because so-called "first-order loss aversion" derived from Prospect Theory was largely antithetical to the models people had used, where a dollar of loss and a dollar of gain were treated as if they had the same absolute value on utility. We've built a wealth management business predicated on first-order loss aversion. For people who are already quite wealthy, capital preservation and asset protection are very important themes.

And other banks don't acknowledge this?

If you've ever gone through a simple survey with an investment bank, they'll ask you, "Are you conservative?" or "Are you bold?" and "How do you feel about risk?" and "Are you calm?" In our judgment these questions have very little meaning: they have no context. Behavioral finance reinterprets this notion of risk aversion as "first-order loss aversion," and asks the following question of our clients: Over time, how much can you afford to place at risk of loss in the quest for additional gain? That turns out to be a tractable question, but one most people have never had to grapple with directly.

Don't most people say none?

No, they don't. If they say none, then their investment strategy is very simple: they need to hold government bonds or if their concern is not only no nominal loss but no loss in real terms, perhaps Treasury Inflation Protected Securities [TIPS]. But most people don't like the expected returns those securities offer, which is between, say, 2 and 5 percent annually. Forcing people to face the fact that incremental expected return can only be had by incurring risk, and that risk should be predicted and weighed – that is to say, forcing people to think about how much they are willing to lose in the quest for incremental gain – is essential and rarely done by others. Obviously we hope our clients never lose anything, but we're extremely careful to disclose that there are ranges of risk in investing, and you ought to come to terms with it, and see how much risk of loss you're willing to incur in the quest for incremental gain.

Putting all the philosophy aside, what is the average percentage of gain you get for your clients?

We very carefully use a technique we call riskometry, which is meant to figure out what it is people want. Some people can tolerate almost no loss. For them you get a return that is modest, because you're trying to buy very, very high probabilities of zero or low loss.

You can get 5 percent return, secure, easily these days.

Let's think about that. If you're willing to hold until duration, you can buy government bonds that will give you a nominal yield of say 5 percent. But they're not inflation protected, and if inflation kicks up those bonds won't deliver a great return in real terms and before they mature there will be a material capital loss. It is actually very difficult to earn 5 percent in real terms, especially if you are unwilling to take any risk. If you're willing to take some risk, that's different.

You said you charge clients 100 basis points for your services. What does that comprise?

If a client gives us $100 million to manage, we will charge that person roughly $1 million per year. We'll provide all their family office services, bill paying, document production, scanning, support, off-site document retention, estate planning, trust management, all of those things, as well as asset management, for a million dollars. And that's not as expensive as it sounds, because we directly allocate a portion of that client's wealth to the world's best hedge fund managers, private equity firms, etc. Typically, many of our clients, before they met us, were putting a third or more of their assets, sometimes one half, into these other kinds of structures through funds of funds and were being charged more like 125 basis points as excess access fees.

What's the smallest amount of investment you will accept?

The simple answer is about $30 million. The more complicated answer is occasionally we have an extended family with a group of $5 million investments, and we feel we can effectively serve them. But we are probably not much help to a single individual until they have close to $30 million in liquid financial assets.

What about the U.S. tax implications for overseas investors?

We're able to manage overseas money very effectively. Many U.S. managers offer tax advantaged off-shore access vehicles. In addition, we don't invest only in U.S. assets. We invest globally. And the kinds of structures we like to use intensively sometimes can be unattractive to U.S. taxpayers. International investors have great advantages in investing in certain hedge funds because they're not taxed disadvantageously the way U.S. taxpayers are.

How old is Guggenheim Partners?

Technically seven years, but we stand on the shoulders of the Guggenheim family office, which goes back to the early 1900s.

You handle the Guggenheim wealth as well?

We do. We celebrate the heritage and connection to the Guggenheim family, which always did things in a very thoughtful way. The Guggenheims were remarkably successful very quickly and they became, from 1875 to the early 1900s, one of the wealthiest families in the world largely through incredibly aggressive direct investments in mining and minerals. They were really very early in paying people for performance and talent, which was a new approach back then. They hired a mining engineer named John Hayes Hammond in 1910, and paid him a quarter of a million dollars in cash plus 25 percent of the incremental value that he created, very much like modern private equity structures. So our foundation is based on their experience, as well as their connection to culture, science, and energy innovation. They were real seekers of talent and integrity and we celebrate that. When we tell people what we do, we start by saying, "I think what we're going to tell you will be very different." People sort of roll their eyes, but at the end they realize it is authentically different.

You still haven't told us what average percentage gain you earn for your clients.

We can't, because it depends drastically on each client's interest in risk. Our goal would be, in each case, to get people greatly reduced risk, extra return, and significant extra return beyond our fee, but the people we do this best for are the people who are trying to make 7 to 12 percent annually after fees recurrently with little variation or equity-like drawdowns – of course there is no guarantee of return and people bear risk. We're less effective with people who don't mind gaining more on average but by going way up one year and losing say 15 percent of their wealth the next.

What about that person who reaches a certain age and doesn't want to remain very active as an investor, but just wants to take out, say a million a year, to live on?

That's a central part of what we do. We help people with estate planning and we help people with family governance. This is an important point to make. For some of our clients, making more money is less important than family harmony and succession. Maintaining close relationships with their children, grandchildren, and beyond become paramount concerns for them. We have discovered a lot of innovations about how to create family harmony. We've come to think of large family wealth more like a company, with stakeholders operating like equity holders on the one hand, and debt holders on the other. The biggest struggle in these large families is transition, as you often have people who are working in the business, and people who are outside of the business, which creates significant potential for disharmony. One way to solve that problem is to treat the people outside of the business as if they are more like debt holders. They have a more secure stake in the enterprise, and they have fewer ups and downs. The people in the business are more like equity partners. They're putting in their time and effort, and if they double the wealth, they should have a commensurate stake in the gains. We have developed structures that help people effectuate those kinds of rules and governance systems within the family to create harmony. Indeed what you said is right, we are perfectly able to take a wealthy family and set up a structure to allow family members to live very well as they age, and to create tax-efficient structures to benefit children and grandchildren.

You've been very successful. What is your outlook for growth?

Yes we're doing well. What's very interesting is, we're building a business that I think has the opportunity to be quite large and successful. The hard work is all in the stage of building these new ways to manage money, opening the channels to the world's best money managers, getting capacity, acquiring and growing the family office services businesses, and then the business scales very nicely, because we can accommodate another $10, $20, $40 billion quite easily in the structure we have. ●