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What Entrepreneurs Can Teach The Wealth Management Industry: *Cash Flow Is King*

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OVERVIEW:

Every successful entrepreneur knows the business reality that **Cash Flow Is King.** In other words, the financial success of their company depends upon the people in their company effectively & efficiently harnessing the assets & resources of the company in order to generate **Revenues** that exceed **Expenses** that results in a **Cash Profit.**

In my view, the same **Cash Flow Is King Principle** should be applied by the wealth management industry in the successful stewardship of client assets. Every investor that we've met in our careers has some form of Cash Flow Needs for their assets – either now or in the future; it might be lifestyle funding for a family, annual disbursements from a foundation or funding of employee retirement incomes from a defined benefit pension plan.

As a result, the assets of every investor need to be thought of as an **Asset Management Business** (instead of just a **Pool of Assets**) that generates that cash flow, either now or in the future, for that investor.

VIEWING CLIENT PORTFOLIOS AS ASSET MANAGEMENT BUSINESSES:

The **Cash Flow Equation** for the Asset Management business is the same as for any other business:

Cash Flow = Revenues – Expenses

The **Revenues** are the Interest, Dividend & Realized Capital Gains from the investment assets while the **Expenses** are all of the investment management related expenses such as Investment Management, Trading, Custodial Costs and Realized Capital Losses.

An extension of this view is the accounting separation of:

Cash Flow Generated From The Operations Of The Business, and

Cash Flow Generated From The Sale Of Assets Within The Business.

In other words, business owners need to delineate between their **Core Activities** (ie: regular, recurring & predictable generation of operating cash flow) versus their **Non-Core Activities** (ie: irregular, sporadic & unpredictable generation of cash flow from asset sales).

In the case of a client's investment portfolio, the Core Activities are the regular & predictable Interest & Dividends while the Non-Core Activities are the irregular & unpredictable Realized Capital Gains (and unfortunately sometimes, Realized Capital Losses).

Similarly, trust companies, as investment fiduciaries, have historically accounted for the performance within portfolios according to two distinct types of accounts: Capital Account, and Income Account, in order that they can be accountable to the beneficiaries of trusts who can sometimes have different needs (ie: Beneficiaries of Income versus Beneficiaries of Capital).

THE WRONG FOCUS:

This is such a simple principle but I find it amazing how many investment professionals lose sight of this Cash Flow Is King Principle when advising & managing client wealth. Instead, the focus of advice seems to be primarily oriented towards trying to either **Beat The Market** (ie: Active Investing) or **Match The Market** (ie: Passive Investing). As a result, the client conversations are primarily about the total performance of each client's portfolio relative to the markets instead of the performance of each client's portfolio against their capital & cash flow requirements (ie: either now or in the future), and their true tolerance for risk in pursuing such cash flow & capital goals.

THE REAL & EXPECTATIONS MARKETS:

One of the best analogies I've read in recent months is in a book written by Roger Martin, the Dean of Rotman School of Business, Fixing the Game: Bubbles, Crashes, and What Capitalism Can Learn from the NFL. In his book, Martin states that the coupling of the "real" market (ie: the business of designing, making and selling products and services) with the "expectations" market (ie: the business of trading stocks, options and complex derivatives). It's a bit like confusing winning the Super Bowl with winning a bet on the Super Bowl. In the NFL, there is the real market where teams take to the field to play a game. Real touchdowns and real field goals are scored. And there is the expectations market: gambling. "Gamblers try to guess who will win a given game on a given Sunday and place bets based on that expectation." The bets are balanced on either side through the use of a point spread which is similar to the pricing of securities in the investment business".

I really like Martin's view as it's the same issue that is happening in the wealth management industry today. Advisors & clients are too focused on playing the Expectations Market (ie: relative return investing) instead of focusing on the Real Market (ie: absolute, cash flow & capital goals). But unlike the wealth management advisory business, the NFL looked thoughtfully at the relationship between the real game and the expectations game and identified a serious danger…They clearly saw that the

pressures of the expectations game could do serious damage to the real game…it could destroy the sport…[they] have enforced **a strict separation between the real market and the expectations market**…exactly the opposite of the way we have managed it in the wealth management advisory business." Our single-minded focus on the expectations market is driving us (and our investor clients) from crisis to crisis with ever-increasing volatility.

THE NEGATIVE OUTCOME:

By obsessing about relative performance, so many families and institutional investors have been misled by the global wealth management industry over the past four decades to focus on the wrong investment outcomes, which in turn has led to:

- Families not having sufficient financial assets to generate required retirement income.
- Pension plans who have seriously unfunded liabilities because their portfolios were designed to perpetually chase relative returns through high investment manager turnover instead of focusing on matching their assets to future pension obligations.
- Foundations & Endowments who have had to cut their disbursements because their asset bases — and subsequently income generating capabilities — were impaired due to their focus on trying to find investment managers who consistently beat the indices or following the portfolio construction patterns of other foundations & endowments (ie: the Yale and Harvard approach to alternative investments).

The quote below, unfortunately captures what's going on today in the management of client wealth… just ask any entrepreneur...they'll tell you!

"If you don't know where you are going, you might wind up someplace else."

Yogi Berra

THE SOLUTION:

The solution in our view is for the wealth management advisor business to 'Get Back To The Basics' of designing objective portfolio solutions for clients that are purpose-driven with an absolute cash flow & capital goals orientation instead of perpetually chasing illusive, relative returns that cause investors to completely miss their real financial goals.