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An Institutional Approach

Many affluent investors have implemented institutional investment strategies; they may want to adopt these “best practices” as well.

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Institutional investors, such as pension funds, foundations and endowments, often use sophisticated investment strategies to improve long-term returns. Many of these strategies, such as investing in hedge funds and private equity or following a multi-manager approach, have become available — and even common — for affluent individual investors. But to be truly successful in pursuing these strategies, individual

investors need to adopt the mindset of their institutional counterparts.

Create and Follow a Strategic Plan

While institutional investment strategies continue to grow in popularity among affluent investors, one critical factor still compromises individual investors’ results: emotion. Removing emotion from investment deliberations is a key element

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of institutions' successful investment record. Moreover, achieving superior long-term returns by employing institutional-grade investment strategies requires a heightened commitment to a disciplined, pragmatic decision-making process.

Professionally managed foundations, endowments and pension funds eliminate emotion from their investment programs by adhering to investment policies that identify permissible investments and prescribe corresponding asset allocation guidelines for everything from stocks and bonds to hedge funds and commodities. Even allocations to specific sub-categories — such as investment-grade vs. high-yield bonds — are quantified with precision.

Institutional investment policies often also stipulate appropriate benchmarks for each investment manager, and outline monitoring and termination criteria. In addition, institutional investors conduct regular board or investment committee meetings to review their programs' progress and discuss specific results with their advisors and investment managers.

Don't React Emotionally to Headlines

In contrast, affluent investors often react emotionally to financial market volatility and other environment changes. Unfortunately, strategically sound long-term investment programs can become a casualty of these emotional responses.

An example of this sub-optimal behavior can be seen today in affluent investors' growing reluctance to invest in private equity. While private equity has been the subject of negative press in recent months, individual investors need to remember that private equity is unique in that its investments have a long maturation cycle — typically five to seven years. By sitting on the sidelines because of newspaper headlines, affluent investors run risks that could ultimately prove costly:

1. Without regular investments, an investor's strategic allocation to private equity will wane as early-year commitments mature, resulting in an unbalanced, long-term investment portfolio.
2. Individuals who respond to headlines by delaying or terminating regular private equity commitments may miss a vintage year that includes the next Google.

Compare Apples to Apples

Individual investors often measure performance by comparing investment returns to peers or broad market indices. As a result, individuals' portfolios usually exhibit greater turnover, often with adverse tax consequences. Placing too much attention on short-term trends and results also may make individual investors vulnerable to "selling low and buying high."

Institutional investors, on the other hand, make "apples to apples" comparisons by evaluating their portfolios' performance relative to specific policy benchmarks. This approach helps institutions maintain a disciplined, long-term asset allocation and avoid being "whip-sawed" by short-term market gyrations or temporary periods of underperformance.

Rebalance Strategically, Not Reactively

Too often, when a specific asset class or investment manager is underperforming, individual investors respond with a sell order. Institutional investors, on the other hand, generally demonstrate far greater patience, understanding that all asset classes and even skilled investment managers periodically experience temporary periods of poor performance.

In combination with patience and a firm focus on long-term results, successful institutional investors also regularly rebalance their portfolios back toward strategic asset allocation targets. By doing this, institutions maintain balance in their asset allocation strategies and improved long-term investment results.

Without a regular rebalancing discipline, investors' portfolios will drift away from strategic asset allocation targets and become increasingly concentrated in certain asset classes. Over time, these concentrations become the source of pronounced risk, resulting in exaggerated portfolio volatility and diminished returns.

Partnering for the Future

Given human nature, it would be unreasonable to assume individuals could make investment decisions completely independent of their emotions. But by working with an experienced investment advisor and adopting many of the best institutional practices, individuals can improve both their emotional and financial well-being. ■