Real Terms

Continuing our look at how best to protect your estate and wealth for future generations


Igor Zjalic of XLX Capital

Regular readers of Investor Media publications might recall Igor Zjalic and his investment strategies designed to protect the wealth of an estate and the wellbeing of future generations. With inflation and global costs going through a period of flux and increase, Igor's real terms strategies have never looked more relevant or important.

Portfolio manager Igor Zjalic runs XLX Capital, an advisory investment firm based in London and Europe dedicated to providing effective advice on Capital Allocation and Portfolio Management to HNW investors and Family Offices.

Zjalic and XLX place a good deal of importance on ensuring investment strategies that deliver real terms value on both the disposable wealth and future purchasing power of future generations. Taking both of these factors into account, a strategy is reverse engineered to ensure future financial freedom is maintained.

Having previously looked at how traditional strategies might fall short of an investor's needs and future aspirations, we then saw an example of XLX's reverse engineering, what it considers and how it creates a different type of investment plan. In this article we now look, in detail, at such a strategy and how the diversification of assets is taken to a whole new level.

Igor Zjalic take up the investment strategy story:
Our approach is a departure from the very classical approach in finance commonly termed "diversification" of assets. The diversification, in this context, stems from empirical properties of returns on financial instruments as well as, quite simply, the mathematical properties of variance.

Going one step further, we consider assets in and of themselves to be bundles of risk premia and apply the diversification process on these constituent parts of asset returns. Assets and asset classes are, nonetheless, a starting point of analysis so let us define what the properties of an asset class are.

What is an Asset Class?

By definition, an asset class must have, at a minimum, the following characteristics:

1. An Asset Class must be sufficiently large to absorb a substantial portion of a portfolio,
2. Trading in an Asset Class must be sufficiently liquid to ensure uninterrupted investment and divestment
3. Returns in an Asset Class cannot be replicated by a linear combination of Returns in other Asset Classes.

   Asset Classes represented in our portfolio, out of which we allocate based on the risk premia criterion are:

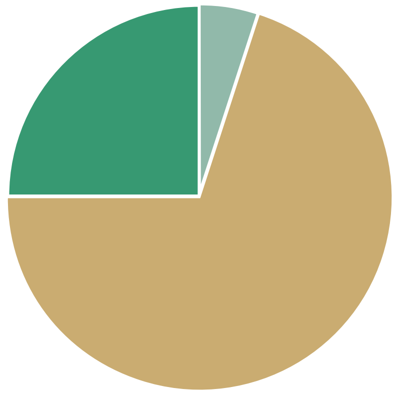
Foreign Exchange, Interest Rates, Equities, Credit, Inflation, Volatility, Commodities, Real Estate

As an example, we may allocate capital to risk premia in Equities via investments in listed Equities, Private Equity and Venture Capital as well as Equity Volatility. Notably, we would not consider Debt as a stand-alone asset class as the returns on Debt can be approximated using risk premia on Interest Rates and Credit (as well as Equity, in case of Corporate Debt) to a statistically significant degree. Therefore, Debt would not qualify as a stand-alone Asset Class (within the above definition).

Applying this methodology, we seek to allocate individual client's portfolios in a generalized three-tiered approach, such that these individual portfolios approximately resemble the following allocation:

Target Portfolio Allocation

- Core Portfolio - 70%
- Tactical Portfolio - 25%
- Cash and Equivalents - 5%



Core

Whereby the Core Portfolio consists of Long dated and illiquid investments (such as Venture Capital, Private Equity, Private Debt - including Direct Lending and/or Mezzanine Debt - Real Estate, Infrastructure etc.) and is designed to generate long term capital appreciation. .

Tactical

The Tactical Portfolio consists of investments in liquid Hedge Funds and/or Multi-Strategy direct trading in liquid financial instruments (including strategies such as Global Macro, Long/Short Equity, Long/Short Credit, Algorithmic Foreign Exchange, Algorithmic Commodities, Algorithmic Equities, Volatility etc.) and is designed to absorb the short-term market volatility and insulate the Core Portfolio from adverse liquidity events. .

Cash

Finally, the Cash and Cash Equivalents is designed to provide a cushion of liquid cash for various purposes and/or offer a possibility to hedge risks in less liquid strata of the global portfolio and it consists predominantly of short-term Credit and Algorithmic Directional Trading strategies in liquid assets.

Expected Returns

Depending on individual client preferences and capital constraints, we seek to obtain a target Expected Return, further constrained by the acceptable level of risk of each individual client. As an Example, a global diversified portfolio constructed as described above could have the following Expected Return profile (percentage return per annum):

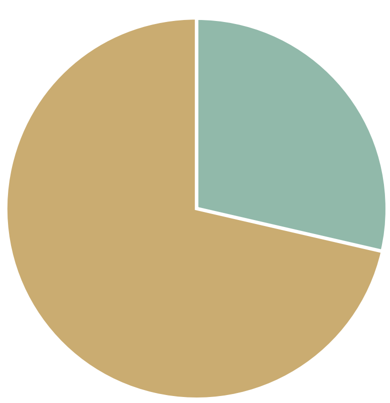
	Weight	Expected Contribution	Expected Weighted Contribution
Core Portfolio	70%	8.00%	5.60%
Tactical Portfolio	25%	8.00%	2.00%
Cash and Cash Equivalents	5%	2.00%	0.10%
			TOTAL: 7.70%

Based on the above described logic, we present, an **actual live trading portfolio** and its characteristics.

Portfolio Component:	% of TOTAL:	E(R) p.a.
Tactical	28.66%	8.00%
Core	71.34%	6.00%
	100.00%	**6.57%**
CASH	2.50%	1.43%
FUND	50.02%	8.00%
DIRECT	2.43%	0.28%
REAL ESTATE	45.04%	5.61%
	100.00%	**6.57%**

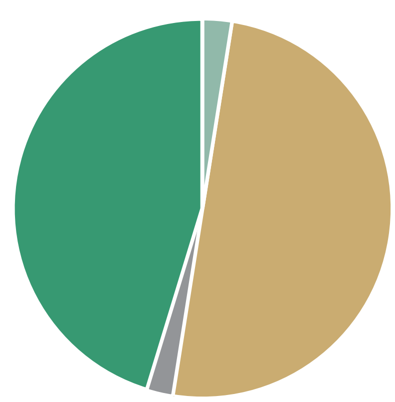
Target Portfolio Allocation - Live Portfolio

- Core Portfolio - 71.34%
- Tactical Portfolio - 28.66%



Target Portfolio by Assets - Live Portfolio

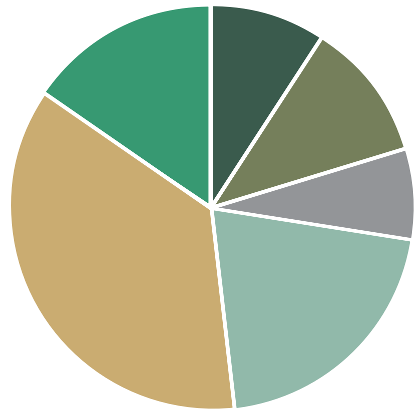
- Cash - 2.5%
- Fund - 50.02%
- Direct - 2.43%
- Real Estate - 45.04%



Target Portfolio - Risk Premia

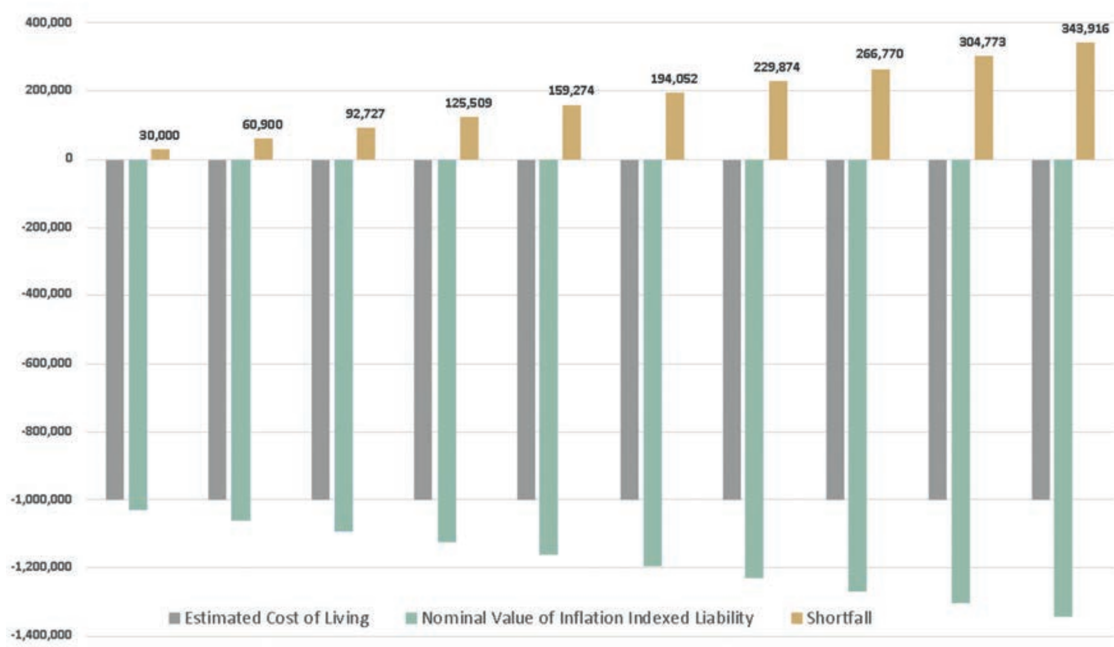
Specifically, the Tactical Portfolio is designed to absorb market volatility and benefit from any adverse liquidity conditions, as we have witnessed in recent months.

- Long / Short Equity, US Technology Sector - 9.21%
- Long / Short Equity, UK Broad Index - 11.33%
- Algorithmic Foreign Exchange, G10, 3x Leveraged - 7.22%
- US Equity Volatility, Dispersion Index - 20.64%
- Global Macro, Interest Rates and Commodities - 36.12%
- Global Oil Majors, "Worst Off" basket, 5 year structure, 12.50% coupon p.a. - 15.48%



We note the performance of this essential part of the portfolio with respect to major global equity indices:

Planning Discrepancy -
Shortfall of Cash Assumed 3.00% Inflation per annum



Let us now return to our initial example and show the benefits of Asset-Liability Management approach as an investment strategy for Family Offices based on a supposed cost of living increase over 10 years, as per the below graph.

We make the following assumptions:

1. The client disposes of EUR 50 million of investable capital.
2. The assumed constant Expected Return per annum is 6.57% (using the real-life example above).
3. The client expects his/her cost of living to amount to EUR 1 million per annum for the next 10 years.
4. We assume the inflation rate to be 5.00% per annum (NB: whilst highly unrealistic in practice, this allows us to verify the methodology in an extreme scenario).
5. The FO manager will distribute inflation adjusted cash flows each year to the client so as to maintain the purchasing power and therefore the life style of the client.
6. The FO manager will reinvest any nominal amount of annual performance in the global diversified portfolio.
7. The FO manager will not change the portfolio composition.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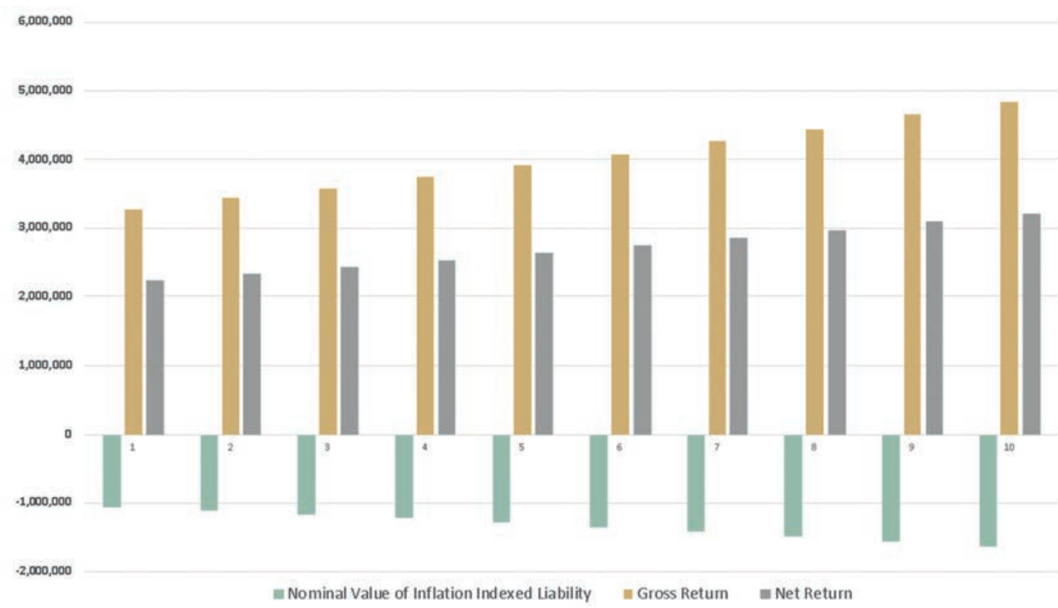
ALM Approach
at Assumed 5.00% Inflation per annum



Strategy Analysis

We note that the client was able to both meet the real costs of his/her lifestyle and achieve an increase in wealth over the period.

Reflecting on the events of 2020, we also note that extreme events such as those we have witnessed – brought on by simultaneous shocks of both aggregate demand and aggregate supply – can disrupt any portfolio allocation which is not, by construction, designed to absorb market volatility and, indeed, benefit from such occurrences.

This is not to say that a portfolio must at all times contain a certain type of exposure to volatility within a particular asset class – indeed, such portfolios would not have fared well for a number of years post 2008 crisis and the ensuing drive of monetary authorities to control and contain extreme market events.

It does, however, mean that the strategy must account for volatility as an asset class and allow for incorporation of this risk premium (whether through long or short exposures) when appropriate and in adequate amounts.

Accounting for Volatility

In 2020, the market volatility was generated mostly in the equity market, energy and precious metals (notwithstanding the prevalent extreme levels in crypto currency). In 2021, the source of market volatility lies in the interest rate markets and is mostly driven by a change in inflation expectations. This very fundamental change of macro-economic outlook conditions a host of other factors, in pretty much every branch and domain of economy on a global level.

Going forward, this marked shift in expectations must be taken into consideration when formulating investment strategies, both long-term (as in our Core Portfolio example above) as well as their short to medium-term counterparts (as in our Tactical Portfolio example above).

It is likely that we will not witness extreme levels of inflation, such as those seen in the previous decades, however, it is equally likely that a considerable departure from the hitherto adhered levels (i.e. the globally accepted target of 2.00% inflation per annum in most developed countries) will materialize over the medium term and, likely, remain a feature of financial markets and macro economies for some time.

Strategy Shifts

We can, therefore, consider the events of 2020 as a point of regime shift in both expectations as well as realized financial conditions. It is, therefore, ever more pertinent and important to adopt an appropriate capital allocation and portfolio management strategy that incorporates this particular risk premium in its very core and allocates capital in order to protect the real returns and purchasing power of investors.

We would wholeheartedly suggest to all HNW investors and all the Family Offices that represent them to examine their long-term goals and adopt our methodology. At this point in time, when we are witnessing a major shift in the way our world is likely to work in the foreseeable future, it is imperative to incorporate concepts of asset-liability management, risk premia diversification and inflation trading into a global portfolio management strategy.

Our own approach is deeply rooted in these concepts. Inflation trading, specifically, is an area we are very well-versed in. We seek to thoroughly explain and convey the tenants of this approach and work together with families on achieving their objectives.

And remember – start from the outcome! In this art and science of ours, what ultimately really matters are only – and simply - results.