Rethinking the Asset Class in Modern Portfolio Management

Key Takeaways:

- **Expand Your View of Wealth:** A person's true wealth includes more than just stocks and bonds. It's essential to consider a privately owned business, concentrated stock, salary, pensions, and specialized trusts as distinct asset classes.
- **Each "Asset Class" Has Unique Rules:** These unconventional assets have their own specific risk, return, and liquidity profiles. For example, a concentrated stock position carries company-specific risk, while a salary provides low-volatility, predictable cash flow.
- **Holistic Planning is Essential**: This broader definition of wealth requires a new approach to financial advice. Planning must be integrated, addressing unique risks like illiquidity and concentration, and leveraging the specific tax advantages of each asset.

The traditional definition of an asset class—a group of assets with similar characteristics, such as stocks, bonds, or real estate—is too narrow for many high-net-worth individuals and business owners. For these investors, a significant portion of their wealth is often held in forms that do not fit neatly into standard categories, yet carry distinct risk, return, and liquidity profiles. To build a truly comprehensive financial plan, it's essential to expand the notion of an asset class to include these often-overlooked components.

NON-TRADITIONAL ASSETS AS DISTINCT ASSET CLASSES

These non-traditional holdings should be considered separate asset classes due to their unique properties, which include specific risk factors, varying levels of liquidity, and distinct tax implications. Acknowledging them as such allows for a more holistic approach to portfolio management, one that accounts for the full spectrum of an individual's financial position.

- **Owned Companies and Concentrated Stock:** For many entrepreneurs and executives, their primary wealth is tied up in a privately owned company or a concentrated stock position in their employer's firm. These are, in essence, their largest "asset classes." A private business is highly illiquid, and its value is not easily determined or priced by the market. A concentrated stock position exposes the investor to company-specific (aka "idiosyncratic") risk, meaning the risks separate from the broader market.

- **Employment Compensation and Retirement Income:** Employment compensation and retirement income, such as a pension or Social Security, also function as asset classes, offering a unique risk and return profile. These income streams exhibit very low volatility and are largely uncorrelated with traditional financial markets. This lack of correlation is a valuable diversification tool that provides stability during market downturns.
- **Charitable Trusts and Insurance Policies:** Complex financial instruments like charitable remainder trusts (CRTs) and life insurance policies such as Variable Universal Life (VUL) or Private Placement Life Insurance (PPLI) also deserve consideration. The primary benefit of these instruments lies in their tax-advantaged growth and unique tax implications. Their value is not just in their investment performance but also in their ability to achieve a broader financial objective in a highly tax-efficient manner.

RISK, RETURN, AND BENCHMARKING

The risk, return, and risk-adjusted return characteristics of these expanded asset classes are fundamentally different from those of traditional investments.

- **Owned Companies and Concentrated Stock:** The return is a combination of profitability and valuation, while the risk is may be high due to its non-diversified nature. A concentrated position's risk-adjusted return can appear poor when using standard metrics, as they do not fully capture the illiquidity and specific risks. Benchmarking a private company's performance requires a Public Market Equivalent (PME) analysis or a comparison to an "opportunity cost" benchmark.
- **Employment and Retirement Income:** The return is a fixed or inflation-adjusted cash flow, with a risk of job loss or company insolvency. The risk-adjusted return is often exceptionally high due to low volatility, but this overlooks the risk of a complete loss of the asset. Their "performance" should be evaluated based on whether they are meeting the individual's liquidity needs and providing a stable foundation. A benchmark could simply be an inflation rate.
- **Charitable Trusts and Insurance Policies**: The return includes both tax savings and investment growth. The risk is not just market volatility, but also legal and regulatory risk. The risk-adjusted return is difficult to quantify because a significant part of the "return" is the tax efficiency and the ability to achieve a philanthropic goal, but a significant downside being a loss of control (i.e., such trusts are irrevocable). The appropriate benchmark should capture these specific tax and estate planning objectives.

IMPACT ON WEALTH ADVISORY AND INVESTMENT PLANNING

Recognizing these expanded asset classes fundamentally changes the role of a wealth advisor, shifting the focus from simply managing a liquid portfolio to a holistic wealth strategy.

- **Comprehensive Analysis:** Advisors must begin with a full inventory of a client's wealth, including all non-traditional assets. This requires a deeper, more personal dialogue to understand the client's emotional attachment to a business and the timing of future liquidity events.

- **Risk Management**: The primary goal is no longer just portfolio diversification, but holistic risk management. This means addressing the biggest risk a client might face such as the undiversified position in their business or concentrated stock.
- **Liquidity Planning:** Investment planning becomes less about short-term returns and more about long-term liquidity planning. The advisor must help the client understand the illiquid nature of their wealth and develop a strategy for converting these assets into a liquid, diversified portfolio over time.
- **Integrated Planning**: The advisory process should be fully integrated, bringing together investment management, tax planning, estate planning, and risk management into a cohesive strategy that treats all assets—traditional and non-traditional—as parts of the same whole.

CONCLUSION

Expanding the definition of an asset class to include a business, concentrated stock, income streams, and specialized trusts and insurance policies provides a more accurate and comprehensive view of a person's total wealth. It enables a more robust financial analysis and allows advisors and individuals to identify hidden risks, capitalize on unique opportunities, and create a truly diversified, goal-oriented portfolio. By acknowledging these unconventional holdings as the distinct asset classes they are, investors can build a more resilient and effective financial strategy for the long term. This paradigm shift in financial planning empowers individuals and their advisors to move beyond a myopic focus on liquid assets and embrace a truly comprehensive approach to wealth management.

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