

The Forgotten Somewhat Wealthy: Ideas for Now

Shirley M. Mueller: Physician's Financial News Live, October 8, 2008

According to the IRS Statistics of Income Division data,
Seventy nine thousand in the US have \$10-20 million.
Two hundred and thirty one thousand have \$5-10 million.
Two hundred and forty thousand have \$2.5-5 million.
Finally, 846,000 had \$2-3.5 million.

Tom Herman (2008) Tax Report: WSJ 8 27 08, page D2.

The official definition for being ultra affluent in the US is having \$25 million or above. This excludes most Americans. In fact, it only includes about 47,000 individuals. Clearly, the rest of us are not ultra affluent. Still, some of us are modestly affluent.

This minor privilege can lead to a problem. While every financial manger in the country is secreting saliva and seeing dollar signs when he encounters a person that is ultra wealthy, the less financially endowed are not as sought after as clients. Therefore, we have to consider options to protect ourselves on our own.

Enter star manger David F. Swenson, Yale's' chief investment officer. For the last 10 years, Swenson has returned an annualized 16.3%. We can learn some strategies from him.

Swenson's Yale Portfolio.

Asset Allocation	Yale 2008	Yale 2009 (%)	Conventional (%)
US Equities	11%	10%	40-50
Fixed Income	4%	4%	20-60
Foreign Equities	15%	15%	10-20
Real Assets*	28%	29%	5-10
Private Equity	19%	21%	0
Hedge Funds	23%	21%	0

**Real Assets include physical as opposed to financial assets such as gold, land, equipment, valuable antiques or art, coins, real estate and commodities.*

One of Swenson's secrets is that he invests in more asset classes than do traditional portfolios. For example, he uses six asset classes rather than the customary three or four (stock, bonds, cash and maybe real estate) that are part of most portfolios. In addition, he invests in the right proportions. For example, 70% of his portfolio is in non-traditional assets (real assets, private equity and hedge funds). The remainder, only 30%, is what the conventional investor generally holds.

This tendency to select what are called “alternative investments” is typical of the investing pattern of an institution with large sums to invest. It is also characteristic of a high net worth individual, someone with \$25 million or more. A 2005 survey of the New York-based Institute for Private Investors (a group of high-earners) showed that their allocation was 40% alternatives.

For the most part, though, this alternative investing can't be done by individual investors, for several reasons. One is that hedge funds and private equity** are too risky for an investor who is not affluent. Another is that, by law, private equity firms must require that their investors have a net worth of \$1 million or above. Hedge funds similarly insist by law that the investor has assets of \$1.5 million or above.

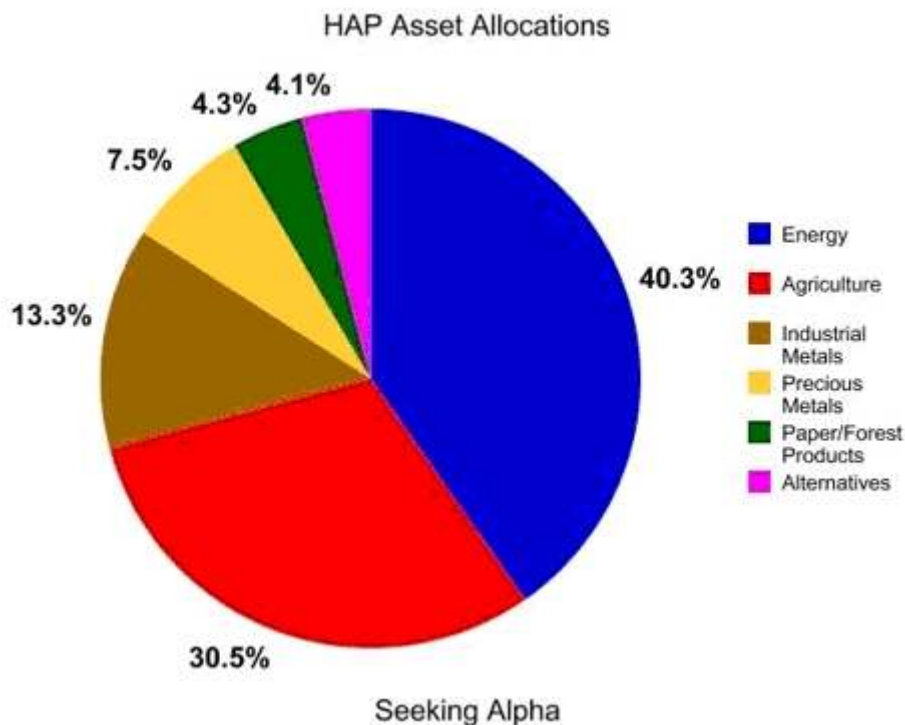
Therefore, even if a traditional individual investor wanted to participate and expose himself to extra risk, many would be excluded because their net worth would not be sufficient. Nevertheless, there are several ways for a moderately affluent investor to partially emulate a star investor like Swenson.

One is investing in real estate in a concrete way. An example is buying a vacation home, especially now that the housing market is depressed. Another is buying a second home for another purpose, such as rental. If possible, either purchase should be in a different geographic location from your own.

Another would be to invest in a real estate fund, for example, Vanguard REIT Index (VGSIX) or the managed Third Avenue Real Estate Value (TAREX) fund. The Vanguard REIT Index (VGSIX) returned 1.91% year to date and has a 5-year average return of 13.71%. Still it is currently at 20.41 with its high for the year being just above 25. This index fund is no-load and has an expense ratio of 0.20% compared to the average of 1.44% for the category. It is considered a specialized real estate of medium blend with three stars, an average rating (Morningstar).

The managed Third Avenue Real Estate Value (TAREX) fund has a yearly return of 15.20% with a five year return of 11.07%. It is currently at 22.92 and has reached nearly 36 this year. This managed mutual fund is also no-load and has an expense ratio of 1.10% compared to the average of 1.44% for the category. It is considered a specialized real estate fund in the medium growth category. It has two stars from Morningstar (less than average). An exchange traded fund that is in the same category is I shares Dow Jones US Real Estate (DJR).

Buying into a real asset fund would offer even more diversification in the real asset class. There is a new exchange-traded fund that fits the bill. It is Hard Asset Producers (HAP), an index. It includes 310 companies in 39 countries and 6 sectors from around the world that produce real assets. Though its correlation with stocks is not as directly inverse as futures, it still will not have a direct correlation. That is the benefit. The downside is that it is so new it does not yet have a trading history. Further, it is small (because it is new) so the trading spreads are likely to be substantial.



Source: Jonathan Liss, “Van Eck Hard Assets Producers: Consumption-Based Commodity Weighting,” Seeking Alpha, September 5, 2008.

According to the material published by the company sponsoring the ETF, the Index would have returned 262% in the 5-year period ending July 31, 2008. This is versus the physical commodity returns of just 73% over the same period (using the Dow Jones-AIG Commodity Index). This makes HAP an appealing alternative to futures-based commodities.

While the somewhat wealthy are not wealthy, there is no reason why we can’t play the same game, at least to some degree. Warren Buffet says, “It is not necessary to do extraordinary things to get extraordinary results.” Maybe this kind of diversification is one of these cases.

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**David R. Lovejoy wrote in *Private Equity Investing: A Primer for the Serious “Smaller” Investor*; white paper No. 40 (designed for investors who have less than \$50 million to put into a private equity portfolio): *“Unfortunately, most investors in private equity don’t earn returns anywhere near what they need to compensate for the risk they have taken”*