The Ultra High Net Worth Investor: Coming of Age
The Ultra High Net Worth Investor: Coming of Age

If we are right about the macroeconomic backdrop that we laid out in our 2017 Outlook: Paradigm Shift, then Ultra High Net Worth investors, particularly those with large sums of patient capital, are in an excellent position. The investing world is becoming more, not less, complex, and we believe that they will be able to leverage their skill sets to seek out differentiated opportunities across both public and private markets. However, such investors could face increasing return and volatility headwinds; we also see potential shortcomings in processes around hedging strategies and concentration risks. Maybe more important, though, is that the CIOs who run these programs likely need more flexibility than in the past to adjust their asset allocation game plans as well as additional time to allow their convictions to play out, even if it may be potentially at odds with certain ideas or preferences of the individuals they serve.
From our perch at KKR, we definitely have seen a major upward step function in demand for our asset allocation offering of late. It really started with the shift by global central banks towards negative interest rates, but it accelerated through Brexit into the election of Donald J. Trump in the United States. “Do I have enough cash? Are bonds mispriced at current levels? What is the right amount of equities at this point in the cycle? How should I think about my portfolio in an increasingly protectionist world?”

Importantly, when we originally began to disseminate our “target asset allocation” views via our INSIGHTS notes to clients and prospects back in 2012, we utilized a benchmark that we built during an earlier period in our career when we actively managed large swaths of money for a handful of sophisticated U.S. pension clients.

Our hope at the time – and it remains our primary goal today – was to find an efficient vehicle for synthesizing our core global macro beliefs into an easy to understand, top-down asset allocation framework that could serve as a guide for investors to generate solid risk-adjusted returns on their own portfolios.

To help measure our conviction levels about different asset classes, we consistently use quantifiable overweight and underweight positions relative to the aforementioned diversified, global, multi-asset class benchmark. Our suggested weightings, we believe, allow us to articulate effectively where we see both opportunities and risks across the global capital markets at any point in the cycle.

However, as our readership has grown and our client base has diversified, we are not only engaging more with allocators who serve as fiduciaries for large pensions but also with sophisticated individual investors, many of whom have or run large family offices. Not surprisingly, the investment objectives of KKR’s average Ultra High Net Worth investor can be quite different from the objectives of the traditional pension, endowment, or foundation.

So, in an effort to better understand the changing dynamics of the Ultra High Net Worth market, we recently worked with our Individual Investor team, led by Jim Burns, to compare asset allocation preferences within this unique subset of individual investor clients that KKR now serves on a global basis. As part of the exercise, Jim and his team surveyed over 50 of our Ultra High Net Worth clients, including several family offices. We define Ultra High Net Worth as an investor with $30 million or more in investable assets, compared to $10-$30 million for the typical HNW investor. In addition to the formal survey, we followed up with a series of customized interviews to delve deeper into key opportunities and challenges that the high net worth market now faces. What we uncovered during the process were the following facts/trends:

• The average KKR Ultra HNW investor that we surveyed has a much different profile than the typical High Net Worth investor represented by traditional private wealth managers and independent advisers. Indeed, according to our proprietary survey, most Ultra High Net Worth investors operate in a formalized family office format, with an average net worth well north of one billion dollars, a sum that is – as we detail below – many multiples of what most consider when they think of an average high net worth account. Both segments of the market (Ultra High Net Worth and High Net Worth) are extremely attractive parts of the markets, we believe, but they do operate with a much greater degree of differentiation than one might think.

• Consistent with Ultra HNW accounts of such size – not surprisingly – comes a sophisticated approach to global asset allocation that tends to include a diversified, multi-asset class portfolio, with a heavy weighting to Alternatives. Many have broad sourcing networks and are comfortable embracing illiquidity. All told, our survey work shows that the average KKR Ultra HNW investor has 46% of his or her assets in Alternatives. This total compares to 24% for the typical global pension plan and a suggested 22% for the typical HNW account at a private wealth management firm. One can see the overall allocations in Exhibit 1, which compares KKR’s average Ultra HNW client to the average private wealth management firm’s target allocation as well as to a traditional pension allocation.

**EXHIBIT 1**

The Ultra High Net Worth Investors We Surveyed Often Have Dramatically Different Asset Allocation Profiles

<table>
<thead>
<tr>
<th>Asset Allocation, % of Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ultra High Net Worth</td>
</tr>
<tr>
<td>Pensions</td>
</tr>
<tr>
<td>HNW</td>
</tr>
</tbody>
</table>

Note: For Ultra High Net Worth, Private Credit is included in the Fixed Income allocation. Data as at March 2017. Source: KKR Global Macro & Asset Allocation analysis, Willis Towers Watson Global Pension Assets Study 2017, publicly available private wealth manager data.

“**We think that the current Ultra HNW asset allocation positioning appears to make more sense for the environment we just left — and not necessarily the one to which we could be headed.**”
EXHIBIT 2
The Overall High Net Worth Market Is Large and Growing

Asset Comparison, US$ Trillions

<table>
<thead>
<tr>
<th>Global Pension Assets</th>
<th>Global HNW Assets</th>
</tr>
</thead>
<tbody>
<tr>
<td>$36.4</td>
<td>$60.0</td>
</tr>
</tbody>
</table>

Global Pension Assets 5-Year CAGR stands at 5.8% vs. 7.4% for the Global HNW market


In recent years, Ultra HNW investors, including family offices, in our survey have been earning strong returns, harnessing three structural themes to their benefit. First, Ultra HNW clients were often early to embrace capital markets dislocation, more aggressively deploying capital than many folks during periodic shocks like the Chinese currency devaluation, the threat of a Greek default, and the U.S. debt downgrade. Second, the CIOs for our Ultra HNW clients we interviewed were early to take advantage of a shifting landscape in the banking system, deploying billions of dollars into areas such as Private Credit and Asset-Based Lending when traditional financial intermediaries backed away. Finally, given the long duration of their liabilities and minimal payout commitments, they have taken advantage of the illiquidity premium in areas like Private Credit and Private Equity to earn strong absolute returns in recent years.

However, not all the news is good news in terms of what we learned from our survey work. In fact, as we discuss below in more detail, there are some potential asset allocation “storm clouds” ahead that may warrant investor attention in this segment of the market. We note the following:

- We think that the current Ultra HNW asset allocation positioning appears to make more sense for the environment we just left — and not necessarily the one to which we could be headed. Key to our thinking is that our future expected return forecasts for many asset classes suggest lower returns across the board, including many of the asset classes where our Ultra HNW investors have particularly large concentrations (Exhibits 3 and 4). If we are right, then we estimate that the return for Ultra HNW portfolios could fall to 5.3% from 9.3% unless portfolios are repositioned for the environment we think that we are entering. As such, we think that Ultra HNW investors must find new opportunities to harness complexity and dislocation to their benefit, allowing them to earn better returns than what typical indexes may deliver during the next five years. At the same time, they must also be able to select managers with products that can truly deliver top-tier performance (Exhibit 27).

- Beyond potentially lower absolute returns, our work also shows that the Sharpe ratio, or return per unit of risk, could be poised to fall. This insight should not come as a major surprise, as Sharpe ratios across almost all asset allocation accounts we see from our seat are currently well above trend line. We link the recent boost in return per unit of risk to the notable acceleration in coordinated global quantitative easing (QE) that started with the Federal Reserve and accelerated following the European Central Bank’s commitment to do “whatever it takes” in 2012. However, in the coming years, as part of our Paradigm Shift thesis, we expect less monetary boost, partially offset by more periodic – and potentially more volatile – fiscal stimulus.¹

- Finally, our survey suggests that many Ultra High Net Worth investors appear over-indexed to their local markets, the U.S. in particular. All told, a full 20% of those we surveyed owned distinct operating businesses in their local markets, a consideration that may not be fully reflected in the way many Ultra HNW investors think about their global asset allocation targets. Also, too few of our Ultra HNW survey respondents hedge currency and concentration risks, in our view.

If we are right about the macroeconomic backdrop that we laid out in our Outlook for 2017: Paradigm Shift, then Ultra High Net Worth individuals, particularly those with large sums of patient capital, are in an excellent position.

EXHIBIT 3

Our Survey Results Show That Ultra HNW Allocations Have Had a Productive Investment Mix...

Note: From 1Q86 to 3Q16 where data is available, deemphasizing 2008 and 2009 returns at one-third the weight due to the extreme volatility and wide range of performance, which skewed results. Using MSCI AC World Gross USD for Listed Equities; Barclays GlobalAgg Total Return Index Unhedged USD for Fixed Income; Cambridge Associates Global Private Equity for Private Equity; HFRI Fund Weighted Composite Index for Hedge Funds; Cambridge Associates Global Mezzanine for Other; and Barclays GlobalAgg Total Return Index Unhedged USD for Cash. Pension fund allocation as per Willis Towers Watson; Endowment and Foundation allocations as per Commonfund. Source: Bloomberg, Cambridge Associates, KKR Global Macro & Asset Allocation analysis, Global Pension Assets Study 2017, 2015 NACUBO-Commonfund Study of Endowments.

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EXHIBIT 4

...However, If Our Future Return Assumptions Are Correct, Then Many Ultra HNW Portfolios May Need to Be Repositioned to Further Harness Volatility and Dislocation to Their Advantage

Note: From 1Q86 to 3Q16 where data is available, deemphasizing 2008 and 2009 returns at one-third the weight due to the extreme volatility and wide range of performance, which skewed results. Using MSCI AC World Gross USD for Listed Equities; Barclays GlobalAgg Total Return Index Unhedged USD for Fixed Income; Cambridge Associates Global Private Equity for Private Equity; HFRI Fund Weighted Composite Index for Hedge Funds; Cambridge Associates Global Mezzanine for Other; and Barclays GlobalAgg Total Return Index Unhedged USD for Cash. Pension fund allocation as per Willis Towers Watson; Endowment and Foundation allocations as per Commonfund. Source: Global Pension Assets Study 2017, 2015 NACUBO-Commonfund Study of Endowments, KKR Insights 2017 Outlook: Paradigm Shift, KKR Global Macro & Asset Allocation analysis.

Despite these potential cyclical repositioning headwinds, our overall view is that the Ultra HNW market has some embedded competitive advantages that may serve its investors well in the macroeconomic and geopolitical environment that we envision. In particular, a high degree of flexibility relative to more traditional asset allocators should accrue to their benefit. Key to our thinking is that both the private and public markets are increasingly rewarding allocators that have dynamic capital, can move fast, and are willing to try new things. Ultra HNW investors clearly fit this billing, and they are increasingly eager to use non-traditional strategies, including direct private investments, to try to earn outsized, idiosyncratic returns. Consistent with this view, they generally do not have large fixed payout liabilities (which we see more often in the traditional parts of the market), which allows them to embrace volatility and complexity to their advantage during periods of stress.

In addition, the entire high net worth market remains a structural growth market. All told, according to the 2016 World Wealth Report, this $60 trillion market has grown nearly four-fold over the last 20 years and a full 60% from 2006-2015 (despite the 2008 financial crisis). By 2025, it could be more than $100 trillion. Moreover, the number of individuals with US$30 million or more in net assets, defined as Ultra HNW individuals in the report, rose by 6,340 in 2016, boosting the total ultra-wealthy population to 193,490, according to data prepared for The Wealth Report 2017 by Knight Frank. The same report indicates that some 60 people saw their wealth move past the US$1 billion mark, taking the total number of billionaires to 2,024, up 3.1% year-over-year and 45% during the last decade.

"Key to our thinking is that both the private and public markets are increasingly rewarding allocators that have dynamic capital, can move fast, and are willing to try new things. Ultra HNW investors clearly fit this billing, and they are increasingly eager to use non-traditional strategies to try to earn outsized, idiosyncratic returns."
Our bottom line: the Ultra High Net Worth investors, including family offices, that we surveyed for this report are representative of a sizeable and growing market, one that is now larger than many parts of the traditional investment management market and with a faster growth rate. Without question, the fundamentals are compelling. However, from an asset allocation standpoint, what has worked in the past may be changing, and as such, our strong belief is that a ‘refresh’ on the asset allocation front is likely required. Maybe more important, though, is that the Ultra High Net Worth market is now “coming of age” as its processes become more formalized. If we are right, then the CIOs who run these programs may need to be awarded more autonomy to implement their asset allocation game plans, even if – at times – it may be potentially at odds with certain ideas or preferences of the families they serve.

Section I: Defining the Ultra High Net Worth Universe and Its Investment Philosophy

While my colleague Jim Burns and his team have been fully up to speed on the intricacies of the HNW world, the KKR Global Macro & Asset Allocation team had to do a little more homework on what defines Ultra High Net Worth. What we found was that term has about as many meanings as a cat has lives, if the old saying is to be believed. Said, differently, the term Ultra High Net Worth means different things to different people, and as such, we wanted to be clear at the outset about what it means to us for purposes of this specific research analysis.

Digging into the details, the clients who talked with us about their asset allocations have an average net worth of $1.5 billion, with a median net worth of $800 million. Within the survey, the U.S. was the most heavily represented, followed by Europe, then Latin America/Other. Account size within the survey ranged from just under $100 million at the low end to north of $20 billion at the high end.

“A significant and growing number of HNW families are focused on social change, using their assets to promote education equity, environmental progress, disease cures, and medical research, alongside other public objectives.”
Looking at the big picture, we left this assignment with the view that the high end of the High Net Worth market is extremely complex. For example, the investment objectives of first and second-generation families may be wildly different than those of fourth and fifth generation. Some HNW individuals and families pride themselves on owning their businesses; on the other hand, some want nothing to do with the industry or companies that helped them to accumulate wealth.

Not surprisingly, a significant and growing number of our Ultra HNW families and their offices are focused on social change, using their assets to promote education equity, environmental progress, disease cures, and medical research, alongside other public objectives. Interactions with these families typically consist of discussing strategies and assessing tactics including how to influence public policy and how impact investments can help achieve key goals. Said differently, each family with whom we interacted approaches their investment strategy through a unique set of eyes, and accordingly, we do not want to over-emphasize any one trend or insight as a truism. Like any business endeavor, success can come in many forms.

That said, in aggregate there are some substantial and consistent differences in asset allocation targets and business objectives between the Ultra HNW investor identified in this survey and the more traditional asset allocation schemes that we are used to seeing. To this end, we note the following:

**There Is a Greater Commitment by the Ultra HNW Community to Alternatives**

As shown in Exhibit 1, our clients have a full 46% of their assets in Alternatives, essentially double what a pension might have allocated to this asset class and certainly well beyond what most traditional wealth manager allocations target. Within the Alternatives bucket, our work shows that about 52% of their assets are in Private Equity, 25% in Hedge Funds, and 23% in Real Assets (with a notable skew towards Real Estate versus more Energy-related Real Assets). Interestingly, our survey respondents included Private Credit in Fixed Income, so the total actual commitment towards Alternatives is even higher if one adjusts for this technicality.

Consistent with a strong commitment to Alternatives, essentially all the Ultra HNW individuals and family offices with whom spoke are fully committed to leveraging their flexible mandates, strong liquidity positions, and minimal fixed payouts to pursue investment strategies that may be outside of the mainstream. For example, many were willing to try first-time funds if they believed that the opportunity set was real, particularly as it relates to disintermediation of traditional financial intermediaries following the financial crisis.

Without question, some folks could argue that our Ultra HNW sample set is biased, because we interviewed high net worth principals and allocators who do business with KKR – and as such, likely have a notable predisposition towards alternatives. While amongst some participants this bias is potentially true, it is worth noting that more than a third of those surveyed had 15% or less allocated to Private Equity. Anecdotally, our HNW team does not believe that the results and insights would change if we included an equal number of similarly sized HNW investors whom Jim Burns and his team covers from a relationship standpoint but have not invested at KKR.
According to Our Survey, Ultra HNW Investors Have Heavy Alternative Allocations...

EXHIBIT 8

Alternatives as a % of Total Asset Allocation

46% 24% 22%

Ultra High Net Worth  Pensions  HNW


EXHIBIT 9

...And Most of This Is in Private Equity and Hedge Funds

Alternative Asset Allocation: Asset Class as a % of Total Alternatives Allocation

Other  Hedge Funds  Private Equity  Real Assets

23% 51% 23%

52% 35%

25% 4%

28% 34%

Ultra High Net Worth  Pensions  HNW


Ultra HNW Allocations Towards Public Equities Tend to Be Much Smaller

As many of our readers may know, the current KKR GMAA Target Asset Allocation benchmark, which we developed from our prior work as fiduciaries to large pension clients at Morgan Stanley Investment Management, has a large weighting – north of 50% to be specific – towards Public Equities. By comparison, those clients included in our proprietary survey of KKR Ultra High Net Worth investors only keep about 29% of their portfolio in Public Equities.

Our follow-up interviews from our survey work uncovered two important points to consider. First, many KKR Ultra HNW individuals own operating businesses, and in each case there was clear and intentional reduction in Public Equities to compensate for heavy exposure to equity via ownership of an operating business. Second, many Ultra HNW clients of KKR believe strongly in the advantages of illiquid assets, Private Equity in particular, and as such, they are willing to run with smaller public equity balances.

Of those that distinguished between domestic versus international, overall weightings were generally two to one in favor of Domestic (U.S.) Equities over International Equities. This weighting is significantly less diversified than the MSCI AC World Index, an index that is closer to a one to one ratio of domestic relative to international equities. This increased weighting makes sense to us, as these accounts were generally associated with more formal, diversified asset allocation strategies. We did not ask specifically about passive versus active, but some offered up that passive was a growing percentage of their liquid books (e.g., 50-70%). Finally, we also discovered that Ultra HNW families tend to skew their Public Equity portfolios away from the sector in which the operating business is involved.

EXHIBIT 10

Ultra HNW Investors Tend to Have Smaller Public Equity Allocations...

Listed Equities as a % of Total Asset Allocation

29% 46% 43%

Ultra High Net Worth  Pensions  HNW

Ultra HNW Investors in Our Survey Tend to Have a Large Allocation to Private Equity According to our survey, our Ultra HNW investors, including family offices, have a full 24.4% of their portfolios in Private Equity (PE). Our public pension target asset allocation for Private Equity is at five percent, though our current tactical target includes a three percent overweight to the asset class (i.e., we are suggesting an eight percent allocation). Our conversations with Ultra HNW investors suggest a very rational approach to holding such a large allocation to PE. For starters, Ultra HNW investors typically have both a lower need for current income as well as a penchant to hold more cash on hand, which serves as an important buffer to fund PE fund commitments. Second, we know that a high proportion of the Ultra HNW investor base created wealth through founding, running, and selling businesses, which creates comfort with and a mindset of growing book value and compounding capital over a long period of time via investments in PE – both direct investments and funds. In many instances, HNW investors are often active in their local communities sourcing deals that are often private equity-like in structure and duration. Consistent with this view, many high net worth families have a mentality that makes the governance/control associated with direct deals appealing versus being subject to the daily whims of the public equity markets.

Another point of feedback we heard was simply that Private Equity has outperformed Public Equities over a long period time, particularly when public market conditions get more challenging. One can see that in Exhibits 12 and 13. However, as we show in Exhibit 13, Private Equity has not maintained the same premium so far this cycle, so we would expect some greater scrutiny if the premium for illiquid investments does not reassert itself in the coming quarters.

U.S. Private Equity Average Relative Returns in Various Market Environments, %

-7.5

> 20%

10-20%

0-10%

< 0%

S&P 500 Total Return


Many KKR Ultra HNW individuals own operating businesses, and in each case there was clear and intentional reduction in Public Equities to compensate for heavy exposure to equity via ownership of an operating business.
...To Date, Though, the Strength of the Public Equity Market This Cycle Has Made Differentiation Harder for the Average Private Equity Manager

Ultra HNW Portfolios Have Sizeable Weightings to Hedge Funds

All told, allocations to Hedge Funds account for 8.9% of the Ultra HNW portfolios that we surveyed. Though we have trafficked in and out of Hedge Funds in recent years, our current weighting in the KKR GMAA target allocation is zero. To be sure, we do not think that the Ultra High Net Worth market needs to go to a zero allocation, but we do think that nine percent is likely too high, particularly for an asset class that we think faces some structural headwinds, as market dynamics and flows change.

Overall, though, some of our longer-term conservatism is tempered by the fact that our work actually shows that hedge fund performance on a relative and absolute basis could improve in the coming quarters. We see several factors at work. First, we do expect some mean reversion, as we show in Exhibit 14. Second, as we show in Exhibit 15, hedge funds often perform better in rising rate environments. Third, we think that the trend towards passive investing may actually create alpha opportunities. In our humble opinion, today’s environment feels a lot like 1998/1999, a time when investors aggressively shunned active management right before one of the most significant alpha opportunities during the post 2000 period.

Ultra HNW investors typically have both a lower need for current income as well as a penchant to hold more cash on hand, which serves as an important buffer to fund PE fund commitments.
Interestingly, during our follow-up conversations, we learned of several examples where HNW CIOs are either shuttering and/or revamping their hedge fund programs. Returns have generally been disappointing, particularly in the long/short space, and several CIOs feel that there is a better risk-adjusted return elsewhere in the markets these days. Said differently, we think that the traditional hedge fund model is going to change, favoring a barbell of more quantitative as well as more niche, idiosyncratic strategies.

Ultra HNW Investors Have Small Fixed Income Allocations, but Large Private Credit Allocations

With rates at such low levels, the Ultra HNW clients, including family offices, that we interviewed are running with small allocations to Fixed Income. Specifically, our survey results suggest that our Ultra HNW clients have just 15% of their entire portfolio in Fixed Income, compared to a 33% target within the traditional private wealth management community and 28% for a pension.

This more guarded viewpoint from our survey respondents makes sense to us, given our forecast that the 10-year Treasury will return 1.3% (Exhibit 7), compared to 4.6% during the past five years. Also, given high cash balances in the Ultra HNW community, we conclude that many survey respondents are using cash – not sovereign debt – as the shock absorber in the portfolio compared to many of the traditional pension firms with whom we speak.

Interestingly, while our Ultra HNW investors have fewer investments across Fixed Income, they are actually large buyers of one segment of the fixed income market: Private Credit. On average, Private Credit accounted for six percentage points of the 15% allocation to overall Fixed Income. Without question, many of our Ultra HNW investors have the ability – and maybe more importantly, the desire, we believe – to trade near-term liquidity to capture incremental absolute returns. They also like the high current coupon associated with Private Credit, particularly those with high annual spending needs. Many of our Ultra HNW clients are also opportunistic, and given their high cash balances and flexible mandates, they were early to take advantage of macro trends towards bank deleveraging/reregulation post the Great Financial Crisis, including opportunity sets in both Europe and the United States.
Our bigger picture conclusion on Fixed Income allocations amongst our Ultra HNW and family office client base is that they generally do not incorporate regime change investing into their allocation decisions. Specifically, there appears to be little appetite for solving for a low growth, low inflation environment that would favor long duration fixed income securities. Rather, they appear just much more focused on absolute return performance. This viewpoint does not come as a total surprise, but we do think it represents a notable point of differentiation relative to the more traditional pension managers with whom we interact, many of whom are apt to allocate significant capital towards long duration fixed income assets during potential periods of low growth and low inflation.

Ultra HNW Investors Hold Much More in Cash As we show in Exhibit 21, cash balances, which average 10%, tend to run high within KKR’s Ultra HNW investor community. Maybe more interesting, though, is that 56% of Ultra HNW clients surveyed have 10% or more of assets in Cash, and 20% have 20% or more in Cash. By comparison, pension funds hold around three percent in Cash while traditional wealth managers suggest their clients should have around two percent allocated to Cash.

**EXHIBIT 20**

KKR Ultra HNW Portfolios Have Larger Allocations to Illiquid Asset Classes...

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"From an asset allocation perspective, the high cash balances of Ultra HNW investors lowers the risk involved in alternative asset classes, which in itself is an interesting and progressive strategy in today’s environment."
KKR Ultra HNW Clients Have a Large Portion of Their Assets in Cash

EXHIBIT 22

Cash Allocation as a % of Total Assets, Ultra HNW Client Survey Participants


To be sure, some of the cash was linked to large asset sales or sizeable annual dividends from operating companies. However, we spoke with some individuals who just want more liquidity, while other survey respondents just want to protect what they have during today’s uncertain times. Also, consistent with being opportunistic, some do not see great value in the market today, and hence, want to wait for a better entry point. Regardless of the reason, from an asset allocation perspective, the high cash balance lowers the risk involved in the alternative asset classes, which in itself is an interesting and progressive strategy in today’s environment.

Section II: Where Are We Headed and What Does It Mean for the High-End of the Ultra High Net Worth Market?

As we peer around the corner today to see what tomorrow might look like for the Ultra HNW and family office market that KKR serves, we wanted to offer up some conclusions from our top-down framework. They are as follows:

Similar to Our Pension Forecast, Expect Lower Returns Ahead in the Ultra HNW Market; As Such, Further Differentiation Is Required

Similar to the call we are making for pension returns, we too believe that managers of Ultra HNW portfolios need to appreciate that the outlook for forward-looking returns is likely to come down notably. Specifically, as we show in Exhibit 23, we are forecasting around 5.3% for a generic Ultra HNW portfolio, compared to 9.3% during the past five years, a decline of 400 basis points.

One of the key factors potentially putting downward pressure on portfolio returns in the Ultra High Net worth market is its 29% weighting to Listed Public Equities. Indeed, given our view that the S&P 500 will deliver just north of four percent per year during next five years, compared to 12.6% in the past five years, the Listed Equities contribution to the total return falls to 1.3% from 2.5%, despite no absolute allocation change to the asset class in our analysis.

EXHIBIT 23

Ultra HNW Expected Returns Based on Current Allocation and Historical vs. Expected Return, %

EXHIBIT 24

Our Work Shows That Pensions Face Potential Downward Pressure on Future Returns

Pension Expected Returns Based on Current Allocation and Historical vs. Expected Returns, %

While that sort of absolute decline in returns may feel monumental to some in the Ultra HNW market, it is actually less than what we are forecasting for the pension community. Specifically, as we show in Exhibit 24, pension returns could potentially fall by 430 basis points to 4.2%, a 51% decline. Driving this substantial decline is the 450 and 510 basis points drop in expected returns versus 5-year prior returns for Listed Equities and Fixed Income, respectively.

If we are correct in our forecast, then all allocators of capital need to consider either lowering their liability payout amounts and/or shifting their allocations towards higher returning products. Against this backdrop, however, we do not expect allocators of capital to sit idle. Rather, we expect them to seek out pockets of alpha, align with the best managers, and cultivate relationships that allow them to drive better investment processes.

Consistent with this need to differentiate amidst tougher capital markets return assumptions, we see at least four major macro themes that we believe that asset allocators, including both pensions and high net worth investors, can leverage to earn above average returns in the coming years. First, we continue to want to harness the market’s periodic volatility to lean in. Right now areas like Healthcare in the U.S., Asset-Based Lending in Europe, and forced sales in Infrastructure appear attractive to us. Second, we think that investors should continue to embrace the notion that an unlevered and more highly regulated global financial services system is unable to provide the credit required to fund new businesses and asset purchases around the world. Real estate credit in the U.S., bank disposition sales in Europe, and lending to performing private credit across the various continents where we do business all look interesting to us at the moment. Third, we expect consumers to continue to shift towards more experiences and away from more goods. This viewpoint supports investments in areas such as travel, recreation, and wellness – often at the expense of more traditional consumer products and retail. Finally, we are structurally bullish on de-conglomerization. In our humble opinion, corporations used low cost funding to over-expand in recent years, and with global trade now slowing at the same time domestic agendas are taking precedent, we expect more firms to hive off unprofitable subsidiaries and non-core businesses. This trend has fully gained momentum in Japan, Europe, and India, and we expect other business communities to move this way in the coming months and quarters.

Ultra HNW Allocations May No Longer Enjoy the Same Sharpe Ratios

Maybe more important than the reality that forward returns may decline for the Ultra HNW community is our belief that the return per unit of risk will also be coming down. Consider the following: If there is no change in volatility, just based on our returns outlook, return per unit of risk would fall by fully 43%. Unfortunately, this viewpoint may actually be too optimistic, because while there have been sharp periodic spikes in volatility (Exhibit 28), quantitative easing has caused overall annual volatility across many asset classes to fall to decade lows. As such, if annualized volatility were to rise another 25% from current levels (which would still be below average), then return-to-risk ratios would fall yet another 20%.

We continue to want to harness the market’s periodic volatility to lean in.
**EXHIBIT 27**

Manager Selection Matters, Particularly in Alternative Asset Classes

Data as at 3Q2016. Data for alternative investments based on the average Since-Inception-IRR for vintage years 2000-2010 from Cambridge Associates. Data for traditional asset classes based on average CAGR for time periods 2000-3Q16, 2001-3Q16, etc. through 2010-3Q16 from eVestment Alliance database to match the alternative asset class time frame. Source: Cambridge Associates, eVestment.

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**EXHIBIT 28**

Historical Asset Class Returns Suggest a Higher Allocation to Alternatives Make Sense...

Source: From 1Q86 to 3Q16 where data is available, and de-emphasizing 2008 & 2009 returns at one third the weight, due to the extreme volatility and wide range of performance which skewed results. Using MSCI AC World Gross USD for Listed Equities; Barclays GlobalAgg Total Return Index Unhedged USD for Fixed Income; Cambridge Associates Global Private Equity for Private Equity; HFRI Fund Weighted Composite Index for Hedge Funds; Cambridge Associates Global Mezzanine for Other; and Barclays GlobalAgg Total Return Index Unhedged USD for Cash.

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**EXHIBIT 29**

...However, Future Returns Will Be Far Different From Historical Returns

Many Ultra HNW Investors Are Too Levered to Their Home Markets, and When They Do Go International, They Tend Not to Hedge

As we mentioned earlier, about one in five of our HNW clients own an operating business in their local market. Most do not include the business in their asset allocations, which suggests to us that they are notably overweight domestic assets. However, sector ownership can influence how wealthy folks think about their assets. For example, if their operating business is real estate-related, there tends to be more of an impulse to diversify away from it with their investment asset allocation. That said, we actually found fewer examples of this type of thinking across cyclical industries like energy and industrials. Another key point is that many of the operating businesses actually throw off a fair amount of cash each year. As such, certain Ultra HNW CIOs actually have the exact opposite problem that a pension or endowment may face with their cash flow streams (i.e., they have to pay out a certain amount of money each year).

Our other big take-away is that more hedging is likely required, especially for larger U.S.-based Ultra HNW investors. Without question, many Ultra HNW investors, particularly those with established family offices, are increasingly becoming more global in nature, but most do not think of hedging currencies or using options to lock in long-term gains. The former issue is likely more immediate than the latter, in our view, but our overall view is that more needs to be done in both areas.

More Commitment to an Asset Allocation Game Plan

We wanted to make one more subtle but important point about the environment that we think we are entering for the high end of the HNW and family office market. With growth in assets under management expected to continue, there is a mounting need for this segment of the market to continue to evolve. Specifically, our view is that, as this market size expands further, it will need to become more formalized. Said differently, our view is that a dedicated staff is increasingly required, a long-term game plan is needed, and more risk management/downside scenario analyses must be incorporated into the day-to-day processes. In adopting this approach, principals must come to terms with the fact that they are empowering and effectively ceding a meaningful measure of influence to their investment team in hopes of avoiding the many common pitfalls of investing, such as 1) over-concentration to a product, asset class, or geographic region; 2) emotion-led pacing of capital deployment; 3) over-reliance on established investment strategies versus seeking new strategies or employing new tactics.

Section III: Conclusion: Coming of Age

No doubt, the high end of the HNW market, including the family office market, has “come of age.” These investors are using increasingly sophisticated products, becoming more global, and learning to leverage their competitive advantages in the market place. Coupled with strong growth, this market should remain a dynamic one for the coming years.

However, as we mentioned above, such investors also face return and volatility headwinds. They must also address hedging and concentration risks. Maybe more important, though, is that wealthy individuals and families need to stay more aligned with their CIOs by either sticking to the originally agreed upon asset allocation game
plan or showing a willingness to diverge from the original plan as market conditions evolve – even if it causes some degree of discomfort in the short term or represents a sea change from past practices. Our research leads us to believe that – on occasion – a good asset allocation game plan may be derailed by a personal interest in a non-core area or a desire to buy more of what has worked previously, versus venturing into new areas, particularly non-correlated ones.

Overall, though, if we are right about the macroeconomic backdrop that we laid out in our Outlook for 2017: Paradigm Shift, then Ultra High Net Worth individuals and family offices, particularly those with large sums of patient capital, are in an excellent position for the Paradigm Shift we are envisioning. Indeed, the world is becoming more, not less, complex, and we believe that they will be able to leverage their skill sets to seek out differentiated opportunities across both public and private markets. In doing so, they will not only provide ample income for their current constituents but set the stage for future generations to enjoy the benefits of the creative asset allocation work that is being implemented today.
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