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What Does Cost of Capital Mean?

EXECUTIVE SUMMARY

Many people are familiar with *cost of capital* in a corporate finance context. Every corporation understands what it costs to borrow money or issue stock for a combined weighted average cost of capital. That number informs executives of the hurdle rate to use when considering any kind of investment that will consume capital. Promising projects are ones where expected returns are in excess of the cost of capital used to fund an investment.

In a family portfolio context, cost of capital has a similar but more complicated meaning – because families are lot more complicated than corporations. Cost of capital incorporates a family's desired rate of return, time horizon, and risk tolerance. But it goes beyond that to consider a family's liquidity preferences, values, philosophical beliefs, and even very practical issues families face in how they organize and run their affairs. These more qualitative issues might include ESG preferences, concerns about investing in China, the wisdom of investing in emerging markets or developed non-US markets, interest or lack thereof in private markets investments, concerns about investment complexity, the ability or willingness to deal with complicated tax reporting (K-1s, for example), how decisions are made, and so on.

Establishing a clear cost of capital serves as the foundation of sound portfolio design, and working through the process of establishing a cost of capital will surface many of the critical issues involved in designing successful portfolios. Among other things, a family and its advisor must reconcile how much investment return is desired with what is likely over the investor's time horizon, given how much risk the investor is willing to bear *as well as* how the qualitative issues mentioned above affect the return and volatility of the portfolio.

WHAT IS YOUR COST OF CAPITAL?

Sound portfolio design seeks to match what investors want from their investable assets with what capital markets can likely deliver, especially on an after-tax basis. A family's cost of capital is the totality of its investment-related goals, including:

The level of growth in assets the family desires to achieve. Typically, that growth is calculated net of all the expected frictions on the portfolio's growth, including distributions, taxes, fees, expenses, and inflation. The volatility of portfolio returns will also impact the growth of assets because for any given average rate of return, lower volatility portfolios will build wealth faster

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than higher volatility portfolios.

- → **The ability of the portfolio to support distributions for spending, intra-family gifting, charitable giving, and other purposes.** The ability to support distributions depends on generating returns, but also on maintaining appropriate liquidity, that is, the ready ability to convert a portfolio's assets into spendable cash when needed.
- → **The desire to limit the uncertainty of returns, which is a function of the volatility of the assets held in a portfolio**. The more volatile a portfolio, the more its value moves up and down relative to long-term average performance.
- → **How best to contend with significant family-owned assets that often need to be complemented, offset, or otherwise considered when designing the main portfolio.** Examples are large concentrated stock positions, directly-held real estate portfolios, or large closely-held operating businesses.
- → **How to rationally prioritize estate planning structures**, for instance by making sure that certain kinds of assets are optimally owned across generations or within certain kinds of trusts.
- → **A preference to own assets that align with a family's philosophy and values, as well as other personal preferences.** These preferences will affect the strategies undertaken (or avoided) in the portfolio, as well as manager selection and sizing.
- → **How to complement family decision-making styles.** Governance in a family context can be informal or complex and iterative or linear. How decisions are made, documented, and implemented can impact what kinds of investments can or should be made.

These investment-related goals create a set of requirements for a portfolio that represent a family's cost of capital: the risk-adjusted after-tax return *and other characteristics* required in order to justify any investment the family makes.

EXAMPLES OF THE IMPLICATIONS OF COST OF CAPITAL

Example 1 – China. Many families have concerns about investing in China; some based on ethical considerations, some based on more practical geopolitical concerns, or even worries about potential asset confiscation. But China is a huge capital market and eliminating it entirely from consideration likely means reducing a portfolio's return and/or decreasing its overall risk-

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adjusted return, an important measure of efficiency. If a family isn't willing to accept lower potential returns by eliminating exposure to China, the risk level of the portfolio may need to be increased, perhaps by raising the equity component of the portfolio.

Example 2 – Complexity of tax reporting. Advisors sometimes recommend complicated investment strategies that are designed to reduce portfolio volatility without a corresponding reduction in return. Unfortunately, these kinds of investments are often offered only in limited partnerships that can produce long, complicated K-1s every year (thank you, IRS). For families lacking a robust internal financial office, they must outsource tax compliance (with the associated costs and oversight) or avoid investing in assets offered only via limited partnerships. To achieve the same long-term wealth outcome, the family will need to take on more risk, at least in the sense of volatility.

Example 3 – Local knowledge investments. Not all qualitative cost-of-capital considerations *reduce* the efficiency of a portfolio – some actually may improve it. All around the US, operators and entrepreneurs with informed local knowledge (especially in real estate, but also sometimes in private equity) seek investment capital from local wealthy families. These investments are not usually on most advisors' lists of recommended managers, partly because of their local nature and partly because the managers simply can't put to work the larger amounts of capital needed across an advisor's client base. Locally-sourced investments may simultaneously improve the family's returns and reduce its risk. Even though the investments might not fit neatly into a traditional asset allocation structure or manager selection process, they *may* fit neatly into the family's cost of capital.

MOVING FROM COST OF CAPITAL TO STRATEGIC PORTFOLIO DESIGN

This paper isn't about asset allocation, but it's useful to consider how cost of capital is used to design portfolios. Successful Strategic Portfolio Designs are those that can credibly meet or exceed a family's cost of capital, not solely its target for after-tax, risk-adjusted rate of return (hurdle rate). A Modern Portfolio Theory-based portfolio design can consider some but not all components of a client's cost of capital. MPT is good at addressing whether a design can surpass a "simple" hurdle rate, but it doesn't readily incorporate other important elements of the cost of capital, such as those described above. This is where judgment, experience and qualitative choices about portfolio design come into play.

But what happens when you "can't get there from here" because a family's cost of capital is so high that it can't reasonably be met by what future capital markets are likely to supply. Advisors

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need to be forthright and, as the Rolling Stones put it, tell a family "You can't always get what you want." In other words, it's not the job of an advisor to force a solution to every cost of capital question. There are some goals that can't be credibly met and others that shouldn't even be attempted given the damage likely to ensue.

At the heart of the interplay between cost of capital and portfolio design is the necessity to dispassionately consider whether the *supply* of returns from global capital markets can meet both the *demand* for returns *as well as* the qualitative components of a family's cost of capital. This is the job of a good Strategic Portfolio Design, and it requires a clear framework, credible inputs, good judgement, listening capabilities, and intellectual honesty. ♦

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