WEALTH STRATEGIES ADVISORY GROUP

The Household Endowment Model®, Venture Capital, and Your Portfolio

WEALTH STRATEGIES ADVISORY GROUP

THE HOUSEHOLD ENDOWMENT MODEL®

CLARAPHI
Illuminating Financial Security™

Wealth Strategies Advisory Group (WSAG) is a financial advisory firm that advocates alternative investments in our asset allocation models. Our proprietary portfolio design called The Household Endowment Model® (THEM), distinguishes us from many other advisors in our field and emulates the Yale Endowment approach to investing. Over 25 years ago, Yale started shifting its asset allocation mix to allow for a much higher percentage of alternative investments. At WSAG, we have designed customized portfolios to follow a similar concept for our clients. The result is that our clients can now enjoy the benefits of multiple asset classes, both liquid and illiquid, that are well beyond the traditional equity and debt constituents.

The Household Endowment Model® is Built On Three Basic Principles

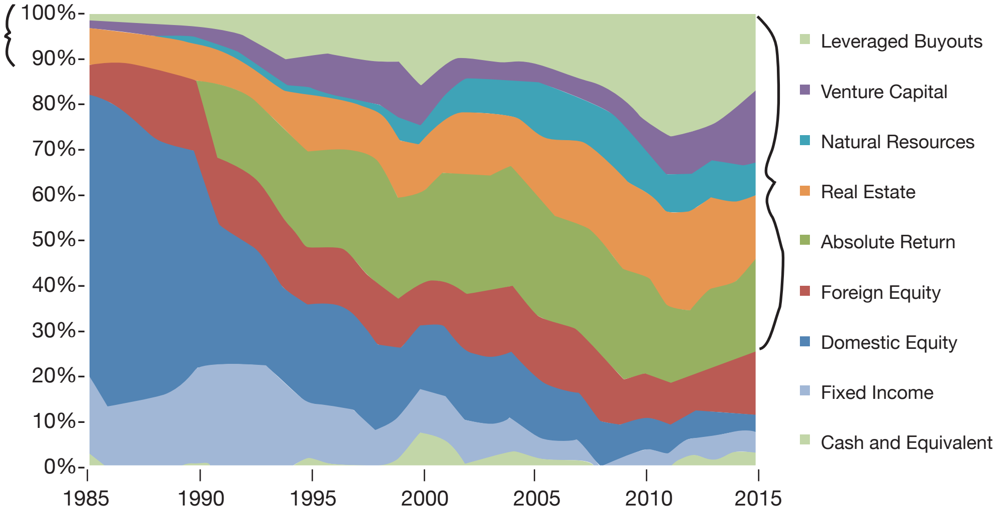
1. Similar to Yale's Endowment Model we believe in using outside managers to manage our client portfolios. We believe that qualified external managers should be used and given considerable autonomy to implement strategies as they see fit.

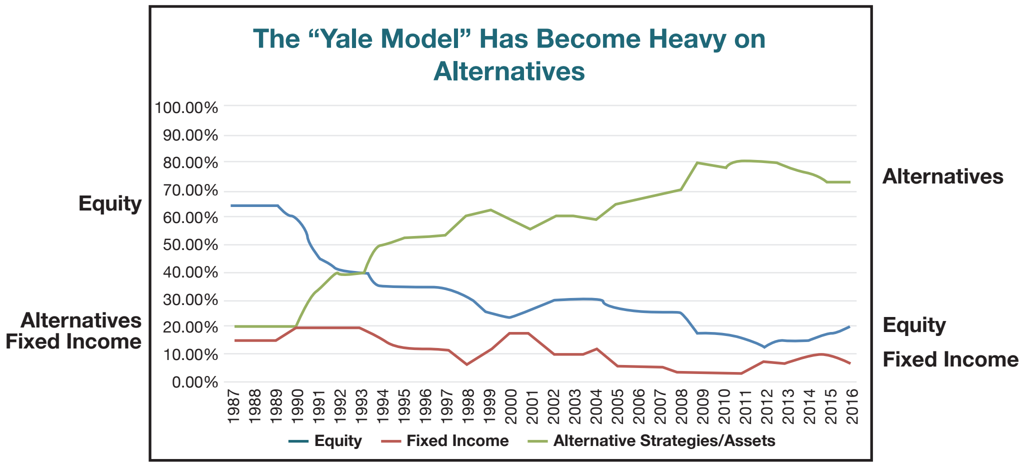
2. Maintain an allocation to correlated and non-correlated private and public asset classes.

3. Where inefficient markets exist and where there is illiquidity, opportunity abounds for the patient investor. Yale has long believed that incremental risk adjusted returns could be increased by selecting superior managers in non-public markets.

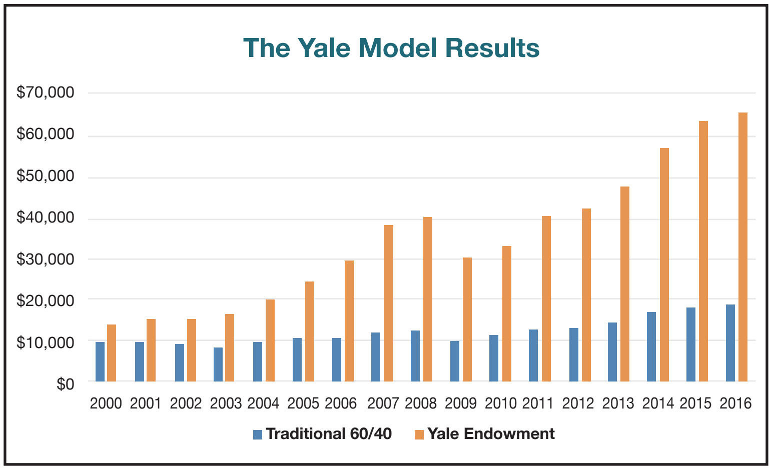
Portfolio Construction

In following the Yale Endowment Model, and through its industry relationships, WSAG's Household Endowment Model has access to a multitude of highly qualified, and heavily vetted alternative investment strategies. These alternative strategies are utilized as we construct our clients' portfolios. As shown in the graphs below, Yale has significantly increased its allocation to alternative investments over the past 20+ years.





Over the past 2 decades, Yale's endowment generated returns of 12.6% per annum, outperforming the classic 60/40 Model (see "The Yale Model Results" right). Yale's investment performance added $22.1 billion of incremental value. During the 20-year period, the endowment grew from $4.9 billion to $25.4 billion, net of spending.[1]



Not only has Yale and other endowments benefitted from the returns of alternative assets, but so have all investors over time. The following chart[2] outlines the top quartile, historical returns of different asset classes over numerous finite investment periods. In all cases, private investments such as venture capital, private equity and real estate, outperform large cap equities and traditional bonds.

Top quartile

Asset	5-year	10-year	15-year	20-year	25-year
Venture capital	48	38	29	92	57
Private equity	25	22	27	31	31
Real estate	27	24	26	24	24
Large-cap equity	12	7	5	8	10
High yield bonds	5	6	7	6	8
Aggregate core bond	4	5	5	5	6

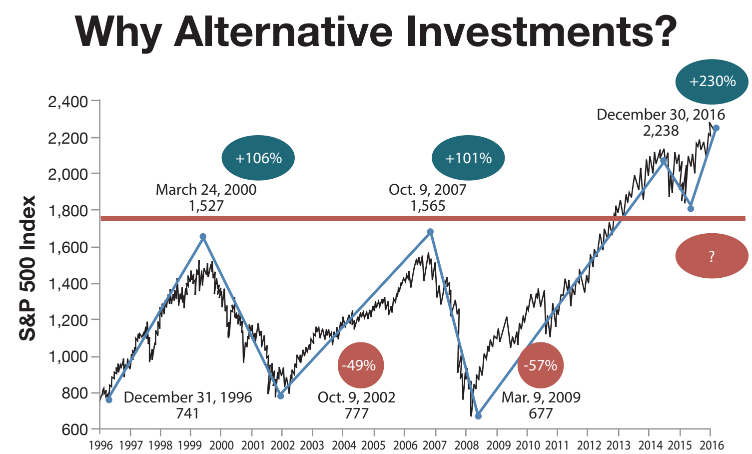
Source: Cambridge Associates Global Venture Capital, Global Private Equity, and Global Real Estate Benchmarks Return Report. Private equity asset class excludes venture capital. 5-, 10-, 15-, 20-, and 25-year returns representative of average pooled IRR for vintages dating back from 2014. Top quartile returns for all asset classes shown. Large-cap equity proxy is Lipper aggregated US large-cap equity fund performance. High yield bond proxy is Lipper aggregated high yield bond fund performance. Aggregate core bond proxy is Lipper aggregated core bond fund performance. Returns as of Dec. 31, 2015. Sample size for each asset listed is as follows: venture capital: 91-440; private equity: 174-630; real estate: 71-207; large-cap equity: 62-674; high yield bonds: 30-421; and aggregate core bond: 22-385. Past performance is not a guarantee of future results.

The Household Endowment Model (THEM), created by Wealth Strategies Advisory Group, provides accredited and qualified investors with access to these same asset classes. By utilizing a highly select group of outside managers, focusing on key alternative asset classes such as real estate, private equity and venture capital, and creating a portfolio of both correlated and uncorrelated assets, THEM believes it can create an opportunity for higher overall portfolio returns, as well as lower overall portfolio volatility over time.

Volatility

While the return profile for private investments has been extremely good, one of the positive aspects of these investments, is their low correlation to public stocks and bonds. This low, and in some cases, negative correlation to stocks and traditional bonds, provides a meaningful mechanism in which to reduce overall portfolio volatility.

We all know how volatile the public markets can be:



Equities represented by the S&P 500 Index. Data range is December 31, 1996 - July 31, 2016. Index returns are provided for illustrative purposes only to demonstrate a hypothetical investment vehicle using broad-based indexes of securities. Returns, represented in circles, do not represent any actual investment. Returns are cumulative and based on S&P 500 Index price movement only, and do not include the reinvestment of dividends. Past performance is not indicative of future results. Source: Yahoo Finance. The past performance figures do not represent performance of any Hatteras Funds security and there can be no assurance that any Hatteras Funds security will achieve the past returns of the illustrative examples. The unmanaged indexes do not reflect fees and expenses and are not available for direct investment.

Longer term, alternative private investments, like those recommended by THEM, have the additional benefit of reducing overall portfolio volatility due to their lower correlation to stocks and bonds.

As one can see in the following chart[3], venture capital as an investment has shown significant non-correlation with other asset classes. Despite generally benefitting from cyclical upswings in the economy/market and being negatively affected by downturns, the process of solving substantive long-term issues (curing cancer, addressing climate change, etc.), the long-term nature of the harvesting period, and longer-term pricing mechanisms, allows venture capital investments to be substantially uncorrelated with other, more traditional investments in one's portfolio.

Real estate has shown very low correlation to public equities and bonds. The twin benefits of cash flow and price appreciation has generally provided real estate with a steady stream of returns over many investment cycles. Private equity also shows lower correlation, but it is not as low as real estate and venture capital.

	Venture capital	Private equity	Real estate	Large-cap equity	High yield bonds	Aggregate core bond
Venture capital	1.00	0.71	0.69	-0.06	-0.13	-0.13
Private equity	0.71	1.00	0.65	0.46	0.33	-0.06
Real estate	0.69	0.65	1.00	0.13	0.03	-0.11
Large-cap equity	-0.06	0.46	0.13	1.00	0.73	0.13
High yield bonds	-0.13	0.33	0.03	0.73	1.00	0.35
Aggregate core bond	-0.13	-0.06	-0.11	0.13	0.35	1.00

Source: Cambridge Associates Global Venture Capital, Global Private Equity, and Global Real Estate Benchmarks Return Report. Venture capital, private equity and real estate data from Cambridge Associates. Private equity asset class excludes venture capital. Large-cap equity proxy is Lipper aggregated US large-cap equity fund performance. High yield bond proxy is Lipper aggregated high yield bond fund performance. Aggregated core bond proxy is Lipper aggregated core bond fund performance. Returns for period dating 1990-2014, as of Dec. 31, 2015. Sample size for each asset listed is as follows: venture capital: 771; private equity: 932; real estate: 309; large-cap equity: 674; high yield bonds: 421; and aggregate core bond: 385. Past performance is not a guarantee of future results.

The Case for Venture Capital Investing

Investments in private companies and the entrepreneurs that lead them, are the single most effective wealth producer the world has ever known. American entrepreneurs use “creative destruction” to transform economic structures, advance technologies and raise living standards worldwide. And they generate tremendous profits in doing so. Want to create the next blockbuster drug or medical device? Pick an entrepreneur. Want to transform our energy landscape? Pick an entrepreneur. Want to create jobs? Pick an entrepreneur. The resilience of our global economy comes from customers eager for better answers, entrepreneurs bold enough to think differently, and investors willing to fund new ventures.

Entrepreneurs make America great. Investing in entrepreneurs, via venture capital, makes the wealthiest Americans even wealthier. Yet this asset class has historically been unavailable to investors at lower wealth levels. In addition, even high net worth investors, family offices and small institutions, may have limited access to the best funds, or may wish to have more direct control over how their capital is deployed. Fortunately, recent legislative changes, such as the JOBS Act, are changing this, opening up the venture capital asset class to a wider array of American investors.

Venture capital, the process of investing in emerging companies, has outperformed every other asset class, over most holding periods, since it was first institutionalized in 1946 by George Doriot. Doriot formed American Research and Development (ARD) and generated the first true home run of the asset class with his $70,000 investment in Digital Equipment Corporation (which was subsequently worth over $400 million[4] when the position was eventually liquidated). In addition, in a seminal report sponsored by the Kauffman Foundation, an analysis of over 3,000 early stage investments, by over 500 individuals, resulted in over 1,000 exits and generated a 27% Internal Rate of Return over a 3.5 year period[5]. This performance is well above public market average returns.

It is true there have been certain periods during which venture has underperformed public markets and other asset classes, occasionally by a significant amount. It is also true that most individual venture investments do not achieve a positive return. Inevitably, all asset classes will underperform periodically due to poor economic conditions, out of favor sentiment, declining business cycles, poorly performing managers, etc. But as outlined above, this asset class, when properly diversified, has consistently outperformed all other asset classes over the long-term. And that is the crucial point. The ability to be largely shielded from the effects of public market volatility, monetary policy, real estate crashes, etc., creates the potential for a certain number of companies in a diversified venture portfolio to nevertheless create significant value over time even when other asset classes are underperforming.

The Illiquidity Premium

The higher returns attributed to venture capital and private equity are also generally attributed to what's called, the "illiquidity premium." In general, the more liquid an investment, the less risk is involved and the lower the required return. Examples of highly liquid, low return assets include cash, Treasuries, large-cap equities, etc. Less liquid, potentially higher risk assets like venture, private equity, real estate, etc. call for larger required returns. The Blackstone Group calls this the "Illiquid Opportunity and Illiquid Advantage" for "Patient Capital"[6] - i.e. capital that is invested for the longer term.

In Blackstone's words, "The lack of a public market for these assets and their resulting illiquidity is the primary source of both the benefits and challenges they present."[7] So what does this mean? Blackstone goes on to say (elaborating to some extent on the Efficient Capital Market Hypothesis) that in a developed public market, information discovery is generally in real time and assets can be traded immediately. This can create opportunities for profit, but it also creates a relatively uniform market with equal chances of profit and loss for most participants. While information (and trading) advantages can be attained by earnest due diligence, true corporate insider information is illegal to obtain, and cannot be legally traded upon. This transparency in the markets inherently (and usually, but not always) delivers a return that is symmetric across most marketable security holders.

In private markets, asymmetric information advantages exist (see table below for a simple comparison of private markets vs. public markets[8]). There is generally no requirement for private companies to disclose corporate information to the public. As a result, investors in these companies have superior information compared to others - access to company management, company financials, sales pipelines, and strategies. This information allows for an advantaged analysis of the investment vs. those that do not have this information. The important distinction of course, is that this is perfectly legal in the private markets.

Display 2

A Natural Complement: Private and Public Market Investments

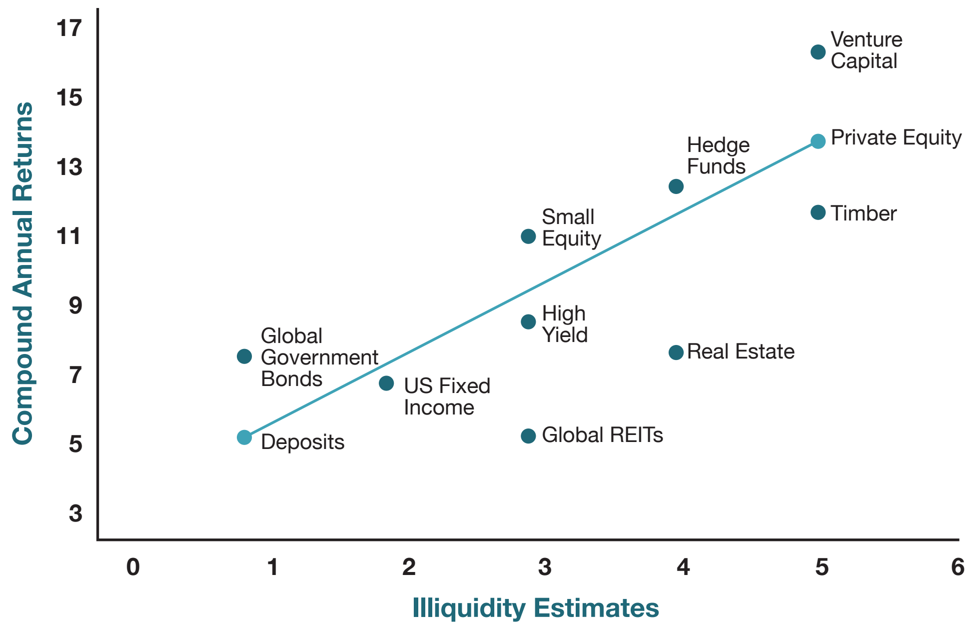
Public Markets	Private Markets
➜ Frequent transactions	➜ Infrequent transactions
➜ Information widely and quickly shared	➜ Asymmetric information
➜ Performance generally in line with markets	➜ Performance premium to liquid markets

Note: For illustrative purposes only. There can be no assurance that an allocation to alternatives would provide higher real returns. Please consult your own third party advisor before making any investment decisions based on this information.

As outlined in the table on page 6, longer term oriented investors such as endowments and pension funds, have long known these advantages exist. As opposed to individual investors, their percentage of alternative and less liquid assets (venture capital, private equity, real estate, hedge funds) has increased from 4-5% in 1990 to 20-30% in 2010[9]. Meanwhile, most individual investors rarely allocate more than 5% of their liquid and investable wealth in these asset classes. As Blackstone states, "Having a long horizon, may give more patient investors a natural edge, for harvesting this premium. They are rewarded for sacrificing this liquidity that they simply do not need."[10]

One of the main tenants of THEM is "Where inefficient markets exist and where there is illiquidity, opportunity abounds for the patient investor." This is perfectly aligned with the Illiquidity Premium and the investment strategy outlined by Blackstone and others.

Investment Returns Generally Increase with Degree of Illiquidity



From: "Expected Returns," by Antti Illmanen, 2011. Scatterplotting average asset returns 1990-2009 on (subjective) illiquidity estimates. Sources: Bloomberg, MSCI Barra, Ken French's website, Citigroup, Barclays Capital, JP Morgan, Bank of America Merrill Lynch, S&P GSCI, MIT-CRE, FTSE, Global Property Research, UBS, NCREIF, Hedge Fund Research, Cambridge Associates.

The Case for Venture Capital Investing

Despite the many attributes of venture investing, it also comes with many challenges. If one were to invest on one's own, proper deal flow and deep due diligence can both be issues. If you are not seeing enough deal flow, then you cannot build a properly diversified portfolio. Deep due diligence is time consuming and difficult, even if one has the proper expertise to evaluate companies. But do you have enough expertise to conduct due diligence on many deals? In different industries? Are you willing to spend the time needed to conduct such diligence or spend ongoing operating capital to fund an in-house management team?

An alternative is to invest in a fund. Traditional funds often have high minimums - $1 million or more - if you can even get an allocation. In order to be continuously invested in the asset class and avoid the risks of a particular business cycle, you must "ladder" funds over a number of years (often five), requiring more diligence on the fund, subjecting you to more fund manager risk, and multiplying the minimum investment by five - again if you can even get in. And, what do you do about sector diversification? Do you pick a generalist or a specialist? Or stage diversification? Should you choose Seed, Series A, Series B or even later stage growth capital?

And then there are the capital calls. Often you must allocate a portion of the capital upfront, and pay a fee even though it has not been invested. Additional capital will be demanded when investments are actually made. Unfortunately, the timing of these capital calls has nothing to do with your availability of cash, so often you must overweight in cash or near cash securities to have cash available, sub-optimizing the return on your overall portfolio.

It is possible to act on one's own as a direct investor in companies, an angel investor, a participant in crowdfunding platforms, or even as an investor in venture capital fund of funds. While these are all viable options, they too come with various challenges:

- Securing adequate and high-quality deal flow to diversify away the inherently risky profile of early stage investing.
- Limited time and expertise in evaluating companies within your limited deal flow universe.
- Limited time and expertise in due diligence. Once companies are chosen, few individuals or even family offices have the expertise and in-house team members to conduct the extensive due diligence that is required to properly analyze a company, its prospects, its industry, its competitors, its finances, etc.
- Limited time and expertise to properly monitor and assist the company once the investment is made.
- Funds of funds provide diversification and can provide limited access to "name" funds, but also layer on extra fees, generally concentrate on past performers who invest in a limited number of industries, and still maintain high minimum investment thresholds.

While it is clearly possible to generate higher returns by investing as outlined above, we believe a more prudent and beneficial approach would be more ideal. This approach would entail:

- A means to invest in a wide number of offerings, such that early stage capital could be allocated and diversified over many companies over time. Even the best of VCs cannot tell you at the outset, which one of their portfolio companies will be winners or losers. They believe they will all be winners! Thus, the most responsible approach would be to allocate a small portion to each company at the outset, and then invest more, over time, in those companies that experience further commercial or developmental success.
- Investing in companies and emerging areas that are not usually targeted by the large coastal VCs. These regions provide access to opportunities that are not as crowded or overvalued as the emerging companies on the coasts.
- A means to stage your investments over time, only paying fees when your capital is actually deployed.
- A means to invest at reasonable minimums ($50-100k), instead of the usual $1M minimums at premier funds.
- Having access to a professional management and investment team that reviews extensive deal flow on a monthly basis and only selects a small percentage that meet strict due diligence criteria.
- The opportunity to invest in an evergreen fund, which does not have a set investment period or vintage year, and in which capital is not tied up for a mandatory period of time.
- The opportunity to review and allocate your capital into new companies on a monthly basis - thereby providing optimal diversification.
- A means to co-invest with many prominent regional and national VCs, thus guaranteeing access to a broad range of funds and companies.

Conclusion

Wealth Strategies Advisory Group believes that portfolio management success results from suitable strategies, exceptional investment management skills, and access to best of breed Investment products.

Empirical evidence has shown that over the long term, exposure to private alternative asset classes, such as those provided by The Household Endowment Model® may add considerable return performance to an investor's portfolio, while reducing overall volatility. And while real estate and private equity are fairly common alternative investments, to-date, accessing institutional grade venture capital has proven to be extremely difficult.

That has changed. The Household Endowment Model® now provides access to venture capital opportunities that are closely aligned with the bulleted points listed on the previous page. This new, investor-friendly approach is available to the clients of Wealth Strategies Advisory Group. An investment in this product will not only broaden overall exposure to venture capital and provide diversification for your portfolio, but will also benefit the entrepreneurs who are taking risks, breaking through barriers, innovating, and creating new companies that will improve our quality of life, and ensure the future financial health of our world.

Footnotes

1 Yale News 2016 Annual Report on Endowment Performance, Sept. 23, 2016

2 The Case for Venture Capital, Invesco, 10/2016

3 The Case for Venture Capital, Invesco, 10/2016

4 ”Forbes Greatest Investing Stories”, 2001, page 190

5 “Returns to Angel Investors in Groups”, Kauffman Foundation, November 2007

6 Patient Capital, Private Opportunity, Blackstone Group, 9/2014

7 Patient Capital, Private Opportunity, Blackstone Group, 9/2014

8 Patient Capital, Private Opportunity, Blackstone Group, 9/2014

9 Patient Capital, Private Opportunity, Blackstone Group, 9/2014

10 Patient Capital, Private Opportunity, Blackstone Group, 9/2014

Have you seen our brief overview video?

Click over to view it at thehouseholdendowmentmodel.com!

For more information, or to arrange a complimentary consultation to learn how The Household Endowment Model® might fit as part of your long-term investment strategy, contact Wealth Strategies Advisory Group or Claraphi today.

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