How the Rich Play the Market

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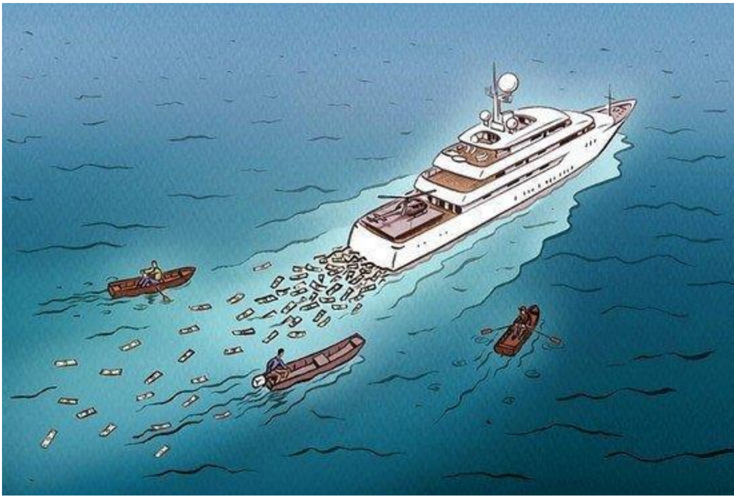

The Wall Street Journal/Christophe Vorlet - A new study offers a comprehensive look at the portfolios and investment decisions of several hundred of the wealthiest families in the U.S. (Christophe Vorlet)

F. Scott Fitzgerald wasn't entirely right. The very rich are different from you and me—but not by much.

A new study offers a comprehensive look at the portfolios and investment decisions of several hundred of the wealthiest families in the U.S. Every investor, rich or otherwise, can learn from how these people make the most of their advantages—and from how they mess up.

These households, with an average net worth of roughly $90 million, invest intelligently, for the most part, spreading their bets widely, seldom trading and keeping their investing taxes to a minimum.

But the superrich also commit rookie mistakes. Their approach to diversification might not always be ideal. They chase investment fads like dogs chasing parked cars. They freeze with fear just when bravery is most likely to be rewarded. Maybe the "smart money" isn't so different from the middle-class "dumb money" that Wall Street likes to mock.

Three economists—***Enrichetta Ravina*** of Columbia Business School, ***Luis Viceira*** of Harvard Business School and ***Ingo Walter*** of New York University's Stern School of Business—analyzed the holdings and trades of more than 260 ultrawealthy families between 2000 and 2009. The data came from an unnamed private company that consolidates account information for the wealthy.

What have these rich investors gotten right?

First, they made the most of their "comparative advantages," or their unique strengths: They have access to privileged investments and can afford to tie up lots of money for a long time. The ultrawealthy keep about 20% of their assets in hedge funds and various forms of private equity, much of it in "angel investments," or fledgling companies to which they supply both capital and management advice in exchange for potentially higher returns.

And the wealthiest "don't turn over their portfolios too much," says Ms. Ravina, who led the study. They rarely trade, although they are more willing than regular investors to realize losses for tax purposes.

Perhaps that's because, with an average of six advisers apiece, they always have someone else to blame for the loss, making them less reluctant to admit a mistake.

The rich don't do everything right, however.

In early 2001, these wealthy families had a paltry 0.01% of their total wealth in the complex instruments known as mortgage-backed securities. But the rich "were chasing returns, and mortgage-backed securities seemed to be successful at the time, so they got into them," says Ms. Ravina.

By spring 2007, mortgage-backed securities accounted for more than 2.3% of the families' total wealth. Some of these trendy investments turned out to be risky. The Barclays CMBS 7+ index, a measure of one segment of that market, lost 36% in 2008.

"It's dangerous to follow fashion if you can't reverse in time when the fashion changes," says Ms. Ravina. By early 2009, the wealthy families had only 0.6% left in these securities.

The typical portfolio in the study contains nearly 120 individual stocks, plus two dozen mutual funds, exchange-traded funds and the like. Ms. Ravina believes that by holding so many positions, the wealthy get the flexibility to realize gains and losses, thereby minimizing tax bills.

But it's also possible that by owning so many securities, the rich incur excess cost—and fritter away some of the information advantage they could obtain through their social and business networks.

They might be better off putting most of their money into an index fund that holds all the companies in a broad market average and the rest into a handful of companies they know well.

The rich do rebalance, trimming from assets that have risen and adding to those that have fallen. But they aren't consistent enough.

The wealthy "are good at rebalancing when it is easy, but they didn't do it when it was hard," says Ms. Ravina. "They are human, like all of us. During the financial crisis, most of them were just paralyzed."

The total stock portfolio held by the rich families fell from $8 billion in mid-2008 to $3 billion in March 2009—considerably worse than the 36% decline in the overall stock market over the same period.

Had they sold some bonds and other assets to buy stocks as the market fell, the families would have been richer by a total of more than $500 million by March 2009, estimates Ms. Ravina.

You, too, should think about what your comparative advantage is as an investor. Most individuals aren't likely to have an edge in trying to beat Wall Street at its own game of fast trading and constant measurement of returns relative to a market index.

You're better off doing what Wall Street can't: cultivating patience, trading as seldom as possible, focusing only on those rare companies where you might know something everyone else doesn't and, finally, rebalancing when it is hardest.

Right now, that might mean trimming stocks a bit just as other people are most tempted to add to them.