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Lessons from the House of Morgan

Proven Principles (Invisibly) at Work

On December 22, 2003 a magnitude-6.5 earthquake struck the central California coast. The quake's epicenter lay near San Simeon, about five miles from Hearst Castle, William Randolph Hearst's extravagant, over-the-top estate (if you've never visited Hearst Castle, think Xanadu in *Citizen Kane)*. The Castle, designed by an independent-minded architect named Julia Morgan and built starting in 1919, has been a popular tourist destination in California for decades. Because of the quality of thought and engineering design that Julia Morgan put into the walls and foundations of the castle—not always appreciated by the crowds coming to "ooh" and "aah" over the opulence of the estate—the castle made it through this quake intact and continues to play its role in providing a piece of rich history to California.

This story demonstrates the importance of the role of the architect who upholds such core design principles as advance planning, rational design, careful engineering, flexibility, and durability in building structures that endure. These principles can determine the ultimate success of those things that are built to last through conditions that can change dramatically – even violently – over the years and decades. The principles that apply to the very tangible – great buildings – also apply to investments and the portfolios that contain them, determining their ability to weather the types of "earthquakes" that can rattle the investment world.

Ahead of Her Time

Julia Morgan was a native of San Francisco, and she had witnessed the great earthquake of 1906. While she did not have the benefit of 21st-century building materials or knowledge to guide her in the design of Hearst Castle, she did have the benefit of extensive, high-quality training and substantial experience, and she recognized the risks inherent in building on the California coast. Having seen the effects of one great earthquake, she was determined to build Hearst Castle to withstand

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the next. With degrees in civil engineering from the University of California and architecture from the École des Beaux Arts in Paris, plus her experience as an architect (her prior work included re-building the Fairmont Hotel in San Francisco after the 1906 quake), she had the tools necessary to translate her judgment of known risks into principles and then into practice. The reinforced concrete piers that she sunk to bedrock for the foundation of the main structure waited eighty-four years for a serious test, but when the test came, they came through with stunning success. In spite of the magnitude of the quake and the age and size of the building, the Hearst Castle survived the event essentially unscathed.

By contrast, in Paso Robles, a pleasant, small city located about thirty miles away from the quake's epicenter, several historic buildings, some not much older than Hearst Castle, collapsed or sustained enough damage that they will be razed. That the huge, opulent castle survived this quake testifies to the skill and vision of Mr. Hearst's architect, whose engineering and architectural skills and experience – rather than specific building codes such as we now have today – guided the construction. Mr. Hearst had hired the best architect he knew – one who could and did apply real knowledge and experience to create a structure that would survive known risks. Neither Mr. Hearst nor Ms. Morgan would have been content merely to meet the then current building codes. As a result, their legacy stands.

Preparing for the (Known) Unexpected

Californians today broadly understand that we live in an earthquake zone, and our building codes have now caught up with what a visionary like Julia Morgan would have said should be required of building designs out of respect for that fact. We know that odd things happen in earthquakes. Landfill turns into quivering goo, too unstable to support heavy buildings. Solid masonry walls reveal themselves to be nothing but neat stacks of bricks that can collapse into disorderly heaps. Solid walls crack and buckle, and heavy objects fall from shelves. These are changes that are almost impossible to imagine – until they actually happen. But they do happen in earthquakes, so our codes require us to apply construction principles that can greatly reduce the resultant damage. Reinforced frame structures flex and shake but are less likely to break. Sheets of plywood affixed to large walls help them hold together. Brackets and adhesives help keep objects from falling. The ridiculously simple step of strapping the water heater to a wall prevents a common cause of earthquake damage: the fire that results from a broken gas line near a pilot light. Above all, we recognize that in an earthquake a building will shake. Rather than trying to prevent the shaking, we engineer our structures to tolerate it.

"Earthquakes" have hit the investment world, with possibly the same intensity and regularity as geologic earthquakes, since the earliest days of investing. The past fifty years have seen major advances in portfolio construction techniques – the methods of dealing with the know risks of investing. Academics and skilled practitioners have thoroughly understood, tested, and documented these techniques, but not everyone holding themselves out as a "financial advisor" or "investment advisor" understands or

uses them. Individuals can sustain huge portfolio losses during economic "earthquakes" like the ones that have hit the investment world since the turn of this century – the quivering collapse of a market unable to support the over-valued stocks of ephemeral dot-com companies, the crumbling of the vast wall of tech stocks at the NASDAQ, and the abrupt toppling of such guiding lights of corporate America as Enron and Worldcom, which reduced millions of investor's portfolios to ashes. Yet too often investors don't follow Julia Morgan's example and use solid building principals to structure their portfolios to withstand the next quake. The temptation is strong to see the last "earthquake" as an aberration. Too soon the temptation returns to plunge into speculative stocks, follow the latest investment fashion (right now it's hedge funds), succumb to plausible schemes or systems, or even to cash out and not invest.

Without a rational, sound foundation, investors often act too much in the moment, rather than according to a well-conceived strategy. Their decisions may be premised too much upon their most recent experiences, whether positive or negative, and subsequently set them up for problems when conditions change again. Hot stocks can cool quickly. Strategies or funds that stack up steady returns for months can suddenly reveal that their success depends on lack of market volatility – with unpleasant results when volatility returns. The attractive facades of some highly-touted companies' financial reports can develop dangerous fissures overnight. Just as with a building in an earthquake, the soundness, structure, and flexibility of your portfolio will determine whether these problems bring about financial disaster or merely require minor repairs.

No building can withstand every conceivable disaster, and no portfolio can offer complete protection from losses. But investors can take proven, disciplined, steps to improve the soundness and resiliency of their portfolios, while remaining in the market for the long-term growth that it yields. Building a portfolio on a solid foundation, using good techniques and materials, can greatly increase your chances of coming through the next investment earthquake without disastrous damage.

How to Approach Building Your Portfolio

You may not possess the wealth of a William Randolph Hearst, but you can apply the same guiding principals to building your portfolio as he did to building his castle. Here are a few that we recommend to see your legacy survive over the longer term:

The training and experience of your advisor can make a big difference: When you seek investment advice, the person you select should have knowledge and experience to apply to the important tasks with which you are entrusting them. Most importantly, that person should be able to distinguish between hype and reality, with respect to choices that affect your overall return. Your advisor should also be a person who believes in managing to the best of his or her ability, and not merely to the level required by current codes (which probably will always lag behind current knowledge). Recognize that in today's finance environment, you must distinguish between those

who merely know how to sell investments and those who know how to make investments.

Lay a durable foundation: The foundation for a sound portfolio is a sound portfolio plan, which starts with your goals, your tolerance for risk, and your spending needs. Clarity on these items lends clarity to fundamental investment choices, including how aggressive your portfolio should be, and how it should be managed. If you have a durable foundation, a violent, short-term market trend will be less likely to tempt you to pile into or bail out of the market at the wrong time, adding to the damage.

Pay attention to the difference between the structural and ornamental parts of your portfolio: Not every part of your portfolio has to serve a narrow, risk-controlled investment purpose. You may wish to speculate in a controlled way in an area of your knowledge or interest, or you may seek certain types of private investments for the cachet they carry, or for the possibility they hold out for a big win (and the attendant bragging rights). Hearst Castle – including important parts of Julia Morgan's design – is far more famous for its ornamentation than for its earthquake-proofing. But Ms. Morgan understood that ornamentation is not what keeps the building standing. And if the building falls, its beauty becomes a memory.

Don't ignore incremental costs or tax inefficiencies, as these can undermine your return: Excess costs reduce your return, which in turn reduces the chance that you will meet your investment goals. An unnecessary percentage point in costs forces you to choose between settling for a return a percentage point lower or taking on extra portfolio risk in an effort to make up the percentage point. I have written on a variety of occasions about both the explicit and the implicit costs of investing but briefly, extra costs afflicting individual portfolios come in a variety of forms. Among the most important costs that investors can avoid are excessive layers of fees (introduced by excessive layers of management such as in wrap programs and outsourced arrangements to a series of "best of breed" managers), broker markups on purchases of fixed income securities, particularly municipal bonds, and sales charges on mutual funds. Furthermore, if your investment return is not evaluated on a true, after-tax basis, then you are probably not maximizing the value of your investments. Your investment manager should be watching out on both these fronts on your behalf.

Make sure all the parts of your portfolio do what they are supposed to do, and work together as they should: Recognize that your "portfolio" comprises *all* of your assets, and that your human capital (your future earning power), your real estate holdings and even more remote sources of family wealth constitute important parts of your total net worth. Make sure that these components are factored into your risk analysis of the more purely investible portions of your portfolio. If you have a sound portfolio plan, and if you follow it in a disciplined fashion, then the structure and purpose of each component of your portfolio should be clear. Most important, make sure that the risks you take in your portfolio are appropriate, and offer an adequate possibility of compensation. Make sure you maintain enough diversification, taking all facets into account. Allocate assets to your various accounts (trust, personal account, IRA rollover, and so forth) in a way that corresponds to their various tax characteristics. And if you

have personal preferences, special investment circumstances, or significant concentrations in particular stocks that you choose to hold (or must hold), the contents of your portfolio should reflect them and sometimes compensate for them.

Conclusion

Earthquakes are unexpected events that we can nevertheless anticipate. Those of us that live in earthquake zones know that another quake is coming –we just don't know whether the next big shaker will be twenty years from now, or tomorrow afternoon. So it is with investments. Big investment surprises happen in the same unexpected, sudden fashion as earthquakes, and just as with earthquakes, it is virtually certain that one will happen sooner or later. The knowledge that the California coast is an earthquake zone did not deter Julia Morgan from taking on the challenge of building Hearst Castle; she designed and built the Castle with that reality firmly in mind. Neither should investors attempt to avoid all the risks and challenges of building a successful portfolio; but they do well to select an investment manager who, at a minimum, recognizes that they are working in an earthquake zone, and they should choose instruments, structures and techniques with an eye toward absorbing the inevitable, but somehow unexpected, shocks of the market.

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