Putting horses atop the pyramid

For high-risk elements of an investment portfolio, Thoroughbreds are a possibility, but be sure to diversify

by Neal Hayias

PERHAPS YOU have heard of the investment pyramid. No, it is not a Ponzi scheme or anything improper or illegal. The investment pyramid is that triangular marketing piece your broker uses to explain how to build your portfolio as safely as possible.

At the base of the pyramid are the least-risky financial assets, such as certificates of deposit or short-term bonds. As you move toward the top of the pyramid, the asset choices become more risky and include growth stocks, longer-term bonds, and real estate.

As you get to the top of the pyramid, you get to the most-risky investments, such as precious metals, commodities, oil and gas, and collectables.

Should bloodstock be part of your investment program? Only you, in consultation with your professional investment counselor, can answer that one. But, for those who want to sample Thoroughbred ownership, syndications and partnerships are available that allow you to buy in for as little as $5,000.

The investment pyramid establishes a base of low-risk assets, such as certificates of deposit, and progresses upward to high-risk, speculative investments

If Thoroughbreds are appealing for the top level of your pyramid, you may want to consider adding a breeding or racing investment—or perhaps both—to your portfolio. I like to diversify my Thoroughbred interests by spreading the risk in two ways.

First, I would rather own 10% of ten horses than 100% of one horse. The more you can diversify for a given dollar of investment, the more you can help to reduce risk.

The second, equally important factor is to further diversify by breeding, pinhooking, and ultimately racing if necessary. I say if necessary because I consider racing to be a losing proposition. But, if you do race, fillies with as much pedigree as you can afford are an option because they may have residual value in the breeding shed as a broodmare.

As a financial professional, I always take a holistic view of my clients' assets. In other words, how does an investment in horses fit with a client's overall investment and financial plan?

Policy statement

An important tool for any investor is a written investment policy statement (IPS). It is helpful in seeing the big picture, and without one you are likely to end up going nowhere. Creating an IPS embodies the essence of the financial planning process: assessing where you are now, where you want to go, and how you plan to get there. Having and using an IPS compels you to become more disciplined and systematic, increasing the probability of satisfying your investment goals.

In addition, if you are a trustee, the development and use of a written IPS will go a long way toward ensuring you meet your fiduciary responsibility. Once you have created your IPS, you need to monitor the performance of your investments on a regular basis to see what progress, if any, you have made.

Most financial professionals will recommend that you introduce assets with what is known as negative correlation. That is, they balance each other out and tend to move in different directions. These assets remove risk from a portfolio because they will react differently to given market conditions. You will want to diversify across asset classes and blend both growth and value equities.

Along with this, investing overseas in both established and emerging markets will further help to balance risk and return. By doing this, in the long run you attain a similar investment result with reduced risk.

I like to check the asset allocation in my clients' portfolios periodically and rebalance if necessary. For example, I may have a moderate risk tolerance and start out with a 10% exposure to an emerging market's high-risk asset classes. But these assets may outperform other sectors and eventually grow to 20% of the portfolio's value.

At that point, I would be inclined to rebalance the portfolio by selling half of the outperforming sector, now representing 20% of the total portfolio, and investing the proceeds in other sectors. In doing so, you have achieved two goals. First, you have harvested the profits from a relatively high-risk investment that sits near the top of the investment pyramid. Second, you have restored the balance of assets that you sought in the portfolio, assuming that your risk tolerance has remained the same.

Human factor

The biggest single factor in building wealth is not what you might think. Yes, a written IPS plan, proper asset allocation according to your risk profile, and rebalancing are essential. But the human behavior carries the biggest weight.

If you are the breeder, you also have the potential for breeder's awards. As the breeder of record, you may receive continuing revenue on horses that you have bred and sold when they earn purse money. This can be a very significant source of income in states with generous breeding funds.

Consider the return of the Standard & Poor's index of 500 high-capitalization companies over the last 20 years. The average annual return during that period was approximately 11%, according to Ibbotson Associates Inc.

But the average investor over that period achieved a rate of return of 3.9% annually, as reported by Dalbar Inc.'s 2005 Quantitative Analysis of Investor Behavior. The reason: Human behavior.

When the stock market began to explode in the 1990s, many investors bought, bought, and bought some more with little understanding of what they were buying. They did not want to miss the boat on a market that supposedly was defying gravity—despite then-Federal Reserve Chairman Alan Greenspan's warning in late 1996 against "irrational exuberance" in the equity market.

For quarter after quarter, it indeed appeared that the age-old cycle of boom and bust was a thing of the past, but then the bust came, and it was vicious. In many cases, investors saw their portfolio's total value cut by 40%. So, what did the average investors do? They sold, of course, because they feared losing more money than they already had lost.

Had these investors stayed the course by adhering to their original plan, they would have weathered the storm, because markets will revert to the norm over time. Many of those who sold during the downturn have not returned to the markets and thus are missing out as the world's economies continue to rebound and expand.

These average investors got the classic maxim backwards and paid the price. They bought high and sold low. When investing in stocks or in Thoroughbreds, the goal always should be to buy low and sell high.

Looking again at a possible Thoroughbred investment within the high-risk asset class, breeding is always my first choice for two reasons. First, it has a tax advantage: Breeding stock is a capital asset and generally enjoys capital-gains tax rates after a two-year holding period.

Capital-gain tax rates are at or near historical lows, so you pay a lower tax when the mare is resold. If you are actively engaged in the breeding business, you also may be able to deduct such expenses as board, veterinary bills, and farriers from other income.

Second, with foals, you have four options:

- You can attempt to sell the offspring at the weanling sales;
- You can attempt to sell it at the following year's yearling sales;
- You can take the horse to the two-year-olds in training sales; and
- If all else fails, you might be able to go to the track and have some fun (but expect to lose money).

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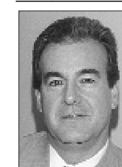
Some horses are sold at the track, either in private transactions or through the claims box. I much prefer to take fillies to the races because they may have residual value as a future broodmare.

In 2003, I bought an unraced, in-foal mare for $120,000 because of her pedigree and conformation. Her first foal was sold for $100,000. Her second foal sold in September for $50,000, and I will be selling her 2006 foal next year.

When she eventually goes through the sales ring (in foal, I hope), the tax rate will be a fraction of what a pinhooked horse or racehorse would be.

Before making your Thoroughbred investment, you will want to develop a business plan and put together an advisory team of horse and business professionals whom you trust. With the right information and advice, you can undertake a top-of-the pyramid investment that is fun and stimulating. Just remember to diversify, diversify, diversify.



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