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The strategic asset allocation debate in the private wealth management world rages on and, in fact, several articles in this issue deal with one or another facet of the question. Yet, to this humble observer at least, the tone and focus of several contributions seem to be somewhat misdirected. Indeed, as is often the case in our post-modern society, we are at times witnessing a debate on labels rather than on the issues that drive the problem.

For instance, postulating that mean-variance optimization is the only appropriate approach to deal with strategic asset allocation is often offered as an indictment of behavioral finance constructs, when in fact a substantial body of literature discusses the limitations of mean-variance optimization, even when viewed solely in the context of traditional finance. It does not help to argue that mean-variance optimization can be modified to incorporate additional features: the fact is that current practice involves unmodified versions of the traditional approach and an impartial observer must note that the solutions that it generates appear at least debatable.

Similarly, postulating that behavioral finance is the only reasonable framework for dealing with individuals often fails to consider the nature of the question that is being asked. Indeed, in certain circumstances, a goal-based allocation process might indeed make more sense while, in others, it may be a disastrous emphasis. Individuals with no discretionary wealth, for instance, may not have any option but to accept investment risk and to live by a strict interpretation of optimality. Others, with substantial discretionary wealth may not need to take that risk or may wish to focus on different elements of the wealth management problem.

Extending the framework introduced by Wilcox [2003], one can indeed propose the following likely "need for" or "desirability of" risk taking. Discretionary wealth being defined as excess wealth relative to required uses for one's wealth, individuals with no or negative discretionary wealth must take investment risk failing which they would not be able to meet their eventual needs, be they relative to income replacement, charitable or estate commitments or selected asset purchases. Individuals with some discretionary wealth ought to take an increasing amount of risk as the relative size of their discretionary wealth rises. Whether the function thus described is linear, quadratic or some other shape need not be debated here!

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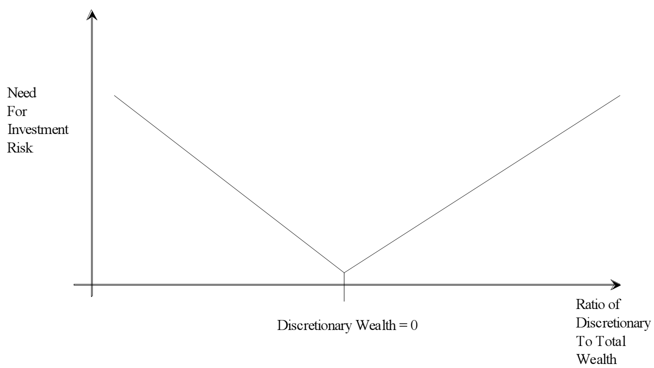

Yet, one should not lose sight of the fact that there is a significant difference between "ought to" and "must." Indeed, there may be instances when a family does not view the maximization of its wealth as a desirable outcome. This can occur when a patriarch or matriarch worries that excessive wealth might "corrupt" or otherwise "negatively affect" their heirs and thus prefer to limit the value of potential transfers, for some time (during which they can nurture and educate these heirs) or forever. Thus, one should be prepared to accept the notion that there can be some measure of sub-optimality in a family's own objective function and that the optimality of the way in which one would deal with that becomes a moot point!

Let me thus offer a simple – and probably non-exhaustive – list of the five issues which I believe should be discussed, recognizing that all of us who focus on this problem, probably, only have a small portion of the solution.

The Limitations of Traditional Finance. A crucial question when dealing with individual investors relates to their ability or inability to set goals. It has often been argued that institutional investment pools have a built-in advantage in this process. Indeed, insurance companies, endowment funds, foundations or defined-benefit pension funds, to name a few, only exist for the purpose of meeting certain current and future liabilities. Thus, their assets are solely dedicated to the purpose of defeasing these liabilities, and the formulation of a risk/return trade-off can naturally proceed from the analysis of these liabilities. Further, as those liabilities often are related to a multiplicity of agents and as the laws of probabilities can thus be assumed to apply, an actuarial approach to that analysis is not only feasible, but in fact eminently reasonable. This does seem to fit very well with the notion of some terminal utility being used to select the optimal portfolio on the efficient frontier.

Does this apply to individuals? In certain instances, the answer may be yes, while in others, it may be no. It chiefly depends upon whether the individual investor has enough assets to meet his or her liabilities. The strictures of some terminal utility or distant risk/return trade-off may be the only acceptable solution for someone saving for retirement. Does it however fit as well for individuals whose lifestyle calls upon a minute portion of their potential income and who thus do not need to take risk? They may first want to learn both from theory and experience and then make appropriate decisions. For many of them, the cost potentially associated with some short-term portfolio inefficiency pale into insignificance when assessed against the comfort implied in an approach that incorporates other concepts, such as those offered by behavioral finance.

Our first conclusion should therefore be to investigate whether and how the formulation of investment goals satisfies the premises underpinning traditional finance.

The Impact of Taxes: The impact of taxes on the strategic–and tactical–investment process is the next important consideration. Clearly, most institutional investors are fortunate enough not to have to deal with the problem of taxes, though some, like insurance companies, certainly do. Individuals rarely can afford to ignore taxes and, with that, comes a number of problems, which can be addressed by traditional finance but make the problem considerably more complex as proposed, among others in Brunel [1998]. This is true whether the portfolio does or does not involve multiple holding structures with different tax circumstances, as richly discussed by Reichenstein and Jennings. Ankrim and Bouchey [2000] dealt with the issue of total portfolio management across multiple structures and proposed a model where risk is not defined by the conventional measure, portfolio volatility, but is defined in terms of a function that penalizes potential investment outcomes falling below a specific financial target. The objective of the model is to maximize wealth at the final horizon and minimize the shortfall against a wealth target, with large shortfalls penalized at a greater rate than small shortfalls. It uses a stochastic process to arrive at its solution. It is said to offer an important advantage in that it is dynamic and recognizes the inherent path dependency associated with taxation. Other models also purport to achieve similar goals.

Our second conclusion therefore should be to investigate how well any proposed solution deals with the path dependency and multi-location issues that arise in a taxable environment.

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The Importance of Non-normal Distributions and Related Considerations. An additional element of complexity arises when the investor either currently holds or desires to hold assets that do not naturally lend themselves to the strictures of raw mean-variance optimization. I am referring here to three important sets of circumstances, though there may be several others:

- An entrepreneur still owns an important share of his or her wealth in a single or several operating businesses. There, financial modeling of expected returns and risk, together with the necessary correlations, is at best doubtful.
- A former senior executive owns a significant portion of his or her wealth in instruments such as options. There, a pay-off pattern may not lend itself to traditional return and risk estimation.
- An individual investor is attracted by alternative assets whose returns are not normally distributed. A reasonable optimization, as proposed by Davies, Kat and Lu [2004], must also incorporate higher statistical moments such as skewness and kurtosis, and is currently seemingly beyond the computational capabilities of most common hardware.

Our third conclusion should therefore be to investigate how best to take a total wealth focus and to structure an approach that can deal with all relevant and likely circumstances.

Non-financial Dimensions of Wealth Management. Studious observers of the wealth management scene will also know that it is often quite dangerous to reduce the wealth management problem to an asset management question. In the letter from the Editor in our Winter 2005 issue, I mentioned one possible framework, which was given to me by one of the families we serve: the idea is that financial goals are only one part of the full picture and thus that the management of the family's wealth must also contribute to the fulfillment of the family and the achievement of some form of greater good that transcends the family. There, the concept of optimality must be evaluated in that greater context, and it may well be that a compartmentalized approach to asset management is highly desirable. Similarly, families that need to be concerned with the interactions between wealth and legacy, and for whom human capital is at least as important as financial assets would probably remind their overly theoretical adviser that they are addressing a much broader problem, one where financial optimality may not be the most important outcome.

Our fourth conclusion should therefore be to make sure we understand the full circumstances of the problem at hand and thus ask the right questions!

Practical Considerations. Without waxing overly philosophical, it is also important to remind ourselves that the proverb "the best is the enemy of the good" is found in many cultures and languages, probably for some important reason. Thus, the adviser will be often well served defining "best advice" as the "best advice the client can take."

I am here reminded of a personal experience which has nothing to do with investment management and everything to do with the question at hand. Twenty five years ago, as a golfer with a seven handicap, I set out to find a coach to better myself. Seeing me swing, he proceeded to make what he called were minor little adjustments here and there, and four years later, I was playing to a three handicap. After having moved to a different city, I again sought a coach, who, upon seeing me swing proclaimed: "I am certainly going to earn my money!" He wanted to change everything, at once. Our relationship terminated two years later with no improvement in my game. I cannot say which of the two was the better golfer or even the better golf teacher in absolute terms. Yet, I know I can tell who did the best job for me.

This analogy is a solid reminder of the twin needs (a) to understand theoretical solutions to the best possible extent, but (b) to appreciate that, in dealing with individuals who are not professional investors, one needs to make sure that the solution can be sustained through time. Investment theory, for instance, clearly demonstrates the fallacy of any tendency to use a dollar-cost averaging approach to portfolio changes. Yet, any seasoned observer will know that the assumption that the individual will stick to the program whatever path markets decide to take in the short run is simply not backed up in practice. Thus, rather than assuming that individuals should learn and should follow the advice of the professional who knows best, advisers are best served reminding themselves of our fifth conclusion: *What counts is not the validity of the advice, but the success of the interaction between that advice and the biases that the client will bring to the table. One should thus investigate how to minimize the discrepancy between the original advice and the final actual outcome.*

In conclusion, I would encourage authors to continue to contribute to the debate. This is an important issue and one which is far from being resolved. Certain conceptual advances have been offered that appear to contain important seeds, although they may not yet reflect the final solution. Thus, given its long-term track record, one should not reject the tenets of traditional finance and modern portfolio theory simply because individuals are different. At the same time, it is just as advisable not to postulate that individuals can be made to become theoretically rational, in the face of monumental evidence to the contrary. In either case, a bit of humility does not hurt. In short:

- Efforts to maintain a holistic approach to total portfolio allocation offer many potential advantages, but they arguably tend to fall down when they make assumptions that may not prove accurate in the greater wealth management picture. Indeed, certain investors would, as postulated by Wilcox [2003], accept more risk as the ratio of total to discretionary wealth increases. Others, however, might not, on the grounds that they have more important fish to fry, for instance: making a second fortune, managing their families or taking care of their philanthropic avocations.
- Efforts to arrive at an overall solution through some initial portfolio compartmentalization offer many client-acceptability advantages, but need to be mindful of the potential cost in terms of sub-optimality. Brunel [2006] suggests a way of maintaining a sharp eye on overall portfolio optimality while allocating different asset pools to defeasing the multiple goals that individuals have. Others can certainly improve on that initial effort.

My final message to all authors has to be this: please keep the dialog civil and avoid advocacy or stridency. Wouldn't it be nice if one of us really knew everything? Yet, one thing we have been learning since Socrates' days is that "the most important piece of knowledge is that we know very little."

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The Summer 2007 issue of *The Journal of Wealth Management* is concerned with both soft and hard issues. With respect to strategic asset allocation, and for the first time in our nearly 10-year history, we publish an article together with a comment on, or reply to, it. It is a part of the research process to recognize that no one has a monopoly on insights and it is thus useful to foster constructive dialog.

The first three articles focus on broad wealth management issues: Trent Kiziah first discusses the seven fundamental rules which can prevent mistakes costing millions of dollars in estate taxes. Tom Boczar describes the rapidly expanding duties of fiduciaries and financial advisors to manage single stock concentration risk. Finally, John Kilpatrick explores the investment criteria of the real estate portfolios of the ultra-affluent, with an eye to bridging the gap between real estate investment vehicles and the needs of those portfolios.

The next four articles are somehow related to asset allocation and the use of models. First, Jeffrey Horvitz and Jarrod Wilcox offer a critique of the article by Ashvin Chhabra which was published in our Spring 2005 issue, asking how investment advisors can give private investor clients what they need while still giving them what they say they want. Ashvin Chhabra then responds to that critique. Then, Jeff Grover and Angeline Lavin present a practical solution to the strategic asset allocation problem that investors face when attempting to construct an optimal portfolio from a given set of available mutual funds. Finally, Raymond Théoret and Francois-Eric Racicot use a new set of instruments based on higher statistical moments to discard the specification errors that might be present in the Fama and French model.

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Editor

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