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Current global capital market conditions can be used to review a number of important issues and to educate clients. Most likely, the most successful advisors will have already worked with their clients over the last several years to help them form reasonable expectations and deal with more challenging market periods. It is indeed considerably easier to educate families and individuals on the vagaries of capital markets when times are "good," returns are higher than normal, and volatility is surprisingly low. Yet even in difficult times, it is still very important to discuss with clients the challenges posed by current circumstances. Indeed, clients who may be under the impression that their advisors know it all still often appreciate the candor of the manager who discusses the puzzlements associated with challenging times.

A first issue worth discussing might be the limits of traditional strategic diversification. In difficult times, markets have a tendency to move all in the same direction, making the benefits of diversification less visible at best. In those circumstances, though correlations do not always go straight to one (implying that all assets move in exactly the same amount in the same direction), they still often go up. It is then difficult to see how portfolio diversification helps, when all positions appear to be losing money at the same time. Even though statistics might still suggest that some diversification did occur, as certain assets fell more than others, this is not of much comfort to the investor who sees the portfolio's value fall more than expected. Unless well explained and understood, a period such as the one we are currently experiencing presents the risk that families will be tempted to doubt their long-term strategies at that time, possibly compounding the problem of an overly aggressive allocation by changing it at the point of maximum pain; the job of the advisor is to help them deal with that temptation.

This requires at least two important thought processes. The first involves revisiting the validity of long-term capital market expectations; the second relates to discussing the validity of assumptions and conclusions with respect to the family's financial needs and goals. Revisiting capital market assumptions is always a tricky process. Yet, particularly when the source of uncertainty rests with what could be a major structural development—such as the unwinding of structural imbalances within the U.S. economy—it is very important to be assured that the most likely scenario still fits within the set of assumptions underpinning capital market forecasts. In this context, it is useful to remember three important attributes of a capital market forecasting model: clarity of architecture, clarity of assumptions, and clarity of expectations. A clear

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architecture will help the forecaster ensure that relationships postulated within the model are still valid, and, if they are not, to express change in a visible and justifiable fashion. Clarity of assumptions will help the forecaster ensure that the assumptions currently in place are still valid and, if they are not, to change them explicitly. Finally, clarity of expectations will help the forecaster maintain a healthy dose of humility with respect to the range of possible outcomes that need to be considered. At the same time, it may be fruitful to review the assumptions that were made with respect to the family's financial needs and goals and to ensure they are still all valid.

A challenging market period also provides the opportunity for the advisor to test the relevancy of what might be called tactical diversification. While strategic diversification uses a variety of asset classes and strategies to balance portfolio risks and returns, tactical diversification relates to the need to incorporate a range of possible outcomes into the portfolio make-up. Peter Bernstein famously used to say that the greater the range of possible outcomes, the greater the diversification that should be incorporated into a portfolio, and vice versa. In many ways, his admonition, although still very wise, creates a range of challenges for the individual investor who is subject to taxes.

Tax-efficiency indeed teaches us that one should be ready to harvest occasional and random capital losses to shelter capital gains that might have been taken, particularly within strategies controlled by managers rather than by the individual. Though sensible over time, such a strategy has the effect of broadening the gap between the portfolio's market value and its tax basis. Thus, taken to an extreme, it is possible that a portfolio might comprise little or no unrealized capital losses, at a time when raising the porfolio's diversification would require cutting back on positions with material unrealized capital gains. Recent work by authors such as David Stein on the topic of enhanced tax rate management might help address the issue to the extent it offers a theoretical framework within which taking capital gains can be justified. Yet, another important possible solution might rest in the use of selected derivative contracts, although suitability, counterparty risk assessment, and administrative complexity should be explored. These contracts might be used to reduce market risk without requiring the actual liquidation of physical positions and thus the need to realize capital gains.

Importantly, challenging market circumstances ought also be used to revisit all the operational assumptions incorporated in the portfolio. Many of these are under the direct control of the investor or his/her representatives. Yet a number of others are not and are in fact subsumed in the manager-selection process. These are areas that might be especially ripe for some renewed attention. Operational processes, the security of counterparties, the actual protection of the assets against operational failures, and the occasional straying beyond the normal limits of the "reservation" on the part of managers can all have dramatic consequences: While one cannot but bemoan marked-to-market losses, one might be really sorry when an operational issue transforms them into permanent losses of capital.

In short, however unpleasant current market conditions might be to many advisors, families, and individuals, they do offer important opportunities for advisors to distinguish their services by demonstrating more than ever appropriate sophistication, understanding of all times—good and bad—and a concern for the long-term financial welfare of their clients.

As has been our practice for some time, the Spring 2008 issue of *The Journal of Wealth Management* is concerned with both soft and hard issues.

The first two articles revolve around the softer dimension of wealth management. Charles Lowenhaupt explores the challenge family members and their service providers must face and that involve becoming free from one's wealth and thus allowed to develop as individuals. Elizabeth Mathieu describes a process by which a family office can identify and prepare for alternative future worlds in which it might be operating, and reduce the number of surprises that could make current plans for sustaining the family over generations ineffective.

The next two articles deal with two dimensions of the investment process. Noting that suitability is a legal concept that refers to the propriety of the match between the individual and his or her portfolio, authors Paul Bolster and Sandy Warrick develop a model of suitability using the Analytic Hierarchy Process to create unique asset allocations for individual investors based on their personal attributes. Next, David M. Stein, Hemambara Vadlamudi, and Paul Bouchey explore the tax-management strategy of realizing long-term capital gains in a portfolio of equities and quantify how much it can add to after-tax performance.

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The next two articles deal with two aspects of the hedge fund industry. Scott Mackey examines differences in average estimated risk premiums of individual distressed hedge funds as compared to those of their surviving counterparts, showing that the hedge funds with the greatest exposure to the risk factors are the funds most at risk of dissolution. Then, Victor Fang, Kok Fai Phoon, and Vincent Yi Ding Xiang tackle the asset allocation challenges associated with the non-normality of hedge fund returns and present a heuristic approach that seems able to provide better forecasts, more stable portfolio allocations, and more diversification than the traditional mean-variance optimization approach.

The final two articles deal with broad issues concerning the U.S. investment industry, with respect to both stock selection and to client service. Anita Arora, Lauren Capp, and Gary Smith use the relative performance of stocks added to and taken out of the Dow Industrial Index to test the insight offered by Daniel Kahneman and Ivan Tversky that regression to the mean is a pervasive but subtle statistical principle that is often misunderstood or insufficiently appreciated. Finally, Brian Barrett, Celine Moreno, and Thomas Sanders present the results of a study designed to determine why managers move from one firm to another and conclude that clients still tend to be more loyal to the money manager than the firm, despite recent, more aggressive efforts by departure firms to institutionalize the customer.

Jean L.P. Brunel
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