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On the Cover

Robert Hague *is a Sydney-based sculptor who works primarily in fabricated bronze. Born in New Zealand, he migrated to Australia in the mid-1980s and has been a practicing artist there for more than two decades. In 1999, he was awarded the "Director's Prize" at Sculpture by the Sea, Bondi. His work is part of corporate and private collections in Australia, China, New Zealand, United Kingdom and the United States.* www.roberthague.com

As this issue celebrates the 10th anniversary of *The Journal of Wealth Management*, the first order of business is to thank all those who contributed to achieving this milestone. Our readers and subscribers thus deserve a heartfelt thank you for your support, which has allowed the *JWM* to become one of the fastest growing publications within its stable. The members of the Advisory Board also made crucial contributions by faithfully reviewing and commenting on all the articles that eventually were published. All the Production and Operation staff, from the most humble to the most senior, also deserve thanks and should be associated with this success. Our publishers, first Gauri Goyal, who presided over the launch of this journal, and then Allison Adams, who managed its expansion, played key roles as well. Last, but not least, I must thank all the authors who have supported us by submitting articles over the years and put themselves through the sometimes thankless editing and publishing process.

This 10th Anniversary is also a good time to reflect on the birth and growth of the integrated wealth management industry and to anticipate a few of the challenges that loom ahead.

MUCH PROGRESS

Ten years ago, our industry effectively did not exist. Wealthy individuals were served by providers who did their best but, practically speaking, were not offering the right services, in large measure because they did not fully understand the true nature of their clients' needs. Consider a corporation. Everyone would immediately recognize that the successful chief executive must relate to each and every division, rather than simply focus on one or another area, be it finance, sales, marketing, research, legal, human resources, production, or accounting. The corporate world is, in fact, littered with companies whose management paid too much attention to one facet of their business rather than to the whole. Taking this analogy where Charlotte Beyer often does when she calls wealthy individuals the CEOs of "My Wealth, Inc.," one can easily understand why the model that prevailed until the mid-1990s was flawed. Rather than focusing on the whole set of issues that a wealthy individual must address—asset management, cash flows, estate planning, risk management, roles, values, philanthropy, and taxes, to name the most important—the wealth management industry thought it was only involved in asset management. It did not appreciate that the numerous interactions between all the various issues could and would require something other than the retrofitting of institutional asset management solutions.

The Journal *of*
Wealth Management

Thankfully, times have changed. Chronologically, the first indication that change was afoot was the introduction of the concept of tax-efficiency. People realized, "What matters is not what you get, but what you get to keep." This changed a previously two-dimensional problem, where the only relevant dimensions were risk and return, to a three-dimensional challenge, where taxes entered into the equation. It led to the recognition that there are different ways of being an active manager. First, one could trade some increase in tracking error relative to an index—or, more generally some increase in risk—in the expectation of higher returns. However, as pioneered by David Stein, there is another way of being active: One could be active relative to tax management, usually accepting some higher tracking error to enhance the portfolio's tax-efficiency.

Focusing on taxes, or rather recognizing that taxes matter, led to another important change: Portfolio construction needed to recognize that what I came to call the "murky middle" was not the most optimal place. The inspiration for that came from the seminal article by Arnott and Jeffrey, who observed that portfolio activity could have a dramatically negative impact on tax-efficiency. Thus, one moved from a portfolio that comprised middle-of-the-road strategies, with multiple subsectors, to one that adopted a barbell approach—one portion of the portfolio worked to produce the market beta without which real returns are virtually unachievable, and it did so with a very high degree of tax-efficiency. The other looked for alpha, or value-added, and did so using strategies that often were tax-inefficient. Yet, the combination of the tax-efficiency—or at times hyper tax-efficiency—of the indexed or semi-indexed portion of the portfolio with tax-inefficient satellites often ended up providing better after-tax returns than the old traditional construct.

The next crucial change was a result of the work that led Daniel Kahneman to his 2002 Nobel Economics Prize, an honor that reflected the work that he did, with Anton Tversky, which serves as the basis for behavioral finance. Recognizing that individual investors have a series of built-in biases and prejudices, it involves appreciating that they also have multiple goals and, as suggested by Meir Statman among others, that each of these goals may have a different risk profile. This led to the concept of goal-based allocation, where initially individual subportfolios were designed to defease each goal, but which is now evolving in interesting integrated solutions, with Jarrod Wilcox an early leader.

Together with the multiple goals that individuals often possess, there is also the important issue of asset location, which is a topic amply covered by William Reichenstein and a few others. Here the idea was that it is not enough to ask how assets should be allocated; one should also ask what holding structure should hold what asset. Darryl Meyers added to the complexity of the problem by recognizing that certain structures have time constraints, while Bruce Paulson has done a considerable amount of work defining how certain asset classes or strategies fit or do not fit with the structural constraints of certain pockets.

A final important element of the complete change in landscape noticed over the last 15 years or so has been the broader use made of alternative strategies. Here, the challenge was not made any easier by the tendency for many to use sound bites rather than thoughtful insights. Thus, one has had to fight, and still is fighting, the notion that "hedge funds" are an asset class rather than a multiplicity of strategies significantly different from one another, or that all hedge funds involve a material loss of liquidity when only a few have that major drawback. One also has had to deal with the nonnormality of the typical return distribution of nontraditional assets, and the world is still waiting for a fully integrated solution, although the work of Neil Davis, Harry Kat, and Sa Lu is very interesting.

WHERE DO WE GO FROM HERE?

Although the industry has thus unquestionably made much progress, there is a lot left on our plate before we can rest on any sort of laurels. A first and relatively obvious step is to keep building on the work of the last 15 years, effectively consolidating it. A sharper focus on tax-efficiency is indeed needed, for instance, to begin to recognize its dynamic nature. Clearly, one needed initially to accept a few of the negative implications of our static tax-efficiency, under which one tends to defer the recognition of gains thus eventually leading to some measure of portfolio freeze. Equally important, however, is the need to begin to evaluate and try to resolve the trade-off between current tax-efficiency and future loss of alpha. This probably involves the recognition that there is some optionality in the process and that the option ought to be better understood and valued. One might need to begin a more serious investigation into the use of derivative structures, and potentially of their securitization—a topic on which Robert Gordon has substantially written. This is to allow investors to benefit from the internal contradictions associated with tax codes that often become more convoluted, as politicians appear to believe that the solution to any challenge is to pass a new law, irrespective of what may already be on the books. Similarly, progress is needed on the

The Journal of
Wealth Management

issue of goal-based allocation to avoid a few of the more dangerous traps of getting caught in serious suboptimality for the sole sake of avoiding the risk that an investor will change his or her mind at the worst possible time. Finally, there is a crying need to develop an understanding of dynamic asset location, whether through the use of derivatives or intrafamily loans, short sales, or similar strategies, among others.

The role of alternative strategies and their incorporation in portfolio optimization is undoubtedly a major challenge. I mentioned earlier the work of Davis, Kat and Lu and it is obviously quite interesting, although they themselves view the complexity of the actual implementation of their algorithm as still a major computational challenge. A better understanding of the continuum between passive and very active security selection strategies is also a must. This will help investors understand that the difference between two potential investments should not be viewed as driven by the fee structure or the legal manner in which the portfolio is structured or held, but rather with respect to expected return, return volatility and associated measures of risk. An initial step might thus be to reintegrate traditional and nontraditional strategies, differentiating them by traditional statistics, to which the quotient of risk accounted for respectively by manager or by market might drive some insight as to the normality or nonnormality of the distribution of returns. There is also a need to find a way to quantify liquidity risks and truly to be able to distinguish between strategies that have limited liquidity in terms of the underlying investments and those where liquidity is only initially limited by the manager.

A THIRD ELEMENT

Just as we identified tax and behavioral finance issues as two of the main distinguishing descriptors of wealth management, it may now be the time to "discover" a third: broader family context. Jay Hughes pioneered this effort, and he is now aptly followed by such disciples as Lisa Gray and Patricia Angus, to name only two, who promote the notion that one cannot ignore broader interactions.

As a matter of fact, the first relevant element is for the industry to understand a variety of important constraints. Much has already been written on liquidity and times horizons, but some work is still needed in differentiating between investment and performance horizons and their impact on liquidity. It is indeed not enough to postulate that a multigenerational family *must* have a long-term time horizon. It may or it may not, depending upon its own comfort with capital market risks to which it may not have previously been exposed. Thus, it may have an almost infinite time horizon and yet maintain a relatively short-term performance horizon. Liquidity issues would play out quite differently there. Family values and preferences also are an important constraint that needs to be investigated. Once one accepts that the management of the family's assets is only one dimension of a much broader problem that starts with its human capital and moves on from there, recognizing that families may not be prepared to invest in a way that is disconnected from their own values is crucial. This extends to making sure that financial and nonfinancial investments may need to maintain some manner of congruency. In fact, that congruency goes even further, as it may well need to extend to all goals, for instance to philanthropy.

Better documented, but still in need of clarification and expansion, is the role that can and may be played by personal biases and the interaction that this might have with broader strategic issues. The literature amply discusses the notion of home bias across many different countries. How does this affect the choice of base currency? How should this affect constraints imposed on geographical diversification issues? How should geography be addressed? The list is almost endless.

A final element relates to even more esoteric and currently underresearched issues, which are only now being discovered. The difficulty of managing the interaction between philanthropy and investment management processes is known, but precious little literature has been compiled to inform families on best practices. Charles Lowenhaupt brings up an even more "out-of-the-box" concept when he notices that families are becoming increasingly global, which creates problems of, at times, virtually unlimited complexity. How does one deal with different, if not directly conflicting, legal systems, principles, or definitions? With conflicting philosophical, religious, or cultural systems? The list could go on. Other interactions also worth considering relate to risk management, defined here as relative to investments and assets. In a world where the hitherto virtual total dominance by the U.S. and its culture is no longer the case, how important is it to introduce cultural diversification within one's manager stable? How does one diversify government risk, defined in a multiplicity of ways, ranging from the radical risk of confiscation, to that of regulatory, taxation, or politico-economic change? I have kept a favorite of mine for last: How should one deal with illiquid assets? How do they relate to the whole of the portfolio, and how should they relate?

The astute reader will have noticed that your humble editor is more adept at raising issues and asking questions than at providing answers. Yet, after all, this is the mission that we set out to accomplish when *The Journal of Private Portfolio Management*, subsequently renamed *The Journal of Wealth Management*, was created. We initially wrote, "This is the premier issue of a new Journal that will provide a forum for exploring investment issues relevant to individual investors." But we quickly recognized that the task was broader: we needed to shift our focus from investment issues to the much more challenging task of helping individuals manage their wealth.

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The Winter 2008 issue of *The Journal of Wealth Management* continues with the tradition of dealing with a number of important and interesting issues with several themes, although we have attempted to privilege interactions between multiple disciplines. A few months ago, we invited authors to submit articles to celebrate our 10th anniversary, and the response has been so overwhelming that we need to spread these excellent pieces over more than one issue. We apologize to authors whose articles were moved to the upcoming Spring 2009 issue.

The first article, by Charlotte Beyer, supplements this letter in that she considers the changes she has seen in the market place, principally through what she sees as the shattering of myths about the proverbial individual investor. The next three articles focus on important qualitative elements of integrated wealth management. First, Jay Hughes offers important thoughts as to the value of altruism and observes that it can lead either to entitlement or to enhancement. Then, Charles Lowenhaupt discusses a few of the main complexities associated with the needs of global families. Finally, Lisa Gray uncovers the basis for goal formation by showing how the roles family members perform identify the needs and goals of the family and of the individual members within it.

The next four articles relate in some manner to the formulation of an investment policy. First, Jarrod Wilcox offers an enhancement to the discretionary wealth management approach he originally proposed to drive strategic asset allocation by incorporating some notion of the uncertainty with which the particular investor's discretionary wealth is estimated. Next, Ashvin Chhabra, Ravindra Koneru, and Lex Zaharoff expand on prior work focused on goal-based allocation structured around three different goals: 1) Protect one's minimum wealth level, 2) Maximize the probability of maintaining one's standard of living, and 3) Provide an opportunity to reach for "aspirational" goals. Stephen Horan and Ashraf al Zaman then add to the current asset allocation literature by incorporating an asset's cost basis, addressing a broader array of taxable entities, and deriving expressions for off-diagonal terms in the covariance matrix. Finally, William Reichenstein revisits a very important concept and discusses its implications in more depth than hitherto.

Though it is unfair to group the next three articles as they differ greatly from one another, we will allow ourselves that error for ease of presentation. Ray DeGennaro's article focuses on an important alternative measure of risk: the concept of value at risk. Scott Welch then works to explain the core/satellite portfolio construction approach in a manner readily accessible to wealthy clients. Finally, David Jacobson introduces and discusses the challenges associated with estate planning for art collectors.

Jean L.P. Brunel
Editor

Publisher's Note
This issue marks the 10th Anniversary of The Journal of Wealth Management. *After a great first decade, we have decided to invest in some renovations. The most obvious change is our front cover. Starting with this issue, our designer will be working with international galleries and with the artists directly to feature original contemporary art from around the world. We plan to feature artwork for JWM's cover which is both aesthetically pleasing as well as a possible investment opportunity; both are in the eye of the beholder. As the global community takes shape we will work on sourcing more articles internationally to keep JWM fresh and timely with a global perspective. Lastly, in 2009 we are scheduled to launch a new website for the IIJournals. The new website is being built with the researcher in mind, with lots of wonderful features to help you with your analysis. If you have questions or comments, please don't hesitate to contact me directly at Institutional Investor.*

Allison Adams, Publisher