The Journal *of* Wealth Management

VOLUME 11, NUMBER 4 SPRING 2009

ON THE COVER

Kusho #1, 2006 *by Shinichi Maruyama*
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Shinichi Maruyama : Kusho
January 15 – February 21, 2009
Bruce Silverstein Gallery
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The serious economic and resulting capital market difficulties experienced in the U.S. and worldwide offer a great opportunity to reflect on relationship management issues. In this letter, I would like to highlight three important insights that wealthy individuals and families have indicated did make their experience of the most recent market debacle less painful or more bearable.

The very basis of these insights is that one of the most important elements behind discomfort is the fact that challenging conditions create fears of the unknown. Investors and wealthy families are suddenly presented with an environment with which they are not familiar and stress sets in. That stress can take a number of forms, but it often revolves around worrying that their eventual goals will not be met. Fearing that their future is no longer "certain," they begin to entertain all sorts of scare scenarios, which is often not only not helped but in fact compounded by attention-grabbing press headlines. From behavioral finance, we know that individuals frequently will be poor forecasters and tend to overreact to chance or simply recent events. We also know that they may well feel like shifting horses in the middle of the race and how expensive this can be in the long term. Thus, the responsibility of advisors revolves around both helping families to keep doing the "right" thing and providing them as much comfort as possible while doing so.

Though advisors at times have had the luxury of seeing more than one economic or market cycle, many investors or wealthy families have not. This latter point is important because we need to appreciate that "living" through difficult times means not only having been alive and conscious when they were happening, but also having a connection to them. Thus, a sharp equity market contraction may be an event that is perceived differently by someone who was just a casual observer with no stake in it and by someone else who has material financial commitments to it. Many families or individual investors may well have been alive and economically active during a few of the last capital market crises, but that does not mean they experienced any of them. They would only have experienced them, in this definition, if they were active investors at the time and if the crisis had a material impact on them. This is where the difference is so crucial between advisors who make a living dealing in financial markets and families that may only have been vicariously involved.

Thus, the solid relationship management advisor will work to help the client set up in a way such that the uncertainty associated with difficult business conditions is minimized. Recently, I was told of a great illustration of this principle. A client apparently told his advisor that the one thing that helped him go through the recent challenges had been the impression that he had "already lived through that." In truth, the client had never lived through such difficult conditions. But his advisor had led him through a series of hypothetical scenarios that helped the client recognize the situation when he finally experienced it. Familiarity is best created through experience; yet, when this is not possible, the best alternative is to build a form of "synthetic experience" through extensive scenario analyses.

PLAN AHEAD

The first principle has to be that one should help clients live in both the present and the future. Managing wealth is indeed very much about helping clients identify their dreams and find ways of bringing them to reality. How sad would life be if one came to argue that one has achieved all the dreams that one ever had; except maybe if that was to be one's last words….

Planning ahead involves three important activities. The first relates to keeping the family's list of dreams under perpetual review and to make it clear that this is the primary utility of their wealth. Making sure that one fully understands that connection is primordial—this is what makes families tick. The second involves recognizing that dreams can take many forms. This requires the skillful advisor to understand how circumstances might change with adverse impact on these dreams: Said differently, let us not simply assume that the loss of some wealth is the stressful element. How about the realization that one may not be able to contribute to one's favorite charity, either for pure philanthropic reasons or more prosaically because of some possible loss of face from no longer being able to contribute?

The third involves recognizing that, in the end, great relationship management starts when times are very good. Human tendencies being what they are, it is often the case that relationship managers have less time for their clients in good times. That is indeed when opportunities to build their business may appear to be the best and most plentiful. Thus, existing clients can be a bit short-changed while time appears best spent on business development. This is made possible by the fact that clients are generally happy in good times and thus may need less handholding. Yet this is a beginner's mistake. While good times do make some of the job easier, they offer plenty of opportunities both to tackle issues that might otherwise seem impossible to address or simply to plan ahead. Consider a straightforward asset management relationship. Good times, defined as periods when returns are good in both absolute and relative terms, remove some of the possible tensions that can creep in between the advisor and the client. Rather than "enjoying" that period as a brief—but deserved—respite until such times when challenges resume, the smart relationship manager will use it to raise the difficult questions; to highlight the limits of great performance; to point to areas where improvement could be made; to ask for more detailed feedback on what the client likes and dislikes in the current environment; to anticipate what might go wrong and discuss it before it happens. In short, with a few of the classical stresses removed, good times are the best time to deepen the relationship so that one increases even further the chances of exceeding one's client's expectations when business conditions are less favorable.

COMMUNICATE

Challenging market conditions at times lead individuals to feel deserted or abandoned. They potentially bring despair that what seemed well-ordained is now being threatened. Remember that for many families, managing the assets is but a minor portion of the focus, often not much more than a means to an end. As suggested earlier, discomfort comes from fear of the unknown. Hopefully, the planning undertaken both at the onset and through the life of the relationship while things were good will have created the right kind of foundation, one where the family is aware, in an explicit rather than implicit mode, of what could happen. Now, the bad stuff is happening and more is needed from the relationship manager. Solid communication also can be viewed as comprising three elements.

The first is, whenever possible, to place the current environment in some sort of perspective. Using various comparisons to different times and even places, one can begin to make sense of the current environment, of what may be causing the problem, and of how that challenge might play out. Ideally, this also involves recalling, in a humble rather than proud manner, that the current environment was within the range of outcomes that had been anticipated. The second element of solid communication is to keep helping the family see through the maze of information that bombards them every day. Simple factual analyses will do a lot to help the family place the event and current developments into the proper perspective, appreciating what is noise and what may be serious information on which some action might be needed. This is in fact the third element—being not only prepared, but proactively reviewing whether the current environment justifies a change in strategy. Although this should rarely be the case, it may be that a sufficiently dire event or chain of events ought to lead to a revision of the family's policy.

This revision can take at least a couple of forms. In the context of a goal allocation-based strategic investment policy, it may well be necessary to review decisions made when the assets available to the family were much larger. Something similar would be needed and effectively quasi-automatic in the discretionary wealth management framework described by Jarrod Wilcox. Another potential reason for revisiting one's policy might simply be the observation that some fundamental change is so serious as to require a serious rethinking of capital market assumptions or even optimization techniques. What if one felt that returns are decidedly not normally distributed? What if one felt that the definition of diversification must be changed from a statistically dominated base to much more of a qualitatively determined focus?

BE STRAIGHTFORWARD AND HONEST

The final insight is that there no substitute for honesty. Particularly, but not solely in the case of advisors working within institutions who happen to have specific products and services to sell, the temptation can be very high to try to protect one's backside by finding excuses. This can take many forms, but the most classical involve changing the way performance is assessed, discussing special situations, or blaming the market. While there may well be quite a bit of truth in any and all such excuses, many, if not most, of the families whom I have known invariably tell me that excuses are a massive turn-off.

One of the first things a client expects is empathy, which starts with an honest observation that one is just as disappointed as the client. Wealthy families and individuals—not to say most investors—expect their true advisors to be on their sides, to look at their clients' assets as if they were their own. Thus, when actual results fall short of expectations, it should not be too hard to admit to that as an absolute first step. Clearly, there is a time and a place to look at results in an analytical manner and to separate the wheat from the chaff, but that time hardly ever is at the beginning.

Honesty involves more than simply expressing empathy. This is where serious analysis may be required both to understand how one got to where one is, but what could have been done differently. I can imagine readers saying that the last thing one should want to do is to encourage hindsight. There is truth to that. Yet, being honest and pointing to some rational—as opposed to irrational—determination of what signal might have been missed and what that meant will provide the ideal framework and opportunity to help a client distinguish between foolish hindsight and constructive self-criticism.

Difficult capital market environments do not, thankfully, occur too frequently. Yet, when they do, they provide great opportunities for top-flight advisors to consolidate their business and even gain new relationships.

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The first two articles in the Spring 2009 issue of *The Journal of Wealth Management* are among the longest we have ever published. Yet, they both constitute such fundamental pieces that we feel they are well worth the space dedicated to them. First, Dennis Jaffe and Fredda Herz Brown delve into the issue of entitlement and focus on how parents can be helped encourage the development of a sense of stewardship in their children. Robin Miranda and Joachim Klement look into the issue of trust in business and extend that notion to wealth management, making the very important point that the advisor's interest in the well-being of the client must be genuine and not simply a marketing gimmick. The third article in this first group relates to the business of wealth management. Magali Dubosson, Emmanuel Fragnière, and Nils Tuchschmid conduct a thorough literature review related to the production aspects of wealth management, describe the investment process schematically as it has been adopted by most "industrialized" wealth management entities, and conclude with several arguments that could lead to new research directions in wealth management.

The next three articles are more specifically focused on traditional wealth management issues. In the first, Bruce Paulson revisits the issue of asset location in the context of the integration of all wealth management services and in the light of specific changes in the legal and regulatory framework. Next, Robert Gordon looks into the pitfalls created by regulators to control the ability for holders of low basis stock to diversify their risk in a tax-efficient manner and

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concludes that the exercise is still possible provided one is careful in terms of both design and execution. Finally, David M. Stein, Vassilii Nemtchinov, and Sam Pittman focus on the management of emerging market equity portfolios, concluding that a structurally rebalanced portfolio will likely outperform one that simply replicates a capitalization-weighted index.

Our last four articles focus on various aspects of life insurance. The first, by Huaxiong Huang, Moshe Milevsky, and Thomas Salisbury, focuses on retirement income insurance that would help individuals protect against longevity risk and retirement "ruin" in an economically efficient manner and argues that the product actually already exists. Then, Miles Padgett discusses the income taxation of insurance and annuity products, how those products function economically, and the advantages and disadvantages of accessing those products through privately placed contracts, as well as reviewing examples of how such privately placed products could operate under a robust set of economic and other assumptions. Teresa Wells next looks at private placed life insurance as a tax-managed wealth accumulation and transfer strategy. Last but not least, Richard Harris takes a look at the ways life insurance can be made a part of an overall wealth management strategy.

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Editor