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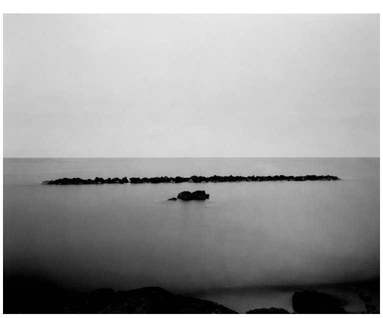
ON THE COVER



Anzio 1944, Yellow Beach, 2004
28" x 33" Chromogenic Print

Bart Michiels *(b. Belgium, 1964) makes photographs of European landscapes that are both beautiful and contemplative while tracing the history of Europe through the wars that it has waged. Michiels carefully chooses sites marked by significant battles that have been turning points in shaping destiny and our world history. His photographic project,* The Course of History, *refers to how these wars of the past defined the future of the world and how war has become an essential part of our history. Bart Michiels is represented by Foley Gallery in New York City. Visit the gallery website foleygallery.com to view more works by the artist.*

The current politico-economic debate brings to mind a crucially important lesson: the need to be able to distinguish between reality and fiction. It is indeed an unfortunate reality that a frequently enough repeated fiction can be perceived as and eventually become reality. Though this may be true in practice, it is one of the major dangers against which investors must try to protect themselves. This suggests five important lessons to this humble observer.

1. Facts remain our most reliable friend. The recent debate on the sovereign debt crisis is a very useful illustration of the need to remain a slave to facts. Even a detailed reading of most of the press in the U.S. over the last three months would lead the casual observer to believe that most of Western Europe is in dire straits while the U.S. is in solid fiscal shape. Nothing could be further from the truth, particularly when state and federal obligations are combined. Whether in terms of total "state" debt to GDP or fiscal deficits to GDP ratios, the U.S. is among the worst positioned countries in the developed world. The data needed to support this latter assertion are readily available, for example in the IMF World Economic outlook database, which is published twice a year. It is hard to understand how one could be a long-term success in the investment world if one is not prepared to carry out the most elementary analysis into the fundamental facts that underpin reality. Although one could thus easily be wrong in the short term, as one deviates from "accepted and perceived" wisdom, one would need incredible intellectual contortions to argue that, in this as in many other instances, there is not a great deal of value in the knowledge of the factual basis of current developments.

2. Opinions are relevant, but must be fact-based. In an environment dominated by both long-term trends and a plethora of information, the ability to form an opinion is another major element of likely success. The long-term nature of selected trends is such that one will likely need to form an opinion on what is actually happening before having collected all the information that is available. Markets are known effectively to anticipate and discount future developments. This exposes the individual who wants to have all the possible information to the proverbial paralysis by analysis. Yet, the understandable desire—nay, necessity—to take the occasional shortcut cannot be confused with the tendency to jump to conclusions or to be unprepared to change one's mind if some disturbing new element comes around that challenges the hitherto accepted wisdom. Thus, educated guesses, which investment opinions often are, can save time and, most importantly, provide useful opportunities to profit from one's insights. Yet, one must first base these on irrefutable facts and, then, be prepared to evolve or change that view if new data comes to the surface. Parenthetically, one must also avoid the temptation to compress something that should take some time in a shorter than reasonable time frame, just because one believes that one's thinking must evolve or that one has to be in tune with the 24-hour news cycle.

3. Ideology should be our biggest enemy. Ideology is defined here not in political terms but in a much simpler, more practical fashion: It is the tendency to prefer certain outcomes irrespective of the evidence. The political world offers a useful example, but it is not the only area where ideology is at play. When evaluating various desired policies, one should be prepared to discuss what it is that is "right" from a given point of view and what the alternatives might be, together with their "costs" that make them less desirable from that same point of view. The use of misleading spin or gimmicks to make certain recommendations more likely to gain acceptance by hiding their costs and overstating their benefits should be avoided. Similarly, any form of personal conflict should be disclosed, not because this conflict makes the analysis wrong, but because it can lead one to make certain simplifying assumptions driven by biases or preferences and not by facts. The most obvious example relates to an instance where a policy is likely to have certain unfavorable economic implication, all the while serving some desirable social purpose. A full disclosure of the pros and cons or of the terms of the inevitable trade-off can help guide a proper debate where all views are given equal weight: Why should it be so that lower economic growth is necessarily "bad" if it yields some desired social goal? But simultaneously, why is it that some desired social goal should necessarily be viewed as most important irrespective of its economic cost? Different people will have different views on this trade-off, but how can one be sure that the optimal decision is reached if the debate has served more to convince by obscuring inconvenient elements than to present a clear alternative? Being able to determine whether any debate is couched in the proper terms will help the insightful investor to the right evaluation process.

4. Relativism is the key. One of the most challenging elements of the current environment is illustrated in the views offered here or there that some "objective" value exists. Last quarter, I looked into the challenges that a hypothetical Japanese investor might have faced as he or she contemplated the local stock market a few quarters into what has turned out to be a 20-year bear market. This is brought to life today when one hears this or that manager, or investor, profess a form of "certain" knowledge as to the attractiveness—or lack thereof—of various equity or credit markets. In a steady state, such objective analysis is already debatable; it becomes downright dangerous when one assumes the possibility that one is at some important secular changing point. How much simpler the problem becomes when it is analyzed in purely relative terms; consider this: if I have a view as to what the outlook is for a certain fundamental variable and if I can determine what the market's view of that same variable is, is it not a simple fact that prices should move in the direction determined by the difference between my view and the market's? This will happen as the market gradually adjusts its views to reality—defined here as my view—and discounts it into current prices. One will object that I may be wrong. This is certainly a fair objection, but what value is there to any analysis if I do not assume that my best efforts will lead to my being correct? The width of the difference between my views and those of the market, together with my own conviction in my own view, should serve as the basis for determining the risk of that decision.

5*. Cultural diversification has become irreplaceable*. The increasingly clear trend toward a more global capital market and the danger that the world's economy may be reaching some form of geographical inflection point make it crucial for one to be prepared to consider a wide range of opinions. Although this should not come as a surprise to many of our global readers, it may prove a difficult challenge to those who have maintained more of a domestic focus in their investment analyses. Years ago, we used to differentiate between global and domestic investors, defining the latter as investors primarily concerned with their home circumstances and the latter as "citizens of the world." This simply reflected the well-known "home bias" that tends to make us more comfortable with our own environment and thus more prepared and willing to accept a disproportionately large exposure to our home markets. Yet, with most investors being price takers rather than price makers, it becomes a simple matter of survival for anyone to be informed as to the range of views that are held by market participants, worldwide, on any current development. For instance, with Asia a major buyer and holder of U.S. Treasury securities, how can one invest in U.S. Treasury bonds without being clearly informed and aware of the views of these investors as to the sustainability of U.S. fiscal policies, the likely persistence of the status of the U.S. dollar as the world's safe haven, and several other related considerations?

An important final element relates to the danger of allowing emotions to creep too far into the process. A very astute investor recently said something quite insightful to me: "I am not sure I can deal with the consequences of this being true." The "this" to which he was referring was a scenario that involved quite dire politico-economic implications for his home country, here, the U.S. Although totally understandable in a gifted young individual totally dedicated to his country, it brought out another important source of potential error: in this case, the inability to distinguish between reality and fiction did not come out of a form of intellectual laziness. It was the result of an emotional challenge that made it impossible to accept the consequences of an honest analysis. I can easily sympathize with such a challenge, having had a firsthand opportunity to see the continuing disbelief of many Japanese investors as their bear market and economic downturn kept unfolding with apparently no end in sight. Yet, history in this instance clearly tells us that those who were successful were the investors who were able to look at the harsh reality, accept it, and deal with the opportunities it created.

One is here reminded of the analysis that contrasts the fate of Jews and overseas Chinese to that of landed aristocracy in France or the U.K. Jews have historically been chased throughout the world, and yet they have survived and prospered. Similarly, many Chinese families felt they needed to leave their motherland when they saw the rise of Communism. Many, if not most, also prospered. The common thread is that the successful ones were always ready to leave, engaged in businesses that did not tie them to a single location, and focused on education in skills and trades as commodities that would be valuable anywhere. They worked to maximize their flexibility to pick up and leave if there was a problem, and they never allowed ties to some land, physical or emotional, to constrain them. Consider the contrasting histories of Rabbi Isaac Abrabanel (Treasury Minister in Spain) and Rabbi Abraham Seneor (Leader of the Congregations and Advisor to the King and Queen) during the Spanish Inquisition. They both had become quite wealthy and well-respected when they had to deal with the order by Queen Isabella and King Ferdinand that all Jews should leave Spain or convert to Catholicism. While the former left and settled in Venice, the latter could not abandon his worldly goods and converted, earning for himself shame in Jewish history! Contrast this preparedness to look reality in the eyes and to be ready to leave if needed to the fate of landed aristocracy, either in France or in England. The bulk of the family's wealth and status was local and tied up in land and buildings. Their trades were primarily agriculturally based and could thus not easily be relocated. Their educational focus was not on skills and trades, but on liberal arts, which allowed them to shine at the court of the reigning monarch. When trouble came, they were sitting ducks as they had nowhere to go and would not have been able to leave as they had too much invested in where they were, again, both physically and emotionally. The lesson for the careful investor is the need to avoid allowing emotions to creep up too much into one's thinking and to be ready to reconsider at all times.

Assiduous readers will view in these simple lessons an echo of a theme we discussed a few quarters ago: Intellectual honesty and rigor are keys to investment success. The late Sir John Templeton used to say that he had never seen any investor who was correct more than 65% of the time. Though this could be a bit of an intellectual downer, it is the essence of wisdom and should serve to promote humility. This humility is made necessary by the fact mentioned earlier that we usually are price takers rather than price makers. We are thus exposed to a wide range of possible outcomes, depending upon how others interpret the evidence that comes out on a daily basis as to how the key fundamental variables are behaving. That the range is wide requires staying power on the part of any investor; the alternative is to behave like the proverbial floater on the surface of the river—totally out of control. Such an investor is thus subject to the vagaries of the human mind, aptly described by behavioral finance. Usually, the process is not in doubt: buy high and sell low! Buy when everyone is excited and sell when everyone is depressed!

Intellectual honesty and rigor form the backbone of our likely staying power, and this for three reasons. The first is that one is much more likely to come to an insightful conclusion when one has taken the time to consider the various alternatives in some depth. The second is a second-degree effect, but it is no less important: the more detailed and honest my analysis, the more convinced I am likely to be and thus the less volatile my own humor is likely to be. Finally, the third relates to the ability that an intellectually honest and rigorous process provides to integrate new information. In short,

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irrespective of where other investors wander, intellectual honesty and rigor serve as anchors and thus protect investors against the risk of being unable to distinguish between reality and fiction.

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Our Fall 2010 issue of the *Journal of Wealth Management* maintains a great deal of diversity in both topics and the geographical distribution of authors, and its articles can be broadly divided into two main groupings.

The first four articles broadly relate to investment policy issues. First, Steve P. Fraser and William W. Jennings focus on investment policy statements and conclude that they should include a clear statement of investment beliefs, provide specific, measurable investment objectives, and avoid ambiguous descriptions of desired outcomes. They should also identify specific performance benchmarks, provide guidance on proxy voting, and offer appropriate rebalancing ranges around the target allocations. Then, Andrei Shynkevich takes a historical look at asset location issues and shows that changes in taxation, dividend, and inflation considerations have led the two opposite strategies he investigates to perform in radically different ways during the two halves of the period he studied. Third, Bala Arshanapalli and William Nelson revisit the classical question of the cost of diversification and conclude that, using changing correlations and potentially including more asset classes, diversification still enhances risk-adjusted performance. Finally, Hubert Dichtl and Wolfgang Drobetz look at the constant proportion portfolio insurance (CPPI) strategy using elements of behavioral finance to explain its popularity and provide hints as to how a CPPI-based investment product should be designed in order to best meet the preferences of a prospect theory investor.

Our next four articles relate to specific areas of an investment portfolio. First, Ramon DeGennaro considers "angel investors" and describes the advantages and disadvantages of angel investing, suggesting ways for investors to extract the maximum benefits—both pecuniary and non-pecuniary—from angel investing. Then, Greg Gregoriou, a member of our Advisory Board, and Razvan Pascalau consider a simple trading strategy focused on funds of funds (FOFs), concluding that selecting (up to) the six best-performing FoFs is a winning strategy that outperforms both the market and the benchmark FOF indices. Then, Natalie Dempster and Juan Carlos Artigas offer insights into the potential role of gold as an asset class, a topic that can be viewed as exceptionally timely given recent developments. Finally, Joachim Klement and Yves Longchamp, noting that many families face increasing complexity in the area of currency risk management, describe the sources of currency risks for global families and suggest ways to manage them for ongoing living expenses and cash flows as well as the long-term investment portfolio.

Our final two pieces do not fall into a neat category, and yet offer very insightful comments. First, Tom Arnold, John Earl, Jr., and David North ponder the important issue of the influence of the press on investment performance, considering firms featured in cover stories collected from *Business Week*, *Fortune*, and *Forbes* over a 20-year period (1983–2002), and conclude that positive cover stories are often followed by abnormally low performance in stock price on a risk-adjusted basis, although the returns are still positive. Finally, Greg Gregoriou reviews two books (*Enough: True Measures of Money, Business, and Life*, by John C. Bogle, and *No One Would Listen: A True Financial Thriller*, by Harry Markopolos) bringing together an industry giant and a truly dogged financial investigator, suggesting that the "system" might work better if it had Bogle as the SEC frontman and Markopolos digging into corruption wherever he could find it.

Jean L.P. Brunel
Editor