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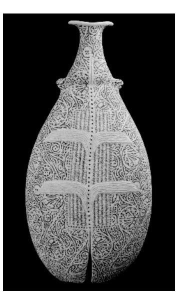
ON THE COVER



Inannah V
Handbuilt Earthenware, 2009
26.75 x 13 x 7 inches; 68 x 33 x 18 cm

Avital Sheffer *(Israeli/Australian) is a ceramic artist based on the north coast of NSW, Australia. The artist's work primarily consists of large, free-form, ceramic vessels with hand-painted designs of filigree and written Aramaic script to the central frieze. The artists' work is a reflection of her native country of Israel and her deep appreciation of Middle-Eastern culture and design. The artist is known for intersecting the style of antiquity with the technique of contemporary design. Avital Sheffer is represented by Cavin-Morris Gallery in New York, NY, and seen throughout Europe and South East Asia.*

Visit www.cavinmorris.com to view more works by this artist.

Once in a while, a series of seemingly unrelated events reminds us that there is a great need to go back to first principles.

A self-professed trader proclaims that he has dreamed of a recession and that he does not care about fundamental developments: his job is just to make money. A broker executes a block trade at a price, which is very disadvantageous to his client, because he needs the commission to make some quota and consolidate his bonus. A financial advisor suggests a particular strategy to a client, because it can be implemented through a product that will increase his compensation. Official inspectors delve into compliance audits and miss some egregious exaction, because they follow rules rather than try to understand what is happening. The list could go on, but the case is made: ethics cannot be regulated by rules; one needs a few broad principles.

For many years, our industry has increasingly moved toward specific rules in a bid to protect clients. These rules have illustrated the intellectual fallacy that holds that one can regulate honesty and fiduciarily responsible behavior. Reality demonstrates that the more specific rules are, the easier, paradoxically, they make it to navigate around them. Moving ethics out of the realm of values and into the compliance and regulatory space has effectively failed us.

Mathematicians know that any model must, by definition, be but a simplified version of reality. After all, why does one build a model? If reality could be understood in all of its inherent complexity, one would not need a model, would one? However, reality is frequently too complex to be readily apprehended. Thus, one is required to make a number of simplifying assumptions to be able to understand it. At the same time, one does not take all the conclusions suggested by a model at face value. One shades them bearing in mind the nature of the original simplifying assumptions, so that the eventual conclusions are brought back to the natural complexity of reality and are, thus, actionable in the real world. What does this have to do with our current topic? Arguably, it is at the center of our debate.

At some theoretical level, indeed, one could postulate that rules can be so air tight as to allow one complete control over an entire decision or implementation process. Yet, just as mathematicians know that reality is often too complex for models, a practical mind would recognize that there are multiple ways in which a small variation in one or another element of any process can make the

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hypothetical air-tight rule nothing more than a mere sieve. Consider generic compliance processes. They are engineered typically to provide some measure of control over individual behavior and either promote regulatory compliance or avoid inappropriate behaviors. Yet, they will always reach their limits of validity in special circumstances.

One could argue—and the argument is certainly valid—that it is better to promote general and broad compliance in most cases, even if it means missing out in unusual circumstances, than to be exposed to the risk of serious fraud because of being unable to reach perfection, one eschews compliance altogether. This is the regulatory analog of, "better for ninety-nine guilty individuals to go free than for one innocent to be wrongly convicted." One might, however, wonder whether this form of syllogism is really appropriate, or is just a simple cop out where movement is mistaken for progress.

Indeed, rigid rules are often promulgated, because of a mistaken belief that one should treat everyone in the same way. Thus, one supervisor is ipso factor considered necessarily equivalent to any other supervisor; no-one can have a better appreciation of nuances. Similarly, all supervisees are equivalent to one another; no one can justify taking different circumstances into consideration. Finally, all circumstances must be equivalent and treated in a similar manner, so that one can avoid capriciousness. While starting from a laudable concern for fairness, such logic fails to provide adequate flexibility for supervisors to take all elements into consideration, weigh them appropriately given the circumstances and exercise their legitimate right to judge. In fact, a cynic might argue that they are designed more with the view to protecting supervisors in the event of a suit than to promote true fairness.

Reality should be treated as such: it is, but a set of specific circumstances should be assessed through some value prism to arrive at the appropriate insight or judgment. Using basic principles rather than rules offers a much greater scope for "doing the right thing at the right time." It ensures that no short-cut can be taken; it also ensures that one cannot create any loophole because of sloppy rule writing or mildly changing circumstances that the rules had not anticipated. It leaves the potential rule-breakers in the dark as to what might really constitute an offense. As an illustration, consider the classic security warning heard by travelers on U.S. airlines: "Federal law prohibits tampering with, disabling, or destroying smoke detectors," with the similar clause most often heard in overseas airlines: "tampering with smoke detectors is prohibited." I am sure that a sharp legal mind could argue differences between the words "destroying," "disabling" and "tampering with." It might even point to some increase in the severity of the offense. Yet, for most non-legal minds, the question boils down to this: is it possible to destroy or disable a smoke detector without tampering with it? If not, why not simply focus on the one that must be at the origin of the problem?

Thus, wealthy families—because this is still our primary focus—are asked to sign increasingly complicated contracts or waivers without being necessarily sure that they will be served in a more ethical manner. Similarly, service providers are asked to follow increasingly detailed and onerous compliance procedures—and subjected to audits to verify such compliance—without gaining any real confidence that it will provide for a better client service. After all, if regulators could miss several of the most egregious scandals of the last 20 or 30 years, should it not give all of us and all of them reasons to pause? Does it not potentially indicate that they and we may not have had the correct focus?

Investment managers know that their decisions will only be correct some percentage of the time—the late Sir John Templeton used to say that he had never seen an investment manager be right more than 65% of the time. Thus, they design investment processes based on a philosophy, which accepts that philosophical truth. Depending upon their convictions, they will either accept the material volatility associated with occasional undiversified major bets, or diversify their bets in a way that a couple of wrong decisions do not destroy the client or their own business. Some analogous process would help regulators and supervisors better control and monitor ongoing activities. Certain areas probably cannot suffer any error—the "fail safe philosophy, which underpins certain industries"—while others offer a greater room for inaccuracies, which can be fixed without dramatic consequences.

Thus, when looking at service providers in the wealth management space, it is important for wealthy individuals and families to recognize the limitations of regulatory and control procedures. They should therefore exercise principle-driven due diligence in their evaluation of the service providers they select. Ensuring a solid overlap between their and their service providers' values can indeed help protect against future worries. When there is little, or no overlap, it is important to understand what this might mean. In short, this would ensure in the words of John Pierpont Morgan that "errors of judgment may be deplorable, but they are acceptable; errors of principle are unacceptable."

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The Winter 2011 issue of *The Journal of Wealth Management* starts with three articles, which share a focus on broad issues. The first, by Joachim Klement, takes an interesting perspective arguing that the starting and ending point of the wealth management process is risk management. The second, by Jean Brunel, revisits the goals-based wealth management process in practice, starting from the premise that the industry is now ready to adopt that approach. The third, by Murad Antia, suggests that investors may not understand the wealth-destroying implications of their investment decisions, because of the deleterious effect of volatility of returns on wealth creation and proposes that managing the volatility of returns is integral to creating long-term wealth.

The next two articles share a concern for the potential impact of inflation. The first, by John Twomey, Jason Foran, and Conor Brosnan, examines the extent to which various asset classes, including managed futures, stocks, bonds, commodities, and gold, have hedged against inflation, suggesting that managed futures provide a robust hedge against inflation, increasingly so over longer time frames. The second, by Michael Grelck, Stefan Prigge, Lars Tegtmeier, Mihail Topalov, and Igor Torpan, empirically investigates four real assets for which there are investment instruments available, which trade in liquid markets and presents four sets of interesting results.

The next two articles relate to two specific technical investment issues. The first, by Marc Freed and Ben McMillan, focuses on the real alpha generated by hedge funds and suggests that recent innovations in hedge fund replication permit us to estimate the extent of the misattribution between skill and market returns. The second, by James Chong and Michael Phillips, focuses the inherent potential inaccuracies in the estimation of beta, suggesting that it is common for the estimated beta to be more extreme in value than either the up-market or down-market beta for a given asset.

Our final two articles cover specific investment categories. The first, by Katsiaryna Salavei Bardos and Nataliya Zaiats, explains how common misconceptions about residential real estate returns contribute to unrealistic expectations about house price appreciation. Last, but not least, is an article by Razvan Pascalau, which uses a sample of 66 UCITS to find that the risk-adjusted performance of some typical hedge fund strategies outperformed the corresponding traditional hedge fund indices over the January 2006 to March 2010 period, however, often, with higher volatility.

Jean L.P. Brunel
Editor