Downloaded from https://jwm.pm-research.com by guest on September 27, 2021. Copyright 2012 Pageant Media Ltd.

The Journal *of*
Wealth Management

VOLUME 15, NUMBER 3 WINTER 2012

JEAN L.P. BRUNEL Editor

HARRY KATZ Video and Print Production Director
DEBORAH BROUWER Production/Design

CATHY SCOTT Editorial Manager

ANNA LEE Marketing Director
LAURA PAGLIARO Senior Marketing Manager
SHARON CHIEN Marketing Manager

ERIN SCANLON Global Digital Sales Manager

PETER JUNCAJ Head of Subscription Sales
SARAH ABDELAAL Account Manager
SOPHIA SAAFIR Account Manager

DEWEY PALMIERI Reprints Manager

KELVIN LOUIE Senior Fulfillment Manager
EMPERATRIZ MIGNONE Fulfillment Manager

STEVE KURTZ Director, Finance & Operations
ALINA LEONOVA Business Manager

DAVE BLIDE Associate Publisher
SABRINA GLOVER Art Consultant

JANE WILKINSON President & CEO
ALLISON ADAMS Group Publisher

Cover design: Loewy Design

ON THE COVER

Canyon Walls #24
Madrone burl, bleached and unbleached, 2005
16.5 × 16 × 8 inches, 41.9 × 40.6 × 20.3 cm

***Christian Burchard** (Hamburg, Germany, born, 1955) is a German-born sculptor, having spent the majority of his career in the U.S., and known for his exclusive work with Madrone burl wood. The artist utilizes a technique called woodturning, which allows him to be experimental with form, and display a reflection of abstract expressionism. Burchard's accomplishments are included in numerous public collections throughout the U.S. and around the world. He has been included in numerous SOFA Art + Design fairs. Christian Burchard's work can be seen at Cavin-Morris Gallery in New York, NY. Visit www.cavinmorrisgallery.com to view more works by this artist.*

It is nice to see that goals-based wealth management—more specifically, goals-based strategic asset allocation—is gradually getting a greater following in the wealth management industry. The approach indeed helps advisors and families better understand how multiple goals and preferences should affect the way individual portfolios—and subportfolios—are strategically constructed. The more intimate relationship that thus prevails between a family and its financial assets is one more element of the protection the family needs against decision risk, which we have been defining as the risk of changing horses in the middle of the race. The intuitive appeal of goals-based wealth management to individuals has been its primary strength, reflecting the otherwise daunting challenge associated with defining some unifying return and risk profile, which very few noninvestment professionals can do. In all humility, I should add that even though I have been an investment professional for nearly 40 years, I count myself among those unable to define their own return and risk profile!

As we gain increasingly relevant experience with the goals-based wealth management approach, however, we also learn that our earlier efforts need to be refined. For instance, following the road mapped for us by Wilcox in his article defining discretionary and nondiscretionary wealth, we have been assuming that individuals want to allocate all assets not needed to achieve a stated goal—which Wilcox called discretionary wealth—to some "growth" objective.[1] Yet experience seems to be suggesting that not all individual investors find that implicit decision to be acceptable.

In 1936, John Maynard Keynes published *The General Theory of Employment, Interest, and Money*, a seminal book in which he defines the concept of liquidity preference. Keynes's theory postulates three rationales for wanting liquidity: to facilitate transactions, protect against times of trouble, and speculate that bond prices will fall. In fact, he argued that the demand for liquid money should depend on the interest forgone by shifting from higher-interest-paying bonds to lower-interest-paying cash. This theory helped clarify the hitherto widely held notion that interest received from fixed-income assets was a reward from refraining from consumption and thus for saving; he argued that one could keep one's savings in cash hidden under a mattress and thus be saving (i.e., refraining from consuming) and yet not be paid anything. This concept is understood today as meaning that individuals should prefer liquidity to illiquidity, all else being

equal. It is therefore the essence of the argument that one should be paid to forgo liquidity.

In a somewhat similar, although considerably humbler, way, one is tempted to argue that there probably is some growth/capital preservation preference that advisors would be well advised to discuss and elicit when helping their clients determine their strategic asset allocation. In other words, advisors should refrain from assuming that any "excess assets" their client might possess—excess meaning "not needed to meet specified goals"—should be allocated to growth objectives.

In practice, this means that individuals whose assets exceed a level required to meet currently stated goals might not necessarily choose to risk their "excess assets." They might prefer instead to protect them against either some absolute loss of capital or, at the very least, loss of purchasing power. It may be interesting to note the parallel between this and the concept of surplus management, which was common in the U.S. pension industry in the 1980s. This idea, which came out of the move toward bond immunization and eventually contingent immunization, postulated that pension sponsors should be prepared to risk any excess asset—or surplus. Although it may have made sense at some point, certain sponsors might have argued that a surplus that was cautiously managed might reduce the risk of their contributions to the defined-benefit plan having to increase at some future date.

Helping individuals decide how much growth is needed or desirable is therefore fundamental to the advisory dialogue and should not start with the premise that growth must be the default option. We have looked at a few questions to consider to justify growth in prior letters and articles, but it may be useful to mention our current top four: a) protect against future unanticipated inflation; b) protect against the generational fragmentation of capital, as it grows in a geometric manner while the number of family members might grow more rapidly; c) protect against the inability to change one's lifestyle, for instance, by becoming more philanthropically oriented; and d) protect against decision risk, as too cautious a portfolio might be untenable during particularly high-return periods in risky assets.

Experience indeed suggests that families that do not "recognize themselves" in any of these may well be more comfortable investing their "excess assets" in a strategy that is less risky than growth. It is not unusual, for instance, for a family to choose to be more aggressive for their dynastic (and at times philanthropic) endeavors and considerably less aggressive for the assets still held in their names. Note that these assets would naturally comprise the funds needed to satisfy their lifestyle needs. But they may also extend beyond them as well. Whether this reflect some theoretically suboptimal risk aversion or not, one would be well advised not to be judgmental; one should rather interpret such a position as a preference for capital preservation. Conversely, one can interpret the decision to seek growth with any excess asset as a preference for growth.

Although such a dichotomy will have a considerably more modest an influence on the macroeconomic scene than Keynes's liquidity preference, it seems to represent a humble conceptual equivalent that should help wealth advisory professionals refrain from a rush to judgment. In recent client situations, I have been privileged to see how the flexibility to choose either the growth or capital preservation options appeared to "liberate" families and remove any residual guilt associated with the perception that they were not "reasonable."

In fact, over time, it is not unusual to see families modify their growth/capital preservation preferences. This probably simply reflects the natural self-educating process at work, as families with little or no prior personal experience with the vagaries of capital markets eventually become less focused on the short to medium term and more tolerant of what might initially appear to be unacceptable return fluctuations in the higher reaches of the return spectrum. The converse is also true. Certain families determine that seeking growth—because it is the thing to do—may be preventing them from "being" or living in the present, as they cannot, and may never, become comfortable with these fluctuations. To this humble observer, the very fact that such a dichotomy might exist across the wealthy family spectrum may be the strongest argument for seeking to elicit the preference that any given family has between growth and capital preservation.

Downloaded from https://jwm.pm-research.com by guest on September 27, 2021. Copyright 2012 Pageant Media Ltd.

The Journal *of*
Wealth Management

The Winter 2012 issue of *The Journal of Wealth Management* starts with two articles dedicated to broad issues related to households and financial matters. The first is an article by Alex Wang which deals with the effects of knowledge, gender and age on the comprehension of investment disclosures; the author concludes that differences in gender, education, and knowledge affect comprehension of investment disclosures, also noting that male investors may be overconfident in their ability to understand investment disclosures, whereas an educated and informed investor provides the best defense against costly mistakes in investing. The second is a piece by Alessandro Bucciol and Marina Stuefer that investigates the link between portfolio risk and household characteristics, finding both a wide heterogeneity of risk across households and a number of common characteristics particularly with respect to age profile, and correlations between risk and wealth as well as income.

The next three papers are broadly related to strategic asset allocation issues. The first, by Bernd Scherer, focuses on shadow assets and liabilities; the author shows that adding shadow assets to a family's financial assets has two effects on investors, making them more aggressive and potentially creating demand for hedges, concluding that these need to be incorporated in the strategic asset allocation advice. The next paper, by David Laster, Anil Suri and Nevenka Vrdoljak, focuses on spending rates and asset allocations for retirees that minimize the expected lifetime shortfall for a Systematic Withdrawal Plan, showing that sustainable spending rates depend critically on a client's age, gender and risk tolerance. The third article, by Willi Semmler, discusses dynamic portfolio decisions with time varying asset and labor income, setting out a basic framework on a portfolio model for a financial fund that manages savings for retirement income and where the inflows to the fund are asset returns as well as labor income and suggesting a practical way to rebalance portfolios as new information on returns and labor income are available.

The next four papers focus on a range of different issues. The first, by Francois-Serge Lhabitant offers a simple look at two common beliefs in finance postulating that a high positive correlation signals assets moving in the same direction while a high negative correlation signals assets moving in opposite directions and that the mantra for diversification is to hold assets that are not highly correlated, explaining why both beliefs are not only factually incorrect, but can actually result in large losses in what are perceived to be well diversified portfolios. The second, by Kenneth Small, Jeff Smith and Erika Small, discusses a highly topical issue: it offers an analysis of diamonds as an investable asset, concluding that diamonds have the potential to enhance portfolio returns through diversification. The third, by James Chong and Michael Phillips, considers investing in a low volatility environment, an area that has recently witnessed a surge in media coverage and experienced renewed interest in academic research, concluding that by constructing a low volatility portfolio with economic factors would enhance a portfolio's risk-reward ratio over a portfolio constructed purely with returns-based measures. The fourth article, by Offer Moshe Shapir, Uri Ben-Zion and Koresh Galil, examines ratings of Israeli mutual funds specializing in the major stock indices during the period from December 2003 to April 2007, showing that the ratings of the commercial models (Morningstar and S&P-MAALOT) outperform the ratings of conventional measures (Sharpe, Jensen and Mean) and that the difference between the commercial models is statistically insignificant despite the relative simplicity of the Morningstar model.

Our last two papers are by Advisory Board member Greg Gregoriou, who reviews two different books. The first, a book written by William Reichenstein and William Meyer, asks a simple question: "What is the best strategy for claiming Social Security benefits?" The reviewer concludes that this book with its companion software will take the guesswork out by providing a smart claiming strategy. The second, a book written by Donald DePamphilis, aims to demystify the topic of mergers, acquisitions and other restructuring activities, helping the reader think of the activities involved in mergers, acquisitions, business alliances, and corporate restructuring in an integrated way, explaining M&A activities in the context in which they occur while identifying common interactions among these activities.

Jean L.P. Brunel
Editor

[1]See Jarrod Wilcox. "Harry Markowitz and the Discretionary Wealth Hypothesis." *The Journal of Portfolio Management*, Vol. 29, No. 3 (2003), pp. 58-65.

Downloaded from https://jwm.pm-research.com by guest on September 27, 2021. Copyright 2012 Pageant Media Ltd.