

The Journal of Wealth Management

VOLUME 16, NUMBER 1

SUMMER 2013

JEAN L.P. BRUNEL Editor

HARRY KATZ Video and Print
Production Director

DEBORAH BROUWER Production/Design

CATHY SCOTT Editorial Manager

LAURA PAGLIARO Marketing Director
SHARON CHIEN Marketing Manager

ERIN SCANLON Global Digital Sales Manager

SOPHIA SAAFIR Account Manager
WILLIAM LAW Regional Account Manager, Asia

DEWEY PALMIERI Reprints Manager

VINCENT YESENOSKY Head of U.S. Fulfillment
CHERLY BONNY Customer Service Manager

BEN CASTLE Finance Manager
SEAN CASEMENT 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



The Head of Chiyou

Carved Ox-hide, Ox-hide Glue, Pigments,
Mounted on LED Light Box, 2008

54 7/8 × 50 7/8 × 5 1/8 inches, 140 × 130 × 13 cm

Wu Jian'an (Chinese, born 1980) is a Beijing-based artist known for his imagery evoking Chinese mythological themes that have evolved from paper-cut to pierced ox-hide materials. According to Chinese mythology, Chiyou, the war deity, had a bronze head with metal foreheads. He had 4 eyes and 6 arms, affixed with sharp weapons in each hand. His head was that of an ox with two horns, but his body was of human form. The artist's focus depicts the gruesome result of a sowed partnership between the Yellow Emperor and Chiyou. Wu Jian'an's work can be seen at Chambers Fine Art Gallery in New York City and Beijing. Visit www.chambersfineart.com to view more works by this artist.

With U.S. tax rates on the rise, it may well be useful to revisit the issue of tax-efficiency and, more specifically, of measuring the effect of one's effort to manage wealth in a tax-aware manner. Recently, a family in effect asked that very question. My first instinct was to point to the key fundamental insight: There are several ways to define tax-efficiency, and they differ mostly in terms of why we ask the question and what we intend to do about it.

In its simplest incarnation, tax-efficiency can be observed as the ratio of after-tax to pretax returns. The main purpose of performing that analysis is to observe the extent to which taxes eat into returns. The benefit of the approach is its simplicity; its main limitation is that it does not really consider the full array of issues that revolve around tax-efficiency. For instance, as evidenced by the complexity of the after-tax computation rules promulgated by the CFA Institute, one must think through whether the concept applies on a pre- or post-liquidation basis.

We will look into portfolio freeze below, but at the simplest level, minimizing current taxes—which is usually associated with the systematic deferral of net capital gain realizations—exposes the portfolio to the certainty that taxes will have to be paid later, when a part of, or the entire portfolio, is liquidated. As one starts looking at the idea of measuring tax-efficiency, it is thus important to ask whether the partial or total liquidation horizon is near or far. This naturally leads to the observation that one should probably eschew tax-efficiency when the liquidation horizon is too near; tax-awareness indeed really pays off only in the long term, measured in decades rather than years.

Simply, again, one can define tax-awareness as the act of avoiding all unnecessary, and deferring unavoidable, taxes. That definition clearly has a couple of underpinning “truths” which one must seriously ponder. The first is the notion that deferring taxes must mean that one chooses to allow the ratio of a portfolio's market value to its tax basis to rise through time. In short, in that design, portfolio freeze is bound to occur at some future point in time. The speed of the occurrence will depend upon both average rates of return and market volatility. The former contributes to faster portfolio freeze as rates of return rise, while the latter works in the opposite direction: higher volatility, particularly if associated with stable correlations, will delay it.

The second “truth” is guided by the humble hierarchy of certainties. You can generally argue that taxes are a virtual certainty, alpha is a goal but an elusive one, and return volatility is somewhere

The Journal of Wealth Management

in the middle in terms of controllability. Thus, the general postulate that you should defer taxes broadly rests on the notion that it is the one lever over which you have the most control. Its importance to eventual after-tax wealth rests on the observation that deferring taxes provides the investor with an opportunity to earn some return on assets that would be paid out to the government if taxes are incurred. The weakness of that latter element of the argument is evident when rates of returns are low. The level of tax rates also obviously contributes to the analysis.

This truth led to a healthy debate on the difference between static and dynamic tax-awareness. Essentially, one must be able to get over the fact that dynamic tax-awareness leads you to the certainty of paying some more tax than absolutely needed for the probable but not certain benefit of raising the manageability of the portfolio, gaining some additional management alpha, or simply moderating its tracking error. If one can accept that it is not always irrational to incur the certainty of taxes with uncertain benefits, then dynamic tax-awareness can make some sense. The reciprocal is equally true: dynamic tax-awareness appears not to be sensible if one only focuses on the fact that unnecessary taxes are incurred.

It is really a case of choosing one's own poison: Do I prefer to incur taxes that I do not have to incur, or to suffer from an equally unnecessary tracking error, the damages associated with portfolio freeze, not earning any alpha? Depending upon the "ill" which one is trying to avoid, dynamic tax-efficiency can make sense. In many ways, this can be viewed through the prism of Pascal's wager. One must create some measure of statistical expectation, defined as the probability weighted sum of opposite outcomes.

There are two ways of thinking of dynamic tax-awareness; the first is continuous and the second is periodical. Dealing with a desire to avoid portfolio freeze, periodical tax-awareness can be viewed as an activity based on a logic arguing that it makes sense to establish a threshold in terms of market to book ratios. Once such a threshold is reached, one would naturally "refresh the basis of the portfolio" in order to delay the onset of portfolio freeze. There might be not one but several thresholds, as one might argue that the pain in terms of taxes that one is prepared to tolerate increases as one approaches a point at which the likelihood of portfolio freeze reaches unacceptable levels.

Similarly, when focused on rising tracking error due to a prelude of portfolio freeze—decreased manageability—one can follow a similar approach. One might choose one or several tracking error thresholds and take action when they are reached. On the other hand, continuous dynamic tax-awareness takes this multiple threshold concept to its logical extreme. It postulates that some systematic acceptance to pay some current tax helps potentially defer forever the onset of portfolio freeze or the need to accept potentially excessive tracking error. Ostensibly, the main discriminating factor in the choice between the two extreme approaches—and all the gray steps in-between—is the belief that some alpha (beyond the tax-managed alpha related to systematic loss harvesting for as long as it is feasible) is available either in terms of return enhancement (security or asset class selection) or risk management (tracking error to the relevant benchmark).

From this, one can derive two alternative approaches to tax-efficiency that you might want to consider and assess in a different way:

1. Impact if systematic loss harvesting;
2. Management of the portfolio market to book ratio.

Both measures in fact amount to accepting that tax-efficiency can be more than a simple ex post observation of what some degree of randomness of market and manager behavior might have generated.

Systematic loss harvesting is a double-edged sword. On the one hand, it promotes the realization of the "option value" associated with any current unrealized loss that exceeds twice the expected transaction costs. In this thought, random market moves lead to price fluctuations which, when the market to book ratio is not too high, create occasional unrealized losses that may be of a magnitude that allows some portfolio benefit. A current unrealized loss can indeed be taken and used now or at some future time to shelter some gain elsewhere in the portfolio, or it may be ignored. If the latter, it may grow or disappear. Allowing a loss available today to disappear involves allowing the option to shelter some future realized gain to lapse. At the same time, and on the other hand, systematic loss harvesting will, *ceteris paribus*, promote the onset of portfolio freeze, as it involves systematically taking losses and letting gains run.

The Journal of Wealth Management

Taking advantage of systematic loss harvesting requires some active portfolio construction decisions, together with an analysis of the kind of manager stable one wishes to assemble. I originally proposed the idea that a tax-aware portfolio should be effectively bar-belled. One portion of the portfolio is dedicated to tax-efficiency through investments that are either highly tax-aware per se (index strategies) or that promote potential hyper-tax-efficiency (systematic loss-harvesting strategies). The other portion seeks investment alpha and thus accepts tax-inefficiency as one of the costs of that alpha.

The balance between the two—i.e., the portfolio amounts allocated to each—is driven by the philosophical beliefs of the investor in the availability of non-tax-related investment alpha and by the time horizon of the portfolio. That idea still works today, and can be viewed as applying both within and across individual asset classes and strategy. This is all the more important if the investor believes that some form of tactical portfolio rebalancing alpha is available.

Measuring systematic loss harvesting is tricky, as the portfolio, as discussed, acquires “tax-options” in a semi-continuous manner and may simultaneously allow them to expire worthless. Two actions might still inform the manager of such a portfolio on the impact of the process. First, at year-end, compute and track the percentage of the portfolio’s market value that has been realized in terms of capital losses. Ostensibly, this will fluctuate through time, as it is a path-dependent item; tax options are more likely to arise in falling markets than when they rise! Second, measure at the end of each month the percentage of the portfolio’s market value represented by unrealized capital losses. A solid systematic loss harvesting process should see this ratio remaining low.

Managing the portfolio market to book ratio may be less overwhelming as it can, as discussed earlier, be limited to periodical interventions, as and when one believes that the ratio has reached a “dangerous” level. Yet, particularly in the kind of market environments we are seeing at present, it may be materially sub-optimal for an investor to consider only the occasional intervention.

Measuring that activity is simple. It only requires one to track the periodical value of the market to book ratio. However, one really does not know whether few or many tax-options have been lost.

It may thus be that the most intellectually satisfying option is to combine the two approaches. First, establish some measure of systematic loss harvesting potential within the portfolio and second, be prepared to manage the market to book ratio down when and if it reaches levels that create an unduly high risk of portfolio freeze.



The Summer 2013 issue of *The Journal of Wealth Management* starts with two articles dedicated to behavioral finance issues. The first, by Robert Johnson and Stephen Horan, focuses on the idea that human capital often is the largest asset owned by individuals, and that behavioral biases play a major role in the poor choices individuals make with respect to portfolio decisions related to human capital. This suggests that wealth managers should be aware of these biases and help their clients fully integrate all forms of capital in portfolio decisions.

The second, by Ronald Janssen, Bert Kramer, and Guus Boender, deals with the use of goal-based investing to tailor a dynamic investment strategy to the needs of individual clients. It argues that this approach is superior to the “one-size-fits-all,” target-date-oriented static allocation path used in most current life cycle funds and presents the two pillars of their approach: the methodology for obtaining financial and economic scenarios, and the methodology of the goal-oriented dynamic allocation strategy.

We then turn to an article, by Olivier Mesly and Richard Maziade, that stands on its own. This multidisciplinary paper proposes to warn banking and financial institutions about the possibility that an undetected functional psychopath (read, a financial predator) will, in his drive for success, run their company down. Sisi Tran then offers important insights into wealth management with a discussion of the use of a lifetime QTIP strategy, suggesting it offers a variety of tax advantages for married couples, including tax-free gifting between spouses, and the ability to take advantage of both spouses’ transfer tax exemptions regardless of who dies first.

The next article, by William Meyer and William Reichenstein, discusses the benefits associated with tax-efficient strategies to withdraw funds from one’s portfolio, effectively adding longevity to the withdrawal period.

The Journal *of* Wealth Management

The next two papers share a common theme, as they are again focused on client preferences and trust. The first, by Akash Dania and D.K. Malhotra, delves into the issue of faith-based and socially responsible investments (SRI), examining dynamic linkages among four major Islamic indexes and their corresponding “conventional” indexes of North America, European Union, Far East, and Pacific nation markets, and evidence of a positive and significant spillover from conventional market indexes on their corresponding faith-based SRI returns. The second, by Robert Elliott, argues that regaining client trust requires further commitment by wealth managers, as events since the onset of the millennium have all tended to lead wealthy investors to lose their trust in firms that may seem not to have them and their well-being as a central focus.

Bradley Jones authors a piece that revisits the issue of contrarian investing, which can prove exceedingly difficult to put into practice—particularly in the heat of battle. He proposes four relatively straightforward ways in which long-term investors might look to build a defense against the damaging effects of pro-cyclical investment.

Next Manu Sharma, Payal Dey and Rajnish Aggarwal dig into the issue of precious metal investing, investigating the relationship between the Dow Jones Precious Metal Index (DJGSP) and market indexes of the largest economies of the world—which included the U.S., the U.K., Germany, Sweden, Spain, Brazil, Hong Kong, Australia, Norway, and Canada, for the five-year period from April 2007 to April 2012.

Our final paper, by George Kester and Scott Hoover, provides a bit of useful levity, examining the returns and risk-adjusted performance of the 99 mutual funds that have been in continuous operation for the 45-year period 1967–2011, comparing them to the results of a passive buy-and-hold strategy (S&P 500) and simulated portfolios market timed in accordance with the Super Bowl Stock Market Predictor. They find that the simulated market timed portfolios outperformed 95 of the 99 mutual funds based upon return and terminal portfolio value, and all 99 mutual funds on a risk-adjusted basis!

Jean L.P. Brunel
Editor