The Journal *of*
Wealth Management

VOLUME 17, NUMBER 2 FALL 2014

Cover design: Loewy Design

ON THE COVER

Golden Tree
Brass Sculpture, 2006
47.4 × 36.6 × 36.6 inches, 120.5 × 93 × 93 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, pierced ox-hide materials to brass sculpture. The artist's rendition of a tree of life complete with branches as hands in mudras, or hand gestures, is similar to the Buddha surrounding mythological figures and creatures representing the interconnectedness of all life forms. 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.

This quarter's topic—consumption, investments, and hybrid investments—for our letter from the editor was prompted by a series of conversations I've had over the last few months. In effect, they caused me to revisit a dichotomy that I'd been using with many of the families we serve: when should an asset be viewed as an investment and when should it be considered a toy? That dichotomy had been made necessary by the fact that quite a few of the families we have been serving indeed had investments that did not easily fit into "classical" or "traditional" categories. They needed help to decide which should appropriately be included in their investment policies and which should not.

My initial distinction between toys and investments was based on a simple idea: something you are prepared to sell at some price is an investment, whereas something you're not prepared to sell at any price is not. The classic example I'd been using was drawn from the world of art. Imagine I have a painting by Van Gogh and the subject is a portrait of my grandmother. Imagine, on the other hand, that I have another painting, also by Van Gogh, but rather than being a portrait of my grandmother, it represents someone else's grandmother. You might reasonably expect that I would never sell the former, almost irrespective of whatever price it might fetch, whereas it would surely be reasonable to expect that I would be prepared to sell the latter, assuming an attractive price. Well, I would conclude, the former is a toy, and the latter is an investment.

Although that dichotomy certainly served me well for many years, I have had to revisit it, recognizing, as these few recent conversations forced me to, that it was both incomplete and too digital, that is, "1 or 0, on- or off-type" to cover all instances as faithfully as it should. For our readers who are familiar with mathematics in general and geometry in particular, I had failed to remember that a theorem, to be valid, needs to be demonstrably correct in both its direct form and its reciprocal formulation; for others, this is the genesis of the "if, and only if" qualification. Simultaneously, I had failed to recognize that certain investments provide more than financial returns. There, I had omitted the notion that there are numerous forms of capital, as initially proposed by Jay Hughes and expanded on by Lisa Gray, when the former talked of "authentic capital" or "authentic wealth" and the latter of "authentic assets." Both taught us that families also have emotional, social, human, philanthropic, and artistic capital, to name but a few, and that these additional dimensions often matter as much as, if not more than, financial capital.

The Journal *of*
Wealth Management

Two recent conversations dealt with two distinct forms of investment in collectible assets. The first related to classic cars. The individual had bought one such car that seemed to me to fit all the appropriate requirements: rarity, beauty, manufacturer pedigree, and desirability. The individual described in glowing terms the fact that he thought that the body of the car was one of the finest examples of the pen of the designer and the last such type of car from that manufacturer to have been that elegant. Yet, he recalled that he was utterly disappointed, in that, rather than rising in value, the car's market price had in fact dropped by half since he'd bought it. Though that did not mean that the investment was a failed one in the truly longer term—after all, it could always rise in value at some later point in time—it had not met with expectations. Discussing that case with a client who is a true classic car collector, I was told that he was not surprised; no car by that manufacturer with any rear seating space—however small—had ever reached true classic status. To achieve that status, cars by this manufacturer should have been raced or be race-worthy or once owned by a celebrity; by the way, he added, this is true of virtually any carmaker unless one went back to at least early in the first half of the twentieth century. In short, the first individual had not bought the car on pure classic grounds; he had also bought it because he liked it and he had done so without the depth of knowledge required to be a successful investor in classic cars.

The second conversation dealt with pictorial art, specifically with paintings. Again, the individual who had, he thought, invested in art, had made an analogous mistake to the one we just discussed. He had selected the paintings he had purchased in large measure based on what he actually liked to see on the walls of his homes. So, though there were both figurative and nonfigurative, or abstract, paintings, and though the names of the artists were by and large known and respected, he was upset and somewhat surprised that none had appreciated to anywhere near the extent of various forms of so-called contemporary art. "How can people pay such a fortune for this pile of randomly assembled rocks here or this piece of canvass painted in a single color there, and not recognize the beauty of this landscape or of this harmonious combination of shapes," he would ask. I should add that he was openly critical of the contemporary art market, which he regarded as driven by fashion or mass self-delusion rather than true understanding of art. Speaking of this to a client who is a true connoisseur and collector of contemporary art provided an answer that is conceptually analog to the one given by our classic car collector in the previous paragraph. Our self-described art investor had failed to appreciate the factors that drive the art market and rather had focused on what he liked.

At first, both sets of conversations were a bit puzzling to me, since they seemed to negate one of the first pieces of advice I had received when I dipped my own toe in the art market: buy things that you like, I had been admonished. How could I do that if it happened that what I liked did not turn out to be liked by anybody else over time?

Remembering the lessons I learned on the financial investment front provided the simple answer: virtually no single financial investor can claim to be a price maker; most of the time, we must be content with being a price taker. The lesson this simple and trivial fact taught is that successfully investing requires identifying what features markets will eventually value and reward with higher prices, and anticipating that process by buying things before they are recognized as valuable. Though obvious, such a statement explicitly requires that we should be focusing our search among investments that markets will eventually like, rather than on investments that we like now. Notwithstanding the advice of certain pundits, just picking on a few criteria we feel are right in an absolute sense rather than empirically proven by history is not a recipe for success; though, it might occasionally work—just as a stopped clock shows the correct time twice every twenty four hours—it certainly is not a recipe for success in most instances and in a repeatable fashion.

Applying this lesson to the worlds of art in particular and collectibles in general, the new dichotomy that came to mind was described in terms of consumption and investment. Investing in something does not require that we like what we're buying: it requires only that we should have reasons to believe that others will like it at some point and bid its price up. Similarly and reciprocally, selling something does not require that we do not like it anymore: it requires only that we should have reasons to believe that the rest of the world will probably not like it any more aggressively. Investing in what we like is therefore more a form of consumption than a form of investing. Note that the two are neither incompatible nor mutually exclusive. Yet buying art that I like can be seen at least in part as consuming art rather than investing in art.

The Journal *of*
Wealth Management

Learning that lesson naturally led me to ask the obvious next question: are there hybrid forms of the matter that combine both consumption and investment features or involve investing different forms of capital? Ostensibly, the last sentence of the previous paragraph might be rewritten to reflect the notion that I may be investing in art to earn both financial and artistic emotional returns. In that case, it would be perfectly fine to predict that my financial return should be less than the returns afforded to art investors who solely seek a financial return; my financial return should be lower because the equality should be between the total returns earned by all investors. So since my returns also include an artistic emotional element, the purely financial part of this total return should be correspondingly lower. Note that one cannot take this to the logical extreme of arguing that things that appear so ugly as to generate negative artistic emotional returns should be those that earn the highest financial returns, although this may precisely be what our self-described art investor above might argue.

An interesting iteration on the multiple return sources theme is provided by an activity that is drawing an increasing amount of attention as this is written: impact investing. Here, the idea is that the two returns an impact investor will earn are financial and philanthropic. In short, such an investor will accept to earn a lower financial return because he or she will earn a philanthropic emotional return due to the fact that the investment is geared to "doing good," as that investor defines "good." Taking this even one step further, but backward in time, one can think of so-called socially responsible investing. Here, an investor will impose a series of filters on the investment universe that, by limiting this universe, will ensure that the investor does not participate in an investment that either violates his or her conscience or religious edicts, for instance. In some ways, one can even think of impact investing as an analog form of socially responsible investing, as the latter typically applies negative screens whereas the former tends to use positive screens. I do not want to overplay this latter statement since my point here is not to discuss either of these investment approaches in any depth, but rather to illustrate the notion that certain forms of investment comprise both consumption and investment dimensions or multiple sources of investment returns, with the financial dimension being only one and, at times, not even the most important.

Another form of hybrid investing might be related to investments that have a utility value. Here, the idea is not that the two components—financial and utility—might be additive, but rather that they might impose constraints on each other. I may actually appropriately identify a location where home prices are more likely to appreciate than another, both being hypothetically within reasonable proximity of where I might choose to live. Financial capital availability might prevent me from buying a home in the area most likely to appreciate, whereas utility constraints might be the other side of that same coin because the house might require a number of bedrooms that takes it in the appropriate location out of my price range.

To me, this notion that consumption, investments, and hybrid investments represent a useful framework within which to evaluate various opportunities leads to three major conclusions. First, any investment that is not made for pure financial reasons should be expected to earn lower financial returns that any other; though this may not be true in practice for a variety of reasons, the reciprocal should always require investors to pay close attention: it is counterintuitive to argue that selecting any investment from within a universe through criteria that are not based on financial considerations should be expected to add financial value. Second, there is nothing wrong in adopting a hybrid approach to investment selection; this simply reflects the known fact that most families and individuals are not solely driven by financial considerations. After all, though this is not the first conclusion that jumps to mind when dealing with behavioral finance, it is a predictable implication of its tenet that individuals have biases and preferences. Thirdly, a derivative statement of the first two conclusions, investors should be crystal clear in their minds as to what drives this or that investment. Although there is nothing wrong in buying a secondary residence that might seem a bit outrageous when compared to other elements of the family's wealth, it is downright silly and dangerous to work to convince oneself that the rationale for the purchase is that it doubles up as an investment; for that logic to hold water, one would need to be able to make a clear, objective, and emotion-free case that the investment makes sense when contemplating both its utility and its financial dimensions; one way of arriving at this conclusion might be to compute both the rent that the family might earn and the price appreciation that would be needed to make that investment pay for its cost of capital, even if the family elected not to live there.

As is almost always the case with these letters from the editor, my point here is not to pontificate on a particular

The Journal *of*
Wealth Management

topic but rather to offer a few thoughts to start a possible dialog. Nontraditional and even hybrid investments have scarcely been covered in these pages ever since the journal was founded in 1998. It would be nice if these random thoughts were to stimulate people who have forgotten more on these topics than I have ever learned to contribute pieces discussing this or that element of the issue we're raising. I thank them in advance.

■ ■ ■

The fall 2014 issue of *The Journal of Wealth Management* focuses more sharply than usual on investment management issues, since we're reserving articles dealing with topics concerning the multifamily family offices of the future for our next two issues.

Our first two articles deal with two different aspects of the mutual fund world and might therefore be of interest to those readers for whom mutual funds are a crucial part of their investment execution. The first, by Aymen Karoui and Maher Kooli, examines the commonality between the characteristics of acquirers and those of targets in mutual fund mergers and concludes that acquirers that target funds with poorer performance, higher turnover, and higher expense ratios exhibit a decrease in their post-merger performance. The second by John Haslem reviews the Morningstar analytical grading measures used by investors to select mutual funds, discusses the results of studies that assess the effectiveness of Morningstar grading measures, and proposes a model that systematically applies selected Morningstar measures to ease investor choice of equity funds.

The next two articles focus on a couple of issues related to the bond markets. The first, by Tom Arnold and John Earl, Jr., notes that current yield is a common approximation for a bond's yield to maturity. Suggesting that the approximation becomes less accurate as the bond price moves away from par value, the authors present a relatively easy formulation that incorporates an annuity calculation with the coupon rate and provides a much better approximation of the actual yield to maturity. The second, by Yen-Sen Ni, Pa-Yu Huang, and Chih-Hung Lin, investigates the performance of bond funds sold in Taiwan and suggests that a contrarian strategy is most appropriate for timing entry into and exit out of these funds.

The next four articles deal with various aspects of equity markets. The first, by Akash Dania and D.K. Malhotra, examines the predictive power of the implied volatility originating in the U.S. stock market (USVIX) on returns of Brazil, Russia, India, and China and concludes that the returns of all BRIC nations are negatively and significantly impacted by USVIX, albeit with varying degree and magnitude. The second, by Kin-Yip Ho, Yanlin Shi, and Zhaoyong Zhang, examines the volatility dynamics of the mainland Chinese stock markets (Shanghai A- and B-shares, Shenzhen A- and B-shares, H-shares, and red chips) and concludes that, unlike the Shenzhen and Shanghai A-share markets, the B-share, H-share, and red chip markets do not exhibit significant asymmetric volatility (leverage effect). The third, by Manu Sharma, Gunwant Singh, and Esha Prashar, investigates the relationship between the S&P Global Dividend Opportunities Index and the market indices of largest economies of the world (U.S., U.K., Germany, Sweden, Spain, Brazil, Hong Kong, Australia, Norway, and Canada) and concludes that the market indices of all economies moved in the same direction as that of the S&P Global Dividend Opportunities Index. Finally, the fourth article, by Najeb Masoud and Suleiman AbuSabha, investigates the dynamic of the volatilities off our large, developed country stock markets (U.K., France, Germany, and the U.S.) and eight Middle East and North African (MENA) stock markets (Jordan, Bahrain, Egypt, Morocco, Oman, the U.A.E., Saudi Arabia, and Tunisia) and concludes first that shocks originating in larger markets have increased the volatility of MENA equity markets and second that, regardless of its impact on volatility spillover transmission, there is little evidence to suggest that MENA markets have become more integrated with world-markets since the financial crisis.

Our final article, as has become our custom, is a book review. Jean Brunel reviews Kirby Rosplock's book entitled *The Complete Family Office Handbook, A Guide for Affluent Families and the Advisors Who Serve Them* and published by Wiley/Bloomberg Press.

Jean L.P. Brunel
Editor