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ON THE COVER

New Guinea Basket Yam Mask
Plaited Cane and Earth Pigments, Pre-1970
15 × 15 × 9 inches; 38.1 × 38.1 × 22.9 cm

The cultivation and decoration of yam masks in New Guinea is a symbol of a man's social status and prestige within their clan and village. They are the focus of ceremonies within the village, and have a visual presence that plays a central role in representing the spirit of an ancestor in the form of an animal or human. In addition to being on display in numerous fine art and natural history museums around the world New Guinea art is collected by a significant amount of serious private collectors. This piece and other Oceanic art objects are available through Cavin-Morris Gallery in New York City. Visit www.cavinmorris.com to view more.

Climate change is a topic that has been in the press for quite some time. It has become more prevalent in the recent past, as connected with such dramatically different events as the planning for the United Nations Conference in Paris at the end of this year and Pope Francis's encyclical published in June. Lest our readers worry that we are going to delve deeply into the matter, let me make it clear that I do not view offering opinions on climate change to be the mission of *The Journal of Wealth Management*; it is best discussed in scientific journals in which the editorial board and peer review body are better qualified to opine on the value of one article or another.

Yet, there is a subject that readers of *The Journal of Wealth Management* should be discussing: How should the debate on climate change affect the management of their portfolios, if at all?

Going back to theory, it is worth reminding ourselves of the price-making mechanism in capital markets. Very few, if any, people would disagree with the essential fact that capital markets reflect long-term fundamentals. Yet shorter-term trends in prices principally reflect the intensity of buyers and sellers and the degree to which one group feels a greater urgency to trade than does the other: When buyers are more eager to trade than sellers, prices tend to rise, and vice versa. If this is true, then why do we focus on fundamentals? Is it not true that the long term is only a succession of short-term periods? The answer is simple: We focus on fundamentals because we believe that, over time, buyers and sellers also respond to them; we believe that their decisions to buy or sell reflect positive or negative surprises that occur when the release of information exceeds, meets, or falls short of their expectations. Thus, and possibly a bit paradoxically, it does not really matter whether the fundamental news is good or bad. What matters is whether the news is better or worse than expectations. The stock of a company that reports a 20% increase in profits may fall because market participants had expected 30% growth, whereas a company that reports a 10% decline in profits may see its stock price increase because expectations had pointed to a much larger profit reduction.

An issue as much in the news as climate change must, therefore, be incorporated in some way in the construction and tactical management of portfolios. This does not mean that the whole portfolio must reflect climate change at the expense of any other consideration. Those who want to create a new discipline, which one might call *climate portfolio management*, may be mistaken; climate change, arguably, may be an important environmental factor (no pun intended), but it cannot be the sole determinant of pricing behavior. Portfolio management is about creating an appropriately diversified exposure to a variety of risk factors so that, on balance, the expected risk that one takes—the excess risk relative to the market portfolio—is fairly compensated by the portfolio's expected excess return relative to the same market portfolio. Thus, even if one has a high degree of conviction that the economy is not growing at a rapid pace, for example, one still considers alternative scenarios (in this case, higher or lower growth) to ensure that the risk that the forecast may be wrong will not lead to poor short-term performance that could lead one to change horses in the middle of the race. Note that the forecast being wrong does not mean that the ultimate view is wrong; instead, the ultimate view may simply take more time to unfold or be less visible than expected. In short, even if one believes that climate change is the ultimate urgency, is one prepared, or should one be prepared, to bet everything on it? What if it takes longer than anticipated to unfold? What if the impact is less than anticipated? The world is littered with people who had great ideas but who were too early and therefore never saw their bets pay off.

From this perspective, taking climate change into consideration simply means that some portion of the portfolio (the size of that portion depends on one's level of conviction both about the direction and the speed of the climate change process) is invested in such a way to 1) take advantage of those industries or companies that may be winners, and 2) avoid, or even short, those that may be losers. Before expanding on this latter point, the obvious question would be as follows: Should one take climate issues into consideration at all? Earlier in this letter, we assumed a positive answer, but that should be debated. In fact, there is a corollary question that may be easier to answer: Can an investor afford to ignore climate issues?

If it is true that traders set market prices, at least in the short term, then it must be equally true that one should not ignore climate issues unless one can demonstrate that the topic does not affect traders' thinking. With the wide media coverage afforded to climate change, it is hard to conclude that the topic is irrelevant. Therefore, one should probably include the issue in one's strategic portfolio unless two conditions are simultaneously met: First, one believes that climate change is not a real issue or that it will not have material economic consequences in the long term; and second, one believes that one has a sufficiently long-term time horizon and staying power to make fluctuations related to the topic mere bumps on the road.

For those who feel that they must reflect climate change issues in their portfolio, the next question is equally obvious: How should I proceed? One can argue that the direct impact of climate change in the short to intermediate term is considerably less important than the discussion and political decisions surrounding it. The main opportunities at this point may well be driven not by climate change, per se, but by the decisions made about it by politicians around the world who may or may not be getting it right. Importantly, there is therefore a significant risk that strategy and tactics may become materially misaligned. Indeed, it would be reasonable to design a portfolio policy that reflects one's long-term equilibrium view with respect to the actual impact, if any, of climate change. However, short- and medium-term tactics should incorporate the expected actions of politicians who often work on steps that appear to solve the problem without thinking of whether the solution will really work or is only a short-term show of commitment to gain votes. A serious analysis of the consequences of higher temperatures, for instance, does not appear likely to be rewarded. More to the point, even if some of the results of higher temperatures are "good" in certain places (e.g., a change in the pattern of agricultural activity), that "good" may not be anticipated by higher prices. The disconnect is, thus, that strategy may be based on an analysis of what should happen eventually, whereas tactics may reflect what is happening or is likely to happen on policy and regulatory fronts. That the two may be wildly different is an obvious but unfortunate truism.

Therefore, one can argue oneself into the conclusion that the challenge is too great and that one should ignore climate change issues, yet this is probably an excessive reaction. After all, what other fundamental dimension of the investment decision is crystal clear? Somewhat of an aside from this topic, but still related, is the observation that the past several years have seen behaviors by politicians and central banks around the world that many traditional observers may argue are odd, atypical, and perhaps even imprudent. Yet most individuals and asset managers have had to contend with that uncertainty. Therefore, in the context of climate change, one should be equally prepared to contend with uncertainty by focusing on identifying what policies or regulations are likely to be implemented and who will benefit or suffer from them. Again, this does not mean that the wins and losses thus identified will necessarily occur in some future reality; however, it does mean that regulatory or policy tailwinds or headwinds should be expected in the short to intermediate term.

Three thoughts about implementation come to mind. The first is that a possibly fruitful idea repository may be found within the illiquid equity space because venture, buyout, and growth capital focus on new companies built to benefit from the likely environment. Certainly, a few of these companies will simply be created to benefit from subsidies and will disappear or fail when these subsidies lapse; others may well succeed, and their success may be long enough in duration to generate significant profits. A second idea would be to look for long-short equity managers who create funds dedicated to investing in companies they see as likely winners and shorting those they see as losers. The long-short feature of these portfolios may be desirable enough to mitigate equity market beta and thus deliver what one might call pure *climate-change alpha*. Investors may consider building diversified portfolios around that theme to avoid taking excessive individual manager risk. A third approach involves looking carefully at the many managers who offer funds structured around impact investing. Though not all such funds focus on the impact of climate change, it is fair to assume that a few of them do. As discussed a few issues ago, impact investing typically has a cost in terms of a return penalty or risk increment, but the point is not to be pure but rather to try to benefit from what could be called a *climate-change beta*.

A final note of caution is warranted. With the topic of climate change high on the list of issues covered by the press and emphasized by a meaningful portion of the political spectrum (with various countries offering wider or narrower consensuses on the subject), it is quite reasonable to expect that marketing experts will find opportunities to promote funds and strategies dedicated to it. Individual investors should perform a high degree of due diligence to determine whether the climate change label represents a reasonable focus, whether the manager has unusual insights, and whether risk management considerations justify certain manager mixes.

It goes without saying that this is only a first cut and one person's opinion. It would be wonderful if other authors would consider offering their perspectives on a topic that is certainly in the news and unlikely to leave the front page any time soon.

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As usual, the Fall 2015 issue of *The Journal of Wealth Management* offers a wide variety of articles. The first article represents a category of its own, as Amy A. Castoro tackles the issues of entitlement, lost sense of purpose, and ill-prepared future administrators of wealth. She proposes a redefinition of the preservation of wealth as the preservation of the individual and suggests that the role of the head of the family is to facilitate conversations that support the offspring's dignity, aspirations, and ability to provide for their own families.

The next two articles discuss, from different perspectives, issues related to alternative assets. Markella Karadede-Bouras and Nikiforos T. Laopodis examine the dynamic correlations (and implications) of various financial asset classes and find that the correlations vary across time, which suggests that even well-diversified portfolios must be updated to reflect changing economic and financial environments and that past asset behavior does not imply similar future behavior. Then, Joachim Klement focuses on liquid absolute return funds and, having noted their promising debuts, suggests that they come in a wide variety of shapes and sizes with large differences in risks and expected returns; he proposes that future research should focus on single funds or various strategies of absolute return funds to assess how and when these funds and fund strategies can add value.

We place the next four articles in one group, though, in fairness, they all individually deal with interesting but admittedly quite different issues, save for the last two which both deal with tax-efficiency in the mutual fund world. The first, by Haim A. Mozes, focuses on a timely topic: the time-varying interest rate sensitivity of municipal bonds, demonstrating that municipal bonds' interest rate sensitivity is a function of how cheap they are relative to Treasury bonds, findings which have important implications for investors looking to hedge the interest rate risk of municipal bonds or to evaluate investment opportunities in municipal bonds. The second, by D.K. Malhotra, Vivek Bhargava and Rand Martin, investigates the relationship between mutual fund governance and a fund's tax-efficiency, concluding that, of

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the five determinants of overall stewardship grade, corporate culture, managerial incentives, and regulatory issues play a major role in influencing the tax efficiency of a mutual fund. Dale Domian, Philip Gibson and David Nanigian focus their attention on so-called tax-managed domestic U.S. equity funds and conclude that when compared to their inherently tax-advantaged passively managed counterparts, the tax-managed funds fail to save their investors more money on taxes than their incremental expenses. Last, but not least, Dalina Amonhaemanon examines the benefits of diversification by adding real estate to a portfolio of traditional assets from a Thai perspective over various regimes from 1994 to 2013, concludes that all types of real estate entail benefits for Thai investors in the sense that the mixed portfolio always shows better performance than the benchmark portfolio.

The last two articles in this issue are book reviews. The first, by Greg N. Gregoriou and Lam Pak Nian, focuses on the *Handbook of Digital Currency: Bitcoin, Innovation, Financial Instruments, and Big Data*. The second, by Jean L.P. Brunel, looks at four books covering topics ranging from *Quantitative Approaches to High Net Worth Investment* to *Family Offices: The STEP Handbook for Advisers; Invest with the Fed: Maximizing Portfolio Performance by Following Federal Reserve Policy*; and *The Aspirational Investor: Taming the Markets to Achieve Your Life's Goals*.

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