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Welcome to Y2K. Though we are very encouraged by the increase in both the readership and the flow of articles submitted for publication over the last year, we are setting our sights yet higher in the coming years. We really look for the *Journal of Private Portfolio Management* to become the vehicle of choice for an active and rich exchange of ideas and research findings in the area of private wealth management. Let me express my thanks to all those who have so critically contributed in the last couple of years and wish all, readers, authors, Advisory Board members, and staff, the best for the new year.

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The pace of change in our industry is, if anything, accelerating. Tax-efficiency, a phrase in the past often associated with the "tax tail wagging the dog," is now the order of the day in a large majority of situations involving the wealthy and the affluent. Nowhere is this truer than in the field of asset allocation.

A number of articles have been published, here and in other Journals or magazines, dealing with the issue of strategic asset allocation. And yet, though they argued, often powerfully, that the traditional single period, pretax optimization process was no longer the most appropriate answer, they still agreed with or failed to question an important assumption. Is the traditional mean-variance optimization process still the best approach to finding the right solution? Generally, the industry still seems to accept the proposition that formulating an optimal asset allocation revolves around the resolution of a risk/return trade-off.

Though, at one level, the nature of the problem has indeed not really changed that dramatically, one can argue that its successful resolution requires a radically different approach. Individual investors indeed rarely view the management of their assets relative to a well-defined liability. Having a well-defined liability, as is most often the case in an institutional context, has the property of focusing the mind on a goal and of providing the means through which the solution is generated. Knowing of a stream of future pension payments and of the implications on corporate profits of plan funding

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shortfalls focuses the mind on matching assets and liabilities. Returns and risk — defined as the volatility of returns — suddenly become highly meaningful. Thinking of one's assets in the context of future wealth makes that process much harder. And yet, we, as an industry, have tended to use the same framework to help wealthy individuals, arguably confusing the notion of a "goal" with the "means of measuring how we get there."

Attending a recent conference, I was given an opportunity to look into a new approach which seemingly has a number of very appealing attributes. In fairness, and somewhat paradoxically, the model was not originally developed for individual U.S. investors. Its structure is appealing because it incorporates four critical features that might be viewed as indispensable in a few years' time:

- ***Redefinition of investment goals***: This approach requires investors to identify a number of investment goals at certain future and discrete points in time. An affluent investor might think in terms of college education, a second home, retirement income, and bequests to heirs or charities. Note that such goals would not typically be expressed in terms of investment returns, but rather defined in terms of amounts of money which will be needed at certain future points in time. Note the interesting parallel with the pension world: liabilities are expressed in terms of future payments (discrete payments or payments arranged in streams).
- ***Redefinition of investment risk***: This approach requires investors to express preferences among the goals, if they are not all immediately compatible, and to discuss the extent of preparation for tolerating some shortfall. Here, risk is defined in terms of a penalty function rather than in relation to the volatility of returns. Though this approach shares certain attributes of the mean-semivariance process (where downside volatility is viewed as relevant, while upside volatility is not considered), it really goes further as it allows the investor to express different penalty functions for different goals. While any shortfall might be totally unacceptable in certain circumstances (translated: for a goal which is viewed as a must), some shortfall might be tolerable in other cases (translated: for a goal which falls in the nice-to-have bucket). Note, again, how similar the new formulation is to the pension model

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which we know, and yet how much more "human" it seems to be than the traditional analysis focused on selecting an optimal risk tolerance level consistent with a desired return.

- ***Asset location issues***: This approach also recognizes the fact that most individual investors, affluent, wealthy, or very wealthy, tend to hold their assets in different pockets. Each pocket will have its own tax status as well as, most often, a set of internal rules describing how cash may flow into or out of it. More important, this allows dealing with the potential need for investors to use intra-family lending to enhance the chances of reaching the goal of maximizing wealth across generations.
- ***Capital market expectations***: This approach allows investors to understand the reality that actual market returns fluctuate around their expected long-term values (hopefully). Rather than assuming that markets will, each year, produce their long-term average expected returns, the model takes a stochastic approach, analyzing the problem across a large number of potential market scenarios. This, in effect, arguably helps deal with two critical issues which have, in my experience, often been important stumbling blocks. First, it allows investors to appreciate what possible change may be needed at some future point if markets do not perform in line with their "long-term norm." Second, it recognizes that the process through which after-tax wealth is created can be "path-dependent" (the way in which one proceeds has a bearing on the ultimate outcome).

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This issue covers three broad topics. The first three articles deal with selected aspects of the wealth creation process. We start with the second installment in the research findings of William Reichenstein, which focuses on the issue of savings and asset allocation. His thoughts are complemented by an article by Tracey McNaughton, John Piggott, and Sachi Purcal, all from Australia, who discuss growing old gracefully: age-phasing, targets, and savings rules. Though not necessarily a primary concern for the very wealthy, this topic is germane to a large number of individual investors, particularly because it addresses the question of how wealth should be invested over a multi-period time horizon. Paul Samuelson kindly offers a comment on this article.

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The next three articles deal with selected asset allocation issues. Jeffrey Horvitz first examines the problem through the angle of asset class definition and concludes that the appropriate classification of asset classes is a critical element of the solution. Robert Johnson, Gerald W. Buetow, Jr., and Gerald Jensen focus on a more detailed aspect of the problem — dealing with equity management style issues — and conclude that monetary policy may be a more important determinant of relative performance than style factors. Jean Brunel addresses a related problem and asks whether style diversification can be effective on an after-tax basis. He concludes that it may be more important to focus on broad portfolio questions rather than on individual building blocks.

The last two articles deal with equity markets and vehicles available to invest in them. Charles Jones and Jack Wilson review the performance of equities in the 1990s and draw implications for expectations of future returns in the new millennium. Finally, Amy Lipton and Gerald W. Buetow, Jr. look into the interest rate sensitivity of equity mutual funds and suggest an approach that might allow investors better control of overall portfolio risk.

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