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ON THE COVER

Persian Horn Rhyton
Horn
500 BCE – 400 BCE
5.25 × 7.5 inches
Photo credit: Barakat Gallery

Persia, one of the oldest countries in the world, is one of the earliest civilizations in the history of art. Rhytons are drinking vessels that derive from the Greek rhyta, meaning to run through, and were once ancient vessels used for wine consumption. At this time, wine would have been poured in at the widest end and flowed throughout the horn while exiting at the tapered end. In this case, the wine would reach the sculpted kneeling ram with holes drilled into the sides to release the flow of wine from the horn. Rhytons were often a fixture in many of the great Persian battles. When a Persian king went to war, he not only took his army, but also many luxurious possessions and riches used for entertainment. Even with the combative history between Persia and Greece, Persian culture intermingled continuously with that of its neighbors. This piece and other antiquities are available through Barakat Gallery in Los Angeles, California.
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Following on the first of our four-issue cycle of celebrations for the 20th anniversary of *The Journal of Wealth Management*, we will focus here on the various issues related to asset allocation.

If one goes back far enough, asset allocation for individuals was once an embryonic discipline at best. Although institutions had already moved in the direction of strategic asset allocation and the formulation of detailed investment policies, many a private bank really worked on the barest of bones when it came to asset allocation. Trust law was, in truth, forcing some measure of attention because split-interest trusts were dominant and the need to balance the interests of income beneficiaries (with *income* often defined in accounting rather than total return terms) and remaindermen required some formal differentiation between bonds and equities. However, and at the same time, the fact that equities had rather high yields by today's standards made this formal differentiation looser than what one might have wanted. Finally, diversification was not recognized as the critical element it is today, and as such, the notion of locating a portfolio on some efficient frontier was jargon at best. Eventually, modern portfolio theory did make inroads into the private client—or individual world—but progress was anything but linear.

Other than inertia and a general suspicion vis-à-vis *theory*, three important factors were preventing the wholesale adoption of formal investment policies together with the appropriate strategic asset allocation.

1. A *desire to keep things simple for clients* who, initially, were trust beneficiaries and had an intuitive comfort with equities was initially the most important. It has often been said that a strategic asset allocation helps maintain the plane on the right flight plan, even when market developments may influence people away from it. In marked contrast with the environment as it developed when new money tended to become the norm, old money had lived through the ups and downs of equity markets and learned over time that what goes down eventually goes back up. Even an extensive period of weak equity markets in the 1960s and early 1970s was not enough to dent the confidence of investors who had at one point been fully invested in equities.
2. *Taxes also played an important role* because, for many an investor, moving to a well-diversified strategic asset allocation often involved selling appreciated U.S. equities. Later, in the 1980s and as new money started to enter the fray, portfolios—in trust form or not—funded with low-basis stock experienced a similar challenge. Though the natural tendency to want to shake the industry

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into the modern era naturally pushed advisers to want to adopt institutional approaches lock, stock, and barrel, it quickly became obvious—early in the 1990s—that the problem was considerably less simple than anticipated.

A serious analysis of the after-tax implications of diversifying a portfolio to some strategic mix indeed rapidly showed that "the cost of getting there"—as I dubbed it—could make what looked like an optimal portfolio in fact very suboptimal. Indeed, because one was considering the formulation of the optimal portfolio—using the classic mean–variance approach—one often forgot that the taxes incurred in moving from the pre- to the post-optimization portfolio could be exceptionally costly. It could be so costly, in fact, that the better return-to-risk ratio of the optimized portfolio would not be expected to produce a better outcome than staying with the initial allocation: The new return would indeed be applied to a lower total dollar amount! Equally important, the cost of staying there rendered the assumption that the portfolio would be regularly rebalanced to the optimal allocation also impractical.

Next came the use of derivatives. Although, for a variety of totally understandable reasons, that idea never took off with the power that one could have expected, the industry also investigated the potential of using derivative securities to help deal with the after-tax asset allocation issue. The key insight revolved around the fact that, in the physical security world, any decision that involves selling some appreciated assets will lead to capital gains taxes being paid before one has had a chance to observe the expected diversification or investment prowess benefits. Contrast this with the derivative world, where the initial hedging of a position does not constitute a taxable event and one can thus wait until after the initial transaction has borne fruit to observe whether it was accretive or not.

Finally, recognizing that individuals rarely have a single pocket forced the issue of asset location to the fore. William Reichenstein, a member of our board of advisors then and of our ambassador board now, did more than most to advance the industry's insights in that area. The question, simply put, involved deciding both to look at tax-deferred and taxable portfolios in aggregate if they benefit the same individual and to decide which asset should go where. He added the crucial thought that assets held in a tax-deferred account should be notionally taxed when combined with taxable elements because the tax-deferred portfolio also comprises a deferred tax liability.

3. In the end, probably the most important development proceeded from the *intersection of the world of behavioral finance and asset allocation*. Accepting that investors were not necessarily fully rational, individuals such as Nobel Laureates Daniel Kahneman and Richard Thaler, together with Meir Statman, Terence Odean, and several others, helped the industry understand that one needed to develop something totally new to serve best. The notion of goals-based wealth management, about which we are proud to have published the first several papers from 2003 onward (Brunel, Chhabra, and Nevins, among others, and, more recently, Parker), naturally proceeded with the recommendation to construct bucketed portfolios. It followed on the work of Shefrin and Statman, who were the first to describe the *behavioral portfolio*, and noted that individuals have multiple (and not always totally compatible) goals, as well as a risk profile and a time horizon for each goal. Unfortunately, the idea took quite a while to capture the imagination of the market. The principal criticism was that a portfolio comprising several subportfolios had to be suboptimal.

Thankfully, Das et al. [2010, 2011] got everyone to understand that the two approaches—traditional mean–variance and mental accounts (which is their term for what we call goals-based allocation)—were mathematically equivalent once one accepted a definition of risk as the probability of missing a goal rather than as the volatility of expected returns. This played a very important role in several ways, effectively silencing the cries of suboptimality and convincing industry participants that

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the issue should be incorporated into thought processes. Unfortunately, as is often the case in a society fascinated more by labels than by what they cover, progress, although significant, has not always been as comprehensive or rigorous as it should be. The essence of the need of individuals is to find a way to merge and combine financial, investment, dynastic, and even at times philanthropic planning into a single activity rather than a set of several somewhat disjointed efforts. Although the focus so far has implicitly been on the decumulation phase of one's lifetime wealth cycle, it is interesting and intriguing to note that a similar conceptual approach could also serve to make the accumulation phase of the cycle more rigorous and thus potentially more successful.

This quick review would not be complete without a mention of an important trend that has the potential to drive further change: the move from the traditional asset class or strategy definition toward a greater focus on risk factors. Although this is not as dramatic a change as what we have experienced in the last 50 years or so, it would involve taking a second look at how we define an asset or an investment. Very much as modern portfolio theory forced us to consider the crucial difference between a company and a stock (the latter being but a list of investment characteristics), factor allocation would combine several of the current diversification axes into a single exercise.

Our next letter will focus on the role of alternative assets, which have made the whole asset allocation issue substantially more complex but also potentially more interesting and rewarding. Asset allocation and portfolio diversification indeed have been under somewhat of a practical cloud in the last several years because traditional diversifiers did not really diversify portfolios as expected. That expectations were probably not reasonable is only a part of the challenge: A low but positive correlation between the returns of different asset classes or strategies indeed does not mean that one will go up in price when the other goes down! It simply means that, together, they will go up or down less than they do singly. Capital markets, in part driven by excess liquidity, at least within the developed world, led to the phenomenon of the tide lifting or lowering all boats, thus compounding the trend for global capital flows to mitigate a few of the local features of individual markets.

The Fall issue of *The Journal of Wealth Management* allows us to group articles into three different categories, reflecting strategic portfolio issues, the world of financial advisors, and individual investment strategies.

The first four articles cover strategic portfolios issues. The first, by Gregg Fisher and Michael McDonald, addresses the issue of asset versus factor allocation, examining four different asset pricing factors and their use in a portfolio that varies over time based on an investor's risk preferences, raising questions about the current industry approach to asset allocation and the driving forces behind the magnitude of risk premiums over time. The second, by Michael Christensen, looks at portfolio diversification and argues that high-net-worth investors can usually do a lot to increase their degree of portfolio diversification, not only with respect to the market risk but also regarding a whole battery of potential risk factors that impinge on the portfolio. The third, by Steve Fraser and Brian Payne, extends the literature by examining the shape of the fixed-income glide slope prior to retirement, suggesting that portfolios with high fixed-income allocations, or bond tents, can serve investors well, and nonlinear glide slopes can produce favorable portfolio characteristics for investors. We then have an article by frequent contributors Sarah Campbell, James Chong, William Jennings, and Michael Phillips, who point to the debate on the value of high conviction, or concentrated, portfolios relative to theoretically better-diversified, portfolios. They conclude that the traditional mean–variance optimization approach worked well with very small portfolios but that a minimum Black Swan risk portfolio worked better when more holdings were included in the portfolios. Finally, Tom Arnold, John Earl, Cassandra Marshall, and Adam Schwartz propose an equivalent tax rate framework to compare the tax efficient accumulation and withdrawal of retirement funds across multiple investment vehicles.

Our next two pieces are concerned with the financial advisor community and its interaction with

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investors. The first piece, by Michael Tertilt and Peter Scholz, analyzes how robo-advisors determine their users' risk tolerance and which equity exposure is derived from the individual risk profile; they suggest significant differences in the quality of offered investment advice. The second article is by Jeffrey Camarda, Inga Chira, and Pieter de Jong and focuses on two characteristics found to be associated with reduced financial advisor misconduct: gender and professional designations. The authors conclude that female advisors are statistically less likely to engage in misconduct. In addition, they find that female advisors with a Certified Financial Planner (CFP) or Chartered Financial Consultant (ChFC) designation are less likely to exhibit disclosed misconduct as compared to male and female advisors who have at least one of the CFP, ChFC, or Chartered Financial Analyst designations.

Our final three papers focus on specific investment issues that one might consider quite relevant now. The first, by Haim Mozes, demonstrates that a static model of crude oil price movements, in which the various predictive variables always have the same weights, is not the ideal approach to model crude oil prices because volatility affects the extent to which the various predictive variables matter for crude oil prices during their forecast horizon. Next, Todd Feldman, Alan Jung, and Shengle Lin investigate the question of whether the VIX futures term structure curve can detect inflection points in the U.S. stock market; they find that transformations of the slope of the VIX futures term structure can be used as factors to improve probabilistic models that predict downturns in the U.S. stock market. Finally, Manu Sharma and Rouhi Gopal analyze derivative strategies that have been applied on Nifty IT—long straddle and short straddle—and conclude that the market structurally is more bearish than bullish on volatility for the Nifty IT index and that the short straddle strategy may offer the best trading prospects in the future if this relationship holds.

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