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Cover design: Loewy Design

On the Cover

Heart II, 2017
Japanese Old Kimono Silk, Polyester, and Rayon Thread
Washi Paper
7.87 inches × 7.87 inches × 7.87 inches
(20cm × x 20cm × 20cm)
Photo Credit: Cavin-Morris Gallery

Chiaki Dosho *(Kawasaki, Kanagawa, Japan) is a well-known contemporary Japanese textile artist known for her elaborate three-dimensional fiber works of art. Over the years, the artist's style has transformed from traditional quilts with patterns to art quilts comprised of fashion materials and vintage Japanese silk kimonos. Taking these styles to transition into her own original technique of incorporating dye, paint, and natural materials. Having exhibited on a global scale, this piece and others are available through Cavin-Morris Gallery in New York City. Visit www.cavinmorris.com to view more fine works.*

In this letter, I would like to address a topic which we have not covered in a long time: defining success and getting paid for it in the Registered Investment Advisor (RIA) world. In fairness, I should note that the thought was put into my mind by Advisory Board member Scott Welch, who recently pointed to the difficulty of being paid for advice, particularly in a world where investment performance has become "commoditized," and to the potential benefit of looking at a different success paradigm: progress toward or the achievement of client goals.

If one goes back far enough, the wealth management industry was but an outgrowth of the institutional asset management world. One got paid as investment managers get compensated—that is, based on some fraction of assets under management. As far back as 30 years ago, it was already evident that individuals were not necessarily all that satisfied with such a setup, particularly as the clientele started shifting from grantors or beneficiaries of trusts to newly made wealth. While the former were used to the aggregation of trust and investment management fees, the latter often focused only on investment results; they were not sure that they were as well served as they could be. As had been the case in the institutional world, certain clients started inquiring about performance fees, often oblivious to the fact that they were not necessarily the panacea that many initially believed. Indeed, there were many instances where the "convexity of the trade"—or the way losses and gains were apportioned—were not to the benefit of the client: was it really such a great idea to exchange one's own risk profile for that of the manager, particularly when the manager was working in a large organization and not invested alongside the client?

Even within the asset management industry, pressures started building to cut fees for a variety of reasons. Traditional, long-only managers have been struggling under the twin challenges of cheaper passive strategies and the difficulties of "benchmark-driven" active strategies to generate meaningful value added. The still modest but growing attention paid to after-tax, after-fee returns is indeed leading many investors to select strategies that do not seek to generate security selection value added; rather, they either accept benchmark performance (truly passive managers) or seek active management in the form of systematic tax-loss harvesting. Outside of the traditional management category, so-called "alternative managers" have also been experiencing the need to bring fees down. So-called "market neutral" or "low net exposure" strategies have been suffering from the low returns available on cash, which has depressed their absolute returns. Market risk taking managers have also had their own share of challenges, as long/short equity managers have struggled in markets that seemed driven by excess liquidity, to the point that the tide tended to lift all boats and make factor or security selection alpha seemingly hard to come by. Illiquid strategy managers have so far been relatively spared; this may reflect the fact that the illiquidity premium—to which they provide access—has been too good to ignore. In short, even within the single silo of asset managers, fee pressures developed, though most alternative strategy managers still earn good asset-based and performance fees.

As wealth managers expanded their menu of services beyond asset management, the dichotomy between pure specialists and generalists with some specialized knowledge made it difficult for generalists to generate fees. Indeed, whether one focuses on estate or tax planning or management, financial planning, philanthropic management, family education, risk management, insurance, or the myriad of other needs which individuals and families can have, "one-stop shops" found competition with specialist "silo" providers quite difficult. While the latter could fall back on long-established fee principles, generalists—who often still needed to call on outside specialists for the more complex tasks—had to devise fee structures which would remain simple enough to be understandable and yet allow them to earn a good living.

Multi-family offices (MFOs) were created—at times, as once observed by an anonymous contributor at a conference in Switzerland, as nothing more than a private bank with a new name—in part to reflect the multiservice nature of the needs of their clients. Yet as many, if not most, of them started life as asset managers, they initially defaulted to an asset-based fee, the appropriateness of which quickly was questioned: why should a fee that is supposed to cover a wide range of services be based on only one dimension of the relationship? Why should families with substantial assets but limited needs for other services pay more than clients with smaller assets but more complex planning needs? Eventually, in the US as well as abroad, a number of advisors started focusing on different compensation principles: the time and value of the expertise required by each client. The fact that clients of MFOs were typically at the higher end of the overall wealth scale made it feasible for MFOs to design creative fee principles and structures and have them viewed as acceptable, at least for some time.

Where the challenge may be the toughest is the world of RIAs. Their clients often—but surely not always—have lower wealth levels. This makes it harder for them to have a menu of "a la carte" services, where the combined fees, when brought back to a percentage of total assets, can appear quite expensive, even if they are in effect justified. The fundamental quandary is, how does one justify these fees?

One of the fascinating by-products of the goals-based approach to wealth management is that it has the potential to remove obstacles to RIA success, and by implication to success by any organization designed to serve individuals in need of "wealth" management services. As amply discussed here before and in many articles published in *The Journal of Wealth Management*, the centerpiece of the goals-based approach is its focus on the various goals which each client has, with their own cash flow requirements, time horizons, and urgency or required probabilities of success. One of the least well-understood elements of the approach is that it allows—requires may be a more accurate statement—the computation of the assets needed at any point in time for the client to meet all his or her goals, within the required remaining time frame and with the required urgency.

Rather than focusing on the hard-to-grasp—or to define—performance of invested assets, one can simply (e.g., at the end of each evaluation period) compare current asset levels—in aggregate or with respect to each goal—to the assets required to achieve the remaining goals within their individual parameters. Assets in excess of requirements would signal that the advisor—and the client—experienced success, while any shortfall would tend to point to failure. One needs to be careful here with the concepts of success and failure, as the assessment must be based on the parameters that were set at the beginning of the evaluation period. For instance, an asset shortfall that was due to cash outflows having exceeded expectations would not signal an advisory failure, though it might point to some planning error, or to some extraneous circumstance beyond the client's control. Conversely, a surplus that reflected lower-than-planned spending should not ipso facto be seen as an advisory success. Major adverse market moves early in the life of a goal—or of a plan—might have a disproportionate impact that would need to be evaluated.

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Yet, within the limitations associated with any planning exercise that is by definition dependent upon many assumptions, one can begin to see a path for RIAs and other wealth advisors to agree with their clients on the definition of success and failure. This would naturally lead to an agreement on compensation principles based on the extent to which goals are being achieved or missed. How those principles link up with surpluses or shortfalls is obviously beyond the scope of this note. However, one can fairly argue that a potentially exciting paradigm may be developing to bring the respective interests of advisor and client toward a broader alignment. This may well be the unheralded and yet more material contribution of the goals-based wealth management approach to advisors; its key contribution to clients must remain the fact that it focuses discussions, planning, and execution processes on what the client is truly trying to achieve.

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The Spring 2020 issue of *The Journal of Wealth Management* is a bit more "concentrated" than usual, as we publish a few longer articles.

The first article, by Denise Kenyon-Rouvinez and Jung Eung Park, focuses on family offices and, based on an in-depth review of recent publications aiming to establish the status of family offices, as well as trends in their development and use, seeks to offer a balanced perspective and insightful synthesis of current research on the topic.

The second article, by Jean Brunel, seeks to fill a void in the literature on goals-based planning, extending the focus from cases where an individual is already wealthy and spending down his or her wealth to two others where the client may be wealthy but has unrealized non-financial wealth and ongoing current savings inflows, and where the individual has a significant income and savings power but not enough accumulated financial wealth to live on.

Our next two articles deal with the advisory environment. The first, by Brian Lawler, Brett Mossman, Patrick Nolan, and Andrew Ang, focuses on the risk factors to which advisor portfolios are typically exposed; it finds that there are large common patterns and significant exposures to just a few factors, although fees do not correlate highly with absolute levels of risk, active risk, or the number of positions—implying large scope to obtain greater efficiencies in taking active risk within a given fee budget. The second, by John Grable, Amy Hubble, and Michelle Kruger, describes how financial advisors rank, weigh, and use client characteristics and portfolio development factors when developing an asset allocation recommendation; it concludes that financial advisors alter the importance of certain factors when working with different clients, though they are somewhat inconsistent in their use of portfolio development factors across client scenarios.

Our next two articles deal with issues within the global equity market. Robert Dubil, the author of the first of these articles, looks at the issue of international diversification, concluding that the home country bias by US investors may not be a bias at all, as, perhaps, investors just rationally maximize the return-to-risk trade-off. The second, by Srinidhi Kanuri and Davinder Malhotra, focuses on decoding the characteristics of health care mutual funds and their performance from 2001 to 2018 to understand whether they have provided the returns and diversification results which investors ought to have expected.

Our last two articles constitute our usual somewhat esoteric concluding section. The first, by Raphael Schwartze and Thomas Maier, looks at selection criteria which private equity funds apply to the companies they select, concluding that low headcount-related ratios, low advanced performance ratios, and low leverage ratios are among the most prevalent. The second, by frequent contributors Tom Arnold, John Earl, and Cassandra Marshall, proposes a student loan calculator to determine the weighted average interest for multiple student loans and payout information for an individual or a consolidated student loan, thus allowing for multiple payment scenarios to be considered, something which many advisors might appreciate having.

Jean L.P. Brunel
Editor