The Journal *of* Wealth Management

Downloaded from https://jwm.pm-research.com by guest on September 25, 2021. Copyright 2021 Pageant Media Ltd.

Jean L. P. Brunel
Editor

Mitchell Gang
Production Editor

Deborah Brouwer
Production and Design Manager

Mark Adelson
Content Director

Rosie Instance
Marketing Manager

William Law
Account Manager–Asia/Middle East

Ryan C. Meyers
Subscription Sales Director–Global

David Rowe
Reprints Manager and Advertising Director

Cathy Scott
General Manager and Publisher

Writing this letter at the end of a year that, by most accounts, was rather unusual to say the least, I thought I would focus on three lessons it either taught me or reinforced for me.

The first lesson must be on the difference between the short and the long term. I know that, on the surface, this is about as insightful as talking of the discovery of warm water, but I think this is something a number of people tend to forget. Most people would truthfully claim to be long-term investors, which I have historically tended to understand as meaning “a full business cycle or longer.” Over this long-term horizon, it would generally be fair to argue that classical economic relationships tend to hold and so do traditional valuation metrics. Yet, noting that the length of a business cycle never was a fixed number, it is also fair to observe that government activity, at least over the most recent cycles, has tended to aim at preventing the normal down leg of the cycle. In so doing, fiscal and monetary policies, both in the United States and in quite a number of countries around the world, have contributed to create a massive amount of excess liquidity.

Excess liquidity in turn has led to a dislocation in capital markets, signaled by levels of nominal and real interest rates that would only make sense in a strong deflationary environment, which has not been the case. Keynes’s liquidity preference theory clearly views interest rates as the price of money. Thus, except when price levels keep falling, why should interest rates be negative? Excess liquidity also provided fuel to light up equity markets, which have reached valuation levels that have generally been unseen except, and with the benefit of hindsight, when a severe down phase was imminent.

The lesson here revolves in my view around the theme of respecting market behavior without losing sights of one’s fundamental bearings. While valuation levels, when assessed in a purely traditional framework, may suggest that overvaluation should result in market reversals, a sense that the short and the long term do not necessarily respond to the same stimuli is needed to ensure that one does not sit out a massive bull market—nor remains fully invested by “buying” into fantasy concepts used to justify current events. Being able to understand why markets may be behaving in the short term in a way that does not fit with long-term criteria is needed to help investors cautiously participate in short-term trends. The trigger for stopping that dichotomy between short- and long-term valuation metrics must be the sense that whatever is propelling markets at the moment is about to stop. Think, in the current environment, of a belief that central banks will no longer keep printing money.

The second lesson relates to the need to weed out crazy theories and remain on strong theoretical ground. Speaking as only one person, I have been amazed at the sheer number of theories that people have created to help justify and possibly extend current market trends. Though age is not always a panacea, it does help to remember past circumstances where theories were formulated to proclaim a completely “new paradigm.” The joke initially proposed around the turn of the 20th century is still valid: A new paradigm is worth about 20 cents. Paradigms do change, but one should not assume that they keep changing. Just as a blip out of perfect line on a radar screen

The Journal *of* Wealth Management

Downloaded from https://jwm.pm-research.com by guest on September 25, 2021. Copyright 2021 Pageant Media Ltd.

can be an aberration, what passes for a big change could be just a fad. Crucial to this process is the requirement that one maintains solid analytical practices.

Personally, I have seen at least three of these phases over the last forty plus years and across most continents. It would be foolish to postulate that change does not happen—it does. It would be equally foolish to argue that change cannot happen fast: The speed of change has generally accelerated. Yet, it is also foolish to view everything as changing dramatically and using change as the argument supporting the total obsolescence of certain industries and the de novo creation of new ones. The process of capitalistic "creative destruction" may be accelerating, but it still has to deal with certain practicalities. Consider the shift away from the internal combustion engine to electrical vehicles. The trend is clearly here, and one could be quite correct predicting the eventual demise of the gas-powered car as we have known it for quite a bit more than a century. Yet, the very fact that there is at present simply not enough electrical generation capacity tells the honest observer that the transition will take some time. This is even more forcefully brought home when one realizes the simultaneous push to shut down electrical plants powered by hydrocarbon. Finally, one could observe that research is ongoing in the field of hydrogen-powered vehicles. What if that was the future, and electrical vehicles, simply a transitional contributor?

The lesson from my humble point of view is to be prepared to consider all potential developments, but to show a modicum of humility when it comes to forecasting the future. As an Australian colleague of mine once said: "If you are going to forecast the future, forecast long-term or forecast often!" Particularly at a time when narratives have had a way of replacing facts, the astute investor needs to be very cautious to be able both to respond to change and to understand the time frame over which it is likely to become commonplace. A solid analysis of all the facets of the potential change—evaluating all variables, discerning between wishful thinking and hard realities, and avoiding casting aspersions on anyone that thinks differently—should be a prelude to determining whether a change is earth shaking or just a minor tremor. Contemplating with amazement and admiration the speed at which vaccines may have been developed against COVID-19, it is probably worth remembering that bioengineering came forward in the 1970s and has been the "idea of the year" at least once or twice since then: Change was real, but there may have been a couple of false starts.

The third and final lesson relates to the importance of knowing what our investments are meant to achieve. Ostensibly, I am speaking here of the formulation of an investment policy and the need to stick to it. Definitionally, an investment policy should cover a variety of capital market environments and be sustainable in both favorable and unfavorable conditions. Behavioral finance teaches that many investors tend to cling to biases or preferences that are at least semi-hardcoded into our brains. Thus, a policy that links the construction of a portfolio to the achievement of one's goals—recognizing that one may have several goals, referring to several time periods and possessing different degrees of urgency (required probability of success)—has the fundamental attribute of "marrying" an investor to his or her portfolio. More-sophisticated versions include nonfinancial assets, up to and including human capital.

Understanding that a typical policy will incorporate ranges within which exposures may vary without requiring an immediate rebalancing is crucial. But, then again, it is

The Journal *of* Wealth Management

Downloaded from https://jwm.pm-research.com by guest on September 25, 2021. Copyright 2021 Pageant Media Ltd.

necessary to understand what a position that differs from the neutral policy allocation MUST say about one's market views. One cannot be overweighted an asset class or a strategy all the while thinking that it is expensive or not necessarily more attractive than others; and vice versa. Parenthetically, tax considerations aside for a minute, adhering to these ranges and systematically rebalancing portfolios are ways to capture some of the return available from plain and simple random market volatility.

Clearly, the situation becomes more complex when taxes are taken into consideration, at least for countries that tax realized capital gains or have different tax rates for short-term and long-term capital gains. There, one needs to formulate specific processes both to capture the "free option" given by an unrealized capital loss and to avoid the tax penalty associated with overly frequent systematic portfolio rebalancing. The investment management literature is plentiful on these topics, and individuals responsible for taxable assets would be well inspired to be fully up to date. The classic quote "you should not let the tax dog tail wag the whole portfolio" may have been acceptable thirty years ago; it clearly no longer applies.

The lesson seems to be to retain a strong tether to one's investment policy. We all know, and behavioral finance predicts, that recent successes tend to make us downplay the risks of investments that have proven successful and overestimate their potential returns looking ahead. The Bernstein paradox clearly tells us that investors with positive cash inflows into the portfolio should hope for markets to fall, while those that need to take cash out of the portfolio should wish for them to go up. And yet most of us have trouble buying when prices are down or selling when prices are up. Adhering to a well-specified investment policy may have been what Rudyard Kipling was thinking of when he wrote: "If you can keep your wits about you while all others are losing theirs and blaming you. . . . The world will be yours and everything in it." I cut off the last phrase in the quote as it did not seem to respect the diversity that is required today.

With this, let me thank all our readers and authors for their faithful support during the year, as well as our advisors and numerous peer reviewers. Without them, *The Journal of Wealth Management* would not exist. Let me also wish everyone the best of everything for the coming year as well as for the year-end holiday season.

The Spring issue of *The Journal of Wealth Management* covers a wide range of topics, with a smaller number of articles than usual. Two of the articles we did publish are longer than our norm, and yet quite interesting.

Our first article, which stands on its own and focuses on behavioral finance, is by Sam Sivarajan and Oscar De Bruijn. They review current literature and conduct a statistical analysis to determine the relationship between risk tolerance and risk taking, concluding that return expectations and demographic variables are important predictors of risk-taking decisions, whereas risk tolerance questionnaires are not.

The next four articles discuss issues that directly relate to the investment management world. The first, by Nathan Sosner and Stanley Krasner, deals with tax efficiency, as the authors focus on transitioning an appreciated equity portfolio to an actively managed strategy, concluding that a tax-aware relaxed-constraint post-transition strategy significantly outperforms a traditional tax-agnostic long-only strategy in its ability

The Journal *of*
Wealth Management

to preserve and grow the investors' after-tax wealth over the long term. The second, by Manu Sharma and Sandhir Sharma, analyzes the performance of private and public equities and concludes that there is no significant relationship between the variance of returns of private and public equities in the United States. The third, by Andrew Cohen and Feng Dong, looks into how the divergence among investor opinions affects stock performance, concluding that because corporate sales are a more direct demand-driven evaluation measure than earnings and sales forecasts can be generated for all companies, sales dispersion is more robust in predicting future stock performance than earnings dispersion. Last but not least is an article by Guntur Anjana Raju and Velip Suraj Pavto, which seeks to yield a deeper insight into portfolio diversification by looking at the integration between frontier, emerging, and developed stock markets in Asia and concludes that the integration of emerging and developed markets is quite high, although frontier markets still provide useful diversification.

Our final two articles stand on their own as well. The first, by Shivani Inder, Arun Aggarwal, Sahil Gupta, Sanjay Gupta, and Sanjay Rastogi, presents an integrated model of financial literacy of Indian business school graduates and concludes that five key factors play a major role: financial and professional training, financial behavior, financial attitude, financial knowledge, and financial culture. The second, by Peeyush Bangur, Manoj Kumar Singh, Pankaj Kumar Singh, and Ruchi Bangur, proposes a new option strategy to replace a traditional short straddle on the Indian Stock Exchange—an angled short trade.

Jean L. P. Brunel
Editor

Downloaded from https://jwm.pm-research.com by guest on September 25, 2021. Copyright 2021 Pageant Media Ltd.