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The Journal *of* Wealth Management

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As I was reflecting on current investment issues faced by individuals and families, one theme suddenly dawned on me: education and the importance of understanding theory.

Taking a step back to explain my thinking, it is important first to acknowledge that we are all somewhat prisoners of our experiences. Though I am no psychologist, I still believe that something through which we have lived must have a stronger image in our memory than something else about which we only read. The logic behind this belief is simply that we actually had to deal with the issue rather than behave as a simple observer. For me, actual experience includes at least three investment bubbles, whether they were called that or not at the time: Hong Kong 1982, Japan 1989 and USA 2000. In all three instances, the proverbial "change in paradigm" had been invoked to justify stock prices which appeared somewhere between overvalued and crazily overvalued on any traditional valuation tool. Yet, in each case, wonderful stories were concocted to explain the current state of prices and suggest that there was no compelling reason to anticipate a material correction. In many ways, I was living through the processes so well described by Robert Shiller in his book "Narrative Economics," which is the subject of a review in one of our articles in this issue.

Readers will have noticed that the three events mentioned above resulted in some serious pain for equity holders, with stock prices falling by 50% or more, not to mention adverse currency moves in the case of Hong Kong. In all three cases, unbridled enthusiasm had been allowed to build to the point where individuals who had little or no experience investing in individual stocks had become active participants in markets. That they were buoyed by greed and, though the term had not been coined by then, FOMO, or the Fear of Missing Out, is highly probable; but that did not diminish their enthusiasm while things looked good and their complete disarray when all hell broke loose. Life savings evaporated, not to mention the dire situation of those who borrowed to play.

I will leave it up to each reader to decide whether one can suggest that US equities are in one of these bubbles and, if so, how inflated the bubble might be. To this observer, it makes sense to believe that a bubble has inflated, helped along by unprecedented liquidity creation by the Fed and loose fiscal policy by the government. The situation is not unique to the US, as Japan shows us how inefficacious such a strategy has been, if not combined with the correct, albeit not always consistent, economic policies (think of raising consumer taxes as one tries to stimulate an economy, for instance).

One can imagine two investor behaviors in the face of the situation. The first involves the euphoria leading people to adopt a riskier than appropriate approach, tactically. That may not be the most conservative way to invest, but one would probably not have much more to say: let the one who has never been caught in it throw the first stone, and I will not be that one. Where this can become a real challenge with serious implications is the second behavior: the use of a current narrative is allowed to affect the formulation of long-term strategy. Again, I leave it up to each reader to rememorate the various narratives that prevailed in each of the three

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aforementioned events. Once that is done, try to imagine how painful it might have been to transform what was principally hype into policy. In Hong Kong, a recovery came relatively quickly; in Japan, the recovery has yet to come, with equity prices still materially below where they were more than 30 years ago; in the US equity prices recovered, relapsed in 2008 and early 2009 but have not looked back ever since.

How can one avoid the trap of extrapolating the recent past, and its excesses, into some indeterminate and distant future? One can think of five general principles that can help ensure that one's decisions remain strongly based:

(1) ***Remember the long-term relationships that prevail among the various asset classes or strategies.*** Clearly, things can deviate from some norm for an extended period of time. One does not need to look any further than the length of time during which the global economy has operated based on negative real interest rates, pretty much throughout the full maturity range. Yet, theory tells us why certain relationships should prevail and experience demonstrates that these rules are generally quite well founded. Excess liquidity in an economy can surely cause a variety of short- to medium-term exceptions, but it cannot persist forever. Eventually something gives and the long-term equilibrium parameters reassert their position.

(2) ***Stay true to the likelihood of achieving a goal over a given time horizon with the correct combination of assets.*** It can always be tempting to overlook this or that negative attribute for any asset class given its recent performance. This is one of the most classical traps into which individuals fall. They thus find themselves overinvested in the best or at least better performing strategies after they have reached their peaks. The risk is particularly high with respect to illiquid assets which are often assumed to be more liquid than they are, specially in difficult market conditions.

(3) ***Remember the key differences between active and passive strategies, and the reason why active or passive was originally selected.*** There are two key reasons to select an active strategy: it can generate some extra return, though usually at the cost of some higher return volatility, and the active process can be designed to achieve greater tax-efficiency. The main reason to select a passive strategy is that it usually costs less, particularly when considered in the light of the fact that many active managers fail to earn after-tax value added. Yet, there are areas or strategies where some extra returns have been earned by a cross section of managers.

(4) ***Remember which decisions you have chosen to make and those you prefer to delegate.*** It is often tempting, particularly after a bubble has been inflating, to feel capable of making certain investment decisions which, in reality, often require resources or skills that one does not have. A bull market surely makes many investors feel that they have certain talents, as a tail wind can help forgive mistakes: one can underperform and still achieve solid absolute performance. Yet, in practice, it is helpful to remain humble and accept that most individuals are better generalists than specialists.

(5) ***Remember the key insight of Modern Portfolio Theory***: A stock is a set of investment characteristics, not a company. Often, but most importantly during happy bubble inflation times, it is easier to justify buying or selling a stock

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> with reference to the company rather than to its stock. Yet, this almost always ends up leading individuals to buy too high and sell too low. There are good stocks, for instance where the underlying company is an oversold industry; conversely, many leaders in that industry may be overbought: their stocks can thus be unattractive. Note that the rationale weakens for strictly buy-and-hold strategies, though many individuals often abandon the buy and hold commitment precisely at the wrong time.

A crucial insight here is the role of education. It is not new that one should observe that wealth management is all about the integration of multiple disciplines into a service delivered to individuals and families. It is important to note, however, that education is often a *sine qua non* where the individual is expected to learn about the work of the specialist he or she has hired. This probably reflects the fact that investment management can be incredibly sophisticated as much as appear extraordinarily simple, particularly in the world of 24/7 “investment programs” on radio or TV. Seasoned investment managers know—whether they truly disclose it or not—that they do not walk on water: they know their limits. Individuals should learn theirs too, as they wear a target on their backs, a target placed by anyone who hopes to sell them some investment service.

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The Summer 2021 issue of *The Journal of Wealth Management* as usual covers a wide range of topics, with, two articles quite a bit longer than usual. Yet, we feel that they should be quite interesting and are germane to our mission to help wealthy individuals and families as well as those who serve them do the best possible job managing their assets, whether these be financial, human, social, cultural, or other.

Our first two articles are definitely in the world of classical investment management, though they focus on different strands within that sphere. The first, by Ritesh Patel, looks at the integration of US and Asian equity markets with respect to the 2008 financial crisis and since and concludes that, though markets have become more integrated over time, there is still ample room for diversification in portfolio construction. The second, by Alfred Ma and Ted Yu, looks into a variant of technical analysis, the application of empirical mode decomposition, and concludes that it contributes to enhancing performance.

The next two articles still involve investment issues but expand the focus to incorporate at least one other dimension. The first comes to us from Australia, as Subhash Abhayawansa and Shailesh Tyagi look at the differences among ESG ratings and rankings (which produce significantly different assessments of the ESG performance of companies) and observe that these differences often arise because of variations in defining ESG constructs and methodology; they recommend that, instead of attempting to compare and contrast ratings and rankings of different agencies, investors should determine the ESG constructs material to their investment strategy and match them with an ESG ratings/rankings product that closely resembles those constructs. The second, by Renu Isidore and Joe Arun, looks into whether the personality of investors influences their behavior in terms of the behavioral biases exhibited and the returns earned in equity investments, with the idea that advisors

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could caution their clients to beware of the biases they are likely to exhibit based on their personality type.

The next three articles each have a different focus, while the fourth is a book review. The first of this group, by Nathan Sosner, Joseph Liberman, and Steven Liu, looks at the integration of income and tax planning, quantifying the benefits of such planning and showing that families investing with income and estate tax efficiency in mind can achieve substantially higher terminal wealth levels. The next piece, by Harsimran Sandhu, Kousik Guhathakurta and Pradip Banerjee, addresses a topic of interest, particularly in the emerging market world: the preference of investors for lower priced stocks, independent of their valuations. The third, by Haim Mozes and John Steffens, looks at equity performance drivers and concludes that a sluggish US economy with low interest rates is likely to cause the classic 60-40 equity-bond allocation to perform more poorly than in the past; though their work is addressed to the pension and endowment industry, their findings should also concern individuals and families who at times imitate their institutional investment approaches. The fourth and final paper by Jean Brunel reviews two timely books: Robert Shiller's *Narrative Economics* and Kirby Rosplock's second edition of *The Complete Family Office Handbook*.

Jean L. P. Brunel
Editor

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