

The Journal of Wealth Management

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Very strong capital market returns have provided a good deal of satisfaction to many of the families we are privileged to serve. Yet, at the same time, such returns have brought several families to a point where a very serious question had to be raised: Should we rebalance the portfolio to its policy allocation? Ostensibly, any answer to the question revolves around two equally important issues: (a) what is the tax cost and related challenges associated with a potential rebalancing? (b) what are the limitations imposed by questions of illiquidity?

A tax-efficient investor has typically chosen to avoid incurring capital gains taxes unless the risks that the current asset allocation entails are unacceptable. Whether the family uses a goals-based asset allocation approach or some variant on the traditional institutional process, there will come a time when portfolio rebalancing would appear inevitable. In short, there comes a point at which the current portfolio assumes more risk than is acceptable given the family's goals.

Though I have to be biased on this issue, I believe that the goals-based asset allocation process is likely superior to deal with the problem. Indeed, involving as it does the listing of each of the family's goals together with its respective time horizon and urgency (or required probability of success for the more quantitatively inclined), it makes it possible to identify first whether the portfolio does or does not comprise some "surplus assets" and second what the implication of the current higher level of portfolio risk means for the various goals. Readers know that we tend to simplify the range of family goals into four categories: needs, wants, wishes, and dreams, as an alternative to looking at specific required probabilities of success.

Thus, let us assume that the current allocation only imposes either a modest reduction in the probability of success or a change in the time horizon (shorter time frame for needs for which the probability of success cannot be tolerably reduced or longer time frame for those goals that are less crucial), a debate about the excessive risk in the portfolio can more easily be addressed. Conversely, assume that the changes required to the parameters of each goal are significant, the family has the option of figuring out how much of a change it can tolerate, that is how much of a rebalancing is feasible.

Muddying up the waters some more is the issue of asset location. Indeed, it is not unusual within a family for the controlling generation to own significant assets on its own, while the balance is owned partially or totally through trust structures with or without philanthropic characteristics. It is thus quite possible that certain gains can be taken with less immediate cost to the family—or consequences in terms of forfeiting opportunities of step-up in basis where they exist.

Finally, still under the header of "tax efficiency," one should note the importance of systematic loss harvesting. There were a number of material market downturns in the last couple of years. Further, there was also significant divergences between the performance of certain markets, with most rising sharply and other falling—the example of Greater China immediately comes to mind, and so do gyrations in the prices of certain commodities, particularly but not solely in the precious metal world. In these circumstances, it would not be illogical to assume that certain positions might in fact be held with an unrealized capital loss. Taking these losses when they

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are meaningful enough to offset transaction costs can eventually provide a way to take capital gains with a lower tax penalty.

A second important dimension, particularly this cycle around, relates to the actual liquidity of the assets of the family. We have seen several instances this year where the exceptional performance of illiquid equities, venture capital in particular, has brought illiquid portfolio allocations beyond where they would typically be. This raises two related and equally important issues: (a) typically, one would have to assume that a family has no realistic way of reducing exposure to illiquid equities, given the usual discount required in secondary offerings, (b) equally importantly, families do not want to lose future access to their current illiquid equity managers by curtailing their annual new commitments beyond a modest point.

It should thus be apparent to our readers that the current environment creates unique challenges to many families for whom what is usually a simple arithmetic calculation becomes a multi-dimensional challenge. As a general rule, one can probably draw three main lessons from the experience:

- (1)** Continuous asset allocation monitoring is not a luxury or something that one carries out once a year at the end of the year. It is a very important element of the ongoing management of the portfolio and should involve an interplay with the family's goal-based allocation. While it is true that families who may have made small cuts in US equities, for instance, during the year may have forfeited some modest further gains, it is equally true that these modest moves may allow them to avoid having to face more serious—and possibly more costly—decisions later on.
- (2)** Illiquid investments can, from time to time, look particularly attractive, especially when the implied liquidity premium looks high. Yet, experience suggests that it is better to work on a principle of annual commitment budgets that avoid effectively “picking vintage years.” It is also important to have a detailed cash flow plan that helps to define expected disbursements and distributions, and is kept up to date to reflect changing circumstances. Thus, the recent pattern of having managers come back to market for their next fund much more quickly than usual can be identified and provisions made in the deployment of any liquidity.
- (3)** Finally, this situation illustrates the need to maintain a permanent linkage between investment, tax, estate, and financial planning disciplines, and this highlights how traditional institutional practices must be adapted to the specific needs of individual families.

One of my mentors always said that a bull market can make a hero of anyone. This is a message that I have kept in mind as the observation by that same mentor, “trees do not grow to the sky” made me realize that there has to be some bear phase awaiting us in the quarters or years ahead. The need to manage a family's long-term assets through these peaks and valleys makes careful planning as indispensable as the contingency planning that any CEO carries out in the management of large or small corporations.

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The Spring 2022 issue of *The Journal of Wealth Management* covers a number of topics, including goals-based investing, cryptocurrencies, world allocation funds, hedge funds, and private equity. We hope the wide range of ideas introduced is useful to our readers.

Our first three articles deal with the impact that bear markets can have on a portfolio. The first, by Sanjiv Das, Dan Ostrov, Aviva Casanova, Anand Radhakrishnan, and Deep Srivastav, deals with goals-based investing and a regime-switching model in the context of bull and bear markets. The second, by Jack DeJong and John Robinson, revisits the classic problem of sequence risk—what happens to various withdrawal strategies in the face of a prolonged bear market? The third, by Tom Arnold and Terry Nixon, examines stocks with negative beta characteristics and evaluates whether they can offer protection to investors during bear markets.

The next two articles examine the performance of investment strategies that have few restrictions on them. The first, by Srinidhi Kanuri and Davinder Malhotra, studies world allocation funds and finds their performance lacking. The second, by Anthony Loviscek and Kangzhen Xie, takes a closer look at the performance of Berkshire Hathaway and finds that recent returns are not as compelling as those of previous decades.

The next three articles are focused on alternative investments. The first, by Ramesh Bhat, Papiya De, and Amit Shrivastava, is a case study on private equity investing in India—the names have been changed to preserve confidentiality, but the case is a real one and sobering for those that are making direct investments in the emerging markets. The second, by William Jennings and Brian Payne, is a quantitative piece that outlines a technique for extracting factor assumptions from a set of asset class assumptions, using hedge funds as an example. The third, by Mark Schaub, looks at reversals in the major cryptocurrencies.

We end the issue with a pair of book reviews by Paul Bouchey on *First Generation Wealth* by Robert Balentine and Adrian Cronje and *The Destructive Power of Family Wealth* by Philip Marcovici.

Paul Bouchey

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