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Recently, I had a fascinating opportunity to see how much progress individual wealth management has been making over the last several years. I attended a conference organized by the Association for Investment Management Research (AIMR), which focused on "Integrated Wealth Management." The message I took away from the conference was that integrated, tax-efficient wealth management had become "mainstream." Three general themes emerged.

First, the importance of the two dimensions of taxation has entered our collective consciousness. Barely a decade ago, pioneers in our industry got us to realize that after-tax returns were the main goal, and that, therefore, too sharp a focus on the traditional, tax-oblivious process aimed at generating pretax returns was not only not appropriate, but also potentially dangerous. The transformation of a two-dimensional space governed by risk and return into a three-dimensional one, where tax-efficiency also played a critical role, forced many investment managers into thinking in terms of "tax-awareness." Though arguments raged between those who worried about the excessive "alpha-invasion" associated with tax-awareness, and those who advocated "buy-and-hold" approaches, a number of smart process changes were brought to bear, resulting in several interesting techniques, which, today, have commendable track records. The active-passive debate was also cast into a different light, with the introduction of the concept of "active tax-management," alongside the traditional "active security selection."

This brings us naturally to the second point, which throws us all back to the drawing board, reminding us that individuals are subject to two forms of taxation. Taxation of investment returns indeed only covers one part of the story, and many would say not the largest part of that story. Taxation of wealth transfers is also very important, if one's goal really is to manage wealth in a tax-efficient manner *across generations*. The need for *integrated wealth management* becomes clear, and the integration of investment, financial and estate planning a necessity. The recent AIMR conference proved the importance of that concept, on which several authors have contributed interesting articles in our Journal in the past, with several speakers addressing the various aspects *asset location* together with similarly important

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topics such as philanthropy, low basis diversification and family wealth planning, for instance. The most noteworthy, from its direct influence on the investment process, is asset location, which has two important implications.

1. Asset location makes the traditional strategic wealth planning considerably more involved. The most important challenge relates to the need to begin to look at one single portfolio broken into several individual components, with different taxation, access, ownership and control parameters. Though the impact on expected returns and total wealth at some future point in time is certainly considerable, so is the increased complexity of the analysis. Different algorithms and models must be used which allow the evaluation of return and risk, both after-tax, across multiple locations and multiple time periods. An important first step relates to the way in which these individual pockets are even accounted for. Following on the traditional process, the industry has been accounting for dollars invested in taxable, tax-deferred and tax-exempt pockets in very much the same way. And yet, as William Reichenstein suggested about a year ago, one should probably compute the asset allocation differently bringing all dollars to a common, after-tax basis. This provides a better sense of the future value of the portfolio and allows one to recognize that return and risk are shared differently with the Government in taxable and tax-exempt or tax-deferred portfolios.
2. Differentiated asset location can help deal with the problem of total portfolio tax-efficiency better, even when only the issue of return taxation is concerned. Indeed, certain locations help the individual investor defer, or even eliminate, the taxation of investment return. This makes it considerably easier to justify greater exposures to certain assets or strategies, with demonstrably poor tax-efficiency. For instance, though the case for hedge funds has been made somewhat powerfully over the last several years, a nagging question has remained: how can I justify investing in strategies, certain of which are totally tax-efficient and do not generate significantly greater after tax returns

than municipal bonds? The diversification argument has always been proposed in response, but several observers could not yet be fully convinced, observing that survivorship bias in historical data makes a solid understanding of forward-looking expectations hard to develop. The ability to consider tax-exempt locations offers quite a convincing rationale, once these tax-inefficient strategies can be allowed to compound for quite some time in a tax-exempt or deferred manner.

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The third message harks back to a theme which has been with us for a while and yet has not been fully accepted in practice: the need to think differently about overall portfolio construction. That is bringing investment managers to consider what I once called "the upside-down world of tax-aware investing." The active-passive debate actually is helping place the problem into the proper perspective, as it isolates the relevant issues and allows an unbiased focus. At issue here is the simple idea that sequential portfolio optimization may well not be appropriate. Sequential portfolio optimization characterizes a world which is based on the idea of building blocks, which optimally assembled will produce an optimal portfolio. The concept, which came about in the tax-exempt world as a result of manager specialization, finds its clearest illustration in the world of equity management. There, it has become common practice for managers and consultants alike to argue that actively managed portfolios should be divided into individually and discretely managed sub-portfolios. This has given us the frequent "six-way" portfolio, where domestic equities are divided along two dimensions: three size considerations (large-, mid- and small-cap) and two style biases (growth and value). The active-passive debate is helping show that such a form of specialization actually causes a substantial amount of unnecessary portfolio turnover, which, in turn, imposes significant and an unnecessary capital gain tax drag on portfolio returns. The issue can then be broadened into its full complexity, suggesting to managers that a tax-efficient wealth management process focuses on the whole portfolio and divides it into as small a number of parts as possible, to ensure that portfolio rebalancing can be done in the most tax-friendly manner.

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This Summer Issue of *The Journal of Wealth Management* provides us with an opportunity to look into three different broad topics. But, first, we start with an article by Robert Jeffrey, who explores the challenges of actually managing assets in a tax-efficient manner and concludes that the challenge is anything, but simple.

We then turn to the issue of strategic asset allocation, with three articles. William Reichenstein revisits a theme which he investigated in the four-article series published in the last eighteen months and discusses asset location issues for different types of investors. Jean Brunel presents a case study designed to illustrate the opportunities associated with multi-location portfolios, together with the complexity which multi-location injects into the analysis. We conclude this section with an article by Cris Lewis, Tyler Bowles and Frank Caliendo, who explore the effect of current and future income taxes on optimal portfolio selection.

The next two articles deal with individual investment strategies or tools. Heidi Schneider and John Geer, Jr. first turn to employee stock-options and discuss the pitfalls which investor face when a substantial portion of their wealth is allocated to them. Then, Robert McFall Lamm, Jr. and Tanya Ghaleb-Harter discuss the role of hedge funds in taxable portfolios and conclude that they do play a particularly important role.

We then turn to the interaction between market developments and valuations, with two forceful and controversial pieces. Joseph Bartlett looks into the assertion that we have been in the middle of irrational exuberance and, applying it to the world of private equities, where he has spent most of his career, and suggests that the game has changed. Victor Canto considers volatility and valuation, focusing on the same question: is the U.S. equity market really dramatically over-valued. He looks into the most frequently used metric and suggests a different model.

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