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The desolation and sadness associated with the attack on the U.S. on September 11, 2001, was compounded by a sense of disarray for a number of wealthy investors. This disarray reflected the onset of the process through which decision risk arises, decision risk being defined here as the risk of changing horses in the middle of the race.

Many investors adopt an investment strategy without having followed the appropriate process. Wealth management requires an iterative process comprising four distinct phases: understanding my own circumstances and the opportunities available to me; planning a strategy that fits with these constraints; implementing the strategy; and finally supervising and monitoring the execution of the strategy. Note that the process is iterative, in that individual investors will "travel on the road to optimality," rather than reach it in one fell swoop. They will need to learn about the opportunities and about themselves. They will need to get used to and comfortable with markets and strategies, before being fully committed to them.

- ***Understanding one's own circumstances and the opportunities available*** is critical because it constitutes the foundation of the overall wealth management effort. At the top of the list is the requirement for every investor to know himself or herself. Particularly important is the need to appreciate the way in which they will react to adversity, defined here as a strategy producing unexpected and disappointing results. Ensuring that the investor will be able to define his or her "comfort zone" is one of the most important elements of the planning process.

  Equally important is the need for the investor to develop rational investment expectations. Behavioral finance, common sense, and experience all suggest how frequent it is for individuals not to have fully rational expectations. Thus formulating a process through which these expectations can be developed is important, because it will help us identify the issues which should be raised when an individual or a family start on their wealth management journey. They can therefore begin to appreciate what it is reasonable for them to expect and what should make them worry. They can understand which asset classes or strategies make sense for them, and which are likely to make them uncomfortable, for some intermediate period of time or more permanently. Finally, they can learn how the con-

THE JOURNAL OF
WEALTH
MANAGEMENT

straints they would like to impose will or will not significantly affect the returns they can expect.

- ***Planning the wealth management strategy*** is a crucial second step. Investment management is not a tactical game. What are the chances of anyone hitting their target if they have not taken the time to identify and locate it? The late 1990s message that a great deal of money could and would be made through day trading or the idea that just having access to information or certain electronic tools will pave the road to great wealth echoed well then with the "greed-cord," which is in all of us. Yet, both fictions disguise the simple fact that there is a lot more to wealth management than picking a few stocks or mutual funds.

  A very powerful reason for being careful and developing a well-thought-out wealth management plan has to do with taxes. In contrast with the blessed environment in which a tax-exempt investor lives, the world of the taxable investor penalizes mistakes very heavily. Indeed, taxable investors can be hurt *twice* by a poor decision: they must live with disappointing performance *and* accept the tax costs associated with any subsequent change.

  Thus, they need to develop an investment policy, which should discuss values, goals, and needs. It should cover philosophical preferences (with respect to wealth management issues) together with important constraints. It should describe both strategic asset allocation and the general ranges within which portfolio rebalancing will be conducted. It should discuss asset location issues, when the investor has more than one pocket through which the investments are held. Finally, it should specify the governance structures to administer and control the process, and the way in which investment decisions will be made and implemented.

- For many individuals, ***implementing the strategy*** is the real start of "the action." It is true that it involves making decisions, but these decisions must be well informed and carefully made. Implementing the wealth management plan principally is concerned with manager selection and management, but it also involves several important other issues, such as market timing and tactical portfolio rebalancing, the use of derivative instruments, and, most importantly for newly liquid investors, initial portfolio funding.

  One of the most important lessons associated with this step of the process is the need to keep the focus on the whole portfolio. Taxable individual investors indeed need to appreciate that, by arbitrarily breaking the portfolio down into too many components, they expose themselves to unnecessary administrative complexity and, probably more importantly, to increased adverse tax consequences, as argued in these pages in the Fall 2001 issue by Stein, among others.

- Though the initial effort to outline values, goals, and needs and enhance individual understanding of opportunities and issues goes a long way toward raising the prob-

THE JOURNAL OF
WEALTH MANAGEMENT

ability that the wealth management process will be successful, there remains ***the need to monitor progress***. In a world where returns are uncertain at best, a few of the assumptions originally incorporated in the modeling of the portfolio strategy are likely to appear farfetched at one point in time or another.

This will often require individuals to face up to three important challenges. The first has to do with the design and delivery of a reasonable portfolio appraisal. Designing the contents of the desired periodical reporting package is the first step to a successful wealth management process. The second challenge faced by individual investors relates to performance measurement and assessment. Calculating after-tax performance is a complex process, and assessing it is even more difficult, given the challenges associated with the design of a benchmark subject to the same general external circumstances as the portfolio. The third challenge involves the need to provide for governance in circumstances where it is not always natural. Here, the issue involves creating a process through which decisions will be made, and to stick to that process.

Many of the investors who, intentionally or unwittingly, sidestepped one or several steps in that process are now experiencing various forms of anxiety, as they do not know how to react or are uncomfortable reacting to the unexpected. The performance of many markets and strategies had already been disappointing in many instances prior to the terrorist attacks. The dramatic impact which the attacks had on capital markets around the world, in particular the substantial rise in volatility, only compounded the problem.

In the end, an important element of the solution involves thinking all risks through. Though I will cover those in more depth in a subsequent letter, it might be worth thinking of the six critical risks which individual investors incur.

- *Market risk* reflects the extent to which the value of the portfolio is dependent upon the general movements in global capital markets.
- *Manager risk* reflects the extent to which the activities undertaken by the managers of each individual strategy (including the investor himself or herself, if a part of the portfolio is self-managed) can lead the behavior of the portfolio to deviate from that of underlying capital markets.
- *Liquidity risk* reflects the fact that investors may not be able to access their assets in certain circumstances.
- *Operating risk* applies more particularly to investors who retain an interest in businesses or activities which they control or manage directly.
- *Decision risk* reflects to the tendency we must control of wanting to change horses in the middle of the race.

THE JOURNAL OF
WEALTH MANAGEMENT

- *Systemic risk* relates to the fact that investors are participating in global securities markets and are thus exposed to the risk that systemic failures may develop, whether they involve a simple counterparty risk or a more serious institutional disruption.

Setting out in detail both the nature of these risks and the way in which they can affect the portfolio, as well as discussing how they are managed, is an essential element of the first two phases of the wealth management process.

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This issue of *The Journal of Wealth Management* offers even more diversity of topic than usual. We start with two articles of very broad interest. First, Barbara Hauser investigates the issues associated with transferring one's wealth to one's children. Then William Jennings and William Reichenstein take us through a discussion of Social Security benefits and provide insights into the value of such benefits to wealthy individuals.

The next six articles focus more specifically on various stages of the wealth management process we just discussed. First, Lex Zaharoff and Ashvin Chhabra deal with strategic asset allocation issues, introducing a new risk concept: personal risk, defined as the probability of achieving one's financial goals. Then, Andrea Trachtenberg looks into the value of professional advice, in an article which brings together investment and behavioral finance issues. Douglas Rogers investigates the challenging question of equity manager selection in a tax-efficient context. The next two articles, by David Stein on the one hand and Michael Seiler and Thomas Bengtsson on the other, deal with security selection issues. Stein discusses a common misconception, which inappropriately equates indexing with a momentum strategy. Seiler and Bengtsson look into the industry performance divergences that are brought about by equity market bubbles. Our final piece is by Victor Canto and Peter Mork and, though more tactical, it is potentially quite interesting, as it addresses the issue of currency management in emerging countries.

I would like to conclude by welcoming Scott Welch, who is the director of equity risk management at CMS Financial Services, as the newest member of our Advisory Board. Scott has been a strong supporter of the journal, both by submitting great articles and through unusual insights.

Jean L.P. Brunel
Editor