THE JOURNAL OF
WEALTH MANAGEMENT

VOLUME 4, NUMBER 4 SPRING 2002

JEAN L.P. BRUNEL Editor

HARRY KATZ Production Director
PEGGY MALONE Production Supervisor
MICHELLE WRIGHT Senior Production Artist
DAVID GOMBAC Copyeditor
AJANI MALIK Reprints Manager

INGRID BONEY Marketing Manager
STEFANNY HSU Senior Marketing Associate
JOHN POLEK Web Customer Service Coordinator

MARYANN ARMOND Account Manager
NANCY SAGL Account Manager
KATHY ANDREW Advertising Sales Assistant

ALEX BELINSKY Fulfillment Director
CHERLY-NINA BONNY Fulfillment Supervisor
NASHELLE ORTIZ Fulfillment Assistant

JESSICA REID Group Finance Manager
CLAUDIA MYERS Accounts Manager

GREG ANDERSON COO

ALLISON ADAMS Publisher
CHRIS BROWN CEO

Though this issue of the Journal will not reach our readers until the early spring of 2002, it is compiled at the end of 2001, at the time when we both think of sending warm holiday wishes and of the looming tax deadline, in the United States at least. While I would not want to miss the opportunity of wishing all of our readers a happy and prosperous New Year, our focus here will be more directly placed on the issue of tax efficiency.

As an industry, we have made major strides over the last several years, as thinking in after-tax return terms has gone from a very solitary preoccupation to a broadly publicized concern for most private wealth managers. Yet, I have not yet met any wealthy investor who does not feel that we, as an industry, still have a long way to go. Indeed, tax-efficient investing still rarely is the central consideration it should be. I have heard individuals say that it is principally a marketing gimmick for the industry and, though protesting the statement as too broad by a large measure, I must confess that it still holds a kernel of truth. If it were not the case, why would certain "tax-efficient" mutual funds launched at the height of the bull market in growth and technology appear so tax-inefficient a year or two later, when the two factors are no longer in favor?

Being tax-efficient requires a complete change in the mindset of the portfolio manager and forces him or her to jettison many of the dearly held beliefs acquired over many years. I have argued that there are at least five central principles to tax-efficient wealth management and would like here to revisit the topic.

- Arguably the most basic principle, challenging conventional wisdom, substantially underpins the others. Dealing with taxable individuals unfortunately makes the incremental process development approach followed in the institutional world for decades at best ill suited, and arguably unable to produce the desired outcomes. Challenging conventional wisdom takes on several dimensions, but three of the most important may well be the need to think in terms of the components of return rather than in a total return space, to recognize the importance of comfort for an investor to stay the course, and to develop appropriate performance assessment tools. To the extent that

Downloaded from https://jwm.pm-research.com/content/4/4, by guest on May 16, 2022. Copyright 2002 With Intelligence Ltd.
It is illegal to make unauthorized copies, forward to an unauthorized user, post electronically, or store on shared cloud or hard drive without Publisher permission.

THE JOURNAL OF
WEALTH
MANAGEMENT

the tax code differentiates between income, realized short- or long-term capital gains, and unrealized capital gains, the taxable investor is no longer indifferent as to the way in which return is generated. Similarly, to the extent that an important psychological dimension enters into the investment equation, as predicted by behavioral finance theory, then it becomes important to recognize the need for the investor to minimize the decision risk which tends to push one to change horses at the worst possible point. Finally, the industry has to face the delicate challenge of measuring and assessing after-tax performance, a task that, despite excellent work by AIMR, may still require additional research to develop appropriate benchmarks.

- Appreciating the value of volatility is an important second principle, which drives both the way in which a portfolio manager may look at asset allocation and actual investment processes. Volatility indeed has an option feature to it in the after-tax space, since, as aptly noted by William Reichenstein, a taxable investor shares some of the risk he or she takes with the government. Thus a taxable investor can see a loss as an opportunity to shelter a gain, today or in the future, to rebalance the portfolio's asset allocation or to raise the tax basis of the portfolio. This can lead more volatile asset classes or strategies to have a more important place in the taxable portfolio than they might have in a tax-exempt environment. Indeed, as amply demonstrated by the providers of passive structured portfolios—which David Stein calls actively tax-managed portfolios—a greater amount of diversifiable volatility can substantially promote tax efficiency both within a specific account and across the whole portfolio.
- This leads one to recognize that there are two different kinds of transactions. A direct consequence of the potential to use "loss harvesting" as a means of raising portfolio tax efficiency is that one needs to look at individual transactions in a different way. In a tax-exempt or tax-oblivious environment, the only sensible rationale for executing a transaction must be that it will improve the portfolio, by raising the expected return, lowering the expected risk, or some of both: in short, this is an "alpha generating" transaction. The tax-efficient investor needs to consider another transaction, which one can call "alpha enabling." An alpha enabling transaction would be one which does not in and of itself produce any incremental alpha. However, it makes it possible for another transaction to create after-tax alpha, usually by sheltering an unrealized gain on the sell side of the transaction. In short, it enables a transaction which, *per se*, might be able to produce pretax alpha but could not generate after-tax alpha, for instance because of the interaction between the tax basis of the "sell candidate" and the expected excess return of the "buy candidate."
- A tax-efficient investor cannot afford to allow his or her focus to be diverted to individual sub-portfolio pockets and must keep a sharp focus on the whole portfolio. It is a truism that one pays taxes on the whole of one's wealth, and not on individual pockets. Thus, the sequential portfolio optimization process, which is the rule in the world of the tax-exempt investor, must give way to a simultaneous optimization in the taxable world. This arises because, even if each of the sub-managers were to be individually tax-efficient, we would not necessarily know whether the tax-sheltering activity performed within each sub-portfolio has not "wasted" unrealized losses which would be more valuable elsewhere in the portfolio. This has at least three interesting implications. First, style diversification does not always make sense, in that a broader mandate can avoid the costs associated with narrowly based portfolio rebalancing, as recently observed by David Stein. Second, it may not always be good to try to diversify manager risk by having multiple managers, as this increases the challenge associated with total portfolio coordination and the risk of broad tax inefficiency. Finally, mutual funds or similar commingled structures

Downloaded from https://jwm.pm-research.com/content/4/4, by guest on May 16, 2022. Copyright 2002 With Intelligence Ltd.
It is illegal to make unauthorized copies, forward to an unauthorized user, post electronically, or store on shared cloud or hard drive without Publisher permission.

THE JOURNAL OF
WEALTH
MANAGEMENT

may not always be better than individual accounts, with the implication that our industry needs to develop the technological tools to be able to offer cost-efficient mass customization.

- The final principle involves recognizing that portfolio drift is not trivial. Whether the portfolio is taxable or not, it is inevitable that the better performing asset classes or strategies will tend to see their overall portfolio weights rise, while those which trail the portfolio's average return will see their weights decline. To the tax-exempt investor, this is not a significant problem. One just needs to execute a simple portfolio rebalancing, controlling execution costs. The taxable investor, however, needs to be concerned about the tax costs associated with the transaction, as selling an asset that has outperformed must generally mean that one is realizing a capital gain. Therefore the challenge posed by what I have called "the cost of staying there" is very real, and the alternative of allowing the portfolio to drift is not viable given the increase in expected risk that ensues. Managing the trade-off between that risk and the tax inefficiency associated with the alternative is an important part of the role of the private wealth manager.

* * *

This issue of *The Journal of Wealth Management* starts with an issue of concern when dealing with broad investment policy issues in general and decision risk in particular with an article by Michael Seiler, Clint Tan Chee Leong, and Mark Lane which considers irrational exuberance and apparent bouts of valuation excesses in a behavioral finance framework. We then turn to the formulation of a long-term strategy with articles focused on two important issues. Joanne Howard first discusses the benefits of asset allocation, while Scott Welch then addresses the question of diversifying a low basis holding and evaluates a number of techniques and tools to execute that process.

The next three articles are concerned with hedge funds, which have attracted both substantial investor capital in the last several years and press attention in the recent past. First, Alexander Ineichen discusses the relative advantages and disadvantages of funds of funds. Jean Brunel then revisits absolute return strategies, also known as non-directional hedge funds, and suggests that they may be more highly correlated with broad markets than often suggested by marketing literature. The third article in this section is by Shoaib Khan, who discusses the specifics of one such absolute return strategy: risk, or merger, arbitrage.

Finally, Peter Susko proposes an interesting methodology to deal with the interaction between capital gains and the alternative minimum tax, while Ivo Stoyanov focuses on a broader practice management issue, looking into the technology business case for wealth managers.

* * *

I would like to conclude by welcoming James R. Hedges IV, who is the president of LJH Global Investments, as the newest member of our Advisory Board. Jim and his firm have long been strong supporters of the Journal, and we are thrilled to be able to benefit from his insights.

Jean L.P. Brunel
Editor

Downloaded from *https://jwm.pm-research.com/content/4/4*, by guest on May 16, 2022. Copyright 2002 With Intelligence Ltd.
It is illegal to make unauthorized copies, forward to an unauthorized user, post electronically, or store on shared cloud or hard drive without Publisher permission.