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The market gyrations to which I referred in my last letter have only gotten worse! They remind us of a few basic principles, on which it is well worth reflecting. The first is that integrity is a non-negotiable, *sine qua non*, ingredient of business. It cannot be legislated, it can only be assumed to be present, and egregious behavior must be punished. Yet before one jumps onto the bandwagon of finger-pointing, it is worth also remembering that a questionable part of our free-market culture involves the careful trade-off between individual and collective freedom. Adam Smith argued that the collective actions of free individuals provide the invisible hand guiding the economy. At the same time, many elected officials—presumably reflecting the views of fellow citizens—incessantly argue for the need to safeguard the public against the potentially predatory behaviors of selected individuals. The problem arises when these two diametrically opposed views collide.

They collide when the free market of ideas runs into the free market of regulations, which can create untold complexities as well as opportunities. As a for-instance, one can think of the integrated wealth management opportunities provided by the fact that the estate and gift tax code does not always "talk" to the income tax code. Therein lies the opportunity to create defective grantor trusts, a powerful tool that allows numerous families to transfer wealth across generations. Similarly, the different tax treatments afforded to physical and derivative securities provide numerous opportunities to enhance the tax efficiency of a portfolio through the judicious use of derivatives.

The relevancy of these examples to the current environment is in the fact that most of these conflicting rules and regulations also suffer from a notable lack of clarity. Very few situations could be described as black or white, with the resulting challenge of living across many shades of gray. This is where integrity becomes the absolutely critical ingredient, as it is the one that allows one to decide how far to "push the envelope," and to find out where that invisible "line in the sand" is.

The second fundamental principle is that greed and fear drive valuations. The price of a security indeed should not be viewed simply as a direct, almost formulaic, reflection of some fundamental

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data. Rather, the price of a security is driven by the interaction between the fluctuations of these fundamental variables and the fluctuations in greed or fear, which effectively prescribe how much investors are willing to pay for these supposedly objective pieces of data. An interesting by-product of that process is that *greed* and *fear* determine not only how to value fundamental characteristics, but also which fundamental characteristic to study and evaluate.

Thus, investors are currently seeing the unfolding of the second half of an investment cycle which seems, in the end and with the benefit of hindsight, quite "normal." The end of the twentieth century was characterized by an almost unmitigated greed which pretended to invent new economies, new investment valuation approaches, and even a new way of looking at the typical income statement. The focus on revenues rather than profits (which often did not exist) and the tendency to dispel any notion about the importance of the quality of earnings led to visible excesses which fed an exceptional bull market. The reestablishment of a number of these possibly trite, but certainly proven and time-tested principles is now feeding an equally impressive bear market. In the end, one can hope that these "cleansing rites" will wear out any remaining fear, heralding the next greed-led leg of the cycle.

The last principle in this troika is that *diversification* is still the most appropriate approach to constructing an intelligent portfolio. Diversification applies equally within and across strategies. Recent market developments have indeed proven the dangers associated with concentration, which is particularly problematic when event risk is highest. The press widely reported the dramatic decline in the still quite short-dated WorldCom bonds, whose price fell from nearly 80% to less than 15% of par in a day, as they moved from investment grade to junk status! Less dramatic, but still broadly analogous price moves occurred in both stock and bond markets as news items substantially changed investor perceptions as to the investment worthiness of certain corporations. This will rekindle the well-worn debate as to the relative benefits for individual investors of selecting a portfolio of individual securities versus purchasing a diversified portfolio of commingled vehicles such as partnerships or mutual funds. Note that the debate is not limited to the world of traditional investments. Indeed, a few hedge fund managers found out about the challenges associated with diversification in March, as telecommunication equities rebounded: They had established short positions to diversify market risk away from their portfolios. Yet these short positions did not provide the market risk diversification they expected, as their prices rebounded more sharply than those of their long holdings. Diversification had failed and they were effectively net short an outperforming market sector. The lesson of these episodes is that one needs to be sure that one has achieved the diversification goal one had set for the portfolio, and not be satisfied by vague approximations.

The current market environment also reminds us of the value of broad diversification in those instances where the outlook appears particularly uncertain or when we happen not to hold any particularly strong opinion. Though wealth is indeed often created through activities that involve accepting the risks associated with high concentration, it is well worth remembering that wealth is protected by managing that concentration risk efficiently and humbly. The fallacy associated with the idea that broad traditional investments are one of the avenues to create vast wealth (a few people have done so, but the vast majority of investors have not), which was born of unusually strong (equity) markets, has revealed itself for what it is: a wonderfully appealing idea that does not hold up to careful factual scrutiny. Risk is a double-edged sword and unusual returns are often more likely than not associated with unusual risks. There is no real substitute for a well-thought-out investment policy, executed in a careful manner, with solid risk management and a healthy respect for the market as a whole.

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This issue of *The Journal of Wealth Management* covers a broad cross-section of interesting topics. The first five articles relate to wealth management policy issues. We start with a piece by Barbara Hauser who investigates family governance. Next we turn to an article by Ken Fisher and Meir Statman who discuss the link between investor's expectations that a market bubble may exist and their propensity to invest in that market. The next two articles in this first group relate to the formulation of investment policy, with Roberta Gamba looking into the issue of managing a portfolio of executive stock options and Mark Miller offering a thorough analysis of the hedging options available to taxable investors. We round out that first section of the Journal with an article by Jeffrey Horvitz who offers interesting insights into the challenges associated with portfolio rebalancing in a taxable environment.

The second group of five articles is dedicated to various aspects of the non-traditional investment world. We start with an article by Greg Gregoriou, Fabrice Rouah, and Komlan Sedzro who investigate a somewhat theoretical aspect of the managed futures industry: Does the net asset value of managed futures program follow the tenets of random walk theory and what does that mean for forecasts derived from historical data? The next piece follows in our series dedicated to the analysis of individual hedge fund strategies: Shoaib Khan describes and discusses convertible arbitrage. Majed Muhtaseb and Jonathan Lach then provide two different views on the debate as to the relative advantages, and pitfalls, associated with investing in hedge funds versus traditional strategies. We conclude this section with a very timely piece by Mark Anson who investigates hedge fund transparency and offers useful insights into the potential for substantial improvements in hedge fund reporting.

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Editor