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Recently, attending a meeting of the Board of Trustees of the Research Foundation of AIMR, a simple new insight hit me, which I feel might help a number of students of the private wealth management world. The fundamental issue is not for us to develop entirely new theories prescribing how different our processes must be, but rather to focus on the interactions between existing bodies of research, in the investment management world, and in disciplines that also happen to be important to individual investors. Indeed, what makes our field different from the well-studied institutional investment management scene is that our clients cannot accept a number of the assumptions routinely made for pension, endowment and insurance funds, because of structural or behavioral differences.

We already know that an individual investor differs from institutions in that he or she must usually pay taxes on both investment returns and any ownership transfers, and that he or she does not operate in an asset-liability matching mode—explicitly or even implicitly. This has at least two interesting implications:

1. Private wealth managers must understand the implications of incorporating tax considerations in the investment process. Note that this does not mean that the wealth manager needs to become an expert on taxation matters, or that research needs to be conducted, at least within our industry, into taxation issues. Simply, the wealth manager needs to be sufficiently knowledgeable about taxes to be able to understand how to modify a traditional tax-oblivious investment process both to minimize any adverse consequences of taxation and how to benefit from selected opportunities the tax code affords.
2. Private wealth managers must also understand the implications of incorporating the findings of behavioral finance into the investment process. Note, again, that this does not mean that the wealth manager needs to become an expert on behavioral finance matters or that our industry need to conduct de novo research into behavioral finance. Simply, the wealth manager needs to be sufficiently knowledgeable about behavioral finance issues to be able to understand how the investment process and client interactions must be modified in order

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to account for and deal with the peculiarities of human nature when it comes to financial matters.

Though seemingly not particularly dramatic a finding, it is crucial. Indeed, thinking in that mode led me to understand better why traditional finance specialists could conclude that there was no need to incorporate the higher statistical moments (skew and kurtosis) in portfolio optimization when intuition suggested it would make sense to do so when dealing with individuals. Let's review the issue:

1. In a traditional finance context, mean-variance optimization focuses on generating an optimal portfolio providing for the best possible trade-off between return and risk at some fixed future point in time. For instance, the goal might be to generate a certain expected portfolio value within a set range of possibilities ten years out. Various alternatives would be evaluated using a set of utility functions. It is thus reasonable that the skewness or kurtosis of the distribution of likely returns might not be sufficiently important to justify the increased complexity of the algorithm. In fact, work by Paul Samuelson suggests that the change in expected utility is marginal at best.
2. Note, however, a critical, unsaid, assumption underpinning this analysis: investors are path-indifferent. Indeed, given the focus on some terminal value and the range within which it might fall, little if anything is said about the way in which the value of the portfolio might fluctuate on its way to that terminal point. The fundamental question should thus be: is it the case that individual investors are truly path-indifferent like institutional investors or is there something special about them that create a form of path dependency?
3. Behavioral finance would tell us that individual investors are anything, but path indifferent. This is consistent with the many findings that individual investors will tend to allow a variety of biases and preferences to affect their behaviors, which has led me to argue that one of the main risks incurred by individual investors is the risk of changing horses in mid-race, which I have dubbed "decision risk." Further, though one might argue that more in depth education might lead individual investors to worry less about intermediate steps, and even to adopt the automatic reactions dictated by the belief in the mean-reversing nature of return series, we will likely always still find some path dependency, as behavioral finance demonstrates that certain biases and prejudices outlast education.
4. Now, if decision risk is important and individuals are somewhat path-dependent, then the conclusion that higher statistical moments are irrelevant is at least somewhat debatable. Indeed, one of the stated goals of the optimization process would need to be to minimize the risk of large negative surprises, which one might assume would increase the likelihood that the investor would change strategy, possibly at the point of maximum pain. In that context, it would be perfectly reasonable to seek a portfolio displaying minimum negative skew and low kurtosis. Negative skew and high kurtosis can indeed be viewed as a proxy for the risk of large negative surprises.

This is but one example of the extent to which incorporating other disciplines into the investment process is necessary when dealing with individuals. In many ways, this recalls the changes which tax-awareness wrought into the traditional investment process, thus demonstrating that the issue was not one of the tax tail wagging the return dog, but rather of making sure that one avoided unnecessary and deferred unavoidable taxes.

1. Remember the insight that volatility might have value and thus not simply be the archenemy, given the option structure that it injects into a portfolio. This led us to think in terms of a barbell portfolio structure rather than adopting the traditional middle of the road portfolio that used managers taking some, but not much

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risk. The interaction between manager risk and portfolio efficiency and the option benefit associated with higher volatility strategies made the change sensible.

2. Remember the benefits associated with systematic loss harvesting, which effectively brought us a second way of being an active manager. The traditional activity axis remained, and continued to trade-off tracking error against security selection alpha. At the same time, a new one appeared, which exchanged the same concept of tracking error, but sought not security selection alpha, but higher tax-efficiency. The former aimed to outperform an index by picking the best and avoided the worst securities, while the latter seeks to outperform an index by achieving similar pretax returns and higher tax-efficiency, used either within that sub-portfolio or elsewhere in the broader portfolio.
3. This idea of focusing on the higher moments of a statistical distribution may be the tool to deal more effectively than hitherto with the question of managing the trade-off between manager and market risk. It is becoming a critically important decision given the increased acceptance of strategies involving greater manager risk, such as hedge funds.
4. Another interesting research area must similarly be the value of liquidity and therefore return associated to illiquidity. Now, clearly, this topic is not neatly limited to private wealth management, as all investors need to think in terms of the liquidity of their portfolio, or lack thereof. Yet, note that behavioral finance will also tell us something about the value of that liquidity to individuals. Indeed, I have heard the argument that illiquidity is a "good thing" for individuals, as it reduces the risk that they will be able to shift strategies at the wrong time. At the same time, I have heard the exact opposite argument: individual investors, though they do not need liquidity in a fundamental sense, need it in an emotional sense. Serious work is needed in that context.

In summary, I would like to encourage our readers to focus on the areas where other disciplines intersect with investment management to create the specific, and fascinating world in which we operate. Whether involving tax or trust law, behavioral finance or any other field, such an endeavor is bound to be both eye opening and tremendously useful.

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This Spring 2004 issue of *The Journal of Wealth Management* has three axes, covered in substantially different levels of depth: asset allocation, hedge fund selection and tax-efficient investment processes. The first four articles deal with various aspects of the strategic asset allocation process. Dan Nevins proposes that strategic asset allocation be driven by a detailed analysis of the goals of the investor, defined in both financial and behavioral or utility terms. Bala Arshanapalli, Edmond D'Ouville, and William Nelson focus on spending rules for endowment funds, in an analysis that might be useful for the trust world. Silviu Alb questions why traditional asset allocation processes seek to maximize arithmetic rather than compound return. Finally, Joseph Davis, Nelson Wicas, and Francis Kinniry offer an interesting analysis of the Strengths and weaknesses of various financial simulation methods.

The next two articles are focused on non-traditional investments. Harry Kat investigates whether it is possible for a fund of hedge funds to not only offer investors access to a diversified basket of hedge funds, but to provide skewness protection at the same time next two articles are dedicated to various aspects of the investment management process. Clifford De Souza and Suleyman Gokcan discuss a quantitative approach to hedge fund manager selection and de-selection.

Finally, Dorsey Farr revisits the issue of tax-efficient security selection, suggesting that there are situations where the pursuit of tax efficiency can and should take place outside of an investor's core portfolio.

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