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At a recent seminar, sponsored in part by the Research Foundation of AIMR, we had an opportunity to bring practitioners and members of academe together, to investigate ways to “close the literature gap.” This is in effect a euphemism for saying that most of the great research work that has been done within the academic community with respect to asset management has been focused on institutional problems. Though the seminar identified a number of fertile research areas, none in my opinion is more important than the notion that we need to develop a better understanding of the *path dependency* that characterizes the investment process geared to individuals.

Path dependency is a concept that simply postulates that outcomes are defined or described not only in terms of some final terminal point, but also in terms of the way in which that terminal point is reached. Further, it recognizes that there are instances where the path is more important than the ultimate outcome.

Consider the traditional, institutional, tax-exempt investment problem. As most institutional investors approach the problem from an asset/liability matching point of view, their principal investment policy consideration relates to the question of whether asset levels at some future point in time will be sufficient to defease projected liabilities. Thus, they are chiefly concerned with expected compound return and the variability of that return. Note that the variability of that return is relevant only to the extent that it helps define a confidence interval around that terminal asset value. Further, as they are dealing with liabilities affecting a large number of individuals, statistics can be used to estimate these liabilities with some degree of reasonableness. Similarly, the process used to manage these assets need not worry about the path to a given decision. There is such a thing as “raw alpha” and, leaving transaction costs aside, one can assume that any portfolio can be optimized based on a single model, provided that model is a fair representation of the portfolio’s expected return/risk trade-off.

Contrast this with the situation of a taxable individual investor.

- First, the tax basis of the portfolio imposes a first level of path dependency. Indeed, the ability of a manager to translate his or her “raw alpha” into some after-tax value added is criti-

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cally dependent upon the current state of the portfolio. Certain trades will make sense in certain portfolios and will not in others. Further, portfolios may well diverge over time as the evolution of their market to book ratios will drive the ability of managers to make changes.

- Second, path dependency is also injected into the mix because of the propensity of individuals to change their minds when confronted with certain extreme and undesirable outcomes. The literature indeed amply demonstrates that individuals change horses in mid-race, which led me years ago to the conclusion that “decision risk” was one of the most important and least explored investment policy issues.
- Third, asset location issues also bring about some measure of path dependency. Recall the argument made by Darryl Meyers and focused on wealth transfer planning structures that have finite lives. The assumption that one will earn each and every year the same long-term compound return is clearly flawed. What indeed matters to the success of the wealth transfer strategy is whether the rate of return actually earned from inception to maturity is sufficient to meet the various constraints incorporated into it. This is but one example of the fact that statistics cannot be as helpful assessing the individual problem, as one cannot rely on averages, there at times being only one possible set of binary outcomes.

Back to institutional investors, for a minute: We are taught that they have well-understood “utility functions” (which can be viewed as risk/return preferences), which have been amply described in the literature. In fact, more recent work suggests that attempts to refine these analyses, for instance by worrying about more detailed descriptions of the return distribution (to account for the fact that many do not fully conform to the traditional normality assumption), are not terribly useful. Understandably, and in the process mimicking each new step in the development of

individual-oriented investment processes, the initial assumption has been that these approaches should be simply naturally extended, with little or no change to individual investors. Yet it is fair to ask whether the “path independence” assumption underpinning the traditional institutional investment policy optimization model is a reasonable assumption when dealing with individual investors.

Intuition suggests that the path dependency assumption should produce different processes, but one probably does not want to overstate that conclusion and extend it to what one hears from time to time with respect to an ear for radically different processes, if not *radically* different long-term capital market assumptions. Indeed, it is fair to ask whether some of the individual’s decision risk can be managed down through education. In fact, in their seminal work on prospect theory, Kahneman and Tversky did anticipate that individual biases and preferences could be in part mitigated over time. Yet, they also suggested that there should be some permanency to them as well. Thus, while it is hard to be convinced by the argument that individuals will, eventually, become just like today’s institutions, it is reasonable to expect some evolution.

That likely evolution in individual behavior should not be used to justify the status quo and simply reject all the findings of behavioral finance. Indeed, the argument in favor of sticking with existing processes seems almost too self-serving on the part of its supporters to be accepted in totality—they do have a vested interest in keeping their worlds as simple as possible, but that should not necessarily extend to forcing a square peg into a round hole. Rather, it makes sense to inject a healthy dose of skepticism and invite both academic and practitioner communities to conduct research to determine the real impact of incorporating some path dependency into their asset allocation and investment processes.

An interesting aspect of path dependency, relating more to investment than policy processes, is the fact that individuals often pay twice for their investment mistakes. Indeed, unless a trade is executed through derivatives, in which case

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it becomes considerably similar to a tax-oblivious alternative, the typical taxable investor pays taxes (usually capital gains related) before having had a chance to know whether the trade was alpha producing or not. Thus, with investors typically having a probability of success substantially lower than 1, there will be circumstances when a tax will be paid for the benefit of making an alpha destroying transaction. To what extent does that change laws and assumptions on which a large cross-section of the asset management community relies?

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This Summer 2004 issue of *The Journal of Wealth Management* has two important axes. We start with three articles focused on different aspects of the investment policy debate. Jeff Evans presents numerous findings from an annual survey of its members conducted by the Institute of Private Investors, and in particular discussing attitudes and expectations. Charles Jones looks into the future to help frame the formulation of reasonable assumptions for equity returns in the 21st century. Finally, Li Zhu, Joseph Davis, Francis Kinniry, and Nelson Wicas tackle two very important questions with respect to private equity: How should one measure performance? And what should be the role of private equity programs in a portfolio? The next two articles relate to the general world of alternative assets. Indeed, Yulin Frank Yao, Brian Clifford, and Rodney Berens look at long/short managers and ask whether specialists fare better than generalists. Finally, Greg Gregoriou and Fabrice Rouah discuss the performance of Commodity Trading Advisors in down market environments.

The second axis reflects a decision to start a two-issue series in which we will incorporate a number of articles based on presentations at last September's Integrated Wealth Management Forum in New York. That forum was designed to set out the "foundations of the new paradigm," and thus involved a number of fascinating discussions, a few of which had already been covered in this journal, but many of which had not yet.

Thus, we start with an article by Barbara Hauser, which investigates the area of family governance—an issue that is important enough to have spawned businesses who solely focus on helping families manage that process. Then, Nicolo Torre and Andrew Rudd review strategic asset allocation, with a proposed quantitative re-formulation of the portfolio problem. Alexander Ineichen turns to the question of the use of absolute return strategies and their role in portfolio construction and management, while Robert Gordon discusses ways of making hedge funds more efficient. We conclude with an article by Dennis Ceru, who discusses issues related to strategy and technology for the new wealth management industry.

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