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It is becoming an increasingly broadly accepted insight that the two most fundamental differences between institutional and individual investors are first their respective tax statuses and second that individual investors do not look at their investment problem in an asset-liability matching mode. A fair amount of progress has been made on issues of tax-efficiency over the last 10 years or so, although a number of asset managers are still not fully conversant with the need to reconsider a wide variety of concepts and to adopt at times radically different practices. Helping individuals through the strategic asset allocation process has only started to be topical, thanks in large measure to the insights provided by behavioral finance. The challenge, however, remains as significant as ever, as more time should be spent by practitioners and members of academe alike on the question of what is an appropriate way of setting goals and meeting them, given the behavioral biases of individual investors.

One of the most interesting issues in this field surrounds the simple question of why should one even consider taking investment risk—effectively, seeking growth—if it is true that the disutility of losses is really greater than the utility of gains in the individual investor's mind. This question is quite important and is relevant to a wide cross section of investors. Most critically, it affects individuals with limited resources: without sufficient growth—and the risks associated with it—they may not have enough funds to meet real binding goals such as securing their retirement income needs, for instance. There, one can at least offer an argument to the effect that the investment problem of these individuals is effectively very close to that of institutional investors: future needs can be analyzed as liabilities and the strategic asset allocation can be viewed as a matching of assets and liabilities.

The issue becomes considerably more challenging when one is dealing with individuals who have more money than they can actually, reasonably spend: the ultra affluent are indeed most in need of sensible advice when it comes to structuring their assets, as they could get by, simply allocating all their assets to risk-free investments. For them, the question can reasonably be asked as follows: if I really have more money than I can spend, and if it is true that I am really risk-adverse, why should I even bother with investing in any asset

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that involves any risk? The question is reasonable, particularly as many of these individuals do not enjoy participating in the investment process and could quite profitably divert their energy to pursuing other goals which they enjoy more and where they might feel more in control.

Yet many of them should at least be exposed to the argument that there are several reasons why they should consider an investment strategy that involves some investment risk and the attendant exposure to higher returns. Four such reasons immediately come to mind:

Protection against future inflation: capital market theory does tell us that the current prices of securities should incorporate some return for both current and expected inflation. Yet current prices, by definition, do not incorporate anything from anything unexpected. Thus, a sudden and unexpected increase in inflation could seriously hamper someone's ability to meet his or her financial goals. That risk can in part be cushioned by the higher expected investment returns that should be associated with some exposure to risky assets or strategies.

Generational dispersion: one of the most powerful forces in families is the combination of spending from existing capital and the quadratic increase in the number of family members as generations move forward. Ignoring for a minute the effects of inflation, one needs an excess return of 2.3% per year just to ensure that the next generation will have the same capital as their parents if there are two children. That number rises to 3.7% and 4.7% when the number of children increases to three or four, respectively. Thus, assuming a 3% rate of inflation and a 20% annual rate of taxation (including both Federal and State taxes), the pretax returns needed to preserve purchasing power at each generation are 6.7%, 8.4%, and 9.7%, when a family has two, three, or four children, respectively. Note that such returns would still not allow any annual spending! In short, an important reason to take some investment risk is to seek some capital growth to help slow the gradual loss of capital per capita that families will typically experience.

Future flexibility: the move from "old" to "new" money in the ultra affluent universe has brought to a position of financial control numerous individuals who had little or no experience with or training for that function. It should not surprise therefore that, for these people, it can be very difficult to finalize financial goals at a time when they are not yet comfortable with their new wealth. One of the advantages of incorporating some "growth" in the set of current financial objectives is that this may provide additional flexibility for these decision makers to change their goals, their focus toward or away from philanthropy, their greater or lesser desire to provide wealth to future generations, or even their adjustment to different spending patterns. Accepting some investment risk provides that flexibility.

Score keeping: last, but not least, one needs to recognize that investment returns are one of the principal tools that type-A personalities will need to "keep score," now that they no longer have their business to run. A good advisor will take great pains to ensure that he or she understands and explains to the family the relevancy of this measure, even though the decision makers may initially seem totally uninterested by investment performance. It is indeed not unusual for a family to iterate through emotions with respect to their capital: they might start with a fear of losing their wealth, then move to a fear of not having enough, then move further to a perception that downside risk is not as important that the ability to make a second fortune, which may be the way the cycle closes. A difficult capital market environment can lead the higher risk that was taken not to be rewarded by higher returns, but rather to produce loss of principal, which could well rekindle the initial fears of loss and thus re-start the cycle, potentially at the worst possible time. Understanding what level of risk can and should be assumed becomes an essential element in the fight against the self-destructive nature of this perverse cycle.

There may be others as well.

In short, it is quite important for the various participants in the wealth management industry, from buyers, to sellers, to researchers to work to develop more detailed insights and tools to help individuals formulate reasonable and sustainable investment strategies.

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This Spring 2005 issue of *The Journal of Wealth Management* comprises fewer articles than usual, because one of the pieces is considerably longer than normal. Though we typically seek papers falling in a rough range of 3,000 to 6,000 words, there are times when a particularly short, or long, piece makes a great deal of sense. This is the case with the article written by Ashvin Chhabra, who introduces a wealth allocation framework bringing together Modern Portfolio Theory with aspects of behavioral finance. The next article by Robert Dubil revisits the question of dollar cost averaging, from the point of view of an investor who invests excess savings and suggests that this method does little to returns but tends to reduce risk. The third article within this first section is by Cris Lewis and focuses on a relatively new investment option, an Indexed Annuity Account, and concludes that it offers certain benefits, albeit at substantial costs relative to an equity portfolio.

Though the first section thus dealt with strategic asset allocation issues, the next group of articles is dedicated to various aspects of the so-called hedge fund industry. We start with a piece by Harry Kat, who presents a summary analysis of work he has conducted to integrate hedge funds into a traditional asset portfolio: his focus is to try and eliminate or at least control the undesirable higher statistical moment consequences of investing in hedge funds. The next article is by Jean Brunel, who conducts a forensic analysis on the returns of a variety of different hedge fund strategies to discern whether there is any evidence that recent excess return trends have fallen or not. Greg Gregoriou revisits a theme and a methodology he and a co-author used to identify the causes of mortality in the hedge fund universe, with a particular attention this time to event driven and market neutral strategies. Our final article is by Ron Surz who looks into performance measurement issues in the long/short environment and proposes an interesting, simulation-based alternative.

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**Editor**