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If there is a topic that has attracted a lot of attention over the last two years or so, it has to be the impact of behavioral finance on strategic asset allocation. A number of commentators have offered interesting and innovative approaches to combine behavioral finance insights with traditional finance-based asset allocation modeling, which, in the end, seem to be producing important outcomes. First, individual investors are getting much better educated on their strategic investment choices. Second, these selections are made in ways that seem to be much more sustainable. Finally, consequently, investors are making better transitions from concentrated or inefficient portfolios to more diversified and more efficient alternatives. All is, however, not as rosy. Where behavioral finance has yet to make enough of a significant inroad is in the tactical asset allocation or portfolio rebalancing process.

Behavioral finance indeed does not invalidate one of the principal tenets of investment theory and practice; it simply helps individuals understand their biases and use that knowledge to make better investment decisions. The understanding of how we might behave, however, does not change the often quoted fact that most significant investment opportunities arise from a combination of a substantial change in fundamentals and an extreme of valuation. Fundamental changes involve the actual environment within which a business operates or the way that business is managed; these would therefore include a change in the supply/demand relationship for a given product or service, whether driven by different industry factors or by a change in the regulatory environment; they could also involve a strategic change implemented by management. These changes are thus relatively few and far between. Extremes of valuation occur when market participants feel particularly attracted to or repulsed by a company, a business sector, an investment class, or even a country or a region. Though not always true, extremes of valuations often result from markets having moved in a certain direction—up or down—for a while and that move being extrapolated into the indefinite future, as investors simply follow the trend.

It is not a useless rule to assume that, in most circumstances, somewhat of a cynical or contrarian approach to investments is more likely to be successful over the long term than the alternative, which involves following the trend. This simply reflects the basic investment principle that states that returns tend to revert to some long-term mean. Thus, it is usually a good idea to consider selling or paring back any investment that has done better than expected for some time and vice versa. Interestingly, behavioral finance tells us that our own biases and prejudices will tend to make us behave in a virtually polar opposite manner to that optimal approach. Narrow framing, hindsight, overconfidence and the illusion of control all tend to push us to be "momentum" investors, who follow established trends. This prevails both in the individual wealth management business and in the institutional asset management arena. Indeed, a simple look at the asset, sector, country, or currency allocations found in institutional portfolios, on average, typically suggests that some herd instinct is at work and that the comfort involved in moving in the same direction as others—and the attendant associated reduction in business risk—tends to trump the belief that success resides in being different from others. To the extent that most institutional portfolios rarely deviate from their long-term strategic benchmark only in a very limited manner, that tendency not to be as contrarian as one could be does not affect overall returns too dramatically. Unfortunately, the same cannot be said with individual portfolios.

Individuals, indeed, are often less concerned than institutional portfolio managers with the idea of making "big bets." There are several reasons for that. The first is that many of these individual investors actually made their money taking one or a few "big bets," and that they feel comfortable with such a strategy. The second relates to the fact that risk management is probably viewed by individuals in a somewhat different light: institutional managers focus on the volatility of the portfolio around its benchmark, while individuals are concerned with the downside risk associated with their investments. The third is that individuals rarely enjoy being a portfolio manager and thus do not often take the time to become totally conversant with portfolio theory, which would lead them away from individual bets to overall portfolio construction.

Be that as it may, the tendency for individuals to be relatively comfortable with bigger bets, their tendency to rely on performance records rather than a more systematic review of the investment process—and the attendant risk of confusing luck and insight—and the predilection for a momentum investment style constitute one of the most important risks that our industry should work to manage on behalf of the investors we serve. This involves first the need to keep harping on the tenets of behavioral finance and teaching our clients that their biases may be working against their long-term interests, both when dealing with strategic issues and as periodic investment decisions are considered. This is a part of a crucial ongoing education effort. It also requires managers and consultants to outline and apply a process focused on a systematic analysis of fundamental variables: a stable emphasis needs to be placed on the fact that investment people have a much lower probability of success than most other professions (we are delighted with a 60% success ratio, something which would certainly not tolerate from our airline pilots or surgeons!); on the fact that a performance record confuses insight and luck or even insight and bias (an international equity manager that was systematically short Japan would have looked great from 1990 to 1995 and yet would have looked terrible if 1985 to 1990 was considered) and that alternative performance analysis is needed to come up with a valuable insight; on the need to identify a significant fundamental change or an extreme of valuation before making a significant asset re-allocation of assets; and finally on the need to evaluate all risks before making a return-based decision.

Behavioral finance specialists could help the wealth management industry by devising processes, approaches, or methods to be used to educate individual investors away from bias-driven decisions. A lot of work has been done and has, as suggested earlier, made major strides in education with respect to strategic asset allocation decisions. The same could not be said with respect to the impact of behavioral biases on other steps in the wealth management process: periodic portfolio rebalancing, manager selection and evaluation, or even portfolio monitoring and overall per-

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formance analysis. Traditional finance has helped institutional investors educate their clients over the years and this has certainly been a factor in the success of their industry. Just as behavioral finance provided the ammunition allowing private wealth managers to lead individuals towards a more sustainable strategic asset allocation, we now need it to help us work on continuous education. Just repeating the same string of examples of how our biases may lead us astray will likely henceforth simply not be sufficient. These stories make for entertaining presentations, but they are getting somewhat long in the tooth and require updating.

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This Summer 2005 issue of *The Journal of Wealth Management* offers a highly diverse menu of articles covering the topics of substantial concern for our readers. Our first article is by Patricia Angus and addresses the important issue of family governance, both defining the terms used in the area and offering suggestions as to what steps should be incorporated in the process. Don Mulvihill then re-opens a question that has been reviewed here and elsewhere before: individual portfolios should reflect a core and satellite structure, where market and manager risks may well be separated.

The next two articles focus on variants on the same theme and actually follow on the suggestion offered in the second article. Cliff Quisenberry and Scott Welch first look at the impact of combining a systematic loss harvesting strategy applied to an index-replicating portfolio with a low basis stock diversification process such as a variable prepaid forward. Bruce Paulson and Bruce Tavel then look into two index-replicating strategies (exchange-traded funds and systematic loss harvesting) and into their suitability within different fiduciary holding structures, and conclude that individual indexed portfolios managed with systematic loss harvesting tend to offer superior results to those afforded by exchange traded funds.

We then turn to three articles individually focused on distinct areas within the full spectrum of investment strategy. Bob Gordon first addresses the thorny issue of the potential risk associated with the trader or investor tax classification claimed by hedge fund managers and ways of minimizing these tax risks. Timothy Corriero then turns to an evaluation of the tax efficiency of timber investments, both detailing and illustrating their impact of expected returns. Finally, Marthe Lie, Snorre Lindset, and Arne-Christian Lund look into the potential need for standards in the capital guaranteed product world based on an example taken from the Norwegian market in the fall of 2003.

Our last article is somewhat unusual for our Journal in that it dives into somewhat of an arcane topic and does that using somewhat more complex mathematics than usually expected here. Michael D. Bergmann and C. Thomas Howard indeed delve into the question of multi-index shrinkage estimation. Though the topic is highly specialized, it should be of interest to individuals who are concerned with the typical mean-variance optimization process. We have in the past published articles that discussed other limits of that process, which dominates the way in which the strategic asset allocation of individual portfolios is derived. It thus seemed to us valuable to look at another potential limitation, despite the fact that the article may be hard to follow for people not at ease with mathematics.

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Editor