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Recently, I was honored to be invited to participate in a Thought Leader forum organized by the Family Office Exchange. The one-day seminar focused on the idea that families and family offices need to be concerned about risk management. It is hard to think of a more important issue that has so far not received the appropriate attention in many instances.

Risk management, just like wealth management, tends to be somewhat misunderstood. Portfolio managers of old—who at times called themselves wealth managers—were really only involved in one of the many facets of the much broader wealth management spectrum. As investment specialists, they would often develop their practices as far as their skills allowed, but rarely would they venture beyond the tried and true paths they had traveled for many years. Thus, they would execute potentially very sophisticated investment programs without really understanding or even questioning how their programs might interact with other aspects of the family's wealth management endeavors. Whether that tunnel vision is related to a lack of understanding of tax implications or to the many subtle behavioral quirks that individual investors often display, it almost always ensured that the eventual solution would be sub-optimal at best. I vividly remember a well-respected member of the academic community lecturing me not so long ago on the fact that the kinds of optimization approaches I was discussing had been proven to add nothing to the old mean-variance paradigm. I could only smile, noting to myself that the individual was ostensibly not familiar with the notion of path dependency and with the risk incurred by many individuals of changing horses in the middle of a race: most utility-based optimization models aim to generate the best end of horizon outcome, worrying little if at all as to how one might be getting there. Oops!

In short, the critical element of wealth management is that all individual disciplines never cease to interact with one another. The optimal solution is the one which best reflects these complex interactions rather than the one that best satisfies the dictates of a single discipline.

The problem is no different when we turn to risk management. The discipline can indeed be viewed either in some general perspective or understood in a very narrow context, for instance as

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related to a single discipline. Our earlier stereotypical portfolio manager might indeed have put in place a number of excellent risk management processes. However, while these might in fact do a world of good within the confines of the investment portfolio, they may not be sufficiently conversant with other priorities or concerns to be as effective as one would want them to be. A similar comment could be made with respect to the drafting of fiduciary documents, which, for many years, might have provided for exactly the best dispositions in the narrow world of trust law, but made the investment management process ineffective at best. We could go on and on!!!

Thus, it is probably more sensible to look at the various dimensions along which a family or a family office can encounter risk—defined along as many axes as appropriate—and draw up some form of risk map that differentiates between more and less likely events and more or less severe consequences. These risk issues cover a very wide range of possible fields: they certainly relate to the ability of the family to accumulate and preserve the economic value and purchasing power of their wealth. But they also involve an understanding of the multiplicity of structural issues associated with the location and ownership of assets, and the ancillary issues that surround fiduciary processes. Further afield, but certainly highly critical, one would need to ensure that the family fully understands the issues associated with financial security, whether this relates to the way in which individual service providers are evaluated and monitored on an ongoing basis or the way in which a family office and its staff are supervised. Softer issues play an equally important role in determining the future for families, as well as the uncertainties associated with it: reputation, legacy, privacy, health, and many others.

The wide variety of issues makes it crucial that a plan be devised that recognizes the complexity of the matter and the need to deal with the whole in some integrated manner. Examples abound about the way in which one can observe that the "road to hell is paved with good intentions." Consider a family whose dynastic trusts comprised provisions for the corpus to be reconstituted if a branch was to run out of descendants. What are the implications of such provisions when different branches have different spending patterns or different rates of demographic growth? Consider the case of a family whose financial affairs appeared in perfect order, but who had not had the foresight to consider the implications of the sudden death of one or several members of the family without whom governance cannot work. Consider the family whose ancestors built a fabulous art collection, but failed to leave enough liquid assets for their descendants both to satisfy the original wish that the collection remain in the family and to pay for the kind of property insurance that it would reasonably require. Consider the family who failed to diversify a legacy holding out of respect for the deceased patriarch and yet eventually experienced such a massive decline in the value of that stock when the company fell on hard times despite being uninvolved in its management that the family loses the vast majority of its wealth: shouldn't someone have explained the challenges of diversification in terms that did not simply focus on the standard deviation of returns, but also included issues such as family wealth survivorship and family legacy, not to mention philanthropic goals? Shouldn't someone have explained the difference between being a manager who owns a stake in a company and an investor with no management control or influence?

In the end, risk management across such a diverse spectrum revolves first and foremost around some form of assessment that places the disparate elements on some common footing and around some prioritization of these competing claims. This is likely to require some real hard work, accomplished by many contributors drawn from a wide diversity of backgrounds, brought together by the single simple need to develop a framework that is readily applicable to the wide variety of situations which we all know exist. It is quite satisfying to see that the wealth management scene is getting more and more sophisticated, and that this is happening through an increasingly sharper understanding of a central fact: what makes wealth management both complex and

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exciting is that it requires the integration of a multiplicity of disciplines. Each participant gains, as what better way to learn more about our own specialty than to be asked to look at it from a completely different perspective?

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This Fall 2005 issue of *The Journal of Wealth Management* offers a diverse menu of articles covering the topics of substantial concern for our readers. Our first three articles are all part of multi-articles series and cover "soft" issues that are however critically important. In a first installment in a planned series of three articles, Lisa Gray discusses the relationship between family dynamics and the structure of the family office, and the influence family dynamics and governance have on wealth management decisions. The second piece, by Barbara Hauser, is a first installment in a two-part series: the author examines the relationship between wealth and happiness, in a bid to address the concerns often expressed by wealthy parents who are worried that they might spoil their children. The third article, by Darryl Meyers, is the first of a two-part series that revisits the fundamental topic of the relationship between fiduciary and investment issues, focusing in particular on the tenets of the two principal legal documents governing the way a trust ought to be managed.

The next two articles are dedicated to the review of specific investment strategies. Michael Cohn provides a useful recap of the way in which options can be used to manage risk or enhance income within individual portfolios. Hilary Till and Joseph Eagleeye look into a highly topical issue: the use of commodities in balanced portfolios, concluding that an appropriately structured and managed exposure seems to offer significant diversification benefits.

The final three articles relate to the world of so-called "hedge funds." The first, by Harry Kat and Helder Palaro, proposes a general methodology for replicating hedge fund returns without investing in hedge funds, based on the notion that the statistical properties of hedge fund returns rather than these return themselves matter in portfolio construction. The next two articles focus on legal issues associated with investment in hedge funds. Gene Lipitz and Jonathan Straub cover some of the more and less obvious risks now confronting hedge fund and investor, and they highlight legal risks that have been largely ignored by the industry. Majed Muhtaseb looks into an interesting case study, obscuring the names of all participants and circumstances to protect the identities of all participants, to draw a number of interesting implications on current due diligence practices.

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