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Editor's Letter

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On the Cover

Tang Dynasty Horse
Painted Terracotta
618 AD to 906 AD
27.25 inches
Photo credit: Barakat Gallery

Horses are iconic to the Tang dynasty and are symbolic to China's powerful military position and status as the most prosperous and wealthiest country in the world during this time. Tang horses are among the most famous works of Chinese art. These types of objects reveal a glorified horse culture and a superb appreciation for horses throughout this entire period in Chinese culture. Typically the horses are depicted with their heads raised and nostrils flared, or twisting around to get at something on their backs. This object, which is one of a pair, retains much of its original paintwork, along with superb detailing of the eye, eyelashes and mouth. This piece and other antiquities are available through Barakat Gallery in Los Angeles, California. Visit www.barakatgallery.com to view more objects.

As we start with a full cycle of four issues to celebrate the 20th anniversary of *The Journal of Wealth Management*, we decided that our next four letters from the editor will investigate the way in which four key topics have evolved over the period. Importantly, we also decided that we would look at how they have interacted with one another to illustrate the strong belief that wealth management is, in effect, the integration into one effort of several initially independent disciplines.

Before expanding on this intention, let me reiterate the thanks I expressed when we entered our 20th year. Readers, contributors, II Journals' staff, board members, all of you have played a crucial role in the JWM's success. Without you there would be no journal, and it would be a shame, as I am often told—even adjusting for probable flattery—that there is no alternative in our industry.

Initially, four topics were at the forefront of our thinking, although one or two were already well formulated, while the others were at earlier stages of their development. *Tax awareness* and the use of *alternative investment strategies* were high on our list of priorities. We had viewed taxation as a significantly differentiating feature of individuals and families, when contrasted with institutional investors. Similarly, the willingness of many a wealthy investor to consider nontraditional strategies naturally led us to look into the field of so-called hedge funds, which we, over time, argued were in fact not a separate asset class, but an extension of the degree to which managers were willing to move away from benchmarks. *Asset allocation* and the requirement for families and individuals within them to *learn more about their real needs* were the other two dimensions and developed over time as it became increasingly clear that our industry had not spent the required time to focus on those issues.

In this first "anniversary letter," we will start with tax awareness. The early 1990s indeed saw the publication of several pieces, starting with Arnott and Jeffrey's seminal "Is Your Alpha Big Enough to Cover Its Taxes?" in 1993. Tax efficiency was then defined as "avoiding unnecessary and minimizing unavoidable taxes," producing interesting debates on the real role of turnover. While people initially argued that low turnover was the solution, it quickly became evident that, like cholesterol, turnover has two incarnations: a good one and a bad one. Turnover leading to the realization of capital gains was defined as generally "bad," while turnover that resulted in the generation of net capital losses that could be used to offset capital gains was "good."

Quickly, we all settled on the idea that systematic loss harvesting was a strong principle. The idea was simple. Random price volatility in markets led certain securities to experience book losses even when markets were rising. Appreciating that unrealized losses effectively are free options that can be used to shelter gains that one wants or needs to realize became an important driving force and led to a redefinition of the traditional dichotomy between active and passive management. Traditionally, active managers were perceived to take tracking error risk relative to a benchmark to generate excess return, or alpha. By contrast, the "passive" label was applied to any manager who elected to track an index. Systematic loss harvesting did not fit in that dichotomy. Such managers indeed were trying to track an index but were willing to accept some tracking error if that allowed them to generate tax efficiency, for instance with net realized losses that could help shelter realized gains found elsewhere in an investor's portfolio. Hyper-tax-efficiency was born, and one now had two forms of active management: active with respect to security selection and active with respect to tax efficiency.

Solving one problem rapidly led to the recognition of another. Systematic loss harvesting processes effectively took any capital loss that appeared in a portfolio all the while letting gains run. As such, the ratio of a portfolio's market value to its tax basis would gradually rise over time. Eventually, that ratio would become so high that the portfolio would be "frozen"—no transaction would be feasible. This led to an interesting debate on the relative merits of "static" versus "dynamic" tax efficiency. The former postulated that one should minimize currently net realized gains, while the latter accepted a measure of net gain realization if that allowed a portfolio to remain unfrozen for longer. Another dimension of this debate naturally led to the recognition that the tax rates applied to short- and long-term capital gains were materially different. Thus, why not accept long-term capital realization if that allows one to keep realizing short-term capital losses? The frontier for this discipline as this is written lies with portfolios that retain a neutral market exposure (zero beta) and aim to benefit from the trade-off between short- and long-term capital gains tax rates.

Tax awareness did not stop at the security selection door. Three important dimensions became apparent and were focused on asset allocation issues. The first, which is still crucially important today, relates to the concept of asset location. Here, the idea is that individuals rarely have a single pocket, holding as they often do their assets through taxable, tax-deferred, and even at times, tax-exempt vehicles. Understanding which asset should be favored in which account remains a fertile field to cultivate. The second has to do with portfolio tilting. At a minimum, this concerns periodic rebalancing as natural differences in individual asset class returns lead asset weights to drift away from the policy. Additionally, for investors to believe in the fact that periodic opportunities exist when one can identify the under- or overvaluation of an asset class, there is the issue of moving to an over- or underweighting in one or several asset classes. While derivative instruments originally offered useful potential, changes in tax laws have made the process considerably more difficult.

The third important dimension deserves its own paragraph. How does one determine the optimal asset allocation for a taxable investor whose current portfolio is partially appreciated? It stands to reason that a portfolio entirely invested in cash can be moved to some optimal alternative—found on an efficient frontier or not—with minimal transaction costs. However, what about the portfolio with substantially appreciated positions? How does one achieve traditional geographical diversification in an equity portfolio chiefly invested in the United States, for instance, and with massive unrealized gains? At some limit, the current portfolio is probably optimal, as what I have dubbed "the cost of getting there" is so high that no other portfolio can produce a better expected outcome.

The attentive reader will have noticed that what had started with the concept of tax efficiency has now morphed in the challenge of asset allocation, which we will consider next quarter.

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The Summer 2018 issue of the JWM remains as diversified as usual and includes a couple of pieces that are longer than those we typically publish; we hope that readers will view them as both interesting and useful.

The first four articles cover variants on the tax-efficiency theme. The first piece, by Nathan Sosner, Philip Balzafiore, and Zhenduo Du, discusses the tax efficiency of limited partnerships noting that, as limited partners, investors cannot lose more than their invested capital despite the leverage of the partnership's portfolio, a benefit partly offset by the fact that the availability of tax losses to a limited partner is also more limited as compared with a separate account investor. The second, by Edward Aw, Sanjun Chen, Christopher Dornick, and John Jiang, zeroes in on tax-loss harvesting strategies, pointing to the fact that these are smart beta momentum strategies in disguise and arguing that, just as momentum strategies are managed year-round, tax-loss harvesting strategies should be too—not just in December. The third, by Robert Gordon, a member of the JWM's Board of Advisors, investigates the opportunity opened by the recent tax legislation to achieve a more tax-efficient asset location through the use, when appropriate, of a C corp. Our fourth piece, by Yuntaek Pae and Robert Atra, investigates the benefit of highest-in, first-out (HIFO) accounting when selling shares of various asset classes, concluding that the tax benefit of HIFO accounting is particularly statistically and economically significant for NASDAQ, emerging market, and real estate indexes, while HIFO accounting for bonds offers the least benefit.

Although one could try to create some dimension of aggregation among the seven remaining pieces, it is simpler and more honest to admit that they cover a broad variety of topics, with each having a specific area of focus. The first, by Matthias Uhl and Philippe Rohner, discusses the potential benefits associated with robo-advisors in the implementation of a passive strategy that they contend is generally cheaper, more efficient, and more transparent and thus a preferred way to invest for cost-sensitive clients. Frequent contributor John Haslem, in the next piece, discusses the negative general effects of mutual funds on the returns earned by their shareholders, identifying six critical features contributing to that risk. Our next piece, by Amanjot Singh, attempts to capture dependence structures between major equity market indexes, namely MSCI's China, emerging markets excluding Asia, Europe, frontier markets, Japan, and USA indexes, during a period after the U.S. financial crisis when several unconventional monetary initiatives were undertaken by the international economies, concluding that the highest magnitude of association is observed between emerging markets excluding Asia and Europe, and lowest between the U.S. and Japan indexes. The fourth article in this broad group, by Bana Abuzayed, Nedal Al-Fayoumi, and Talah Arabiyat, examines the notion that less developed markets may be deemed safe havens for international investors, testing the effect of mature markets' fear on risk and return in less developed markets and finding that there is weak volatility transmission between mature and emerging markets around the global financial crisis.

The fifth piece is by Mark Johnson and Yoon Shin and examines the yield spreads of 3,362 revenue bonds issued by 213 private colleges and universities in the United States, finding that the bond ratings of Moody's and S&P have the most important effect on the spreads and that higher ratings result in lower debt costs. Next, Stephen Martin looks into the net returns associated with collectible automobiles as an alternative asset class, updating and extending the literature related to the collectible automobile asset class, further examining the net returns, taking transaction and carrying costs into account, and comparing them with the returns associated with financial assets. He concludes that after accounting for such costs, holding collectible automobiles as an investment asset during the sample period does not produce favorable returns when compared with financial assets, such as equity, bond, and gold investments. Last but not least, Matthew Peterson focuses on a highly topical subject: blockchain technology and how this technology might create substantial changes to how financial services are delivered, concluding that banks and brokerage houses providing custodial and record-keeping services may face a change in the value proposition of these services. Blockchain may also expand our definition of what is a tradable security and, consequently, expand the investable universe.

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