The Journal *of*
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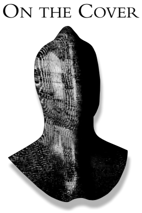
ON THE COVER



New Age Demanded (Spinal Klee)
Unique archival pigment print, 2012
Signed and numbered on the reverse
58 × 42 inches; 147.3 × 106.6 cm

Jon Rafman *(Canadian, born 1981) is a Montreal-based artist whose work explores the paradoxes of modernity. Well known within the digital community, this particular work represents the technique in which the artist employs 3D technology to create "skin" in the manner of a Paul Klee color grid sequence over a virtual classical Greek bust, with both human and non-human features. Jon Rafman's works are exhibited across North America and Europe. This piece and others by this artist are available through M + B Gallery in Los Angeles, California. Visit www.mbart.com to view more works by this artist.*

Recently, I "discovered" the obvious: 10-year U.S. Treasury bond rates peaked at 15.84% in September 1981 and have been in a unidirectional downtrend ever since; except for an interest rate spike between February 1983 and June 1984, all trend reversals since then have been small and mostly around 1% to 1.5%! To put it differently, an entire generation of investment managers has never experienced a real bond bear market! Would they know how to handle fixed income investments if long-term rates were to rise significantly over the next several years?

Years ago, portfolio managers who specialized in fixed income management for individuals (many institutional portfolio managers converted to a total return focus, as they often did not have to worry about taxes) had gotten into the habit of managing "laddered portfolios;" these consisted of portfolios structured so that some fixed portion matured at the end of each calendar quarter or year. Thus, they felt they did not have to worry about interest rate movements, as bonds that matured would always return to par value at maturity. "Sophisticated" portfolio managers tended to smile at the "low-tech" nature of the approach, and many an author wrote articles showing how laddered bond portfolios left quite a bit of return on the table: As they usually followed a pure buy and hold strategy, they eschewed most, if not all, credit, maturity, industry, or instrument-specific swaps and focused only on re-investing maturing bonds together with unused interest payments.

With the benefit of hindsight, it has to be relatively clear that this approach was driven by a desire not to lose money—in the sense of permanent loss of capital, rather than periodic mark-to-market valuations—when interest rates went up. The logic that portfolio managers followed was supported by the observation that their clients had to have some fixed income exposure in order to deal with disbursement requirements, or to dampen the otherwise excessive volatility of an all-equity portfolio. Yet, because there had been times when bond return volatility could be quite significant in the short term, the intellectual artifice based on ignoring mark-to-market variations seemed to satisfy both clients and managers. In hindsight, the results demonstrate that there was a bit of an ostrich approach to the dangers in the strategy and suggest that, at times, material opportunities to add value were lost. As we now face what will be an inevitable interest rate trend reversal at some point over the next

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several years, it is hard not to ask whether the strategy should be revisited, in one form or another, or not.

Besides the notion that interest rates cannot remain at the current levels forever—unless economic theory is totally revisited and revamped—the needs imposed by goals-based wealth management to have some portion of one's portfolio invested in lower volatility, liquid securities raise the question of how one should approach fixed income management going forward. Economic theory postulates that short-term interest rates over the long term should average the sum of equilibrium inflation and real potential economic growth (the latter being used as a proxy for real short-term interest rates). In an environment when inflation is non-negative, short-term interest rates approaching zero appear unsustainable, unless the economy has entered a protracted period of stagnation around zero. Further, with longer term bond rates theoretically equal to short-term rates plus some maturity premium, it stands to reason that 10-year bond rates at or below 2% make little sense, except in a long-term deflationary economic contraction. Some increase in interest rates would expose bondholders to negative returns, possibly for extended periods of time, and even to severe capital losses occasionally.

Yet, goals-based wealth management postulates that client needs that must be met with a high probability and over periods of 5 to 10 years will require a significant exposure to asset classes with predictable income streams, high liquidity, and lower long-term capital value volatility. This describes fixed income securities! How can using bonds make sense in the face of potential capital losses? This would not be an issue if there were a way to derive some return from short-term bonds; managers who fear an interest rate rise typically opt for lower-duration bonds, given their price sensitivity to interest rate moves. However, with shorter-term bonds offering little or no current yield, is there not a better solution?

Goals-based wealth management suggests that most shorter-term client needs should be met with declining balance rather than endowment portfolios: While the former distribute both income and some of the liquidated principal each period, the latter distribute only income at most (and at times, they distribute only that portion of income that exceeds inflation to protect the real purchasing power of the corpus of the fund). Note that endowment solutions may create inter-generational and thus transfer tax challenges, because assets cannot be passed on *inter vivos* to future generations—they must remain in the name of those who benefit from the income stream. A declining balance portfolio allows the current generation to meet its expenditure needs and to structure its remaining wealth, if there is any, so that it can be most effectively passed on to future generations. Note the conceptual parallel between a declining balance strategy in the private wealth management arena and an immunized bond portfolio in the institutional world.

It quickly becomes obvious that a "laddered bond" strategy might be particularly well suited to the management of a declining balance portfolio! Sure, the periodical value of the portfolio might appear to decline if interest rates rise. Yet, for as long as the structure of the portfolio and the amounts invested in each rung of the ladder (maturing at the end of each distribution period) do fit with the client's spending requirements, the variations in the value of the principal are nuisances, but will not endanger the sustainability of the program. Could this be the lesser of two evils: One does suffer from low current yields, as well as yield to maturity, but one does not have to run the risk of potential capital value volatility impairing the ability to liquidate a portion of the portfolio as and when needed to meet disbursement requirements?

Further, one could even revisit the laddered investment process, inspired by contingent bond immunization principles, which had a portfolio semi-actively managed for as long as its value remained above a threshold defined by the minimum amount required to meet one's goals with a pure immunized strategy. In that context, one could imagine having a rather strict laddered approach for the first few years—five, for instance. Within that sub-portfolio, the manager would hold the correct amount of face value for each maturity, but would also be allowed to perform credit or sector swaps, although he or she could not trade if a swap reduced the expected maturity value of the holding, as this would create a risk that the portfolio might not meet its distribution requirements. Beyond that first sub-period, one could imagine that the manager would be allowed to deviate from a pure laddered approach for as long as the duration of the sub-portfolio matched the duration of the equivalent ladder, for example. This would allow the manager to take advantage of perceived opportunities along the yield curve, while maintaining the portfolio's interest rate sensitivity along the way.

In short, it may be possible to consider an original strategy that would not doom investors to the unattractive

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choice of either accepting little or no return in exchange for avoiding the volatility of equities, or enduring the illiquidity of lower volatility non-traditional strategies, or of running what may look like equity risk in a fixed income portfolio at times.

I would like to encourage readers who specialize in the fixed income sector to consider this idea and to perform the required research and analysis to determine whether or not it makes sense once it has been put through its paces. Further work would allow us to begin to see the various sensitivities that are at play through time and to help devise guidelines that could help managers adopt an approach that allows them to benefit from higher average coupons without taking unacceptable risks.

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The Spring 2015 issue of *The Journal of Wealth Management* continues where Winter 2014 left off, with an article by Scott Welch and Jamie McIntyre that addresses the issue of the multi-family office (MFO) of the future. They ask how advisers and MFO professionals should be serving investors and families and generally help clients to achieve their evolving goals and objectives by using "best practices" from some of the most successful, profitable, and fast-growing advisers. We continue to invite authors to ponder the issue of how the industry can serve its clients better and to submit articles on these topics.

The next two articles focus on the psychological influences present in the markets. The first article is by Olivier Mesly and deals with the characteristics of market bubbles, positing that fear, predatory webs, and blind trust characterize their emergence and implosion. The second article is by John Haslem and deals with sentiment issues in stock prices and mutual funds, with a comprehensive review of all available literature.

Though completely different from each other, our next two articles are related to financial planning issues. The first, by Steven Cosares, presents a scheme that helps an investor or financial adviser compare adaptive strategies to maintain a robust financial plan over some time horizon. The second, by Bala Arshanapalli, William Nelson, and Micah Pollak, looks at the impact of the 2007–2009 financial crisis on retirement wealth withdrawals, with a review of the implications for private wealth. The authors conclude that an equally weighted portfolio of stocks and bonds performs better than a portfolio of 100% stock, or a portfolio of 100% bonds, by providing more stable withdrawal patterns.

The next three articles focus on various aspects of investment policy formulation and process execution, and present a somewhat heterogeneous whole. The first article, by Nicola Zanella, revisits a 1984 study suggesting that dividend yields can be used to forecast expected equity returns and concludes that future returns might be lower than historically has been the case. The second article, by Lee Dunham and Thuy Simpson, examines the impact of securities lending on ETF performance, concluding that income from securities lending activities has been used by these ETFs as a means of reducing tracking errors considerably over time, and suggesting that this could have important implications for investors who use tracking error to evaluate the performance of ETFs. Last, but not least, we have an article by Greg Gregoriou and Stephen Henry that uses data envelopment analysis (DEA) models to investigate CTA rankings using *undesirable* outputs. The authors conclude that a traditional DEA will produce different rankings than an undesirable output model.

Our next two articles shift our focus to emerging countries. The first, by Parneet Kaur and Amanjot Singh, is quite technical and investigates the leverage effect and volatility of BRIC equity markets since the 2007–2009 financial crisis; the article concludes that a global investor should discount and understand the volatility behavior as well as the business environment of the investee country as it changes through the years. The second article, by Vivek Bhargava and D.K. Malhotra, analyzes the impact of foreign institutional investment on the Indian stock market, concluding that while there is no evidence of volatility spillover, turnover and market values rise with increases in foreign institutional investment over time.

Our final article, as has become our custom, is a book review. Greg Gregoriou reviews "Quantitative Models for Performance Evaluation and Benchmarking: Data Envelopment Analysis with Spreadsheets," by Joe Zhu, now in its third edition and published by Springer.

Jean L.P. Brunel
Editor