The Journal *of*
Wealth Management

Editor's Letter

Jean L.P. Brunel

JWM 2016, 19 (3) 1-4
doi: https://doi.org/10.3905/jwm.2016.19.3.001
http://jwm.iijournals.com/content/19/3/1

The Journal *of* Wealth Management

VOLUME 19, NUMBER 3 WINTER 2016

Cover design: Loewy Design

ON THE COVER

Kalamkari Series, 2014
Blown Glass
19 × 7.5 × 6 inches

***Paul Cunningham** is an established American glass artist born and raised in Seattle, Washington. He began his career as a glass maker in 1984 at the Glass Eye studio in his native Seattle. The artist is known for creating subtle textile-like patterns throughout the surface of his pieces. His works are present in museums, galleries, and private collections throughout the world. This piece and others by this artist are available through Schantz Galleries in Stockbridge, Massachusetts.*
Visit www.schantzgalleries.com to view more works by this artist.

Let me start by thanking those who were kind enough to send comments to my last Letter from the Editor. This feedback is always helpful, particularly when one is dealing with topics that can be seen to border on the controversial. These comments have led me to the conclusion that I should expand on the points made last quarter. Though one should not see this as a forecast, as there are by far too few data points to come to a solid conclusion, one should probably begin to consider whether some major environmental change may not be on the way. Hence, we have the topic of this quarter's letter.

Way back when, economists used to work diligently to define super cycles and were primarily focused on explaining the behavior of market participants in response to a variety of possible macroeconomic developments. Whether they based their conclusions on the unwinding of inventories, on variations in long-term capital spending cycles, on demographic or technological trends, or even on debt deflation, the message clearly suggested that certain forms of imbalance will almost inevitably be allowed to develop. The correcting of these imbalances could be interpreted as the down-leg of thus predictable macroeconomic cycles, whether they involved shorter-duration business cycles or truly long-term waves, the most famous of which is probably Kondratiev's. These down-legs would then be followed predictably by uptrends.

Recently, I read a piece written by Peggy Noonan in *The Wall Street Journal*. It struck me as offering a potentially important and new insight: technological innovation has created a change in the way people learn and process information. Clearly, there is nothing particularly new in the observation that today people have massively more information available to them than in the past. However, what I believe to be new is that learning has evolved from an active process, in which the individual needed to interact with the written word, to a more passive process, based on pictures and sounds. More specifically, she states: "They've heard the sound bite but not read the speech. Their understanding of history, even recent history, is superficial. They grew up in the Internet age and have filled their brain space with information that came in the form of pictures and sounds. They learned through sensation, not through books, which demand something deeper from your brain. Reading forces you to imagine, question, ponder (and) reflect." The piece then notes that this tends to promote shallowness, echoing a point made here a few times over the last few years. The importance of this insight is that it can affect the democratic process. Voters may not have the appropriate information or even the necessary ability to move beyond simple Pavlovian reactions to sound bites or superficial messages. Similarly, they can be "duped" into judging certain economic outcomes as "good" or "bad," without in fact that judgment being correct.

Now, consider many of the trends that we have observed around the world in the last 10–20 years, with more urgency recently. We have seen a gradually increasing interference in the economic process on the part of politicians (our point is more germane to the Western world, as it is clear that politicians in China, Brazil, or Russia, for instance, have been interfering in their respective economies for quite some time). These interferences have taken multiple forms: well-meaning efforts to alleviate the consequences of the down-legs of economic cycles; equally well-meaning efforts to impose regulations to prevent the most egregious excesses bred by unbridled capitalism; the fundamental belief that government knows best what should be done. Yet, the very nature of government is that it rarely stops when it should: what may have started as a desirable development can be argued to have expanded to a point where it can be hurting the very people it is trying to help.

All in all, the net effect of the growing role of these "super decision makers" must have been a decline in the role of the individual decisions of multiple economic agents: *Adam Smith's "invisible hand" has been amputated*. Although this alone is, itself, a superficial description of the politico-economic reality in the world, it is a basic, observable fact that global growth has declined structurally, that poverty-fighting programs have not made a real dent in poverty, and that more generous social protection programs have seemingly also served to reduce the willingness on the part of people to work and have failed to overcome the vexing unemployment problem, particularly when it comes to the young and less skilled.

Looking ahead, the real new issue is that families should incorporate into their thinking the possibility that "free markets"—which is the locution I use to refer to decisions made by many individuals rather than by governments and lobbies—may be a thing of the past. The link between this latter comment and our earlier observation in the broadening role of government is the fact that "activist" local politicians (defined here as politicians within a country or a small block of countries) operate best in a closed or semi-closed system; open the system in which they live, and their ability to control the outcome of their policies can shrink to a mere shadow of its original self. Consider taxation as a potentially useful example. With the notable exception of the United States, most countries tax income on the basis of tax residency—as opposed to citizenship—considerations. A French citizen residing and working in Germany or Japan, for instance, pays income taxes to the German or Japanese government, but not to the French government. Thus, raise tax rates in a country to a level that is interpreted as confiscatory by local citizens and they simply move to a different country. What is true for individuals is also true for corporations. The debate on Apple's taxes in Ireland is an example of what can happen when a country, here Ireland, attempts to attract economic activity to its shores by providing certain tax breaks. Fearful of what unmanaged tax rate competition among European countries might mean, the European Union elected to force Ireland to collect taxes on earnings it had specifically told Apple would not be taxed in Ireland, and that it is not at present willing to collect. In short, politicians who seek a greater role in economic management will naturally tend to want to move away from free markets.

This movement away from the free flows of capital, individuals, or even certain traded goods makes sense in the context of shallow politics in which one seeks to be elected rather than to work for the long-term good of one's country. However, what about the longer-term implications? Clearly, in the short term and as discussed three months ago, this makes it easy to harp on the basic instincts of voters, to focus on first-degree analyses and thus to avoid any decision that has visible costs occurring before the benefits can be felt. The analogy of a vaccine comes to mind: quite a few vaccines have short-term negative side effects (pain, fever, and the like). Yet, it is easy to argue that such discomforts pale in comparison to the long-term benefits of being inoculated against potentially deadly diseases. But, in the long term, one cannot accept this move away from free markets as a reasonable possibility and not take the analysis to the next step: what are the longer-term consequences which are currently not even discussed? How could they be expected to change the environment in which families must invest?

In short, what are the important wealth management implications of such a development—should it really occur—for families? They can probably be summarized in three main elements:

1. Without adopting the "death" of free markets as an inevitable conclusion, *families might want to consider what a decline in the role of free market forces might mean to their effort*. At this point, the trend is, at best, speculative. Yet, the behavior of the developed world's central banks promoting what seems like a massive bond market bubble has clearly had material short-term investment implications (many of which were favorable). More ominously, a comment to the effect that these same central banks may consider intervening in the equity market as well could be interpreted as the realization by officialdom that there is no painless end to the experiment. What happens next? Can this trend be sustained or does it contain the seeds of its own demise?
2. *Families might want to have a formal process*—possibly annual—*to evaluate whether the risk of such a development is rising or receding.* The classic analogy of the frog in the pan of hot water comes to mind: dump a frog in a pan of hot water and it will jump out and live; place it in cold water and gradually heat the water and it will die because it will not discern the change in temperature until it is too late. Thus, agreeing on a limited number of flags and assessing what they signify from time to time may be the best way to avoid complacency.
3. *Families who pay taxes should make sure that they build sufficient investment flexibility into the various structures they create*. With the vast majority of families subject to taxes and many of them planning for the truly long term, there would be little real benefit to become aware of the massive environment change if there is nothing that can be done from an investment standpoint to deal with that insight.

In short, as is often the case, one needs to be watchful and to accept the fact that change is one of the few constants in the world. While we had the luxury of enjoying the benefit of free markets for almost a half century, it may be a good time to reconsider whether the implicit assumption that free market conditions generally will keep prevailing is still valid and, if not, what that change might mean—before everyone else has that question on their radar screens.

■ ■ ■

The Winter 2016 issue of *The Journal of Wealth Management* is probably as diversified as any issue in the recent past, although I still regret that we are not receiving more worthwhile submissions covering non-investment management aspects of the wealth management challenge.

The first article deserves a category in and of itself, as it can be seen as an operating manual for some useful, beyond-the-basics private wealth management tools. Written by William Jennings, Brian Payne, and Thomas O'Malley, it presents five quantitative tools, attempts to convey the underlying intuition in plain English, and offers shortcuts to implementing the calculations in Excel.

The next three articles discuss different aspects of the strategic or policy allocation process. The first, by Franklin Parker, presents a goal-based portfolio optimization approach and finds that this procedure lowers the probability of failing to achieve a specified goal while delivering higher excess wealth than the processes currently available. The second, by Lujer Santacruz, follows up on an article published last quarter and focuses on the decision of how much of the investment portfolio to place in each of the broad asset classes (e.g., cash, fixed interest securities, property, equities). Observing that there is a relatively low level of usage of asset allocation theory and theory-based methods in the industry, this article concludes that perceived usefulness appears to have the strongest influence on usage followed by facilitating conditions. The third, by Javier Estrada, focuses on the use of exposure to commodities and real estate and conclude that they belong to the set of allowable options and generally increase risk-adjusted returns, but are more effective at reducing risk than at enhancing returns.

The next two articles focus on the issue of active management from two different angles. The first, by David Ranson, proposes and illustrates a simple model for anticipating the absolute and relative performance of the major asset classes. The second, by Paul Bouchey,

The Journal *of*
Wealth Management

Jean Brunel, and Tianchuan Li, investigates how ETFs, which are well known for tax efficiency, can be used to create broader portfolio tax efficiency. They show that it is reasonable for investors who are already comfortable with an opportunistic use of ETFs for loss harvesting to broaden their use in a systematic manner, provided they understand that care should be taken to avoid using replacements that are substantially "identical," as this would trigger a wash sale.

Although each of the next four articles could easily be classified into a distinct category, it is probably easier to look at them as two groups of unrelated, yet quite interesting, articles: the first two focusing on classic asset class issues, and the latter two turning to more exotic assets.

Within the classic asset class group, the first article, by Haim Mozes and John Steffens, focuses on the links between hedge fund liquidity and age on the one hand, and performance on the other, showing that hedge fund performance is positively related to funds' exposure to illiquid assets and that, because older funds and funds with larger increases in assets under management tend to invest less in illiquid assets, these funds tend to have weaker performance. The second, by Ines Gargouri and Lawrence Kryzanowski, looks at equity fund flows and performance around economic recessions, suggesting that empirical copulas in the extreme left tails indicate a positive dependence for the early 2000s recession, and independence for the Great Recession between performance and net fund flows.

Within the more exotic asset class category, the first article, by Helyette Geman and Tara Michelle Velez, focuses on the price dynamics of prime real estate markets across alpha cities, finding that they are more positively correlated than with nonprime markets in respective cities and, more broadly, concluding that prime real estate is also highly related to other tangible luxury assets, including diamonds and museum-quality paintings. Last but not least, we turn to a topic we have never covered with an article by Stephen Martin, who looks at collectible automobiles as an asset class and concludes that, based on a sample between 2007 and 2016, collectible automobiles exhibited superior holding period returns to traditional equity, bond, and gold investments.

Jean L.P. Brunel
Editor