The Journal *of*
Wealth Management

Editor's Letter

JWM 1999, 2 (2) 1-4
doi: https://doi.org/10.3905/jwm.1999.390968
http://jwm.iijournals.com/content/2/2/1.citation

This information is current as of February 17, 2019.

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The Journal Of
PRIVATE PORTFOLIO
MANAGEMENT
VOLUME 2, NUMBER 2 FALL 1999

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The topics covered in this issue of the *Journal of Private Portfolio Management* may, on average, be a bit softer than usual, but they are no less critically important. Three articles focus on issues surrounding investor sentiment or reactions caused by sentiment, while another two discuss structural issues which wealthy families must consider. The last three deal with more traditional strategic questions: time diversification, asset location, and equity management style.

Though many investment managers would like to think that investment performance has to be the be-all and end-all of an investment strategy, reality is often considerably more complex, particularly when dealing with individual investors. Surely, investment performance does remain a critical element of the whole, but measuring or assessing investment performance is considerably more complex in the individual investor world. At the simplest level, performance may actually have non-numerical dimensions. Who has not heard of psychological rewards? How can investor comfort be ignored? More complex, but no less important, are issues related to how investment results interact with other objectives: intergenerational transfers, charitable endeavors, or, more simply, the "education" of younger generations in the management of the wealth they will eventually inherit. This mosaic of non-fully-numerical issues makes the measurement and the assessment of investment performance particularly tricky.

A contrast between stereotypical institutional and individual worlds can help illustrate the issue more fully. In short, one can argue that in the institutional world, measuring performance is virtually trivial, while assessing it can be both complex and difficult. In the individual world, the issue actually starts with measuring performance. One of the first critical issues has to be the topic of taxes. Measuring after-tax returns can prove a daunting task, though, at first brush, it can appear deceptively simple. After all, one can measure pretax returns easily and one knows how much has been paid in taxes; so, where is the complexity? The challenge arises from the fact that individuals tend to pay taxes on the whole of their assets, rather than on each single portfolio. Thus, though one may be able to calculate how much total taxes have been paid, the difficulty is in allocating the appropriate amount of taxes to each

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portfolio in a fair manner. How does one reflect the fact that certain tax-inefficient assets may have been placed in a tax-exempt or tax-deferred pocket, thus, arguably, potentially unduly penalizing tax-efficient assets by placing them in a taxable pocket? How does one reflect the fact that a portfolio (or manager) may have been penalized by being asked to harvest unrealized capital losses to help raise the tax-efficiency of the whole of the assets or of another sub-portfolio? How should one account for the tax-implications of cash flows, which may have disproportionately affected a single portfolio? As if this was not enough, there are other issues such as the question of whether performance should be measured on a pre- or post-liquidation basis, or whether unrealized capital gains should really be assumed taxed at zero.

Assessing performance is even more complex. Here, we define performance assessment as the process through which one can reach a conclusion as to whether performance was good, bad or indifferent. A significant void in the after-tax world is linked to the lack of a broadly accepted set of after-tax benchmarks. Clearly, at one level, one can argue that each portfolio should have its own benchmark. Indeed, after-tax performance is path dependent, being in large measure influenced by such factors as the starting point or the nature and extent of cash flows and their interactions with market developments. Thus, each portfolio will probably have unique circumstances which, in a perfect world, would require a unique benchmark. Yet, it would already be a very significant step forward if the investment management industry would develop a set of benchmarks for the major asset classes. While that would arguably not solve the problem in its entirety, it would surely provide a better basis from which to apply qualitative judgment.

Another important void which should be addressed is the lack of reliable composite industry after-tax data. Though several managers have created and published AIMR compliant after-tax data, they very often do not offer as much value as they could. Indeed, these composites can include a variety of portfolios, many of which would not be relevant for individual investors, given minimum size requirements, for instance. One can hope that much more emphasis will be placed on the question of after-tax performance, to allow investors and their advisors alike to assess their results or those of existing or prospective managers more reliably.

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Sentiment issues intersect with investment performance in many ways. Three of the articles in this issue deal with various aspects of investor sentiment and the way in which changes in sentiment or the willingness to allow sentiment to drive or influence investment decisions affect investment performance. Statman considers the question of investor sentiment and stock returns and demonstrates that there is precious little insight to be gained by surveying investor sentiment. Trachtenberg offers interesting comments on the proverbial issue of whether it pays to attempt to time the market and confirms the generally accepted conclusion that the critical issue is whether one is invested in equities rather than when one elected to invest in equities. Brunel takes a different look at that same issue, approaching it from the point of view of the after-tax cost of panicking out of equities after a market correction. While each of these articles points in the same general direction (one should adopt a strategy which is comfortable over time and thus minimizes decision risk), they illustrate, in different ways, one of the challenges which may arise when attempting to measure the performance of an equity portfolio: how should one account for the transaction and tax costs associated with significant asset allocation moves.

Structural issues also plays a very important role in the investment performance equation. In the final analysis, given the fact that performance should be measured on the totality of one's assets, any cost incurred in the management of that wealth should, in some fashion, be taken into consideration. Thus, a number of additional questions arise. How are the assets held, by whom and with which tax status? How does the family deal with day-to-day management issues, does it create a family office or not, and, if yes, what is the role of that office? How does the family select its advisors or trustees and how does that decision interact with investment decisions or comfort? Beyer offers interesting insights on the issue of family offices, tracing their genesis, discussing their key functions and analyzing why the enthusiasm for family offices seem to be waning. Mathieu focuses on the question of selecting trustees and offers valuable advice as to critical do's and don'ts.

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Charron revisits the issue of asset location and proposes simple decision rules to deal with it. Howe focuses on time diversification and considers the issue in the case where there are periodic cash flows. Finally, Stein and Narasimhan look into the issue of active versus passive equity management in the presence of taxes and conclude that active tax management may offer more potential value added than active security selection.

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On a personal note, I would like to express my thanks to Nancy Jacob who leaves her co-editor role. She was a strong force in the creation of the Journal and her insights were particularly valuable.

I would also like to welcome Roberto Apelfeld and David Stein as the newest members of our Editorial Board. Both have already contributed in a substantial manner, as writers or reviewers of selected articles and I look forward to benefit even more from their support.

Jean L.P. Brunel
Editor

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