The Journal *of*
Wealth Management

Editor's Letter

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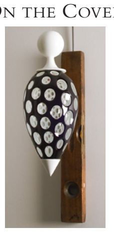
On the Cover



Wall Bob, 2010
Suspended blown glass, carved, polished, mixed media, assembled
37 × 5 × 9.5 inches

Nick Mount *(Australian, born 1952) is a leading figure in the studio glass movement in Australia, known as an innovator, advocate, and instructor of glassblowing since his beginnings, working with the medium in the early 1970s. The artist has developed his technique through the heavy influence of master Venetian glassblowers and the new guard of studio artists in America. 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.*

A number of years ago, the Family Office Exchange sponsored research on risk management for families and published two studies over a period of a few years. The focus then was not on risk as asset managers understand it, but rather on the various dimensions of risk that families take, at times unwittingly. The tone was set by the story of a wealthy Georgia family: The family was traveling in Africa when one of the two private planes they had chartered crashed. Sad as this already was, the major additional challenge was that *all* the trustees of *all* the family trusts had boarded the same plane, leaving the grieving grandchildren with the unenviable task of having the courts replace the trustees, quite a cumbersome process. The story illustrated a simple question: If most corporations routinely have rules for the number of senior executives who can travel on the same plane, whether private or commercial, why is this not the rule for families as well? From there flowed the greater agenda, which centered on the various complex risks that families typically underwrite and the need for advisers to help them develop policies and tools to manage these risks.

The list of risks that families take can be expanded or cut back at will. Yet, it seems that four areas should be of particular concern currently, given their crucial importance and in light of external developments:

1. **Cybersecurity:** Not a month goes by without some reminder of the risks associated with hacking. Years ago, when the Internet was in its infancy, computer users already needed to worry about viruses and the like, but these worries were limited in scope to whatever was stored on that computer's hard disk. Connectivity had not been invented. Now, with smart phones, tablets, and computers being on a first-name basis with one another and having a number of functionalities that one would not naturally associate with the Internet, the room for mischief has expanded exponentially. Consider the fact that you can routinely interact with your car from your phone or tablet; that many a home security or comfort system can be also be also remotely controlled; that most modern pool systems can be switched on or off, or have their settings altered, from a simple smart phone; and that each and every one of these functions can, in some way, also interact with your computer, whether your data are kept locally or in the cloud.

   The consequences of any security breach, particularly at the weakest link in the chain, can be dramatic for any family. This can involve the loss of critical data as well as privacy, to name just two, with a close third being the risk of having your data held hostage.

Having a special focus on cybersecurity and considering it a crucial function within one's family office is an absolute necessity. Although it has long been argued that the iOS platform has not yet been penetrated by hackers, does anyone truly believe that it never will be?

2. **Travel policies:** The story with which we introduced this subject is certainly sufficiently dire to suggest that one needs to be careful, but there are several dimensions to the quandary. Understandably, many individuals would balk at the notion of having to travel on separate planes. In fact, I once heard someone argue that the risk that one person will be in a tragic accident doubles when two people travel on different planes. Although this may be true, it is equally true that the risk that both will be in a tragic accident at the same time is substantially cut. Similarly, I have heard people argue that those who travel to the airport in the same car and then fly on different planes for security reasons are silly—in fact, there used to be a sign as one left Tullamarine Airport in Melbourne, Victoria, Australia that said: "You have now completed the safest part of your trip." The sign made sense, but rather than concluding that individuals should simply fly together, why not conclude that they should also be careful when driving together?

   Consider another dimension of the challenge: the difference between outright private plane ownership and private plane chartering. If it is true that terrorists could use fully fueled aircraft as suicide bombs, should not one think about the difference between flying with a crew that one knows versus a crew that one does not know? What does this say about the due diligence that should be conducted to ensure that aircraft chartering outfits have solid crew selection, vetting, and management processes?

   Equally importantly, the caution associated with how many people should fly on the same aircraft, be it private or commercial, should cover both the key members of the family (*key* here meaning those who have an important executive or trustee role) and the members of top management. Indeed, a family that has a single-family family office usually has multigenerational goals. It is thus crucial to ensure that continuity exists in the management of the wealth.

3. **Regulatory and legal changes:** Families usually are naturally careful with issues related to regulatory, tax, and even legal compliance. But to what extent do they consider how the rules could change? With the increasingly polarized nature of politics in the United States and in numerous other countries, it has now become less than a total surprise when a framework that was approved in one regime is replaced in the one that follows it, at times by the simple stroke of a pen. This carries two important implications. The first is obvious: One should be doubly cautious with all the appropriate vetting that takes place before relevant actions are taken. The second may be less obvious, but it is no less important: One should avoid both sailing close to the wind (as this may be the area most likely to represent danger) and doing anything that could be interpreted as violating the principles that underpin currently accepted practices.

   In many ways, this is the analog to what one used to say about conflicts of interest: Avoid both conflicts and any potential appearance of conflicts. I vividly remember turning down, in a prior life, at least a few potentially lucrative new business opportunities based on what I called the *C-1 risk*, which simply meant the risk of an article appearing on the first page of the C-section of the *Wall Street Journal*. Although such processes may prevent certain goals from being easily achieved, they may well be an important element in a strategy to avoid ever having to "unscramble the eggs."

4. **Education of future generations:** The education of future generations is surely one of the major building blocks of wealth management, at least when dealing with wealthy families. Here, one focuses more specifically on educating the younger generations on the notion of risk. It is a truism to say that most young people have a tendency to view themselves as invulnerable, and thank God for that tendency because it must be what leads them to foster innovation. Yet, whether dealing with issues such as relationships, marriage, personal

safety (many families from Latin America know firsthand about the risk of kidnapping), or even the risks of short-term versus long-term investment processes, they need to hear and begin to appreciate how challenging the environment truly is.

Thankfully, most families have a number of safeguards in place with respect to prenuptial agreements and trust and/or LLC structures to hold assets, not to mention solid investment education. Yet, how many (outside of Latin America and other high-risk locales) take the time needed to warn children and grandchildren of the risks associated with bearing a well-known name or showing off one's wealth? How many families choose to make philanthropic gifts in an anonymous manner, precisely so that their name remains in some shade rather than in full public view?

This was not meant to be a complete list of potential issues or, within each of the four areas we selected, all the potential challenges. Rather, this was meant to raise a topic that may not have received the attention it deserves, hopefully triggering among potential authors the idea of writing an article to be submitted to *The Journal of Wealth Management*. Over our nearly 20-year history, we have indeed not published more than a handful of articles on the topic of non-investment risks, and we would love to see quite a few published over the next 10 to 20 years.

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The Fall 2017 issue of *The Journal of Wealth Management* remains as diversified as usual, although it does contain an above-average number of articles dealing with asset management issues.

The first three articles broadly fall in one group that we view as being focused on individual investors and the wealth management services they receive. The first, by Douglas Roberts, asks a question that quite a few families ponder: Can simple allocation strategies outperform the Ivy League endowments? The article concludes that the superior performance is due to a riskier portfolio allocation through the use of alternative investments and focuses on the question of whether these alternative investments offer additional value that could not be created by increasing the level of risk in these public portfolios, possibly through the use of leverage. The second, by Steven Albrecht, focuses on the impact of net unrealized appreciation election and company-owned stock in a tax-exempt structure, pointing to the fact that proper analysis of the relevant options can significantly affect income-generating capabilities for many years. The final article in this initial trio is by Stuart Lucas and Alejandro Sanz, who show how wide the range of answers can be and offer some suggestions for how to manage taxable portfolios more effectively. They suggest the *50% Rule*: if you don't get to keep at least 50% of your profits after accounting for leakages to pay taxes and investment management fees, you should reassess your approach.

The next three articles focus on broad investment issues. The first, by Steven Dolvin and Bryan Foltice, deals with the question of trend following in the U.S. equity market and notes a monotonic relationship between decile portfolios formed based on their prior six-month performance and subsequent twelve-month holding period excess returns for the 1986 to 2006 period. The authors find that this relationship has broken down since the financial crisis (and, in our opinion, the onset of material quantitative easing by the Fed and other central banks). The second, by Atreya Chakraborty, James Grant, and Emery Trahan, refines tactical asset allocation by arguing that the equity style component of a tactical asset allocation (TAA) strategy should distinguish between—and rotate among—predefined value creators and value destroyers in the marketplace, considering some well-known value creators and value destroyers, as well as known market anomalies that can also drive an economic profit approach to TAA and active portfolio management. Our final article in this group is by Wai Mun Fong, who shows that dollar-cost-averaging (DCA) investors are not doomed to inferior returns, considering a DCA strategy that invests in stocks with high gross profits-to-asset ratios and high dividend yields that significantly outperforms lump-sum investing in the market index in many dimensions.

The next three articles constitute a somewhat heterogeneous group but remain focused on asset management issues. The first, by Daniele Lamponi and

David Latto, offers a practitioner's insights into the life cycle of dividend futures contracts, which allow investors to gain direct exposure to the dividend stream of equity indexes. The article shows how prices are initially driven by earnings growth and inflation expectations and converge toward realized dividends as expiration dates approach and the visibility of earnings and dividends improves. The next article, by Winfried Hallerbach, takes a different perspective on portfolio diversification and suggests that rather than evaluating individual assets on the basis of their undiversified returns, the focus should be on diversified return. The author shows how these can be calculated. The next piece, by Qiang Bu, looks into a perennial question: Do long-term mutual fund alphas come from manager skill or luck? The author concludes that evident differences between winner funds and a bootstrapped benchmark with regard to return distribution properties, market exposure, alpha consistency, and portfolio holdings suggest that persistent fund alpha is earned by manager skill.

Our last two articles are quite short. The first is by Tom Arnold, John Earl, Cassandra Marshall, and Adam Schwartz and provides two different retirement calculators to help investors plan for retirement savings and retirement disbursements; the calculators are created in Excel and require minimal programming. Finally, Jean Brunel offers a review of Dan Nevins's latest book: *Economics for Independent Thinkers: A Practical, No-Nonsense Guide to Understanding Economic Risks*.

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Editor