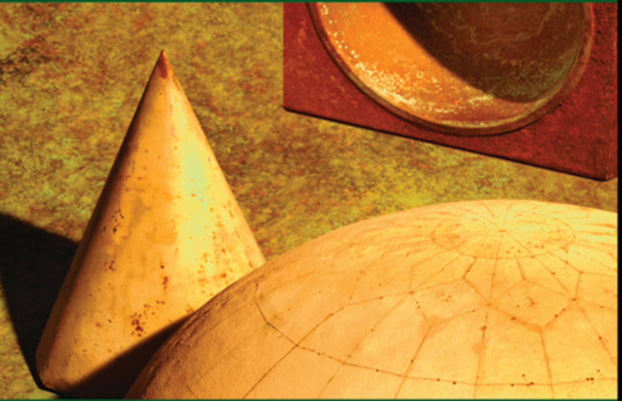
CFA INSTITUTE INVESTMENT SERIES

THE NEW WEALTH MANAGEMENT

THE FINANCIAL ADVISOR'S GUIDE TO MANAGING AND INVESTING CLIENT ASSETS



Harold Evensky, CFP • Stephen M. Horan, CFA • Thomas R. Robinson, CFA

Foreword by Roger Ibbotson

THE NEW WEALTH MANAGEMENT

CFA Institute is the premier association for investment professionals around the world, with over 101,000 members in 134 countries. Since 1963 the organization has developed and administered the renowned Chartered Financial Analyst® Program. With a rich history of leading the investment profession, CFA Institute has set the highest standards in ethics, education, and professional excellence within the global investment community and is the foremost authority on investment profession conduct and practice.

Each book in the CFA Institute Investment Series is geared toward industry practitioners along with graduate-level finance students and covers the most important topics in the industry. The authors of these cutting-edge books are themselves industry professionals and academics and bring their wealth of knowledge and expertise to this series.

THE NEW WEALTH MANAGEMENT

The Financial Advisor's Guide to Managing and Investing Client Assets

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WILEY

John Wiley & Sons, Inc.

Published by John Wiley & Sons, Inc., Hoboken, New Jersey.
Published simultaneously in Canada.

Library of Congress Cataloging-in-Publication Data:

Evensky, Harold.
The new wealth management : the financial advisor's guide to managing and investing client assets / Harold Evensky, Stephen M. Horan, Thomas R. Robinson.
p. cm. — (CFA Institute investment series ; 28)
Rev. ed. of: Wealth management. ©1997.
Includes bibliographical references and index.
ISBN 978-0-470-62400-5 (cloth); ISBN 978-1-118-03689-1 (ebk); ISBN 978-1-118-03690-7 (ebk); ISBN 978-1-118-03691-4 (ebk)
1. Portfolio management. 2. Financial planners. 3. Investment advisors. I. Horan, Stephen Michael. II. Robinson, Thomas R. III. Evensky, Harold. Wealth management. IV. Title.
HG4529.5.E955 2011
332.6—dc22 2010053526

Printed in the United States of America

10 9 8 7 6 5 4 3 2 1

Harold:
To all my wonderful associates at E&K, my two amazing co-authors, and to Deena, who makes it all worthwhile

Stephen:
To Connie and Cayse

Thomas:
To Linda

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ACKNOWLEDGMENTS

We would like to thank the many individuals who played important roles in producing this book.

The CFA Institute Investment Series was developed under the leadership and guidance of Robert R. Johnson, CFA, now senior managing director of CFA Institute. Most of the titles in the series are developed out of the CFA Program curriculum. The CFA Program is a generalist program in investment analysis and portfolio management and emphasizes the highest ethical and professional standards for the investment profession. Over time, the number of CFA Program candidates and CFA Institute members who practice in the private wealth area has increased, calling for additional educational content in this important area. The private wealth content in the CFA Program has increased as well, and this new edition of Harold Evensky's *Wealth Management* is designed to be a practical guide to implementing many of the concepts found in the CFA Program to private wealth practice.

Christopher Wiese managed the process of acquiring the rights to the earlier edition and guided the manuscript through all stages of production. Tina Sapsara kept the authors on task and edited the manuscripts to a uniform style. We also appreciate Deena Katz adding her expertise for our capstone chapter.

FOREWORD

The New Wealth Management is a new edition of the book *Wealth Management*, originally written by Harold Evensky. Fourteen years may be a long time to wait between editions, but the new edition is more of an overhaul than a mere update. Two co-authors have also been added to the mix, Stephen Horan and Thomas Robinson; both are accomplished authors in their own right. The current book builds on the strong foundation of the earlier edition while encapsulating the many advances and examples of rethinking that have been accomplished during the intervening time.

CFA Institute has participated in the financial revolution in many of its publications. *The New Wealth Management* is a part of the CFA Institute Investment Series. Most readers are probably familiar with Stephen Horan, because he has been the manager of the education and private wealth management content for the series. He is a professor, frequently published author, and the editor of the CFA Institute book *Private Wealth: Wealth Management in Practice*. He brings extensive knowledge and an ability to implement it. Thomas Robinson is managing director of the CFA Institute Education Division. He is also a regularly published author in the fields of accounting and financial planning, as well as an accomplished professor. He has had extensive speaking and consulting experience relating to the issues that come up in this book. CFA Institute is fortunate to have these two very active contributors who are so well-versed in the issues that financial practitioners face.

The combination of the renowned Harold Evensky with CFA Institute support makes for a great book. The writers are not only excellent expositors, but also at the forefront of the field. In this book, they include the latest advancements but still make the book practical for the financial advisor. Advisors need to know not only the latest techniques, but also how to communicate with their clients.

Of course, I am partial to some of the discoveries that I have been involved in. The first edition certainly took the holistic approach to investing, in which each individual client's specific circumstances are considered and asset allocation portfolios are customized to the client's needs. But now we have a life-cycle approach to use to determine the appropriate asset allocation for each individual. The approach makes use of a "life balance sheet" that uses human capital theory to consider both the net employment capital and the financial assets as two separate but related sources to fund the lifetime retirement and other expenditure needs.

Now that the life-cycle approach is more developed, we can start with the readily valuable data from a family's earnings, financial wealth, age, cash flow needs, retirement plans, and so on. These data are then supplemented with information about the nature of the client's employment, risk questionnaires, and capital market assumptions. The theoretical framework of the life cycle approach was barely available at the time the initial edition was published. Now, we really can take a holistic approach to investing that considers not only the nature of capital markets, but also the client's circumstances and needs, as well as the personality characteristics that make each client unique.

The importance of the asset allocation decision has also been further clarified in the intervening time between the editions. No longer do we merely think that asset allocation policy explains more than 90 percent of performance. We know now that asset allocation policy usually explains 100 percent of the typical *return level* because most active management does not actually add any alpha. This is particularly true on average, by definition, because in aggregate all money managed can only sum to a broad market return.

The differences among various manager returns are also only partially explained by asset allocation policy manager differences. Roughly half of the differences in the variation of returns among money managers comes from asset allocation policy differences, whereas the remaining half of the variation of returns among managers is explained by differences in asset allocation timing, security selection, and fees.

Even the time-series variation of returns has three parts: participation in the overall market movement (instead of just holding cash), each portfolio manager's asset allocation policy differences from the overall market or peer group, and the variation in returns caused by the active management of each portfolio manager's specific timing, security selection, and fee level. It is the first two parts that explain about 90 percent of the variation in time-series returns of a typical portfolio. But the major part of portfolio variation comes from the market movement, in which most funds participate. Most of us performed well in the bull market of 2009, whereas most of us performed poorly in the bear market of 2008.

I have only touched on a few of the ideas in the book. I hope, though, that this Foreword has whetted your appetite for all the ideas that are inside. These include discussions on risk and taxes, as well as such implementation topics as goal setting, client education, and manager selection. Harold Evensky, Stephen Horan, and Thomas Robinson have done a great service for the financial advisor.

Roger Ibbotson
Chairman and CIO, Zebra Capital Management
Professor in Practice, Yale School of Management

PREFACE

Short-term clients look for gurus. Long-term clients want sages. There are no gurus.
—Harold Evensky

Welcome to *The New Wealth Management*. What you are about to read is a blend of a textbook, an investment process road map, lessons, opinions (lots of opinions), and recommendations based on the experience of practitioners and recent research.

It is easy for a professional, interested in portfolio or asset management, to find and accumulate a library appropriate to the subject (references to the best will be provided throughout this book). There is a continuing stream of books published on the evaluation, selection, and management of individual stocks and bonds. However, for the holistic practitioner managing private wealth and responsible for orchestrating a portfolio of multiple managers, the selection is limited. The only guidance has been to attend professional conferences and network with like-minded professionals. *The New Wealth Management*, first published as *Wealth Management* in 1997, was written to address this need. This edition captures the recent advances and thinking that have evolved since the first edition. And there has been quite a bit.

Perhaps a brief profile of the practitioners envisioned as the audience for this book will assist you in determining if this book is for you.

- Those whose clients are individuals, pensions, or trusts with significant investable assets whose primary goal is to earn reasonable returns for the risk they are prepared to take.
- Those who advise clients on the development and implementation of an investment policy.
- Those who assist clients in the selection of multiple managers, exchange-traded funds (ETFs), or mutual funds.
- Those who monitor and manage multiple asset class investments for client portfolios.
- Those who call themselves financial planners or provide financial planning services.

If you are involved in advising clients regarding investing or managing multiple asset class portfolios for clients, this book has been written for you even if your primary profession is as a comprehensive financial planner, investment advisor, accountant, insurance specialist, securities broker, trustee, or lawyer.

WEALTH MANAGERS AND MONEY MANAGERS

One of the most confusing issues for the public (and many professionals) is distinguishing between the profession of money management oriented toward managing assets for institutions or others that may have already determined an appropriate asset allocation and the profession of wealth management geared toward individuals who need assistance in both asset allocation and asset selection. In order to proceed without further semantic confusion, we will define these terms as they are used in this book.

Wealth managers bear little resemblance to money managers for institutions, such as mutual funds or pension funds. Wealth management is more comprehensive, customized, and complex. Appreciating the differences is particularly important for practitioners, especially for those who hope to transition their careers from an institutional setting.

Exhibit P.1 summarizes some of the more striking differences. Money managers are professionals responsible for making decisions regarding the selection of individual bonds and stocks for a portfolio. The money manager offers the client an expertise, a philosophy, and a style of management.

EXHIBIT P.1 Wealth Management versus Money Management

	Wealth Management	Money Management
Scope	Comprehensive	Focused
	Life balance sheet	Financial assets
Management approach	Customized	Standardized
	Orientation toward client goals	Orientation toward relative returns
	After-tax wealth accumulation	Periodic pretax returns
Client profile	Complexity of the individual	Few constraints
	Diversity of client goals	Homogeneous
	Limited investment sophistication	High investment sophistication
	Psychological/behavioral profile	Psychology neutral
Investment constraints	Dynamic	Static
	Finite or multistage	Infinite
	Tax aware	Tax neutral

Wealth management is more comprehensive because the scope of advisement extends far beyond the management of a fixed sum of financial assets. The wealth manager incorporates a client's implied assets, such as expected retirement benefits and the value and character of the earnings stream, into the analysis. The portfolios of a government employee and an investment banker will probably look very different. Moreover, the nature of their financial goals (such as retirement, a vacation home, or travel) is likely to differ. These elements combine to form what can be thought of as a life balance sheet that calls for unique solutions.

How then does the customization required of the wealth manager differ from that of the money manager? The difference relates not to the resources or the demographics of the clients but rather the differences in their goals. Wealth management clients' goals vary over a wide spectrum, whereas money manager clients' goals typically do not. If money managers present themselves to the market as experts in the investment of large-cap domestic equities, they may well define their goal as providing a risk-adjusted return superior to the S&P 500 index. Hence, all investors selecting that money manager should have, by definition, the same goal at least with respect to their use of that manager.

Money managers inform the public of their expertise and philosophy and invite investors to trust them with investment dollars. It is the investor's responsibility to determine how much of the portfolio to allocate to a particular asset class (e.g., intermediate-term corporate bonds) and the money manager's responsibility to do a competent job of managing the funds in that class.

For example, the money manager might have expertise in intermediate-term corporate bond management and a philosophy that value can be added by the manager's unique analytical ability to discover value through the analysis of underlying but unappreciated credit qualities. Money managers' focus is on the asset class of their expertise. Their efforts are devoted to the process of successfully implementing their philosophy. In the case of the corporate bond manager, it may be through a detailed study of bond indentures, corporate earnings statements, and corporate earnings prospects.

The practice of a money manager is focused and institutional. Money managers are focused on the implementation of their philosophy, called an investment mandate. Their goal is to maximize return. They are an institution in that they expect to be measured against other institutional managers in their asset class. The money manager is also more likely to be managing assets for other institutions, whereas the wealth manager is usually managing wealth for individuals.

Much of the confusion in separating these two professions results from the fact that many practitioners perform elements of both roles (e.g., asset allocation and individual security selection). Nevertheless, each is a separate responsibility and requires different areas and levels of expertise.

As a result, the wealth management approach is entirely different. It requires customized solutions to address clients' unique needs. The approach also requires a change in mind-set. Mutual funds compete for business by advertising their return—usually relative to competitors or an index. Investors may chase these historical returns when left to their own devices. Ironically, this is not what individual investors are most concerned about. Their primary concern is their ability to accumulate, after taxes, adequate assets to meet their financial goals. Achieving this requires a unique solution for each client.

Wealth managers address the complexity of individuals with diverse goals and often limited investment sophistication. They understand that individuals tend to react to risk in ways that traditional institutional models fail to recognize. The bottom line is that the client defines the practice, and dealing with individuals requires a very different analysis than dealing with a pension fund investment committee.

After all, individuals are unique. Their life circumstances and tolerance for risk tend to change over time. It's a rare individual who does not reevaluate his or her appetite for risk after a portfolio drops in value by 30 percent. Unlike a mutual fund or pension fund with an infinite time horizon, individuals and families have multiple time horizons. Retirement planning, for example, can be divided into two distinct phases of accumulation and distribution.

It is also important to incorporate the influence of taxes. Taxes affect not only the types of assets that might be appropriate for clients but also the types of accounts or taxable entities that are best used.

As a fundamentally unique profession, wealth management requires a broad skill set of the practitioner.

WEALTH MANAGERS AND ASSET MANAGERS

These are new marketing titles that have blossomed as a result of the media hype associated with the popularization of the research of Brinson, Hood, and Beebower and others regarding the importance of asset class diversification. Along with the proliferation of inexpensive optimizers and packaged model portfolios, the marketing appeal of becoming an asset manager has been overwhelming for many practitioners. In theory, an asset manager differs from a money manager in that the former is focused on multiple asset class portfolios, whereas the latter concentrates on individual securities in a single asset class.

Unfortunately, in reality, many self-proclaimed asset managers are neither competent to implement recommendations based on optimizers nor trained to intelligently evaluate and select from the multitude of predesigned models offered to practitioners by the middleman packagers. Many self-proclaimed asset managers are not professionally educated to adequately integrate the unique needs of the client with the portfolio design. The title "asset manager" suggests a professional, but it may mask an untrained salesperson.

A typical recruiting ad touts "By automating this tedious and recurring process, advisors can spend less time on back-office tasks and more time building their businesses" or "Complete Turnkey System Allows Your Brokers to Be Totally Dedicated to Marketing and Sales!" Practitioners falling into this classification should either read further and strive to become wealth managers or return to the field of their primary expertise.

WEALTH MANAGER—A NEW PROFESSION

Most professionals whose practices have evolved into what we call "wealth management" or "private wealth management" are experienced financial planners or investment advisors focused on serving individuals.

The wealth manager's efforts are devoted to assisting clients in achieving life goals through the proper management of their financial resources. While the money manager may not necessarily know if a client is male or female, single or married, a doctor, lawyer, or candlestick maker, the wealth manager must know all of this, as well as the client's dreams, goals, and fears. The wealth manager designs a client-specific plan. In doing so, the wealth manager is concerned with data gathering, goal setting, identification of financial (and nonfinancial) issues, preparation of alternatives, recommendations, implementation, and periodic reviews and revisions of the client's plan.

The practice of the wealth manager is holistic and individually customized. It is holistic because there is very little about the client's global fiscal life that is not important information. It is customized because success is measured not by performance relative to other managers (the wealth manager does not try to maximize returns) but rather by the client's success in meeting life goals.

INVESTMENT PLANNING TODAY

Client needs come in an almost endless array of combinations. There is no generic client for the wealth manager. Much of the popular literature offers two forms of modeling guidance for investors—multiple-choice and aged-based investing. Both are carried over from the institutional concept of a model portfolio.

A major function of the wealth manager is to advise clients on the allocation of their investments across different asset classes and across different taxable entities. In order to place the contents of this book in perspective, consider the simplistic advice that is currently proffered to the investing public.

Multiple-Choice Investing

One form of asset allocation advice is based on scoring the results of a simple investor questionnaire. The process may be so basic that investors simply have to select, from among a series of descriptions, the single phrase that most closely represents their goal. The following is an example from a simple questionnaire:

- My objective is to have minimal downside risk.
- My objective is long-term growth of capital and an income stream.

Other more sophisticated questionnaires may have from 5 to 25 questions. The following are questions taken from a nine-question quiz offered by a multiple-fund company:

- I have funds equal to at least six months of my pay that I can draw upon in case of an emergency. “Yes” scores 1 point; “No” scores 0.
- Does the following statement accurately describe one of your views about investing? “The only way to get ahead is to take some risks.” “Yes” scores 1 point; “No” scores 0.

All too often these multiple-choice questions are a perfunctory attempt to satisfy an advisor’s legal requirement to “know your client.” That said, questionnaires can be a useful tool to collect data about a client’s fiscal life and even personality type that may provide insights regarding his or her risk tolerance. Even so, simplistic questionnaires fall short of being able to provide a reliable, replicable process on which to base an investor’s asset allocation.

Age-Based Investing

An increasingly popular offering is to relate the portfolio allocation decision to the client’s stage of life: age-based investing. As we will frequently remind the reader, this is a useful concept for a sociologist but dangerous if applied to the unique needs of individual clients. The age-based concept tends to institutionalize the belief that age is the paramount, if not the sole, criterion to be considered when designing an investment portfolio.

One of the most popular formulas, designed to provide a stage-of-life allocation:

$$\text{Investment in Stocks} = 100 - \text{Current Age of Investor}$$

$$\text{Investment in Bonds} = \text{Balance of Investor's Assets}$$

This is certainly an easy technique:

Age	Stock	Bonds
40	60%	40%
55	45	55
80	20	80

In fact, this is such an easy rule of thumb that it has become one of the most often-quoted suggestions in the popular media and was once equated with the concept of life-cycle investing. Since then, the field of life-cycle investing has matured to take a more holistic view of the client, incorporating an understanding of the client's earning potential, investment goals, risk tolerances, and risk exposures.

Unfortunately, the popular press is not the only supporter of age as the simplistic default solution. The examples that follow, from a college investment text, reflect a similar academic institutionalization of age as the major portfolio allocation criterion. Although the text refers to investors as "preferring" and "favoring" or being "principally concerned with" certain goals, most readers are likely to conclude that an investor's age should be the primary determinant of portfolio allocations.

Middle-aged clients (middle 40s) are seen as transitioning their portfolios to higher-quality securities, including "low-risk growth and income, preferred stocks, convertibles, high-grade bonds, and mutual funds."

Investors moving into their retirement age are described as having portfolios that are "*highly conservative* [emphasis in original], consisting of low-risk income stock, high-yielding government bonds, quality corporate bonds, bank certificates of deposit (CDs), and other money market investments."

We will reserve for later a discussion about the wealth manager's concepts of "higher-quality," "low-risk," and "conservative." They differ significantly from the usage here. Suffice it to say, these canned approaches for planning the financial welfare of our clients are woefully inadequate.

The following example of two demographically and sociologically similar families will set the stage for the balance of the book and place in perspective the positive difference professional guidance can make for our clients.

EXAMPLE P.1 The Browns and the Boones

The Browns, husband and wife, live in Denver, are working professionals, are both 57 years old, are in good health, and expect to retire together when they reach 62. Our other married couple, the Boones, also live in Denver, are working professionals, are 57 years old, are in good health, and expect to retire together when they reach 62. Both couples consider themselves moderately conservative. Neither the Browns nor the Boones have any desire to leave an estate.

With this information about demographically twin couples, let's see how successfully multiple-choice and life-cycle solutions would serve the Browns and the Boones.

First, we must determine the recommended investment allocations. For this example, we have used the published recommendations of a large investment advisory firm, a large accounting firm, and a major trust company, along with the recommendation determined by the "100" formula for clients meeting the profile of the Browns and Boones. Exhibit P.2 summarizes these recommendations.

EXHIBIT P.2 Asset Allocation Recommendations for the Browns and the Boones, Multiple-Choice and Age-Based Models

	Stocks	Bonds
Investment advisory firm	30%	70%
Large accounting firm	80	20
Trust company	50	50
100 – Age	43	57

Note that the recommendations are significantly different between sources but are the same for the Browns and the Boones, as they have similar ages and planned retirement dates.

Now envision personal circumstances that would lead a wealth manager to recommend radically different allocations for the Browns and the Boones. Mr. Brown has a defined-benefit pension, while his wife and the Boones have defined-contribution plans. Mrs. Boone is very comfortable with risk, but her husband is a bit more cautious, as are the Browns. Their goals may be subject to differing inflation rates: the Browns plan to retire to a small house in a planned retirement community, while the Boones want to travel extensively. Standardized solutions fail miserably to provide useful guidance for such variations. Multiple-choice solutions are simplistic and unprofessional, making them a poor way to plan for a client's future. As noted earlier, age-based investing, as a concept, may work well for a sociologist dealing with large populations. However, translated to the micro level of individual clients, it results in families consisting of 2.3 children and 1.8 parents.

WHAT COMES NEXT

The balance of *The New Wealth Management* discusses issues of importance to the wealth manager. The depth and nature of coverage of these issues will vary significantly.

Some areas assume an existing familiarity with the subject and only highlight specific issues (e.g., client goals and constraints). Other discussions assume a familiarity but also assume that a review may be helpful (e.g., the mathematics of investing). When there are existing references readily available on the subject*, The New Wealth Management* provides an overview and will guide you to appropriate references (e.g., development of an investment policy). Some issues are well covered by other texts; however, there are particular aspects that deserve special attention. In these instances, in addition to referencing other work, *The New Wealth Management* focuses on these special issues (e.g., asset allocation and sensitivity analysis). For issues that are not covered by traditional texts, this book covers the subject in more depth (e.g., behavioral finance). In all areas, we have provided additional resources so that you may read further on a subject you find of interest.

We have attended innumerable professional meetings and read uncounted articles and books on subjects related to the practice of wealth management. All too often, we've been left with the thought "That's nice; now what do I do with it?" If there has been one overriding goal in the preparation of this book, it has been to avoid leaving you, the reader, with that thought. *The New Wealth Management* provides immediate and practical assistance for the practitioner. It includes far more than theory and philosophy. At the practice management level, we include detailed examples of risk tolerance questionnaires and data gathering guides. For use in investment implementation and management, we include specific recommendations for fund selection criteria and asset class rebalancing criteria. Throughout are examples and vignettes that practitioners should find helpful in client presentations and meetings. At a professional level, *The New Wealth Management* includes many recommendations regarding what we consider investment myths (e.g., tax management, income portfolios, and intuitive optimization). Our conclusions may contradict the strong convictions of many readers, but we don't intend to pick a fight. You may take our recommendations for what they are worth to you. The purpose is to assist the reader in developing a clear philosophy and process that will work in your practice.

As you can see, *The New Wealth Management* is eclectic. It is neither an academic textbook nor a comprehensive practitioner manual. It is some of both, and more. It most closely resembles a series of essays on the most important issues for a wealth manager. These essays are integrated, by general subject matter, into a series of chapters. The chapters generally follow the wealth management process. Our goal is to assist the reader in becoming a better and more profitable (emotionally and financially) wealth manager. So, make the book work for you. Skip, jump, or plow straight on through; there are no rules, only what works for you.

CHAPTER 1

THE WEALTH MANAGEMENT PROCESS

The responsibility of advisors revolves around both helping families to keep doing the "right" thing and providing them with as much comfort as possible in doing so.

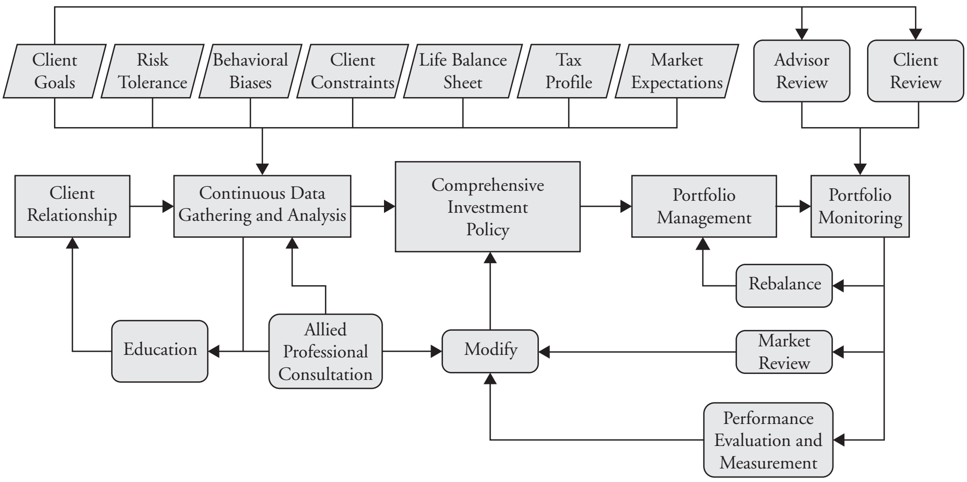
—Jean Brunel

We discussed in the Preface that wealth management geared toward individuals is fundamentally different from money management for institutions. Money managers are focused on the portfolio, whereas wealth managers are focused on the client; therefore, wealth management is a more comprehensive, customized, and complex approach that captures a broad array of issues and interactions that asset managers can often safely ignore. Exhibit 1.1 presents a series of important elements of the wealth management investment process. This chapter provides an overview of that process and is a road map for the rest of this book, which establishes a framework for an effective wealth management practice. We provide a brief introduction of these ideas in this chapter to give an overall perspective, and leave more detailed treatment for the relevant chapters that follow.

The wealth management investment process can be organized into four general, interrelated categories.

1. *Client relationship*. The start of any wealth management process is establishing a solid client relationship built on communication, education, and trust. These elements are represented in the bottom-left part of Exhibit 1.1.
2. *Client profile*. As alluded to earlier, understanding your client in a private wealth management context is complex and based on many factors, some of which are represented by the parallelograms across the top of the chart.
3. *Wealth management investment policy*. Using the relationship and profile factors as inputs, developing a wealth management investment policy is at the heart of the wealth management process.
4. *Portfolio management, monitoring, and market review*. Represented by the systems to the right, implementation, monitoring, and review processes are iterative in nature. That is, they are recurring processes that rely on ever-changing information—such as changes in performance, client circumstances, and market conditions. Many behavioral tendencies exhibit themselves in this part of the process, especially in response to volatile market conditions.

EXHIBIT 1.1 The Wealth Management Investment Process



It is important to recognize that this process is independent of a client's wealth level. Although the relevant issues and optimal solutions are often related to net worth (e.g., the use of trusts, the management of estate taxes, philanthropy), the fundamental process remains unchanged.

THE CLIENT RELATIONSHIP

Because everything is client driven, developing a strong relationship with the client is critical to gathering the appropriate data and helping the client understand what the plan is intended to accomplish. Let's begin on the left side at the bottom-left section of Exhibit 1.1. You may have already noticed from the schematic that the overall wealth management investment process is recursive and ongoing. Developing a client relationship is also iterative, because the wealth manager is continually collecting data from the client and working with other allied professionals, such as attorneys and accountants. The wealth manager uses this information to educate the client about the process in general, possible investment alternatives, and the purpose of chosen investment strategies.

Education is important for developing a strong relationship and ensuring that the advisor and client are speaking the same language. For example, does the client understand what the advisor means when the advisor discusses the concept of risk? Education is performed in cooperation with other investment professionals involved in the client's financial affairs. Expert professional consultation requires effective and active collaboration among the advisory team members. Typically, the catalyst for this collaboration is the wealth manager, and it requires communication and interpersonal skills. It also involves incorporating accountability into the process, which we discuss more fully later.

The educational process is tailored to the individual, evolves over time, and adapts to a client's changing levels of familiarity and comfort. For example, as a client becomes more familiar with different asset classes and notions of risks, the wealth manager may introduce and suggest different investment strategies that might have been avoided earlier in the relationship because their complexity might have potentially compromised the rapport between advisor and client. We discuss client education more thoroughly in Chapter 6.

There are as many data-gathering and educational techniques as there are wealth managers. However, successfully building the relationship depends, in part, on understanding the unique characteristics of each individual. Some clients may be reserved, withholding valuable information from their advisors. Other clients, such as successful self-made entrepreneurs, may have little tolerance for exchanging information and want to jump directly to the implementation stage of an investment strategy. Many people (investors and noninvestors alike) exhibit behavioral biases that shape the way they approach decisions and react to investment outcomes. A deft wealth manager identifies these traits and biases and develops tactics to address them. We address these techniques in Chapter 4.

THE CLIENT PROFILE

Determining the client's profile is a detailed endeavor and is the area in which the differences between private wealth management and institutional investment management are most pronounced. The parallelograms across the top of Exhibit 1.1 list some of the primary elements of a client profile.

Client Goals

An investment strategy starts with identifying an investor's goals. Asset managers often think of client goals in terms of return requirements, which can come in many forms. They may be expressed as nominal returns or real returns. They may also be expressed in absolute terms or relative to a predetermined benchmark, such as a market index. In any case, goals and objectives must be consistent with an investor's risk tolerance. That is, an investment objective or agreed-upon investment goal should not require more risk than an investor can reasonably bear. For example, a 10 percent real return investment objective is not congruent with a moderately conservative risk tolerance.

In a wealth management context, a client's goals can be broader than simply identifying return requirements. They can include planning for wealth transfers; managing risks (e.g., property, longevity); managing family dynamics; and preparing for charitable donations. They do not stand in isolation, but are related to each other, forming part of an integrated whole. Moreover, clients tend to express their goals not in quantitative terms (like percentage return) but in qualitative terms. They often wish to maintain their current standard of living through retirement, pay for a child's college education, or leave some kind of legacy after their passing. The wealth manager's job is to help clients quantify these goals with time and dollar specificity and to prioritize them.

Risk Tolerance

Many methods exist for determining a client's risk tolerance, from the objective to the subjective. Wealth managers often review past investment behavior. Many wealth managers refine their understanding with questionnaires and interviews, while others form opinions based on their holistic experience with the client and an understanding of the client's lifestyles and habits. In any case, although risk tolerance commonly refers to an investor's emotional tolerance for volatility or suffering a loss, it is also important to understand a client's risk capacity (i.e., the financial capacity to withstand market losses).[1] They need not be the same. When an investor's risk tolerance exceeds his or her risk capacity, the lower risk capacity should prevail and the wealth manager needs to educate the client on that client's financial capacity to withstand losses. If risk capacity exceeds risk tolerance, resolution is also needed. When market losses exceed a client's risk tolerance level, a nervous client is likely to bail out of the market independent of his or her risk capacity. As a result, the decision should generally be resolved in favor of the more conservative risk tolerance. This discrepancy is illustrated in Exhibit 1.2. We discuss a client's risk tolerance more fully in Chapters 4 and 5.

EXHIBIT 1.2 Risk Tolerance versus Risk Capacity

	Risk Capacity	
Risk Tolerance	*Below Average*	*Above Average*
Below Average	Below-average risk tolerance	Resolution needed
Above Average	Resolution needed	Above-average risk tolerance

Source: Adapted from John L. Maginn, Donald L. Tuttle, Dennis W. McLeavey, and Jerald E. Pinto, "The Portfolio Management Process and the Investment Policy Statement," and James W. Bronson, Matthew H. Scanlan, and Jan R. Squires, "Managing Individual Investor Portfolios," both in *Managing Investment Portfolios*, 3rd edition (Hoboken, NJ: John Wiley & Sons, 2007): 12, 36–38.

Behavioral Biases

Behavioral biases also affect the way investors approach investment decisions and experience outcomes. Standard finance theory suggests investors prefer certain gains to uncertain gains, all else being equal. In other words, investors are risk-averse, which is borne out empirically. However, when it comes to losses, experiments suggest that most people prefer uncertain losses to certain losses. For example, when individuals are presented with the choice of losing $500 for certain or going double-or-nothing (i.e., losing either nothing or $1,000) with equal probabilities, most go double-or-nothing. This phenomenon is called loss aversion—investors are reluctant to take risk for gain but will take risk to avoid loss. It is a behavioral bias that affects investors' reactions to risk and hence can affect asset allocation. It can manifest itself as the negative emotional impact of realizing an investment loss, thereby making it difficult for an investor to cut losses. We discuss the loss aversion phenomenon and the psychology of risk more fully in Chapter 4.

Client Constraints

Constraints establish the parameters within which the wealth manager must work. They can be categorized into time horizon, priority, liquidity requirements, legal considerations, taxes, and unique circumstances. Here, too, wealth management presents unique challenges. Private clients typically have multistage investment horizons. They may, for example, have a period of anticipated wealth accumulation, concurrent with or followed by a series of large cash needs

[1] In other contexts, risk tolerance is understood as the *willingness* to accept risk, and risk capacity as the *ability* to accept risk.

(e.g., funding college education or starting a business), followed by a retirement phase. Some clients may also wish to transfer wealth after death to subsequent generations or charity that extends the time horizon further. Although the succession of these stages may result in a nearly infinite time horizon, it should not be treated as a generic infinite time horizon, because the intermittent stages are significant. A schedule of anticipated funding requirements will help the wealth manager design a plan to meet interim liquidity needs without interrupting the balance of the portfolio.

Legal considerations are potentially vast. Clients with plans to transfer wealth through an estate plan or charitable giving may encounter complex legal issues around estate taxes, trusts, and perhaps establishing endowments. While the wealth manager must be familiar with the tax and legal issues of these different strategies, this is an area for collaboration and coordination with other professionals, such as attorneys or accountants. Effective coordination ensures that achieving goals in one part of the overall wealth management plan does not unduly infringe on other parts of the plan.

Potential client-specific circumstances are many and varied—ranging from managing concentrated stock positions that either are illiquid or have very low cost basis to managing family dynamics. Although it may not fit everything neatly into standard categories, an effective plan incorporates these unique circumstances. Chapter 3 discusses client constraints in more detail.

Life Balance Sheet

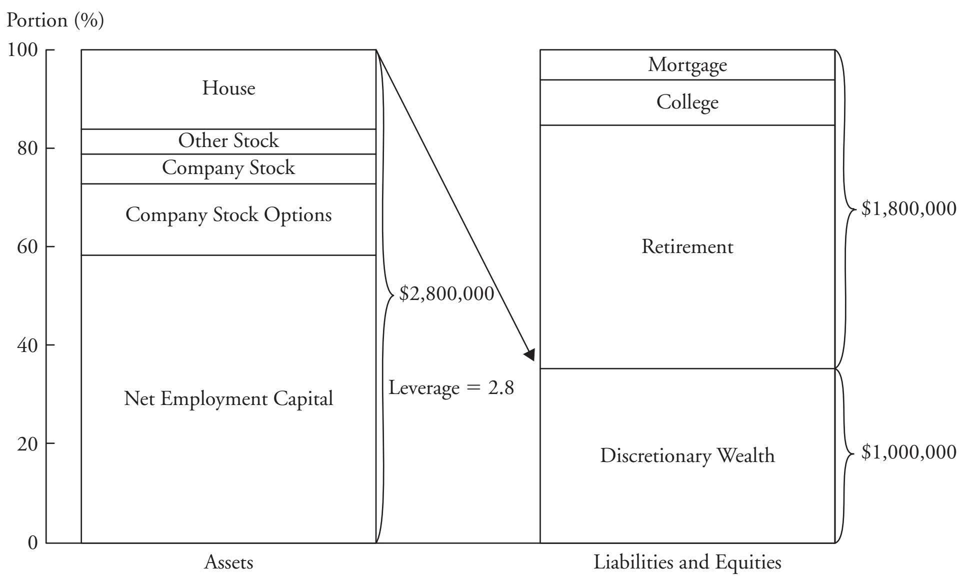
No chief executive officer (CEO) can effectively run a business without understanding its financial position. Similarly, wealth managers need a framework to assess their clients' overall financial status. A "life balance sheet" is one such framework that provides a comprehensive accounting of a client's assets, liabilities, and net worth.

The left side of the balance sheet lists a client's assets. It certainly includes traditional financial assets, such as stocks, bonds, alternative assets, and the like. The listing of assets would also include tangible assets such as real estate, gold, and collectibles. (We discuss how to treat a client's primary residence more fully later.) The left side of the balance sheet must necessarily include implied assets, as well. Implied assets are nonliquid assets, often nontradable, that nonetheless accrue value to the client. Human capital, for example (sometimes called net employment capital), represents the present value of the investor's expected earnings stream. (Again, more on this in a later chapter.) Similarly, expected pension benefits represent implied assets that can be valued in present value terms based on expected cash flows.

Liabilities on the right-hand side of the balance sheet can be viewed similarly. Mortgages, car loans, and other debt secured by tangible property are explicit liabilities to be considered in weighing one's assets against one's liabilities. But investors' implied liabilities are determined by their investment goals. For example, a client wishing to maintain a certain standard of living through retirement is expressing an implied liability to be funded by the assets on the left side of the balance sheet. Aspirations to fund a child's college education, purchase a vacation home, start a business, or fulfill a charitable bequest represent implied liabilities in a similar fashion.

Exhibit 1.3 presents a simple life balance sheet with a few explicit and implied assets as well as implied liabilities. In addition to the traditional investment portfolio, assets include the value of the investor's personal residence, holdings of company stock, and company stock options. In this example, assets total $2.8 million. Liabilities include the capitalized expenses associated with funding children's college education and retirement in present value terms. In this case, liabilities total $1.8 million, which represents the amount of capital necessary to fund these core requirements. Therefore, this amount is sometimes referred to as "core capital." These figures imply that assets are sufficient to meet these core obligations, leaving $1 million of excess capital, or discretionary wealth. Investors with insufficient assets to meet core capital needs must accumulate more assets, reduce the obligations they wish to fund, or risk leaving these needs unsatisfied.

EXHIBIT 1.3 Hypothetical Example of a Life Balance Sheet

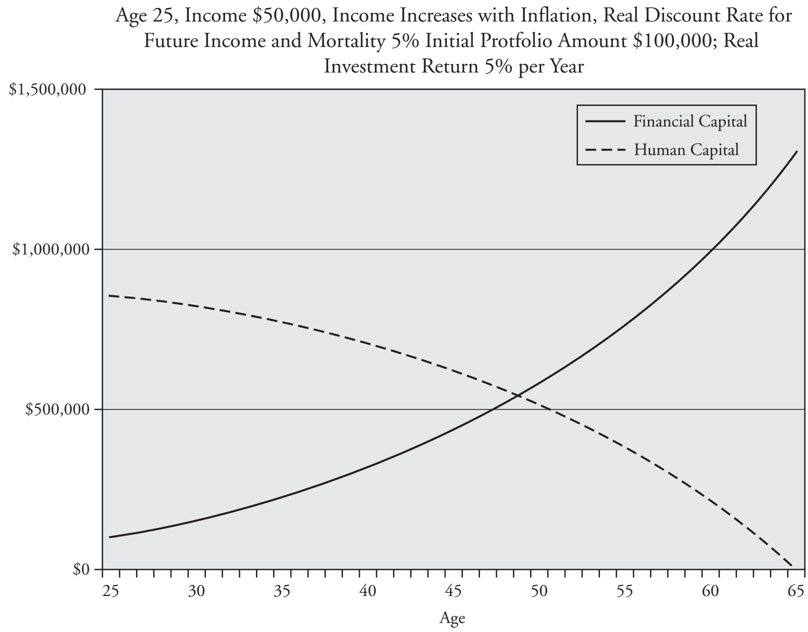


Source: Adapted from Wilcox, Horvitz, and diBartolomeo (2006, 18).

An alternative, and more traditional, approach is to prepare a balance sheet without the implied assets and liabilities. In this case a separate analysis is performed to determine future cash needs such as college and retirement and to determine how much additional periodic investment is needed such that when combined with the client's current portfolio there are sufficient future funds to meet cash needs. In either case the wealth manager has information to determine whether the current investment plan and assets are sufficient to meet future objectives.

As you can see from this example, investors' human capital can represent the bulk of their assets. The present value of their expected earnings stream can exceed the value of their financial assets by quite a bit. This situation is common for young investors who have many years in the workforce ahead of them, but have yet to accumulate a large amount of financial capital. Typically, financial capital and human capital follow opposite patterns over one's lifetime, with financial capital replacing human capital over time as shown in Exhibit 1.4. The value of human capital relies heavily on its nature, depending not only on an investor's current and expected wages, but also on the volatility of the earnings stream. For example, a tenured university professor faces far less human capital risk than an investment banker does.

EXHIBIT 1.4 Stylistic Depiction of Financial Capital and Human Capital



Tax Profile

The intersection of taxes and investments is one of the most daunting of challenges for the wealth manager. Even determining an investor's marginal tax rate is complicated by varying tax brackets, alternative tax structures, phaseouts, taxation of retirement benefits, and more. Similarly, a seemingly simple task of determining an investor's current asset allocation is complicated by the notion that assets held in tax-deferred accounts have a different after-tax value than those held in taxable accounts. Moreover, a portfolio's tax drag is jointly determined by its asset class composition, the types of accounts, and the level of taxable turnover.

There are also opportunities to optimize a client's after-tax returns by placing certain types of assets into certain types of accounts—a practice called "asset location" (not to be confused with asset allocation). For example, it is often beneficial to hold bonds in tax-deferred accounts and to hold equity (particularly if it is passively managed) in taxable accounts.

Many high-net-worth individuals have large holdings in low-cost-basis stock. These positions may have been handed down from previous generations, accrued from executive stock options, or secured through a public stock offering of an entrepreneur's business. Various strategies for managing these low-basis positions exist, and the best choice depends heavily on the nature of the position and the specific circumstances.

The world of estate taxes adds another layer of complexity to the wealth management process. Trust structures are often useful ways to achieve wealth transfer goals. Wealth managers are typically not estate planners, but a familiarity with estate planning issues allows the wealth manager to work with estate planners and accountants to develop and implement a solid estate plan. The situation becomes even more complex when a client or family has multijurisdictional accounts or residences. We discuss wealth management in the taxable environment fully in Chapter 11.

Market Expectations

The astute reader may notice that capital market expectations for the macroeconomy and various asset classes are not part of a client's profile. Rather, they are determined outside and independent of the client's unique circumstances, and in that sense deserve to be categorized separately. Although this is certainly true, establishing expectations of the capital markets is an important input to establishing investment policy.

WEALTH MANAGEMENT INVESTMENT POLICY

Once a wealth manager establishes a client's profile and capital market expectations, the wealth manager's next task is to develop an investment policy statement (IPS). The IPS serves as the governing document for all investment decision making. It sets out the investment objectives (risk and return) and the constraints (liquidity, time horizon, tax considerations, legal and regulatory factors, and unique circumstances) for managing the portfolio. Some wealth managers include the planned asset allocation in the IPS, as well. Exhibit 1.5 presents an outline for a typical investment policy statement.

EXHIBIT 1.5 Investment Policy Statement

- a. Brief client description
- b. Client goals
- c. Investment objectives
  - i. Return objective
  - ii. Risk objective
- d. Investment constraints
  - i. Time horizon
  - ii. Tax considerations
  - iii. Liquidity needs (e.g., cash flow management)
  - iv. Legal and regulatory concerns
  - v. Unique circumstances
- e. Strategic asset allocation
  - i. Asset class constraints
  - ii. Investment constraints (e.g., margin restrictions)
  - iii. Investment strategies
  - iv. Investment styles
- f. Implementation, monitoring, and review
  - i. Responsibilities of client, manager, custodian, and other parties involved
  - ii. Performance measures, evaluation, and benchmarks
  - iii. Review schedule
  - iv. Rebalancing guidelines