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CFA Program

PRIVATE WEALTH PATHWAY

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Private Wealth Pathway

LEARNING MODULE

1

The Private Wealth Management Industry

LEARNING OUTCOMES

Mastery	The candidate should be able to:
☐	discuss the typical business models of private wealth management service providers and their segment-based strategies
☐	discuss typical fee, revenue, and compensation structures prevalent in the private wealth management industry
☐	discuss how various advisers, consultants, and professionals support private wealth managers and their clients
☐	describe and evaluate regulatory and compliance considerations influencing the private wealth management industry

INTRODUCTION

1

Wealth management is also an increasingly important segment of the global financial marketplace. This reading provides an overview of the wealth management industry, including a discussion of the common categories of clients served, the various types of advisers practicing wealth management, and the various business models found across the industry. This reading concludes with a discussion of the CFA Asset Manager Code and complex regulatory and compliance considerations wealth managers must navigate on behalf of their clients.

LEARNING MODULE OVERVIEW

- Private wealth is the term applied to the industry and practice of managing the wealth, financial and otherwise, of wealthy clients who need financial advice. This is a team effort, involving professionals with different areas of expertise.
- The comprehensive needs of wealthy clients extend beyond investment advice into tax, law, philanthropy, property, country of residence, and generational planning. These complex client needs require experts beyond basic investment managers — lawyers, tax specialists, accountants, investment bankers, custodians, insurance specialists, and even health, education, administrative support specialists are frequently called upon and require management.

- However, these services can be costly. Clients and advisers should understand the nature of the services and costs. A shared understanding of typical fee, revenue, and compensation structures used in the industry, and those applied to a particular client.
- In all relevant jurisdictions, private wealth management must adhere to local regulations and compliance. Clients increasingly demand high ethical standards, encapsulated in the CFA Asset Manager Code.

2 INDUSTRY SEGMENTS, BUSINESS MODELS, STRATEGIES

☐ discuss the typical business models of private wealth management service providers and their segment-based strategies

This introductory reading focuses on the business models and strategies employed by wealth management firms and describes their clients and the other industry players who support them.

A Brief History of Private Wealth Management

Private wealth management has adapted over time to meet the complex needs of wealthy individuals and families, evolving from ancient civilizations through global economic and regulatory changes.

After World War II, private banks went global, setting up operations in major financial hubs. This growth was driven by increased international trade and the rise of **offshore financial centers (OFCs)** that offered legal asset protection and tax planning.

The late 20th century saw economic growth from globalization and emerging markets, which led to industry expansion. During this time, the quality of services and ethical standards in wealth management also improved.

Regulatory reforms like the Sarbanes-Oxley Act and Markets in Financial Instruments Directive (MiFID) increased transparency standards, with similar changes happening globally, such as Hong Kong's Banking (Capital) Rules revision in 2007. In particular, the 2008 Global Financial Crisis became a catalyst for many significant reforms that impacted wealth management including the Dodd-Frank Wall Street Reform and Consumer Protection Act (2010) in the United States, the Markets in Financial Instruments Directive II (MiFID II) in the European Union, and similar global efforts coordinated by the Financial Stability Board promoting expanded supervision, oversight and transparency for bank and non-bank entities. These reforms are covered more fully in the section "Competitive and Strategic Drivers."

THE SO-CALLED END OF SWISS BANKING SECRECY

> If you see a Swiss banker jump out of a window, jump after him. There's bound to be money in it.
>
> *Voltaire (1694–1778)*

Switzerland's private banking sector has been a cornerstone of the global financial system since the mid-18th century, with institutions like Wegelin & Co. founded in 1741, Lombard Odier in 1796, and Pictet in 1805. While banking secrecy was once a long-standing tradition, codified by the 1934 Swiss Banking Act, it exists today under highly restrictive legal frameworks. The sector underwent significant changes, especially after the 2008 financial crisis. In 2014, Switzerland became a signatory to the Organization for Economic Co-operation and Development (OECD) Common Reporting Standard (CRS), aligning itself with global transparency norms. This adaptation has implications for both clients and financial institutions, as it necessitates more rigorous reporting and compliance measures, thereby affecting the attractiveness of Swiss banks for certain types of asset protection that require confidentiality.

Today, transparency is the industry standard, driven by global regulatory bodies like the Financial Action Task Force (FATF). The industry continues to evolve, offering abundant, legitimate opportunities for wealth management professionals.

The Wealth Management Industry Today

The wealth management industry is shaped by history, demographics, geography, culture, and capital market trends. A country's social infrastructure, including health care, unemployment, and retirement benefits, also influences the evolution of services in the wealth management industry.

KEY SERVICES IN PRIVATE WEALTH

- *Private Wealth:* Refers to assets owned by wealthy individuals or families, often managed by financial professionals. It includes various forms of capital such as real estate, equities, and bonds.
- *Wealth Management:* A comprehensive service that combines financial and investment advice, accounting and tax services, and legal or estate planning. Often used interchangeably with "private wealth management."
- *Private Banking:* A personalized financial and banking service that is traditionally offered to high-net-worth individuals. It includes a range of services such as investment management, tax planning, and estate planning, in addition to banking.
- *Asset Management:* More focused than wealth management and sometimes also referred to as portfolio management, this involves managing a client's investments and providing specialized investment strategies. Usually a firm but can also refer to a specific role within a larger financial institution.
- *Wealth Manager/Adviser:* An individual who offers a combination of financial planning, investment portfolio management, and other aggregated financial services to clients. This role may also be referred to as a private banker, client adviser, or wealth adviser.

Governments provide defined benefit (DB) and defined contribution (DC) retirement schemes along with individual savings plans. In countries where capital markets are large and diverse, the volume of transactional activity supports a wide range and depth of financial services and products. As a result, the wealth management industry is typically fragmented and non-uniform, notwithstanding certain dominant players with Swiss heritage or who are well established among the locals.

In the United States, the private wealth marketplace is fragmented. A multitude of institutions, varying in type and size, offer services to citizens who find government-sponsored DB retirement programs and post-retirement health care insurance insufficient. Service providers, including wealth managers, offer a wide range of investment products, personal saving plans, insurance products, and support for employer-sponsored DC plans.

Conversely, in many continental European countries, such as France, Italy, and Spain, wealth management services lean toward an oligopoly, dominated by a few large universal and local banks. These countries place more emphasis on defined benefit retirement plans, which often provide better post-retirement income replacement coverage than DC plans. The public health care systems are generally free or low-cost, hence there is less need to save for medical care in retirement. Elsewhere, including in the United Kingdom and in many Asian countries, a diverse array of banks and financial advisers offer wealth-management-related services. Governments provide DB and DC retirement schemes along with individual savings plans. In countries where capital markets are large and diverse, the volume of transactional activity supports a wide range and depth of financial services and products. As a result, the wealth management industry is typically fragmented and non-uniform, notwithstanding certain dominant players with Swiss heritage or who are well established among the locals.

Offshore versus onshore

"Onshore" and "offshore" services refer where financial services are offered relative to the client's home country. Wealthy clients may choose to use one or both of these options, depending on their unique needs. *Onshore* services are provided *within* the client's primary country of residence which is typically where they are considered to be resident for tax purposes. *Offshore* services, on the other hand, are offered outside of the client's primary country of residence (or prevailing regulatory authority).

For some private wealth clients, offshore services may be attractive due to factors such as political stability, legal advantages, tax incentives, and access investment products not available locally. These jurisdictions often provide stronger rule of law and are sometimes preferred due to distrust in local authorities, possibly stemming from corruption or threats. For instance, Singapore has emerged as a leading offshore wealth management hub in Asia, driven by its political stability and financial robustness. Concurrently, political and economic concerns in the region have heightened interest in such services.

The terms offshore center and **cross-border financial center** are sometimes used interchangeably and in many ways they are. Cross-border financial centers, such as the United States, United Kingdom, and Switzerland, serve both domestic and international investors, whereas offshore centers, such as the Isle of Man predominantly cater to foreign investors.

KNOWLEDGE CHECK

1. Which of the following factors would not reliably attract global clients offshore?

   A. Recourse to the courts and a lack of confidence in one's local authorities

   B. Political stability and improved legal and tax regimes

C. Lower transaction fees

Solution:

C is correct. Lower transaction fees may seem attractive, but they are not among the primary factors that attract clients to offshore wealth management services, which may even incur higher transaction fees.

Exhibit 1: Global Cross-Border Financial Centers

	Cross-border financial center wealth 2021 (USD trillions)	Dependency on cross-border wealth (%)	Top source region of cross-border wealth
Switzerland	2.5	60	Western Europe
Hong Kong SAR	2.3	51	Asia
Singapore	1.5	73	Asia
US	1.1	1.5	Latin America
Channel Islands and Isle of Man	0.6	>90	Western Europe
UAE	0.6	62	Middle East
UK mainland	0.5	13	Western Europe
Luxembourg	0.4	82	Western Europe
Monaco	0.3	>90	Western Europe
Liechtenstein	0.2	>90	Western Europe

Note: Wealth in local currency is converted into US dollars using the 2021 year-end exchange rate across all time periods.
Source: Zakrzewski et al. (2023)

Exhibit 1 illustrates major cross-border financial centers and their relative importance. Jurisdictions offer distinct advantages tailored to client needs. Switzerland excels in traditional private banking, while Monaco and Dubai attract residents with tax-free environments. Portugal's **golden visas**, which are residency permits granted in exchange for investment, offer initial 10-year tax exemptions.

Specialized centers include Luxembourg, known for its fund and insurance industries, and the US state of Delaware, a hub for company formation. The Isle of Man specializes in trusts, and the Cayman Islands serve hedge funds. Geographically advantageous locations like Uruguay attract Argentine clients, Andorra appeals to mainland Europeans, and Gibraltar, though no longer in the European Union (EU), remains conveniently located next to Spain. Exhibit 2 shows some of the most common offshore centers, their areas of specialization and their level of compliance with international transparency requirements.

Exhibit 2: Selected Offshore Centers and the Main Clients Served

Jurisdiction	Summary	OECD Transparency Classification
Hong Kong	One of the world's leading financial hubs with a highly developed financial sector.	Largely Compliant
Singapore	Significant Asian financial center with substantial assets under management.	Compliant
Cayman Islands	Known for its hedge funds and other investment structures, holds significant financial assets.	Largely Compliant
Guernsey	Important center for trusts and funds in Europe.	Compliant
Jersey	Significant player in trusts and funds in Europe.	Compliant
Isle of Man	Robust financial sector but smaller in terms of assets under management.	Compliant
Bermuda	Known for insurance and reinsurance companies, holds substantial financial assets.	Largely Compliant
UAE/Dubai	Major financial hub in the Middle East, known for its free zones.	Partially Compliant (2019)
Bahrain	Major financial center in the Middle East, particularly in Islamic finance.	Partially Compliant
Panama	Known for its banking sector and the Panama Papers, has a significant amount of financial assets.	Non-Compliant
Lebanon	Historically a significant OFC in the Middle East, but recent financial instability.	Non-Compliant
Mauritius	Emerging financial center, particularly for investments into Africa.	Largely Compliant
Philippines	Not traditionally considered an OFC but has a growing financial sector.	Largely Compliant
Gibraltar	Smaller European OFC but still note-worthy for its financial activities.	Largely Compliant
Bahamas	Known for its trusts and private banking.	Partially Compliant

*Source for compliance status:*OECD (2023); compliance status correct as of October 2023. OECD rankings for tax information sharing and transparency categorize countries as "Compliant," "Largely Compliant," "Partially Compliant," or "Non-Compliant," indicating their adherence to international tax transparency standards. A "Compliant" rating signifies full adherence, "Largely Compliant" denotes minor shortcomings, "Partially Compliant" points to significant gaps, and "Non-Compliant" suggests a failure to meet most requirements.

KNOWLEDGE CHECK

1. Which of the following jurisdictions is known for its significant role in Islamic finance and is also a major financial hub in the Middle East?

   A. Singapore

B. Bahrain

C. Cayman Islands

Solution:

The correct answer is B, Bahrain. Bahrain is known as a major financial hub in the Middle East and is significant in the field of Islamic finance. In contrast, Singapore (A) is a financial hub but not specifically known for Islamic finance. The Cayman Islands (C) are recognized for hedge funds and investment structures but not for Islamic finance.

Wealth Management Participants

The infrastructure of wealth management firms comes in different forms. We list the main types of service providers here.

- *Universal banks* – Wealth management is only one segment of their services, sometimes under a different brand name, as they leverage their extensive client base across various businesses. They have a global presence, both onshore and offshore.
- *Local banks and trust departments* – With either retail banking or wealth management on offer, these players include local, state, regional, and private banks.
- *Private banks and trusts* – Independent private banks and trust companies (or trust departments in larger banks) primarily offer wealth management, though larger firms may offer additional services.
- *Investment banks* – Fenced by a very high entry level, and not direct competitors to traditional wealth managers, they provide institutional-type services in the realms of mergers and acquisitions and capital raising for ultra-high-net-worth individuals (UHNWIs). The types of investments on offer are typically unavailable to smaller clients.
- *Digital and direct banks* – Focusing on smaller clients and using digital platforms that produce automated investment advice, these entities have a minimal presence or no physical sites at all. Their automated processes are low-cost and rely extensively on robo-advisers.
- *Brokerage firms* – Brokerages act as intermediaries between buyers and sellers to facilitate market transactions. Larger brokerage firms may also offer a wide range of investment management and planning options. Their low-fee structure mirrors that of digital and direct banks. Interactive Brokers and Charles Schwab are well-known US firms.
- *Asset managers and fund managers* – These teams emphasize their asset management capabilities through dedicated funds or products. Wealth management isn't usually on offer, and instead their investment products constitute single building blocks for clients' portfolios.
- *Independent advisers (also referred to as financial advisers, wealth advisers, independent or external asset managers)* – These advisers operate primarily on an independent basis, meaning they are not tied to any specific financial institution's set of investment products or strategies. Some may choose to affiliate themselves with larger entities like global platforms, banks, or insurance groups to access additional resources or investment options. Despite these affiliations, they typically maintain their autonomy in investment decision-making, managing assets using their own strategies and sometimes their proprietary funds.

- *Family offices* – Family offices manage a diverse array of financial matters, which can include administration, investments, tax planning, wealth and estate planning, and philanthropy, among others. Some are single-family offices (bespoke to the needs of one single family), and some are multi-family offices (servicing ultra-high-net-worth clients). They may manage their portfolios directly or delegate to banks and fund managers.

Competitive and Strategic Drivers

Porter's Analysis

An analysis of Porter's five forces (Porter, 1980) supports an understanding of the industry.

Threat of New Entrants

High regulatory barriers and the importance of trust and reputation make entry relatively difficult. Established firms such as Goldman Sachs or J.P. Morgan enjoy economies of scale and reputational strength. In recent years, family offices, specialized wealth management firms that exclusively serve the financial needs of a single family, and **multi-family offices**, which extend that specialized service to multiple families, have gained market share in the ultra-high-net worth (UHNW) and high-net-worth (HNW) spaces based in part on their high level of personalized service. At the same time, **robo-advisers**, which are automated platforms that use algorithms for financial planning and investment, have demonstrated some success by offering lower costs, making them popular in the mass affluent segment (Napach 2022).

Bargaining Power of Buyers

The primary buyers in the wealth management industry are the mass affluent, high-net-worth individuals (HNWIs), and ultra-high-net-worth individuals (UHNWIs). Among these, UHNWIs possess the greatest bargaining power owing to their substantial wealth and the alternative options available to them. They typically demand highly personalized services and have the flexibility to switch providers with ease.

Bargaining Power of Suppliers

The suppliers in this space are tax advisers, legal specialists, technology providers, custodians, and asset managers, to name a few, and their bargaining power is limited, except when directly dealing with large banks and DC providers, when they can exercise more influence. Specialized expertise, such as custody of non-traditional investments, can grant moderate power. Firms often rely on suppliers for advanced tech and legal advice.

Threat of Substitutes

Alternative options include self-directed investment platforms, robo-advisers, and family offices. Multi-family offices, which serve multiple families and can operate internationally, may appeal to clients seeking specialized, highly personalized services. For UHNWIs, multi-family offices pose significant competition, offering highly personalized and often outsourced services that can match or exceed those provided by traditional wealth management firms. Notably, both family offices and multi-family offices can act as clients when they outsource specific services.

Intensity of Competitive Rivalry

Competition is high among various types of wealth management firms. It centers on service quality, not just investment performance. The breadth and depth of products, and specialized expertise enhance competitive positioning.

Factors Influencing Specific Strategic Decisions

Factors influencing a wealth management firm's strategy include:

- unique in-house expertise that differentiates from competitors;
- reputation as a strategic asset or liability;
- financial capacity for technology investments, positioning for either a mass market or niche market;
- target market segments;
- sophistication of markets and clients in operational regions;
- extent of regulation in operational regions;
- presence or absence of an established distribution network; and
- presence or absence of physical branches or offices.

When considering location, wealth management firms must decide between offering onshore and offshore services, as well as whether to establish a local presence. The decision is complex and must take into account various local requirements. For example, a firm planning to operate in multiple countries will need to navigate disparate regulatory landscapes, understand cultural preferences in client-adviser relationships, meet professional norms that may differ significantly, and offer services that address the unique needs of clients in each location.

To illustrate, if a US-based firm is contemplating an expansion into Switzerland, it must consider Swiss banking secrecy laws, the local appetite for risk, and even the types of assets that Swiss investors commonly hold. The firm will also have to decide whether to open a local branch or operate remotely, keeping in mind the high value that Swiss clients place on privacy and face-to-face interactions. Therefore, deep knowledge of local requirements such as licensing, cultural nuances, professional norms, and specific client needs is essential for a successful international strategy.

Legal, Licensing, and Technology

The firm's license sets the framework for strategic planning. Firms typically identify target markets based on opportunities and then ensure compliance with local regulations. Access to qualified legal advice is generally not a constraint and is essential for navigating regulatory landscapes in different markets.

Technology is universally important in client acquisition and management, although its specific role can vary. While traditional methods like personal connections and referrals remain key, technology is increasingly integral in managing these relationships. The degree of reliance on automation and tech resources may differ based on the firm's focus and the wealth level of its clients.

Client Acquisition and Retention

Understanding the dynamics of client retention, acquisition, and development is crucial for wealth management firms looking to build a sustainable business model. Wealth management firms, like many other service providers, operate in three key stages: client acquisition, development, and retention. In the acquisition phase, the goal is to attract new clients cost-effectively, leveraging referrals and collaborations with professionals like lawyers and accountants. Marketing strategies, including digital outreach and events, also play a role.

During the development stage, the firm aims to deepen client relationships. This involves cross-selling various offerings and persuading clients to allocate a greater share of their investable assets to the firm.

For client retention, the focus is on maintaining profitable, growth-oriented relationships. The firm stays attuned to changes in client circumstances and proactively adjusts its services. Trust-building, open communication, and problem-solving are key, along with expertise that adds value and encourages long-term engagement. Exhibit 3 provides a summary of the client acquisition, development and retention cycle.

Exhibit 3: Client Acquisition, Development, and Retention Cycle

Implementation Strategies

Wealth managers employ strategies grounded in Porter's three core approaches for competitive advantage: cost leadership, differentiation, or focus/niche strategies. These strategies are not mutually exclusive and can be adapted to create a multi-pronged approach to market competition.

- *Cost Leadership* – This strategy is geared toward a broad customer base, focusing on economies of scale and operational efficiency. In the context of wealth management, this often means offering low-cost investment options and automated platforms. Both universal banks and specialized services compete in this segment.
- *Differentiation* – Targeting HNWIs and the mass affluent, this strategy seeks to provide unique offerings valued by clients. It aims to achieve higher margins by offering comprehensive wealth planning and exclusive investment opportunities not readily available to retail investors.
- *Focus/niche* – This involves targeting a specific, often niche, segment of HNWIs or UHNWIs in specialized markets or regions. The strategy prioritizes personalized, face-to-face interactions and specialized services that warrant premium pricing.

By understanding and leveraging these approaches, wealth managers can create a competitive advantage tailored to their operational markets and client base.

To illustrate how some wealth management firms are uniquely tailoring their strategies to meet the complex needs of HNWIs and UHNWIs, let's consider the case of Pi R-Squared Investors (PRS), a newly established firm that leverages long-standing industry relationships and specialized investment opportunities.

CASE STUDY

Pi R-Squared Investors

Motivated by the opportunity for greater innovation and personalized service, a group of experienced partners from a leading international financial institution founded Pi R-Squared Investors (PRS), a newly established wealth management firm. These partners were confident that their loyal client base would follow them to the new venture.

PRS allows the team to leverage their long-standing relationships with asset managers to offer clients truly exceptional investment opportunities. Through diligent research and risk assessment, they identify and access high-caliber alternative investments. This is particularly appealing to their clients, eager for better investment options.

While PRS may not have the scale to compete purely on cost, they strategically partner with independent service providers to deliver top-quality services at reasonable prices. As a result, clients might encounter slightly higher fees and fewer conveniences, but they benefit from better risk-adjusted returns and more personalized attention.

KNOWLEDGE CHECK

1. Which of the following best describes the main implementation strategy for brokerages, such as Charles Schwab and Interactive Brokers?

   A. Cost leadership

   B. Differentiation strategy

   C. Niche strategy

   Solution:

   A is the correct response. As per the reading, Interactive Brokers and Charles Schwab offer a low-fee structure mirroring that of digital and direct banks, with many similar firms operating globally that emphasize costs.

Services and Product Range

Wealth management firms offer a diverse range of services, which may vary by firm and by type of client, some of which are in-house and some are outsourced.

Core services typically include:

- deposit management,
- liquidity and payment oversight,
- client reporting (statutory, tax, and on-demand), and
- account administration.

Lending services might encompass:

- mortgages (private or commercial),
- credit cards (usually via separate issuers),
- Lombard loans (secured by investment assets),
- specialized lending (eg for aircraft, artwork).

Brokerage and securities dealing services can include trade execution for securities, currencies, funds, and structured products.

Asset management services usually involve:

- portfolio management,
- discretionary and advisory mandates,
- asset allocation advice, and
- investment products (in-house or third-party).

Wealth planning and advice can cover:

- wealth structuring,
- legal and tax guidance,
- estate planning,
- financial planning,
- retirement and pension optimization, and
- philanthropy advice.

Insurance and wealth protection services may include:

- life insurance and
- trusts and global fiduciary services.

EXAMPLE 1

The Success of External Asset Managers: A Look at Switzerland and Beyond

Swiss **External Asset Managers (EAMs)**, also known as independent asset managers or independent wealth managers, have carved out a unique space in Switzerland's financial system and offer a distinct alternative to larger financial institutions.

The EAM landscape is diverse, ranging from specialized asset managers to client-focused wealth managers. With more than 1,500 firms, the average EAM employs between three and four people and manages a median of around CHF100 million in assets. Collectively, they oversee CHF600–700 billion, making up 10% to 15% of the total assets held in Swiss banks that offer services to EAMs.

For their clients, who are primarily HNW and UHNW, EAMs focused on wealth management offer several advantages. Their smaller size often translates to greater agility and flexibility, allowing for more personalized services. Clients may also benefit from better access to specific markets and sectors, as well as specialized expertise. Additionally, the legal separation between asset ownership and management can offer an extra layer of security that some clients find appealing. The success of the EAM model in Switzerland has inspired similar regulatory changes in other countries, including Singapore, resulting in the emergence of more than 1,000 EAM firms there.

Private Client Segmentation

After understanding the different services offered by wealth management firms, it's crucial to delve into how these firms segment their client base to tailor these services effectively. Most wealth management firms' cater to clients that fall into one or more wealth-based segments determined by client assets.

Wealth-based segmentation

Wealth-based segmentation employs specific terminology and asset ranges:

- retail,
- affluent,
- HNW, and
- UHNW.

Each category has a theoretical asset range, whether made up of deposits, investable, or liquid assets.

- *Retail:* At this entry level, clients typically receive minimal dedicated servicing. The focus is largely on savings accounts and product-driven solutions like inexpensive passive vehicles (ETFs) and in-house investment funds.
- *Affluent:* Services may include basic financial planning and tax considerations. Technology and digital tools often play a significant role, and standard in-house products dominate the offerings.
- *High net worth:* These clients generally have a longer investment time horizon and may require wealth-transfer assistance. The focus shifts to tailor-made investment solutions, and the range of investment products becomes more exclusive.
- *Ultra-high-net worth:* This group is a subset of HNWIs and their needs are often highly complex. They may require a network of both internal and external advisers. The asset mix is diverse, often including both liquid and non-liquid investments. Senior management and even the board of directors of the wealth management firm may be involved in client relationships.

WHAT IS HNW AND UHNW?

Classifications and categorizations vary by region and by firm. However, the following could be used as a general guideline in the United States:

Client Type	Net Investable Assets
Retail	Up to USD250,000
Affluent	Between USD250,000 and USD1 million
HNW	Between USD1 million and USD30 million
UHNW	Above USD30 million

Though wealth-based classification is relatively straightforward and used by many private wealth managers, it does have some obvious shortcomings. Applying net worth to client segmentation can prove challenging when clients, influenced by historical or cultural taboos, are reluctant to divulge information about their total global wealth. Provided clients agree to share it, a tax declaration gives a comprehensive view of income and its sources.

Another shortcoming of a wealth-based classification system is that it fails to capture the complexity of clients' circumstances, which will vary from client to client; however, it remains, by large, the most common approach in the private wealth sector.

QUESTION SET

1. Which of the following is the biggest driver of the bargaining power of wealth management clients?

   A. The formation of "buyer's groups" for such services

   B. Heavy reliance on suppliers of specialized services (tax, legal, etc.)

   C. Widespread availability of providers via traditional and non-traditional engagement (e.g., virtual, low-touch)

   Solution:

   C is the correct response. The ability to switch wealth management firms is relatively easy, and buyers have power due to the plethora of alternative providers. A could be true if such a thing existed at scale. B is related to the bargaining power of service providers to the wealth management industry.

2. Which of the following statements best describes the impact of technology on client acquisition and retention strategies in private wealth management?

   A. Technology has limited the reach of firms to potential clients.

   B. Technology has made wealth management services less accessible and affordable.

   C. Technology has enabled firms to reach a broader audience and made wealth management services more accessible and affordable.

   Solution:

   The correct answer is C. Technology has enabled firms to reach a broader audience through digital marketing and social media platforms. Additionally, digital tools have made wealth management services more accessible and affordable.

3. How are advisory and execution-only investment mandates similar?

   A. Similar relative cost structure

   B. Same underlying decision maker

   C. Legal contracting

   Solution:

   B is the correct response. In both cases, the final investment decisions reside with the client. A is wrong as we would expect advisory to often have different fees. C is wrong as advisory would typically need an additional set of documentation relating to the provision of advice.

FEE, REVENUE, AND COMPENSATION STRUCTURES

3

☐ discuss typical fee, revenue, and compensation structures prevalent in the private wealth management industry

This section will examine the prevalent fee and compensation models in the private wealth management sector, which typically charges higher fees than retail banking, thereby generating greater revenue for professionals. Advisers should be aware of regulatory mandates that require detailed, regular disclosure of all fees to clients, especially considering the reporting rules in the countries where their clients reside.

The industry is experiencing a transparency shift led by new online wealth management firms that prioritize clear fee structures. This contrasts with traditional institutions, which may offer personalized services at higher fees but with less transparency.

Business Models and Industry Drivers

Beyond prevailing market conditions, a wealth management firm's revenue-generation capacity is influenced by its business model and available operating licenses. Company size, geographical presence, and staff experience and efficiency also play crucial roles.

Most revenues can be grouped into the following categories:

- *Recurring* – These revenues primarily originate from portfolio management activities, the use of investment funds and other products, custody, and tax planning as well as other service-related activities that occur on a regular basis.
- *Non-recurring* – These revenues may arise from activity prompted by various life events or "one-off" events (death, divorce, sale of business, etc). Also, special projects such as bespoke analysis and reports requested by clients can result in fees.

Revenues can also be seen as:

- *Fixed Revenue* – These could include service fees charged on a periodic basis.
- *Variable Revenue* – These would typically include transaction fees or assets under management (AUM)–based fees.

It's likely that most fees are a combination of these characteristics. For example, a one-time transaction might be charged a fixed fee that would qualify as non-recurring. Or, as a client's AUM rises or falls, the related charges will track the variation.

External Drivers Impacting Revenues: Industry Trends

External factors influencing wealth management firms' revenue growth include:

- The growing connectivity of global capital markets and increased sensitivity of markets and market valuations to macroeconomic and geopolitical developments brings both benefits (broader access to global opportunities) and costs (greater asset sensitivity to geopolitical risks).
- While publicly traded asset prices may be more sensitive to global risks, the growing use of private markets investments (private equity and debt, real estate, or venture capital) alternative investments can provide diversification for investors and should benefit from a return premium due to their low liquidity. There are two views of the impact of lower liquidity. Some market

participants reason those infrequent valuations and low turnover make alternatives lower volatility choices. Other participants counter that the less frequent valuation of alternative investments leads to less pricing information and only helps to make volatility measurement unreliable.

- Continued adoption of technology such as robo-advisers and trading platforms with lower cost structures than traditional firms, could lead to lower client costs but also lower industry revenues. Alternatively, technology could also create opportunities for small investors to use wealth management firms for the first time, raising industry revenues.
- Environmental, social, and governance (ESG) awareness has become an important consideration in portfolio management and is increasingly expected to be included in related wealth management services. However, ESG-related services are not costless to advisory firms. As with any service, if costs related to providing the service cannot be passed to clients they will compress net revenue.

These trends and other factors reflect the increasing intensity of competition in wealth management. Additional initiatives, such as those described in the example below, could further compress industry revenues.

EXAMPLE 2

Retail Distribution Review (RDR) and Financial Advice Market Review (FAMR)

Since the 2000s, regulatory authorities have intensified their focus on fee transparency and reducing incentivized payments, particularly in the United Kingdom through initiatives like the Retail Distribution Review (RDR) and the Financial Advice Market Review (FAMR), as well as under European regulations like MiFID.

The RDR, implemented by the UK Financial Conduct Authority in 2013, aimed to elevate advice standards and transparency in the retail investment market. A key objective was to eliminate commission-based payments for financial advisers to minimize conflicts of interest. Instead, advisers must charge clients directly through transparent fee structures, enhancing client understanding of costs. The RDR also mandated higher qualifications and ongoing professional development for financial advisers, along with stricter disclosure requirements, enabling clients to make more informed decisions.

Launched in 2015 by the UK Financial Conduct Authority and HM Treasury, the FAMR aims to make financial advice more accessible and affordable, especially for those with lower wealth levels. Recognizing that traditional face-to-face consultations may not be cost-effective for this demographic, the FAMR explores technology-driven and simplified advice models. It also aims to streamline regulations to reduce unnecessary burdens while maintaining consumer protection. To address the advice gap, the FAMR promotes alternatives like automated investment platforms and online tools.

Internal Drivers Impacting Revenues: Growth Strategies

When considering the revenue drivers of wealth management businesses, it is critical to remember that the wealth manager's primary task is to ensure that clients receive the most suitable investment products and services at fair fee levels. At the same time, wealth management firms need to generate revenues and profits. A firm's revenue can generally be increased through four methods:

1. *Client portfolios can hold investments with increasing returns.* Since a large amount of fees in this industry are based on AUM, higher asset returns lead to higher assets and higher revenue. While this can be a powerful force for generating client returns and adviser revenues, this procyclicality cuts both ways, leading to lower revenues in down markets. Moreover, this is a passive and unreliable approach to revenue growth in a competitive marketplace in which firms are actively competing for earnings.
2. *Firms can increase their fees.* This seems simple, but higher fees imply higher charges for clients. Significantly raising fees is difficult to do in a competitive and transparent industry. However, advisers with unique or differentiated products may have more pricing power. This might mean having a strategic advantage with a certain type of client (perhaps certain types of business owners) or through providing differentiated services. For example, discretionary accounts may be less cost sensitive, in which case delivering a higher mandate penetration rate, meaning the percentage of an adviser's mandates that are discretionary or advisory, ties to increased ability to raise fees.
3. *A firm can solicit new clients.* If client growth leads to growth of net assets at a firm, this should raise firm revenue. However, catering to all market segments is not feasible for most small to mid-sized firms. Accordingly, sensible revenue planning calls for wealth management firms to focus on the relevant segment of clientele and monitor the efficiency of their efforts However...
4. *...a firm's clients may choose to leave for a variety of reasons.* All else equal, a strong focus on client retention can help to keep AUM and revenue losses to a minimum. While this is a defensive strategy, it is good business practice as satisfied clients are more inclined to remain with a firm and to refer new business to the firm. Some firms use scorecards to monitor advisers' effectiveness in adding and retaining clients, as well as success across products and market segments. This practice can enhance wealth managers' productivity and help a firm's management to gauge progress on key goals over time.

Two common metrics related to revenue management are **Net New Money** (NNM) and **Net New Business Volume** (NNBV). NNM is focused on bringing new client new money to the firm. NNBV captures the volume of new business across new and existing clients.

Pricing Strategies and Characteristics

Wealth management firms align their pricing strategies with the price sensitivities of clients. Pricing strategies revolve around fees which are either recurring or non-recurring and they can be fixed or variable. Most fees can be bundled together or charged separately. Additionally, they may be directly applied or may be imbedded in the product.

Pricing consistency should be the norm at the firm level, with special pricing as occasional exceptions rather than a standard practice. In most markets, firms are legally bound to provide clients' with transparency on how fees are assessed.

EXAMPLE 3

LPL Financial

LPL Financial is a US company that white-labels a set of investment products and services, meaning it puts its own name on offerings from certain third-party managers, and then it distributes these investments through its own network of advisers and through independent advisers who have no ownership affiliation with LPL. Behemoths such as USAA and Northwestern Mutual, both old insurance companies, drive this process as well.

End clients in these distribution chains face a lack of transparency in that they bought from LPL Financial but are left with investments at third-party firms that may not be as transparent or responsive as a direct provider might be. CFA Codes and Standards should be fully applied by market participants to increase the level of transparency for end users.

Types of Fees

Fees can be levied on most activities undertaken by a wealth management firm. While fees are often described as advisory fees or management fees, direct fees often take one of these forms:

- asset-based,
- transaction-based,
- interest- and margin-based,
- service- and maintenance-based, and
- additional or supplementary.

Certain indirect or hidden fees are applicable to each of those categories.

Some fee structures are not available to all industry participants. Only banking institutions and their equivalents can act as custodians, hold client deposits, and generate interest income from these deposits. Similarly, entities to whom the authorities have granted trading authorization can levy brokerage and transaction fees. Types of fees common to different types of wealth managers are highlighted in Exhibit 4.

Exhibit 4: Indicative Fees Category by Type of Entity in Wealth Management

	Asset	Transaction	Margin	Service	Additional
Universal bank	X	X	X	X	X
Local bank and trust	X	X	X	X	X
Private bank and trust	X	X	X	X	X
Commercial bank			X	X	X
Bank assurance	X	X	X	X	X
Investment bank	X	X	X	X	X
Digital bank	X	X		X	
Brokers		X	X		
Asset/fund manager	X	X			
External asset manager	X	X			X

	Asset	Transaction	Margin	Service	Additional
Family office				X	X
Other players				X	X

Because no client likes to be surprised by unexpected fees, best practice requires active transparency and updating clients on changes to both direct and indirect fees. A fee schedule should be presented at the beginning of the client relationship and updated periodically, or when fees change. This is mandatory in many jurisdictions. Major costs associated with each service should be outlined clearly, either in a pricing brochure or in a formal agreement or both.

Asset-Based Fees

Asset-based fees are recurring charges applied to the market value of the client's assets and therefore are variable. They are calculated as a percentage of the total portfolio, provisioned daily, and usually invoiced on a quarterly basis. The fee rate, expressed in basis points, is multiplied by the period-end value, or the average value, of client assets. The rate is often degressive, meaning that the greater the assets the lower the marginal fee for additional assets. Fees of this type are mainly custody fees and investment mandate fees.

Fees for securities custody are much lower than asset management fees, despite the greater work and administrative costs that are often involved. On average, management fees can be three to five times higher than custody fees.

Asset-based fees are charged at the level of the underlying investment funds used in clients' portfolios, sometimes expressed as the total expense ratio, or TER, which diminishes a fund's return by the costs of running it. A discount could be applied at the investment mandate level to incentivize clients to use the firm's proprietary products instead.

It is the responsibility of a wealth manager when constructing portfolios to take into account embedded costs in mutual funds/ETFs to minimize the overall cost for the clients while maintaining returns for the clients. Many wealth managers are shifting to constructing portfolios using less ETFs instead of more expensive mutual funds if the performance is similar, especially in large liquid markets.

Transaction-Based Fees

Transaction-based fees, including commissions, are charged for transactions performed in client accounts, either as a percentage of the transaction amount or as a fixed amount or both. These fees apply mainly to transactions involving securities, funds, structured products, fiduciary deposits, money market instruments, and securities delivery. A decreasing scale is commonly employed that adjusts fees based on the size of the transaction and the asset class involved.

Firms should disclose all fees to the clients before transactions and provide relevant reports regularly. Fee schedules for equity securities trading can be easily displayed; however, fees associated with other securities, such as secondary market (often over-the-counter) bond trades, may be less clear to the client. Ultimately, the client should be provided clarity, even if this not a regulatory requirement in a particular country.

When dealing with investment funds, additional fees appear at the fund level, not only in the management fees but also in subscription and redemption costs, or distributors' fees for regulated funds approved for distribution in various markets. Alternative funds may impose additional fees. For example, some real estate funds incorporate a premium or discount to the trading price depending on the overall demand for the product.

RISK OF CHURNING

When a broker, asset manager, or wealth management firm benefits from active trading in a client's account, and that activity has been undertaken without considering the client's investment objectives or is simply excessive, this activity is referred to as churning, which is unlawful. This generates income to the firm but does not support the client and, in fact, may be in violation of the agreement with the client and legal obligations toward the client.

Warning signs of churning include unusually high trading frequency, going in and out of a position of a regular basis triggering the wash sale rule, and excessive fees in both absolute and percentage terms. Unauthorized transactions are a warning sign that larger problems may also be evident. Additionally, within certain large asset managers that cross-sell financial and insurance products, the risk of excessive cross-selling is a frequent risk that can erode the clients assets without fundamentally managing the risk of the client.

Firms usually have a legal obligation to monitor trading for various activities. Hence, they should conduct direct and indirect regular monitoring of clients' accounts to identify potential churning. Implementing red-light thresholds that highlight abnormal revenue figures will discourage exploitation. Meanwhile, clients should be reviewing the transactions and performance of their portfolio regularly. Ideally, if there is trouble in an account, it is best for the firm to find and disclose issues before the client identifies a problem.

Interest and Margin-Based Fees

Interest and margin-based fees are associated with lending programs. Financial intermediaries with a banking license or an equivalent such as the ability to take client deposits apply a margin on loans. These fees or margins apply to negative cash balances, mortgages, Lombard loans, and securities lending. Margins depend on the size of the transaction (and maybe the overall client relationship), the length of the engagement, prevailing interest rates, and associated risks.

These fees differ considerably from other fee categories. The capability to lend is directly linked to the financial intermediary's ability, expressed by the strength of its balance sheet (capital requirements), and its willingness or risk appetite. Wealth management firms without a banking or equivalent license cannot directly derive income from lending.

Substantial preliminary work to evaluate the client's borrowing capacity is required, especially for mortgages. Similarly, Lombard loans necessitate an assessment of pledged portfolios and underlying securities to establish a suitable lending ratio. Lending activities offer a considerable boost to revenues, however, comparable to or even exceeding those from investment mandates.

Service and Maintenance Fees

Service and maintenance fees are fixed charges that can be either recurring or one-time, and are related to the upkeep and functionalities of an account. These fees encompass a range of costs such as administrative fees, charges for payments and transfers, fees for initiating new services like loans or mortgages, and costs for mail, checks, and safe deposit boxes. These fees are generally not tied to the size of the asset but are instead based on the volume of transactions or the number of payments made.

Minimum fees may be applied to client accounts, and these can either have a cap or be uncapped. In specific scenarios, such as account closure, wealth management firms may levy substantial closing fees and high charges for transferring stock market securities. These fees are occasionally waived by the client's new bank as a gesture of goodwill.

Additional Fees

These fees may not form part of the traditional private wealth offering. They may arise from services that are not specific to portfolio management, such as accounting, taxation, legal support, or operational and technological support like the distribution of portfolio data.

Additional fees apply for held-away assets that are not directly custodied and related assets under advisory. Assets sitting with different financial intermediaries for diversification, on different platforms as digital assets, or with differing liquidity status — an art collection, for instance — can be aggregated by dedicated providers that offer both consolidation services and overall portfolio analysis and follow-up.

These fees can generate remarkably high expenses for clients, particularly when specialists with significant hourly rates are involved. Lawyers' fees, for example, can escalate in the face of complex, lengthy succession planning.

ACQUISITION OF BUSINESS VOLUME - PAYMENT FOR ORDER FLOW (PFOF)

In some markets, PFOF is a mechanism in which brokerage firms earn money by sending their customers' trade orders to market makers or trading firms. Market makers or trading firms pay the brokerage firm for the opportunity to execute the trades. PFOF is typically associated with retail brokerage firms and is more prevalent in the stock and options trading space.

The practice has been controversial, as critics argue that it may create conflicts of interest for brokers, potentially compromising the best execution of trades for customers. Proponents of PFOF argue that it helps to offset costs for brokerage firms, enabling them to offer commission-free or low-cost trading to retail investors.

Regulators and industry organizations closely monitor PFOF practices for fairness and transparency in the execution of trades.

New clients can be obtained via digital channels, or thanks to the public recognizing the expertise of a specific wealth manager, or in response to the outstanding reputation of a wealth management firm. They can also be brought in by introducers, who can be remunerated based on either new AUM or the revenue generated.

EXAMPLE 4

Acquisition of New Clients: Referral Fees and Retrocessions

The use of referral fees and retrocessions have historically been a widespread practice in wealth management, insurance, and other financial products. For example, a wealth adviser may receive a fee from a mutual fund company for recommending their fund to a client, and this fee is known as a "retrocession." Retrocessions can have both advantages and disadvantages for the financial markets. On the positive side, retrocessions can incentivize advisers to offer a wider range of products and services to their clients while helping asset managers to reach a larger audience. On the negative side, the money earned from retrocessions can create conflicts of interest and reduce transparency for the investors, who may not be aware that their advisers are being paid to recommend a certain investment. In turn, this can raise concerns that the arrangement may influence the advisers' recommendations and affect the quality and suitability of the products they suggest. Moreover, the suggested products may come with higher costs than viable alternative products. All else equal, higher fees and expenses imply lower returns for the client, who may not be aware of the added costs.

Regulators in various markets have developed varying approaches to this practice. In the United Kingdom and Australia, retrocessions are banned or severely restricted. The European Union has eliminated or restricted the use of retrocessions for products or services including investment funds and investment advice. Meanwhile, the practice has continued in the United States and Canada, where retrocessions are allowed but subject to disclosure and fiduciary obligations. Consequently, as retrocessions have attracted greater scrutiny they have become less common.

There are markets where retrocession remains a common practice, including in Switzerland, Asia, and some Latin American markets.

Beyond investment funds, other asset classes and products can be subject to fee-sharing, including new mortgages, structured products, and foreign exchange transactions. While the same rules may not apply to these transactions as with investment funds, best practice for advisers is to be open with clients about the costs and potential conflicts of interest.

Compensation Models for Wealth Managers

The compensation structure for wealth managers depends on the firm's structure (public or private ownership), size, its global presence, the complexity of its business model, and its annual financial performance.

Financial performance measures are mainly based on the net revenue that the manager generates for the firm. Compensation systems, however, do not always strictly follow a formulaic approach and may take into account the performance of other divisions and subsidiaries of the firm.

Wealth managers are increasingly responsible for additional duties, particularly in compliance and administration. Adherence to criteria around key risk indicators (KRIs) and key performance indicators (KPIs) also determines the wealth manager's final remuneration package.

Wealth Manager Remuneration Models

For a senior wealth manager, compensation may begin before employment starts, often in the form of a welcome bonus. This bonus might be included in the manager's remuneration package, or it could serve as compensation for a forfeited bonus from the previous employer.

Throughout the wealth manager's tenure, remuneration typically comprises four elements: a fixed salary, variable remuneration, long-term incentives, deferred pay or equity participation, and fringe benefits.

The mix of these benefits can vary widely from firm to firm as well as within firms, depending on an employee's role and experience. Many firms focus on total compensation when recruiting new employees or communicating annual amounts to employees. In general, total compensation almost always includes a base (fixed) salary, paid throughout the year. Most also have a performance-based variable component (often called "the bonus"). Depending on the firm, the bonus may include an immediate cash payment and deferred payments vesting and payable over one to five years, and typically dependent on continued employment with the firm. Some portion of this deferred amount may be in stock shares (for publicly traded firms).

Fixed Remuneration

How a fixed salary is set up depends on the employee's role, experience, and network, as well firm-specific factors such as the size of the business. Educational background, years in the industry, and the quality and profitability of the employee's portfolio itself factor in.

How advisers fixed salary is set up depends on factors related to both the firm and the employee. Despite the digital revolution, in-person interaction and face-to-face meetings remain crucial, and their effectiveness will inform wealth managers' pay, as will their perceived ability to retain clients and to find new ones.

With an emphasis on client retention, traditional players might prioritize the stability of their personnel by making the bulk of compensation fixed, with a small proportion of pay as variable. If the firm is structured as a partnership, fixed compensation may be set rather minimally, with the variable pay linked to financial results.

Variable Remuneration

The variable component of compensation for wealth managers usually includes an annual bonus, which recognizes contributions to the previous year's earnings. Bonuses are generally paid in full, though a portion might be held back for future distribution.

Bonuses and other forms of variable compensation can be risk-adjusted for senior roles or in the face of local regulations. Invoking claw-back provisions allows for the withholding or even rescinding of variable compensation in the case of misconduct.

Variable remuneration is often determined at three distinct levels: the firm, the department, and the individual. At the firm level, remuneration is influenced by overall financial performance, accounting for both profitable and challenging years. The firm's culture around growth and risk appetite may weigh heavily.

At the department level, remuneration is linked to the team's performance, efficiency, and growth in the respective region or client type. For instance, the financial results of the Latin American (LATAM) team may differ significantly from the Middle East and North Africa (MENA) team.

On an individual level, the wealth manager's performance greatly affects variable remuneration. Their results can be based on:

- the number of accounts under a discretionary or advisory mandate, along with the associated profitability,
- the net new business volume acquired over the calendar year, and
- how well margins on client relationships are maintained.

Profit-sharing remuneration models show relationship managers retaining up to a third of the income produced from their clients' portfolios. This proportion could be higher in smaller structures with less overhead and fixed costs, reaching up to two-thirds of the generated income.

Variable compensation must comply with internal and external legal requirements. For instance, in some jurisdictions or at some firms, there may be a limit on the ratio of fixed-to-variable compensation in order to balance incentives for advisers to perform core duties well, with creating incentives to expand business and revenues. In the European Union and the United Kingdom, the pay of those who are in senior roles and are deemed to be material risk takers (MRTs) may be subject to additional regulation.

Long-Term Incentives, Deferred Pay, or Equity Participation

As part of their compensation package, senior relationship managers may be offered equity or stock ownership in the institution they work for. Long-term incentive plans (LTIPs) are designed to retain managers and encourage loyalty. These plans typically involve vesting periods during which the relationship manager must remain with the firm to fully realize the benefits. After a period of three to five years, a portion of the accrued benefits are distributed in the form of registered shares or cash payments.

Fringe Benefits

Compensation models within wealth management differ widely because of differences in both growth models and risk appetite. Nonetheless, the size and profitability of portfolios often serve as reliable indicators of the total compensation package.

Fringe benefits, though usually less substantial, can include insurance packages and retirement perks. There may be special pension categories for senior managers, as well as preferential terms such as reduced mortgage rates. Other non-financial benefits may include access to exclusive, high-quality training and recognition programs.

No matter the compensation model, there is an ever-present obligation for wealth management firms and relationship managers to serve private clients impartially, to adhere to transparency and disclosure requirements, and to apply the relevant sections of the CFA Code of Ethics and Standards of Professional Conduct.

To complete our understanding of private wealth, a closer examination of industry participants is in order, which we take up in the following section.

QUESTION SET

1. A firm making a strong push for NNM is trying to boast which of the following?

   A. Interest income

   B. Recurring revenue

   C. Transaction revenue

   Solution:

   B is the correct answer. NNM increases translate into a higher basis for drawing recurring revenue such as management fees. Interest income and transaction revenue may also increase if the client borrows on margin or if they actively trade securities. The firm seeking more NNM is seeking a larger revenue base while planning to maintain or increase revenue per assets. They may be relatively agnostic about their particular sourcing within that realm.

2. In comparison to custody fees, management fees tend to be _________

   A. lower.

   B. similar.

   C. higher.

   Solution:

   C is the correct answer. Management fees tend to be multiples of custody fees.

3. Which of the following is an example of a retrocession agreement, as defined in the reading?

   A. A hedge fund refers clients to a private equity firm and receives a regular advisory fee based upon the magnitude of assets those clients invest.

B. A large software company offers the services of a wealth management firm to its employees in exchange for discounted pricing of those services.

C. A tax firm refers clients to a wealth management firm in exchange for the wealth management firm referring clients to the tax firm.

Solution:

A is the correct answer. Retrocession involves the payment of a commission to a referring entity based upon the resulting business. In this case, the hedge fund is getting a kickback from the private equity firm. In B, this is just a negotiated discount — the software firm does not directly benefit per se. In C, this is simply a mutual referral and there is no promise of payments to be exchanged.

THE ROLE OF OTHER ADVISERS AND CONSULTANTS

4

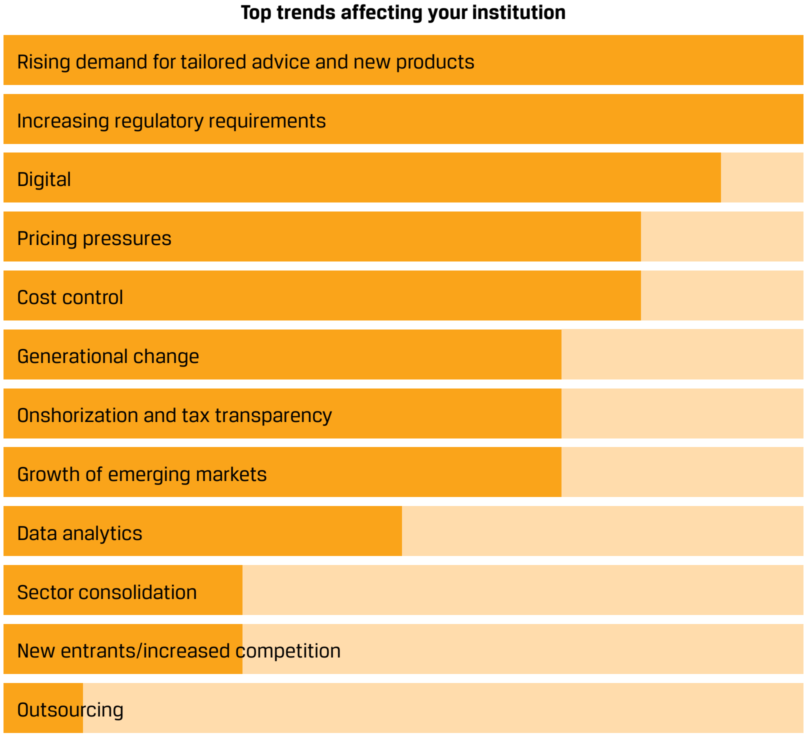
☐ discuss how various advisers, consultants, and professionals support private wealth managers and their clients

In the increasingly complex private wealth management sector, advisers, consultants, and professionals support wealth managers and their clients with strategies to grow wealth and safeguard assets (Maude, 2006). These experts range from tax advisers to legal consultants to specialized roles such as asset custodians and client-support staff.

In a survey of wealth management and private banking professionals conducted by Deloitte, rising demand for tailored advice and new products emerged as the top trend affecting the wealth sector. Alongside, "introducing new value-added customized services" and "redesigning advisory processes" were two of the top five organizational priorities, as shown in Exhibit 5 and Exhibit 6. This underscores a significant shift in expectations; clients are increasingly dissatisfied with one-size-fits-all cookie-cutter solutions.

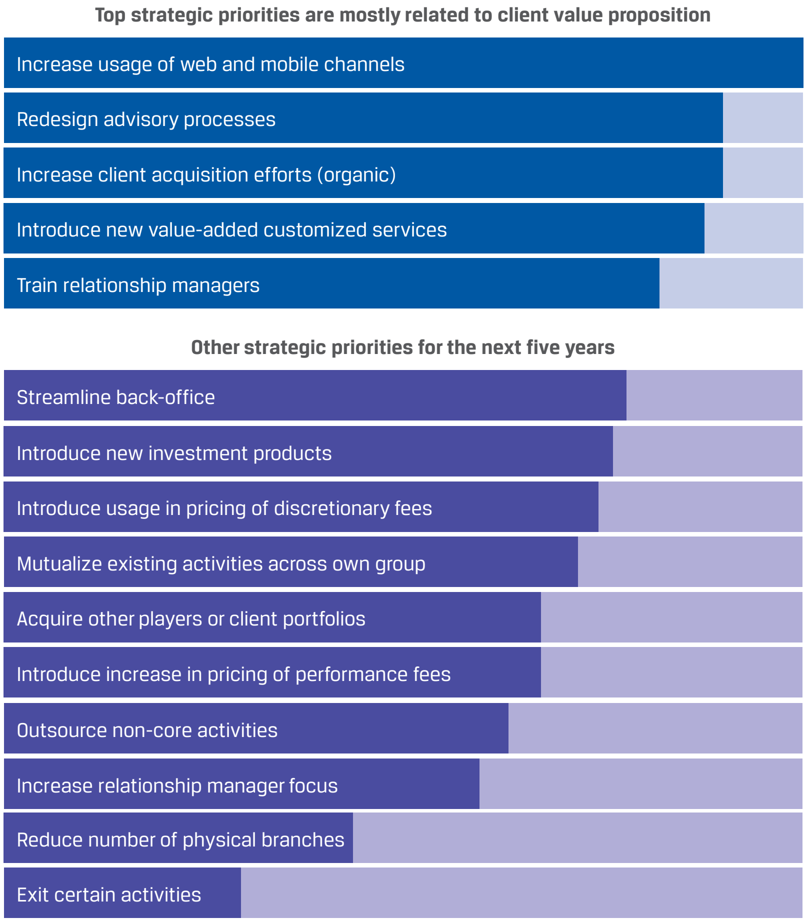
Instead, clients seek services that are planned and executed based on their unique needs and circumstances. This trend amplifies the importance of a diverse range of advisers and consultants offering specialized expertise in various aspects of wealth management, from tax planning to estate management and beyond.

Exhibit 5: Top Trends Affecting the Wealth Management Sector



Source: Collette et al. (2014).

Exhibit 6: Wealth Management Institution Strategic Priorities

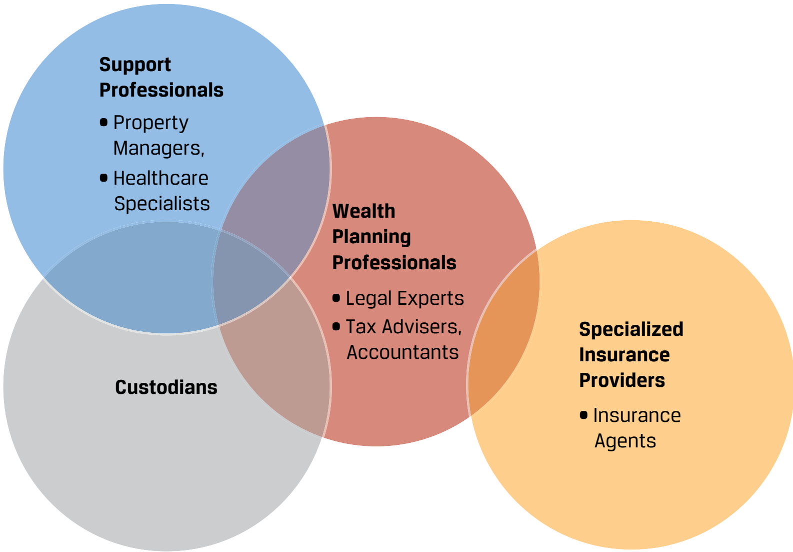


Source: Collette et al. (2014).

Advisers Supporting Private Wealth Managers

Besides legal expertise, tax advisers and accountants who provide the foundational structure for the protection and preservation of wealth, other advisers in wealth planning, listed in Exhibit 7, play an indispensable role. The **custodian**'s role involves safekeeping assets, record keeping, performance analytics, and trade processing that ensures managed assets are legally separated from the assets of the manager. Specialized insurance providers may step in to answer the needs of the wealthy with high-value property insurance, umbrella liability cover, and art and collectibles insurance. Support professionals ranging from property managers to physical security providers and from education to health care specialists contribute to the well-being and the lifestyle of their HNW and UHNW clients.

Exhibit 7: The Cooperation of Certain Private Wealth Support Professionals



Professional Services in Wealth Planning

The cornerstone of any effective wealth management strategy is thorough and detailed planning. Wealth managers rely on the advice of lawyers, tax advisers, accountants, and specialized consultants for tax planning and the legal protection of their clients' assets. As wealth grows and assets are spread across multiple jurisdictions, the advice of these professionals increases in importance.

Lawyers

The legal advice in wealth management requires specialized expertise. Lawyers specializing in estate planning, trusts, and wills ensure that assets are not only protected but efficiently transferred across generations and without any legal or other uncertainties. They draft legal documents that stand up to scrutiny and meet the client's objectives. Clear and uncontestable legal records proving asset ownership are especially important as clients and their advisers plan for general wealth transfer, deal with divorce or estrangement, provide financial support to children, or move assets to another jurisdiction.

Legal professionals mediate disagreements and conflicts that arise within wealthy families. As divisions may emerge across generations, among siblings or between different family branches, legal advice can either preempt or reduce these conflicts.

Safeguarding the client's interests with respect to transactions and legal proceedings, and guiding families through contracts and dispute resolution, the role of legal professionals often extends to coordinating with tax advisers and wealth managers to create a cohesive strategy that aligns with legal and financial goals.

A day in the life of London-based private wealth lawyer Alexandra Milton of law firm Moore Barlow, who lists her expertise as mental incapacity, probate services, wealth succession planning, wills trusts and estates.

"We meet clients in the office, at their home, and in care homes. We occasionally take instructions in hospital, but it is often too late to mitigate taxation just prior to a person's death.

Approximately half of our time is spent in tax planning. The remainder of my time sees me advising my clients on estates and trusts. We ensure personal representatives and trustees fulfill their duties. For example, personal representatives of an estate have a duty to preserve the value of the estate for the ultimate beneficiaries."

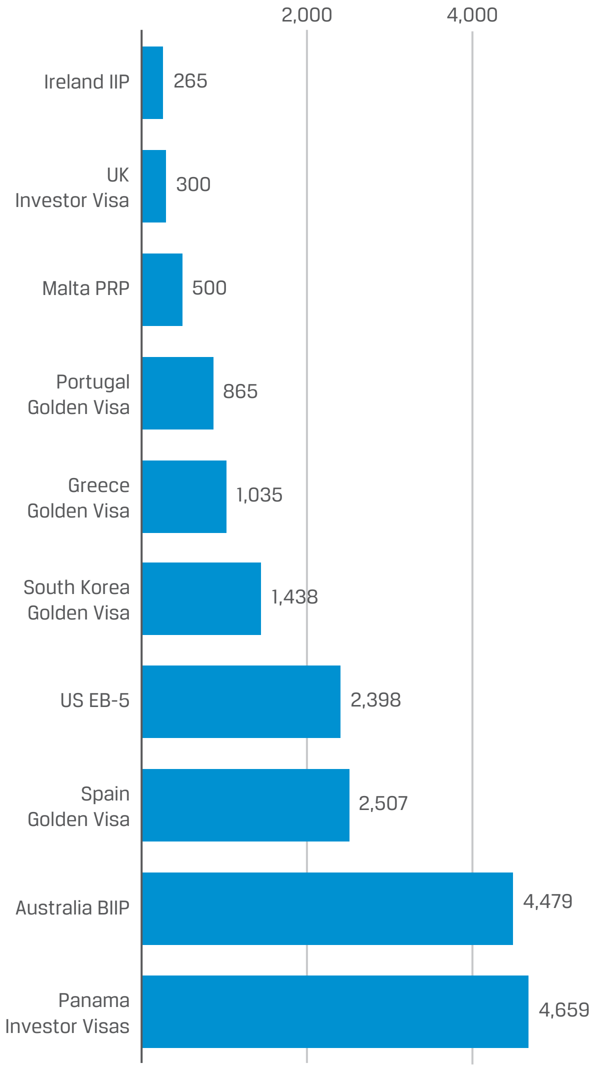
Expatriation and Relocation Services

Certain lawyers and consultants focus on immigration and investment law, assisting high-net-worth individuals in various citizenship and residency-by-investment programs, commonly known as golden visas. These experts advise on the programs while preparing complex immigration, legal, and tax documentation, and they represent their clients in negotiations with immigration authorities and investment advisers.

These programs require that foreign investors make a qualifying capital investment in the host country. This could be in commercial enterprises, real estate, or other approved investment vehicles. Lawyers in this niche devise investment structures that meet the legal prerequisites for residency or citizenship.

Consider the Malta Individual Investor Programme in the European Union and the Significant Investor Visa in Australia. Each of these programs has its own investment requirements, benefits, and pathways to permanent residency or citizenship. Due diligence is crucial to protect clients from fraudulent schemes and to ensure adherence to legal, tax, and immigration requirements.

Exhibit 8: 10 Most Popular Golden Visas in 2021



*Source:*Nesheim (2022).

Tax Advisers

Taxes reduce the long-term accumulation of wealth. Mitigating the impact of taxes on long-term wealth, while fully adhering to tax laws, is generally within the scope of a wealth manager's responsibilities. Given the complex and changing nature of tax rules and their application, specialized tax advisers may be needed.

Suitable strategies include income splitting, charitable giving, and investment in tax-efficient funds. Tax advisers also assist in compliance, ensuring that tax filings are accurate and submitted on time to avoid penalties. They identify deductions and credits that clients are eligible for.

Choosing to pay taxes up front or deferring them can be a strategic decision on which wealth managers and tax advisers must cooperate closely. For HNWIs, complex vehicles like family limited partnerships, family investment companies, or offshore trusts may be in order, as they offer significant tax advantages.

In the United Kingdom, family investment companies and offshore trusts serve similar purposes, offering control over assets and tax benefits. In the United States, high-net-worth investors make use of charitable remainder trusts and donor-advised funds to achieve philanthropic goals and tax benefits.

Working with specialized tax advisers lets wealth managers offer more a comprehensive and effective financial strategy. Optimizing for tax liabilities while planning for future financial scenarios maximizes long-term growth and the preservation of wealth.

Personal Banking Services

For high-net-worth individuals who travel frequently and own property in several countries, personal banking goes beyond basic checking and savings accounts. The lifestyle necessitates specialized services. Banks cater to these needs by offering multi-currency accounts, overseas property financing, and streamlined international wire transfer services. Personal lines of credit, home equity loans, and premium credit cards with high spending limits and exclusive benefits are common offerings. These services are often tailored to meet the unique financial needs and lifestyle demands of high-net-worth individuals.

Commercial Banking

Entrepreneurship is a key source of wealth creation and entrepreneurs frequently rely on banks for capital. Building relationships with banks benefits both parties: it allows the bank to expand its customer base while providing the entrepreneur with the financial resources needed for business growth. Commercial banking can be tailored to business owners and entrepreneurs, including those who run family businesses. Specialized business accounts and loans are on offer, as is treasury management designed to optimize cash flow. For international businesses, risk management such as hedging currency and interest rate risks come into play.

When a client needs capital, commercial banks offer various financing alternatives including term loans, lines of credit, and other financing. The assets of the family business often serve as collateral. For high-net-worth individuals with significant wealth and human capital tied up in the family businesses, accessing liquidity on a short notice without having to liquidate assets becomes important.

Investment Banking

High-net-worth investors who own businesses and/or are high-level executives in large companies may well find value in the offerings of investment bankers.

Mergers and Acquisitions (M&A) Advisory

Investment bankers guide clients through the process of buying or selling a business while they conduct business valuations, lead negotiations, and perform due diligence.

Capital Raising

For clients looking to grow their businesses or make new investments, investment banks facilitate access to capital. Whether private equity, venture capital, or other private placements (on the sell side), options are tailored to the client's financial goals and risk tolerance.

Exit Strategies

Investment bankers provide guidance when clients contemplate exiting their business. The exit may come through an initial public offering (IPO) or finding a strategic buyer, for instance, and the banker navigates the complexities of the process to maximize financial returns.

Investment Opportunities

Beyond transactions, investment bankers may identify investments that align with a client's financial objectives. This could range from private placements (on the buy side) to specialized investment funds that offer attractive growth or income potential.

KNOWLEDGE CHECK

1. Sarah, a high-net-worth individual who owns a tech startup, is working with a wealth manager for her personal finances. The parent company of Sarah's wealth manager is a large financial services firm that also has an investment banking division. How could investment bankers specifically add value to Sarah's overall financial and wealth strategy in a way that her wealth manager alone might not?

   A. Investment bankers could help Sarah manage her personal investment portfolio, focusing on stocks and bonds.

   B. Investment bankers could guide Sarah through the process of potentially selling her tech startup, including business valuation and negotiations.

   C. Investment bankers could assist Sarah in setting up a retirement savings account like a 401(k) or an IRA.

   Solution:

   The correct answer is B. A and C are typical of core services provided by wealth managers without the help of advisers, whereas valuing, negotiating the sale, and completing the sale of businesses fall within the remit of investment banking.

Accountants

Tax advisers focus on tax strategies, while accountants provide a broader range of financial services. They maintain accurate financial records, which is essential for compliance and financial planning, and they help with cash flow management, budgeting, and forecasting.

Other Specialized Consultants Involved in Wealth Planning

Consultants offering niche services include educational consultants who communicate the benefits of setting up educational trusts or savings plans for children or grandchildren. Philanthropic advisers manage charitable giving and social impact initiatives.

Specialized asset managers have expertise in non-traditional investments such as timberland, farmland, fine wine, classic cars, watches, and artwork or even more rarified assets like racehorses, coppices, antique books, musical instruments, and sports memorabilia. Deep market knowledge matters here, as does valuation expertise and connections with auction houses and specialist dealers.

Custodians

Custodians often work behind the scenes to ensure the safekeeping of assets, accurate record keeping, and performance analytics. The basic custodial roles of safeguarding and segregating assets to prevent commingling are in place worldwide. Variations arise, however, because of local laws and market norms. In some regions the custodian and the asset manager must be separate, independent legal entities. Elsewhere they can fall under the same ownership structure. The overarching goal is to keep assets separate and secure, with a third party acting as a safeguard between the asset manager and the client to protect the client's interests.

The primary way custodians support wealth managers is through the safekeeping of assets. They hold a variety of asset types, from equities and bonds to alternative investments like real estate, in segregated accounts. This ensures that client assets are insulated from the custodian's own financial risks, providing an additional layer of security. Increasingly, custodians safeguard digital assets as well.

Custodians are also involved in verifying and recording transactions post-settlement. This matters for regulatory compliance and for informed decision-making on the part of wealth managers. Record keeping even extends beyond transactions to include all activities related to the client's portfolio. The real-time analytics many custodians offer aid wealth managers in portfolio assessment and strategy formulation. Some integrate portfolio analysis with wealth management so they can better understand the risks and returns associated with their strategies.

As client needs become more complex and globalized, a custodian's role becomes even more important. Their expertise in navigating diverse regulatory frameworks contributes to the seamless operation and compliance of the wealth management ecosystem. A good custodian offers not just asset safekeeping but valuable analytics and insight, while a poor choice of custodian can lead to compliance issues, financial losses, and reputational damage.

EXPERT INSIGHTS ON CUSTODIANS IN WEALTH MANAGEMENT

Selecting the right custodian is a crucial decision for private wealth clients, as it significantly impacts the efficiency of managing complex financial portfolios. Here are some key considerations:

- Ensure that your custodian accurately captures all transaction data across all your accounts, regardless of the number of investment managers involved in your portfolio.
- Timely and comprehensive consolidated monthly reports from your custodian are essential for effective wealth management.
- 24/7 access to your financial data should be a standard offering from your custodian.
- Continuous investment in technology by your custodian is vital, especially as your financial needs evolve over time.

KNOWLEDGE CHECK

1. Ahmed, a wealth manager, is tasked with shortlisting potential custodians for his high-net-worth clients, many of whom invest solely in listed shares and bonds. What should be a top priority for Ahmed when evaluating these custodians?

   A. A custodian that offers the lowest fees for asset safekeeping.

   B. A custodian that continuously invests in technology and provides 24/7 access to financial data.

   C. A custodian that specializes only in traditional assets like equities and bonds.

   Solution:

   The correct answer is B. A custodian's tech investment and 24/7 data access are crucial for adapting to clients' complex needs. Option A is incorrect because low fees may indicate poor tech investment. Option C is incorrect as HNWIs, including Ahmed's clients, often diversify beyond traditional assets.

Insurance Specialists

Beyond risk mitigation, complex insurance products function as investment vehicles, offering tax advantages and portfolio diversification. Wealth managers frequently work with specialist insurance providers to ensure they are providing a holistic service to their clients.

Investment-Oriented Insurance Products

Private Placement Life Insurance (PPLI), which is used in many onshore and offshore jurisdictions, combines the benefits of life insurance with investment opportunities. Unlike traditional life insurance, PPLI allows the policyholder to invest in a broader range of assets, including hedge funds and private equity. Variable annuities offer another avenue for both investment and insurance, allowing policyholders to invest in various sub-accounts, similar to mutual funds.

Specialized Liability and High-Value Asset Insurance

High-net-worth individuals often require specialized liability insurance, such as umbrella policies, which cover a range of risks beyond standard policies. These include personal liabilities, those associated with owning multiple properties or luxury assets like yachts, and even internet-related risks like fraud, slander, and data/identity theft. Umbrella policies may also cover legal costs in defamation cases, typically not included in standard insurance.

High-value property insurance provides extensive coverage against risks like natural disasters, theft, and accidental damage to valuable items such as art or antiques.

For valuable art and collectibles, specialized insurance protects against theft, damage, and value depreciation post-restoration. Policies can be customized to cover items loaned to museums or moved between residences.

Unique Risks: Kidnap and Ransom Insurance

Kidnap and ransom insurance is increasingly considered essential for high-profile individuals. Beyond accounting for ransom payments, such insurance includes crisis management, providing negotiation services and psychological support for victims and their families when necessary. Some policies even cover virtual kidnappings, in which a ransom is demanded by criminals who made a kidnapping appear to take place when none actually did (Moorcraft 2019).

Wealth managers often work with security consultants and specialized insurance brokers to assess the level of risk facing a client, especially when they are traveling to or residing in high-risk areas.

Portfolio Diversification and Investment Management Implications

The make-up of a client's insurance portfolio can influence how their investment portfolio needs to be managed.

For instance, a client who opts for less insurance coverage would need to maintain higher liquidity to self-insure against potential risks. This could point to a higher allocation in cash or short-term bonds.

The insurance portfolio provides insights into a client's risk profile, but it is only one piece of the puzzle. Recommendations on investment strategy and insurance coverage evolve jointly so that wealth managers can identify if the client is over- or underinsured or if there is a misalignment in their portfolio risk. By understanding this interplay, wealth managers can more precisely tailor their services, often in collaboration with insurance specialists, to better align both the tangible and intangible aspects of a client's life with their financial goals.

Support Professionals for the Wealthy

Wealth management, especially for UHNWIs, extends beyond financial assets and investment portfolios. A range of support professionals contribute to the well-being and lifestyle management of wealthy clients, indirectly affecting how wealth is managed. These include health care professionals, property managers, family support staff, educational consultants, office staff, and specialized consultants.

Health and Well-Being

Doctors and healthcare consultants frequently collaborate with wealth managers. The saying "good health is a form of wealth" is especially true for high-net-worth individuals seeking top medical care. Specialized consultants may recommend medical insurance aligned with a client's financial strategy or even work out routines.

Concierge medicine provides round-the-clock health care teams. Private hospitals offer services like immediate appointments, personalized care plans, and exclusive facilities that protect privacy.

While wealth managers will not directly influence medical decisions, they can facilitate access to premier medical services. They may handle the financial logistics of obtaining specialized treatments abroad, including tax implications and even targeted investments in promising therapies.

Understanding this health care–financial planning intersection enables wealth managers to offer a more comprehensive service.

KNOWLEDGE CHECK

1. Maria Sigal-Escalada is a wealth manager working at a firm specializing in UHNWIs. One of Maria's clients is interested in accessing medical treatments available only in a foreign country. What role is Maria most likely to play in this scenario?

   A. Directly influence the medical treatment choices for her client.

   B. Facilitate the financial aspects of accessing these treatments, such as setting up international transfers of funds and accounting for tax implications.

   C. Focus solely on the client's investment portfolio and leave the medical treatment considerations to health care consultants.

   Solution:

   The correct answer is B. Maria is likely to handle the financial logistics of accessing foreign treatments, as her firm specializes in UHNWIs and offers holistic services. Option A is wrong because medical advice is not Maria's domain. Option C is incorrect; her firm's holistic approach means she won't focus solely on investments.

Property and Lifestyle Management

Property managers and family support staff like nannies and personal assistants maintain the client's lifestyle, especially when properties are spread across multiple locations or countries. Such properties often make up a significant portion of a client's investment portfolio and require regular upkeep, upgrades, and renovations.

Physical and **digital security**, technologies safeguarding sensitive digital assets, are vital for affluent clients. Advanced measures are crucial for shielding both tangible properties and digital holdings. Wealth managers collaborate with security specialists to defend against both physical and cyber threats, ensuring the safety of properties and confidential financial information.

Education and Skill Development

Tutors and educational consultants prepare the next generation to manage family wealth. Their input can influence how their clients invest in educational plans or trusts or even what property they invest in and where, which wealth managers need to consider.

Office and Administrative Support

Office staff and specialized consultants, such as those in IT or security, see to the smooth operation of the family offices and personal businesses of wealthy clients. Their roles are often more indirect but crucial in allowing wealth managers to focus on their core responsibilities.

The Synergy with Wealth Management

Wealth managers collaborate with support professionals to gain a holistic view of a client's life, needs, and aspirations. This collaboration allows for a more comprehensive and effective wealth management strategy, tailored to the client's circumstances.

The roles of these support professionals intersect with the work of wealth managers in nuanced ways. For example, a property manager's assessment of the maintenance needs for a vacation home can impact budgeting and cash flow projections. Similarly, a health care consultant's advice may lead to the purchase of specialized medical insurance, affecting the allocation of financial resources.

CASE STUDY

Visas: Mitigating a Family's Dilemma

Emily is the head of a prominent family who own a chain of luxury hotels in a country that has become politically unstable. Given the volatility and her family's high profile, Emily is concerned about regulatory unpredictability and the courts' decreasing independence leading to asset seizures and kidnapping risk. Apart from their business assets, the family has sizable non-business wealth, mostly in low-yield, highly liquid assets. Some of these are kept overseas.

Emily switches to a well-established private bank that was recommended to her and is known for its network of external consultants. In her initial consultation with Nevio, her new private banker, Emily outlines her family's challenges and their ultimate goal of greater financial and personal security. Emily has no plans to leave her country but wants to prepare for any contingencies.

Nevio's employer conducts a comprehensive background check, confirming the source of Emily's assets. After a comprehensive risk assessment, Nevio determines that a multidisciplinary approach is best, given his client's complex situation. He identifies the family's immediate, intermediate, and long-term needs.

Nevio engages an external insurance consultant who specializes in high-risk environments. The consultant creates a customized insurance package that includes kidnap and ransom insurance, as well as political risk insurance for the family's business assets, which will provide protection against seizures.

Nevio consults an immigration lawyer experienced in golden visa programs. The lawyer identifies politically stable countries offering the right to reside and a path to citizenship, ensuring these countries have no extradition treaties with Emily's home country. Emily proceeds with two golden visa applications but has no immediate plans to move abroad.

Once the visa applications are in progress, Nevio focuses on the family's investment strategy. With security and political risks mitigated, the portfolio can now align with the family's long-term goals. Nevio consults a tax adviser to ensure the new investments are tax-efficient.

This case study underscores the value of a multidisciplinary approach in complex wealth management scenarios Nevio coordinated with various specialists, both in-house and external, to address his client's multifaceted needs. The case highlights the limitations of insurable risks and the residual risks the family has decided to bear. The family now has a more secure and flexible financial future, thanks to the collaborative efforts of their advisers.

Engagement and Management of Advisers

The wealth management ecosystem consists of a variety of institutions that cater to the needs of wealthy clients. These include the wealth management or private banking arms of large multinational banks, such as UBS, JP Morgan, and HSBC, which offer comprehensive suites of financial services, often all under one roof. Standalone private banks, such as Julius Baer and Hoares, and boutique wealth managers, like Bessemer Trust, offer specialized, highly personalized services, often engaging external advisers for specialized tasks.

An increasingly prominent part of this ecosystem are single- and multi-family offices. These entities offer highly tailored financial and lifestyle services, often extending beyond traditional financial advice to include services like philanthropy coordination, lifestyle management, and even security services.

Regardless of the institution's size or focus, the role of wealth managers is pivotal in orchestrating this complex ensemble of advisers. Their responsibilities go beyond mere technical coordination; they must also align the various recommendations and strategies with the client's overall financial and life objectives. For example, if a client's tax adviser recommends a certain trust structure for tax efficiency, the wealth manager must ensure that this aligns with the client's estate planning goals, avoiding complications down the line.

KNOWLEDGE CHECK

1. Which of the following best describes the primary difference between large multinational banks, boutique wealth managers, and family offices in the context of breadth of services offered?

   A. Large multinational banks focus exclusively on investment portfolios, boutique wealth outfits specialize in tax planning, and family offices deal only with lifestyle management.

   B. Large multinational banks offer comprehensive suites of financial services, boutique wealth outfits offer specialized, highly personalized services, and family offices offer highly tailored financial and lifestyle services.

   C. Large multinational banks, boutique wealth managers, and family offices all offer the same range of services but differ only in the scale of assets they manage.

   Solution:

   The correct answer is B, which accurately captures the primary differences among each type of institution. A is incorrect for oversimplifying the services, and C is wrong because the institutions differ in service types, not just scale.

QUESTION SET

1. Which of the following is generally regarded as the primary function of a custodian?

   A. Coordinate activities among various wealth managers

   B. Ensure segregation and safeguarding of assets

   C. Calculate performance analytics and determine fees due

   Solution:

   Answer B is the correct answer. Safeguarding of assets is the #1 role of a custodian around the world. A, if it is done, would be a wealth management activity. C is often done by the custodian, but again, it is not the main function.

2. In addition to safekeeping of assets, what role do custodians play that helps wealth managers?

   A. Offer investment advice tailored to the client's risk profile

   B. Provide portfolio analytics to aid wealth managers in portfolio assessment and strategy formulation

   C. Engage in active trading to maximize the client's portfolio returns

   Solution:

   The correct answer is B. Custodians offer more than just asset safekeeping; they also provide real-time analytics that can help wealth managers in portfolio assessment and strategy formulation. Option A is incorrect because custodians typically do not offer investment advice. Option C is incorrect because custodians do not engage in active trading on behalf of the client.

3. What role do property management companies play in a client’s overall financial well-being?

   A. No bearing on financial well-being. Property management is solely concerned with upkeep, upgrades, and renovations.

   B. Property management can influence a client’s cash flows and overall net worth.

   C. Property management is aimed at maximizing rental income and impacts short-term cash flows.

   Solution:

   The correct answer is B. Property management for high-net-worth individuals often involves complex considerations, especially when properties are spread across multiple locations or countries. These properties are not just residences but also significant investments that require regular upkeep and sometimes upgrades or renovations. As such, property management can have a substantial impact on a client's overall investment portfolio and cash flow. Option A is incorrect because property management is not just about day-to-day upkeep; it also plays a role in the broader financial strategy. Option C is incorrect because property management's role extends beyond just maximizing short-term rental income and can influence long-term financial planning.

GLOBAL REGULATORY PRINCIPLES

5

☐ describe and evaluate regulatory and compliance considerations influencing the private wealth management industry

Ethics is a key focus in the CFA Exam curriculum and holds specific relevance for private wealth management. This reading underscores the interplay between ethics, laws, and regulations and emphasizes the need for compliance. It offers practical insights into the regulatory impact on wealth managers and clients and discusses how the CFA Asset Manager Code can aid in meeting compliance requirements.

Ethics, Laws, Regulations, and The Practice of Wealth Management

Regulation of wealth advisers is a complex topic that involves various practical aspects, such as licensing, registration, disclosure, fiduciary duty, regulatory supervision, enforcement, and cooperation with relevant authorities. Wealth advisers often operate in multiple jurisdictions and markets and, therefore, need to comply with the relevant laws, rules, and regulations of each country, region, or jurisdiction where they conduct business.

Asset managers for high-net-worth and ultra-high-net-worth clients not only must guide clients through the ebbs and flows of the economy and market conditions, but over the past few decades they have had to operate in an increasingly challenging legal and regulatory environment.

Historically the structure of the wealth management industry was based on privacy and client confidentiality. For many decades, Hollywood and the global film industry have spun suspenseful tales involving secretive private bankers confidentially moving large sums of money in or out of ultra-private numbered bank accounts. These dramatic portrayals of banking are characteristic of legacy private banking practices and are often featured from a negative perspective. What Hollywood looks past in telling such stories is that these types of banking and wealth management practices can be both good and bad. There are many reasons clients may want privacy — perhaps they just value privacy, or they want to quietly engage in legitimate investment or tax management strategies.

But the dark side of financial privacy is that it can shield nefarious activities like tax evasion, money laundering, terrorist financing, or other illicit activities. Money laundering is a particular concern for regulators and law enforcement, as it is typically a complex process, is often difficult to detect, and plays a fundamental role in facilitating the ambitions of drug traffickers, terrorists, organized criminals, insider dealers, and tax evaders as well as many others who want to avoid the kind of attention that sudden or extreme wealth brings.

One industry expert notes that certain aspects of private banking and wealth management are vulnerable to money laundering. These include:

- *Private bankers and advisers as client advocates.* Private banking relationships are often developed and forged over years. Relationship managers and advisers can develop intense loyalty to their clients, perhaps causing them to look past otherwise troubling warning signs.
- *Powerful clients.* Wealthy clients may also exert significant political and economic influence. For example, if the client is a government official or a Politically Exposed Person (a prominent person that may be susceptible to being involved in bribery or corruption) with real or perceived influence

over the bank or adviser's operations, there could be a reluctance to cause offense and perhaps damage the relationship. Given the recent history of problems associated with Politically Exposed Persons (PEPs), many adviser firms now avoid engaging with them as clients.

- *Culture of discretion, privacy, and secrecy*. There are layers of privacy that wealth managers and their clients have used to mask accounts and transactions. For example, the creation and use of shell companies ("private investment corporations") or trusts can shield the identity of the beneficial owner of various assets. Historically, some banking center nations (including Switzerland, Luxembourg, and Lichtenstein) have had strict secrecy laws that made it illegal to disclose client information. In recent years, many jurisdictions have taken steps to actively discourage these practices.
- *Intense competition and high profitability*. Private wealth management is perceived as a highly profitable business, and competition to acquire and retain clients is intense. The dual pressures of competition and expansion are powerful disincentives for relationship managers to impose tough anti-money laundering (AML) controls that may discourage new business or cause existing clients to move to other institutions. However, in recent years, changes in laws in many countries have incentivized firms to have strict AML controls. Moreover, the reputational and financial loss of not doing so may significantly exceed potential revenue from banking clients exposed to these types of activities.

The presence of these factors can create space for bad actors to use private banks and wealth managers to their own benefit. Exhibit 9 details several high-profile examples of market events that exposed weaknesses in prudential regulation and firm level risk management.

Financial crises and crimes have underscored the urgency for enhanced global regulatory collaboration. Although not always directly linked to private banking, these events often reveal hidden gaps in oversight and risk management, making the case for stronger, harmonized regulations.

Exhibit 9: Financial Crises and Financial Crimes Have Highlighted the Need for Greater Regulatory Oversight and Cooperation Globally

Years	Crisis	Description	Impact
1997–98	Asian financial crisis	An unexpected currency devaluation in Thailand triggered a regional bank and financial crisis, revealing weak prudential regulation of banks across the region.	While this was mainly a macroeconomic shock, it also demonstrated the need for transparent and accountable institutions and more consistent international rules.
2001	Terrorist attacks on United States	The attacks exposed the vulnerabilities of the global financial system to abuse by terrorist groups and their financiers.	Policy responses included the expansion of the FATF, which sets standards and monitors compliance with anti-money laundering and counter terrorist financing (AML/counter-terrorism financing [CTF]) policies.
2004–05	Riggs Bank	Washington, DC–based Riggs Bank operated US-based accounts for many foreign embassies and related officials. It failed due to poor governance, lack of oversight, weak ethical standards, and its pursuit of profits at the expense of compliance and reputation.	Following a US Senate investigation, Riggs was fined USD25 million in May 2004 for not reporting suspicious transactions in accounts of several PEPs. The Riggs failure prompted stricter AML regulations and enforcement actions from bank regulators.

Years	Crisis	Description	Impact
2007–09	Global Financial Crisis (GFC)	High systemic leverage created by subprime loan securitizations revealed weakness in global regulation of banks and securities dealers including significant gaps in international national regulatory practices. Many banks and wealth managers failed.	The crisis exposed the vulnerabilities in the private wealth management sector, which had invested heavily in risky and complex financial products. It eroded the trust and loyalty of many clients and prompted increased interest in and awareness of responsible investing.
2008	Madoff Ponzi scheme	Madoff defrauded investors, successfully concealing fraudulent activities from regulators and auditors for years. Losses arising from the GFC exposed his actions and the failures in regulatory oversight.	The SEC and others implemented reforms to enhance investor protection, increase transparency, and strengthen oversight. These include requiring surprise examinations of advisers, the use of qualified custodians, creation of a whistleblower program, expansion of authority of the SEC's enforcement division, and improved information sharing among federal and state regulators.
2015	1Malaysia Development Berhad (1MDB) scandal	The Malaysian sovereign wealth fund (1MDB) scandal is one of the largest cases of corruption and money laundering in history. According to the US justice department, more than USD4.5bn was siphoned from 1MDB through a network of shell companies, bank accounts, and intermediaries. Proceeds were used to fund lavish lifestyles, bribe officials, and influence elections.	Impacts of the scandal on private banking and wealth management include increased scrutiny and enforcement by regulators on the sources and flows of funds. Several banks were fined or closed for their facilitating or concealing illicit transactions. Regulators also tightened the requirements for due diligence, anti-money laundering, and compliance for private banks and wealth managers, especially when dealing with politically exposed persons or high-risk jurisdictions.
2016	The Panama Papers	Leaked documents containing personal financial information of individuals using offshore shell companies, many of which facilitated illegal activities including fraud, tax evasion, and evading international sanctions.	The leak exposed the gaps and inconsistencies in the regulatory frameworks and standards of different countries regarding offshore finance. The impact on private banking and wealth management regulation varied across different jurisdictions. Responses included greater disclosure on clients, their sources of funds, and the beneficial owners of holdings/shell companies. Due diligence and compliance processes were enhanced.
2017	The Paradise Papers	A data hack of a law firm and related entities leaked detailed information on the offshore investment activities of prominent companies and individuals.	Similar to the “Panama Papers.”

Years	Crisis	Description	Impact
2017–2018	Danske Bank money laundering scandal	Denmark-based Danske Bank was discovered to have abetted, through its Estonia-based branch, around EUR200bn in suspicious transactions from Estonia, Latvia, Russia, and other sources. Regulatory failures allowed the scandal to persist for almost a decade.	Regulatory responses that followed include the launch of criminal investigations and sanctions against Danske Bank and its executives, the revision and harmonization of AML/CTF legislation and standards at the European Union level.
2021	The Pandora Papers	A data leak exposed the secret off-shore accounts of major world leaders, including current and former heads of state. Also, billionaires, celebrities, and business leaders were exposed. While the activities alleged in this leak are not necessarily unlawful, they highlight the extensive use of offshore firms for tax management.	In contrast to the earlier leaks, the Pandora release focused on famous and/or high-profile individuals. These leaks may have been more about creating public pressure for further reforms than exposing illegalities.

As Exhibit 9 demonstrates, financial regulatory reform and regulation often follow in the wake of scandals or large financial disruptions. While legal change and regulatory reforms must take place through lawmaking on a national or sub-national level, new regulations are often modeled or otherwise influenced by the work of multilateral organizations. Examples of organizations that have been influential in the policy development impacting banking and private wealth management include:

OECD, which sets standards on transparency and exchange of information between governments to fight money laundering, tax evasion, and terrorist financing. It created the CRS, an information-gathering and reporting regime for financial institutions involving more than 90 countries. CRS is similar to Foreign Account Tax Compliance Act (FATCA), which focuses on US-based institutions and persons.

The FATF is another intergovernmental organization that designs and promotes policies and standards to combat financial crime, AML, and counter-terrorism financing and require wealth advisers to implement customer due diligence, transaction monitoring, record keeping, reporting, and risk management measures to prevent and combat money laundering and terrorist financing. CRS and FATCA are important tools for fighting tax evasion and money laundering. CRS is a multilateral framework, and its main objective is to prevent tax evasion by individuals who hide their assets or income in offshore accounts. Under CRS, participating jurisdictions agree to collect and share information on their residents' financial accounts with other jurisdictions annually. CRS applies to individuals and entities that are tax residents of a participating jurisdiction, regardless of their nationality or citizenship. In contrast, FATCA requires foreign financial institutions to report information on the accounts of US citizens and residents to the US Internal Revenue Service (IRS).

Other international regulatory efforts important to wealth managers, but not aimed at AML or terrorism, include:

- The International Organization of Securities Commissions (IOSCO). IOSCO is an association of securities regulators from more than 120 jurisdictions. IOSCO also facilitates cooperation and information exchange among its members and other stakeholders. IOSCO principles on securities regulation provide guidance on the objectives and functions of securities regulators, such as protecting investors, ensuring fair and efficient markets, and reducing systemic risk. IOSCO has published principles and reports on a wide range of markets and wealth management activities. It has also published reports on the role of regulation in asset management, which addressed issues such as leverage, liquidity, product design and distribution in the context of private banking and wealth management.

- The Basel Committee on Banking Supervision (BCBS) sets standards on banking regulation, which includes minimum requirements for capital adequacy, liquidity risk, operational risk, market risk, credit risk, and other aspects of banking supervision. While the BCBS does not have direct authority over banks or financial advisers, it has published guidelines for banks stressing the importance of risk management and legal compliance. Financial advisers who work with banks or advise clients on banking products or services should be aware of how BCBS standards may affect their professional obligations.

The participation of key official-sector stakeholders in crafting the rules and standards helps to ensure adoption. These principles have been widely adopted and implemented by national regulators through their own laws and regulations. Private wealth advisers need to be aware of the different regulatory regimes and requirements that apply to them in each jurisdiction in which they operate or have clients. Importantly, with more jurisdictions having enacted more complex laws and more regulations in recent years, modern wealth managers and their firms must work much harder to really know their customers and what those customers are doing at home and abroad.

KNOWLEDGE CHECK

1. Which of these statements about the CRS and FATCA are true?

   A. FATCA is primarily concerned with the actions of US financial institutions outside of the United States, while CRS is multilateral.

   B. Under CRS, US banks agree to collect and share information on their residents' financial accounts with other jurisdictions.

   C. FATCA requires financial institutions to report only those customers who qualify as US persons.

   Solution:

   C is correct. FATCA requires financial institutions to report only those customers who qualify as US persons. CRS was developed by the OECD and is similar to FATCA and involves more than 90 countries.

CFA Ethics and the CFA Institute Asset Manager Code

The mission of CFA Institute is "to lead the investment profession globally by promoting the highest standard of ethics, education and professional excellence for the ultimate benefit of society." The CFA Institute Code of Ethics and Standards of Professional Conduct (the Code and Standards) promotes the integrity of charterholders and establishes a model for ethical behavior. CFA Candidates and charterholders must meet the highest standards among those established by the CFA Institute, regulators, or their employer. Failure to act accordingly exposes candidates and charterholders to disciplinary action. The Code and Standards set an investment management professional's duty to market integrity as the overriding obligation. CFA Charterholders and CFA Program candidates are required to adhere to the Code and Standards and to annually sign a statement attesting to that continued adherence.

In addition, asset managers, including persons engaged in private wealth management, are also guided by the CFA Institute Asset Manager Code™ (AMC). An integral part of the CFA Institute mission is to develop and administer codes, best practice guidelines, and standards that guide the investment industry and help ensure all investment professionals place client interests first. To this end, the Institute strongly encourages participation in the voluntary AMC. By helping investors identify asset managers who have committed to high standards of professional conduct, the Institute is building the integrity of the investment industry.

The AMC sets ethical and professional standards for asset managers. By adhering to a code of conduct, they affirm their commitment to ethics and investor protection. The AMC *General Principles of Conduct* require Managers to:

- act in a professional and ethical manner always,
- act for the benefit of clients,
- act with independence and objectivity,
- act with skill, competence, and diligence,
- communicate with clients in a timely and accurate manner, and
- uphold the applicable rules governing capital markets.

Beyond these General Principles, the Code outlines the ethical and Professional Responsibilities of firms ("managers") in six areas:

- loyalty to clients;
- investment process and actions;
- trading;
- risk management, compliance, and support;
- performance and valuation; and
- disclosures.

The AMC lists multiple requirements in each area which must be fulfilled to comply with the code. Importantly, besides outlining best practices, these AMC requirements often correspond to existing laws and regulations in multiple developed nations. Said another way, the AMC is closely aligned with laws governing asset managers in many of the world's largest public and private wealth markets.

While participation in the AMC is voluntary, managers may put their clients, their firms, and their reputations in peril if they choose to ignore the AMC requirements. Managers should be aware of both the requirements of the AMC and any overlap with legal requirements in locations they operate in on behalf of their clients. Failure to comply with existing laws and regulations risks significant consequences for clients, the manager's firm and for managers themselves. Penalties for breaching securities laws differ by jurisdiction, violation severity, and enforcing body. They may encompass fines, disgorgement, restitution, adviser registration limitations, injunctions, criminal charges, and civil litigation.

KNOWLEDGE CHECK

1. Compliance with which of the following is voluntary for CFA Charterholders and CFA Candidates?

   A. The Code of Ethics

   B. The Asset Manager Code

C. The Standards of Professional Conduct

Solution:

B is correct. The AMC is encouraged but not required.

The AMC and The Global Legal and Regulatory Landscape

The coming sections highlight the connection between AMC and global securities laws. Please note that the laws referenced are examples and not an exhaustive list.

A. LOYALTY TO CLIENTS Managers must:

1. place client interests before their own.
2. preserve the confidentiality of information communicated by clients within the scope of the Manager–client relationship.
3. refuse to participate in any business relationship or accept any gift that could be expected to affect their independence, objectivity, or loyalty to clients.

The AMC requirement for Mangers to *place client interests before their own*, reflects two related principles: "loyalty to clients" and "the duty of care." *Loyalty to clients* requires that financial advisers act in the best interests of their clients and avoid or disclose any conflicts of interest. US law, via the Investment Advisers Act of 1940, and the European Union's MiFID II both impose fiduciary duties on advisers. Australia's Future of Financial Advice reforms introduce a "best interests" duty.

In the same vein, *duty of care* requires that financial advisers exercise reasonable care, skill, and diligence when providing advice or services to their clients. The UK's Financial Services and Markets Act and Hong Kong's Securities and Futures Ordinance (SFO) both impose this duty. Client interests must also be prioritized in trading, as stipulated by MiFID II.

Furthermore, prioritization of client interests puts clients' interests over advisers or those of their firm. Examples of the many securities laws dealing with client interest include MiFID II in the EU, which requires investment firms to take all sufficient steps to obtain the best possible result for their clients when executing orders or placing orders with other entities for execution.

Client confidentiality is another cornerstone. The US Gramm-Leach-Bliley Act, the European Union's General Data Protection Regulation, and Singapore's Personal Data Protection Act all mandate the protection of client data.

Advisers should also avoid undue influence. Gift-giving is often legally discouraged. Retrocessions, fees paid by funds to advisers for recommendations, can create conflicts and should be transparent. "Payment for order flow" poses similar ethical challenges.

Advisers need to be transparent with clients about retrocessions and similar arrangements, to avoid related conflicts of interest.

B. INVESTMENT PROCESS AND ACTIONS Managers must:

1. use reasonable care and prudent judgment when managing client assets.
2. not engage in practices designed to distort prices or artificially inflate trading volume with the intent to mislead market participants.

3. deal fairly and objectively with all clients when providing investment information, making investment recommendations, or taking investment action.
4. have a reasonable and adequate basis for investment decisions.
5. when managing a portfolio or pooled fund according to a specific mandate, strategy, or style:
   a. take only investment actions that are consistent with the stated objectives and constraints of that portfolio or fund.
   b. provide adequate disclosures and information so investors can consider whether any proposed changes in the investment style or strategy meet their investment needs.
6. when managing separate accounts and before providing investment advice or taking investment action on behalf of the client:
   a. evaluate and understand the client's investment objectives, tolerance for risk, time horizon, liquidity needs, financial constraints, any unique circumstances (including tax considerations, legal or regulatory constraints, etc.), and any other relevant information that would affect investment policy.
   b. determine that an investment is suitable to a client's financial situation.

Prohibition against market manipulation and misrepresentation. The AMC prohibits practices that distort prices or artificially inflate trading volume with the intent to mislead market participants. Some of the many laws that address this issue include the SFO in Hong Kong, which prohibits false trading, price rigging, disclosure of false or misleading information, stock market manipulation, and other market misconduct in the Hong Kong securities and futures markets. Similarly, in the EU, the Market Abuse Regulation prohibits insider dealing, unlawful disclosure of inside information, and market manipulation in the financial markets.

Reasonable and adequate basis for investment decisions. Managers are expected to have a reasonable and adequate basis for their investment decisions, supported by appropriate research and analysis. In the US, the SEC has indicated these requirements fall under the *Care Obligation of Regulation Best Interest* ("Reg BI") for broker-dealers and the duty of care enforced under the Investment Advisers Act of 1940 (the "IA fiduciary standard") for investment advisers.

Similarly, in the EU, MiFID II contains rules applying to advisers covering the concepts of appropriateness and suitability. "Appropriateness" refers to the evaluation of whether a product or service is consistent with the client's level of understanding and ability to bear the risks involved. "Suitability" evaluates if a product or service matched the client's needs, preferences, and goals.

In other jurisdictions there is a similar fiduciary obligation expected of managers which can both include using "reasonable and adequate basis" but also imply a wider set of responsibilities. For example, in recent years in the United Kingdom and EU, fiduciary obligations have been expanded to require consideration of ESG criteria in investment decisions.

Portfolio management. In portfolio management, investment managers must align actions with a fund's stated objectives and constraints. US regulations like ERISA set standards for fiduciary duties and diversification in pension plans. In the European Economic Area, the Undertakings for Collective Investment in Transferrable Securities (UCITS) laws governs retail open-ended funds, imposing restrictions on terms, liquidity, and transparency. Additionally, Alternative Investment Fund Managers Directive (AIFMD) regulates alternative investment funds like hedge funds and private equity. Many such funds opt for UCITS compliance to enhance transparency and best practices.

KNOWLEDGE CHECK

1. In the European Economic Area, the UCITS rules apply to:

   A. retail open-ended investment funds.

   B. alternative Investment funds.

   C. all investment companies.

   Solution:

   A is correct. Open-ended funds are generally covered under UCITS. Alternative Investment Funds sometimes voluntarily comply with UCITS rules.

C. TRADING Managers must:

1. not act or cause others to act on material non-public information that could affect the value of a publicly traded investment.
2. give priority to investments made on behalf of the client over those that benefit the Managers' own interests.
3. use commissions generated from client trades to pay for only investment-related products or services that directly assist the Manager in its investment decision-making process and not in the management of the firm.
4. maximize client portfolio value by seeking the best execution for all client transactions.
5. establish policies to ensure fair and equitable trade allocation among client accounts.

Material non-public information (MNPI). Rules against the use of MNPI exist in most developed markets globally. In the United States, the Securities and Exchange Commission enforces the federal securities laws, including Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5, which prohibit fraud and deception in connection with the purchase or sale of any security. The SEC also adopted Rule 10b5-1, which defines when a purchase or sale is based on MNPI. In Canada, the provincial securities regulators enforce the provincial securities acts, which prohibit insider trading and tipping, or disclosing MNPI to another person who then trades on that information. In the United Kingdom, the Financial Conduct Authority (FCA) enforces the Market Abuse Regulation, which prohibits insider dealing, unlawful disclosure of inside information, and market manipulation. The FCA also issues guidance and codes of conduct, such as the Code of Market Conduct, which provides examples of behavior that may amount to market abuse.

Prioritizing client activities. Investment managers should not favor their own interests over those of their clients when making investment decisions. For example, they should not trade for their own accounts before executing client orders or allocate more favorable trades to their own accounts than to client accounts. This practice is prohibited by many global rules and laws, including the MiFID in the EU and the Asset Management Association of China Code of Conduct. It is also prohibited by the CFA Institute Code of Ethics and Standards of Professional Conduct.

Use of commissions. This involves allocating a portion of client brokerage fees to services aiding investment managers, known as "soft dollars" in the United States and "inducements" in the United Kingdom and Europe. These can be research reports, data feeds, or software. Managers should allocate commissions solely for client-beneficial services and disclose this usage to clients. Various global regulations, like the US's Section 28(e) and the EU's MiFID II, govern this practice, and the CFA Institute maintains Soft Dollar Standards.

Best execution. Best execution mandates managers to secure optimal terms for clients during trades, considering factors like price and speed. Managers should maintain and regularly review policies for achieving this, disclosing their methods and any conflicts to clients. Regulations such as the EU's MiFID II and the UK Financial Services and Markets Act 2000 set similar requirements, including the disclosure of best execution policies and ongoing monitoring.

D. RISK MANAGEMENT, COMPLIANCE, AND SUPPORT Managers must:

1. Develop and maintain policies and procedures to ensure that their activities comply with the provisions of this Code and all applicable legal and regulatory requirements.
2. Appoint a compliance officer responsible for administering the policies and procedures and for investigating complaints regarding the conduct of the Manager or its personnel.
3. Ensure that portfolio information provided to clients by the Manager is accurate and complete and arrange for independent third-party confirmation or review of such information.
4. Maintain records for an appropriate period of time in an easily accessible format.
5. Employ qualified staff and sufficient human and technological resources to thoroughly investigate, analyze, implement, and monitor investment decisions and actions.
6. Establish a business continuity plan to address disaster recovery or periodic disruptions of the financial markets.
7. Establish a firmwide risk management process that identifies, measures, and manages the risk position of the Manager and its investments, including the sources, nature, and degree of risk exposure.

Developing Policies for Risk Management, Compliance, and Support.

This requirement of the AMC also has a legal basis. Some of the common regulatory requirements that asset managers must comply with include:

- Develop and maintaining policies and procedures that cover all aspects of their business activities, such as trading, valuation, disclosure, conflicts of interest, anti-money laundering, cybersecurity, and ethics. These policies and procedures should be reviewed and updated regularly to reflect changes in laws, regulations, and best practices.

- Appoint a compliance officer who oversees the implementation and enforcement of the policies and procedures, conducts periodic compliance audits and tests, reports any violations or deficiencies to senior management and regulators, and handles any complaints or inquiries from clients or regulators.
- Provide accurate and complete portfolio information to clients, such as performance, fees, risks, holdings, and transactions. This information should be verified by an independent third party, such as an auditor, a custodian, or a benchmark provider, to ensure its reliability and integrity.
- Maintain secure, accessible records of all business activities for a legally mandated period (usually between 5 and 10 years), available for regulatory or client inspection.
- Implement a business continuity plan with contingency measures for key functions like portfolio management, trading, and IT.
- Establish a firmwide risk management process covering market and non-market risks, with defined risk appetite, limits, controls, and reporting mechanisms.

In the United States, the Investment Advisers Act of 1940 requires investment advisers to register with the SEC and to adopt a code of ethics, a compliance program, and a business continuity plan. Another example is MiFID II in the EU, which imposes various obligations on investment firms, such as ensuring the suitability and appropriateness of their services for their clients, disclosing conflicts of interest, costs, and charges, providing best execution and fair allocation, and reporting transactions and positions to regulators. In Singapore, the Securities and Futures Act regulates fund management companies and requires them to obtain a license from the Monetary Authority of Singapore and to comply with various rules on capital adequacy, risk management, disclosure, reporting, and record keeping. The Financial Services Act 2013 in Malaysia regulates fund management companies and requires them to obtain a license from the Securities Commission Malaysia and to comply with various guidelines on governance, compliance, risk management, disclosure, reporting, and record keeping.

E. PERFORMANCE AND VALUATION Managers must:

1. Present performance information that is fair, accurate, relevant, timely, and complete. Managers must not misrepresent the performance of individual portfolios or of their firm.
2. Use fair-market prices to value client holdings and apply, in good faith, methods to determine the fair value of any securities for which no independent third-party market quotation is readily available.

The CFA Institute's Global Investment Performance Standards (GIPS®) are voluntary ethical standards for calculating and presenting investment performance information based on the principles of fair representation and full disclosure. The GIPS standards are widely adopted by asset managers around the world and are recognized as a global benchmark for performance reporting.

Many individual jurisdictions have statutory reporting requirements for performance data. These include:

- The Investment Advisers Act of 1940 in the United States requires registered investment advisers to provide clients with a brochure that discloses, among other things, their methods of analysis, investment strategies, performance fees, and performance-based advertising. The brochure must be updated annually and delivered to clients within 120 days of the end of the fiscal year.

- MiFID II in the EU has disclosure requirements on costs and charges, inducements, conflicts of interest, and best execution. MiFID II also requires asset managers to provide clients with periodic reports on the performance of their portfolios, including a comparison with a benchmark.

F. DISCLOSURES Managers must:

1. Communicate with clients on an ongoing and timely basis.
2. Ensure that disclosures are truthful, accurate, complete, and understandable and are presented in a format that communicates the information effectively.
3. Include any material facts when making disclosures or providing information to clients regarding themselves, their personnel, investments, or the investment process.
4. Disclose the following:
   - **a.** conflicts of interests generated by any relationships with brokers or other entities, other client accounts, fee structures, or other matters.
   - **b.** regulatory or disciplinary action taken against the Manager or its personnel related to professional conduct.
   - **c.** the investment process, including information regarding lock-up periods, strategies, risk factors, and use of derivatives and leverage.
   - **d.** management fees and other investment costs charged to investors, including what costs are included in the fees and the methodologies for determining fees and costs.
   - **e.** the amount of any soft or bundled commissions, the goods and/or services received in return, and how those goods and/or services benefit the client.
   - **f.** the performance of clients' investments on a regular and timely basis.
   - **g.** valuation methods used to make investment decisions and value client holdings.
   - **h.** shareholder voting policies.
   - **i.** trade allocation policies.
   - **j.** results of the review or audit of the fund or account.
   - **k.** significant personnel or organizational changes that have occurred at the Manager level.
   - **l.** risk management processes.

As with other AMC requirements, those related to disclosure have a similar basis in regulation. Investment advisers or investment funds are subject to various legal requirements depending on their jurisdiction, registration status, and the type of clients they serve. Some of the common requirements are:

Communicating with clients on an ongoing and timely basis. This typically includes providing periodic reports, statements, disclosures, and notices to inform clients of their account activity, performance, fees, risks, and other relevant information. For example, under the SEC's 2023 rules for private fund advisers, the advisers are required to provide investors with quarterly statements detailing certain information regarding fund fees, expenses, and performance.

Clean and clear disclosures. Modern regulations increasingly demand that disclosures be truthful, accurate, complete, and easily understood. For instance, the Investment Advisers Act of 1940 mandates advisers to provide a comprehensive brochure to clients. Similarly, the SEC's 2023 rules for private fund advisers require the disclosure of material facts, important for investor decision-making, including:

- conflicts of interest from relationships, fee structures, etc.;
- regulatory actions against the adviser or its staff;
- changes in investment strategies; risk factors; and use of derivatives;
- fee structures and calculation methodologies;
- soft or bundled commissions and their client benefits;
- timely performance updates;
- shareholder voting policies;
- trade allocation policies;
- audit or review results; and
- significant organizational changes.

The trend suggests a global shift toward transparency in both public and private investment sectors.

QUESTION SET

1. Which section of the AMC requires managers to "Deal fairly and objectively with all clients when providing investment information, making investment recommendations, or taking investment action"?

   A. Loyalty to clients

   B. Trading

   C. Investment Processes and Actions

   Solution:

   C is the correct answer. The Investment Processes and Action section has six total requirements, also including "Use of reasonable care and prudent judgment when managing client assets" and "Have a reasonable and adequate basis for investment decisions."

2. Which event was triggered weak oversight and risk management related to AML rules and PEPs in the United States?

   A. 1MDB

   B. The failure of Riggs Bank

   C. The Bernard Madoff Fraud

   Solution:

   B is the correct answer. Riggs Bank operated US-based accounts for many foreign embassies and related officials. It failed due to poor governance, lack of oversight, and weak ethical standards. Answer A (1MBD) had similar elements but was based in Malaysia. Answer C, the Madoff affair, was a complex Ponzi scheme following the Global Financial Crisis.

3. Which section of the AMC requires managers to "Give priority to investments made on behalf of the client over those that benefit the Managers' own interests"?

   A. Loyalty to clients

   B. Trading

   C. Investment Processes and Actions

   Solution:

   Answer B, Trading, is the correct answer. The Trading section has six total requirements, also including the pledge to "Not act or cause others to act on material non-public information that could affect the value of a publicly traded investment" and "Give priority to investments made on behalf of the client over those that benefit the Managers' own interests."

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PRACTICE PROBLEMS

The following information relates to questions 1-4

Belmont Partners manages investments for high-net-worth individuals and families using specialized investment strategies that are not readily available to retail investors. Its clients delegate decision-making authority for specific investments to Belmont. It is based in the Cayman Islands and serves clients throughout North America, South America, and the Caribbean, including many who live in the Cayman Islands. All of its investments are equity investments in companies based in the United States.

Most of Belmont's clients are referred by other investment professionals who want to provide their clients with access to Belmont's services. Belmont's relationships are typically with these professionals rather than with the client directly. Clients receive periodic financial reports from Belmont but typically do not have personal interaction with Belmont employees.

1. Belmont Partners is *best* classified as:

   A. a private banking firm.

   B. a wealth management firm.

   C. an asset management firm.

2. Belmont's investing mandate is *best* described as:

   A. advisory.

   B. discretionary.

   C. execution-only.

3. For its clients who reside in the Cayman Islands, Belmont provides:

   A. onshore services only.

   B. offshore services only.

   C. both onshore services and offshore services.

4. Belmont's implementation strategy is *best* described as:

   A. niche.

   B. differentiation.

   C. cost leadership.

The following information relates to questions 5-8

Harding Pike Advisers manages investments for high-net-worth individuals, many of whom work in the music industry, and some of whom are quite famous and value privacy and discretion. For these clients, Harding Pike often recommends specialized investment strategies that are not readily available to retail investors. To increase its revenue, Harding Pike Advisers has set the goal of having a higher mandate penetration rate.

Most of Harding Pike's clients are referred by other investment professionals who want to provide their clients with access to Harding Pike's services. In such cases, Harding Pike pays the referring professional 20% of the revenue Harding Pike will earn in the client's first year.

In order to attract top-quality investment talent, Harding Pike offers a range of benefits that includes equity participation.

5. Harding Pike's fee structure is *most likely*:

   A. asset-based.

   B. margin-based.

   C. service-based.

6. Harding Pike's revenue growth strategy is *best* described as:

   A. increasing fees.

   B. soliciting new clients.

   C. generating high investment returns.

7. Harding Pike's payments to other investment professionals are *best* described as:

   A. a service fee.

   B. a retrocession.

   C. payment for order flow.

8. The type of benefit Harding Pike uses to attract top investment talent is *best* described as:

   A. a fringe benefit.

   B. a long-term incentive.

   C. variable remuneration.

The following information relates to questions 9-12

Chris Thompson is the wealth manager for Howard Stein, a high-net-worth individual. Stein's assets are managed by a variety of managers, but Hamlin & Co. provides centralized safekeeping, record keeping, performance analytics, and trade processing. Legal assistance on asset structure, estate plans, and other related services are provided by Carol Dufresne, Esq.

Stein tells Thompson that he has substantially increased his liability insurance coverage and asks whether this purchase has implications for his investment portfolio.

Stein would like to generate higher returns on his fixed-income investments. Thompson suggests private placements and offers to connect Stein with a banker.

9. Hamlin & Co is *best* described as a:

 A. custodian.

 B. tax adviser.

 C. property manager.

10. Dufresne is *best* categorized as a:

 A. custodian.

 B. support professional.

 C. wealth planning professional.

11. Does Stein's change in insurance coverage justify changes to his investment portfolio?

 A. No.

 B. Yes, it reduces his need to hold cash and short-term bonds.

 C. Yes, it increases his need to hold cash and short-term bonds.

12. For the desired purpose, it would be *most* appropriate to refer Stein to:

 A. a private banker.

 B. a commercial banker.

 C. an investment banker.

The following information relates to questions 13-16

James Beauregard is a senior wealth manager for Prudent Investments, a wealth management firm based in the Bahamas that has adopted the CFA Institute Asset Manager Code (AMC). He manages both separate client accounts and a pooled investment fund that has a mandate to hold at least 90% of its assets in the shares of technology stocks.

Beauregard has been analyzing the shares of Superfrack, a shale oil company. He believes it is well positioned in the industry, will grow its profits considerably over the next several years, and is attractively valued. He makes the shares a 5% holding in all the accounts he manages. It marks the first time he has ever placed a non-technology stock in the pooled fund.

For the pooled fund, Beauregard directs a great deal of trades through TechBroker, as they specialize in trading technology stocks and therefore usually offer tighter spreads and better access to less liquid shares. Because of the high volume of his trades, TechBroker offers to pay for his attendance at an industry conference that Beauregard believes will generate investment insights. Beauregard accepts the offer.

In a meeting of senior management, Prudent's compliance officer shares an update of the firm's policies, including:

- Portfolio information provided to clients is verified by the firm's custodian rather than its auditor.
- The risk-management process covers market-related risks firmwide.
- The business continuity plan provides contingency measures for key functions like portfolio management and trading but not for some areas such as marketing and staff recruitment.

When reporting performance, Prudent presents information that is fair, accurate, relevant, timely, and complete but does not fully comply with the GIPS Standards. Securities that do not have readily available third-party quotations are valued using models. Prudent's management believes the resulting valuations are reasonable estimates but have no way of knowing whether they are completely accurate.

13. Are Beauregard's actions regarding Superfrack consistent with the AMC with respect to investment process and actions?

A. Yes.

B. No, it is not consistent with the objectives and constraints of the pooled fund.

C. No, he does not consider the investment objectives and constraints of each client.

14. Is Beauregard's decision to accept TechBroker's offer consistent with the AMC with respect to trading?

A. Yes.

B. No, he is required to seek best execution.

C. No, he should not use client commission dollars to attend the conference.

15. Prudent's policies are *least* consistent with the AMC's guidelines for risk management, compliance, and support regarding:

A. client reporting.

B. risk management.

C. business continuity.

16. Are Prudent's performance reports consistent with the performance and valuation guidelines of the AMC?

A. Yes.

B. No, they are not fully compliant with the GIPS Standards.

C. No, they are insufficient with respect to securities without readily available quotations.

SOLUTIONS

1. C is correct. Asset management is more focused than wealth management, involving managing a client's investments and providing specialized investment strategies. Wealth management firms and private banks typically offer a broader suite of services including accounting and tax services and legal or estate planning.

2. B is correct. With a discretionary mandate, the wealth manager has sole authority and acts on behalf of the client, who usually fully delegates investment decisions to the manager. In an execution-only mandate, transactions are initiated solely under the client's instructions, and in an advisory mandate, the wealth manager offers advice, but the final decision still rests with the client.

3. B is correct. Providing access to US investments to clients who reside in the Cayman islands would be considered an offshore service. "Onshore services are provided within the client's primary country of residence, which is typically where they are considered to be resident for tax purposes. Offshore services, on the other hand, are offered outside of the client's primary country of residence."

4. B is correct. Offering exclusive investment opportunities not readily available to retail clients is a characteristic of a differentiation strategy. Cost leadership is geared toward the mass market and often involves automation or low-cost investment options, while niche strategies tend to prioritize personalized, face-to-face interactions with clients in distinct groups or specific regions.

5. A is correct. Harding Pike Partners is an asset/fund manager, and the primary types of fees for such firms are asset-based and transaction-based.

6. A is correct. "Delivering a higher mandate penetration rate, meaning the percentage of an adviser's mandates that are discretionary or advisory, ties to increased revenues from higher fees."

7. A is correct. A fee from a mutual fund company for recommending their fund to a client is known as a "retrocession." Service fees are fixed charges, both recurring and non-recurring, associated with the account's existence and maintenance. Payment for Order Flow (PFOF) is a mechanism in which brokerage firms earn money by sending their customers' trade orders to market makers or trading firms.

8. B is correct. As part of their compensation package, senior relationship managers may be offered equity or stock ownership in the institution they work for. Long-term incentive plans (LTIPs) are designed to retain managers and encourage loyalty.

9. A is correct. Custodians' role involves safekeeping assets, record keeping, performance analytics, and trade processing that ensures managed assets are legally separated from the assets of the manager.

10. C is correct. Legal experts and tax advisers are considered foundational for the protection and preservation of wealth and, as such, are best classified as wealth management professionals.

11. B is correct. A client who opts for less insurance coverage would not need to maintain as much liquidity to self-insure against potential risks. This could point to a lower allocation in cash or short-term bonds. However, it may also indicate a

higher degree of risk aversion on the part of the client and, thus, a lower willingness (rather than ability) to take risk. Thus, while the need is lower, a conversation with the client regarding risk preferences would still be in order.

12. C is correct. Investment bankers may identify investments that align with a client's financial objectives. This could range from private placements (on the buy side) to specialized investment funds that offer attractive growth or income potential.

13. C is correct. Beauregard places the shares in all of his accounts, which include both the pooled technology fund and separate accounts. The 5% stake is within the mandate of the pooled fund because the mandate is for at least 90% in technology stocks, which is not violated by the 5% stake in Superfrack. However, for separate accounts, the AMC requires him to "Evaluate and understand the client's investment objectives, tolerance for risk, time horizon, liquidity needs, financial constraints, any unique circumstances." It is unlikely that such an evaluation would result in the same portfolio weight in Superfrack for every client.

14. A is correct. Beauregards trade volume with TradeBroker is made because they offer best execution in the form of tight spreads and superior access to illiquid shares. As the conference is expected to provide information that directly assist Beauregard in his investment decision-making process, it is an acceptable use of client commission dollars.

15. B is correct. The AMC specifies a firmwide risk management process covering market and non-market risks, and Prudent's policies cover only market-related risks. The custodian is an acceptable third-party verifier for client reports, and the business continuity plans cover key functions.

16. A is correct. Under the AMC, Managers must: 1. Present performance information that is fair, accurate, relevant, timely, and complete. Managers must not misrepresent the performance of individual portfolios or of their firm. 2. Use fair-market prices to value client holdings and apply, in good faith, methods to determine the fair value of any securities for which no independent, third-party market quotation is readily available. The GIPS Standards are voluntary, and Prudent's is consistent with AMC.

LEARNING MODULE

2

Working With the Wealthy

LEARNING OUTCOMES

Mastery	*The candidate should be able to:*
☐	describe how family and human dynamics relate to wealth and its management
☐	describe skills needed in profiling, acquiring, advising, communicating with, and educating private clients
☐	describe the unique characteristics of ultra-high-net-worth individuals and how these characteristics distinguish them from other private wealth management clients
☐	recommend appropriate approaches to the development, implementation, adherence, and amendment of a common, long-term framework for joint family decision making

INTRODUCTION

1

This reading introduces frameworks and tools to help private wealth advisors work effectively with wealthy clients. These include methods for understanding wealth in human and family dynamics, what distinguishes different groups of wealthy individuals, and their differing needs and expectations, with particular attention to ultra-high net worth (UHNW) clients, as well as how to facilitate and promote good family governance. We focus on both the social and psychological aspects of wealth and how these shape the "wealth identity" of clients and on practical tools and structures including family offices and family constitutions that are key to realizing wealthy clients' goals and aspirations for their family businesses, transitions in leadership, estate planning, and philanthropy.

LEARNING MODULE OVERVIEW

- Wealth in human dynamics can be understood using a framework organized around the following elements: shared sets of norms, clear roles, established power structures, forms of communication, and rituals and traditions.

- Individuals' and families' responses to wealth are shaped by various social and cultural factors captured in Hofstede's six-dimensional framework: individualism/collectivism, uncertainty avoidance, masculinity/femininity, power distance, long-term versus short-term orientation, and indulgence versus restraint.
- Private wealth clients can be classified across three demographic characteristics: wealth levels, generational cohorts, and means of acquiring wealth.
- Following sound ethical practices, building trust with clients, and effective communication strategies are all essential for the private wealth advisor in effectively carrying out their role.
- UHNW clients, typically defined as those individuals with more than USD30 million (equivalent) in investable assets, present a unique set of challenges and opportunities for the private wealth advisor in terms of their differing needs and expectations, and how they are met, compared to the mass affluent clients (those with USD100,000 to USD1 million in investable assets).
- One of the key structures through which UHNW clients' needs are met is the family office, including single-family and multi-family offices and variations of them.
- Issues in family governance are essential for all wealthy families but are even more critical for UHNW and high net worth (HNW) clients. HNW clients are typically defined as those individuals with over USD1 million in investable assets.
- For such families, a sound family governance strategy includes a family constitution that typically focuses on transparency and collaboration, family business management, succession rules, and philanthropy guided by family values.
- All HNW family members must have wills in place so that a smooth and efficient transfer of resources and responsibilities can proceed under the guidance of the family constitution following the death of a member. Additionally, a living will can offer valuable guidance to family members regarding treatment and care in the event of an accident or a terminal illness.

2 WEALTH IN HUMAN DYNAMICS

☐ describe how family and human dynamics relate to wealth and its management

Introduction

In this section, we look specifically at wealth in human dynamics. We explore a framework that can help organize how we understand these dynamics and consider how various social and cultural factors shape individuals' and families' responses to wealth.

We start with a case that illustrates how a family's response to wealth is a product of that family's "operating system." The metaphor of an operating system serves as shorthand for the convergence of factors that explain a family's interpersonal interactions as well as its interactions with others. While the concept of a family operating system may seem daunting, it can be a helpful framework for a private wealth manager to apply, as they determine the most effective approach in working with the family.

CASE STUDY

Meet the Sankar Family

You are a private wealth advisor recently introduced to Arun and Ariana Sankar, both Canadian citizens who were born in India. They are 60 and 58 years old, respectively, and have had successful careers in medicine: Arun as an orthopedic surgeon and Ariana as a radiologist. However, most of their wealth came from a patent Arun owns on a medical device that represented a significant innovation in shoulder replacement procedures. For the past 15 years, Arun left the day-to-day practice of medicine and concentrated his energies on further developing and marketing his medical device. His business, "Sankar Enterprises," employs approximately 100 people and specializes in developing orthopedic medical devices, often working closely with physicians and surgeons.

You can sense that Arun has a real passion for innovation and a sense of deep satisfaction in being an entrepreneur. Shortly after Arun obtained his first patent, Ariana shifted to part-time work to create a stable environment for their children: Rohan, Anjali, and Jaya, who are 25, 23, and 20 years old, respectively. Rohan and Anjali no longer live at home, and Jaya remains at home while she attends school, as does Arun's 78-year-old mother, Divya. None of the children are married or have children of their own.

Rohan and Anjali have taken roles in the family firm: Rohan works in product development, and Anjali works on the business development team. Jaya has interned at the firm during her summer school breaks, and Arun is hopeful she will take on a role on the finance team.

The Sankars have reached a decision point on a significant liquidity event, as a large medical device manufacturer has recently offered to purchase Arun's company for a substantial sum. Arun is reluctant to sell and keeps finding problems with the deal, but Ariana is eager to conclude the transaction and pushed him to meet with your firm to discuss the overall financial implications of the sale.

Family and Human Dynamics

The first thing to note is that families are always more extensive and more complicated than the sum of their parts. One way to think about family dynamics is as an operating system that runs in the background and shapes the interactions of all the participants. We can think about families as systems with the characteristics shown in Exhibit 1.

Exhibit 1: Characteristics of Families as Operating Systems

Characteristic	Description
1. A shared set of norms	Unwritten rules that set expectations for appropriate behavior
2. Clear roles	The division of responsibilities, privileges, and resources assigned to each family member

Characteristic	Description
3. Established power structure	How authority to make certain decisions, including the distribution of family resources, is assigned
4. Forms of communication	The preferred medium and style of communication among family members
5. Rituals and traditions	How family members interact and engage in celebrating and honoring important events and achievements
6. Navigating transitions	How responsibilities, privileges, and family resources are initially reassigned and possibly later redistributed following a significant change in the situation of one or more family members, including, but not limited to, death, divorce, diminished abilities, or incapacitation

We now discuss each of these characteristics of a family system in more detail.

1. A shared set of norms: A set of informal, and often implicit, rules and expectations that govern the behavior of members. An example of norms could be that the Sankar children have never asked about the extent of their family's wealth. Even as negotiations have reached a formal point, the children (also business employees) do not have a general sense of what the family business is worth. It is an established norm within the Sankar family not to discuss money or challenge the parents' authority.
2. Clear roles: Refers to the process of assigning responsibilities, resources, and tasks to individual family members. Arun and Ariana have settled into distinct roles regarding managing the family wealth. Arun is the primary financial decision-maker and has directed the management of the family's financial assets with consultants he has selected and hired. Ariana, who is not involved in managing business assets, is primarily responsible for distributing these assets. She runs the household budget and has full authority for expenditures related to the maintenance of the children, the home, and their considerable philanthropic commitments.

   Arun collects a salary from Sankar Enterprises, as do Rohan and Anjali, who are employees. Arun and Ariana, being the firm's primary shareholders, receive dividends every quarter, and this is their primary source of income. Divya is not paid by the firm but has access to a company car and driver to take her anywhere she wants and an aide to look after her during the day. The salaries of Divya's aide and chauffeur and all expenses related to her car are paid by Sankar Enterprises.
3. Established power structure: It can seem off-putting to discuss power within the context of families, where bonds of affection and care should govern interactions. A helpful description of power is the ability to control or direct the behavior of others. We can interpret this in a formal sense, which would be financial or coercive power, or in an informal sense, in which power exists through the members' belief that it is legitimate or reasonable that a given family member exercises power. In the Sankar family, while Divya is financially dependent on Arun and Ariana and depends on Ariana to help her with the activities of daily living, she exercises a considerable amount of influence over Arun and frequently directs outcomes according to her preferences.
4. Forms of communication: Families have set approaches to communicating (or not communicating) with each other. This can involve which family members communicate and with whom and which do not. It can also concern the directness of the communication as well as the medium used.

Returning to the Sankars, the children communicate frequently with their mother, mainly through texting and instant messaging. Ariana and the children are active on social media and explore shared interests through various platforms. While the children were growing up, it was important to Arun that the family had dinner together every Saturday evening. This remains his principal way of communicating with his children as children, rather than as employees. The Sankars both state that they prioritize communication and view it as an important means by which to stay connected.

5. Rituals, celebrations, and traditions: These are the more formal ways families acknowledge shared values and priorities.

   When Arun and Ariana met and married, they both agreed that a commitment to living Arun's Indian traditions would be critical to the success of their union. This proved a significant adjustment for Ariana. But with Divya's support, they integrated into a local Indian community and have taken satisfaction in the sense of belonging to a shared way of life that this has given their family. The entire family, including Divya, travels to India every two years for a month-long trip to visit family and friends. Divya is the "keeper of tradition" and is vital in passing down stories to her grandchildren about their heritage and shared values. The children have been willing participants; however, they have been even more excited about the "world tour" that follows college graduation, in which the graduate can pick three global destinations and travel to each for several weeks, fully funded by their parents.

6. Navigating transitions: Every family must confront the inevitability of change, both in its members and in its business. Founders age and yearn to retire, children mature and are eager to take on responsibilities, and businesses face challenges from new and dynamic competitors. Some of the changes can prove painful: siblings fight, spouses divorce, and accidents, death, and disease afflict both individuals and families. A well-managed family business will have processes to manage these transitions gracefully. Responsibilities, privileges, and resources need to be reallocated as leadership transitions from one generation to the next, sometimes smoothly and at other times haphazardly.

   Divya's eventual passing will likely have little impact on the business, but if Arun has a heart attack and is incapacitated, the day-to-day responsibility of running the business will fall immediately on Ariana's, Rohan's, and Anjali's shoulders. If they are ill prepared for this sudden transition, particularly if the firm does not have professional managers and well-developed processes in place, the firm can enter a downward spiral and even go bankrupt. Arun is acutely aware of this risk and talks every evening with Ariana about what happened at work that day. He does a similar summary for his children each Saturday after dinner.

The critical point is that a family's attitude towards wealth is a product of their preexisting operating system. Moreover, the areas of cooperation and conflict regarding wealth management in a family context will be derived from the family dynamics and processes. While a private wealth advisor is not expected to be trained as a psychologist or family therapist, it can be helpful to view the characteristics above as a sort of checklist for filling in information you learn about the family and its dynamics from your fact-finding conversations with them.

KNOWLEDGE CHECK

1. Which characteristic of families as operating systems best describes the following situation?

   Divya Sankar is financially dependent on Arun and Ariana Sankar and depends on Ariana to help her with the activities of daily living, but she exercises a considerable amount of influence over Arun and frequently directs outcomes according to her preferences.

   A. Shared set of norms

   B. Established power structure

   C. Clear roles

   Solution:

   B is correct. Established power structure relates to the ability to control or direct the behavior of others. In the Sankar family, Divya's power is informal and exists through the family members' belief that it is legitimate or reasonable for her to exercise power.

   A is incorrect because a shared set of norms set would describe, for example, the fact that the Sankar children have never asked about the extent of their family's wealth.

   C is incorrect because clear roles would describe, for example, the fact that Arun is the primary financial decision-maker and has directed the management of the family's financial assets with consultants he has selected and hired.

SIDEBAR: PUTTING IT INTO PRACTICE: QUESTIONS TO GET CONVERSATIONS GOING

Wealth planning aims to effectively organize the family's wealth to achieve their goals during and after their lifetime. The private wealth advisor's ability to create a map of the family system will enable them to meet their clients' needs best and form the basis for a profitable and sustainable relationship. Exhibit 2 presents a list of questions designed to help a private wealth advisor understand their client's family system. Note that these questions are meant to be illustrative. The private wealth advisor should consider their relationship with the family as well as any culturally sensitive issues when embarking on this line of questioning.

Exhibit 2: Questions the Private Wealth Advisor Can Ask to Help Reveal the Family System

1	What has your family accomplished together that has made you the proudest?
2	If one of your children were to describe your family's approach to wealth, how would they do so?
3	What was your most significant professional accomplishment? What was a significant disappointment?
4	Was there a time you witnessed something that made you feel inspired? Was there a time you saw something that made you feel angry?

5	What is your favorite TV show, movie, or book? Why do you believe you enjoy it so much?
6	What has your family accomplished together that has made you the proudest?
7	How would your family situation change if one of you died or were suddenly incapacitated, and how would the family respond? Is there a will, a succession plan, or a family constitution to guide the family through this difficult transition?
8	What are your most important life objectives for your children?

Family Firms and Acquired Wealth

Arun and Ariana Sankar's wealth has been generated through a family business. In future readings, we will discuss the unique implications of inherited wealth, which presents a different set of challenges and opportunities for the wealth advisor. However, there is a body of research on family firms that should prove helpful when dealing with clients like the Sankars.

This research starts from the insight that family firms differ significantly from non-family firms. Gómez-Mejía et al. (2007) identified **socioemotional wealth (SEW)** as a methodology for understanding how family firms make decisions regarding the disposition of their business. SEW takes into account the fact that family business owners are often motivated by considerations other than profit. They often use their business enterprise to pursue rewards and benefits that are social (the family's reputation within the community) and emotional (the level of connection and identity derived from being a business owner).

As shown in Exhibit 3, the FIBER scale, which was first defined in Berrone et al. (2012), specifies five significant dimensions of SEW that are important to family business owners and includes the following elements:

Exhibit 3: The FIBER Scale

Characteristic	Description
1. F	**F**amily control and influence
2. I	**I**dentification of family members with their firm
3. B	**B**inding social ties
4. E	**E**motional attachment of family members
5. R	**R**enewal of family bonds to the firm through dynastic succession

The central insight of SEW is that family business owners do not necessarily make decisions based purely on financial considerations. This framework can be helpful to the wealth advisor, since it points to the possibility that both Arun and Ariana view the family business as more than just a financial asset. The challenge for the wealth advisor is that it appears that they view it in different ways. Arun could be viewing the business as a way to continue work that affirms his identity as an entrepreneur and deepens his bonds with his children. In contrast, Ariana may look at the family business as a financial asset that can be liquidated to achieve the family's larger goals.

While SEW was originally designed to apply to family-owned firms, it can be adapted to families that do not own family businesses but who are bound by ties of inheritance and who share interests in indivisible (or hard-to-divide) properties.

KNOWLEDGE CHECK

1. How does the importance of non-financial goals for family business owners influence the way a private wealth advisor approaches their work with such clients?

   Solution:

   The private wealth advisor should focus on the initial "fact finding" interview to uncover their client's non-financial goals. In addition to soliciting information about the client's family business and non-business assets and holdings, it is also essential to use this opportunity to ask questions about the outcomes they would like their wealth to achieve for themselves, their beneficiaries, and the world around them.

Understanding Families in a Cultural Context

It has been said that if a private wealth advisor understands the dynamics and processes of one family, then they appreciate the processes and dynamics of just that particular family. In other words, while the private wealth advisor can have a set of tools to understand and map the processes of the family they work with, there is seemingly endless variation in processes among families. One of the principal drivers of this variation is cultural differences. In this section, we review a theory of cultural difference that will be helpful when working with wealthy families.

Geert Hofstede (1980, 2001) developed a way of understanding cultural differences that has become a classic. Hofstede's framework was originally designed to interpret and explain the behavior of cross-cultural workplaces (it focused on IBM, the preeminent multinational firm of its time). While this framework has limitations (for example, it does not specifically identify religious or historical factors), it can be adapted to provide a valuable heuristic for understanding cultural differences and the way different cultures orient to wealth and financial decision making. Hofstede's framework has six dimensions, as shown in Exhibit 4.

Exhibit 4: Hofstede's Framework of Cultural Dimensions

Power Distance Index How much does the society accept unequal wealth distribution?	
Low: Society is more comfortable with power sharing	High: Society is more comfortable with authoritarianism
Individualism vs. Collectivism Does the society encourage individuals to rely on themselves or on their community?	
Collectivism: Society encourages relying on others	Individualism: Society encourages relying on oneself
Masculinity vs. Femininity Does the society align with "masculine" or "feminine" values?	
Femininity: Society encourages "feminine" values, like caring for others and a cooperative mindset	Masculinity: Society encourages "masculine" values, like competition and materialism
Uncertainty Avoidance Index How intolerant is the society of ambiguity and risk?	
Low: More tolerant of ambiguity and risk	High: Less tolerant of ambiguity and risk
Long-Term vs. Short-Term Orientation Does the society value postponing gratification?	
Long-term orientation: Society values hard work for a distant reward	Short-term orientation: Society values present experiences over future ones
Indulgence vs. Restraint How permissive is the society?	
Indulgence: Society encourages the gratification of desires	Restraint: Society discourages the gratification of desires

We now discuss each of these dimensions of a family system in more detail.

- **Power distance index**: This dimension reflects the degree to which a society accepts that power in social groups is distributed unequally. Individuals in societies with high power distance are more comfortable with authority and less inclined to disagree with people in power. Individuals in societies with low power distance are more comfortable with challenging and confronting authority figures. Since power is typically associated with a monopoly of resources, greater levels of power distance usually point to greater wealth inequality.
- **Individualism versus collectivism**: This dimension considers the degree to which individuals are supposed to look out for themselves versus relying on the community for support and sustenance. Societies with high levels of individualism will be characterized by a reluctance to seek assistance from and to aid others. Societies with high levels of collectivism find it easier to rely on others and expect fellow community members to do the same.
- **Masculine versus feminine**: Perhaps the most anachronistic dimension of Hofstede's approach, it defines "masculine values" as success, wealth, and personal accomplishment and "feminine values" as those that emphasize caring for others and a holistic quality of life. Societies that align with masculine values are generally characterized by a higher degree of competition and materialism. Societies that tend to align with feminine values are usually characterized by a concern for the well-being of all and have more of a cooperative mindset.

- **Uncertainty avoidance index**: This dimension considers the degree to which individuals are comfortable in ambiguous situations and tolerant of risk. Societies and individuals with high uncertainty avoidance emphasize security and clearly defined rules and expectations. Societies with low uncertainty avoidance rely less on written rules and are more risk tolerant.
- **Long-term versus short-term orientation**: This dimension refers to the degree to which cultures encourage delayed gratification of material, social, and emotional needs. Societies with a long-term orientation are willing to work harder for a distant reward and value virtues such as discipline, persistence, and care with money. Societies with a short-term orientation emphasize present pleasures and experiences more than future pleasures and experiences.
- **Indulgence versus restraint**: While this may seem duplicative of the long-term versus short-term dimension, this continuum refers to society's willingness to accept and encourage the gratification of desires versus discouraging the gratification of desires within a relatively rigid set of norms. Another way of looking at this is the degree of permissiveness within a society.

We next apply Hofstede's framework to the Sankar family based on what we know about them. This is not intended to be a complete application of the theory to the Sankar case but rather provide an illustration of how this theory can illuminate the family dynamics and decision making of clients.

Individualism and collectivism: In the case provided, it is not stated how the family has historically made decisions. However, we can infer that the Sankars take a more collectivist approach, particularly given the role of Divya in family decision making as well as the active engagement of Ariana in discussions as to whether to sell the family business. The identification of who is recognized as a legitimate stakeholder in family conversations is an important dimension for wealth advisors to be aware of when they work with families.

Attitudes towards risk: Risk tolerance is a willingness and capacity to accept financial risk. It is essential to keep these two components separate, as an individual could have the willingness to take risks but lack the financial capacity to sustain a significant financial loss. Looking at Hofstede's framework, we can see that a low level of uncertainty avoidance could lead to a greater risk tolerance.

While the Sankars may seem to be a more traditional family in some ways and thus more risk averse, this is an example of why it is necessary to consider the unique circumstances of the particular family in your assessment. Arun is an entrepreneur and left a stable and lucrative income-producing role as a surgeon to build his own business, while Ariana also left a successful career as a radiologist to support his efforts. This indicates a greater level of risk tolerance than may be expected from a cursory consideration of the family's situation.

Influence of family, cultural, and religious values on wealth: Wealth is only valuable insofar as it can be used to purchase goods and services that are of value to the possessor. It is a "basic good" that enables access to other goods, both material and psychological, including stability, status, security, enjoyment, experience, and the fulfillment of our obligations to other people. Like most goods, what wealth signifies depends on the larger cultural context and the individual experiences of each family member. It is possible that for the Sankar family, wealth means something different to each member of the family.

For Arun, his wealth could be a means of engaging with his children in productive and meaningful pursuits. For Divya, family wealth could convey a sense of status among her peers. For Ariana, it could be a means to fulfill her charitable impulses within her community and among those less fortunate than her. For Jaya, her family's wealth could be perceived as a burden, creating expectations of her that she does not wish to fulfill.

The idea that the meaning of wealth is negotiated in conversations with family members also applies to decisions about how the family's wealth should be disbursed and who should be a part of that decision-making process. This is where the notion of family dynamics comes into play. If the Sankar family has a norm of not discussing finances, this could prove an obstacle in gaining consensus among family members regarding a joint mission statement, a topic that will be addressed later. Referring to the research on family-owned businesses, if Arun is approaching the business as a vehicle for multiple other goods (e.g., identity, self-actualization, self-respect, a means to connect with his children), then this could come into conflict with Ariana's vision of the business as merely an asset whose sale would enable achievement of the family's larger goals.

Expanding the circle of care: Hofstede's concepts of individualism and collectivism can inform conversations about who should benefit from the family's wealth and how. The "Giving Pledge" is a worldwide initiative in which billionaires publicly commit to giving away their fortunes during their lifetimes or in their wills. The signatories to this pledge aim to shift the focus of the wealth away from the perpetuation of financial dynasties and towards the betterment of the world for the benefit of all. An important series of questions that the Sankars should consider related to the expanding the circle of care concept are the following:

1. What values do we want to drive our wealth disbursement decisions?
2. What impact do we want our wealth to make during and after our lifetimes?
3. Who should our wealth impact, and what should that impact be?

These concepts will be addressed in greater detail in a later reading, but it is important to note that clear answers to these questions will inform the answers to a variety of other questions, including how to handle the dissolution of a marriage and specific bequests as well as inheritance and succession issues.

Rational Behavior and Behavioral Economics

One might reasonably expect that decisions related to wealth will be made with clear eyes and with little regard for non-economic considerations. Rather, emotions deeply influence a family's pursuit of wealth and its use of wealth. Moreover, these emotions are often amplified by wealth and can lead to sub-optimal outcomes in the management and planning of family businesses.

Neoclassical economics has no place for emotions and the acts they engender, but the field of behavioral economics accommodates them to some degree. The main principles of behavioral economics have a long history, although its contemporary renaissance began in the 1970s.

That said, it has not resulted in a consistent and unified body of economic prescriptions that are viable alternatives to free markets, and behavioral economists no longer view their discipline as supplanting neoclassical economics; instead, they view their contributions as an amalgam of psychological insights and economic thinking and as an essential supplement to the neoclassical position. Kahneman (2011), Thaler (2015), and Housel (2020) offer outstanding surveys of behavioral economics. The first two focus on human behavior in general, while the third consists of 19 short stories that focus on different aspects of the psychology of money.

Neoclassical economics is built around three categories of assumptions regarding individual behavior:

1. Individuals are rational and have well-defined preferences.
2. Individuals maximize their own utility, most often defined as a trade-off between wealth and risk to that wealth.
3. Individuals act independently in their own interest with all relevant information.

Neoclassical economics assumes that individuals are rational, have well-defined preferences and unbiased beliefs and expectations, and make optimal choices based on these beliefs and preferences. Furthermore, individuals are assumed to express their preferences through well-defined utility functions that map wealth and consumption to the *utility* derived from these quantities. Formally, rational individuals are assumed to be utility maximizers — their choices reflect a desire to maximize utility, which can be thought of as a trade-off between wealth (or consumption) and risk to wealth (or consumption). Finally, individuals are presumed to act independently and in their own interest using all information available to them that is relevant to a particular choice.

Behavioral economists challenge each of these assumptions. In particular, they take aim at the assumption that an individual's preferences remain stable regardless of the context and environment in which those preferences are articulated and pursued. Thaler (2015) refers to **supposedly irrelevant factors (SIFs)** that affect an individual's preference structure and are often seen to have an outsized influence on decision making. Remarkably, in some situations, an SIF proves to be the single most important determinant of decision making!

Framing, anchoring, and disposition effects are some of the more familiar, bias-related SIFs. **Framing effects** refer to the fact that the way in which a choice is presented affects decisions. For example, presenting a choice in terms of gains can make people behave differently than if the same choice is presented in terms of losses. Experiments have shown that more people agree to undergo a medical procedure if it is presented with a 20% success rate than if it is presented with an 80% failure rate.

Anchoring refers to the notion that individuals tend to fix an idea or concept in their minds and subsequently use that as a baseline. For example, assume that two groups of people, each holding a jar with the same number of cookies, are asked to guess the number of cookies in their group's jar. Suppose further that the people in each group can hear the first person's guess, *but only for their group*, and that the first guess for the first group is 20 and the first guess for the second group is 50. Anchoring bias suggests that other group members will anchor their guesses around the guess they hear so that the average guess for the first group will be significantly lower than that of the second group.

A more common example of anchoring is related to the **disposition effect**, or the tendency to be unwilling to sell one's possessions at a loss. The mind anchors the value of the possession, say, a portfolio of stocks, at its initial purchase price, and the disposition effect makes it psychologically painful to sell the portfolio at a lower price.

Regarding the second category of assumptions, behavioral economists have demonstrated that rather than being utility maximizers, humans use a variety of heuristics or shortcuts when solving complex problems. The **availability heuristic** refers to a tendency to overweight information that is readily available, while **hindsight bias** is the tendency to misremember the past in ways that make one appear to have made better and more well-informed choices.

The third category of assumptions regards individuals' propensity to act independently in their own interest. Research on the one-shot, two-party, ultimatum game demonstrates that people are willing to punish others for what they perceive as unfair behavior. In this game, one subject (the proposer) receives a sum of money and proposes how it should be divided between themselves and another player (the responder). The responder decides whether to accept or reject the proposed split. If the responder rejects the proposal, neither party gets any money.

The neoclassical prediction is that the proposer will offer the responder a minimal amount (e.g., a penny). This outcome meets the game's requirements (since it is mandated that the proposer make some distribution to the responder) while maximizing the proposer's gains. Similarly, it is assumed that the responder will accept the proposal since a penny leaves them better off than before the exchange. However, research does not support these predictions, with proposers offering between 30% and 50% and responders demanding between 25% and 40% for the offer to be accepted.

KNOWLEDGE CHECK

1. Which term refers to the tendency of a person to give too much importance to information that is easily remembered or comes to mind quickly?

   A. Framing effects

   B. Availability heuristic

   C. Anchoring

   Solution:

   B is correct. The availability heuristic suggests that people tend to place too much importance on (or overweight) information that is easily remembered or quickly brought to mind.

   A is incorrect because the framing effect asserts that how a choice is presented influences people's decision making.

   C is incorrect because anchoring asserts that individuals tend to fix an idea or concept in their minds and use that as a baseline.

Exhibit 5 summarizes the key neoclassical economic assumptions and the challenges presented by behavioral finance.

Exhibit 5: Neoclassical and Behavioral Economics: Assumptions and Challenges

Category	Neoclassical economics assumptions	Challenges from behavioral economics
1: Preferences	Individuals are rational, and have well-defined, stable preferences and unbiased expectations.	Individuals' preferences are time varying and are affected by SIFs.
2: Utility	Individuals have well-defined utility functions for wealth and consumption that they maximize based on access to all available information.	Individuals find it hard to specify their utility functions and use heuristics/rules of thumb when making choices, which often lead to sub-optimal choices.
3: Self-interest	Individuals face structurally simple decision situations and act in their own interest.	Individuals face complex decision situations and do not always act in their own interest (e.g., ultimatum games).

In short, the central insight of behavioral economics is that humans are not rational, calculating machines and that individual decision making deviates from rationality in regular and predictable ways. Often, within the context of behavioral economics, human behavior is described as irrational. This can be an unduly negative characterization of individual decision making. The important point is that humans make decisions under conditions of uncertainty that do not adhere to the rigorous requirements of a rational decision-making framework. Moreover, this is normal and is to be expected.

Since this topic is covered extensively in other readings, we will look briefly at three cognitive biases — (1) *the endowment effect*, (2) *the framing effect*, and (3) *confirmation bias* — and consider how they might manifest themselves in an initial meeting with the Sankars regarding the decision on whether to exit their family business.

The **endowment effect** leads people to value an object more highly if they own it than if they do not. The classic example is that while someone might be willing to mediate the sale of an asset, say, a business, between a willing buyer and a willing seller for USD5 million, this price no longer seems adequate if they are selling their own business (even if they had recently inherited it).

Regarding the decision-making conversation between Arun and Ariana, the endowment effect may impact Arun, as he has invested a significant amount of his intellectual and financial capital into his business. He feels like he owns the business in more than a legal sense. If Ariana thinks differently about ownership, she might be more impartial to the actual valuation of the business.

Second, consider the role of the framing effect, in which the way a choice is presented influences people's decision making. Arun and Ariana may be framing the decision to exit the business differently. Ariana is focused on the opportunity to spend more time together as a family and engage in family-based philanthropic efforts, while Arun is perhaps more focused on losing the energizing and engaging sense of productivity and purpose that his entrepreneurial efforts provide him.

Finally, **confirmation bias** can also derail decisions by causing the decision-maker to view information that confirms beliefs they already hold as more salient. In this way, the preponderance of new information is viewed as additional evidence supporting a preexisting belief. As Arun and Ariana weigh the positives and negatives of selling their family business, it is possible that each places more weight on lines of reasoning that affirm their existing viewpoints.

CASE STUDY

Private Wealth Manager Meets the Sankars

During your initial meeting with the Sankars, you share the metaphor of wealth from apple trees versus wealth from a bushel of apples. A grove of apple trees, if carefully tended and pruned, will yield a harvest for many years. The value of the apples comes partly from nature and partly from the farmer's skill. If well-tended, the apple trees will produce fruit year after year.

The value of a bushel of apples is different. Again, the apples can be preserved with care and attention, but this seems fundamentally different than the process of co-creating undertaken by the farmer. In a way, the apples have become a commodity with a definite market value. Indeed, the value of the apples has been reduced to the amount of money for which they can be sold. For the farmer who values the process of co-creation, this can be viewed as a loss; for the farmer who considers the process of co-creation as a burden, this can be viewed as freedom.

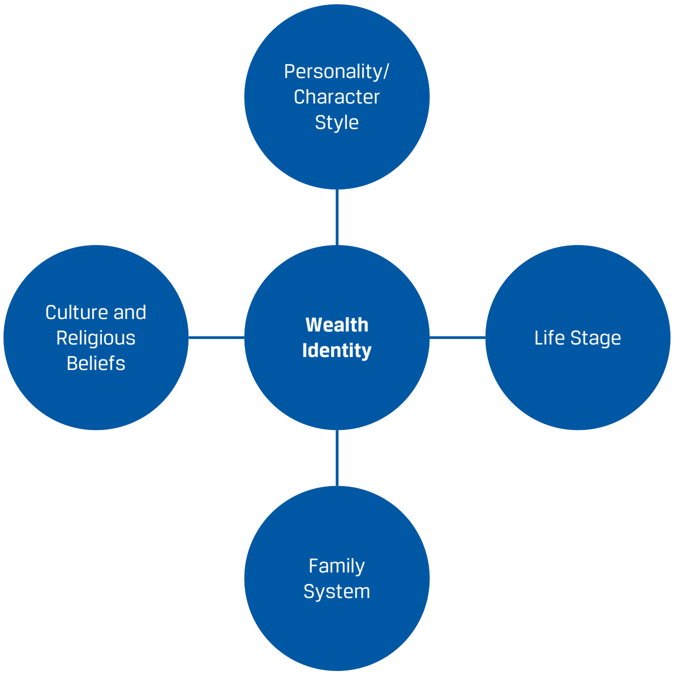
You observe that this metaphor has affected the Sankars. In your next meeting, Arun and Ariana said that they used it as a springboard to discuss their concerns about selling (or not selling) the business. Arun views leaving the process of co-creation as a significant loss, mainly because his co-creative activities were performed with his children. Ariana views it as freedom, enabling the family to find new ways of creating meaning together and in a way that can take all their interests into account.

Another concern also emerged during these conversations — Arun's fear of what acquiring a significant amount of wealth would mean for him personally and for his family. He wonders if the lack of a plan for what feels like a windfall is holding him back from making a sound business decision.

Arun and Ariana's concerns are well founded. Jaffe and Grubman (2007) discuss the **acquirer's dilemma**, which occurs when a new identity as a "person of wealth" must be incorporated into an already-existing identity. As Jaffe and Grubman note, "Liquidity events are both heady and disorientating." The acquirer of wealth is often required to navigate a sharp and sudden upward shift in social status. The situation is analogous to the choice of how deeply to assimilate into a new society, one faced by all immigrants.

Goldbart, Jaffe, and DiFuria (2004) explore the psychology of this transformation in greater detail and start from the assumption that wealth poses a psychological challenge to a person's core beliefs and resources. Moreover, they note that this challenge is perhaps more significant in cases where wealth was acquired suddenly and relatively late in life. An individual's wealth identity refers to the ways in which personal characteristics and environmental contexts inform how someone reacts to the experience of being wealthy. It is relevant insofar as an individual's wealth identity affects the way in which they make decisions and even the level of comfort they have in dealing with financial matters. As depicted in Exhibit 6, they describe four factors that can influence the ease with which an individual can make the necessary adjustments to integrate their "wealth identity" into their life.

Exhibit 6: Factors Influencing Wealth Identity



1. *Personality/character Style*: In general, individuals who have a strong and integrated sense of self, as well as a level of introspective insight into their motivations and attitudes, will have an easier time incorporating a wealth identity.
2. *Life stage*: As mentioned earlier, it can be more challenging to change one's wealth identity as a mature adult whose identity has been forged by a lifetime of experiences and social environments. Goldbart et al. (2004) also mention that having time to prepare for the assumption of a wealth identity can help the integration process.
3. *Family system*: Goldbart et al. (2004) further note that the experiences of an individual from a family with clarity around its money values can be crucial in shaping initial attitudes and responses to a changing wealth identity.
4. *Culture and religious beliefs*: Acquirers who inhabit a culture that treats money as something shameful or to be hidden may have more difficulty integrating their wealth identity than someone who inhabits a culture that celebrates material prosperity as a sign of divine satisfaction or favor or one that views conspicuous consumption as a mark of success.

   Thinking back to our consideration of Hofstede's cultural dimensions, a person from a society that ranks highly on collectivism may view the sudden acquisition of wealth as a threat to the overall community-focused dynamic. In contrast, a person from a society that ranks highly on masculine values would view such an acquisition as the mark of a strong character and something to be admired.

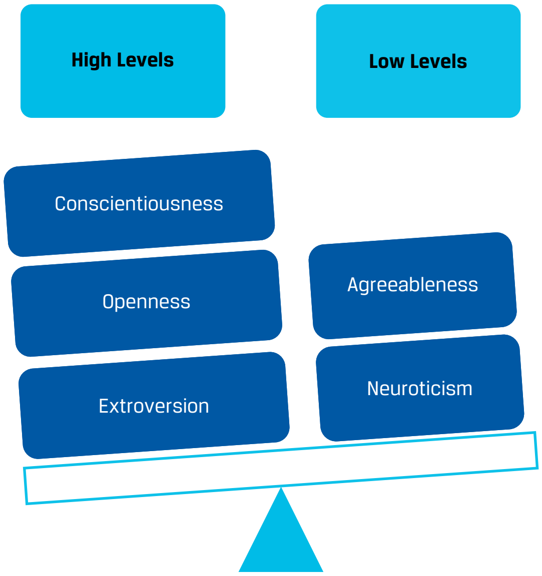
Applying these considerations to the Sankars' situation could yield some reassuring results for Arun and Ariana.

In his book *The Entrepreneur Next Door: Discover the Secrets to Financial Independence*, Bill Wagner presents interesting research on the **entrepreneurial personality profile**, which is characterized by a combination of

- high **extroversion** (the degree to which an individual is comfortable in social environments);
- high **conscientiousness** (the ability to exercise discipline and self-control to achieve goals);
- high **openness** (the willingness to be open to new experiences);
- low **agreeableness** (having a kind and empathic orientation to others); and
- low **neuroticism** (emotional instability) (Wagner 2006).

The factors comprising the entrepreneurial personality profile are presented in Exhibit 7. There are a variety of free online resources available to wealth advisors that assess an individual's personality along entrepreneurial dimensions. It is important to note that the results of these assessments should not be taken as definitive but rather as one factor among many that can help a private wealth advisor understand their client.

Exhibit 7: Factors Characterizing the Entrepreneurial Personality Profile



Considering the Sankars, Arun and Ariana are in the middle stage of their lives and have a history of experiences behind them. It could be helpful to note, however, that as Arun built his business and as that business continued to experience success after success, the idea that a liquidity event could precipitate a change in their lives would not be wholly unexpected. Arun and Ariana grew up in family environments and in a culture that admired the results of hard work. While they may have a more difficult time adjusting to a windfall of wealth, enjoying the results of their hard work should be easier to accept.

As a private wealth advisor whose role is to help the Sankars navigate this decision point in a way that reflects their stated values and goals, it is essential to remain neutral to their eventual choice. However, let's assume that the Sankars share with you that they are ready to exit the business and would like your firm to work out the terms of the deal and help them prepare for what comes next.

Goldbart, Jaffe, and Difuria (2004) articulate what they call the four stages of development regarding the assumption of a "wealth identity," which are shown in Exhibit 8. It can be helpful for a private wealth advisor to use this framework to support clients through each of these phases.

Exhibit 8: Four Stages of Development for Assuming a Wealth Identity

Honeymoon Phase → Wealth Acceptance → Identity Consolidation → Achieving Balance

The first phase is called the "*honeymoon phase*." As Goldbart et al. describe it, "With sudden wealth, there is an adrenaline-raising blend of excitement and disbelief, as well as feelings of being blessed, lucky and all-powerful." This is the phase in which an individual, flush with newly acquired wealth, goes on a spending spree, often making impulsive purchases. It is also the phase in which the new wealth holder begins navigating the demands of family and friends. This can be a double-edged sword, creating feelings of esteem as they can contribute to the support of loved ones while at the same time leading to feelings of suspicion as to people's true motivations. This is sometimes seen in lottery winners who dissipate a large fraction of their newly found wealth shortly after gaining it and who find themselves either destitute or back to their former circumstances in a relatively short period.

The second phase is termed "*wealth acceptance*." In this phase, "there is increasing awareness of the variety of ways in which wealth has made life more interesting and richer, and also more complicated and difficult." We can understand this as a growing realization of the ways in which newly acquired wealth has made life both easier and more difficult. There is also a recognition of how wealth cannot change certain outcomes or shape the totality of our external environment. The feeling of being "all-powerful" in the honeymoon phase becomes curtailed and bounded.

In the third phase, "*identity consolidation*," there is increasing internalization of the idea of oneself as the possessor of wealth. People are able to find a middle ground on the continuum of identity consolidation between over-identification with wealth at the one end and under-identification on the other end. In this phase, individuals move away from the idea of their wealth as somehow external and foreign and towards an understanding of being wealthy as a part of their identity, but not the entirety of it.

The final phase is called "*achieving balance*." In this stage, "the person achieves full responsibility for their wealth through initiating a life plan where money is seen as a resource to fulfill personal needs and goals." The critical part of this phase is creating a plan to implement the desired ways of manifesting their wealth in the world in cooperation with significant others. The idea of balance comes from the fact that wealth is integrated into a larger plan or strategy for achieving financial and non-financial goals. It is in this final stage that the private wealth advisor can bring their technical expertise to bear in designing and implementing the plan.

It is essential to note the element of co-creation here, where the wealthy individual is proactively shaping how their wealth informs their life and the lives of those around them. Far from being an external benefit or constraint, their plans for their wealth reflect a holistic conception of a life well lived. The wealthy individual is empowered and settled in their decision making around their wealth.

Transition Planning and the Need for a Will

Nothing is surer in life than death, and it is prudent, regardless of wealth, to create a will and to register it if needed with the relevant authorities. The treatment of persons who die intestate (i.e., without a will) varies from country to country and even from one state to another within a country but is almost always a long, drawn-out, and complex affair. More often than not, the estate is turned over to a probate court and can take years to resolve. If the deceased person has property in more than one country, a multi-jurisdictional probate can turn into a logistical nightmare.

For a HNW family, the process of adjudicating the division of property and control of resources without the guidance of a will or an estate plan can turn a routine matter into a destructive battle and often causes family businesses to falter. A will does not need to be complex, but it must cover the major items of an estate so that an alternative mechanism can be used to distribute minor items of modest financial or sentimental value.

Pratt and Zeckhauser (1990) describe how a game theorist helped successfully adjudicate the division of a 93-year-old decedent's silver that was not explicitly assigned in her will to one or more of her surviving descendants. Two trunks of silver objects were divided among Mary Anna Lee Paine Winsor's grandchildren by a mixture of expressed preferences, lotteries, and auctions, and all her grandchildren were happy with their share of the silver. Many of the choices made by Mrs. Winsor's grandchildren reflected emotional, not financial, value (e.g., "I want my grandmother's silver hair clip").

More generally, auctions and game theory have proven to be remarkably effective ways in which to allocate resources ranging from 5G spectra to kidney transplants, resulting in a dozen Nobel Prizes. They likely have an equally important role to play in the allocation of resources among wealthy families and their descendants. A good private wealth manager should be able to arrange for such mediation by qualified professionals with a background in auctions and game theory for some (but clearly not all) inheritances.

In a later reading, we discuss estate planning, which generalizes the concept of a will and jointly covers issues of inheritance, taxation, and the creation of trusts, as well as the transfer of resources, responsibilities, and charitable gifts in a unified way.

QUESTION SET

1. Describe a key insight of the SEW framework.

   Solution:

   The SEW framework takes into account the fact that family business owners are often motivated by considerations other than profit. They often use their business enterprise to pursue rewards and benefits that are social (the family's reputation within the community) and emotional (the level of connection and identity derived from being a business owner).

2. What are the three categories of assumptions utilized by neoclassical economists in their study of individual behavior and how do behavioral economists challenge each of them?

   Solution:

   1. Individuals are rational and have well-defined preferences. Behavioral economists challenge this assumption by proposing that individuals' preferences are time-varying and are affected by SIFs.

2. Individuals maximize their own utility. Behavioral economists challenge this assumption by proposing that individuals find it hard to specify their utility functions and use heuristics/rules of thumb when making choices, which often lead to sub-optimal choices.
3. Individuals act independently in their own interest with all relevant information. Behavioral economists challenge this assumption by proposing that individuals do not always utilize all relevant information or act in their own interest.

3. What is another characteristic of the entrepreneurial personality profile besides high extroversion and high openness?

   A. High agreeableness
   B. High neuroticism
   C. High conscientiousness

Solution:

C is correct. High conscientiousness, the ability to exercise discipline and self-control to achieve goals, is another factor in the entrepreneurial personality profile.

A is incorrect because low, not high, agreeableness is another factor in the entrepreneurial personality profile.

B is incorrect because low, not high, neuroticism is another factor in the entrepreneurial personality profile.

3 CLIENT PROFILES AND ACQUISITION

☐ describe skills needed in profiling, acquiring, advising, communicating with, and educating private clients

Introduction

In this section, we review how clients can be identified and understood across three demographic characteristics: asset levels, generational cohorts, and the way in which wealth was acquired. We then turn to a consideration of the ethical duties owed to clients by the private wealth advisor and explain how these duties can be implemented during client engagements. We discuss the importance of client onboarding, focusing on the critical element of building trust with clients, which is essential for obtaining information needed to perform the private wealth advisory role. Finally, we discuss several strategies to effectively communicate with clients and provide examples of how these can be implemented.

Client Segmentation across Demographic Characteristics

Let's explore how private wealth advisors can segment clients to identify and meet their needs. Clients are typically segmented in three ways:

- *by their level of wealth;*

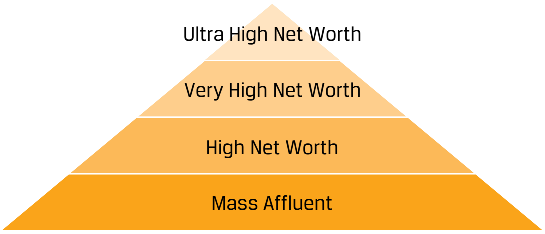
- *by their generational cohort;* and
- *by their means of acquiring wealth.*

Before we begin to categorize clients based on their levels of wealth, it is helpful to acknowledge that, up to some point, the similarities between the groupings outweigh the differences. It is not easy to pinpoint precisely where this line is drawn, but it is reasonable to assume that the differences begin to dominate when the client's focus shifts from accumulation and financial goal satisfaction to stewardship of wealth.

Stewardship of wealth refers to the responsible management of one's wealth to ensure a positive, lasting impact, which for HNW individuals often manifests as philanthropy, aligning assets with values and benefiting both family and society. In this stewardship mindset, the challenges and opportunities for a wealthy client and their team of advisors differ meaningfully from those faced by traditional financial advisors, whose primary function is to grow clients' assets to be allocated among competing goals in an overall context of scarcity.

However, classifications can be very helpful, so let's consider a typical typology of different client groups based on levels of wealth as shown in Exhibit 9.

Exhibit 9: Client Segmentation Based on Asset Level

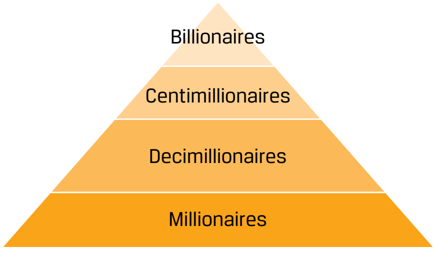


According to this method of grouping private wealth clients,

- *mass affluent* clients are traditionally considered to be those having between USD100,000 and USD1 million in investable assets;
- *HNW* clients are considered to be those having between USD1 million and USD5 million in investable assets;
- *Very-high-net-worth* (VHNW) clients are considered to be those having between USD5 million and USD30 million in investable assets; and
- *UHNW* clients are considered to have more than USD30 million in investable assets.

The private wealth advisor may encounter alternative categorizations such as that presented in Exhibit 10.

Exhibit 10: Alternative Classification of HNW Clients



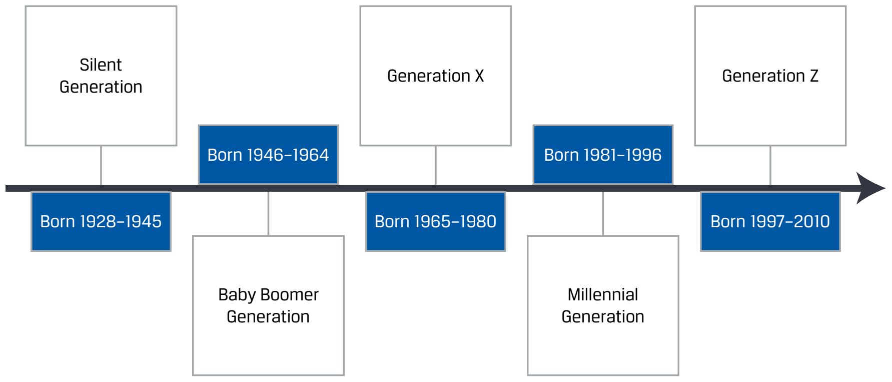
According to this alternative method of grouping private wealth clients,

- *millionaires* have more than USD1 million in investable assets;
- *decamillionaires* have more than USD10 million in investable assets;
- *centimillionaires* have more than USD100 million in investable assets; and
- *billionaires* have USD1 billion or more in investable assets.

Using the distinction between financial goal satisfaction and wealth stewardship, we can create a continuum from the mass affluent to the UHNW client, with an inflection point occurring somewhere in the HNW category.

Private wealth clients can also be segmented based on their age, as depicted in Exhibit 11. This form of generational analysis is popular in thought-leadership pieces in the wealth management industry.

Exhibit 11: Client Segmentation Based on Generational Cohort



Generational analysis for client segmentation can prove useful in at least two ways. Age provides a convenient shorthand way to consider the concerns and needs a client will bring to a private wealth advisor. We might call these life-cycle concerns. For example, a member of the *Baby Boomer* generation may be anxious about turning over the responsibility for the family foundation to their children. A member of *Generation X* may be looking for support in instilling a sense of philanthropic responsibility in their college-age children. A member of *Generation Z* may be deeply troubled by how their family acquired wealth, leaving them with the feeling of inheriting a mixed legacy.

Also, generational analysis can reveal worldviews and attitudes within a larger social context. It is reasonable, for example, to suppose that individuals within the same "age cohort" developed in similar ways in response to influential events. A classic example is how the Great Depression, which seized the world in the late 1920s, shaped the attitudes and beliefs of the Silent Generation. Its pressure on the financial system led to millions of Americans losing their jobs and their ability to support their families. Relief only came as the United States re-energized its manufacturing industries in response to World War II. Generational analysis predicts that members of the Silent Generation, who grew up in a time of scarcity and social disruption, would respond by becoming relatively conservative with their financial resources (e.g., greater tendency to save and allocate investments to bonds over equities) and less trusting of financial institutions. Similar analyses are being developed to explore how the COVID-19 pandemic has influenced the saving and consumption patterns of Generation Z clients.

KNOWLEDGE CHECK

1. What are the two ways that a generational analysis can help in understanding the perspective of a private wealth client?

   Solution:

   A generational analysis can help us to understand the views of a private wealth client, as it is a convenient shorthand for understanding their concerns. It can also provide insights into the worldview and perspective of the client.

While generational analysis resonates with our intuition, it is challenging to apply in a global context. This is true even for global events such as the COVID-19 pandemic, as the responses of governments, both in terms of risk mitigation procedures and financial support for financially stressed industries and families/individuals, varied widely. The central assumption is that the social context shapes individual development, which implies that generational analysis is limited to a specific social context. To use generational analysis effectively, the private wealth advisor needs to be well informed about the historical and social contexts of each client.

A third way of segmenting clients focuses on how wealth is acquired. The first cohort is called the "acquirer." Earlier, we described the "acquirer's dilemma," which considered the unique challenges and opportunities involved with becoming wealthy later in life either through one's own efforts (for example, a successful entrepreneur who has exited their business) or through a windfall (for example, the winner of a lottery).

Another category is the "immediate inheritors" of wealth, which can lead to an "**inheritor's dilemma**," the combination of financial and emotional challenges faced by individuals inheriting significant wealth. It is marked by the pressure to manage and uphold the legacy responsibly.

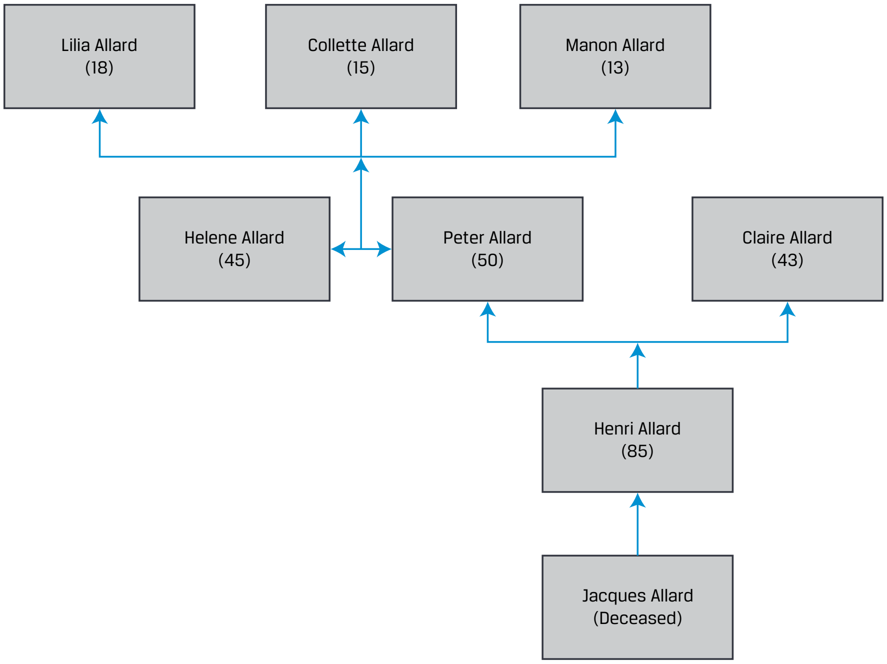
It is also possible to consider a third cohort, the "inheritors and consumers of wealth," which refers to subsequent generations following the immediate inheritors of wealth. Let's introduce the Allard family, who will help illustrate another way in which to segment and understand private wealth clients.

CASE STUDY

Meet the Allard Family

Peter and Helene Allard, aged 50 and 45, respectively, are clients of your private wealth advisory firm. Peter is one of the two children of Henri Allard, aged 85, whose multinational pharmaceutical conglomerate has created significant wealth. Henri expanded the business he inherited from his father, Jacques, and continues to operate as chief executive officer, but neither Peter nor his sister, Claire, aged 43, have ever worked in the family business. Peter is actively engaged in philanthropic activities through his family's foundations. Peter and Helene met in graduate school in the United States before they returned to raise their family in his native France. They have been married for 20 years and have three children: Lilia, Colette, and Manon, who are 18, 15, and 13 years old, respectively. Exhibit 12 presents the Allard family tree.

Exhibit 12: Allard Family Tree



You became acquainted with Peter through a mutual love of sailing and were unaware of the extent of his family's wealth for several years. You have since learned that Peter and Helene's expenses are funded by income from a trust established by his father, income from investments Peter has made (mainly in the business enterprises of his friends and acquaintances), and infrequent, though generous, gifts from his father.

Peter and his sister serve on the board of the family foundation, which is involved in a variety of philanthropic activities, mainly concerning the availability of clean drinking water, as well as the encouragement of entrepreneurial activities in impoverished areas. Peter has yet to share many details about his philanthropic work or his commitment to the goals of the family foundation.

Peter and Helene have asked to meet with you to discuss how to support their eldest daughter, Lilia, in gaining more knowledge about the family's wealth and philanthropic activities. Lilia has expressed concern over the past year as to the nature of how her great-grandfather, Jacques, and grandfather, Henri, acquired their wealth. Peter and Helene are hopeful that increasing Lilia's financial literacy will result in her further alignment with the family's philanthropic goals. You understand that you were brought into this engagement less for your financial expertise or the reputation of your firm but rather because you are a trusted acquaintance of Peter.

The inheritor's dilemma revolves around "how to create an effective individual identity strong enough to separate from, yet integrate with, the massive power of wealth itself" (Jaffe and Grubman [2007]). Individuals like Peter and his daughter Lilia, who are dealing with inherited wealth, can face a variety of challenges (Bronfman [1987]), including the following:

1. *Lack of intimacy and contact with parents, with the parents using money to control their children's decisions and lifestyle choices*. It is important to note that wealthy clients can exhibit a level of control over the lives of their children that is not seen in other families. Influence can be exerted over the choice of educational institutions, peer groups, and even appropriate marriage partners. Since their options are more prescribed than those of their non-wealthy peers, children from wealthy families may lack the opportunity to develop sound decision-making skills independently. This can contribute to a negative feedback loop in which affluent parents are frustrated by their children's lack of initiative and accountability, not realizing that their actions helped create the conditions that inhibited the development of these characteristics.
2. *Family isolation and distrust of other people*. Inheritors are often subject to real fears regarding their physical safety and well-being, which can result in them leading lives in which spontaneous encounters and chance experiences are limited. Inheritors can also be unsure as to the motives of others who seek their time and attention. This can lead to an insularity in which they feel most comfortable among a small and select group.
3. *Anxiety and fear*. Inheritors can be anxious about how to respond if they cannot rely on the family's wealth. Inheritors may believe they lack the resources and skills to be "wealth creators" in their own right. This anxiety and fear are often exacerbated by their perceived lack of knowledge and dependency on their advisors for even basic financial tasks such as bill-paying.
4. *Confusion about career and life purpose*. Without having to support oneself through compensated labor, there can be a lack of urgency to discern one's purpose in life and to engage in fulfilling and meaningful activities.

As this example indicates, the private wealth advisor is often placed as a trusted advisor to their clients. This means that private wealth advisors must conduct themselves in accordance with the highest levels of professional ethics, a topic we turn to next.

Ethical and Compliance Considerations

We now explore why private wealth advisors have additional ethical duties to their clients and review seven principles that should guide their actions when working with them.

The highest standard of care is the **fiduciary standard of care**: an advisor must put their clients' interests above their own over the entire course of a relationship. They must consistently recommend the very best course of action available to the client even if it affects them personally, say, by diminishing their income or the possibility of a promotion. Additionally, an advisor must first endeavor to eliminate conflicts of interest and make full and fair disclosure of all residual conflicts of interest that might incline them, either consciously or unconsciously, to render advice that is not disinterested so that clients can provide informed consent to accept the recommendation if needed.

A fiduciary standard is far more stringent than a suitability standard, which merely states that a recommendation by an advisor must be well-suited to a client and glosses over the question of any benefits that might accrue to the advisor if the client accepts the recommendation. Importantly, the fiduciary standard must be adhered to throughout the relationship and not just at those times when investment recommendations are made.

KNOWLEDGE CHECK

1. Peter and Helene Allard tell you that they want to have exposure to the U.S. Equity market and ask for a recommendation. You present them with two alternatives. The first is an S&P 500 Index–based exchange-traded fund (ETF) with a management fee of 1 basis point per annum. The second is an S&P 500 Index–based mutual fund offered by your firm with a management fee of 1% per annum. Both are competently managed, and their gross-of-fee performance is nearly identical. Your firm proclaims proudly on its website that it holds itself to a fiduciary standard of care.

   Given this information, which of these two investments should you recommend to the Allards?

   A. The ETF

   B. The mutual fund

   C. An equally weighted mixture of the ETF and the mutual fund

   Solution:

   A is correct. As the Allards seek exposure to the U.S. equity market, both the S&P 500 Index ETF and the S&P 500 Index mutual fund are suitable investments. However, as the ETF and the mutual fund are expected to have nearly identical performance prior to the deduction of fees, the net-of-fee performance of the mutual fund will be lower than that of the ETF. Even more importantly, your firm benefits by charging a management fee for the mutual fund, which creates in either appearance or in fact a potential conflict of interest. It does not benefit in any way from the investment in the ETF. Consequently, investing in the mutual fund is not consistent with the fiduciary standard of care owed the Allards.

   B is incorrect because the mutual fund is managed by your firm, which earns management fees from it. Therefore, it does not meet a fiduciary standard of care.

   C is incorrect because a portion of the portfolio is invested in the mutual fund managed by your firm, which earns management fees from it. Therefore, it does not meet a fiduciary standard of care.

Exhibit 13 presents the ethical and compliance principles and considerations that are foundational to how private wealth advisors should work with their clients. Keep in mind that the simple four-word phrase "fiduciary standard of care" captures the essence of every single one of them.

Exhibit 13: Ethical Principles to the Guide Private Wealth Advisor

- Integrity
- Objectivity
- Competence
- Fairness
- Confidentiality
- Professionalism
- Diligence

1. Integrity

   Integrity is derived from the Latin word "integer," which means "completeness" or "wholeness." To have integrity, therefore, also means "to be always one" (Chiu 2014). Integrity requires that professionals act according to similar principles in their personal and professional lives and are consistent in their treatment of other people in alignment with these principles. Moreover, there is an implication that the private wealth advisor will abide by these principles even when it is inconvenient or costly to do so. To have integrity means to hold fast to your beliefs regardless of the situation. We can see by this description that integrity goes beyond honesty and requires a sense of commitment to doing what is right even when it is difficult to do so.

2. Objectivity

   The principle of objectivity refers to the need for professionals to subordinate their own interests to the needs and interests of the client. This is particularly important, since the professional is trusted to give sound counsel, which is in the best interest of the client. In short, the principle of objectivity requires professionals not to be partial to their own perspective or to advantage themselves over their clients. The principle of objectivity deals specifically with conflicts of interest.

   Conflicts of interest can be actual or perceived. An actual conflict occurs when there is an incentive that runs contrary to the advisor's obligation to offer advice or guidance that is in the best interest of the client. Consider, for example, a private wealth advisor who fails to disclose to clients that they earn higher commissions when clients follow their recommendations and invest in high-fee hedge funds managed by the advisor's firm despite there being similarly performing, non-affiliated, and significantly lower-cost hedge funds that could be recommended.

   While the prior example constitutes an actual conflict of interest, it is important also to avoid perceived conflicts of interest. A perceived conflict of interest results from the appearance of the possibility of conflict even if no direct incentive is present. For example, consider an independent private wealth advisor who recommends that their clients invest in the top-performing funds managed by a private wealth management firm in which the advisor has a long-standing friendship with the firm's CEO. Since private wealth advisors rely on the trust and confidence of their clients, it is essential that they avoid such perceived conflicts in addition to actual conflicts.

3. Competence

Competence refers to the expert knowledge a professional maintains and builds upon through continued education and experience. The principle of competence also obliges the professional to recognize and admit to areas that lie beyond their level of expertise. In short, it requires professionals to develop and maintain a level of technical expertise and to refrain from acting outside of it. The ethical obligation of competence is derived from the fact that clients are vulnerable to harm by unscrupulous or incompetent practitioners. Moreover, because clients generally lack expertise in private wealth management, they typically have no way of knowing that harm has occurred until it is likely too late to remedy. It is this "knowledge asymmetry" that makes this principle so important.

4. Fairness

   The principle of fairness revolves around three concepts (Ragatz and Duska 2010), as follows:

   - Concept 1: *The principle of equality*, which requires us to treat "like" people or "like" situations in "like" ways (that is, similar things should be treated similarly)
   - Concept 2: *The golden rule*, which requires us to treat people just as we would like to be treated
   - Concept 3: The *principle of fair allocation,* which requires us to give each person that which is owed to them. This can involve balancing the claims of competing parties.

   The first interpretation of the principle of fairness is a version of the principle of equality, in which "like things" should be treated in "like ways." Any deviation from this principle requires an explanation to the affected parties in which the decision-maker's course of action should be justified using sound reasoning. For example, if a private wealth advisor charged similar clients different fees, then the principle of fairness would require the advisor to justify the differential pricing to perform the particular tasks or functions based on relevant factors such as the amount of work needed or the necessary level of expertise.

   The intuition behind the golden rule is that it can clarify one's obligations since — unless there is a relevant difference between Person A and Person B in a similar situation — Person A should be bound by the principle of equality to treat Person B as they (Person A) would want to be treated. This approach can be quite helpful, since people usually understand what is in their best interests much more clearly than they recognize the interests of others. Our perception of our own advantage is not muddled by prejudice or bias, which is often the case when we consider the interests of others.

   One way to think about the golden rule is in the context of the duty of confidentiality (to be discussed in depth shortly). Both legal and ethical requirements typically permit the private wealth advisor to discuss details of their client's personal and financial situation with other professionals working with the client. However, there are likely specific details that may be irrelevant for performing a given advisory role or would amount to petty gossip if shared. In this case, it is reasonable to ask "How would we like personal information about our relationships and finances to be treated?" The answer is most probably with a degree of discretion and respect, which is how private wealth advisors should treat details about their clients.

The final interpretation of fairness using the *principle of fair allocation* requires that private wealth advisors consider their obligations to constituencies besides their clients. Depending on the jurisdiction in which the advisor operates, these constituencies may include their employer, industry association, and various legal and regulatory authorities. The critical point to note is that one's obligation to look out for the best interests of one's clients is not absolute — one may not, for example, help a client evade punishment after committing a crime. Balancing these competing obligations can be difficult, but this is where professional experience can aid immeasurably.

5. Confidentiality

Clients that rely on the advice of a private wealth advisor are vulnerable. At the fundamental level, the client must turn over sensitive financial information to their private wealth advisor to receive the level of expert advice they seek. Moreover, clients often share sensitive personal information involving their beliefs and attitudes, as well as their hopes and fears, with their advisor. They may also confide information about family dynamics and communication patterns. Importantly, clients are communicating this information for a specific purpose – sound financial advice and the effective management of their assets. This level of trust and transparency requires the private wealth advisor to use this information only for the purposes intended by the client.

Confidentiality also preserves personal autonomy. "Part of what it means to respect a person's autonomy is to acknowledge their jurisdiction over personal information. If someone surreptitiously gathers information about us, we tend to view this as an inappropriate invasion of our privacy. This intuitive response reflects our belief in our right to control access to information about ourselves." (Ragatz and Duska 2010).

However, serious ethical questions can emerge when a client is not fully autonomous — for example, when it appears that the client is suffering from dementia or diminished mental capacity. This is a particularly challenging situation for a private wealth advisor, since the assumption underpinning the advisor–client relationship is that the client is in the best position to articulate what they believe is in their best interest.

When a lack of cognitive capacity undermines this assumption, the other ethical responsibilities discussed here take on greater importance. Moreover, institutional, legal, and regulatory obligations may remain. Fortunately, financial institutions have begun to provide more detailed guidance and resources for private wealth professionals who may find themselves in this position. This is also an important reminder about the limitations of ethical principles — while they can provide abstract ideals and often general guidance, they are often silent on the complicated ethical issues that emerge in particular situations.

6. Professionalism

The principle of professionalism requires that the private wealth advisor act in a way that maintains and enhances the public reputation of the profession. While attitudes towards the wealth management profession differ across a global context, there are situations in which the wealth management profession is not widely trusted. The obligation of professionalism requires participants to think about how their actions will reflect on the industry and to do their utmost to ensure that private wealth advisory and management practitioners are worthy of the trust that their clients place in them.

One way private wealth advisors can display professionalism is by refraining from unfair criticism of other professionals. While private wealth advisors should feel confident in voicing their opinions on the advice and actions of other professionals when it is appropriate and in the best interest of their clients to do so, it is essential to keep such comments objective and fact based. An industry in which professionals undermine the credibility of their peers to gain business will not long be held in high regard by the public.

7. Diligence

   Diligence is perhaps one of the most undervalued professional values. Diligence requires the private wealth advisor to demonstrate respect for clients by fulfilling their commitments and obligations within an appropriate time frame and by setting reasonable expectations regarding the scope of work and when it will be completed. Diligence also requires professionals to conduct their work with due care, which means not only paying close attention to the execution of the agreed-upon strategy but also ensuring that they first understand the goals and objectives of the client. Finally, the principle of diligence requires that the private wealth advisor monitor and support any junior staff working under their supervision and direction.

KNOWLEDGE CHECK

1. Briefly describe three concepts around which the ethical principle of fairness revolves.

   Solution:

   The ethical principle of fairness revolves around the following three concepts:

   1. The *principle of equality*, which requires us to treat “like” people or “like” situations in “like” ways (that is, similar things should be treated similarly)
   2. The *golden rule*, which requires us to treat people just as we would like to be treated
   3. The *principle of fair allocation*, which requires us to give each person that which is owed to them. This can involve balancing the claims of competing parties.

Client Onboarding

We now explore the importance of building trust with clients to ensure an effective client onboarding experience. We describe the distinction between cognitive trust and affective trust and show how this distinction can be used by private wealth advisors to deepen their relationships with their clients. We also explore how to work with clients to identify their values and propose effective advisor–client communication strategies.

Building Trust with Clients

Conducting oneself in alignment with the seven professional principles discussed above is an essential way in which private wealth advisors begin to build trust with their clients. However, more can be said on the mechanics of trust-building. Indeed, there are some situations in which there already exists a level of trust between the private wealth advisor and their clients, such as in the example of Peter and Helene Allard. However, in most cases, the private wealth advisor must take the steps needed to build a trusting relationship.

Because the client must take a "leap of faith" and trust that the private wealth advisor will look after and act in the client's best interests, it is crucial to build trust between client and advisor. Trust, as this leap of faith that entails vulnerability, implies three things. The first is that trust involves an action rather than merely a feeling. The second is that the initial act takes place under conditions of uncertainty. In short, if someone were completely confident that they could rely on an investment professional, then trust would not be needed. Finally, we can see that trust is not absolute. There can be greater or lesser degrees of trust in a relationship, and the level of trust can fluctuate over time.

Cognition-Based Trust, Affect-Based Trust, and Empathy

While trust can seem like an inexplicable matter of personal chemistry, research on trust has been conducted in various fields. A helpful distinction that has been established is the difference between what is referred to as cognitive trust and affective trust. There are multiple definitions of these constructs, but perhaps it is best to think of them as "head trust" and "heart trust," respectively. As Chua et al. (2008) state, "[Cognition-based trust] refers to trust from the head, a judgment based on evidence of another's competence and reliability. It is an instrumental inference that one makes from information about the other's behavior under specific circumstances. By contrast, affect-based trust refers to trust from the heart, a bond that arises from one's own emotions and a sense of the other's feelings and motives. With affect-based trust, individuals express care and concerns for the welfare of their partners and believe in the intrinsic virtue of such relationships."

These forms of trust focus on why people make the leap to trust. As Johnson and Grayson (2005) show, the factors that lead to cognitive trust tend to be objective, measurable, and quantifiable, including product performance and service provider expertise. In the fields of private wealth advisory and management, cognitive factors may have to do with portfolio performance and the level of education of the practitioner. Factors that lead to affective trust tend to be subjective and difficult to quantify. They tend to be concerned with how people feel rather than what they think and cannot often be articulated to others. These factors include the perceptions of similarity, firm reputation, and empathy.

A 2021 study by Nationwide Financial Services, Inc., demonstrated that the perception that a financial professional was empathetic was the most likely factor leading to trust that would drive future sales interactions (Ragatz 2021). *Empathy* means the respondents believed that the financial professional "understands my emotions, feelings, and concerns," "seems concerned about my family and me," "can view things from my perspective," and "asks what is happening in my daily life." What is notable about this research is that across the various demographic groups surveyed (i.e., by age, gender, and asset levels), the most impactful factor driving trust was empathy.

Technical competence and expertise are increasingly viewed as a basic expectation. Moreover, given the information asymmetry between wealth management professionals and their clients, it is difficult for many clients to assess the competence of their private wealth advisor. This emphasizes the importance of the private wealth advisor demonstrating to clients that they see and understand their concerns from the clients' perspectives and take them seriously.

Working with Clients to Identify Their Values and Effective Communication Strategies

Values refer to actions, behaviors, and attitudes that we believe are good and desirable. Everyone is guided by a set of values in their daily life whether or not they are fully aware of it. Our environment informs our values, which can change over time and can conflict with each other.

A standard method of identifying the values of private wealth clients is conducting exercises using "values cards." These activities employ a kit containing a set of note-cards with value names on the front and definitions on the back. For example, a note card might have the value "generosity," defined as "a willingness to give of your time, skills, and resources to help other people or organizations you care about." There are typically between 20 to 40 cards in a set, and clients are asked to select the 3 to 5 cards that they feel align best with what they believe is essential in life.

However, this method and others can present challenges. One of these challenges is **choice overload bias**, which occurs when an individual feels paralyzed into inaction because of the variety and abundance of options. Lacking the cognitive bandwidth needed to analyze and assess options appropriately, people often opt out and refuse to choose. It can be challenging for some individuals to select 3–5 value options from the wide variety provided without feeling like something important is being left out.

A second challenge to identifying the values of private wealth clients involves **social desirability bias**, in which individuals give an answer that they believe is more socially acceptable than their genuine and authentic feeling. An example may be if, when asked how they would spend a windfall amount (such as a lottery winning), an individual may respond that they would go on a mission to help poor communities in an impoverished country, as that seems like what a good person would do, rather than disclose that they would really take a cruise around the world with friends.

A final challenge is **polysemy**, which refers to the fact that value terms can have multiple meanings. For example, the term "respect" can mean one thing for an older person on the verge of retirement (such as being valued for their wisdom) but something very different for someone just starting their career (like being respected for winning a competitive promotion).

As mentioned earlier, a preferred method to identify an individual's values is to ask questions that elicit stories. Research shows that people think in narratives with themselves in a central role, in a linear structure, and with identifiable causal patterns. Stories help people make sense of themselves, the world around them, and the experiences they have within it. The role of the private wealth advisor is to listen carefully to the stories told by their clients. It is important not to focus on listening for details but rather for the underlying themes that emerge in the narrative.

The following list of questions may be helpful as a starting point but is not (and cannot be) comprehensive: each wealthy family's situation is different, and a conversation that starts along these lines with one or more family members will surely lead into other areas that are specific to them and their situation.

1. What do you hope to achieve by your participation in this process?
2. Is there anyone else you wish to include in this process, and at what point?
3. How did you acquire and grow your wealth?
4. What has your wealth allowed you to do during your lifetime, and why was that important to you and your family?
5. What goals do you hope your wealth will help your loved ones and beneficiaries achieve both during your lifetime and after your death?
6. What limitations would you like to place on the use of your wealth? What scenarios or situations are you trying to protect against?
7. Is there anyone, or any institution, who needs help or protection following your passing?

8. How do you think about risk, and what are the primary risks that are of concern to you?
9. Who may we share your responses with? In particular, do you have an attorney or an accountant we should coordinate closely with?

Answering these questions may be challenging for clients, but not because they do not know the answers. Most people lead busy lives and do not necessarily have an opportunity to reflect on how their deeply held values and beliefs have influenced both their accumulation of wealth and their priorities for its use.

Advisor–Client Communication Strategies

We now describe nine strategies that a private wealth advisor can use to elicit trust and improve communications with their clients. The field of financial psychology uses psychological research and theory to create micro-based techniques to help shape idiosyncratic financial beliefs and behaviors to improve financial health (Klontz et al., 2022). Exhibit 14 summarizes some effective advisor–client communication strategies derived from insights gained from financial psychology, as well as potential applications using the context of the Allard family, whom we introduced earlier.

Imagine that the private wealth advisor is leading an initial discovery meeting with members of the Allard family and asks the series of questions presented below. You can refer to the Allard family tree (Exhibit 12) to follow along.

Exhibit 14: Effective Advisor–Client Communication Strategies

Strategy	Description	Application to Allard family
1. Reflective listening	Seeking to understand the speaker's ideas, then offering the ideas back to the speaker. Reflective listening moves beyond the explicit meaning of the words used by the speaker.	***Private wealth advisor to Lilia:*** "I understand you saying that you are concerned with how your grandfather's company generated profits in recent years. Can you tell me more about that?"
2. Scaling questions	Invite the speaker to rate a current situation, challenge, or opportunity on a numbered scale	***Private wealth advisor to Henri:*** "On a scale from 0 to 10, with 10 being completely confident and 0 being not confident at all, and with 5 as a neutral midpoint, do you believe that your family is in alignment about the direction of the foundation?"
3. Miracle questions	Invites the speaker to consider what life would be like if, overnight, all their problems disappeared	***Private wealth advisor to Helene:*** "Can you tell me what life would be like if you woke up and found that your husband and daughter were no longer at odds about the direction of the family foundation?"
4. Channeling	Diverting the focus and energy of the conversation from present or past experience to future hopes and goals	***Private wealth advisor to Peter:*** "Thinking about the future, what are some steps we can take together to align on the future direction and purpose of the family foundation"?

Strategy	Description	Application to Allard family
5. Specifying	Focusing the discussion of desired change to encourage "well-formed" goals	***Private wealth advisor to group:*** "I can hear that Lilia is hoping to expand the list of organizations that the foundation supports. So, would it be possible for us to set as a goal that we will discuss the list she generates in our next quarterly meeting with the intent of giving her a decision shortly after that meeting takes place?"
6. Theming	Widening the lens to explore the thematic significance of desired change	***Private wealth advisor to group:*** "It seems to me that we can all align on the desire to have all members of the foundation engaged in its mission, with everyone having a voice and a seat at the table. Do you agree?"
7. Interrelating	Inviting clients to consider and express a desired change in relationship or interactional terms	***Private wealth advisor to Peter and Lilia:*** "Peter and Lilia, will your relationship change for the better if you agree on the mission of the family foundation?"
8. Mutualizing	Identifying commonalities or shared stories in people's experiences and hopes	***Private wealth advisor to Peter and Lilia:*** "It seems to me, Peter, that you want to continue to honor the family legacy in your work with the foundation. And it seems to me, Lilia, that you want to enhance the family legacy by re-imagining the responsibilities of your family's wealth. But it is really about the legacy for both of you, right?"
9. Prioritizing	Clarifying which issues and requests need immediate attention and identifying a starting point for change	***Private wealth advisor to group:*** "What do we need to decide today for this meeting to succeed?"

QUESTION SET

1. Describe the concept of inheritor's dilemma.

   Solution:

   Inheritor's dilemma typically impacts the immediate inheritors of wealth and is the combination of financial and emotional challenges faced by individuals inheriting significant wealth. These include the pressure to manage and uphold their legacy responsibly.

2. Which of the following is an ethical principle or ethical consideration that applies to private wealth advisors in their work with clients?

   A. Looking out for the best interests of the employer

   B. Balancing the interests of clients, employers, and regulators

C. Looking out for the best interest of the client and only the client

Solution:

B is correct. Looking out for the best interests of their client is not the only ethical responsibility of a private wealth advisor. The private wealth advisor must also consider the interests of their employer, regulators, and other possible constituencies.

A is incorrect because the private wealth manager must consider the interests of their client, their employer, regulators, and other possible constituencies.

C is incorrect because looking out solely for their client's interests may violate the law and may also be to the detriment of private wealth advisor's employer and other related persons.

3. Which of the following best describes an advisor–client communications strategy that diverts the focus and energy of the conversation from present or past experience to future hopes and goals?

A. Interrelating

B. Channeling

C. Theming

Solution:

B is correct. Channeling is a communications strategy that involves diverting the focus and energy of a conversation from present or past experiences to future hopes and goals.

A is incorrect because interrelating is a communications strategy that involves inviting clients to consider and express a desired change in a relationship or interaction.

C is incorrect because theming is a communications strategy that involves widening the lens to explore the thematic significance of desired changes.

ULTRA-HIGH-NET-WORTH CLIENTS 4

☐ describe the unique characteristics of ultra-high-net-worth individuals and how these characteristics distinguish them from other private wealth management clients

Introduction

In this section, we consider the distinct ways in which UHNW clients differ from the mass affluent and HNW clients. We also discuss the expectations that UHNW clients have of their private wealth team and ways that private wealth advisors can meet those expectations. One of the principal means by which UHNW clients meet these needs is by working with a family office. We explore the different types of family offices and consider ways to identify which structure is the best for different types of UHNW clients.

Distinctive Characteristics of UHNW Clients

As mentioned above, UHNW clients can be distinguished from other types of clients served by the private wealth advisor, particularly by the following five characteristics:

1. They are not doing financial planning in the traditional sense.
2. They often have multi-jurisdictional holdings.
3. They have a longer time horizon.
4. They have distinct ways of approaching the risk–reward trade-off.
5. They typically work with a team of professionals to manage their holdings.

Before we explore these characteristics, let's meet Alexi Tanaka, a UHNW client, and his family to set the context for understanding the unique challenges and opportunities that working with these types of clients presents.

CASE STUDY

Meet Alexi Tanaka and Family — UHNW Clients

Alexi Tanaka has always been willing to take chances, which he attributes to his upbringing with his Slavic mother and Japanese father. Growing up in a suburb of Tokyo, Alexi never quite fit in, which was part of the reason he loved losing himself in the online gaming community as a teenager. From being a devoted player of online games, he became an innovative developer of them.

Nearly 10 years ago Alexi made headlines in the emerging social media landscape with his new game "Moonland," in which players imagine themselves as colonists trying to build a homestead on the Moon. What seemed implausible on paper, "Why would people of all ages from all across the world spend real money to build a virtual settlement on the Moon?," turned out to be very popular. Tanaka's critical insight was to launch his game on the thriving platform Faceplace, which enabled him to leverage the community aspect of gaming — it was the presence of other "lunar homesteaders" that made the game so enjoyable and addictive.

This insight has paid off handsomely. When Lunar Games, Inc. (LGI), the company he founded, went public three years ago, Alexi netted around USD100 million. He remained CEO for several years, leading the company through the changes (primarily negative) required for third-party application developers like LGI that resulted from Faceplace's increasing consolidation of the content on its platform.

In part because of his focus on work, Alexi's marriage to Anna, who is 41, dissolved not long before the IPO. He and Anna are on good terms, though, and together they co-parent Greta and Emma, who are 17 and 15 years old, respectively. While Alexi, a Japanese citizen, still has a home and other substantial property in Tokyo, he spends most of his time in Copenhagen, where Anna, a Danish citizen, lives with the girls. Alexi's father has passed, but his 80-year-old mother — whose health is slowly declining — still lives in Tokyo, enjoying the company of her vibrant group of friends. Alexi visits regularly, especially when his mother's chronic respiratory condition flares up.

Now, at the age of 48, Alexi is ready for a new challenge. He has become increasingly disheartened by what he believes are the adverse effects of social media on society. Instead of being a mechanism for bridging gaps between people, it seems to be doing just the opposite. His disillusionment with social media is spurring his next act, which he sees as consisting of two phases. In the first phase, he would like to fund a center at the Japanese university he attended to research how social media impacts trust at all levels of society and to design both legal and non-legal remedies to counteract these effects. Although she is only 17, Greta is also interested in joining in her father's pursuit, given that she has seen several teenage acquaintances hurt by social media influences.

In the second phase, Alexi would like to start a venture capital fund that is explicitly focused on supporting new technologies that increase transparency both in the public and private sectors. Intriguingly, Emma, at just 15, has expressed a strong interest in finance and investments to her father, who helps Emma manage her own small-cap growth stock portfolio.

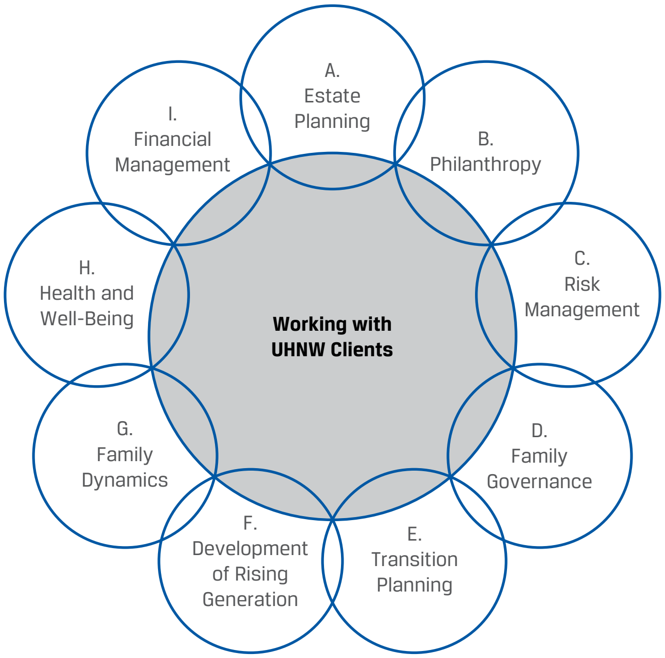
We now discuss the five characteristics that distinguish UHNW clients from other less affluent private wealth clients, using the Tanaka family to facilitate our understanding of them.

1. *UHNW individuals are not doing financial planning in the traditional sense.* The traditional domains of financial planning — investments, risk management, retirement planning, and tax planning — either do not apply directly or are applied differently to UHNW individuals. For example, UHNW individuals are likely not contributing to an employer-sponsored retirement account, nor are they reliant on corporate or state-funded pensions to support them in their old age. In this sense, it is often easier to approach UHNW individuals and their holdings as if they were institutions rather than individuals. However, tax and estate planning are very important considerations for UHNW individuals and their families, which are often large and geographically dispersed. These complications tend not to arise in institutional engagements, as many institutions, for example, are tax exempt.

   It should be emphasized that while UHNW individuals often do not do financial planning in the same way as HNW individuals, this should not be taken to mean that they do not need to do any financial planning. In fact, a failure to do any financial planning is often a recipe for disaster no matter the level of wealth and can completely undo the impact of careful estate planning.

   Inspired by the work of the UHNW Institute, Exhibit 15 highlights the key domains of wealth management that are often involved in developing advisory relationships with UHNW clients.

Exhibit 15: Domains of Wealth Management for UHNW Clients



A. *Estate planning*: One of the primary concerns of UHNW families is the effective transfer of family assets, which is typically described as ensuring that assets are inherited by the right person, at the right time, and with the minimum amount of taxation. A will is the most basic element of an estate plan. A will must be created for every member of a family and be well integrated with transition and succession plans for family-owned businesses. As mentioned earlier, the lack of a documented and attested will can throw even the best-prepared transition plans for UNHW families into disarray following a death, particularly if the death was unexpected.

Depending on the jurisdiction, there are a variety of vehicles and strategies that can be deployed to achieve the estate planning goals of the UHNW client. While we briefly note some of them here, it is worth noting that an estate planning attorney who is knowledgeable about local rules and regulations as well as astute about potential shifts in the regulatory environment is an indispensable partner to the private wealth advisor.

Looking at Alexi's case, it is clear that estate planning will be an essential component of his overall wealth management strategy. In the first instance, Alexi will want to ensure that, in the event of his untimely or premature death, his assets are quickly transferred to his identified beneficiaries, likely his children, former spouse, and his alma mater. Moreover, Alexi will want to implement increasingly sophisticated and tax-advantaged strategies that ensure his intentions for the disbursement of his wealth are implemented as efficiently as possible.

While it is beyond the scope of this reading, it is also essential for private wealth managers to be both aware of and sensitive to issues raised by marriages (and their dissolution) within the family of the UHNW client. In particular, they must obtain expert legal advice on pre- and post-nuptial arrangements specific to the family's jurisdiction (or jurisdictions). By way of example, a wide range of legal and financial complications would arise if Alexi were to remarry and have additional children.

B. *Philanthropy*: Philanthropy is typically understood as making a direct financial contribution in a way that supports and advances desirable outcomes. Charitable giving and values-driven investing can play an essential role in meeting a client's non-financial goals and may also become pillars around which the family of a UHNW client can reinforce family cohesion and promote greater unity and purpose. UHNW clients may seek to deploy their wealth in a way that influences outcomes that they care about. Clients often seek to direct their investments in ways that align with their family's mission, vision, and values. Environmental, social, and governance investing, diversity, equity, and inclusion investing, and other social impact– and value-driven strategies are popular choices for such investments.

We will discuss this topic in more detail shortly, but it is important to note that even when families are aligned on the outcomes they want to achieve (i.e., reducing the incidence of an infectious disease in developing countries, increasing early childhood literacy, or reducing greenhouse gases), it can be challenging to formulate the right strategy, including identifying the appropriate partners, to achieve the desired goal. Philanthropic advisors, often with expertise or deep connections in specific areas of social concern, can support the private wealth advisor in implementing these desires and can create tremendous value for a UHNW client and their family.

In Alexi's case, there is an opportunity for the private wealth manager to provide support as Alexi tries to educate himself on the best means to combat the social problems, dislocation, and isolation resulting from an overreliance on social media, which he is committed to remedying. The private wealth advisor can provide valuable counsel on potential strategies, individuals, and institutions that are well positioned to implement these interventions. They can also offer guidance on how to assess the success of the interventions and how to deploy follow-on investments. In many cases, entrepreneurs like Alexi can bring an impressive set of business skills to these conversations and decisions, but even so, the perspectives provided by specialist advisors operating in this space can be invaluable. Even though the private wealth advisor is not expected to be an expert in every area, they must work with these specialists and institutions to craft a comprehensive wealth management offering.

C. *Risk management*: The topic of risk management will be covered extensively in another reading. Here we note that a variety of financial risks including, but not limited to, volatility, tail risk, interest rate risk, credit risk, inflation risk and currency risk must be taken into consideration when proposing investment portfolios for UHNW clients.

However, it is also important to note that UHNW individuals often face various risks that the traditional private wealth client does not typically encounter. Some of these risks include cybersecurity risks, reputational risks, risks to their safety and that of their family, and risks associated with owning unique assets and other hard-to-value collectibles for which the market is both thin and sporadic and where the high transaction costs associated with auctions can significantly erode their value. A private wealth advisor should be prepared to refer their UHNW clients to the appropriate professionals to manage these risks effectively.

D. *Family governance*: We will explore this issue in depth shortly. However, it is essential to note that the private wealth advisor should be familiar with best practices around family governance and strategies and tactics to ensure inclusive decision making. In Alexi's case, this will be particularly important as his children mature and become more involved in managing the family wealth.

E. *Transition planning*: Most UHNW clients engage in wealth management with a multi-generational perspective. Issues concerning transition planning emerge from the family's personal wealth (e.g., patriarch and matriarch succession), operating company holdings (e.g., executive succession and business exit), and other business assets (e.g., family brand or identity). An important point that is often overlooked is the succession plan for the cohort of professional advisors who are currently working with the family. If, for example, the family's trusted estate attorney or even the long-time private wealth advisor retires (or dies), there must be a plan to ensure the continuity of the relationship so that the needs of the UHNW client continue to be met without interruption.

F. *Development of the rising generation*: In addition to succession planning, it is the domain of the wealth manager working with UHNW clients to ensure that the next generation is well prepared to take over leadership roles. It is also essential to ensure that Generation Two, the UHNW client's adult children, and Generation Three, the UHNW client's adult grandchildren, are well positioned to step into their roles in the family's decision-making structure.

For those individuals who did not acquire their wealth through business ownership or employment, boosting financial literacy may require a substantial amount of planning and effort. UHNW clients are increasingly looking to private wealth advisors to fulfill this role, as they are already trusted members of the client's inner circle and are privy to sensitive financial and personal information about the family.

Given that Alexi has left LGI, and as it is being run as a public company with professional management, the Tanakas' financial literacy and succession planning will likely focus on their children's involvement in Alexi's new ventures. For Greta, this will entail learning more about the university research center her father is establishing and taking on further philanthropic activities aimed at remedying the negative impacts of social media on society. For Emma, financial literacy and succession planning will prove crucial if she wishes to take on a leadership role at Alexi's new venture capital fund, assuming it is successful.

G. *Family dynamics*: A framework for understanding family dynamics, as well as a list of communication strategies, was provided earlier in this reading. However, this topic is critical for UHNW clients, for whom the high levels of wealth typically indicate that its management and preservation are a family affair. This pursuit can become even more difficult when there are multiple members of different generations involved in decision making.

At this point, we move away from the dynamics implicit in a nuclear family structure to a broader and more diverse kinship group, often with different levels of engagement and expectations. Again, while the private wealth advisor needs to be familiar with various theories of family dynamics and skilled in deploying appropriate communication strategies, it can be helpful to identify an outside facilitator trained in guiding family communications to achieve the family's goals and objectives.

As noted previously, an interesting twist to Alexi's story would be if he were to remarry and have additional children. Such a situation would surely complicate the Tanaka family's dynamics. In this case, the private wealth advisor should assist in engaging outside specialists skilled in facilitating the difficult conversations involving Alexi's new and former spouses and his children from both marriages.

H. *Health and well-being*: Increasingly, UHNW clients view their private wealth advisor as a curator for non-financial components that are viewed as essential to living a good life. Two of these components are physical health and wellness, topics around which sensitivity to confidential information is paramount. Private wealth advisors are often called upon to negotiate or manage the relationship of their clients with a personal physician or medical concierge service.

Moreover, "integrated/full-service" private wealth advisors often facilitate a wide range of personal arrangements for their UHNW clients including, but not limited to, health, wellness, travel, childcare, home maintenance, logistics, bill-paying, and even arranging security services for family members at public events such as concerts or sporting events. While some of these requests are straightforward, others are not and may require wealth managers to make ethical judgments or even decline to perform them.

In Alexi's case, among other things, he relies on his private wealth manager to facilitate all medical appointments, specialized hospital-stay arrangements, and private jet transport bookings for his mother, as she frequently requires cutting-edge treatments for her chronic respiratory condition by specialist doctors in Frankfurt.

In addition, recall the previously referenced research that stated the importance of integrating one's wealth into a coherent sense of personal identity. An integrated sense of self is necessary to achieve happiness and individual flourishing. While it is certainly not within the realm of expertise of every private wealth advisor to act as a wellness coach or therapist, it can be helpful to have individuals trained in these areas in the advisor's network.

I. *Financial and investment management*: It may seem odd that financial and investment management is the last domain discussed. UHNW clients, however, consider sound investment management a baseline expectation and expect that their advisor's investment management services will generate returns that are at least as good as those of their competitors. It is no longer sufficient for wealth managers to offer only financial management services, as UHNW clients increasingly seek a broader and more holistic range of services. That said, much of the private wealth advisor's investment management function is represented in the risk management domain, which has the advantage of shifting client focus away from the narrow issue of returns to the broader issues such as risk, return, and responsibility.

Wealth managers will be expected to have a wide range of investment management skills. They must be skilled in the formulation of capital market assumptions, the estimation of risk, the construction of portfolios, the evaluation of investment performance, and manager selection. They must also be skilled in sourcing and evaluating investment opportunities, particularly when investing in start-ups and young entrepreneurial firms.

This skill is particularly important when servicing UHNW clients, as their large portfolios allow investments in private markets as well as co-investments with institutional investors. The skills required for successful private market investing are very different than those required for public market investing, where indexing has proven to be remarkably effective across a wide range of markets.

Additionally, private wealth managers must be skilled at tax planning (or have access to skilled tax lawyers), particularly if the family's wealth is multi-jurisdictional.

2. *UHNW individuals often have multi-jurisdictional holdings.* Many UHNW clients have international holdings, which usually take the form of homes or vacation properties and financial assets, but also sometimes businesses and other assets. Global holdings require a private wealth manager to coordinate investments across the legal, regulatory, and tax frameworks of multiple countries and to identify appropriate tax planning and wealth transfer strategies to meet the needs of their clients in the most tax-efficient way possible.

   In particular, the UHNW client might have taxable accounts in some jurisdictions, one or more trusts in others, a residual interest in a corporation from a liquidity event, various tax-deferred accounts, a charitable foundation or a donor-advised fund, and so forth. Consequently, it is unlikely that a single investment manager can meet all their investment needs, and they may be better served by having multiple separately managed accounts with their assets held at a global custodian institution.

   As noted, Alexi is a Japanese citizen with a home and property in Japan but who spends most of his time in Denmark, where his former spouse and children live. His gifts to establish the university-based social media research center in Japan and the start-up of his venture capital fund in Copenhagen will likely present challenges to his private wealth advisor, especially regarding efficient tax planning and wealth transfer.

3. *UHNW clients have a longer time horizon than other private wealth client segments.* UHNW clients are almost invariably concerned with issues of succession planning and wealth transfer. These issues often constitute the bulk of the issues the private wealth advisor will deal with in serving these clients. Unlike other client segments, especially those within the mass affluent category, the focus for the UHNW client is on effectively transferring wealth to the next generation or generations.

   We have already discussed possible succession issues for the Tanaka family in terms of Greta eventually taking a leadership role in the social media research center and spearheading family philanthropic efforts in this area, as well as Emma's potential interest in joining and maybe eventually running her father's venture capital firm. These issues are in addition to the multi-jurisdictional wealth planning, gifts and wealth transfers, and multi-generational estate planning that Alexi requires to ensure his family's long-term legacy.

4. *UHNW clients have distinct ways of approaching risk and reward, which must be considered when working with these families.* As will be discussed later, the traditional ways of looking at risk management — assessing risk

tolerance (usually using software programs or surveys) and assessing risk capacity (usually through analyzing current holdings and projected spending needs) — do not typically apply to UHNW clients. Instead, their risk tolerance is a function of a balance between their entrepreneurial impulses and the desire to preserve their capital and legacy.

Moreover, in traditional wealth management, risk is typically assessed on an individual basis or in conjunction with the risk tolerance and risk capacity of a spouse. In the case of many UHNW clients, risk is assessed for the family as a whole, with a conscious attempt being made to balance the risk tolerance and capacity levels of various family members, often from multiple generations. Finally, for UHNW families, assessing their risk appetite and tolerance is an ongoing and dynamic process, much more so than for the typical mass affluent or HNW client.

Alexi's relatively high tolerance for risk is apparent in his forming LGI around essentially one video game, Moonland, and now by his desire to start a venture capital firm, which is a high-risk, high-reward business. These ventures are a function of his entrepreneurial impulses. So, a critical role for the private wealth advisor would be to champion efforts at preserving the Tanaka family's wealth as a counterbalance to Alexi's entrepreneurial spirit and to help his children understand and navigate the risk–return trade-off.

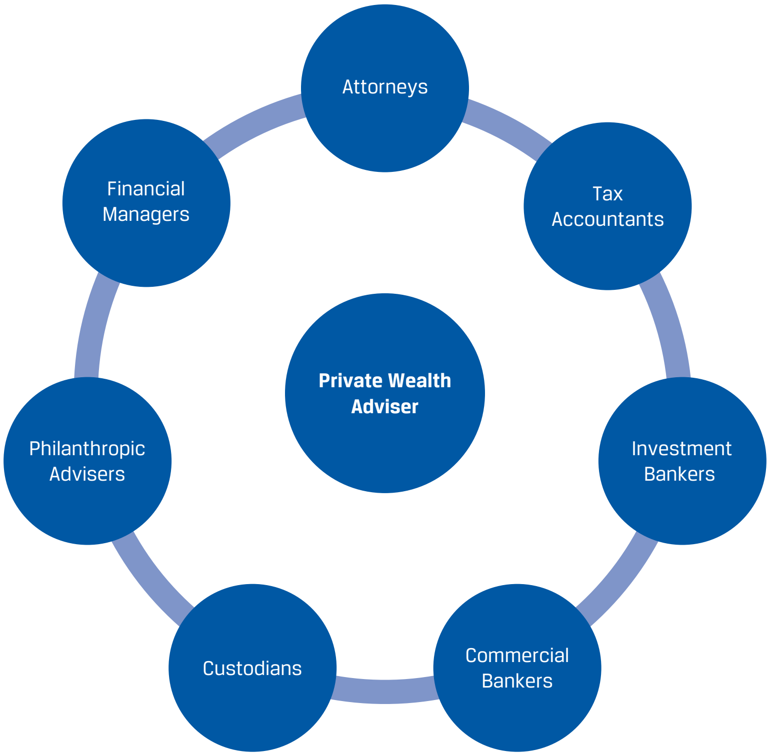
It is important to note that Alexi's situation is just one example of risk tolerance. The UHNW clients of a private wealth advisor could have very different levels of risk tolerance, both innately and on account of their life experiences.

5. *Effectively serving UHNW clients means working collaboratively and successfully with a wide range of other professionals.*

   Before discussing the different structures available to UHNW families to meet their needs, it is helpful to briefly recap the different professional service providers that typically serve wealthy families. They include, among others, attorneys, tax accountants, investment bankers, commercial bankers, custodians, philanthropic advisors, and financial managers.

As Exhibit 16 indicates, the private wealth advisor working with UHNW clients is often required to work collaboratively with a multiplicity of such financial services advisors and providers who address specific needs of the client.

Exhibit 16: Multiplicity of Service Providers Used by UHNW Clients



KNOWLEDGE CHECK

1. Which of the following statements about UHNW clients compared to traditional private wealth clients is *most likely correct*?

   A. They are doing financial planning in the traditional sense.

   B. They often have multi-jurisdictional holdings.

   C. They have a short time horizon.

   Solution:

   B is correct. UHNW clients do often have multi-jurisdictional holdings that may be located in multiple countries.

   A is incorrect because UHNW clients typically are not doing financial planning in the traditional sense. They are likely not contributing to an employer-sponsored retirement account, nor are they reliant on corporate or state-funded pensions to support them in their old age. Moreover, they have special financial planning needs such as estate planning, succession planning, and philanthropy, among others.

   C is incorrect because UHNW clients typically have longer time horizons, as business succession and multi-generational estate plans tend to be prioritized in their wealth planning.

Expectations of UHNW Clients

As discussed previously, how individuals and families acquire wealth can matter greatly in their approach to wealth and how they incorporate their status as wealthy individuals into their overall concept of self. Besides a private wealth manager with whom the family has had a long-term relationship, wealthy clients can feel more comfortable with private wealth managers known to them through their social circles or other networks. Such familiarity can help clients feel confident that the private wealth manager is trustworthy and can be depended on to look out for the client's and family's best interests.

While it is a reasonable proposition that UHNW clients expect the things that other wealthy clients expect, it is also possible to identify some critical areas of added importance to them, as shown in Exhibit 17.

Exhibit 17: Expectations of UHNW Clients

Expectation	Description
Collaboration	An "integrated advisor" is able to work with the client and align the contributions of all the other professional advisors. Willingness and ability to coordinate among other wealth management professionals as well as between various family members, often across different generations.
Competence	Expertise in relevant domains of wealth management. Ability to effectively delegate and oversee the work of others. Willingness to acknowledge areas outside of their own scope of expertise.
Confidence	Ability and willingness to make recommendations backed with sound reasoning. Ability to insert oneself into conversations with family members and other professionals to advocate for the plan and strategy previously aligned upon by relevant stakeholders.
Confidentially	Maintain the privacy and data integrity of sensitive information about finances and family dynamics.
Creativity	Identify solutions to challenges faced by the conflicting priorities and goals of UHNW clients and their families. Clients expect that advisors will bring novel possibilities that are typically only available to a person with a holistic point of view. This ability to solve problems is the hallmark of a successful private wealth manager operating in this space.
Empathy	Empathy is the ability to imaginatively enter into the perspective or worldview of another. It enables the private wealth advisor to inhabit the values, beliefs, and attitudes of their clients. Developing and demonstrating empathy is necessary to earn the trust and continued commitment of clients. Clients expect to be known and understood by their advisors.
Objectivity	A commitment to act in the best interest of the family at all times. Ability to retain a neutral posture and assess information in an unbiased way. Clear perception of issues that may constitute a perceived or actual conflict of interest.

Let's consider one of these expectations by applying it to Alexi Tanaka's situation. Regarding the need for creativity from his private wealth advisor, Alexi has multiple goals for the next phase of his life that need to be addressed. He is looking to engage in philanthropy, working to make a social impact by establishing the university-based social media research center, and starting a new business venture, the venture capital firm. He also wants to ensure his family's financial legacy. This is a complicated nexus of goals, which, if not approached with strategic purpose, could devolve into a mess of uncoordinated initiatives that do not yield substantial or lasting results. It might prove helpful for Alexi to utilize a private wealth advisor as a creative thought-leadership partner to help prioritize his goals, allocate his resources appropriately, and work with his team of professionals to create a plan to achieve his objectives.

Reasons Wealthy Families Use Family Offices

The multiplicity of advisors needed for managing the affairs of the typical UHNW family and the resulting unwieldiness has led such families to look for more integrated options, which has resulted in the creation of the **family office** — a private wealth management advisory firm serving VHNW and UHNW clients. However, there are additional reasons why a wealthy family may be interested in establishing a family office. One is the economies of scale that accrue from unifying a wide range of wealth management activities under one umbrella firm.

A less obvious reason is the role that family offices can play in educating the generation that will inherit the family's wealth. Their education can include both increasing awareness of the nature and structure of the family holdings as well as socializing individual family members into family norms and values around the growth, maintenance, and distribution of the family's wealth.

Finally, there is support from what scholars have called the **kinecon group** (Dunn 1980). A kinecon group is a network of individuals that share both a kinship bond and economic interests. Creating a family office can reinforce kinecon bonds and enable the family network to increase its influence and impact by acting as a cohesive unit.

Characteristics of a Family Office

Family offices are distinguished by four characteristics, including

1. a holistic approach;
2. personal attention;
3. family involvement; and
4. an evolving structure.

The first characteristic of a holistic approach is that it focuses on both the financial and non-financial needs of the family; specifically, a family office is concerned with the SEW of the family.

As we will see, decisions regarding asset management in a family office environment are more nuanced than simply maximizing wealth. This is one of the reasons why private wealth advisors find their work both meaningful and enjoyable. The purpose (or the "why") of the family's wealth is typically an active component of the decision-making process. The family office can also serve as an effective mechanism to transfer assets to younger generations and as a vehicle to express the entrepreneurial visions of family members.

The second characteristic of a family office is the personal attention given to the needs of the specific family. As Kenyon-Rouvinez and Park (2020) indicate, this can mean a focus on keeping family information private and confidential. It can also involve paying particular attention to family values including, but not limited to, how a family's mission statement and values should inform its investment philosophy and asset selection. This personal attention also implies that bespoke investment strategies and business deals can be tailored to the unique needs of the UHNW family.

A third characteristic is the level of family involvement and engagement. Unlike in a traditional wealth management relationship, the family office provides a medium for various members, typically across generations, to interact with each other. This can raise complicated issues of family dynamics, which require the private wealth manager to deploy well-developed communication skills, especially for mediation and negotiation. Finally, members of the family need to be educated as well as socialized into the norms of family decision making, which requires additional resources and skills from the private wealth manager and their supporting team.

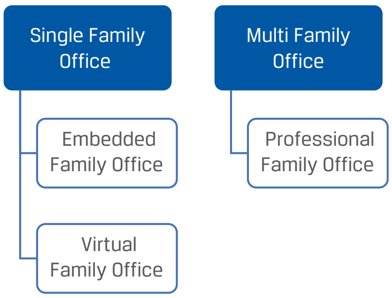
Recall our earlier story of the Sankar family. The role of Divya, the grandmother, as the family matriarch was one in which the ability to influence the outcome of a situation was disproportionate to her financial contributions. The conferring of such influence to Divya is an example of a family decision-making norm. Moreover, it is possible that this norm is not without controversy in other branches of the family. We can imagine a situation in which Arun's wife and his children are irritated by what they believe are Divya's intrusions into matters that primarily impact them and their future. The critical insight is that just because patterns and behaviors have been "normalized" in a family does not mean they are appreciated and approved by all family members.

Finally, family offices have an evolving structure. As the family evolves, so will its needs, goals, and objectives, and it will be necessary for the governance mechanisms in a family office to change as well. It is important to remember that in a family office structure, the institution exists primarily to meet the family's needs and does not necessarily have an independent purpose.

Single-Family Office, Multi-Family Office, and Other Possibilities

From this general description, there are a few distinct family office models that have been developed in recent years. These models, shown in Exhibit 18, are anchored around two categories: the single-family office and the multi-family office.

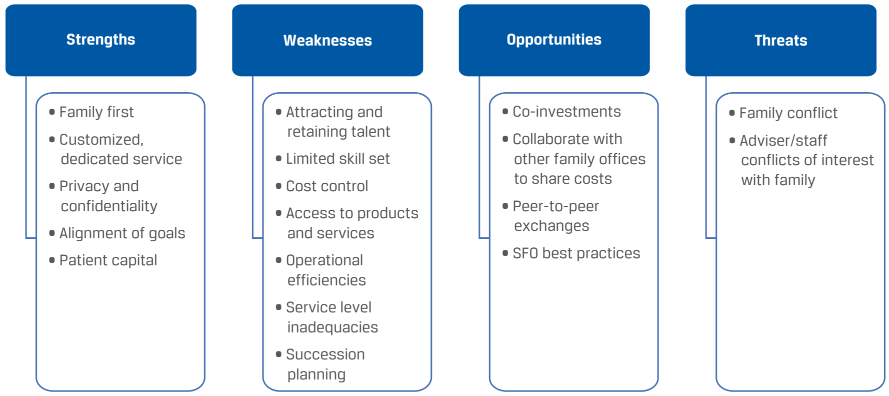
Exhibit 18: Family Office Models



A **single-family office (SFO)** is a "corporate structure owned by a single family and dedicated to the management of family assets and the fulfillment of individual and tailored needs of family members." (Schickinger et al. 2021). The SFO model provides the family with the highest levels of personalization and attention. Rosplock (2020) has developed a Strengths/Weaknesses/Opportunities/Threats (SWOT) analysis that neatly highlights some of the key characteristics of SFOs, as presented in Exhibit 19.

A word of caution is in order: SWOT analyses are best applied to businesses in competitive industries, and family offices are not competitive in the same way as, say, technology businesses. In particular, strengths and weaknesses are best thought of as internal forces, while opportunities and threats are best thought of as external forces. Most often, the threats to a family office are internal and related to the strength of its relationship with the family. Many of its opportunities, on the other hand, are indeed external.

Exhibit 19: SWOT Analysis of SFOs



Source: Author and Kirby Rosplock, *The Complete Family Office Handbook*, 2nd ed. (Hoboken, NJ: John Wiley & Sons, 2020).

However, even within the SFO model, the structure can vary significantly. Researchers (Schickinger et al. 2021) have identified two dimensions along which it is possible to categorize the SFO. The first dimension is the ownership status of the original family business. The second dimension is whether the SFO-owning family is the first generation or a later generation. From these dimensions, we can derive classifications for four different SFO models, as shown in Exhibit 20.

Exhibit 20: SFO Models

	SFO with original family business	SFO without original family business
SFO owned by later generations	Preserver SFO	Entrepreneurial SFO
SFO owned by first generation	Optimizer SFO	Founder SFO

Preserver SFOs have maintained both the original family business as well as the SFO for at least two generations. These SFOs emphasize the importance of asset preservation and intergenerational wealth transfer. In investment decisions, preserver SFOs place a high focus on achieving non-financial goals such as the articulation of family values and the preservation of family reputation, which serve dual purposes, as the family is still a business owner. There is a correspondingly low emphasis on the family office as a vehicle for entrepreneurial expression and a high focus on governance mechanisms. The latter may be reinforced by the experience of the SFO in already having undergone a succession event, resulting in meaningful lessons about the importance of good governance.

Optimizer SFOs are often developed by the current (first) generation to diversify and reduce (optimize) financial risks to family members. There is a reduced focus on asset preservation within the family firm, likely because the family still owns its original business venture, which generates wealth for the family. The ongoing business interest also reduces the need for the SFO to be a vehicle for entrepreneurial intentions and asset accumulation. There is also less focus on governance, likely due to the lack of a succession event.

Entrepreneurial SFOs are inherited by a later generation of a family that no longer controls the original family business. The family has often had a liquidity event (i.e., the sale of a majority or all of the business), and their holdings now consist mainly of financial assets and other non-business assets (i.e., property, homes, collectibles, etc.). The SFO, therefore, has the potential to become the vehicle through which the family exercises its entrepreneurial intentions. There is a greater focus on the importance of governance mechanisms, likely because the SFO has already undergone a succession event. Moreover, as the name indicates, entrepreneurial SFOs are more concerned with the importance of non-financial goals in investment decisions and emphasize asset growth over asset preservation.

Founder SFOs are controlled by the first generation of owners and are often created as the result of a liquidity event from the sale of a family business. The SFO is typically formed to resolve the issue of how to allocate family assets and align family members to a common mission and purpose regarding wealth. Founder SFOs have less of a focus on governance mechanisms and a high focus on entrepreneurship. The latter characteristic may be explained by the fact that a founder SFO is likely controlled by the same family member who held a leadership role in the former family business and may, therefore, have more of a "business owner" mindset. There is also a decreased focus on asset preservation, which could be accounted for by the recency of the founding liquidity event.

There are two variations of SFO. The first is the **embedded family office (EFO)**, a dedicated space within the family business with a small number of staff who handle the financial, legal, and tax matters of the owners. EFOs can be distinguished from a true family office by the fact that they typically do not manage assets outside of the family business, nor are they typically involved in the maintenance or deployment of the family's non-financial assets. In short, EFOs are convenient for a family business owner but do not constitute a holistic solution.

Importantly, locating family office functions within a larger business setting can create challenges, especially when employees are working jointly on family issues and business issues. In particular, there can be a lack of ownership and accountability if the entities are not cleanly separated. Finally, while many business owners view their personal and business interests as being interchangeable, this is not always the case, and embedding family finances within an operating business can create conflicts of interest, as well as potential legal and other risks, which may go unnoticed by the family.

The second variation of SFO is the **virtual family office (VFO)**, "a legally organized business designed to manage, control, and facilitate both the financial and non-financial wealth and transactions of a family" (Handler 2016). A VFO utilizes mainly outsourced services, is typically structured with one or more family members as clients, and has a small paid staff of overall managers, with specialized services outsourced to individual providers and consultants. As Handler (2016) notes, VFOs have accounted for a high percentage of new family offices, while some existing family offices have been restructured as VFOs.

An immediate benefit of the VFO model is that it avoids the significant expenditures associated with a traditional SFO — mainly, the cost of the physical "brick-and-mortar" location and the considerable payroll expenses associated with a dedicated team of full-time employees while enjoying the tax advantages of an independent legal entity. A VFO also avoids the challenges and risks of the EFO approach by establishing a separate entity for managing the family's finances. However, a VFO will inevitably lack the personalization of the traditional SFO.

KNOWLEDGE CHECK

1. Which of the following best describes the type of SFO that might be created for Alexi Tanaka and his family?

   A. Preserver SFO

   B. Founder SFO

   C. Optimizer SFO

   Solution:

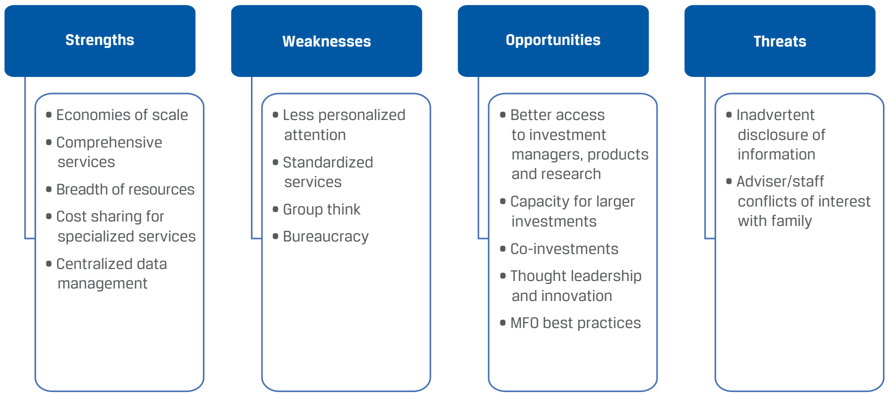
   B is correct. A founder SFO would most likely be created for Alexi since he would be the first generation to own the SFO, and the SFO would not include the original family business, LGI, Inc., as a liquidity event has already occurred (LGI has been sold).

   A is incorrect because a preserver SFO would include the original family business, and LGI has already been sold.

   C is incorrect because an optimizer SFO would include the original family business, and LGI has already been sold.

A **multi-family office (MFO)** is a family office that serves at least two wealthy, typically HNW and VHNW, families. The average MFO has 131 client relationships and manages around USD5.1 billion (equivalent) in assets, equating to about USD39 million (equivalent) per client. Exhibit 21 provides a detailed SWOT analysis for MFOs, as outlined by Rosplock (2020). Our earlier comment on SWOT analyses for SFOs applies to MFOs as well, though the primary threat is different due to the multiple accounts MFOs manage.

Exhibit 21: SWOT Analysis of MFOs



Source: Author and Kirby Rosplock, *The Complete Family Office Handbook*, 2nd ed. (Hoboken, NJ: John Wiley & Sons, 2020.

Many of these items are intuitive to understand. However, there are several important points to note. The first is that MFOs are for-profit entities, which means that the goals of the MFO may not align as neatly with the goals of any individual family as they do for an SFO. Conversely, MFOs are incentivized to reduce costs and increase efficiencies through economies of scale. An additional benefit of the MFO model is that while the advisors and employees divide their attention between multiple families, they also gain knowledge and increase their expertise by working with a variety of families facing different challenges and opportunities. Finally, working with an MFO can accelerate the learning curve for wealthy families, as MFO staff can be typically adept and skilled at developing a family wealth strategy due to the diversity of their clients.

The primary variation of MFO is the **professional family office (PFO)** or **institutional family office (IFO)**, an institutionally backed entity that offers comprehensive services to its wealthy clients. A PFO can consolidate the delivery of the wide range of services required by wealthy clients and can provide a consistent point of contact to the family. Another advantage of a PFO is that it is supported by the resources and economies of scale of the financial institution that backs it. However, due to its institutional nature, the PFO is less able to respond to and support the specific needs of a HNW family.

One area in which MFOs can shine relates to investment capabilities. Some MFOs bring investment opportunities that require large capital commitments (e.g., private equity, direct investments) to clients with smaller portfolio sizes by pooling the resources of multiple clients to meet minimum investment requirements. These clients would not otherwise have access to such investments, which are mostly the domain of UHNW families who have created an SFO.

KNOWLEDGE CHECK

1. Which of the following best describes a family office located within a financial institution?

   A. An SFO

   B. A VFO

   C. A PFO

   Solution:

   C is correct. PFOs (also known as IFOs) are located within financial institutions and provide a single point of contact for HNW individuals and families who utilize a variety of their services.

   A is incorrect because an SFO is not a PFO, which is a type of MFO.

   B is incorrect because a VFO is a type of SFO, not a PFO.

Selecting the Right Family Office Model

As can be seen from Exhibit 18, wealthy families looking for a family office have a variety of options to choose from. Exhibit 22 shows the typical net worth ranges for several of the family office models, which can be helpful as a starting point to understand the choices available to HNW and UHNW families.

Exhibit 22: Net Worth Ranges for Family Office Models

Family office model	Net worth ranges (USD equivalent)
SFO	Net worth of USD100m and above
MFO	Net worth of USD20m to USD30m
VFO	Net worth between USD20m to USD100m

Once a wealthy family has decided on the appropriate structure for their needs (excluding the SFO option), they can ask the representatives of several family offices a range of questions to determine if an MFO, a PFO, or a VFO will best serve their needs. These questions are purely illustrative. Given the heterogeneity of wealthy families, no list of questions can be truly exhaustive, but these can be used as a base to inform the outline of a discussion with a private wealth advisor.

Sample questions include:

1. Who is my primary point of contact, and how many clients is that person responsible for?
2. Can you share a typical client profile as well as a summary of the range of clients you serve? What differentiates me from your other clients?
3. What services do you provide your clients, and how are your services priced?
4. What are your greatest strengths as a firm, and what do you outsource to other vendors?
5. How do you ensure client confidentiality and the security of my family's information?
6. What is your investment philosophy, and how do you implement it for clients like me?
7. How do you think about risk and how do you integrate it into portfolio construction?
8. How do you form capital market assumptions and create portfolios that are well suited to my family's current situation, as well as our spending, inheritance, and succession plans?
9. How do you recommend that families deal with concentrated holdings in single securities or businesses?
10. What information do you need from me to create a portfolio that reflects my needs within the framework of your investment philosophy?

QUESTION SET

1. Identify three ways in which working with UHNW clients differs from working with traditional clients.

   Solution:

   1. UHNW clients are not doing financial planning in the traditional sense.
   2. UHNW clients often have multi-jurisdictional holdings.
   3. UHNW clients have a longer time horizon typically involving intergenerational transfer of wealth.

2. Describe the concept of a kinecon group and provide an example.

   Solution:

   A kinecon group is a network of people who are related and have common economic interests. For example, a multigenerational family that owns and operates one or more family businesses is a kinecon group.

3. Identify three strengths of an SFO compared to an MFO.

Solution:

Among the strengths of an SFO compared to an MFO are

1. services are customized and dedicated;
2. privacy and confidentiality are more easily maintained; and
3. alignment of goals is easier to achieve.

FAMILY GOVERNANCE 5

☐ recommend appropriate approaches to the development, implementation, adherence, and amendment of a common, long-term framework for joint family decision making

Introduction

Modern wealthy families are often very large. In addition to the main wealth creator(s) or business founder(s), they may include numerous siblings, children with their families, grandchildren, etc. Families may face behavioral and emotional challenges such as generational conflict, sibling rivalry, or other tensions, which may adversely impact decision making regarding the family business and transfer of wealth. When many stakeholders are involved, families may establish a system of family governance to ensure the effective generation, transition, preservation, and growth of wealth through time. According to Stalk and Foley (2012), the family-owned enterprise tends to decline by the third generation. The founder *creates wealth*, the second generation *maintains wealth*, and the third generation *depletes wealth*.

While 70% of family businesses fail or are sold before the second generation can take over their management, the decline in wealth across generations can generally be attributed to

- the dilution of wealth among a larger number of descendants;
- a lack of interest in the family business by younger generations; and/or
- a lack of education and planning by family members.

A strong family governance framework can mitigate some of these issues. The next section explains the concept of family governance, its purposes, and the associated governing bodies. We also address specific issues related to wealth transfer across generations in families with wealth concentrated in a family business.

Issues in family governance might seem to apply only to UHNW clients, but a sound family governance strategy is a crucial component of effective private wealth management even for those families whose wealth is significantly lower.

For many of these clients, family governance tends to be closely bound up with the management and succession of the family business. Later in this section, we will meet the Martinez family, who will help us explore issues concerning effective family governance. However, it is helpful to begin with some essential foundational concepts that will guide our understanding as we go forward.

Family Governance

Family governance is a set of processes and structures that are intentionally developed to support decision making in accordance with the family's clearly stated values, beliefs, and goals.

Governance is a broad concept that may be more familiar in the context of either a publicly traded corporation (i.e., corporate governance) or a political entity (i.e., political governance). In recent years, the concept of family governance has gained traction as a way of helping both families and the advisors who serve them, including their private wealth advisor, to understand the processes and structures that can support sound decision making.

The *governance* aspect also provides private wealth advisors the opportunity to utilize the principles of *good governance* to help inform the support they offer their clients. Exhibit 23 shows the seven fundamental principles associated with good family governance.

Exhibit 23: Principles of Good Family Governance

While some of these principles may not, on the surface, seem directly applicable to a family setting, it is remarkable how much alignment there is between running an effective family office and a corporation. Exhibit 24 presents a concise description of each of these seven principles, which bear some resemblance to the ethical principles that guide wealth managers presented in Exhibit 13.

Exhibit 24: Description of Principles of Good Family Governance

	Principle	Description
1	**Competence**	Competence means having the requisite expertise, resources, and tools to perform one's functions effectively.
2	**Objectivity**	Objectivity requires the application of fact, reason, and good judgment to achieve intended goals.
3	**Collaboration**	Collaboration means working well with other parties pursuing the same end or goal.
4	**Integrity**	Integrity means discharging official duties honestly, fairly, and in a manner consistent with sound ethical principles.
5	**Professionalism and transparency**	Professionalism requires that organizations and individuals are open and candid in the execution of their business to ensure accountability, withstand public scrutiny, and hold everything they do to the highest standards.
6	**Diligence and independent oversight**	Diligence and independent oversight require that organizations and individuals be open to feedback from unrelated outside parties and commit to engaging, when needed, with external parties in their decision-making processes.
7	**Fairness**	Fairness means considering the interests, hopes, and dreams of those individuals or groups who may be overlooked or marginalized in decision-making processes.

We now discuss the seven principles of good family governance in more detail.

1. *Competence* in family governance ensures that decision-makers are competent and well informed on the areas within their scope of work. Effective guardrails should be implemented to prevent family members who lack the expertise needed to make decisions from being placed in positions of authority. Efforts should be made to establish the qualifications and criteria that must be met before a family member is placed in a position of authority or influence. Provisions should also be made to relieve a family member of decision-making authority in the event they experience diminished mental capacity (i.e., dementia) or in the event of family discord. Once these determinations are made, family members should receive the information and resources they need to make sound decisions.
2. *Objectivity* in a family governance setting requires that facts, rational thinking, and good judgment be applied to decision making while cognitive biases and emotional influences are minimized. This is often challenging given the personal histories and relationships among family members, which go beyond professional interactions. Good governance also involves an honest evaluation of decisions, assessing whether outcomes, be they financial returns or improved family unity, align with the family's original goals.
3. In the context of family governance, *collaboration* applies not only to family members' interactions among themselves but also to their interactions with their private wealth advisor and any other external advisors involved in managing the family's wealth. This last point is critical, since there are many examples of effective family governance being derailed not by disagreements among family members but by the unprofessional and self-interested behavior of their external advisors and staff.
4. The notion of *integrity* was discussed previously in this reading, but it is important to emphasize it here as a principle of good family governance. Every governance document is necessarily incomplete. As with any contract

or agreement, it is impossible to specify all the relevant rights and responsibilities in every conceivable circumstance. It is in areas where the contract lies silent that trust between the parties is most important. The foundation of trust is a core belief that the other party can be counted on to speak honestly and to keep their promises — that is, to act with integrity. Without this core belief, joint action is filled with friction and difficulties. Depending on the history and experiences of a particular family, this trust may be present as a starting point. However, acting with integrity is a sure way to build back any trust that has been lost and to maintain a trusting relationship.

5. *Professionalism and transparency* are two of the most highly cited requirements for good governance in a corporate and political context, and they are no less important in the governance of families. In a family environment, professionalism and transparency mean making all necessary information available to all appropriate parties and being truthful about decision-making processes. This can be difficult and often emotionally fraught, particularly when families have a distorted or secretive approach to wealth. The private wealth advisor may encounter situations in which the wealth acquirer (or a member of the senior generation) is unwilling to share details about the family's wealth or holdings. This can be problematic, as the next generation may find themselves ill equipped to assume a leadership role when the time comes. Therefore, a commitment to transparency typically also requires openness around the educational process and the standards for access to information about the family's wealth. The best practice is to establish a clear, consistent, and repeatable process through which family members can increase their influence and accountability over time.

   Finally, while we have focused on professionalism and transparency within the family system, an important question is the extent to which the family wishes their processes and activities to be accessible to outsiders. The answer will likely vary across families depending on factors like culture, traditions, and level of wealth. In any case, this question is one that the family should discuss to settle on a consistent approach to how they will deal with inquiries from outside individuals or groups.

6. *Diligence and independent oversight* in family governance are best practices that involve a commitment to receiving external feedback and perspectives on the decision-making process. The principle of independent oversight necessarily involves some level of transparency and candor but goes further to diligently and proactively seek out different points of view. Often, families engage a private wealth advisor because they recognize the need for expertise that is informed by the experience of working with other similarly wealthy families.

   However, it can be challenging to invite outsiders with different perspectives to participate in the decision-making process. Effective family governance does suggest that an outside advisor who serves on a family advisory board or council is often able to remain focused on family priorities and goals, as they are emotionally removed from the outcomes. This is similar to the role of outside directors on corporate boards. These independent advisors are typically valued for their business expertise as well as their experience with efficient and productive decision-making groups.

7. In family governance, *fairness* means ensuring that the interests of all family members are considered in decision making. There are at least three situations in which this becomes very important.

The first is when there are family members or groups of family members whose perspective is in the minority or is unpopular with other family members. An example is support for certain political or social issues such as concern for the environment or a desire to support causes related to diversity, equity, and inclusion of marginalized groups. Recall a situation like this in a previous section in which a family member (Lilia Allard) was troubled by the family's source of wealth — the business founded by her great-grandfather (Jacques Allard) to manufacture and sell pharmaceuticals. In this case, best practices would require purposefully creating a forum for the family member to express her concerns. Importantly, it may also require resources and support for the family member to make her case to the group effectively.

A second situation concerns the interests of future generations. Most wealthy families are oriented towards preserving their wealth and legacy, but it is important to be explicit about the interests of future generations and ensure that their voices are represented. This goes beyond a commitment to preserving and generating as much wealth as possible and requires thinking about the sort of world these generations will be living in as they grow to maturity. For example, it is possible that norms and expectations around environmental concerns will shift over time. Moreover, how will the actions of the family and the family business be judged when current norms have changed?

A third situation concerns the interests of less able family members (for whom there is often sympathy) or those less willing to work (for whom there is little or no sympathy). How should the family allocate resources and responsibilities to such members, knowing that they might fall short of the standards expected of others?

There are no easy answers to these questions, but it is in the best interests of every family to think about them early and well before events over which they have no control engulf them in a crisis.

KNOWLEDGE CHECK

1. Identify two ways a wealthy family's lack of professionalism and transparency about decision making might hinder good family governance.

   Solution:

   A lack of professionalism and transparency about their decision-making processes with some family members may prove problematic, especially for the next generation, as they may find themselves ill equipped to assume a leadership role in matters involving the family's wealth when the time comes.

   A lack of transparency about their decision-making processes with those outside the family may also prove problematic, as it is likely to complicate the work of external advisors including the family's private wealth advisor and other external parties involved in managing the family's wealth.

Structures and Processes that Support Family Governance

Distinct structures and processes can be established that support family governance, some of which include:

- A **family mission statement** is an aspirational statement that reflects a family's shared values and commitments. It can be shorthand for making decisions in complicated or novel situations: for example, when there are potentially conflicting views on intergenerational wealth transfers (i.e., the children might want more wealth transferred than their parents are willing to part with) or on which charitable causes to support.
- A **family council** is a select group of family members who act as a representative body that makes decisions on issues concerning family wealth and family business. In smaller families, the family council may comprise all family members. In larger families, a process is established to select representatives.
- A **family advisory board** is a group of family members and non-family members that assists in setting a strategic direction and establishing priorities. Including external members can infuse valuable experiences from other wealthy families and add professionalism, transparency, and objectivity to the advisory board.
- A **family foundation** is a platform for focused philanthropy. It unites family members toward achieving common charitable goals.
- A **family constitution** is broader than a family mission statement and contains specific elements designed to operationalize the family mission statement, including, for example, a family council.

More specifically, a **family constitution** is a formal written agreement among family members that sets out the principles, values, and guidelines by which the family will interact with its wealth, including its family business(es), investments, and philanthropic endeavors. In essence, it is a living document that aims to provide clarity, continuity, and unity in the management and distribution of a family's wealth and the management of its affairs, particularly regarding succession. Each family's constitution will be unique, reflecting its values, goals, and challenges.

As we shall see next, family constitutions can cover a wide range of areas.

OUTLINE FOR A TYPICAL FAMILY CONSTITUTION

Preamble:

- Description: This section introduces the family's history, core values, and the purpose of the constitution. It sets the tone for the entire document.

1. Vision, mission statement, and values:

- Description: Here, the family states its collective vision and mission for its wealth and other assets. It also defines the family's shared values, which can guide decision making.

2. Governance structure:

- Description: This section outlines how the family will make decisions, specifying roles and responsibilities. This may include the creation of a family council, its composition, frequency of meetings, and decision-making processes, as well as advisory boards, family office boards, and other structures.

3. Family business policies:

- Description: If there is a family-owned business, this section defines policies related to ownership (buy–sell agreements), employment, compensation, leadership transition, and involvement of family members.

4. Investment and wealth management:

- Description: This section provides guidelines for managing, growing, and distributing the family's wealth, including investment principles, risk management, and diversification strategies.

5. Succession planning:

- Description: This section sets out how leadership roles and ownership stakes will transition between generations or in the event of unforeseen circumstances.

6. Philanthropy and charitable giving:

- Description: If the family is involved in philanthropic activities, this section will outline their giving philosophy, the decision-making process for charitable contributions, and any long-term commitments.

7. Conflict/dispute resolution:

- Description: A critical component, this sets forth mechanisms to manage and resolve disagreements among family members, potentially including mediation or arbitration.

8. Education and mentoring:

- Description: This section includes plans for ensuring family members are educated about their roles, responsibilities, and the intricacies of wealth management. This can also include mentoring newer members for roles they might take up in the future.

9. Code of conduct:

- Description: Here, a set of behavioral guidelines is established for family members, ensuring interactions remain respectful, professional, and in line with the family's shared values.

10. Review and amendment procedures:

- Description: This section includes provisions for how and when the constitution will be reviewed and the processes to amend it, ensuring its relevancy over time.

Some of these areas may not apply to every private wealth client or wealthy family, but the critical point is that each family's constitution will reflect its (often unique) needs. Moreover, as noted, it should be viewed as a living document that evolves to meet the dynamic needs of the family. Finally, the family constitution must be drafted by the family, or at least with significant participation by the family. Family members should be able to see themselves and hear their voices when they review the document. If not, a family constitution will lose its unifying and motivating force. These concepts may seem abstract, so we now meet the Martinez family and see how their private wealth advisor can use these ideas in working with them.

CASE STUDY

The Martinez Family

Tomas and Carina Martinez, who are 65 and 63 years old, respectively, are long-term clients of your private wealth firm and are considering the disposition of their family construction company. Tomas's father, Enrique, began working as a contractor in the 1970s, but in the 1980s he founded his own construction company. He started with smaller home construction projects and eventually became a respected residential construction company. By the mid-1990s, Martinez Construction Co., with headquarters in Memphis, Tennessee, was on its way to becoming a regional player in the Midwestern United States.

Tomas took over the family firm in the early 2000s after several years of bitter battles with his two brothers that were sparked by their father's death. This difficult period ended with Tomas buying out his brothers' ownership stakes. With his wife Carina's help, Tomas transformed the company into one of the strongest regional players in the Midwest. Tomas, who has been CEO since the buyout, credits his success in running a large-scale construction company with his upbringing working on construction sites with his father.

Carina had been instrumental in the firm's success. She worked closely with Tomas, especially helping develop areas like marketing and hiring. As the business expanded, Carina took more of a backseat role to raise their three children: Tomas, Jr., Diego, and Katarina, who are 35, 30, and 28 years old, respectively. However, Carina has maintained an active interest in the business and focused on creating and maintaining a family-like culture among the contractors and specialists that Martinez Construction employs. Both Tomas and Carina believe that their strong business culture played a crucial role in the firm's success through a variety of up and down markets.

Growing up, all three children worked in the family business during school breaks. Tomas and Carina insisted the children learn the business from the ground up, and they cycled through various rotations in the office and on construction sites. Tomas, Jr., willingly worked summer jobs for the firm and was well liked by the long-time staff and seasonal contractors. However, no one was surprised when he left home to pursue a degree in music at a prestigious New York conservatory. Diego attended an Ivy League university and earned a degree in financial economics. He worked at the company headquarters all through his college years and then accepted a role on the finance team upon graduation and has worked his way up to the CFO position. Katarina, who has her father's entrepreneurial spirit, left college before graduation to marry and begin her family. Three years ago, she founded a catering company, which received recognition for its high-end take on Memphis barbeque and has expanded from 3 employees to 10 employees.

Tomas and Carina hoped to sell the family construction business several years ago. However, the onset of the COVID-19 pandemic changed their plans. While business was good, supply chain issues caused challenges in existing projects and made planning future work difficult. Tomas felt uncomfortable exiting the business with the economy and society in crisis. Relying on his long-standing relationships with suppliers and deep ties in the local communities he served, Tomas led the firm through the pandemic years, but at significant personal cost.

He and Carina are now eager to move on to the next phase of their lives and have sought their private wealth advisor's support and guidance in determining how best to proceed.

Tomas believes he has three options at this stage, as shown in Exhibit 25:

Exhibit 25: Options for Disposition of Martinez Construction Co.

1. Merger/modest liquidity event	Merge his company with a national player and receive a significant immediate payout plus a stream of payments over the next several years, totaling $80 million, as well as a 10% equity stake in the merged company. Tomas believes that he can negotiate roles for his children at the acquiring company.
2. Sale/major liquidity event	Sell the company outright to a national player for a lump sum payment of around USD325 million
3. Transfer ownership/no liquidity event	Transfer majority ownership of the company to his three children and keep a minority stake for himself and Carina

Part of Tomas's planning was to ensure that his children were willing and able to effectively manage the expanding company that Martinez Construction Co. has become (plans that may not be realized). Moreover, both Tomas and Carina were hurt by the long years of friction with his brothers after their father's death and were deeply marked by the financial sacrifices they made to purchase the business from his brothers. While the relationships with the brothers and their families have improved, they are still strained.

Tomas and Carina have reached out to your firm for assistance in establishing a family governance structure that can help them and their children avoid the troubles that plagued their succession as business owners. They seek your guidance in developing a family constitution that outlines important issues of governance for the family business as well as for the family office that Tomas and Carina would like to create. The focus of the family office will be growing intergenerational wealth through a range of diversified public and private investments and philanthropy supporting climate research, medical research aimed at preventing future pandemics, and early childhood education in disadvantaged communities.

Most family constitutions are developed at the behest of the second generation (the first generation of inheritors) and typically only after the sibling cohort has witnessed an unsuccessful succession event.

In this case, Enrique was the first-generation acquirer of wealth. Tomas and Carina are the second generation: inheritors of wealth who have experienced a painful succession event with Tomas's brothers. They now want to avoid an adverse succession event in their own family, motivating them to create a family constitution.

KNOWLEDGE CHECK:

1. Which section of a family constitution typically outlines how the family will make decisions, specifying roles and responsibilities?

   A. Family business policies

   B. Governance structure

C. Conflict and dispute resolution mechanisms

Solution:

B is correct. The governance structure section outlines how the family will make decisions, specifying roles and responsibilities. It may include the creation of a family council, as well as advisory boards, family office boards, and other decision-making structures.

A is incorrect because the family business policies section outlines policies related to family business ownership, employment, compensation, leadership transition, and involvement of family members, not how the family will make decisions, specifying roles and responsibilities.

C is incorrect because the conflict and dispute resolution section outlines how to manage and resolve disagreements among family members, not how the family will make decisions, specifying roles and responsibilities.

Steps to Develop a Family Constitution

There are five key steps to developing a family constitution, as shown in Exhibit 26.

Exhibit 26: Initial Fact-Finding Steps in Developing a Family Constitution

	Description
1	Interview each family member to determine the current state of decision making within the family, as well as any issues — such as a change in family structure due to an impending marriage or divorce — that may influence the process of drafting the family constitution
2	Communicate the purpose and value of a family constitution, including promoting transparency, fairness, and inclusion in family governance to each family member to ensure their engagement and support
3	Draft a memo that articulates the current structure of the family decision-making process, as well as its strengths and weaknesses
4	Call a meeting to discuss the results of the interviews and memo and solicit feedback from the group
5	Finally, ask for the commitment of each family member for their active partition in the writing process, and then create the family constitution

Family interviews

Family interviews are an essential component in the process of developing a family constitution. As with any map, it is necessary to know where you currently are and where you want to go to chart the right path. These interviews can be time-consuming for the private wealth advisor and their team. However, they are an indispensable step and essential to gaining the trust of each stakeholder in the process. In the case of the Martinez family, their private wealth advisor knows Tomas and Carina very well, and thus embarks on a series of interviews with their three adult children. The advisor's findings are summarized in the following example.

CASE STUDY

Findings from the Martinez Sibling Interviews

Tomas Martinez, Jr., Age 35

Tomas, Jr., is the Martinez's eldest child, the one who has an intuitive feel for the construction business. So, Tomas and Carina were disappointed when he decided to embark on a career in music after college. Based locally, his current job is managing a chamber orchestra in which he plays classical trumpet. However, Tomas, Jr., enjoys the blues/jazz scene in Memphis and can be seen most nights performing in a local band that is building a loyal fan base. These two activities generate sufficient income for Tomas, Jr.'s, modest living expenses but are not adequate to build any significant savings. His main asset is a small downtown apartment that he purchased with help from his parents after college and which has appreciated significantly in value.

Tomas, Jr., has a warm and loving relationship with his parents but a mixed relationship with his siblings. He is ambivalent about working in the family business, especially since it would mean working with Diego, who seems happy to carry on the family business himself. Also, while he had a series of long-term relationships, Tomas, Jr., has, so far, not married and does not seem inclined to do so: he prefers the late-night music scene to settling down. He is happy to meet with you for his parents' sake, but since he has minimal personal wealth and no heirs, he does not think it will matter much to him.

Diego Martinez, Age 30

Diego grew up in his family's construction business. He has vivid memories of his parents working long hours as the business expanded into a prominent regional residential developer. When they were younger, Diego and his siblings were expected to work during school breaks at the company, and while they drifted away from the business, Diego found a home with the finance team, deeply enjoying the quantitative work. His talent, strong work ethic, and connections meant that Diego was destined to eventually take over the role of CFO, which he did earlier this year.

Diego has decidedly different attitudes than his family about the importance of demonstrating the tangible results of financial success. Upon taking on the CFO role (and the 5% ownership stake in Martinez Construction Co. that came with it), Diego and his wife, Michelle, built a large home in one of the most affluent areas of Memphis. Their two young children attend an exclusive (and expensive) private school, where Michelle is involved with the parent–teacher association, and Diego is on the school's board of directors. They also joined one of the most exclusive country clubs and are fixtures on the Memphis society scene, often hosting charitable events and political fundraisers in their spacious and lovely home.

Diego has a close relationship with his parents and less so with his siblings, but they all seem to disapprove of his conspicuous consumption. Diego and Michelle have not engaged in any comprehensive financial planning, but his investments are managed by a college friend who runs a New York hedge fund. As a part of their exit planning from the business, Diego's parents have requested that he meet with you, their private wealth advisor, to work through the details of the transition.

Katarina Martinez, Age 28

Katarina recently divorced her husband of 8 years, Douglas, after an extended separation. Katarina and Douglas have two children. Douglas's drug problems created a difficult financial situation for her and the children, including significant credit card debt. Katarina returned to the workforce five years ago, putting her considerable culinary skills to use supporting a friend's restaurant with its banqueting and corporate events. She enjoyed the work enough to start her own small catering business, which now enjoys local recognition and sufficient financial success to enable the hiring of additional staff and to pay herself a consistent monthly salary.

Katarina has worked diligently at paying down her debts, and although her parents have often offered to help, Katarina has refused. Her compromise was to allow them to make the mortgage payments on her home during the divorce so her children's lives would not be disrupted. At their insistence, Tomas and Carina pay premiums for her family's health insurance and contribute to college funds for her children. Frankly, Tomas and Carina would like to do more for their only daughter.

Katarina is reluctant to accept any money from her parents beyond what is needed to help support her children. She is also unwilling to exacerbate the often difficult relationship with her brother Diego, who seems to have a mental calculator that tracks every dollar of financial support she receives from their parents. Katarina is aware of her parents' intent to sell the family business and is ambivalent about meeting with you. She is not proud of her financial history and avoids thinking about finances whenever possible. However, Katarina feels her catering business is at an inflection point, and an infusion of capital would allow her to buy better equipment and hire more staff. The opportunity to scale up could create some financial cushion for her family and might even be the start of something big for her.

Finally, it is essential to note that Tomas, Jr., Diego, and Katarina agree that climate risk is a key risk for humanity, so climate and other environmental considerations must be taken into account however the family decides to expend its wealth in the future.

From these interviews, you can get a sense of the family history and dynamics around wealth in the Martinez family. These observations of the Martinez family can be interpreted in several ways. Here are several interpretations to consider:

- It does not appear that Tomas and Carina have communicated much about their plans for a transaction involving their family business. The only child who is well informed about the overall finances of the business is Diego.
- Tomas, Jr., and Katarina appear ambivalent about their family's wealth and a possible future for them in the business. Some of their ambivalence results from concerns about working with Diego. Katarina feels judged by Diego for her choices around money and her personal life.
- The three children appear to have differing attitudes around their level of expectation and entitlement to the family wealth.
- It does not appear that the family currently has a decision-making process around financial matters.

Different Types of Money Scripts

There are many frameworks that assess an individual's attitudes about money, dating back at least to the *money attitudes scale* (Yamauchi and Templer [1982]) and the *money beliefs and behavior scale* (Furnham [1984]). More recently, the "money scripts" framework developed by Brad Klontz, a psychologist who specializes in issues of financial planning and wellness, has been validated in the literature and bears some resemblance to these early frameworks (Klontz et al. 2011). **Money scripts** function as unconscious "tapes" consisting of beliefs and attitudes about money that are informed and shaped by one's experiences as a child or a young adult. Money scripts can influence our behavior in unconscious ways (operating like unconscious biases). Importantly, money scripts are based on an individual's reactions to life events, and consequently, people can develop different money scripts from the same or similar experiences.

As shown in Exhibit 27, there are four types of money scripts.

Exhibit 27: Four Different Types of Money Scripts

	Money script type	Description
1	**Money worship**	People who tend to believe that personal happiness is equated with their level of wealth
2	**Money status**	People who tend to believe money is a good indicator of other admirable traits (such as power, intelligence, and personal character)
3	**Money avoidance**	People who tend to be ambivalent about wealth, often attributing wealth to bad outcomes, and are fearful of becoming too preoccupied with financial matters
4	**Money vigilant**	People who tend to emphasize frugality, who have a sense of scarcity and who are discreet about their financial matters, often so that others remain unaware of their true wealth

Money scripts have been shown to be related to personality types and to influence financial decision making. Money scripts also allow the private wealth advisor to tailor communications and framing to their client's particular money script to improve the quality of the client's decision making. For the Martinez family, this money script framework suggests the following:

- Tomas and Carina are likely in the *money vigilant* category;
- Tomas, Jr., and Katarina probably fall into the *money avoidance* category; and
- Diego is likely in the *money status* category.

While there are no strict rules around the interpretation of the money script categories, they can help the private wealth advisor think about how to approach members of the client's family, both individually and in groups.

Communicate the purpose and the value of a family governance structure

A significant portion of the private wealth advisor's role often consists of advocating for courses of action that are in the best interest of the client. It is helpful to be reminded that individuals working as private wealth advisors have the responsibility to act as fiduciaries, continually looking out for the best interests of the clients. Also, the commitment to maintaining confidentiality when speaking with individual family members is crucial.

One challenge for the private wealth advisor is knowing exactly who the client is as they navigate complicated family relationships. In this regard, a useful concept from the field of family therapy is **multi-partiality**, in which the private wealth manager takes the sides of all family members simultaneously. "When this is achieved, each person feels that their concerns, hopes, and goals are as valid and important as those of every other person and that he or she, along with everyone else, is being supported. . . this is better than the negative term 'neutrality.' The key point is that it is preferable to take everyone's side than to take no one's side." (Anderson 1997).

One component of multi-partiality is being purposeful (or intentional) in taking the perspective of each family member that the advisor tries to convince about the value of family governance and why participating in the process is essential to the project's success. There are four key benefits of *intentional* family governance that the private wealth manager can share with individual family members, as shown in Exhibit 28.

Exhibit 28: Four Key Benefits of Intentional Family Governance

	Intentional family governance.
1	Supports a more efficient succession planning process.
2	Helps create a structure to resolve conflicts.
3	Clarifies roles and responsibilities and helps set appropriate expectations.
4	Promotes family cohesion and unity.

We now briefly describe the four elements of intentional family governance.

1. Strong succession planning

   As mentioned previously, one of the main drivers for initiating a family governance process is the challenges around succession planning. A strong succession strategy begins with a statement of the ideal end state. For example, *"At the end of this process, we would like to have crafted an exit strategy where we can live comfortably on the sale of the minority stake, while the three children have found fulfilling roles within the family business."*

   This definition of success, from Tomas and Carina's perspective, may be quite different from what might result when considering the perspectives of their children. It would be surprising if each family member were in complete alignment at the outset. However, the important point is to identify these differences at the beginning of the process.

2. Resolve conflicts

   Drawing on lessons from corporations, consider the role of the human resources department. Besides being responsible for recruiting and hiring activities, they are charged with resolving conflicts between employees or between employees and managers. Such conflict resolution is typically done through a formal process, where each stage is carefully determined in advance and must be signed off on by the affected parties. Sound family governance provides a similar structure for resolving conflicts between family members.

   Relatedly, research on procedural justice shows that people are more willing to accept adverse outcomes if they believe the process was fair and transparent. It may feel difficult to impose a formal process on a family unit that is typically bound together through bonds of affection and shared experiences, but a robust conflict resolution process can be a crucial element of strong family governance.

3. Clarify roles and responsibilities

Strong family governance creates the opportunity to distinguish specific roles and responsibilities as well as any necessary hierarchies. A leading source of friction in family firms and family offices is a lack of clarity among roles. So, to the extent possible, it is helpful to recast statements such as

- "Tomas does this" or "Diego does that" . . .

into something more specific, like

- "The responsibilities of Tomas, as the CEO of the firm, are…" or "The CFO, Diego, is responsible for doing . . ."

Roles clarify scope and responsibilities and set expectations appropriately.

4. Promote family cohesion and unity

   Strong family governance can promote family cohesion and unity. The process of collaborating on a family mission statement, for example, can align family members with the endorsement of shared values.

KNOWLEDGE CHECK:

1. In which money script category would the person making the following statement to their private wealth advisor *most likely* be placed?

   "We are already pretty wealthy, but I'm sure that the more wealth my family and I amass, the happier we will all be."

   A. Money avoidance

   B. Money status

   C. Money worship

   Solution:

   C is correct. A money worship person tends to believe that personal happiness is equated with their level of wealth, which is the sentiment expressed in the statement.

   A is incorrect because a money avoidance person is ambivalent about wealth and fearful of becoming preoccupied with financial matters, not someone who wants more money to be happier.

   B is incorrect because a money status person desires wealth as an indicator of admirable traits, like power and intelligence, not someone who wants more money to be happier.

Moving Forward

After you have communicated the value of participating in a family governance process, you should complete the remaining steps:

- Draft a report that articulates the current structure of the family decision-making process as well as its strengths and weaknesses.
- Call a meeting to discuss the results of the report and listen to feedback from the group.
- Ask for the commitment of each family member to begin the family constitution writing process.

Now, fast-forward four months. After many meetings, some smoother than others and facilitated by your expert guidance, all members of the Martinez family have participated in writing the family constitution, and all have agreed to abide by it.

Here is a brief snapshot of how the process unfolded:

- You started with a half dozen bullet points that you felt needed to be addressed by a family constitution. At a meeting with all Martinez family members present, you shared these key points and asked them to add or subtract bullet points as they saw fit. You edited the list on your computer in full view and, at the end of the meeting, e-mailed each family member the set of bullet points that they all agreed should be included in their family constitution.
- Next, you fleshed-out each of the bullet points. Each week, you met with one or two members of the family, interviewed them further, and translated their comments into a summary that they then reviewed and approved, and then you wove their comments into a draft constitution.
- Every week the draft constitution expanded as you incorporated more views and voices, and each month you shared your current draft with the entire Martinez family, asking for their collective comments. You combined these comments, further fleshed out the draft constitution, and then recirculated it to all family members before interviewing the next group.
- After four months of work, you incorporated all their comments and views, and then you finalized the draft constitution. Once done, you called a meeting and shared the draft with the entire family for their final comments, which you then incorporated on the spot. Finally, you led them through a vote on adopting the final version of the draft constitution, which became the Martinez Family Constitution.

Now let's look at a high-level sample version of your work with the family.

MARTINEZ FAMILY CONSTITUTION

Preamble:

• The Martinez Family Constitution is established to promote unity, transparency, and continued prosperity across generations, keeping in mind the legacy started by Enrique and nurtured by Tomas and Carina. Founded by Enrique Martinez in the 1970s, Martinez Construction Co. has grown from modest beginnings into a prominent regional player in residential construction. This constitution aims to preserve and expand on that legacy. As we, the Martinez family, contemplate the future of our legacy and our family's involvement, this constitution serves as a guidepost for transparent, inclusive, and fair decision making regarding our family's wealth and enterprises.

Vision, mission statement, and values:

• Our mission is to sustainably grow and manage our family wealth and legacy while upholding our core values of dedication, integrity, family unity, and community service. We aspire to be innovative leaders in residential construction and philanthropy, supporting causes like climate research, pandemic prevention, and early childhood education in disadvantaged communities.

Governance structure:

- The Martinez Family Council will comprise Tomas, Carina, Tomas, Jr., Diego, and Katarina. The council will convene quarterly to discuss family matters, the business, investments, and philanthropic endeavors. Decisions will be made through consensus, and in the event of disagreement, external mediation will be sought. Issues regarding the future of Martinez Construction Co., including disposition options (merger, outright sale, or transfer of ownership), will be debated until a collective decision is made. Also, philanthropy-related issues will be proposed, debated, and decided in the family council and implemented via the family office.

Family business policies:

- All family members wishing to join Martinez Construction Co. must complete a structured induction (i.e., orientation and training) process, regardless of their position or experience. This includes rotations at various departments and understanding the family-like culture of the firm.

Investment and wealth management:

- A substantial portion of the proceeds from any potential sale or merger of the construction company will be directed to the Martinez Family Office to be invested in diversified portfolios of public and private financial and non-financial assets. The focus will be on generating sustainable, long-term risk-adjusted returns, taking account of climate and other environmental considerations. The family office will also channel the family's philanthropic efforts.

Succession planning:

- While the direct succession of Martinez Construction Co. remains in discussion, Tomas and Carina envision creating a family office focused on growing intergenerational wealth and philanthropy. The portions of family wealth to be allocated to the family office for investment and philanthropic purposes will be decided by the family council.

Philanthropy and charitable giving:

- A significant portion of the family's wealth will be dedicated to climate research, medical research to prevent future pandemics, and supporting early childhood education in disadvantaged communities. A portion of any sale or merger proceeds of Martinez Construction Co. will be allocated via the family office to a charitable organization that awards research grants or scholarships in the mentioned fields.

Conflict/dispute resolution:

- Recognizing past familial conflicts, any disagreements among family members regarding business or family wealth matters, including the future of Martinez Construction Co. or financial support for family members, will be first discussed internally within the family council. If no resolution is reached, then external mediation will be sought.

Education and mentoring:

- To encourage the next generation's involvement, Diego, with his financial background, agrees to mentor Tomas, Jr., and Katarina on the intricacies of wealth management, ensuring they understand the responsibilities associated with the family's assets.

Code of conduct:

• All family members must uphold the Martinez family values, respecting each other's choices and maintaining the confidentiality of family discussions and decisions.

Review and amendment procedures:

• This family constitution will be reviewed every three years. Any amendments proposed by a family member will be discussed and voted upon in the family council and require a majority vote to pass.

Additional key topics: family office focus

• The soon-to-be-established family office will center on managing the intergenerational wealth derived from any liquidity event associated with the disposition of the Martinez Construction Co. Furthermore, it will channel philanthropic efforts, as envisioned by the Martinez family, into impactful initiatives.

Conclusion:

By drafting and agreeing upon this constitution, we, the Martinez family, pledge to prioritize our family's unity and shared values. We aim to safeguard the legacy created by Enrique and built upon by Tomas and Carina, ensuring that future generations can thrive and contribute meaningfully to society.

Incorporating Tomas, Jr., and Katarina into the Family Constitution Process

Getting all adult members to participate in creating a family constitution may not be easy, especially if there is a history of friction between some members. In the case of the Martinez family, it required significant time and effort on the part of their family's private wealth advisor to convince Tomas, Jr., and Katarina to join in the process. Here are some strategies the advisor likely used to succeed in this matter.

1. Convincing Tomas Jr. and Katarina to join the family council

   Strategies include

   - highlighting the importance of their unique perspectives, ensuring all family members feel included and valued;
   - assuring them that the conflict resolution process enshrined in the family constitution will be transparent, fair, and robust;
   - emphasizing the legacy aspect — being part of the family council is not just about business, but it is also about preserving the family's history, ethos, and values; and
   - reminding them of the broader philanthropic goals that may align with their passions. For Tomas, Jr., his passion for music might translate into support for the Memphis Symphony Orchestra and even some local bands. For Katarina, her passion for entrepreneurship might translate into substantial support for her expanding catering business as well as for other local entrepreneurs with businesses that fit the family's values.

2. Receiving financial mentoring from Diego:

Strategies include

- positioning this not as a "lesson" but a "sharing session" where Diego's intentions are good and he genuinely wishes to impart knowledge about managing and growing wealth;
- emphasizing Diego's achievements as CFO and how his expertise can benefit the entire family, including Tomas, Jr.'s, and Katarina's ventures; and
- organizing joint sessions where all the siblings share and learn from each other, harking back to their fun days growing up as children together and fostering a renewed sense of unity and mutual growth.

By emphasizing the importance of family unity, legacy preservation, and mutual growth, Tomas, Jr., and Katarina can be encouraged to take more active roles within the family's decision-making processes and benefit from its collective expertise.

Conclusion

Working with wealthy families involves much more than simply investment management. Private wealth advisors need to navigate a series of non-financial issues to support effective communication and decision making. Doing so requires

- an understanding of the unique experiences of UHNW families and the unique perspectives of their members;
- techniques to effectively communicate and make decisions; and
- sound governance to avoid and manage conflicts and promote professionalism.

The process demands a multi-dimensional, multi-disciplinary approach that requires the wealth manager to develop broad-based skills. They need not (and cannot) be an expert across the various domains. They must, however, develop enough proficiency to build trust with their client, identify important issues and challenges, connect a family with relevant subject matter experts, and facilitate a process for the proper resolution of these issues.

QUESTION SET

1. All of the following are structures that are useful for supporting family governance, *except*:

   A. family councils

   B. MFOs

   C. family constitutions

   Solution:

   B is correct. An MFO is not generally a structure that is useful for supporting family governance. It typically has many wealthy families as its clients; consequently, the MFO may not align neatly with the goals of any individual family.

   A is incorrect because a family council, a select group of family members who act as a representative body that makes decisions on issues concerning family wealth and family business, is a structure that is useful for supporting family governance.

C is incorrect because a family constitution, a formal written agreement among family members that sets out the principles, values, and guidelines by which the family will interact with its wealth, including its family business(es), investments, and philanthropic endeavors, is a structure that is useful for supporting family governance.

2. Which section of a family constitution typically outlines how leadership roles and ownership stakes will transition between generations or in the event of unforeseen circumstances?

   A. Vision, mission statement, and values

   B. Governance structure

   C. Succession planning

   Solution:

   C is correct. The succession planning section of a family constitution typically sets out how leadership roles and ownership stakes of the family will transition between generations or in the event of unforeseen circumstances.

   A is incorrect because the vision, mission statement, and values section states the family's collective vision, mission for its wealth, and its shared values, which can guide decision making.

   B is incorrect because the governance structure section outlines how the family will make decisions, specifying roles and responsibilities. It may include the creation of a family council, as well as advisory boards, family office boards, and other decision-making structures.

3. Describe an individual belonging to the money script category "money status."

   An individual classified as being in the "money status" category is someone who tends to believe that money is a good indicator of other admirable traits such as power, intelligence, and personal character.

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PRACTICE PROBLEMS

The following information relates to questions 1-4

Michael (age 60) and Sarah (age 58) Hershberg are married with two children, Jessica (age 24) and Adam (age 22). Jessica recently graduated from university as a software engineer and moved to San Francisco to take a lucrative job. Adam is disabled and likely to remain dependent on his parents for significant portions of his needs.

Michael earned an MBA degree and worked as an investment analyst for 10 years until his father became ill, at which point he left the investment industry to manage his father's real estate investments. These investments totaled 100 residential rental units in Newark, New Jersey and surrounding areas. A total of 10 of the units are co-owned by the family of another investor (they have a 25% interest) with whom Michael's father started the business. Although trained as a real estate attorney, Sarah has never been formally involved in the management of the properties, but Michael often seeks her advice on legal matters.

Under the agreement with his father, Michael drew a large salary for managing the business and paid out most of the remaining cash flow to his parents. Upon his father's death, the business was inherited in equal parts by Michael and his mother, with the understanding that Michael would continue to draw a salary and pay out the bulk of revenues to his mother while she remains alive. Michael has also expanded the portfolio and now manages a total of 130 units: 30 units he owns directly, 90 units he co-owns with his mother, and the initial 10 units they co-own (75%) with the other investor family (25%).

The minority-investor family have been passive investors during Michael's tenure as manager. They are seeking liquidity but are unhappy with Michael's offer to buy them out, as this entails a 30% discount from the independently appraised value of the properties to reflect liquidity and minority interest discounts. They want him to sell the properties so that they would be entitled to their full share of any proceeds, and comparable properties are now selling well above appraised values. Although Michael is unhappy with the existing arrangement, due to the additional complications of accounting for the minority stake, he is reluctant to sell these properties since they were the original ones his father bought and both he and his father put in a great deal of effort to bring them to their current state. Michael also feels strongly that the other family should accept his discounted offer, reasoning that no third-party investor would pay the full price for a minority interest, so why should he? As a result, the two parties are deadlocked and reluctantly continue the existing arrangement.

A short time later Michael's mother passes away, and he inherits her interest in the business. No longer paying out a significant share to his mother, Michael suddenly realizes the substantial level of wealth he controls. He feels a bit overwhelmed by the situation, as he belongs to a religious community that frowns on lavish displays of wealth. He also realizes that the need to care for Adam may require a considerable portion of the income.

1. In the context of a family system, the payments to Michael's mother *most likely* represent:

A. clear roles.

B. a shared set of norms.

C. an established power structure.

2. The deadlock with the other family regarding their minority interest in the original 10 properties is *most likely* the result of differing cultural attitudes toward:

A. power distance.

B. long-term versus short-term orientation.

C. masculinity versus femininity.

3. Michael's reluctance to sell the co-owned properties *most likely* represents which of the following behavioral biases?

A. Availability heuristic

B. Endowment effect

C. Hindsight bias

4. Which of the following factors is *most likely* to help Michael integrate his wealth identity?

A. Family system

B. Life stage

C. Culture and religious beliefs

The following information relates to questions 5-8

Enzo (age 63) and Maria (age 62) Lanza recently sold Enzo's Milan-based specialty fabric business for EUR20 million. Although the business offered reasonably high income, they never really considered themselves wealthy. After the liquidity event and a brief splurge on some luxury items, the Lanzas began considering their long-term spending needs and legacy planning. They now understand that being wealthy is part of who they are, but it's not everything.

Gianni Como, Enzo's long-time and best friend, holds a PhD in finance from Bocconi University and works for a highly regarded international investment company. Although he has no experience with private wealth clients, Enzo trusts Gianni to offer impartial advice and to be clear about the limitations of his knowledge.

The Lanzas have two children, Paolo (age 35) and Theresa (age 32). Both have degrees in computer science and began successful careers after university. However, after working for five years, Theresa took a six-year break from her career to raise her two young children. Although Theresa could return to work at any time, her prolonged absence from the "tech" business would result in a substantially lower salary compared to Paolo's salary. Having made a similar sacrifice herself, Maria wants to help Theresa by supporting her grandchildren's education and by offering lifetime gifts and a larger share of the inheritance (than Paolo's share) to offset Theresa's performance of uncompensated work as a homemaker.

5. The Lanzas are *best* classified as:
   - **A.** HNW.
   - **B.** VHNW.
   - **C.** UHNW.

6. The current stage of the Lanzas wealth identity is *most likely*:
   - **A.** the honeymoon phase.
   - **B.** the achieving balance phase.
   - **C.** the identity consolidation phase.

7. Enzo's trust of Gianni Como is *most likely*:
   - **A.** affect based only.
   - **B.** cognition based only.
   - **C.** both affect based and cognition based.

8. Which principle of fairness is *most* consistent with Maria's views toward lifetime gifts and an enlarged inheritance for Theresa?
   - **A.** Principle of fair allocation
   - **B.** Principle of equality
   - **C.** Golden rule

The following information relates to questions 9-12

Edgar Corrigan (age 55) grew up in the oil business. His father started an independent drilling company, which developed into a large business during the shale oil boom in the United States. Edgar inherited this business upon his father's death two years ago and then sold the company to a major global oil firm, netting him USD100 million worth of that company's stock. The shares pay annual dividends of USD3.5 million currently — well above the amount necessary to sustain the Corrigans' lifestyle (Madeline Corrigan is 53 years old). Feeling pressure to diversify their wealth, manage this legacy, and venture into appropriate philanthropic activities, they consult with Anthony Torrent, a private wealth advisor.

The Corrigans have two children. At their parents' insistence, both children attended elite private universities. After earning a finance degree, Greg (age 28) began work in the family oil drilling business. However, he was not retained when the company was sold, and has since applied sporadically for jobs with little success. Greg is concerned he will not be able to succeed on his own. Sarah, 23, recently graduated with a degree in fine arts.

While at university both children faced unpleasant realities related to their family's newfound wealth. In some cases, people whom they believed to be friends or romantic partners turned out to be more interested in potential financial benefits of their relationships. In addition, the fact that their family's wealth was derived from fossil fuels often made them targets of environmental protests, a situation that was always stressful and sometimes posed physical danger. Sarah and Greg would like the family to divest itself of the oil company shares and to focus on philanthropic activities related to environmental issues as a means of "atonement." Sarah, in particular, is also concerned about becoming too preoccupied with financial matters.

In speaking with the Corrigans, Torrent attempts to understand the family's values. He asks each of them to select from a group of 25 notecards the three to five cards with statements that best align with their beliefs about what is important in life. All family members do so, and there is little overlap among the values chosen by each individual. One common thread is "courage," which Edgar relates to making difficult choices, Madeline relates to achieving family unity and alignment, Greg relates to confronting the challenges in finding a new job, and Sarah relates to taking a stand against the source of the family's wealth. Sarah reiterates her desire to promote environmental goals, which she has begun doing by volunteering her artistic talents to an environmental charity.

At the end of the initial meeting, Torrent remarks that "Although there are some differences among your individual preferences, it seems to me that you are all in agreement regarding the need to diversify away from a complete reliance on oil industry–related wealth and to develop a philanthropic vision that incorporates the most significant values of each family member. Is this correct?"

9. Describe three ways in which the Corrigan family faces the "inheritor's dilemma" around creating an individual identity that is both separate from and integrated with their wealth.

10. Sarah's attitude toward wealth is *most* consistent with which money script?

A. Money worship

B. Money status

C. Money avoidant

11. Which of the following is *most likely* a challenge related to the family's value system?

A. Polysemy

B. Choice overload bias

C. Social desirability bias

12. Torrent's comment at the end of the initial meeting is *best* described as an example of:

A. theming.

B. miracle question.

C. scaling question.

The following information relates to questions 13-16

As he continues working with the Corrigan family, Torrent considers the ways in which their financial planning needs differ from the traditional domains of investment management, risk management, and retirement planning. He suggests that they form a family office, and to consider which type of family office would be most appropriate, Torrent interviews the Corrigans again.

Moreover, as the family currently has little experience managing their approximately USD100 million of wealth, Torrent observes that an important part of good family governance, which the Corrigan family needs, is a formal written agreement among family members that sets out the principles, values, and guidelines by which the family will interact with its wealth, including its family office, investments, and philanthropic endeavors.

13. Describe three ways in which financial planning for the Corrigans, as an UHNW family, will likely differ from traditional financial planning.

14. Describe one advantage and one disadvantage of an MFO for the Corrigan family.

15. An SFO established by the Corrigan family would be *best* suited as:

A. a preserver SFO.

B. a founder SFO.

C. an EFO.

16. Identify and describe the family governance structure referred to by Torrent.

SOLUTIONS

1. B is correct. A shared set of norms can be described as informal, mostly unwritten, rules that set expectations for appropriate behavior within a family system or a community system. There is no indication that the payments are required by any formal agreement; rather, they are an understanding and Michael's sense of duty toward his mother.

   A is incorrect because the clear roles, with Michael as the manager and holding an equal ownership share, would suggest that the payout is more skewed in his favor.

   C is incorrect given that his mother never took an active role in the business; it is also unlikely that her outsize payout represents an established power structure.

2. A is correct. Michael's dominant share gives him the ultimate decision on how the property is distributed, and he appears inclined to exercise this power by refusing to pay more than the minimum amount necessary, even though he is unhappy with the existing situation. By contrast, the other family members appear willing to challenge this authority, indicating differing views toward power distance.

   B is incorrect because long-term versus short-term orientation relates to the extent to which individuals or society value distant rewards over present experiences, and the deadlock indicates that both sides are willing to wait for a potential better outcome in the future.

   C is incorrect because masculine and feminine values of success and materialism, and of caring and cooperation, respectively, are not directly relevant to the deadlock situation.

3. B is correct. The endowment effect leads people to value an object more highly if they own the object than they would if they do not own it. Refusing to sell at a time when buyers are offering well above appraised values on comparable properties likely indicates that Michael exhibits the endowment effect.

   A is incorrect because availability heuristic refers to overweighting readily available information. The notion that Michael and his father put substantial work into the original properties long ago is nebulous and not reflective of availability heuristic.

   C is incorrect because hindsight bias is not applicable, since Michael is not putting a previous decision in a context that portrays him as having made a better, more well-informed choice.

4. A is correct. The family system can provide clarity around wealth integration as Michael shifts from providing for his mother to providing for his adult child.

   B is incorrect because life stage makes it more difficult, as mature adults often find it more difficult to adapt to a new wealth identity.

   C is incorrect because Michael's situation is exacerbated by the religious community's disdain towards displays of wealth.

5. B is correct. VHNW individuals have USD5 million to USD30 million in investable assets, so the Lanzas approximately EUR20 million of wealth puts them in that category.

   A is incorrect because HNW individuals have USD1 million to USD5 million in investable assets.

   C is incorrect because UHNW individuals have more than USD30 million in investable assets.

6. C is correct. In the identity consolidation phase, there is increased internalization of the idea of oneself as the possessor of wealth. In this phase, individuals move away from the idea of their wealth as somehow external and foreign and towards an understanding of being wealthy a part of their identity, not the whole of it.

   A is incorrect because in the honeymoon phase, an individual flush with newly acquired wealth goes on a spending spree, often making impulsive purchases.

   B is incorrect because in the achieving balance phase, the wealthy individuals achieve full responsibility for their wealth through initiating a life plan where money is seen as a resource to fulfill personal needs and goals.

7. C is correct. Affect-based trust refers to trust from the heart, a bond that arises from one's own emotions and a sense of the other's feelings and motives. Cognition-based trust refers to trust from the head, a judgment based on evidence of another's competence and reliability. Como has no experience with private wealth clients. However, he is Enzo's long-time friend and Enzo emotionally trusts Como to act on his behalf, which is indicative of affect-based trust. Moreover, Como's PhD degree in finance from Bocconi University and his employment at a respected investment firm provide evidence of his overall competence and reliability. These factors are likely driving Enzo's cognition-based trust in Como.

   A is incorrect because, in addition to affect-based trust, as Como is Enzo's trusted long-time best friend, Como's impressive academic and employment credentials are likely driving factors for Enzo in cognition-based trust of Como.

   B is incorrect because, in addition to cognition-based trust, as Como has impressive academic and employment credentials, Enzo's long-time, best friend relationship with Como is likely a driving factor his affect-based trust of Como.

8. A is correct. The principle of fair allocation requires us to give each person that which is owed to them. This can involve balancing the claims of competing parties. By choosing to financially compensate Theresa for her decision to sacrifice employment compensation to raise her children, Maria is acknowledging the value of otherwise uncompensated duties and offering Theresa what she believes Theresa is owed.

   B is incorrect because Maria's views are inconsistent with the principle of equality, which would favor equal treatment of both Theresa and Paolo.

   C is incorrect because there is no evidence that Maria would want to be treated in the same way she wants to treat Theresa, which is needed for consistency with the golden rule.

9. The inheritor's dilemma is the combination of financial and emotional challenges faced by individuals inheriting significant wealth. It is marked by the pressure to manage and uphold the family legacy responsibly. Examples that demonstrate the inheritor's dilemma among the Corrigan family include the following:

   i. Lack of intimacy and contact with parents can result when wealthy families use their financial resources to exert greater control over the lives of their children. One example is the Corrigans' insistence that their children attend elite private universities.

   ii. Family isolation and distrust of others can arise when inheritors are subject to threats to their physical safety or when they are unsure of the motives of others who seek their time and attention. Greg and Sarah were subject to both situations during their university time.

   iii. Anxiety and fear can result from not knowing how individuals would respond if they were not able to rely on the family's wealth. Greg's difficulty finding a new job and his fear of failure without the family's resources are indicative of challenges related to the inheritor's dilemma.

10. C is correct. Money avoidant refers to people who tend to be ambivalent about wealth, often attributing wealth to bad outcomes and being fearful of becoming too preoccupied with financial matters, which is consistent with Sarah's expressed concern.

    A is incorrect because money worship refers to people who tend to believe that personal happiness is equated with their level of wealth.

    B is incorrect because money status refers to people who tend to believe money is a good indicator of other admirable traits (such as power, intelligence, and personal character).

11. A is correct. Polysemy refers to the fact that value terms can have multiple meanings. The different meanings that each family member assigns to the value of "courage" provides an example of polysemy.

    B is incorrect because choice overload bias occurs when an individual feels paralyzed into inaction because of the variety and abundance of options. Although the family members each chose different values, they were all capable of making their choices.

    C is incorrect because social desirability bias arises when an individual provides an answer that is more socially desirable than one based on their authentic feeling. Both children genuinely want to divest from the oil industry, and Sarah's preference for environmental charities is already supported by her volunteer actions.

12. A is correct. Theming is described as widening the lens away from areas of difference to explore the thematic significance of desired change and goals. The goals of "diversifying away from a complete reliance on oil industry wealth and developing a philanthropic vision" are common themes among the Corrigan family.

    B is incorrect because miracle questions invite the speaker to consider what life would be like if, overnight, all their problems disappeared.

    C is incorrect because scaling questions invite the speaker to rate a current situation, challenge, or opportunity on a numbered scale.

13. The needs of UHNW families like the Corrigan's differ from traditional financial planning in several important ways. These include the following:

    i. Estate planning is more complex. Larger amounts of wealth increase the importance of ensuring that assets are inherited by the right person(s) at the right time with minimal tax consequences. It will require significant planning to develop appropriate strategies and vehicles and will likely require estate planning attorneys with deep knowledge of local regulations in multiple jurisdictions.

    ii. Philanthropy is also of greater importance. In the case of the Corrigan family, it is likely that their philanthropic efforts may even be the way by which the family members form a cohesive identity.

    iii. Multi-generational issues are more prevalent. These include

       - the need for family governance to ensure inclusive decision making involving all family members and eventually the adult grandchildren, and beyond;
       - the need for leadership and transition planning, including for the family's advisors; and
       - the need to develop appropriate knowledge and financial education for the rising generation to ensure they can eventually take over leadership roles.

14. An advantage of MFOs is that they are typically adept and skilled at developing a family wealth strategy due to the diversity of their multiple clients. This, and MFOs' comprehensive services and breadth of resources, can help accelerate the learning curve for the Corrigan family.

    A disadvantage of MFOs, typically used by clients with around USD40 million of investable assets, is that they offer less personalized attention and typically standardized services. The Corrigan family's substantially higher wealth likely argues in favor of establishing an SFO, which would provide them with more personalized attention and customized/dedicated investment strategies and services.

15. B is correct. A founder SFO is controlled by the first generation of owners and is typically created because of a liquidity event from the sale of the family business. This is the case for the Corrigan family.

    A is incorrect because a preserver SFO is owned by later generations that still own the original family business.

    C is incorrect because embedded SFOs are typically set up within the family business and do not manage assets outside the business.

16. The family governance structure to which Torrent is referring is the family constitution. It is a formal written agreement among family members that sets out the principles, values, and guidelines by which the family will interact with its wealth, including its family business(es), family office, investments, and philanthropic endeavors. It contains specific elements designed to operationalize the family mission statement, including, for example, a family council and a family advisory board. A family constitution is a living document that aims to provide clarity, continuity, and unity in the management and distribution of a family's wealth and the management of its affairs, particularly regarding succession. Each family's constitution will be unique, reflecting its values, goals, and challenges.

LEARNING MODULE

3

Wealth Planning

LEARNING OUTCOMES

Mastery	The candidate should be able to:
☐	formulate goals-based financial plans and recommend appropriate strategies to achieve an individual's goals-based financial plans
☐	recommend and justify methods to manage a family's financial exposures holistically across their lifetime and retirement
☐	evaluate how the principles of taxation and taxes influence goals-based planning and holistic financial plans for individual investors
☐	recommend appropriate liquidity strategies for goal-based planning and holistic financial plans

INTRODUCTION

1

The third reading in the Private Wealth Management pathway covers wealth planning, including the creation of comprehensive wealth management plans that take into account financial goals and considerations such as human capital, taxation, and liquidity. The reading first examines how wealth managers can assist clients in achieving their goals, followed by an exploration of wealth planning that considers other assets, liabilities, and risk exposures that wealthy clients may have. The reading then discusses taxation and its impact on wealth management planning from a broader perspective before concluding with a focus on liquidity and liquidity risk management. The reading concludes with a comprehensive case study addressing investment policy statements, goals-based financial planning, wealth structuring, taxes, and liquidity planning.

LEARNING MODULE OVERVIEW

- Goals-based planning aligns an individual's financial resources with their unique goals and circumstances with the aim of achieving specific financial objectives. It prioritizes the attainment of financial goals over benchmark performance.

- The family extended balance sheet takes into account both explicit and implicit assets, liabilities, and surpluses that encompass all aspects of an individual's financial situation. Human capital is a large implicit asset, and the present value of lifestyle related expenses are a large implicit liability.
- The value of implicit assets and liabilities can be hard to quantify: their actuarial present values can only be estimated based on certain assumptions.
- Goals-based planning reflects behavioral and cognitive influences on decision making and aims to tailor asset allocation to specific financial objectives. The four steps in goals-based financial planning are defining goals, prioritizing and quantifying goals, structuring portfolios, and managing portfolios.
- The behavioral portfolio reflects non-discretionary lifestyle spending goals, discretionary lifestyle spending goals, philanthropic goals, and dynastic goals and matches these financial goals with distinct and appropriate subportfolios.
- Each subportfolio is tailored to meet a specific financial goal, time horizon, and the minimum probability of success measured by the likelihood of achieving the set financial goal.
- Financial goals change across life phases, reflecting shifts in time horizons, risk tolerance, and objectives. Providing family support and creating dynastic wealth transfer involves evaluating the impact it has on achieving financial goals and balancing incompressible spending needs with discretionary spending.
- Comprehensive wealth planning establishes appropriate and unequivocal legal ownership and ownership protection to safeguard wealth; minimizes costs, including tax liabilities on income and wealth determined by the investor's legal domicile; and proactively addresses potential conflicts within the family and between heirs and other stakeholders.
- Internally managed assets are assets for which the client generates value through their own activities and include the human capital from either traditional wage-based employment or a privately held business. Externally managed assets include assets managed by a hired external manager.
- For families with most of their wealth tied to human capital from a single business, it's essential to evaluate the company's sustainability. Selling a family-owned business monetizes the family's human capital and transforms an illiquid and hard-to-value asset.
- Asset structuring structures investments, business interests, or other financial holdings to maximize wealth. Creating legal entities that own assets can provides tax benefits, legal protections, and clear ownership and helps avoid unintended legal and tax consequences. Engaging legal, tax, and accounting experts is often crucial for successfully structuring assets.
- In an arms-length transaction, both the buyer and the seller act independently and in their self-interest, which encourages fair pricing. Many inter-family transactions are not arms-length transactions and may trigger unexpected legal or tax consequences because of transfer of wealth.

- Risk management protects assets and income from unexpected events. Loss of human capital can be managed through insurance.
- Asset protection strategies legally safeguard assets from creditors and involve transferring ownership to different legal entities or moving assets offshore.
- For a client with significant internally managed assets, the assets can be structured across three portfolios as in the aspirational investor framework.
- Both goals-based financial planning and the aspirational investor framework underscore aligning personal financial objectives with suitable investment approaches.
- Understanding the impact of taxes on investment returns is crucial for maximizing after-tax profits. For taxable investors, this knowledge is critical in managing their tax liabilities and making informed decisions about asset classes and the timing of gains and losses.
- While non-taxable clients don't face tax implications on their returns, taxable clients face income and capital gains taxes in addition to property or wealth taxes, stamp duties, and wealth transfer taxes. Double taxation affects overall returns, but some tax systems offer specific tax benefits to mitigate its impact.
- Prioritizing tax efficiency directly impacts investment planning, portfolio management, investment style, and asset allocation. The type of account — taxable, tax deferred, or tax exempt — also impacts tax outcomes.
- Asset location strategies aren't rigid and reflect client goals, time horizons, risk tolerance, and liquidity needs.
- Tax efficient strategies involve holding assets in tax-favored accounts, investing in tax-efficient securities, and timing asset sales for favorable tax treatment. Other approaches include deferring taxes to a future date when expecting lower tax rates and employing tax-loss harvesting to offset gains that reduce tax liability.
- Trade timing and portfolio turnover rates can impact tax efficiency. Generally, low-turnover index funds offer greater tax efficiency.
- It's essential to distinguish between legal tax avoidance and illegal tax evasion in financial management.
- Understanding an investor's home country's tax rules is crucial for international investments, particularly considering key citizenship and legal domicile factors that add complexity. For non-resident investors, the differences in withholding taxes vary according to tax treaties between countries.
- Different jurisdictions offer varying structures that can provide tax advantages. Due to these complexities, consulting tax specialists is highly recommended, especially for cross-border investments.
- The liquidity of an investment is determined by its trading frequency, market depth, and transactions costs, as well as information asymmetry and search costs.
- A diversified portfolio should include investments that are sufficiently liquid to meet short-term goals. Liquidity should be managed to reflect the short-, medium-, and long-term goals of the client.
- The liquidity needs may change over the client's life cycle and may be complicated if the client owns a business.

- It is important to factor in the tax implications of planning choices when considering investment strategies. Spending is affected by inflation and market performance, and consideration should be given to income and capital preservation.
- Spending strategies may include rules, such as a percentage allocation rule, and should consider the client's life cycle and worst-case scenarios.

2 GOALS-BASED PLANNING

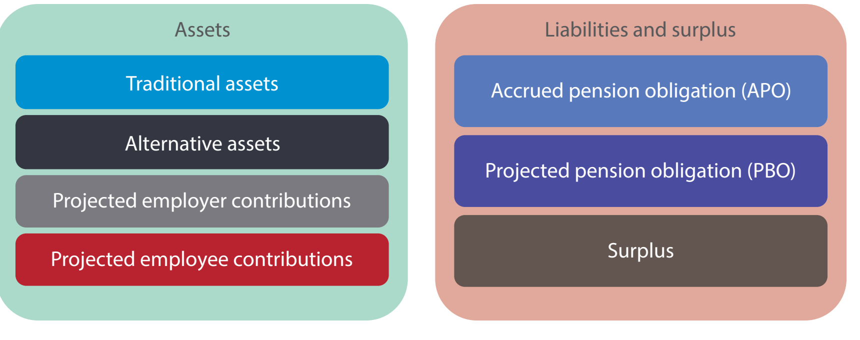
☐ formulate goals-based financial plans and recommend appropriate strategies to achieve an individual's goals-based financial plans

Goals-based planning aligns an individual's financial resources with their unique goals and circumstances, aiming to achieve specific financial targets. Unlike traditional methods that focus on portfolio performance, this approach balances personal spending with income and aligns investments with risk levels and future needs. The success of goals-based planning is measured by the achievement of goals rather than the portfolio's performance against a specific benchmark.

Planning and Human Capital

Goals-based planning in wealth management has some parallels to pension fund management, which uses asset and liability management (ALM) approaches to identify, measure, and evaluate risks. Pension fund assets include both explicit assets and implicit assets. A fund's implicit assets are expected future or deferred contributions from employers and employees. Similarly, pension liabilities include both explicit liabilities, the accrued pension obligation (APO) and implied liabilities and the projected pension obligation (PBO). Exhibit 1 shows a stylized pension fund balance sheet.

Exhibit 1: Stylized Pension Fund Balance Sheet

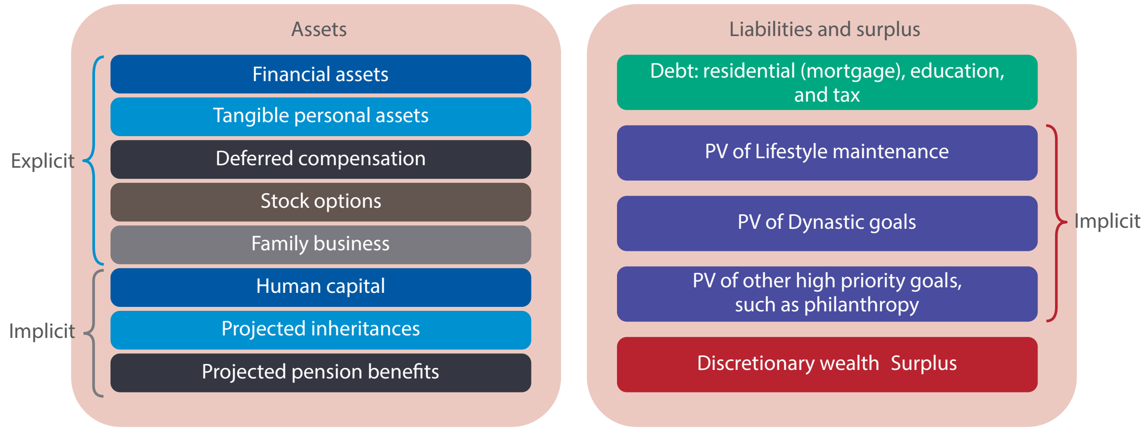


The core focus of pension fund management is measuring and managing risks to the *net* asset value, or the surplus capital. Importantly, pension fund managers prioritize maintaining sufficient assets to balance the liabilities and to manage the long-term payment of the pension obligations to the beneficiaries.

Goals-based planning can be seen through a similar ALM lens. A **family extended balance sheet** comprehensively accounts for a client's explicit and implicit financial assets, current and future expected liabilities, and net worth, as shown Exhibit 2. For most families, non-liquid, implicit assets, such as human capital, expected pension, and retirement, are significant but can be hard to quantify. These implicit assets, including expected inheritances that can significantly influence a family's financial situation, can be estimated based on certain assumptions.

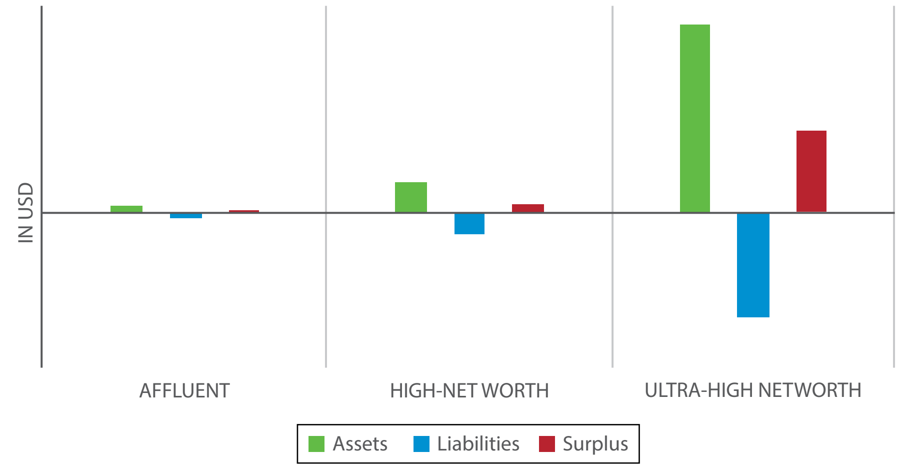
On the liability side, there are two types of debts: explicit ones, like mortgages and loans, and implicit ones such as lifestyle expenses, which are often a family's biggest financial burden. Like pension fund managers, wealth managers evaluate what's known as **discretionary wealth**, the difference between the sum of explicit and implied assets less the sum of current and implied liabilities.

Exhibit 2: Sample Family Extended Life Balance Sheet



The extended balance sheet provides a comprehensive view of assets and liabilities, helping to assess risk exposures. At different wealth levels, the size of assets and the liabilities differ. But it is the size of the surplus that matters and differentiates how assets and liabilities are to be managed to achieve financial goals and other objectives, as Exhibit 3 shows.

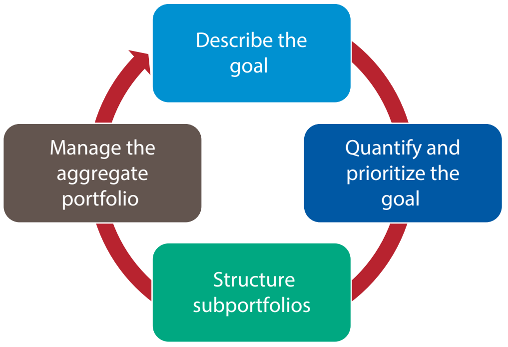
Exhibit 3: Surplus at Different Wealth Levels



Steps in Goals-Based Planning

Goals-based financial planning aligns clients' financial resources with their unique goals to achieve financial goals. The process involves several key steps as outlined in Exhibit 4.

Exhibit 4: Steps in Goals-Based Financial Planning



The Defining Goals of Financial Planning

In the first step, the advisor and the client should collaboratively identify and *describe each financial goal*, outlining the time frame for accomplishing them with the minimum probability of success that the client deems acceptable. Here risk pertains to the significance of the goal and the risk of not being able to realize the goal. It is not synonymous with the traditional volatility of returns. As illustrated in Exhibit 5, a goal matrix can organize these goals by time and urgency.

Exhibit 5: Examples of Different Goals in a Goal Matrix

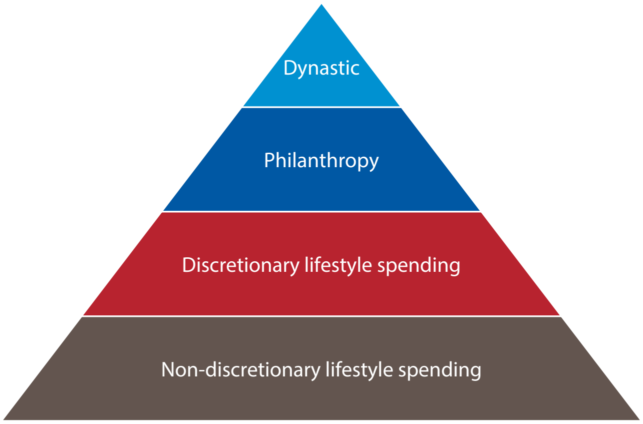
		Short-Term (0 – 5 years)	Intermediate-term (5 – 15 years)	Longer-term (15+ years)
Essential, non-discretionary	Large		• Major home renovation	• Leave a financial legacy for future generations • Achieve financial independence
	Medium	• Create an emergency fund	• Plan for longer-term health care expenses for family members • Retirement savings	• Save for a child's education, wedding, and home purchase • Support family members financially
	Small	• Pay off credit card or other short-term high-cost debt	• Take a six-month sabbatical	
Aspirational, discretionary	Large	• Buy a home	• Pursue entrepreneurial ambitions	• Create a philanthropic foundation
	Medium	• Buy a car or other expensive item	• Purchase a vacation home	• Purchase a rental property
	Small	• Pursue professional education	• Pay off a mortgage and other longer-term debt	• Take a trip around the world

This approach differentiates between short-term (under 5 years), intermediate-term (between 5 and 15 years), and long-term (over 15 years) financial goals and categorizes them either as discretionary or non-discretionary. **Discretionary financial goals** are non-essential objectives that are desirable but not critical for maintaining one's lifestyle. **Non-discretionary financial goals** encompass necessary expenses essential for sustaining the current lifestyle. It is crucial to acknowledge that not all goals can or should be pursued simultaneously: meeting essential goals like housing, education, and health care is crucial, while other goals are discretionary and less critical to the client's lifestyle.

Hersh Shefrin and Meir Statman (2000) formulated the concept of a behavioral portfolio, drawing inspiration from Abraham Maslow's hierarchy of needs, and posited that since individuals possess multiple financial goals and varying risk profiles associated with each goal, these aims should be addressed through a series of subportfolios tailored to the specific goals and risk profiles. Building upon their research, Jean L.P Brunel, in "Goals-Based Wealth Management" (2015), advocates for establishing high-level financial goals, each with its own distinct portfolio featuring unique risk and return characteristics, as depicted in Exhibit 6.

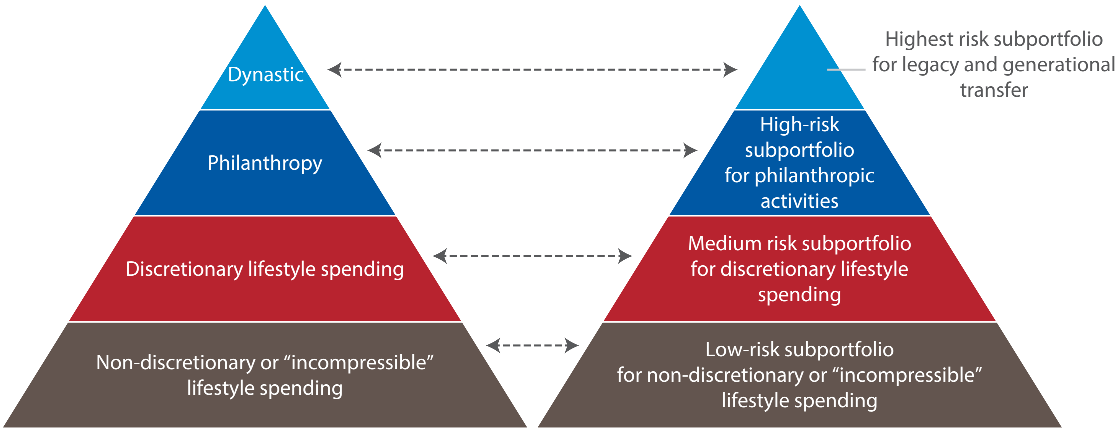
Each goal corresponds to a portfolio with its own unique risk, return, and other characteristics. Most investors easily understand this approach, and it aligns with behavioral decision making. However, it often neglects the interactions between different investment goals, leading to inefficiency. Despite this, many find the trade-off acceptable for a simpler framework, and various methods can usually address the inefficiency.

Exhibit 6: The Behavioral Objectives



The behavioral portfolio can be divided into four subportfolios, each corresponding to a particular goal and risk level as shown in Exhibit 7.

Exhibit 7: Mapping Behavioral Objectives to Subportfolios



These components are

- a low-risk subportfolio to ensure essential, non-discretionary, "incompressible" lifestyle expenses are covered for an extended period;
- a moderately higher-risk portfolio to support non-essential, discretionary spending;
- a higher-risk portfolio for philanthropic endeavors, understanding that increased risk here won't impact essential or discretionary lifestyle spending; and
- the riskiest subportfolio to accumulate capital for dynastic goals, considering current resources may be insufficient and market growth is necessary.

The Prioritizing and Quantifying Goals of Financial Planning

In the second step, wealth managers identify both explicit and ambiguous goals, assessing possible trade-offs. They then quantify these goals and translate them into specific asset allocations, covering lifestyle, philanthropy, and legacy objectives.

CASE STUDY

The Mullers' Financial Goals

Frank Muller, a 45-year-old government employee, and his wife Helga, who is 35 years old, meet with their financial advisor. Collectively they earn EUR300,000 annually. Frank recently inherited EUR4 million.

Financial background:

- The Mullers have EUR100,000 saved across various bank accounts, excluding his recent inheritance. Frank Muller recently received a EUR4 million inheritance after all estate and inheritance taxes were paid. They do not expect to receive any other bequests.
- The Mullers rent an apartment and own a car. They own no other assets such as stock options or ownership interests in a family business. They each anticipate receiving a pension, but the amount is uncertain. Their income covers their lifestyle except for the specific goals outlined below.

Financial goals and their priorities:

Retirement: The Mullers' main focus is preparing for retirement, which, in Frank's case, will begin in 20 years and is projected to last for two decades. Helga is a decade younger than Frank, but they want to have sufficient savings accumulated for retirement by the time Frank reaches his 65th birthday. The Mullers have set three financial targets for retirement:

- Non-discretionary needs: EUR100,000 per year for essential expenditure, growing at 2% annually to compensate for inflation, with their pensions covering additional needs.
- Discretionary goals: EUR50,000 per year for extras like travel, but they can manage without it.
- Aspirational objective: EUR25,000 per year for other expenditures.

Education: The Mullers plan to fund their son's five-year conservatory education, starting in five years, and support him for another five years post-graduation. The annual cost is EUR75,000, with a 3% yearly increase to compensate for inflation.

Vacation Home: The Mullers' plan includes purchasing a vacation home in 10 years. They have three financial goals for this acquisition:

- Non-discretionary need: EUR500,000 in 10 years for a comfortable vacation house that may require some renovation.
- Discretionary goal: EUR300,000 to purchase a property with a pool or with limited renovation demands.
- Aspirational target: EUR200,000 to buy a luxury house.

Entrepreneurial Ambition: Frank plans to start a business in five years, targeting EUR300,000 for start-up costs and an extra EUR200,000 to lessen the need for additional bank financing. If the accumulated capital falls short, he would likely not proceed with the business.

Philanthropy: The Mullers aim to create a EUR1 million charitable foundation for health care in developing countries within 20 years. If funds are insufficient, they'll consider maintaining a smaller fund with recurring donations.

Legacy: The Mullers plan to leave any remaining wealth to their only child, after fulfilling their retirement, education, vacation home, and charity goals.

The plan considers their present earnings, the EUR4 million inheritance, and the specific goals they have set. Their financial advisor summarizes these goals in the following table:

Priority	Goal	Term (in years)	Length (in years)	Priority	Amount (EUR)	Increase	Tolerance of not meeting the objective
1	Retirement	20	20	Non-discretionary	100,000	2%	Low
				Discretionary	50,000	2%	Medium
				Aspirational	25,000	2%	High
2	Education	5	10	Non-discretionary	75,000	3%	Low
3	Vacation home	10		Non-discretionary	500,000		Low
				Discretionary	300,000		Medium
				Aspirational	200,000		High
4	Entrepreneurial ambition	5		Discretionary	300,000		Medium
				Aspirational	200,000		High
5	Philanthropy	20 - 30		Aspirational	1,000,000		High
6	Legacy	20+		Aspirational	Residual / not determined		High

Aggregating this information generates the inputs to a family extended balance sheet. Nevertheless, this balance sheet remains incomplete due to the absence of assets, surplus, and estimates for implicit liabilities. To compute human capital and establish the present value of various expenses, simplified assumptions concerning factors such as mortality rates, income growth, income stability, inflation, appropriate discount rates, and projected changes in lifestyle and financial goals would need to be introduced.

Two main points about essential lifestyle expenses stand out. First, the fear of lifestyle reduction can cause strong emotional reactions in affluent families. Second, uncontrollable expenses like inflation can lead to emotional impulsivity, especially during market downturns. These changes can strain the relationship between the manager and client. Brunel (2011) proposes five questions to help families understand growth needs and limitations:

1. *Do we need to worry about unexpected inflation*? Financial theory suggests that current asset prices and implied returns account for expected inflation. However, unforeseen inflation shocks from long-term, structural, and abrupt non-secular changes can be concerning, especially for families from regions with a history of sudden hyperinflation where life-savings can become worthless in a matter of months.
2. *Do we need to protect against generational fragmentation*? As family members increase with each generation, some families aim for equitable capital distribution, maintaining consistent purchasing power across units. Others may accept varying purchasing power among different family groups.
3. *Do we expect our lifestyle to change*? Changes might involve creating philanthropic objectives, engaging in politics or business, or funding entrepreneurial ventures of other family members including children.
4. *How certain are we about our future needs*? After a financial windfall, families may feel overwhelmed and hesitant to set formal, quantifiable goals. Some may anticipate rising needs, while others desire to maintain wealth above a specific threshold.
5. *Do we need to keep score*? This question can reflect the desire to keep up with others or assess a family's comfort in maintaining their lifestyle spending amidst market shifts. Some families aim to insulate assets from market fluctuations, but not all assets can be protected. Others may express strong preferences for or against certain investment types.

Goals not related to lifestyle are part of the family's discretionary wealth. Excess assets should belong to a long-term growth portfolio. Wealth managers link diverse financial goals and fluctuations in human capital and tailor their advice to align with their clients' changing needs and aspirations. This includes addressing philanthropic aims, wealth transfers, entrepreneurship, and retirement.

CASE STUDY

The Mullers' Financial Goals and Lifestyle Expenditures

To address the Mullers' primary lifestyle goals, their financial advisor suggests implementing separate subportfolios tailored to each financial goal. This strategy eases concerns about lifestyle reduction and the impact of uncontrollable expenses such as inflation and taxes. Their philanthropic and legacy goals are secondary.

1. What is the difference between discretionary and non-discretionary financial goals, and how do they apply to the Mullers' situation?

   Solution:

   Non-discretionary, or essential, financial goals, encompass necessary expenses essential for sustaining the current lifestyle and include meeting basic retirement needs (EUR100,000 per year) and funding their son's education (EUR75,000 per year). Discretionary goals are non-essential and involve additional amounts for retirement (EUR50,000 and EUR25,000 per year), vacation home and enhancements (EUR300,000 and EUR200,000), and potential entrepreneurial ambition (EUR300,000 and EUR200,000).

2. Estimate the present value of the Mullers' retirement spending. They expect to retire in 20 years, and their retirement is expected to last an additional 20 years. The minimum annual retirement income is expected to be EUR100,000, with an additional EUR50,000 considered to be a discretionary and another EUR25,000 as aspirational. Assume that these amounts increase in 2% in nominal terms starting year 20 and that the appropriate discount rate is 1.5% for non-discretionary retirement income, 7.0% for discretionary retirement income, and 10.0% for aspirational retirement income.

Solution:

The annual retirement spending estimates are provided in the table below for years 20 to 39. The calculations are straightforward future value calculations with subsequent discounting.

Retirement spending estimates (in thousands of EUR)

Year	Non-discretionary	Discretionary	Aspirational	Total
20	100	50	25	175
21	102	51	26	179
22	104	52	26	182
23	106	53	27	186
24	108	54	27	189
25	110	55	28	193
26	113	56	28	197
27	115	57	29	201
28	117	59	29	205
29	120	60	30	209
30	122	61	30	213
31	124	62	31	218
32	127	63	32	222
33	129	65	32	226
34	132	66	33	231
35	135	67	34	236
36	137	69	34	240
37	140	70	35	245
38	143	71	36	250
39	146	73	36	255

Based on the above estimates of annual spending, the present value of these retirement spending estimates are the following:

Present value of the retirement spending estimate (in thousands of EUR)

Non-discretionary	Discretionary	Aspirational	Total
1,557	170	40	1,767

The estimated present value of retirement spending is EUR1,767,000: EUR1,557,000 for basic needs, EUR170,000 for discretionary, and

EUR40,000 for aspirational spending. This helps quantify implicit family liabilities.

3. How can a behavioral portfolio approach help the Mullers' better manage their discretionary and non-discretionary financial goals?

Solution:

The behavioral portfolio approach involves dividing the portfolio into distinct subportfolios aligned with specific goals and risk profiles. This approach allows the Mullers to manage their financial goals more effectively by allocating resources based on priority and risk tolerance. For instance, a low-risk subportfolio can be dedicated to covering non-discretionary expenses, while higher-risk subportfolios can be allocated to discretionary and aspirational goals. This method enables better risk management and the development of targeted investment strategies tailored to each specific financial goal.

4. How can the fear of lifestyle reduction and the impact of uncontrollable expenses, such as inflation, influence the decision-making process?

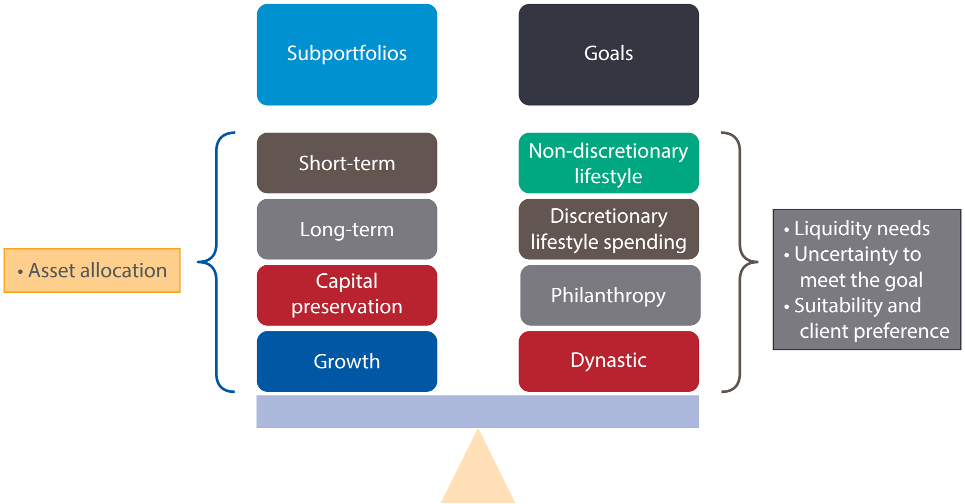
Solution:

Wealthy families like the Mullers often experience emotional stress due to the fear of lifestyle reduction, which can lead them to make poor investment decisions. By actively using a behavioral portfolio approach, the Mullers and their financial advisor can address emotional factors and create a more effective investment strategy.

Structuring Portfolios to Meet the Goals of Financial Planning

The third step is to calculate the assets needed for each goal and *structure the portfolios for these objectives on an aggregate basis.* This may include discounting expected cash flows or assigning lump sums for goals without specific forecasts. Asset classes must match the goals, such as liquidity requirements. The time frame and success probability for each goal guide capital allocation. This step aligns financial needs and objectives with appropriate subportfolios. Exhibit 8 illustrates how portfolios align with goals.

Exhibit 8: Goals and Portfolios



A sound strategy calculates actuarially adjusted cash flows for each client goal to create distinct subportfolios in terms of return and volatility. These subportfolios should cover a wide range of market options and have their own success probabilities, as shown in Exhibit 9. But these subportfolios are managed as one portfolio.

Exhibit 9: Goals, Portfolios, and Probability of Successfully Meeting the Goals

Objective	Portfolio characteristics	The minimum probability of success measured by the likelihood of the set financial goal achieved
Short-term lifestyle	Low-risk subportfolio allocated to ▪ liquid cash and cash equivalents; and ▪ liquid short and high-quality medium-term debt	More than 95%
Long-term lifestyle	Moderate-risk, income producing, subportfolio allocated to ▪ riskier medium- and long-term debt; and ▪ dividend paying public equity	More than 80%
Capital preservation	Higher-risk, income producing, subportfolio allocated to ▪ riskier medium- and long-term debt; and ▪ balance of dividend paying and non-dividend paying (growth) equity Increasing the portfolio allocation to equity and other growth assets allocated to the portfolio.	More than 75%

Objective	Portfolio characteristics	The minimum probability of success measured by the likelihood of the set financial goal achieved
Growth	Very high risk subportfolio allocated to ▪ high risk debt; ▪ growth equity; and ▪ alternative illiquid investments Increasing the portfolio allocation to equity and other growth assets allocated to the portfolio.	Up to 75%

Let's address the portfolio for each of these objectives separately.

- *Short-term lifestyle:* A low-risk subportfolio covers the next five years of expenses. This safety reserve stabilizes emotional responses to market fluctuations and supports the long-term investment strategy.
- *Long-term lifestyle:* A moderately higher-risk portfolio targets spending needs from Year 6 to 25 and sometimes even beyond. The goal is to achieve an 80% probability of financial success.
- *Capital preservation:* A higher-risk portfolio aims to meet intermediate goals while maintaining low risk tolerance. The strategy targets a success probability of over 75%.
- *Growth:* A high-risk subportfolio focuses on long-term or dynastic goals and may include diverse assets like real estate and private equity. The portfolio targets ambitious goals even when the success probability falls below 75%.

Expanding on the Mullers' financial goals example, we now examine how subportfolios can help achieve these goals. We'll first apply goals-based planning to the Mullers' retirement, then explore their other objectives, like education, vacation homes, and business goals, concluding with philanthropy and legacy aims.

CASE STUDY

The Mullers' Retirement Goals

For the Mullers' retirement, subportfolio allocation varies based on their risk tolerance for different spending needs. Essential costs require more certainty, while aspirational expenses allow for more risk. Below is a table listing advisor-offered portfolios with current returns and volatility.

	Available investment portfolios					
Asset classes	**A**	**B**	**C**	**D**	**E**	**F**
Cash and equivalents	20%	10%	5%	5%	5%	5%
Investment grade bonds	60%	60%	40%	40%	30%	30%
High-yield bonds	20%	30%	15%	10%	5%	5%

	Available investment portfolios					
Asset classes	**A**	**B**	**C**	**D**	**E**	**F**
Large capitalization equity	0%	0%	20%	25%	30%	25%
Small capitalization equity	0%	0%	10%	10%	15%	15%
International equity	0%	0%	10%	10%	15%	15%
Illiquid alternatives	0%	0%	0%	0%	0%	5%

Portfolio A is a low-risk, safety reserve option meant to cover expenses for the next five years. Portfolio B aims for longer-term financial objectives. Portfolios C and D are higher-risk options that focus on meeting intermediate goals but still aim to maintain a low tolerance for risk. Portfolios E and F are also higher risk, but they target long-term or dynastic objectives and may include alternative asset classes.

The components of the Mullers' retirement spending objectives are the following:

Retirement	Spending (EUR)	Annual increase	Tolerance of not meeting the objective
Non-discretionary	100,000	2%	Low (95%)
Discretionary	50,000	2%	Medium (85%)
Aspirational	25,000	2%	High (70%)

The Mullers plan to allocate funds across the most appropriate portfolios, based on their risk tolerance and a 40-year time horizon: 20 years for saving and another 20 for spending during retirement. The effects of taxes are ignored for simplicity. Their wealth manager uses a model factoring in estimated returns, volatility, and the clients' comfort with not meeting specific goals. This model projects long-term returns and the initial investment needed for each goal, covering both saving and spending phases.

Retirement spending	Tolerance of not meeting the objective	Optimal investment portfolio	Initial investment (in thousands EUR)
Non-discretionary EUR100,000	Low (95+%)	B	1,557
Discretionary EUR50,000	Medium (85%)	E	170
Aspirational EUR25,000	High (70%)	F	40

The Mullers can meet their basic retirement needs by investing approximately EUR1,557,000. This investment is projected to provide for long-term spending of EUR100,000 per year, adjusted for inflation, over a 20-year period starting in 20 years. To fulfill their retirement objectives, including both essential needs and aspirational components, the Mullers need to invest an additional EUR210,000 for a total of EUR1,767,000. The final table shows the asset allocation and risk level for achieving a specific goal.

Goal Amount in EUR	Basic spending need EUR100,000	Discretionary spending EUR50,000	Aspirational spending EUR25,000	Total (rounded)
Optimal investment portfolio	B	E	F	
Capital allocated	88%	8%	4%	100%
Allocation to asset classes or strategies				
Cash	5%	5%	5%	5%
Investment grade bonds	40%	10%	10%	36%
High-yield bonds	10%	10%	10%	10%
Large capitalization equity	25%	20%	20%	24%
Small capitalization equity	10%	20%	20%	11%
International equity	10%	20%	20%	11%
Illiquid alternatives		15%	15%	2%

Given the Mullers' risk tolerance, 51% of the portfolio is invested in cash and fixed income and 49% to equity and alternatives. This is a medium-risk portfolio.

Next, we consider the Mullers' three other goals: education, a vacation home, and entrepreneurial ambitions.

CASE STUDY

The Mullers' Educational, Vacation Home, and Entrepreneurial Ambition Goals

The table below outlines the Mullers' three goals, their time frames, priorities, optimal portfolios, estimated long-term returns, and initial investments needed.

[redacted]

Goal	Type	Tolerance of not meeting the objective	Optimal investment portfolio	Initial investment in thousands of EUR
Education in 5 years, ongoing for 10 years				
EUR75,000; increasing 3% per year	Non-discretionary	Low (95+%)	C	859
Vacation home in 10 years				
EUR500,000	Non-discretionary	Low (95+%)	D	414
EUR300,000	Discretionary	Medium (85%)	E	186
EUR200,000	Aspirational	High (75%)	F	102
Entrepreneurial ambition in 5 years				
EUR300,000	Discretionary	Medium (85%)	E	258
EUR200,000	Aspirational	High (75%)	F	152
Total				1,780

To meet all these different goals, the Mullers must allocate an additional EUR1,971,000 to the retirement savings of EUR1,767,000 for a total of EUR3,738,000. Their allocation to meeting all their goals is

- retirement, EUR1,767,000;
- education, EUR859,000;
- vacation house, EUR702,000; and
- business, EUR410,000

The portfolio allocation to meet the educational goal is notably significant: the funds are committed for a 15-year period, the tolerance for falling short is very low, and the best-suited investment options offer modest returns.

The overall asset allocation will adjust based on the capital set for each specific goal and its corresponding subportfolio.

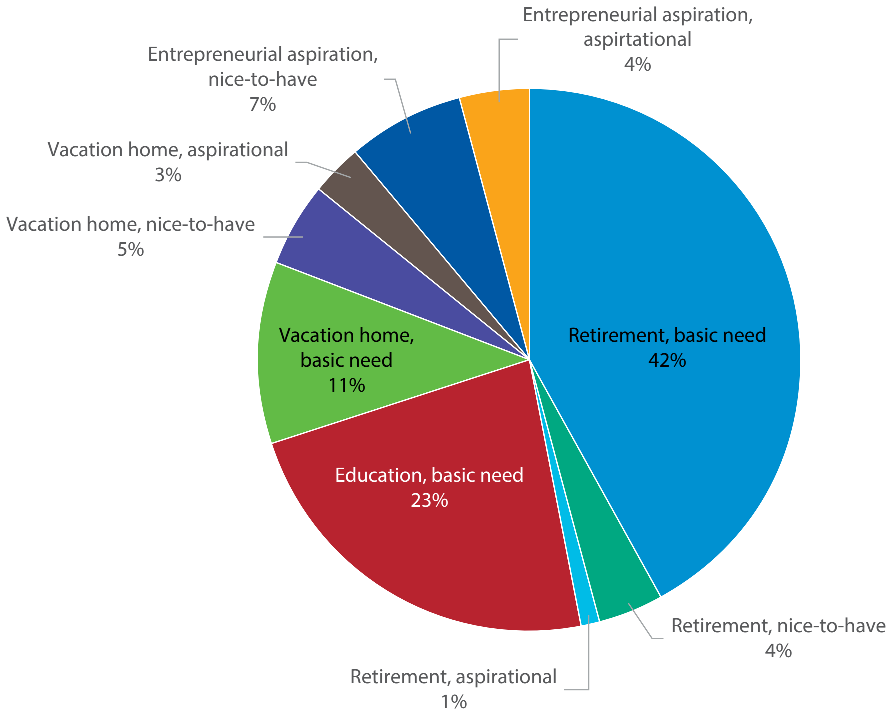
Managing Portfolios to Meet Financial Goals

The final step involves creating and managing goal-specific subportfolios, then combining them into a single, tailored portfolio. This balances lifestyle needs with philanthropic and dynastic goals. The key decision is how much capital to allocate beyond essential spending, considering each goal's risk profile and asset suitability. Contrary to common belief, surplus assets shouldn't always go towards growth.

CASE STUDY

The Mullers' Capital and Portfolio Allocation

The Mullers have received EUR4 million as inheritance. Across their nine goals, they have allocated EUR3,738,000 as follows:



That capital would be allocated across these different goals and investment portfolios as follows:

	Retirement			Education	Vacation home			Entrepreneurial aspiration		
Goal	**Need**	**Nice to have**	**Aspirational**	**Need**	**Need**	**Nice to have**	**Aspirational**	**Nice to have**	**Aspirational**	**Total**
	D	E	F	C	D	E	F	E	F	
Percent capital allocated to goal	42%	5%	1%	23%	11%	5%	3%	7%	4%	
Asset classes or strategies										
Cash	5%	5%	5%	5%	5%	5%	5%	5%	5%	5%
Investment grade bonds	40%	30%	30%	40%	40%	30%	30%	30%	30%	38%
High-yield bonds	10%	5%	5%	15%	10%	5%	5%	5%	5%	10%
Large capitalization equity	25%	30%	25%	20%	25%	30%	25%	30%	25%	25%
Small capitalization equity	10%	15%	15%	10%	10%	15%	15%	15%	15%	11%
International equity	10%	15%	15%	10%	10%	15%	15%	15%	15%	11%
Illiquid alternatives	0%	0%	5%	0%	0%	0%	5%	0%	5%	0%
Total	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%

The overall portfolio combines low-risk with high-risk subportfolios. The combined allocation to cash, investment grade bonds, and high-yield bonds represents 53% of the portfolio, indicating a significant focus on fixed-income securities. The combined allocation to large-cap equity, small-cap equity, and international equity represents 47% of the portfolio. Less than 1% of the portfolio is allocated to illiquid alternatives.

Goals-based financial planning forces wealth managers to maintain discipline due to the constraints placed on asset allocation within the subportfolios, particularly during the annual rebalancing or tactical asset allocation. It also simplifies discussions by focusing on the calculation of assets required to meet spending expectations, which could minimize the risk that the client overspends and extinguishes savings.

If there is enough capital for long-term investment, these goals-oriented plans can be supplemented with more strategic portfolios to possibly meet dynastic needs. Goals-based portfolios are designed to be optimal in satisfying the client's specific needs, ensuring financial protection for their important goals. While the overall portfolio may not be optimized for mean variance, individual subportfolios can be, balancing risk and return effectively. Goals-based portfolios can be further customized to match each client's unique financial conditions and objectives.

Each subportfolio, designed to meet a specific goal or subgoal, self-liquidates over time, and the overall portfolio adapts to changes in the client's financial situation. Just because a subportfolio is depleted doesn't mean that the financial goals and plans are automatically reassessed. Shifts in capital market expectations, market conditions, and the individual's spending habits may necessitate rebalancing at various points in time.

CASE STUDY

The Mullers' Philanthropic and Dynastic Goals

The Mullers inherited EUR4 million and have EUR262,000 in unallocated funds. Their advisor suggests using this surplus for philanthropic and legacy goals, invested in portfolio alternative F, affecting their total asset allocation.

	Asset allocation		
	Retirement, education, vacation home, and entrepreneurial ambitions	Retirement, education, vacation home, entrepreneurial ambitions, with philanthropic and dynastic objectives	Change
Cash	5.0%	5.0%	
Investment grade bonds	37.6%	37.0%	-0.6%
High-yield bonds	9.9%	10.0%	0.1%
Large capitalization equity	24.7%	25.0%	0.3%
Small capitalization equity	11.2%	11.0%	-0.2%
International equity	11.2%	11.0%	-0.2%
Illiquid alternatives	0.4%	1.0%	0.6%

The overall asset allocation shifts parts of the portfolio from fixed income to equities and illiquid alternatives.

Aligning Goals, Human Capital, and Life-Cycle Stages

Financial goals change with life stages, shifting from wealth accumulation to decumulation. Changes in human capital across the various life stages typically involve shifts in time horizons, risk tolerance, and financial goals.

In the early career phase, individuals typically focus on short-term financial goals such as paying essential expenses. During this time, they develop their human capital, which is vital for achieving a variety of financial goals. Intermediate-term goals might include establishing an emergency fund, while long-term goals, such as retirement savings, may not yet be a priority.

In the career development phase, focus shifts to long-term goals like wealth building and retirement planning. This is the peak phase for capital accumulation, covering both short-term and mid-term needs. Approaching pre-retirement, the emphasis turns to short-term goals like debt repayment and asset consolidation. While capital accumulation continues, spending on things like second homes may initiate capital decumulation.

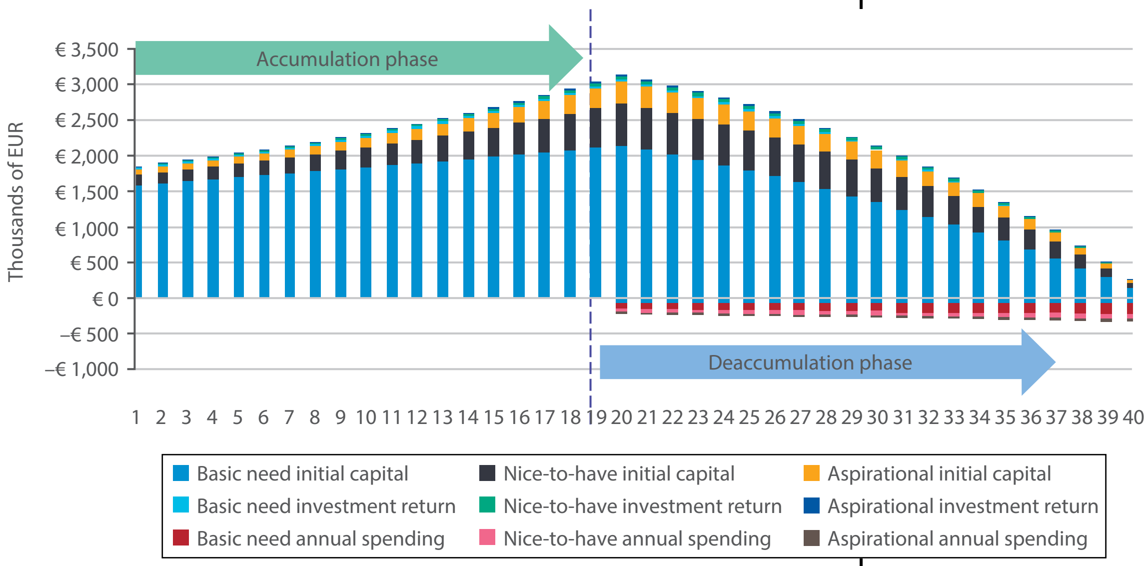
During the early retirement phase, as decumulation begins, individuals generally concentrate on short-term goals like maintaining their lifestyle and medium-term goals like generating income from retirement assets. Wealth managers should guide clients about the optimal cash withdrawals during this decumulation phase. Long-term objectives like estate and wealth transfer strategies are also considered, factoring in available financial resources and philanthropic aspirations.

CASE STUDY

The Mullers' Approaching Retirement

Approaching retirement, the Mullers meet with their soon-to-retire advisor to review their financial progress over 20 years. They've met their goals and built a strong retirement surplus. The advisor outlines how their savings have grown and how withdrawals will impact the balance.

Capital Across Accumulation and Deaccumulation Phase



Wealth managers should guide clients through both wealth accumulation and spending in retirement. This involves setting goals and time lines and ensuring sufficient funds for retirement and legacy plans. Extra income sources should be accounted for to minimize early withdrawals. Managers must be ready to adjust plans for negative returns or income changes while keeping an eye on inflation and portfolio performance.

Monte Carlo simulation can play a crucial role in goals-based financial planning, providing individuals and wealth managers with valuable insights into the likelihood of meeting set financial goals. Through the simulation of various investment returns, market conditions, spending needs, and financial goals, Monte Carlo analysis generates a probability distribution for the success of a financial plan. This information helps both wealth managers and clients gauge the probability of achieving goals. By running simulations for different portfolios, strategies that align best with risk tolerances and financial goals can be identified. Monte Carlo simulations can also assess the resiliency of financial plans by simulating extreme market events and how they would influence the meeting of financial goals during shifting economic conditions, volatility in interest rates, or unexpected changes in spending habits. The simulation also helps fine-tune withdrawal strategies to balance income needs with capital preservation, specifically the optimal approaches to minimize the risk of exhausting available financial resources. An integral factor in this simulation is the life expectancy used for the client(s).

Considerations towards Family Support and Wealth Transfer

Supporting family is often a key part of financial planning and can range from short-term needs like emergency expenses to long-term goals like estate planning. When evaluating how to support family members, it is crucial to comprehend the potential impact on other financial goals: financing a child's education may conflict with retirement savings. Goals-based financial planning helps balance these priorities and help in transferring assets to future generations.

Short-term support for family members might involve addressing unanticipated expenses like emergency repairs. Intermediate-term support could include assisting aging parents with their living expenses. Longer-term support may entail wealth transfer to ensure the financial well-being of future generations through estate planning and establishing foundations and, where legally recognized, trusts.

CASE STUDY

The Mullers' Generational Wealth Transfer Goals

Over 20 years, the Mullers' EUR4 million inheritance grew to EUR6 million even after withdrawals for education, a vacation house, and entrepreneurial projects. These gains will fund their retirement, charitable activities, and generational wealth transfer. Helga plans to support her elderly parents with EUR40,000 annually for the next decade. To cover this, their wealth manager recommends allocating EUR400,000 to a portfolio expected to yield a 3% annual return, offsetting the costs and accounting for inflation.

Helga and Frank want to secure their family's long-term financial future. Both their financial advisors and tax advisors have suggested that due to the punitive structure of inheritance taxation, establishing a family foundation founded by EUR4 million as an initial gift would achieve long-term financial goals for the family. The Mullers would incur a EUR1 million one-time gift tax. Structuring the foundation to support health care in developing countries could reduce tax liabilities while still distributing income to the family and allowing for a tax efficient transfer of assets.

Monte Carlo simulations predict a 95% chance that the foundation, if invested in a diverse portfolio of stocks, bonds, and alternative assets, will grow to EUR10 to 20 million in 30 years. This allows for withdrawals and future generational support. By balancing various financial objectives, the Mullers are set for generational financial stability and societal contributions through philanthropy.

1. How can the Muller family use a charitable foundation and diversified investment portfolio, along with Monte Carlo simulations, to achieve both their philanthropic and generational wealth transfer goals?

   Solution:

   To achieve their philanthropic and generational wealth goals, the Mullers could use a charitable foundation and a diversified portfolio. They already have enough for retirement. Monte Carlo simulations help their wealth manager predict asset growth and assess risks, enabling strategy adjustments to meet their financial objectives.

QUESTION SET

1. In a goals-based financial plan, the subportfolio for which the *greatest* risk can be taken is the:

   A. dynastic portfolio.

   B. philanthropic portfolio.

   C. discretionary lifestyle portfolio.

   Solution:

   The correct answer is A. The behavioral approach was inspired by Abraham Maslow's hierarchy of needs. Dynastic goals are aspirational and long term in nature. An acceptance of higher risk levels allows for greater compounding and should result in a larger ending value. By contrast, basic non-discretionary spending needs must be met with a high degree of certainty and should be subject to as little risk as possible.

2. Goals-based financial plans are focused on the client's:

   A. assets only.

   B. liabilities only.

   C. assets and liabilities.

   Solution:

   The correct answer is C. Much like defined benefit pension fund management, a goals-based financial plan balances explicit assets and liabilities (such as the investment portfolio and debts) and implicit assets and liabilities (human capital and expected spending needs).

3. Describe the steps involved in goal-based planning.

   Solution:

   Goals-based planning involves four steps:

   1. Clearly state the goals: The wealth manager needs to work closely with the client to state their financial goals.

2. Quantify and prioritize the goals: The wealth manager needs to analyze how much money is needed when, as well as how important each goal is.
3. Structure subportfolios: The wealth manager should allocate assets for each goal separately according to their respective risk tolerance, return requirements, and time horizons.
4. Manage the aggregate portfolio: The wealth manager should select the subportfolios and then aggregate them into the entire portfolio.

3 COMPREHENSIVE WEALTH PLANNING FOR PRIVATE CLIENTS

☐ recommend and justify methods to manage a family's financial exposures holistically across their lifetime and retirement

Comprehensive wealth planning, also known as integrated planning or wealth structuring, holistically manages a client's financial and business affairs. Often used by high-net-worth individuals (HNWIs), it aims to grow wealth for various personal and philanthropic purposes. While it's impossible to cover all tax and legal nuances, some basic principles guide the planning process:

- Establishing appropriate and unequivocal legal ownership and ownership protection that safeguards the wealth is of outmost importance.
- The tax liabilities and obligations on wealth and income depend on the investor's legal domicile.
- Minimizing costs, including tax liabilities, increases the growth of wealth.
- Proactively addressing potential conflicts within the family and between heirs and other stakeholders who possess, or perceive themselves to possess, a financial and legal stake in the wealth substantially mitigates the probability of squandering assets amidst disputes.

Goals-based planning focuses on asset allocation from a bottom-up perspective, while integrated planning takes a holistic view accounting for all assets, liabilities, and associated risks.

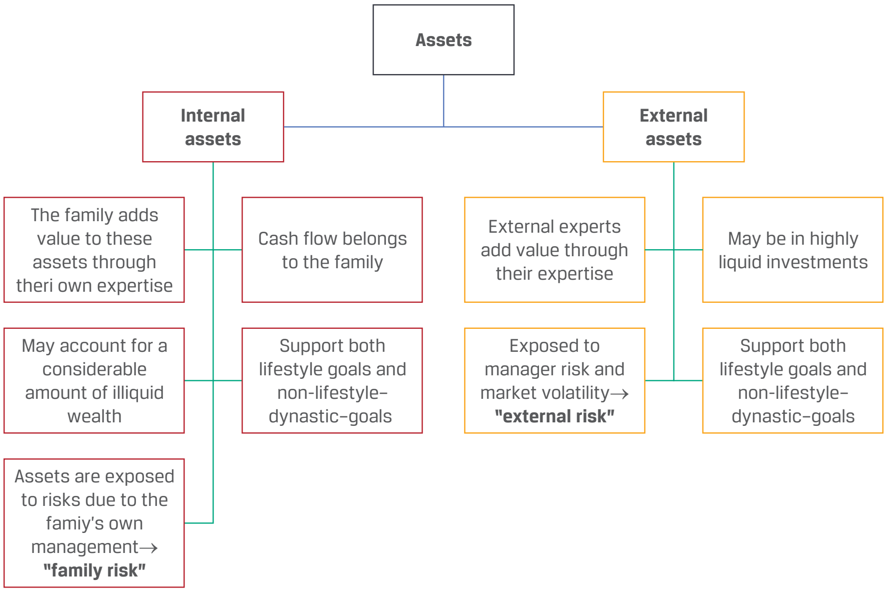
Comprehensive Wealth Planning

To facilitate a thorough analysis, individual or family wealth is divided into internally and externally managed assets.

Internally and Externally Managed Assets

Internally managed assets consist of businesses in which the individual or family holds controlling or direct ownership, privately owned residential real estate, and other properties that generate value through the client's activities. Human capital is an important component of internally managed assets. **Externally managed assets** include financial and investment assets managed by a hired external manager, for which the client has determined that the manager can add more value than the client could. These instances may range from hiring a wealth manager to manage retirement assets to establishing a family office to oversee generational wealth and its management and transfer. Both internally and externally managed assets can contribute to meeting the family's financial goals. Exhibit 10 shows features of internally and externally controlled client or family assets.

Exhibit 10: Internal and External Assets



Understanding the difference between internally and externally managed assets is crucial for wealth creation and business success. Families need to identify which assets they can manage effectively and which need external help. The main risk in entrepreneurship comes from the potential loss of a key person affecting both the business and family wealth. Family risk is essentially key person risk. There are some key questions a client and the client's advisor should consider when weighing the option of exchanging the family business risk for external risk by either selling the business or securing external management:

- What strategies does the family have for maintaining wealth?
- How reliant is the client on various asset types for income?
- Is the business easily sellable, and what risks are involved?
- Is the business dependent on a few key people?
- Is there a succession plan or need for external management?

If the family decides to retain ownership and operations of the company, their ownership should be considered as a single-stock portfolio. Consequently, it should be integrated into the family's comprehensive financial plan as an investment. Additionally, for family members who actively participate in and receive compensation from the business, the company should be recognized as a source of human capital.

If finding a manager for the family business proves challenging, the family may consider selling the business and distributing the proceeds among family members. This strategy is often useful when family members lacking the interest, skills, experience, or aptitude to manage the family business decide to sell the business.

If the family sells the business, it transforms an illiquid and generally hard to value asset to liquid financial assets at a price the market is willing to bear. Such a **liquidity event** converts heretofore illiquid internally controlled assets into more liquid assets, either in the form of cash or securities. Differently put, the monetizes the human capital that family has in the business. This process often requires external expertise for accurate valuation, considering factors beyond physical assets, like brand and customer loyalty, that all converge around the owning family. Additionally, selling a business that has been in the family for generations can have serious emotional implications on the family. The liquidity from the sale enables the family to take on diverse investment opportunities and allows for portfolio diversification as well as funding other interests, aligning individual financial goals and risk preferences, constraints, and personal values.

External risk is a function of the external manager's managerial skill, aptitude, and performance as well as the overall risk from external risk factors such as economic and market volatility.

CASE STUDY

The Rudge Family and Their Business Considerations

Juan Albuquerque, a senior private banker with Banca Privada del Upmann in Panama City, Republic of Panama, has recently returned from a trip to Argentina to speak with clients Bruno and Maria Rudge. Maria, an entrepreneur, recently exited from her technology start-up and received USD10 million, which is now managed by Juan Albuquerque and his team, together with other personal investments owned by the family.

Based in Argentina, the Rudge family carries forward a rich legacy of entrepreneurship. The family consists of Bruno and Maria Rudge, a married couple in their 40s, and their two children. Bruno is the chairman of family's shipping business that he inherited in equal shares with his brother Pedro. A senior team of executives and managers, many of whom were hired by Bruno and Pedro's father and grandfather, have devoted decades to the company. The shipping company is owned by the two brothers and generates over USD1 billion in sales annually. Valuations of the shipping company indicate an approximately USD300 million value of the equity based on current economic conditions and expected growth rates. Bruno and Pedro inherited this company 10 years ago, when it was worth approximately USD50 million.

Although the US dollar is not the official currency of Argentina, due to the economic volatility, high inflation, and the declining purchasing power of the Argentinian peso (ARS), both commercial and private transactions often use the US dollar.

Although the family has entertained thoughts of selling their business, they ultimately trust their abilities for effective management. The family recognizes, however, the intricate task of overseeing the financial aspects of their wealth amid Argentina's turbulent economic conditions. Bruno and Maria Rudge are risk averse and eschew leverage. Their main sources of wealth are the following:

Asset	Amount in USD
Shipping company stock	150 million
Cash from Maria's education technology sale	10 million
Other personal investments	7 million
Private residence	3 million
Total	*170 million*

The family's objectives are maintaining their current lifestyle, funding their children's education, and retaining the flexibility to support poverty alleviation charities or invest in additional business ventures. They do not have a succession plan in place for managing the shipping company.

1. Summarize the Rudge family's view on managing their wealth, their reliance on internally managed and externally managed assets, and their views on the future of the shipping company.

   Solution:

   The Rudge family is confident in managing their shipping business, backed by a strong executive team and significant inherited wealth. Their internally managed assets include the share in the shipping company and their private residence, or USD153 million. Their externally managed assets include the liquidity from Maria's recent sale of her company and other personal investments, or USD17 million.

   While the Rudge family has yet to formalize a succession plan for their shipping company, the involvement of multiple generations and capable senior executives mitigate immediate concerns. Bruno and Pedro and their families maintain the option of continuing with the business as several promising younger executives show potential for future leadership.

   The family is not interested in selling the business. Should they sell the business, the complex financial terrain of Argentina would necessitate specialized expertise to navigate Argentina's financial, tax, and legal intricacies. An international wealth manager is best positioned to manage their wealth.

Both internally and externally managed assets instigate legal, tax, and governance considerations. Assets must be placed in a legal entity that verifies ownership and management. Sometimes multiple legal entities are set up to manage a single client's assets. For example, a client may transfer their shares in their business to a holding company in which children and other family members may own equal or varied stakes.

Most legal systems allow such transactions, but they often bring complex tax and legal challenges. The best approach depends on various factors like asset size, legal frameworks, potential tax ramifications, and the client's own perception of their wealth and values. Consulting external experts like tax attorneys may be necessary. Importantly, the client's understanding and acceptance of this structure is vital. The wealth manager is among several advisors vital for a successful transaction.

CASE STUDY

The Rudge Family and Plans to Manage Dynastic Wealth

As the discussions between Juan Albuquerque and the Rudge family continue, the question of generational wealth transfer has come to the forefront. Bruno and Pedro inherited the shipping company from their father, who gained control after years of vicious legal battles with Bruno and Pedro's uncles. Although the family assets were split evenly at the conclusion of decades of legal conflicts, some relatives, although still relatively prosperous, are embittered. Both Bruno and Pedro are aware of the schism decades of legal battles have caused between their father and his siblings and are concerned that similar conflicts could emerge among the younger generation and consulted Juan Albuquerque on preserving generational wealth. His suggestions include

1. *instilling family values and purpose.* Psychologists emphasize the importance of fostering a strong sense of identity and purpose within the family through regular family meetings and discussions about the business and its legacy. These meetings can foster shared responsibility for the family wealth and strengthen bonds. Inviting estranged cousins could initiate healing among younger family members.
2. *promoting financial literacy*. Education and financial literacy are essential in preparing future generations to manage wealth, and the Rudge family should educate their younger members about financial management, investing, and philanthropy.
3. *encouraging independence and entrepreneurship*. Psychologists recommend fostering individual growth to avoid entitlement. The Rudge family should encourage entrepreneurship among family members, offering resources and mentorship. Maria's recent success shows how wealth can enable innovation.
4. *establishing clear governance structures.* To maintain harmony and smooth wealth transition, psychologists suggest clear governance structures. The Rudge family should form a family council for transparency and aligned interests, possibly including estranged family members.
5. *maintaining a proactive approach to wealth management.* The Rudge family should proactively manage their wealth by focusing on shared values, financial education, independence, and governance. Regular meetings with wealth managers can help navigate their complex financial landscape.

Asset Structuring

Asset structuring optimizes wealth from investments, business interests, and other financial holdings. It takes into account the assets' physical and legal locations as well as their ownership, beneficiaries, and control. The approach also includes strategic asset transfers and protective measures to maximize value and mitigate obligations. Exhibit 11 shows the typical considerations involved in asset structuring.

Exhibit 11: Asset Structuring

Determining the Legal and Physical Location of Assets

The legal location refers to the legal framework that governs asset ownership. This involves determining who has direct ownership over the assets and whether the ownership is straightforward or more complex, involving entities like holding companies. For instance, a business owner might directly own all the assets of the business. Alternatively, those assets could be owned by a separate legal entity like a corporation or partnership in which the business owner owns shares. Adding another layer of complexity, those shares might themselves be owned by another company or set of companies, with the business owner ultimately controlling ownership. The way ownership is structured directly affects the tax obligations for both the entity that holds the assets and the individuals or entities that own that holding entity.

This ownership structure, along with the physical and corporate location of the assets, plays a critical role in determining asset value. For example, choosing to incorporate in a jurisdiction with low corporate income tax but high capital gains tax can be beneficial if the owner does not consider asset sales or the sale of the business. Conversely, incorporating in a high income tax and low capital gains tax jurisdiction would mean higher income taxes but potentially lower taxes should the business sell assets, or if the business is sold by the owner. Thus, the choice of jurisdiction impacts not only day-to-day profitability but also long-term financial planning, particularly if asset sales are on the horizon.

Lastly, an asset's physical location can also affect its value. Real estate prices, for example, reflect geographical factors. Different jurisdictions have varying laws that can lead to various transfer taxes upon the sale or acquisition of assets including financial assets. Therefore, the location factors into both the immediate valuation of the asset and the tax implications tied to any potential future disposition.

CASE STUDY

The Rudge Family and Their Assets

Bruno and Pedro inherited the shares in the family shipping business from their father. Argentine law recognizes separate property ("bienes propios"), and the ownership stake held by Bruno and Pedro falls under this category. These assets are not subject to partitioning in the event of a divorce or inheritance at the death of a spouse. Separate property encompasses assets owned before marriage, gifts or inheritances kept separate during the marriage, and assets acquired using individual resources.

Bruno inherited the shares in the shipping company after his marriage to Maria. However, Bruno's father's testament specifically states that the shares are separate property and that, in the event of a divorce, their spouses would not be entitled to a share of the family business. However, spouses can only inherit the shares in the family business when there are no children in the marriage.

Considering Bruno's desire to share ownership of the family business with Maria, he is contemplating a change to the property regime to community property ("bienes gananciales"). This regime, default for married couples in Argentina, treats property acquired during the marriage as community property jointly owned by both spouses. It encompasses income, assets, and debts obtained during the marriage, irrespective of the spouse who acquired them. In the event of divorce or the death of a spouse, community property is typically divided equally.

To change separate property to community property in Argentina, Bruno and Maria will need to execute a postnuptial agreement. With the assistance of legal counsel who will guide them through the process, they will follow all local procedural and formal requirements to ensure compliance and establish a postnuptial agreement that is legally binding and robust, reducing the likelihood of future challenges by their children or any future spouses in the event of divorce and subsequent remarriage, as well as any children resulting from subsequent marriages. Taking these active measures allows Bruno and Maria to resolve any uncertainty surrounding the ownership of their assets both now and in the future, effectively mitigating potential legal risks. Other alternatives are also possible, including trusts and other legal arrangements.

Addressing Tax, Legal, and Other Obligations.

Asset structuring improves tax efficiency, legal protection, and ownership clarity. Using a corporate structure can lower taxes and simplify asset transfer. However, legal compliance is essential. The challenge is transferring assets to future owners without altering overall ownership. To avoid legal and tax issues, particularly in family businesses with unclear control, it's important to handle transactions as arms-length deals.

In an **arm's-length transaction**, both buyer and seller act independently without any preexisting relationship that may sway their decision making. This independence guarantees that both parties operate solely in their self-interest. This ensures fair pricing and competitive negotiations. A special business arrangement is the **related-party, arm's-length transaction**, in which a company and its owners or executives conduct a transaction on terms that are comparable to what would be offered in the open market to unrelated parties under similar circumstances.

CASE STUDY

The Rudge Family and Asset Transfers

Bruno is the owner of a business called "Bruno's Sculptures." He has the option to transfer these business assets to a new corporate entity, "Bruno & Co Sculpture S.A.S," over which he would have complete control. If he does this but keeps all the shares, he remains in full control of the business.

However, if Bruno during this asset transfer gives shares to new owners — like his spouse Maria or family members — the balance of control and wealth would shift away from Bruno. Such moves require careful planning due to legal and tax implications.

If Bruno sells his business assets to an unrelated third party, the selling price is likely to represent the true market value. On the other hand, if he sells to a company in which his children have ownership, the agreed-upon price may differ and could be merely symbolic. To ensure that it meets legal and tax obligations, it should ideally be conducted at arm's-length terms, meaning the pricing and conditions should be similar to what would be expected if the transaction were between unrelated parties. This could be critical to avoid potential complications with tax authorities.

For example, if assets worth USD10,000,000 are sold in an arm's-length transaction with an unrelated party, it sets a benchmark for market value. However, selling the same assets to his children for just USD1 would be construed as a wealth transfer subjected to various taxes like income, gift, or inheritance taxes. Such interfamily transactions often carry unique legal and tax implications. Family-related transactions, including related-party, arm's-length transactions, come with their own unique set of legal and tax considerations. Ensuring that such transactions adhere to arm's-length principles is essential for compliance and equitable treatment among all parties involved.

For entrepreneurs, how business shares are held is crucial. Shares can be directly owned or held through intermediary holding companies. Even if an operational entity's ownership is equally divided, other assets like real estate may have more complex ownership structures. Maintaining comprehensive records of ownership, transactions, and finances is critical in eliminating any legal ambiguities concerning asset ownership. This is because potential legal uncertainties could lead to legal risks and unexpected tax consequences.

For instance, consider a scenario in which a company owns a subsidiary in a high-tax country. Two foreign holding companies legally established in another country share the subsidiary's ownership. The subsidiary's home country tax rules stipulate that any local company not entirely owned by a single foreign holding company will incur additional taxes on its retained corporate income. This essentially imposes an added tax on the amassed retained earnings. Such capital taxes, acting as an indirect form of business wealth tax, are prevalent in certain jurisdictions. However, by merging the ownership of the foreign holding companies into one entity, it's possible to diminish this supplementary tax load, thereby reducing the corporation's overall tax liability.

CASE STUDY

The Rudge Family and Their Business Assets

Considering the Rudge family's source of wealth and location of their wealth, asset structuring becomes a crucial aspect in protecting their wealth. The company has been an early adopter of technology and has developed new artificial intelligence (AI) for logistics. Determining the legal and physical location of assets is a key step and involves identifying who owns the assets directly or indirectly through holding companies.

The chosen ownership structure and the physical location of the corporation can significantly impact the value of the business.

1. Country A: low corporate income tax, higher capital gains tax rate
2. Country B: high corporate income tax, lower capital gains tax rate

One strategy could be to incorporate a holding company in Ireland to manage European operations, taking advantage of its low corporate tax. This would improve after-tax cash flow and business value. Additionally, the company's valuable intellectual property and AI products could benefit from a Singaporean presence, given Singapore's low capital gains tax. This would maximize returns on these rapidly growing assets.

Therefore, it is prudent for owners and their advisors to undertake an exhaustive evaluation of the business's ownership structure and legal framework. The active help, guidance, and input from competent legal, tax, and accounting advisors are often a prerequisite for successful transactions.

Risk Management

Risk management identifies crucial mechanisms for preserving asset values and income streams irrespective of unforeseen life events. While asset structuring lays the foundation for assets from a legal, tax, and financial perspective, risk management creates predictability in the face of uncertain losses in human capital and financial and business assets. The main tools of risk management are various insurance products that protect wealth, capital, and income.

Deciding between self-insurance and purchasing insurance involves assessing the likelihood and impact of potential losses. Self-insurance may suffice for small, predictable losses, but unpredictable, large losses usually require purchased insurance. For insurance decisions it is important to weigh the impact of potential losses against the value of the asset or income stream as well as the combined value of all assets, including human capital.

Human capital as an asset class is a unique and significant asset that correlates directly with an individual's earning capacity. Morbidity and mortality are the two main risks. To mitigate the effects of morbidity, health issues, and disability, health insurance coverage can provide compensation. Different types of life insurance provide financial protection against mortality, ensuring financial security for dependents.

In countries that offer public, state-provided, government-sponsored, or mandatory insurance against unemployment, health, and disability, the need to proactively secure coverages for such risks might not be warranted except for clients with high human capital or high net worth and inadequate public coverage. These clients should secure insurance coverage outside of the public system either through self-insurance or in the open market to maintain income generation capabilities, fulfilling familial and other financial responsibilities.

Behavioral risks, such as reckless behavior or thrill-seeking through dangerous hobbies, can also lead to financial implications. While securing insurance for such specific risks may prove more challenging and expensive, the coverage may justify the potential financial risks involved.

Property and casualty risks include fire, flooding, and natural disasters as well as legal risks from lawsuits. These risks can be mitigated by both insurance and also by the use of legal structures to isolate legal exposure.

Particularly for HNWIs, personal liability insurance can be important, as they can be targets for legitimate or frivolous lawsuits because of their wealth. Their assets, activities, and profile expose them to various risks.

Legal tools can also protect assets from creditors and other claimants lawfully without resorting to illegal or fraudulent ownership transfers. There is a broad array of asset protection approaches, but the specific approaches are specific to each legal system and typically involve transferring the legal ownership of assets to different and separate onshore or offshore legal entities while allowing the original owner some control or benefits. Owning assets through various corporate ownership structures still provides control over the assets but also offers limited liability protection. Finally, in the common law legal systems where trusts are recognized, holding assets through trusts is an often-used asset protection approach. In civil law systems, this approach is usually disallowed or not recognized.

By moving assets offshore, individuals and business often benefit from more favorable tax regimes. Because the ownership of the assets moved to a different jurisdiction, creditors and other claimants may find it harder to seize those assets. However, while there are legitimate reasons and benefits to moving assets offshore, it is essential that these transactions are legally valid and properly reported in all jurisdictions involved in these transactions.

Comprehensive Assessment of Aggregate Wealth.

Asset structuring devises a comprehensive allocation of wealth and investments that can withstand changes in the business and financial environment and enables meeting both immediate liquidity needs and long-term financial goals.

Suppose a substantial portion of a family's wealth and human capital is tied up in a privately owned business that consistently generates significant cash flow, which is the primary source of the family's income. On the other hand, the family lacks investments outside the business, which could provide additional income to the family should the primary source of income disappear. There is an inherent lack of diversification.

If the family accepts that their financial future is tied to a company (an internally controlled asset), how the company can sustain itself for the lifetime of the family members, and perhaps even beyond, becomes an important consideration. If the family does not accept that their financial future and wealth is tied up in the family business, the question becomes whether the family would consider selling the business and transform their illiquid wealth into liquid wealth or accept the risk of linking their wealth and human capital to an illiquid entity. The wealth tied up in the business is part of the assets on the left-hand side of the family extended balance sheet. It may provide control, stability, and income, while the liquid investments offer diversification, growth potential, and financial flexibility. Its concentrated nature (i.e., lack of diversification), however, would also be noted on the balance sheet. The wealth manager can then devise strategies with the other assets to compensate for the unique risk exposures.

CASE STUDY

The Rudge Family and Their Wealth Assessment

The majority of the Rudge family's wealth and human capital is concentrated in their privately owned shipping business. This lack of diversification exposes them to specific sector and business risks, which could jeopardize their financial stability in the long run. They have a few strategic choices.

First, they could continue managing the shipping business as an internally controlled asset. It is their primary source of income and wealth. Working on its sustainability to support them and future generations would require a focus on long-term planning and risk mitigation within the shipping sector itself.

Second, they could contemplate selling the business, thus converting their illiquid wealth into more liquid, diversified assets. Such a move would give them greater financial flexibility and reduce their exposure to the shipping industry.

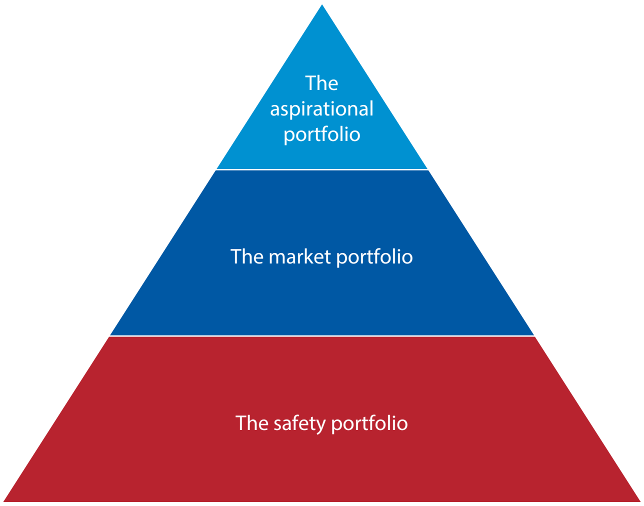
Third, they might explore structuring their non-business assets to balance the risks associated with their primary investment in the shipping company through investments in sectors that are unrelated or even counter-cyclical to shipping, thereby offering some risk mitigation. Additionally, financial strategies like shorting a shipping industry index can neutralize some of the sector-specific risks.

Asset structuring is crucial in wealth management, especially for family businesses with concentrated, illiquid assets. Understanding different asset types, their locations, control mechanisms, and the benefits of legal entities helps maximize wealth and secure financial futures. However, given the intricacies involved, professional advice is often necessary to navigate the many considerations of asset structuring effectively.

The Comprehensive Perspective on Internal and External Assets

For a client with significant internally managed assets, a framework that Ashvin B. Chhabra proposes in his book *The Aspirational Investor: Taming the Markets to Achieve Your Life's Goals* (Chhabra 2015) can be useful. He suggests allocating assets across three portfolios using a wealth allocation framework, as summarized in Exhibit 12. This approach considers both internally and externally managed assets.

Exhibit 12: The Wealth Allocation Framework



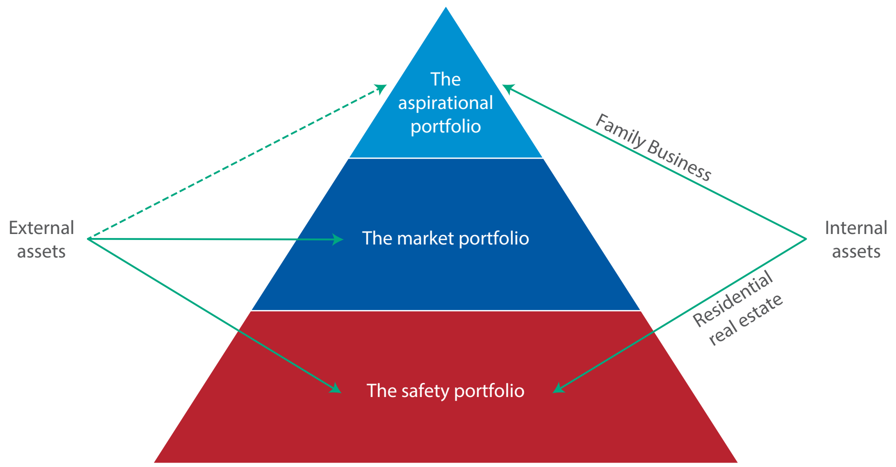
1. The safety portfolio is designed to meet non-discretionary spending demands with minimal risk. As this portfolio caters to personal living expenses at a certain standard of living and other non-discretionary purchases over some short-term interval, such as five years, it should generate relatively low, potentially below-market, returns, thus mitigating the risk of wealth loss. This portfolio is at the core of the framework. The target for this portfolio should be a zero real rate of return.
2. The market portfolio sustains long-term living standards and incorporates both discretionary and non-discretionary spending. It balances out capital needed to meet spending needs and provides capital appreciation to

counterbalance potential inflation. Investments in this portfolio comprise a diversified selection of stocks and bonds in liquid markets. Historically, a globally diversified portfolio held for the long term suggests mid to high single-digit returns.

3. The aspirational portfolio creates wealth by directing capital towards business ventures or investments that involve idiosyncratic — both market and individual — risk and the potential for significant gains or losses. This portfolio sits at the top of the wealth allocation framework and, depending on the size and source of the wealth, may be the single largest component.

From this perspective, some internally managed assets, such as mortgaged primary residences and unmortgaged secondary residences, should be considered under the safety portfolio along with cash and high-quality fixed-income instruments. The market portfolio usually includes investments included in a traditional investment portfolio defined by the principles of modern portfolio theory. Family-owned businesses, another internally managed asset, fall into the high-risk aspirational portfolio along with investments in venture capital, leveraged real estate holdings, and other high-risk, high-reward types of assets, as illustrated in Exhibit 13.

Exhibit 13: The Wealth Allocation Framework in the Entrepreneur's Case



The wealth allocation framework shifts the primary objective from outperforming the market to maximizing the probability of achieving long-term goals. Progress for each portfolio should be benchmarked separately to assess the probability of success to accumulate assets.

CASE STUDY

The Rudge Family in the Wealth Allocation Framework

The Rudge family co-owns a shipping company worth approximately USD300 million. Bruno and Maria Rudge are risk averse and eschew leverage. Their main sources of wealth are the following:

Asset	Amount in USD
Shipping company stock	150 million
Cash from Maria's education technology sale	10 million
Other personal investments	7 million
Private residence	3 million
Total assets	170 million

The family's objectives are maintaining their current lifestyle, funding their children's education, and retaining the flexibility to support poverty alleviation charities or invest in additional business ventures. They have calculated that USD15 million would enable them to sustain their current lifestyle and fund their children's education without relying on income from their shipping business. Differently put, although their overall wealth is overwhelmingly determined by the business, their basic wants are satisfied with cash and other investments. This ensures that their lifestyle remains unaffected even if the shipping company encounters financial difficulties.

Structuring the Shipping Company Ownership

The Rudge family has a plan in place to pass their business down to their children and future generations.

To potentially shift from internal to external wealth, at some point of time, a robust legal framework is crucial. When selling a privately owned company, various tax options exist, from conventional stock or asset sales to more complex transactions. Asset sales may result in double taxation — once at the corporate level and again at the shareholder level. In contrast, stock sales often enjoy tax efficiency, with lower individual capital gains rates. The company's location and the shareholders' residency affect taxes, and moving assets offshore can provide tax advantages. However, these maneuvers require extensive, costly compliance with international tax laws. Offshore structures, like companies, trusts, or foundations, are commonly used for wealth management and risk protection in specific jurisdictions.

Other Objectives

Bruno and Maria have shown a desire to reserve USD5 million for supporting impoverished communities in Argentina. Unfortunately, with only USD2 million remaining available for such initiatives and other goals, their philanthropic aspirations remain unfunded (i.e., would create negative surplus).This remaining sum of USD2 million is also crucial in other aspects. If the philanthropic aspiration is not considered as a high priority objective and is removed as an objective, at least temporarily, they could use these funds to further mitigate the economic and wealth risk inherent in their primary asset: the human capital derived from the shipping company. Ultimately, that is a risk appetite question.Despite their efforts to reduce dependency on the shipping company, the firm's significance to their wealth is dominant and additional risk reduction may not be feasible. The company represents close to 90% (USD150 million out of USD167 million) of their total assets (and excluding their residence). Unlike mass affluent investors, who usually have 90% of their assets in human capital from employment, this situation differs significantly. Its bond-like profile contrasts, however, with the equity-like nature of the Rudges' shipping business.

Wealth Allocation Framework

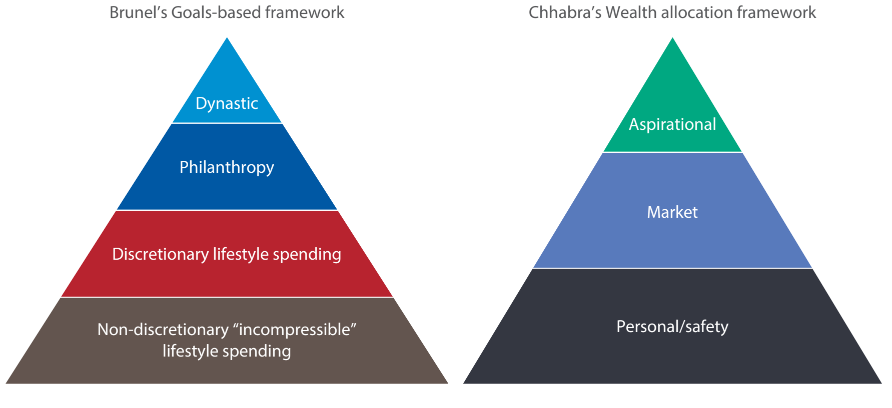
Because the bulk of the family's wealth comes from the present value of the cash flow stream of the shipping company (human capital), the Rudge family has a significant allocation in its aspirational portfolio. The safety portfolio includes the residential real estate and investments managed externally. The smallest allocation is to their market portfolio:

Wealth allocation framework	Capital allocated in USD
Safety portfolio	15 million
Maintenance of current lifestyle without reliance on shipping company's income	3 million
Residential real estate	
Market portfolio	2 million
Aspirational portfolio	150 million
Shipping company	

The family faces key risks such as inflation and the interplay between the company's wealth and their lifestyle. Inflation risks are managed by relying on the US dollar as their currency of choice. However, this alternative may not always be available, particularly in countries with currency controls in place that limit transactions in different but more stable currencies by restricting the exchange of a rapidly devaluing local currency for more stable foreign currencies.

Exhibit 14 below compares these financial goals. Both the wealth allocation framework and goals-based financial planning methodologies stress the importance of aligning personal financial goals with correspondingly appropriate investment strategies.

Exhibit 14: Goals-Based Financial Planning and the Wealth Allocation Framework



Although the terminologies differ, both frameworks match financial goals with suitable investment strategies. The wealth allocation framework's personal and safety portfolio aligns with the non-discretionary lifestyle spending goals in the goals-based framework, as both focus on addressing essential personal needs and ensuring financial security. The goals-based framework's discretionary lifestyle spending goals correspond with the wealth allocation framework's market portfolio, aiming for broader market investments.

A noteworthy difference lies within the aspirational portfolio of the wealth allocation framework. While it seems to merge philanthropic and dynastic goals from the goals-based approach, it uniquely accommodates family businesses and entrepreneurial activities. For many affluent individuals, this is a crucial aspect of both their wealth and their wealth management strategies, reflecting their varied financial priorities. Some may focus on building and transferring wealth across generations, while others might prioritize charitable giving over establishing a lasting family legacy. Although these approaches are complementary, a wealth manager should consider incorporating a private business as part of the overall portfolio. Additionally, the wealth allocation framework avoids the rigid prioritization process found in the behavioral portfolio framework. In this model, investment choices are directly tied to specific goals closely aligning with those objectives.

QUESTION SET

1. Compared to external assets, the value of internal assets is typically:

   A. exposed to greater market volatility.

   B. used to support both lifestyle goals and dynastic goals.

   C. dependent on expertise provided by the investor and his family.

   Solution:

   The correct answer is C. Internally managed assets consist of businesses in which the individual or family holds controlling or direct ownership, privately owned residential real estate, and other properties that generate value through the client's activities. Externally managed assets include financial and investment assets managed by a hired external manager and are typically more exposed to market risk rather than asset-specific risk. Either type of asset can be used to support both lifestyle and dynastic goals.

2. Edna Smith owns Mama's Bakery, a medium-sized business with 12 employees. Mama's was originally opened by her grandmother and has been a family business for more than 50 years, and the current employees have all been with the bakery for at least 10 years. Smith now wishes to retire, but her children all have professional careers and are not interested in running a bakery. Describe one advantage and one disadvantage of selling the bakery.

   Solution:

   An advantage of selling the bakery is that it would create a liquidity event, converting illiquid internally controlled assets into cash or securities. Smith could use these assets to fund her retirement and leave any remainder to her children, who do not wish to run the bakery anyway.

   A disadvantage of selling the business is that it likely has great emotional value to Smith, having been in the family for generations and due to long-term relationships she has formed with employees. Furthermore, the business may be highly dependent on Smith's ownership — for example, products may be based on family recipes and clients may patronize the store due to long relationships with the family. To the extent that such factors would not carry over to a new owner, the value of the business would be reduced, potentially to the point that there would be few or no willing buyers.

3. Smith receives an offer for Mama's Bakery of USD1,000,000 from a local restaurant owner who wants to shift the bakery's focus from being primarily retail to being a supplier for his restaurants, and as a result he intends to reduce the staff by half. Instead, Smith negotiates an arrangement with her

employees to sell the bakery to them for USD900,000. Can this be considered an arm's-length transaction?

A. Yes.

B. No, because Smith does not act solely out of self-interest.

C. No, because the buyers are not independent of the bakery.

Solution:

The correct answer is B.

In an arm's-length transaction, both buyer and seller act independently without any preexisting relationship that may sway their decision making. When both parties negotiate from self-interest, the resulting price represents a fair value for the business. Because she accepted a lower price than was offered by the restaurateur, the transaction cannot be considered arm's length.

4. Describe the typical considerations involved in asset structuring.

Solution:

The main considerations in asset structuring are (1) the legal and physical location of the assets, (2) insurance coverage to protect the assets, wealth, and human capital, and (3) addressing legal, tax, and other obligations.

TAXATION

4

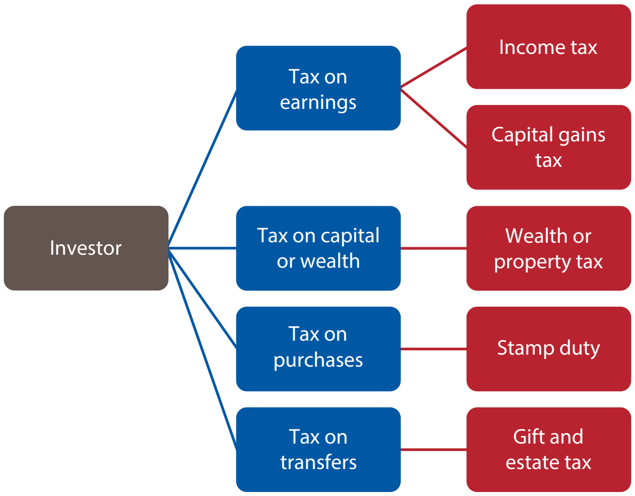
☐ evaluate how the principles of taxation and taxes influence goals-based planning and holistic financial plans for individual investors

While fees and trading costs have been widely discussed in the media and in academia, the impact of taxes on returns can be substantial. In general, a portfolio manager's goal when managing assets for a private client is to maximize the returns after taxes, given a certain level of risk.

Forms of Taxation

Private wealth clients are subject to a wide range of taxes. Although such taxes vary from jurisdiction to jurisdiction, they generally fall into the basic categories presented in Exhibit 15.

Exhibit 15: Different Types of Taxes



Income and capital gains taxes significantly impact daily portfolio management for private clients, while other types of wealth and transaction taxes can also be relevant from a wealth structuring viewpoint. There are additional types of taxes that are highly relevant in private wealth management:

- **Withholding taxes** are imposed by countries for non-resident investors for interest and dividend payments. Depending on the jurisdictions involved, there may be tax treaties between the sending and receiving countries, which will impact the withholding tax rate.
- **Property or wealth tax** typically applies to property, real estate, financial, and other assets and is usually assessed annually. While only a few countries currently implement comprehensive wealth taxes (such as Norway, France, and Switzerland), more are considering it to increase revenue.
- **Stamp duties** are taxes imposed on the purchase price of assets like shares or real estate. In some countries, like the United Kingdom, foreign investors might be subject to higher rates compared to domestic investors.
- **Wealth transfer tax** applies when assets are transferred from one owner to another through means other than a direct sale or purchase. Wealth transfer taxes can take the form of "estate" or "inheritance" taxes, paid when the investor passes away, or "gift" taxes, paid on transfers made during the investor's lifetime. Depending on the jurisdiction, these taxes may be the responsibility of either the person transferring the asset or the recipient.

Another tax with significant impact on investors is double taxation. **Double taxation** occurs when income is taxed twice, such as when corporate earnings are taxed and then dividends to investors are taxed again. Some countries have specific exemptions or provisions in their tax codes to alleviate the burden of double taxation on dividend income, such as credits, exclusions, and adjustments, such as the following:

- In Australia, if the investors' personal tax rate exceeds the corporate tax rate, they can earn "franking" credits. This means that the investor only pays the difference between their personal tax rate and the corporate tax rate.

- In the United States, if an investor holds the stock for more than 60 days, dividends from most domestic companies and qualifying foreign companies are taxed at a lower rate — not a tax credit in the strict sense, but it is intended to reduce the amount of double taxation.

To maximize returns after taxes, investment strategies should prioritize tax efficiency through the portfolio management process, the selected investment style, and asset allocation. The following example illustrates this.

EXAMPLE 1

Tax Efficiency of Various Asset Classes and Investment Strategies

An investment strategy is considered more tax efficient the lower the proportion of pretax return loss to taxes. To the investor, equity portfolios tend to be more tax efficient than strategies involving derivatives, real assets, or taxable fixed income because

1. dividends on stocks often get preferential tax treatment compared to capital gains and ordinary income;
2. many jurisdictions tax capital gains less heavily than ordinary income, and they may differentiate between short-term and long-term capital gains; and
3. the ability to control the timing of purchase and sell decisions provides asset managers more control over the tax burden.

Many investors prefer alternative asset classes for their uncorrelated returns, but the tax considerations for these investments can be more complex than those for stocks and bonds. Private equity may be less tax efficient than public equity depending on how operating income and gains within the fund are treated for tax purposes. Alternative investments, including commercial real estate, timberland, oil and gas partnerships, and other less liquid assets, may be relatively tax efficient due to some of the special tax treatment they receive in jurisdictions like the United States. They often have unique and complex tax rules, however.

Market-neutral strategies, such as short sales, convertible debt, options, futures contracts, and straddles, also tend to have unique tax treatments that also create complex tax implications. Some of these rules can be challenging to understand even for tax experts. Therefore, it's crucial to model these asset classes' contributions to portfolio risk and return on an after-tax, after-fee basis.

Additionally, the portfolio management process and the chosen investment style can also influence a tax efficiency. Typically, strategies with higher yields and higher turnover tend to be less tax efficient. However, the timing of trading patterns is also a crucial factor. For instance, momentum strategies, despite being high turnover strategies, are relatively tax efficient because they hold onto their winners and sell their losers usually for limited periods, allowing gains to accumulate and accelerating the realization of losses, which creates a tax benefit. Conversely, strategies that sell securities reaching short-term price targets are likely to be less tax efficient, especially if short-term gains are taxed more heavily than long-term gains.

Finally, a "style box" approach to select managers can also lead to tax inefficiencies. This approach involves targeted allocations within the equity portfolio such as large cap, small cap, value, growth, and alternative. These style constraints may force managers to realize gains if a security moves out of their style, risking "style drift". In fact, a security sold by one manager might be purchased by another, creating a taxable event with no change in holdings. At the total fund level, rebalancing to the targeted style allocation can create additional taxable gains.

Tax Status, Tax Efficiency, and Asset Location

The tax status of the account factors into investment decisions for private clients and influences tax efficiency, including tax status, investment strategy, and asset location. For private wealth management clients, tax status can be characterized by types of account.

- In a **taxable account**, the normal tax rules of the jurisdiction apply.
- In a **tax-deferred account**, investment and contributions may be made on a pretax basis, and investment returns accumulate on a tax-deferred basis until funds are withdrawn, at which time they are typically taxed at ordinary income tax rates.
- In a **tax-exempt account**, taxes may or may not be assessed on the initial investment or contribution. Investment returns are typically allowed to grow, and the proceeds are withdrawn without tax.

As an example, the US tax system provides distinct treatments for particular investment options, categorized as taxable, tax deferred, and tax exempt, as illustrated in Exhibit 16.

Exhibit 16: US Tax Treatment of Different Savings Accounts

	Traditional IRA 401(k), 403(b), 457, Registered Retirement Savings Plan (RRSP)	Roth IRA 529, Roth 401(k) plans, Tax-Free Savings Account (TFSA)	Non-deductible IRA	Taxable account
Initial contribution	Tax deductible	Taxable as ordinary income	Taxable as ordinary income	Taxable as ordinary income
Accumulated earnings	Tax deferred	Tax deferred	Tax exempt	Taxable as either ordinary income, dividend, or capital gain as realized
Withdrawal	Taxable as ordinary income	Tax exempt	Taxable as ordinary income	Previously unrealized gains taxed as capital gain

In Australia, superannuation plan contributions, investment returns, and withdrawals for retirement are taxed, but at a rate lower than the individual investor rate. Hence, they offer tax advantages to investors. Exhibit 17 provides a breakdown of the tax status for various accounts, categorized by investor type.

Exhibit 17: Examples of Tax Status by Type of Investor and Account

	Taxable	Tax deferred	Tax exempt
Canada	Brokerage account	Registered Retirement Savings Account (RRSP)	Tax-Free Savings Account (TFSA)
United States	Brokerage account	Traditional individual Retirement Account (IRA)	Roth Individual Retirement Account (IRA)
Australia	Superannuation fund		
Other	Personal trust Insurance company		Charitable trusts Foundation Endowment

CASE STUDY

Tax Considerations for a Private Client

John Taylor manages a taxable portfolio for Hugh Jackson, a private wealth client. A few weeks remain in the tax year, and Jackson plans to withdraw EUR450,000 from the portfolio during that time.

		Short-term gains		Long-term gains		
	Market value in EUR	Unrealized short-term gain (loss) in EUR	Realized short-term gain (loss) in EUR	Unrealized long-term gain (loss) in EUR	Realized long-term gain (loss) in EUR	Year-to-date income (dividends / interest)
Domestic equities	8,000,000	(500,000)	250,000	2,500,000	500,000	120,000
Domestic fixed income	5,000,000	0	0	1,000,000	0	150,000
Income-producing real estate	1,000,000	0	0	500,000	0	60,000
Total	14,000,000	500,000	250,000	4,000,000	500,000	330,000

1. Recommend a strategy for Jackson's planned withdrawal. Explain how the strategy might differ if the portfolio were held in a tax-deferred retirement account.

   Solution:

   If the expected returns on the various securities held are similar, a tax-minimizing strategy would be to sell some of the securities with unrealized losses to fund the withdrawal. Realizing losses would reduce the net realized gains for the year, reducing overall tax liabilities. However, the potential tax savings are only part of the investment decision. Because the money is being withdrawn, it cannot be reinvested into similar securities (thus capitalizing on investment growth of the tax savings). If the securities with unrealized losses have higher expected returns than others in the portfolio, the reduced potential future returns may outweigh the current-year tax savings.

   If the portfolio were instead held in a tax-deferred retirement account, Jackson would be taxed on the EUR450,000 withdrawal regardless of its source and the decision of which securities to sell would be based solely on their relative investment merits.

Tax efficiency plays a crucial role in investment planning, influencing not only the security and fund levels but also a client's financial plan, asset allocation strategy, and wealth transfer plan. Clients typically hold a mix of taxable, tax-deferred, and tax-exempt accounts.

Asset Location

Investment planning should consider how the chosen investment strategy interacts with the types of accounts to which it will be applied. As clients approach retirement and begin to draw down their assets, they have additional opportunities to maximize the after-tax value of their assets. Exhibit 18 presents the various stages of creating and implementing a financial plan, offering examples of both tax-aware and tax-indifferent planning at each stage.

Exhibit 18: Examples of Tax-Aware Approaches to Planning

Strategic decisions	Common tax-indifferent approach	Tax-aware approach
Financial planning	Use pretax growth assumptions	Use after-tax growth assumptions for taxable accounts
Investment selection	Use pretax return	Favor tax-efficient investments, such as index funds, ETFs, or tax-managed funds, especially in taxable accounts
Investment strategy	Use pretax return	Favor longer holding periods or tax-motivated overlays such as tax-loss harvesting
Asset allocation	Use pretax return and volatility expectations	Use after-tax return and volatility expectations
Asset location	A single allocation across taxable and tax-deferred accounts	Tax-advantaged assets favored in the taxable account
Retirement income planning	Withdraw from retirement accounts first	Optimize withdrawals from taxable and tax-advantaged accounts
Estate planning	Ignore estate or inheritance taxes	Manage estate tax liability, such as gifting during the lifetime, establishing trusts, or using life insurance products
Charitable giving	Gift cash	Gift highly appreciated stock

A private wealth client usually has assets spread across taxable, tax-deferred, and tax-exempt portfolios. The process of asset allocation should not only establish the appropriate mix of asset classes overall but also determine which asset classes are best suited for which accounts. The asset location determines whether the assets should reside in a taxable, tax-deferred, or tax-exempt account.

Common practice suggests placing tax-efficient assets in the taxable account and tax-inefficient assets, such as equities, in the tax-exempt or tax-deferred account. This is not a hard and fast rule, however. Investors may find that the size of their tax-sheltered assets exceeds the optimal fixed-income allocation, in which case the remainder could naturally be allocated to equity.

If a manager expects a 10% return on equities and a 6% return on fixed income, the pretax return estimate would be 8% for a balanced portfolio. For taxable clients, tax-efficient options like tax-exempt bonds and tax-managed equities can change the expected return. These assets can be especially beneficial if placed in taxable accounts. For example, tax-managed equities can offer better after-tax returns compared to regular equities. Similarly, tax-exempt bonds may offer better after-tax returns than regular bonds, even if they have lower pretax returns. Tax rates for different assets can also affect these calculations. Exhibit 19 illustrates how return expectations might vary by asset class and account, assuming a 50% marginal tax rate on fixed income, a 25% tax rate on equities, and a 10% effective tax rate on tax-managed equities.

Exhibit 19: After-Tax Return Expectations by Asset Location

	Asset location	
	Taxable account	**Tax-exempt account**
Equity	7.5%	10%
Tax-managed equity	9%	10%
Fixed income	3%	6%
Tax-exempt fixed income	4%	4%

Exhibit 20 illustrates asset location strategies for accounts that are equally split between taxable and tax exempt. Here, Panel A follows conventional wisdom, putting high-return assets in tax-exempt accounts to shield gains from taxes, aiming for a 6.5% return. However, higher returns also mean higher risks, which, when accounted for, make the after-tax value similar regardless of asset location.

Exhibit 20: Maximizing the After-Tax Return of a Given Asset Allocation

Panel A: Conventional wisdom

	Taxable account	Tax-exempt account	Pretax weights
Equity		50	50%
Tax-managed equity			0%
Fixed income	50		50%
Tax-exempt fixed income			0%
Total	50	50	100%
After-tax expected return	6.5%		

Panel B: Tax-aware asset location

	Taxable account	Tax-exempt account	Pretax weights
Equity	50		50%
Tax-managed equity			0%
Fixed income		50	50%
Tax-exempt fixed income			0%
Total	50	50	100%

Panel B: Tax-aware asset location

	Taxable account	Tax-exempt account	Pretax weights
After-tax expected return	6.8%		

Panel C: Tax-aware asset location and investment strategy

	Taxable account	Tax-exempt account	Pretax weights
Equity			0%
Tax-managed equity	50		50%
Fixed income		50	50%
Tax-exempt fixed income			0%
Total	50	50	100%
After-tax expected return	7.5%		

Panel D: Partially tax-aware asset location and investment strategy

	Taxable account	Tax-exempt account	Pretax weights
Equity		25	25%
Tax-managed equity	25		25%
Fixed income		25	25%
Tax-exempt fixed income	25		25%
Total	50	50	100%
After-tax expected return	7.3%		

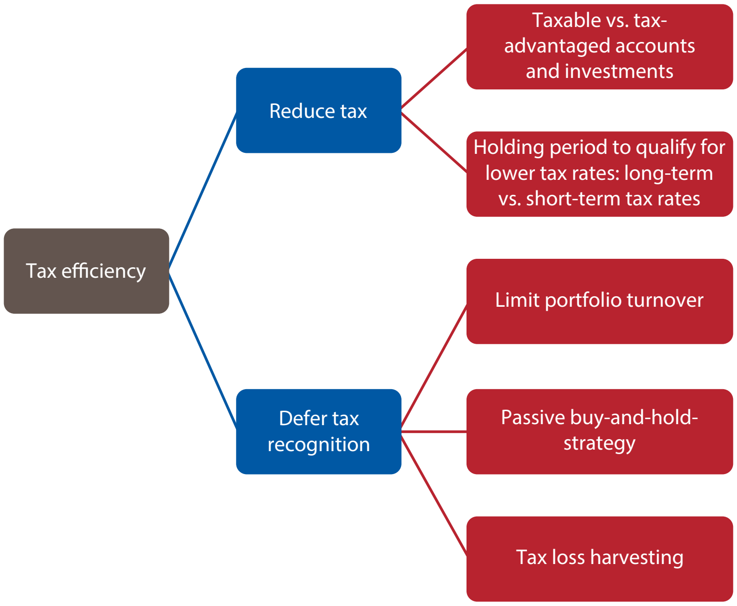
- Panel B shows a tax-smart allocation, putting tax-efficient equity in the taxable account and tax-inefficient fixed income in the tax-exempt account. This strategy yields a 6.8% after-tax expected return, outperforming the conventional approach's 6.5%.
- Panel C boosts the after-tax expected return to 7.5% by using tax-managed equity in the taxable account.
- Panel D, using a partially tax-aware strategy, achieves a 7.3% after-tax return — lower than Panel C but still outperforming other methods.

Implementing an asset location strategy requires flexibility. The client might have a different goal and time horizon for each account type. From a goals-based financial planning perspective, it may be sensible to collect all assets into a sole tax-advantaged account. For instance, a tax-efficient asset location strategy might recommend allocating 100% of the retirement savings account to bonds and 100% of the taxable investment account to tax-managed equities. While it might be ideal to place all bonds in a tax-advantaged account and all tax-managed equities in a taxable one, this may not suit clients with short-term needs in their taxable accounts. Such needs could expose them to undue risk from a 100% equity allocation.

Tax Efficiency

The prevalence of tax-exempt institutional portfolios has led to a prevalence of pretax frameworks in the field of investment theory and practice. This section provides an overview of various tax management techniques to effectively plan and execute investment strategies for taxable clients. The fundamental strategies for managing taxes in a portfolio can be divided into two main categories, as Exhibit 21 depicts.

Exhibit 21: Fundamental Strategies to Manage Taxes in a Portfolio



Some specific examples to achieve tax efficiency include legally structuring investments to reduce the amount of tax owed through a combination of

- holding assets in a tax-exempt account versus a taxable account;
- holding assets in jurisdictions with lower tax rates;
- investing in tax-exempt bonds instead of taxable bonds;
- investing in tax-advantaged investment plans; and
- holding assets long enough to qualify for long-term capital gains treatment.

Another strategy is to defer the recognition of certain taxable income until some future date, allowing investors to benefit from the compounding of pretax rather than after-tax portfolio returns. In a progressive tax system, investors may also benefit from deferring taxes to a future date if they anticipate their tax rate in the future will be lower. Other examples of tax deferral strategies include

- limiting portfolio turnover and the consequent realization of capital gains; and
- selling securities at a loss to offset a realized capital gain (i.e., tax-loss harvesting). Offsetting taxable gains by recognizing tax-deductible losses is a deferral strategy because it resets the basis on the depreciated security to today's (lower) market value when it is reinvested in something else, thereby creating a (deferred) gain some future date if prices increase.

The holding period of an investment often emerges as a common theme among basic strategies. Turnover is sometimes seen as an indicator of tax efficiency. While low-turnover index funds are usually tax efficient, high turnover isn't always tax inefficient. It can incur costs but also offer tax benefits, as seen with tax-managed funds that report high turnover in bear markets.

Tax-loss harvesting is a strategy that investors use to reduce their income tax liability in taxable accounts. It involves selling securities at a loss to offset capital gains, thereby reducing the net tax liability in that period. The tax offset can reduce capital gains taxes in the current or even future tax periods. Not all jurisdictions allow tax-loss harvesting: some jurisdictions allow realized capital losses to offset realized capital gains: there are limitations placed on the amount of net losses that can be recognized or the type of income they can offset (e.g., short-term capital gains, long-term capital gains, or ordinary income). For instance, Canada only allows tax-deductible losses up to the level of realized taxable gains. Realized losses in excess of realized gains may be used to offset gains realized within the last three years. Realized losses beyond that point can be carried forward and applied against gain realized at some future date. Regardless of the specific tax rules, the opportunity to recognize a loss that offsets some kind of taxable gain in a given tax year can create value.

Different countries have different tax laws that affect how investors can use tax-loss harvesting; some tax laws may be more or less favorable for this strategy than others.

CASE STUDY

Tax-Loss Harvesting: Current Tax Savings

Eduardo Cappellino has a EUR1,000,000 portfolio held in a taxable account. The end of the 20X4 tax year is approaching, and Cappellino has recognized EUR100,000 worth of capital gains. His portfolio has securities that have experienced EUR60,000 of losses. These securities have not yet been sold, and their losses are therefore unrecognized.

Cappellino could sell these securities and replace them with similar securities expected to earn the same return. Capital gains are taxed at 20%.

1. Without making any further transactions, how much tax does Cappellino owe this year?

   Solution:

   Capital gain tax = 0.20 × EUR100,000 = EUR20,000.

2. How much tax will Cappellino owe this year if he sells the securities with the EUR 60,000 loss?

   Solution:

   If Cappellino realizes EUR60,000 of losses, the net gain will be reduced to EUR40,000. New capital gain tax = 0.20 × (EUR100,000 - EUR60,000) = EUR8,000.

3. How much tax will Cappellino save this year if he sells the securities with the EUR 60,000 loss?

   Solution:

   Tax savings = EUR20,000 - EUR8,000 = EUR12,000. On a EUR1 million portfolio, the tax savings provide an additional 1.2% incremental accumulation.

It is important to understand that the tax savings realized in a given tax year from tax-loss harvesting overstates the true gain. Selling a security at a loss and reinvesting the proceeds in a similar security effectively resets the cost basis to the lower market value, potentially increasing future tax liabilities. In other words, taxes saved now may be simply postponed. The value of tax-loss harvesting is largely in deferring the payment of tax liabilities.

CASE STUDY

Tax-Loss Harvesting: Tax Deferral

In the previous example, the securities with an unrealized loss have a current market value of EUR110,000 and cost basis of EUR170,000 (an unrealized loss of EUR60,000). Here, Cappellino could

- Option A: Hold the securities with the unrealized loss; or
- Option B: Sell the securities in 20X5 and replace them with securities offering the same return.

Next tax year (20X5), the securities increase in value to EUR200,000 and the securities are sold regardless of which option Cappellino chooses.

1. Calculate Cappellino's 20X5 tax liability if he holds the securities until year end 20X5.

Solution:

Capital gain tax = 0.20 * (EUR200,000 - EUR170,000) = EUR6,000.

2. Calculate Cappellino's 20X5 tax liability if he recognizes the loss today in 20X4, replaces them with securities offering the same return, and realizes the capital gain at year end 20X5.

Solution:

If Cappellino recognizes the loss in 20X4 and replaces the securities, the basis will be reset to EUR110,000 from EUR170,000. Capital gain tax in 20X5 = 0.20* (EUR200,000 - EUR110,000) = EUR18,000.

3. Compare the total two-year tax liability under both options using the 20X4 tax liability computed in the previous example, in which the 20X4 tax liability was EUR 20,000 if the loss was not realized and EUR 8,000 if the loss was realized.

Solution:

The two-year tax liability for both options is the same:

	20X4 (EUR)	20X5 (EUR)	Total (EUR)
Option A	20,000	6,000	26,000
Option B	8,000	18,000	26,000

Although the two-year tax liability does not change, an advantage of tax-loss harvesting is pushing a portion of the tax liability into subsequent years.

A subtle benefit of tax-loss harvesting is that recognizing an already incurred loss for tax purposes increases the amount of net-of-tax money available for investment. Realizing a loss saves taxes in the current year, and this tax savings can be reinvested. This technique increases the amount of capital the investor can put to use.

Investors could conceptually recognize all their losses each tax year by selling all securities trading below their cost basis and immediately repurchasing them at the same price. Many jurisdictions consider this type transaction a "**wash sale**" and do not allow the tax offset. A wash sale occurs when an investor sells a security at a loss and buys a very similar or substantially identical stock or security within a given time period before or after the sale. Depending on the local country rules and the number of days before repurchase, the repurchase of the security may negate the investor's ability to recognize the loss for tax purposes.

CASE STUDY

Asset Location Strategies to Maximize Returns

Charles and Ivy Lee have USD15,000,000 of financial assets. In addition, Charles Lee, 55 years old, will soon receive USD2,500,000 inheritance from his parents, and his partner, Ivy Lee, 54 years old, will soon receive a USD2,500,000 rollover from her company-sponsored retirement plan that will be deposited in her tax-deferred retirement account.

The Lees have agreed that they want to establish a USD2,500,000 "angel" fund to make investments in small start-up companies, as they already have sufficient assets to fund their lifestyle needs. This angel investment, although technically equities, will be over and above the 60% allocated to equities in their core portfolio. The remaining USD2,500,000 will be invested to maintain the 60/40 asset allocation using the same strategies employed for their other liquid assets.

Their other investment assets before considering the addition of the inheritance and rollover are summarized as follows, with the 50% marginal income tax rate and 20% capital gains tax rate assumed, respectively.

	Taxable brokerage account (tax basis)	Tax-deferred retirement account	Other (tax basis)	Pretax/After-tax return expectation
Passive global equity fund		3,000,000		7.0%/7.0%
Passive fixed income (taxable)		2,000,000		3.0%/3.0%
Active global equity fund	3,000,000 (2,500,000)			9.0%/6.5%
Tax-exempt fixed income	2,000,000 (1,800,000)			1.5%/1.5%
Residential real estate			3,000,000 (2,750,000)	n/a
Concentrated equity position			15,000,000 (4,000,000)	n/a
Total	5,000,000	5,000,000	18,000,000	

The Lees' advisor has warned them that while the average angel investor realizes 2.5x per dollar invested, more than half of all angel investments lead to a loss.

1. Which account would you recommend that the Lees use to fund their angel investments? Justify your response.

   Solution:

   Charles's inheritance has been deposited into his taxable account. The angel investment should be made in this taxable account. Held in the taxable account, the Lees can use any losses generated to offset gains elsewhere in the account. Over the long term, the Lees expect to realize significant capital gains on these investments. Held in the taxable account, these gains will be taxed at the 20% capital gains rate. If held in the tax-deferred retirement, the gains would be taxed at the 50% income tax rate as they are withdrawn.

2. Of the four other strategies currently employed in the Lees' accounts, which should the advisor recommend for the balance of the new money? Justify your response.

   Solution:

   Charles is using his inheritance for angel investments, so Ivy's USD2,500,000 company-sponsored retirement plan rollover must be distributed among the current investment strategies to maintain a 60/40 asset allocation. This rollover is in Ivy's tax-deferred retirement account. The most tax-efficient strategy would be to put the equity investments in the brokerage account and the fixed-income allocation in the retirement account. This allows the Lees to fully utilize the more favorable tax rate on capital gains. With the new cash in Ivy's retirement account, the Lees can rebalance their portfolio for better tax efficiency.

   The Lees have USD12,500,000 in financial assets, excluding the angel fund. The 60% equity allocation represents USD7,500,000. The Lees should prioritize equity in the brokerage account. The balance of the brokerage account, however, is USD5,000,000. It should therefore be entirely invested in equities as part of the desired 60/40 asset allocation. However, to rebalance, they would need to realize an embedded gain of USD200,000 from the tax-exempt fixed-income position. The Lees' advisor must evaluate whether it's worth incurring the capital gains tax liability to reinvest in a higher-return strategy. If they can realize losses elsewhere in the portfolio, they could use these to offset this gain.

   The remaining equity allocation, USD2,500,000, would be made through the tax-deferred retirement account. The active global equity strategy is the most appropriate with its higher return (9% versus the 7% expected return for the passive strategy) and will compound tax-free deferred over the Lees' long investment horizon.

   Choosing an equity strategy for the brokerage account is complex. While the passive strategy is more tax efficient, other factors. like tracking error and the manager's ability to execute tax-managed trading strategies. could make the active strategy preferable.

   The 40% fixed-income allocation, USD5,000,000, should be made through the tax-deferred retirement account. The most suitable strategy is the passive fixed-income (taxable) strategy.

   The final asset allocation is shown in the following table:

	Taxable brokerage account (in USD)	Tax-deferred retirement account (in USD)
Passive global equity fund	5,000,000	0
Active global equity fund		2,500,000
Total equity		
Tax-exempt fixed income		0
Passive fixed income (taxable)	0	5,000,000
Total fixed income	5,000,000	7,500,000

Tax Avoidance vs. Tax Evasion

As fiduciaries, portfolio managers and advisors are obligated to invest efficiently and avoid unnecessary frictions. Taxes are one of the frictions to be managed, but there is a risk in being too clever when attempting to reduce that particular friction. Denis Healey, a former UK Chancellor of the Exchequer, is often quoted: "The difference between tax avoidance and tax evasion is the thickness of a prison wall."

Because usage of the terms likely differs from jurisdiction to jurisdiction, we will start by defining what we mean by "tax avoidance" and "tax evasion." The general principle is that **tax avoidance** is developing strategies that conform to both the spirit and the letter of the tax codes of jurisdictions with taxing authority. **Tax evasion**, on the other hand, is the practice of circumventing tax obligations by illegal means such as misreporting or not reporting relevant information to tax authorities. If the primary purpose of the activity is to avoid paying tax and the activities are misleading or do not have merit in their own right (i.e., do not serve a legitimate non-tax purpose), then the activity is likely unethical and may be illegal.

CASE STUDY

Navigating the Nuances of Tax Planning and Avoidance

Distinguishing between tax planning and avoidance hinges on the intent and outcomes of interconnected financial, legal, investment, and tax arrangements.

A real estate developer outright owned multiple substantial real estate development projects. Subsequently, the developer consolidated several residential projects into a newly incorporated entity, Alpha Inc., in which he became the sole shareholder and director as well as one of several hundred employees. The developer incorporated another entity as well, Beta Inc., fully owned by the developer, who was the only director as well.

Next, the developer resigned as an employee from Alpha Inc. but retained his role as its sole director. In this capacity, he established a service agreement between Alpha Inc. and Beta Inc. Beta Inc. then provided development services to Alpha Inc., earning fees that are subject to corporate taxes. Additionally, the arrangement allowed the developer to receive tax-exempt dividends from Beta Inc.

Essentially, this structure mimics the developer's original role in Alpha Inc. but with a different compensation model. The developer now receives taxable compensation from Beta Inc. and also earns tax-exempt dividends, adding layers of complexity to the tax situation.

Tax authorities often scrutinize three key aspects to distinguish between tax planning and tax avoidance:

1. Tax authorities assess the motives behind incorporating an additional company, like Beta Inc.
2. Tax authorities examine the determination of remuneration from Beta Inc. to the developer.
3. The authorities compare overall taxes paid prior to and after the foregoing arrangements.

Typically, merging multiple projects is deemed legitimate business practice. Similarly, creating a separate company to offer services to others is seen as legitimate business practice and is often used to legally shield assets. Both actions qualify as tax planning as long as they are executed for genuine commercial purposes and without a primary intent of avoiding or reducing tax liabilities.

After deducting the developer's remuneration, Beta Inc.'s net profits qualified for tax-exempt dividends. Since Beta Inc. paid the developer less than he earned at Alpha Inc., a surplus was created, allowing him to take these dividends tax free. This change in compensation and its tax implications potentially borders on tax avoidance due to the difference in overall taxes paid pre- and post-arrangements.

Furthermore, the real estate developer's role as the sole shareholder and director of both Alpha Inc. and Beta Inc. necessitated arm's-length transactions. The low compensation from Beta Inc. to the developer likely breached the arm's-length requirements, particularly as the compensation received by the developer was lowered.

The CFA® Institute Code of Ethics and Standards of Professional Conduct require that CFA charterholders and candidates act with integrity, competence, diligence, respect, and in an ethical manner. Focusing on after-tax returns, minimizing unnecessary tax burdens, and being thoughtful about how taxation interacts with a portfolio are all elements of being a good steward of a client's assets. However, it is important to never be involved in helping a client disguise true ownership of assets or otherwise be involved in tax evasion. Charterholders and candidates must not engage in any professional conduct involving dishonesty, fraud, or deceit or commit any act that reflects adversely on their professional reputation, integrity, or competence.

CASE STUDY

Tax Avoidance vs. Tax Evasion — Ethical and Legal Obligations

Esther Pease made a EUR50,000 investment in an equity security on a London stock exchange nine months ago. It is worth only EUR10,000 today, having suffered a EUR40,000 loss. She solicits the advice of her wealth manager. Pedro Easton, CFA, about selling the investment and using the EUR10,000 pretax proceeds to purchase shares in the same company on the Frankfurt exchange where the shares also trade.

1. Should Easton advise Pease to proceed with the proposed transactions?

   Solution:

   The proposed transaction likely represents a "wash sale" because Pease's stake in the firm has not substantively changed, even though the trading venue has changed from London, UK to Frankfurt, Germany. Unless the tax rules in her jurisdiction specifically allow for losses to be recognized for tax purposes even if the identical shares are purchased on a different exchange located in a different jurisdiction, the recognized loss would most likely be disallowed for tax purposes.

The proposed transactions would likely constitute tax evasion because they may violate the letter, and almost certainly violate the spirit, of the law. Additionally, Easton would violate the CFA Institute Code of Professional Conduct if he encouraged it.

In general, wealth managers should consider tax management within the broader context of portfolio strategy. In other words, proper portfolio management and risk management are the primary considerations and ought not be sacrificed to achieve a particular tax result. In this way, the CFA Institute Code and Standards and most tax regulations are philosophically in alignment. It is commonly said, for example, that the "tax tail ought not wag the investment dog."

Investor Tax Domicile and Jurisdiction

Portfolio managers investing on behalf of private clients need to consider the tax ramifications of cross-border investments. Countries often impose withholding taxes on interest, dividends, and royalties earned from investments owned by foreign investors within their jurisdiction. This income may be taxed in the country where it's earned and potentially again in the investor's home country.

Tax systems, which governments use to either encourage or discourage certain investment activities, are specific to each country and can change based on government leadership, political alliances, party agendas, and policy preferences. These systems often include tax incentives to encourage investment in domestic companies, retirement savings, or infrastructure projects, and the structure and framework for these incentives vary globally. Instead of detailing the specific rules for each country and jurisdiction, we provide a general framework to help understand how different tax environments can impact clients. It's crucial for private wealth advisors to familiarize themselves with the tax rules of each jurisdiction that affects their clients.

Main Types of International Tax Systems

In general, the main types of tax systems we find internationally fall into three broad categories:

- A **tax haven** is a country or independent region with no or very low tax rates for foreign investors. For instance, the Cayman Islands, known for having no income or capital gains tax, no property tax (except when property is transferred), and no corporate taxes, is a popular tax haven. The British Virgin Islands and The Bahamas also don't tax income or capital gains. While Russia and Saudi Arabia have very low tax rates, they are not considered tax havens because their favorable tax treatment is only for residents.
- **Territorial tax systems** are found in jurisdictions that tax only income earned within their borders. Hong Kong SAR is an example. It has significantly lower tax rates than mainland China and doesn't tax capital gains, dividends, or income earned outside of Hong Kong SAR. The Philippines and Singapore also have territorial tax systems.
- **Worldwide tax systems** are jurisdictions that tax all income no matter where it's earned. Countries like Switzerland, France, Germany, India, Canada, and Japan use this system. This can lead to double taxation, as the country where the investments are made may also tax this income. To address this, the home country, usually the where the taxpayer resides, may provide tax credits or other forms of relief such as tax treaties (agreements between countries).

Some jurisdictions have hybrid systems. For example, although UK citizens pay tax on worldwide income and are therefore subject to a worldwide tax system, the United Kingdom has a special provision for non-citizen residents who regard some other country, usually their country of birth, as their permanent home. These resident non-domiciliaries are subject to a territorial tax system and taxed only on income sourced in the United Kingdom, as long as they pay a so-called remittance basis charge.

- **Citizenship-based tax systems** tax their citizens regardless of their residential status. If you are a citizen of a country that taxes based on citizenship and live in another country, you will still be required to pay income tax in your native country. The United States uses this system.

Because countries operating under a worldwide tax system generally impose those taxes only on individuals considered to be residents of that country, residence rules become very important. **Residence rules** specify how much time a person can spend in a country without becoming a taxable resident. If an individual spends time in more than one country, tax treaties can play an important role in determining tax residence.

The United States is one of the few countries that taxes citizens and non-citizen residents on a worldwide basis regardless of residence. As a result, US citizens and non-citizen permanent residents (such as green card holders) living in Hong Kong SAR will be subject to US tax on their worldwide income. It is important, therefore, when working with cross-border families to be conscious of the nexus clients create with the United States because it could subject them to US tax on their worldwide income.

When working with wealthy families, it is essential to develop a full understanding of the tax jurisdictions that will affect investment and estate planning, as clients may be citizens, residents, or investors in multiple countries. A good rule of thumb is to start with the tax rules of the investor's country of citizenship, which may influence decisions on how to own assets in another country. Then, the second step is to focus on the domicile of the investor and the location of the investor's assets. Citizenship, domicile, and the location of the assets jointly determine tax exposures and the ability to mitigate different types of tax exposures, as shown in Exhibit 22.

Exhibit 22: Factors Impacting Tax Exposures

EXAMPLE 2

General Income Tax Regimes

Countries typically structure their income tax systems as either progressive or flat. These tax regimes can further be categorized based on how they tax investment returns in taxable accounts. For instance, interest income may be taxed at ordinary rates or at favorable rates under specific provisions. In this review, we assume interest income is taxable at ordinary rates unless significant exceptions apply. We use similar classifications for dividends and capital gains. The exhibit below identifies seven distinct tax regimes based on a classification of common elements of these tax regimes.

Income tax regime	1 – Common progressive	2 – Heavy dividend tax	3 – Heavy capital gain tax	4 – Heavy interest tax	5 – Light capital gain tax	6 – Flat and light	7 – Flat and heavy
Ordinary tax rate structure	Progressive	Progressive	Progressive	Progressive	Progressive	Flat	Flat
Interest income	Some interest taxed at favorable rates or exempt	Some interest taxed at favorable rates or exempt	Some interest taxed at favorable rates or exempt	Taxed at ordinary rates	Taxed at ordinary rates	Some interest taxed at favorable rates or exempt	Some interest taxed at favorable rates or exempt
Dividends	Some dividends taxed at favorable rates or exempt	Taxed at ordinary rates	Some dividends taxed at favorable rates or exempt	Some dividends taxed at favorable rates or exempt	Taxed at ordinary rates	Some dividends taxed at favorable rates or exempt	Taxed at ordinary rates
Capital gains	Some capital gains taxed favorably or exempt	Some capital gains taxed favorably or exempt	Taxed at ordinary rates	Some capital gains taxed favorably or exempt	Some capital gains taxed favorably or exempt	Some capital gains taxed favorably or exempt	Taxed at ordinary rates
Examples	Austria Brazil China Czech Republic Finland France Greece Hungary Ireland Italy Japan Latvia Malaysia Netherlands Nigeria Philippines Poland Portugal Singapore South Africa Sweden Thailand United Kingdom United States Vietnam	Argentina Indonesia Israel Venezuela	Colombia	Canada Denmark Germany Luxembourg Pakistan	Australia Belgium India Kenya Mexico New Zealand Norway Spain Switzerland Turkey	Kazakhstan Russia Saudi Arabia (Zakat)	Ukraine

Sources: Classified based on information provided in International Business Guides from Deloitte Touche Tohmatsu (available at http://www.deloitte.com) and online database of worldwide taxation provided by PricewaterhouseCoopers (http://www.taxsummaries.pwc.com).

- Common progressive regime: This regime applies progressive tax rates to ordinary income while providing favorable treatment to all three investment income categories: interest, dividends, and capital gains. Despite being categorized as "common," variations exist within this regime, with some countries treating certain interest income as ordinary and other interest income as tax-exempt.

- Heavy dividend tax regime: This regime uses a progressive tax system for ordinary income and provides favorable treatment for some interest and capital gains. However, it taxes dividends at ordinary rates.
- Heavy capital gain tax regime: This regime employs a progressive tax system for ordinary income and offers favorable treatment for interest and dividends. However, it taxes capital gains at ordinary rates. We observed only one country with this regime.
- Heavy interest tax regime: This regime uses a progressive tax system for ordinary income and provides favorable treatment for dividends and capital gains. However, it taxes interest income at ordinary rates.
- Light capital gain tax regime: This regime applies a progressive tax system to ordinary income, interest, and dividends but provides favorable treatment for capital gains. This was the second most commonly observed regime.
- Flat and light regime: This regime uses a flat tax system and provides favorable treatment for interest, dividends, and capital gains.
- Flat and heavy regime: This regime applies a flat tax system to ordinary income, dividends, and capital gains. It does not provide favorable treatment for dividends and capital gains, but it does for interest income.

Apart from the various tax regimes that may impose different tax rates on different types of income, there are other crucial aspects in tax planning for investments. Some countries allow the use of tax-deferred retirement accounts. Conversely, a few countries levy a wealth tax periodically on accumulations, which, like income taxes, can reduce after-tax returns and accumulations.

Investment decisions, especially those involving cross-border transactions, can be complex due to various tax implications. The optimal strategy will depend on the investor's specific investment goals and estate planning objectives. Therefore, it's crucial to engage an international tax specialist to ensure all relevant issues are considered in cross-border investment decisions.

CASE STUDY

Considerations in Cross-Border Investing

Josie Boyd is a Hong Kong citizen living in Hong Kong SAR. She wants to invest in the United States. The ownership structure of an investment will have a material impact on its after-tax return. Consider the following:

- Hong Kong SAR operates under a territorial tax system; thus, it would not tax any income or gains arising from the US-located investment.
- The United States taxes investments in the United States regardless of the investor's citizenship or residence, taxing both income from the investment and any capital gain on a sale of an investment. The investment may also be subject to US estate and gift taxes. Depending on the location of the US investment, state taxation may come into play in addition to any federal tax obligation.
- Hong Kong SAR also has no inheritance or estate tax, so the only tax considerations to be addressed are those arising from the United States.

Josie can own the US investment

- directly in her name, and she would be subject to taxes on the income earned without offsetting that income with investment expenses, and there would be an estate tax payable upon her death, although the value of the estate would be reduced by any outstanding debt on the investment;
- indirectly through a US corporation; the US corporation could be owned by a non-US entity, either Josie herself or a non-US corporation, and investment expenses could be used to offset the income. Only the net income would be subject to withholding in the United States when it is paid to the non-US owner. At Josie's death, the shares of the company either pass to Josie's heirs, or if the company is liquidated, any gains on the assets would be taxed at the corporate capital gains tax rate, which is higher than the capital gains tax rate for individuals. In addition, any retained earnings would be subject to withholding; or
- indirectly through a non-US corporation; the value of the asset would not be subject to US estate taxes at Josie's death. The shares of the company pass to Josie's beneficiaries, not the assets itself, on her death. As a non-US company, it is not subject to US taxation.

Owning investments within corporations is a useful alternative but may be a poor choice in some instances. It offers the advantage of legally separating assets, but this approach can introduce tax considerations, as disbursements from corporate entities in some jurisdiction might be subject to ordinary income taxation rather than the treatment as investment income. Naturally, in certain other jurisdictions, all investment-related earnings — whether derived from privately held businesses or publicly traded corporations — might face similar tax rates, aiming to minimize attempts at exploiting legal loopholes for tax avoidance.

Other structures shield investors from taxes, such as trusts, private insurance companies, and private foundations. These structures are dependent upon both where they are located and where the investor is legally domiciled. The next example provides a direct comparison of similar investments based on jurisdiction and domicile, highlighting the importance of legal domicile for the investor.

CASE STUDY

Jurisdictional Considerations for Private Clients

Franz Schmid is a portfolio manager for Global Wealth Advisors (GWA), an investment management firm focused on private clients. Franz manages diversified portfolios of stocks and bonds. GWA has recently been retained by two new clients — Valerie Low, based in Singapore, and David Morehouse, based in Switzerland. Each has a portfolio of CHF10 million, or its equivalent, held in taxable accounts located in their home domiciles and the United States. Valerie and David have similar risk and return objectives, and each has agreed to an asset allocation of 50% domestic stocks and bonds (Singaporean and Swiss, respectively) and 50% US stocks and bonds.

Singapore operates under a territorial tax regime. Switzerland operates under a worldwide tax regime. Based on the general principles of territorial and worldwide tax regimes, describe the implications of the two countries' tax regimes for each client's wealth management strategy.

Franz must first determine the citizenship of each client to determine which tax rules must be considered in structuring the portfolio. He learns that they both are citizens of the country in which they currently reside. The table below summarizes these considerations, which are explained in further detail.

Investor	Home country portfolio (Singapore / Switzerland)	US portfolio (United States)	Wealth and estate taxes
Valerie Low (Singapore)	▪ Taxed only on income earned in Singapore ▪ No tax on most dividends and domestic interest income	▪ 30% US withholding tax on gross dividends ▪ Capital gains not taxed by the United States	▪ No estate tax in Singapore ▪ US estate tax applies to US stock holdings ▪ May create a non-US company to hold US stock investments
Potential implication		▪ Portfolio emphasizes fixed-income securities and high-growth, low-dividend equities	▪ May create a non-US company to hold US stock investments
David Morehouse (Switzerland)	▪ Taxed on all investments in Switzerland and US investments ▪ Dividend and interest income taxed at 35% ▪ Capital gains are tax exempt	▪ US withholding tax on dividends reduced to 15% due to bilateral tax treaty ▪ US withholding tax on dividends reduced to 0% due to bilateral tax treaty ▪ Capital gains not taxed by the United States ▪ Portfolio may have higher allocation to dividend-paying stocks	▪ Modest estate tax in Switzerland ▪ For US estate tax exemption, full disclosure of net worth required ▪ May consider creating a non-US company to hold US investments
Potential implication	▪ Portfolio emphasizes high-growth equities	▪ Portfolio may have higher allocation to fixed-income and dividend-paying stocks held in a non-US corporation	▪ May consider creating a non-US company to hold US investments

Home Country Portfolios

- Valerie Low: As a citizen and resident of Singapore, Valerie will be taxed only on income earned in Singapore. Because Singapore also exempts most dividends from Singapore companies and most domestic interest income from taxation, Franz's management of the Singaporean stock and bond portfolio will be unconstrained by tax considerations.
- David Morehouse: As a citizen and resident of Switzerland, David will be subject to Swiss tax on all of his investments and US tax on his US investments. In broad terms, Switzerland taxes dividend and interest income but exempts individual investors' capital gains from taxation. Between local and federal taxes, David's dividend and interest income is likely to be taxed at a rate well over 40%. The portfolio Franz constructs for David will emphasize high-growth equities in which a large portion of the total return is derived from capital gains.

US Portfolios

- Valerie Low: Franz's chief concern relates to the US taxation of the US stock and bond portfolio. No tax treaty exists between Singapore and the United States, so the United States will impose a 30% withholding tax on gross dividends. Most interest income on government and corporate bonds is exempt from withholding, provided the investor supplies the issuer or corporate trustee proof of beneficial ownership. Because they are held by a non-US investor, any capital gains on the stocks and bonds in the US portfolio will not be taxed by the United States. The portfolio Franz develops for Valerie will emphasize fixed-income securities and high-growth, low-dividend equities.

- David Morehouse: There is a tax treaty between Switzerland and the United States that will reduce the withholding rate on David's US dividends and interest from 30% to 15%, a substantial savings. Thus, David's US equity portfolio may have a higher allocation to dividend-paying stocks and fixed income than would Valerie's portfolio. Any capital gains on the stocks and bonds in the portfolio will not be taxed by the United States.

Wealth and Estate Taxes

- Valerie Low: Singapore has no estate tax, and there is no estate tax treaty between Singapore and the United States. The US estate tax applies to US stock holdings but not to holdings of qualifying corporate and government bonds. Therefore, Valerie's estate will be required to pay US estate taxes on her US stock investments. Franz may look to create a non-US company to hold Valerie's US stock investments.
- David Morehouse: Switzerland's estate tax is relatively modest compared to the US estate tax rate. While there is an estate tax treaty between Switzerland and the United States, to obtain the estate tax exemption, David would have to disclose his entire net worth to the United States, something he is reluctant to do. Thus, David would like to consider the creation of a non-US company to hold his US investments. This is not a clear-cut solution for David, however. If the country in which this company is created does not have an income tax treaty with the United States, David's dividend income would be subject to the 30% withholding tax rate and capital gains realized within the company would be distributed to David as dividends, which are taxable in Switzerland. Short of pursuing other, more complex, options (e.g., a partnership or trust), David's best option appears to be direct ownership and full disclosure of his net worth.

The above example highlights the different tax considerations for two investors regarding their respective home countries and a US investment portfolio. Tax frameworks influence both asset allocation and asset structuring. The next example demonstrates how tax treaties influence after-tax accumulation for international investors based on where the investment is made relative to the legal domicile of the investor.

EXAMPLE 3

Using Tax Treaties to Enhance the After-Tax Return

Your client is a resident of Hong Kong SAR and is interested in adding "safe haven" assets to a portfolio. The client asked that you consider adding equites and bonds located in Switzerland to the portfolio. Switzerland has long been considered a "safe haven" for investors; it is at the center of Europe, has a stable political climate, and is economically integrated with most of the world. After research, you have identified Swiss equities and bonds that you believe will fit with the client's investment profile. You contemplate adding to the portfolio the following equities and bonds, with the following estimated returns:

- Swiss equities: CHF200,000, producing annual dividend payments of CHF5,000 and projected annual appreciation of 5%, or CHF10,000
- Swiss bonds: CHF200,000, producing annual interest payments of 3%, or CHF6,000

In your projections, you assume that the appreciation in the equities will be realized through a sale of the shares at year end. So, for your client, the total return on the CHF400,000 portfolio will be

- Dividends: CHF5,000;
- Capital gains: CHF10,000;
- Interest income: CHF6,000;
- Total gross income, pretax: CHF21,000; and
- Projected pretax return: 5.25%

1. What questions do you need to ask your client in relation to tax matters, and what information regarding Hong Kong SAR and Swiss taxation do you need to determine the after-tax return?

Solution:

First, you need to confirm that the client is not a citizen or permanent resident of a jurisdiction that triggers a tax liability under a worldwide tax regime. US citizens and permanent residents, for example, are taxable in the United States even if not currently residing there.You also need to confirm the Hong Kong SAR tax treatment of the Swiss portfolio. Here, your client confirms that under Hong Kong SAR tax law there is no Hong Kong SAR taxation on interest, dividends, or capital gains earned in relation to the contemplated Swiss investments.

Then, you need to understand the Swiss tax position. On review, you confirm with Swiss advisors that Swiss inheritance taxes would not apply to a non-Swiss investor (except on real estate) and that capital gains are tax free. However, you also learn that Switzerland applies a 35% withholding tax on interest and dividends to foreign investors.

Thus, the after-tax return for your client is estimated as follows:

- Total gross income, pretax: CHF21,000
- 35% Swiss withholding tax on CHF11,000 (dividends and interest): CHF3,850
- After-tax income: CHF17,150
- Projected after-tax return: 4.29% (CHF17,150/CHF400,000).

2. How can returns on the portfolio be enhanced by focusing on tax treaties?

Solution:

You check on whether a tax treaty exists between Hong Kong SAR, the place of residence of your client, and Switzerland, and you find that there is one. Under the treaty, a qualifying resident of Hong Kong SAR is entitled to a reduction in Swiss withholding taxes on both dividends and interest. In the case of dividends, the withholding rate is reduced from 35% to 10%; in the case of interest, the withholding rate is reduced from 35% to 0%.

Your calculation of the after-tax return is revised as follows:

- Total gross income pretax: CHF21,000
- 10% Swiss withholding tax on CHF5,000 (dividends): CHF500
- 0% Swiss withholding tax on CHF6,000 (interest): CHF0
- After-tax income: CHF20,500
- Projected after-tax return: 5.13%

Due to the differences in tax regulations and other factors, investors and their advisors must evaluate the comprehensive tax ramifications of the location of their investment and the source of their investment earnings. This becomes more complicated in the context of international investments, where the tax implications become more convoluted and influence decisions concerning jurisdictional asset allocation, e.g., Switzerland or Singapore. In all scenarios, it's of paramount importance for both the client and their advisor to actively seek out and heed high-quality legal and tax counsel.

EXAMPLE 4

International Transparency, the Common Reporting Standard, and FATCA

In the past, it was not uncommon for people investing on a cross-border basis to assume that their home country would not know about income generated outside that country. While not reporting the foreign income and assets to a home country with a worldwide tax system would have constituted illegal tax evasion, the existence of bank secrecy in such countries as Switzerland facilitated such wrongful activity. Today, substantial information exchange regimes are in operation, including the automatic information exchange under what is known as the Common Reporting Standard (CRS). Tax authorities have also increased their focus on the activities of those who enable tax evasion, such as banks and investment managers. Wealthy international families, with a growing awareness of these rules and of the significant penalties associated with tax evasion, are increasingly understanding the need for tax compliance. Thus, they are highly appreciative of investment management strategies that properly analyze tax exposures and make use of legal tax minimization opportunities.

Taxpaying obligations are also accompanied by reporting requirements internationally, and two major regulations are now in place to promote tax transparency and disclosure of beneficial ownership.

The CRS, also known as the Standard for Automatic Exchange of Financial Account Information, was developed by the OECD with G20 countries and is a reciprocal requirement for the automatic exchange of financial account information. As of February 2023, more than 100 jurisdictions, including Switzerland and all G20 countries, have committed to implementing the Standard.

FATCA, the Foreign Account Tax Compliance Act, is a US program designed to ensure that US taxpayers pay the appropriate taxes on wealth held outside the country. Financial institutions are required to report this information on US account holders. Failure to do so triggers a 30% withholding on all US income. Under the act, the United States demanded that banks around the globe provide the names of beneficial owners of all US securities regardless of whether the owners were US citizens or gave up their access to the US financial system. Fearing that the United States could share this ownership information with authorities in the home country of their non-US customers, most banks agreed to become qualified intermediaries (QIs), who agree only to document this information for all their customers and provide information about US customers upon request. In this way, QIs preserve the confidentiality of their non-US customers but are still required to gather information that could be shared with the US authorities, dramatically increasing bank transparency.

Similarly, under the European Union Savings Directive (EUSD), EU members (with the exception of Australia, Belgium, and Luxembourg) agree to automatically exchange information with each other, apply tax at the source, pool the tax revenue, and transfer the respective proportion of pooled tax revenue to the country of residency.

QUESTION SET

1. A client has a tax-deferred account and a taxable account, each of which has USD1,000,000. The client's tax rate is 40% on earned or interest income and 20% on dividends or realized capital gains. His advisor has determined that a portfolio of 60% equities and 40% bonds is appropriate. What is the appropriate dollar amount of bonds to hold in the taxable portfolio?

   A. USD0

   B. USD400,000

   C. USD800,000.

   Solution:

   The correct answer is A. Interest income is taxed at a higher rate than dividends or capital gains, and therefore income generating assets should be held in the tax-deferred account to the extent possible. As the desired allocation to bonds is USD800,000 (40% of USD2 million) the entire allocation can be held in the deferred account. None should be held in the taxable account.

2. Jose DiCenzo has some securities worth EUR50,000 that have a cost basis of EUR75,000. He believes that they will return to their original value in one year but is considering selling them now to offset capital gains and reduce his taxes. His tax rate on capital gains is 30%. How much could he save in current-year taxes by selling the securities now?

   A. EUR7,500

   B. EUR15,000

   C. EUR17,500

   Solution:

   The correct answer is A. DiCenzo has a EUR75,000 – EUR50,000 = EUR25,000 unrealized loss. Assuming that realizing this loss will decrease his taxable gains by the same amount, his tax bill in the current year will be reduced by 0.30 × EUR25,000 = EUR7,500.

3. DiCenzo sells the securities and reinvests the proceeds in similar securities that perform as he expected. What are his total tax savings over the two-year period?

   A. EUR0

   B. EUR7,500

C. EUR15,000

Solution:

The correct answer is A. Assuming DiCenzo does not reinvest the tax savings, tax-loss harvesting does not reduce the total tax paid over time. It only defers taxes, because recognizing the loss resets the cost basis to a lower figure, which will ultimately increase the gain realized late by the same amount. Tax-loss harvest can augment return by postponing tax liabilities. Reinvesting the current year's tax savings increases the after-tax principal investment, which can augment the value of tax-loss harvesting further.

4. When dealing with investments that cross multiple tax jurisdictions, it is typically best to start with the tax laws of the country in which the:

   A. assets are located.

   B. investor is a citizen.

   C. investor is domiciled.

Solution:

The correct answer is B. A good rule of thumb is to start with the tax rules of the investor's country of citizenship, which may influence decisions on how to own assets in another country. Then, the second step is to focus on the domicile of the investor and the location of the investor's assets.

5 LIQUIDITY AND CASH FLOW PLANNING

☐ recommend appropriate liquidity strategies for goal-based planning and holistic financial plans

Liquidity is the ability to access the funds needed to meet financial goals and other obligations. The inherent liquidity of investments is determined by various factors, including trading frequency, market depth, transaction costs, information asymmetry, search costs, market sentiment, and trade urgency, and plays a critical role in satisfying a client's cash flow needs.

Liquidity risk is the risk an investment cannot be sold quickly at its intrinsic value. This risk increases in times of crisis and is distinct from price risk that reflects normal volatility around intrinsic value. Investments with liquidity risk may be marketable, and the liquidity risk presents itself as the price concession required to sell the investment. For example, a variable annuity may have a specific cash value, but converting it into cash may require a significant surrender charge (effectively a price concession) that represents liquidity risk. The compensation for bearing liquidity risk is reflected by a **liquidity premium** in the investment's expected return and is a positive function of the level of the investment's illiquidity.

In private wealth management, liquidity serves key roles.

- *Emergency funds* provide a safety net for unexpected expenses or income loss, often kept in easily liquidated assets.
- *Short-term obligations* ensure bills, rents, and debts can be paid without borrowing or selling long-term assets using cash flow from investments or other sources

- *Investment opportunities* enable quick action on market or business opportunities.
- *Risk management* helps meet unexpected cash demands such as capital calls in private equity.

An otherwise well-diversified portfolio may include a mix of both liquid and illiquid investments to capture the liquidity premium, assuming a client's liquidity needs can still be met. Highly liquid investments provide the necessary liquidity for meeting short-term goals, satisfying short-term needs, and covering unexpected expenses. Illiquid investments offer higher potential returns over the long term, which makes them helpful in achieving long-term financial goals and objectives, but they are typically inappropriate for meeting short-term liquidity demands.

Because private wealth management encompasses short-, medium-, and long-term financial objectives, the liquidity of the investments intended to fund them should similarly reflect these temporal considerations. In general, less liquidity is needed to fund long-term goals or liabilities. However, as time passes and goals or liabilities that were once long term become more medium term or short term in nature, more liquidity will be needed to fund them. The challenge is to balance liquidity with return requirements.

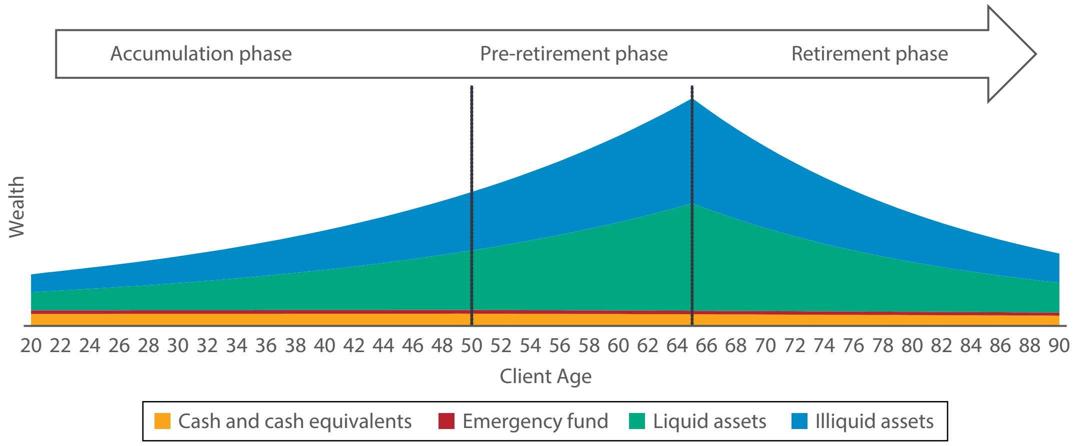
Considerations

In private wealth management, understanding the liquidity spectrum is essential for constructing a portfolio that aligns with a client's financial goals, risk tolerance, and liquidity needs. The liquidity premium component of an investment's expected return is typically a positive function of the level of the investment's liquidity risk. The greater the illiquidity, the greater the liquidity premium. In goals-based financial planning, liquidity ensures that short-term financial demands are met without compromising long-term financial goals.

Portfolios created to meet the objectives within a goals-based allocation are designed to meet specific financial goals. The liquidity allocation in the portfolio is influenced by two key factors: one is the specific purpose of the allocation to meet a stated financial objective, and the other is the changes in the stages of life. As we saw earlier, near-term non-discretionary retirement, educational, and other objectives require liquidity, which results in lower yields. More discretionary financial objectives and long-term objectives can be met with less liquid investments to capture the higher liquidity premia.

For a client seeking to manage liquidity to meet their financial goals, the proportion of assets allocated to more liquid assets evolves throughout their life cycle. Exhibit 23 illustrates an example of how the allocations of assets with different liquidity may change throughout an investor's life cycle and visualizes the varying emphasis on liquidity at different stages of life, from the early earning years through to retirement.

Exhibit 23: The Relative Liquidity Allocation Throughout the Investor's Life Cycle



In the accumulation phase, investors focus on wealth building with less concern for liquidity beyond cash for emergencies. In the preretirement phase, there's a shift towards more liquid, less volatile assets to minimize risk as the time horizon narrows. This reallocation reduces the risk that the investor will not be able to meet non-discretionary lifestyle needs in retirement. Shifting to more liquid, less volatile assets, such as investment grade bonds, reduces the probability of substantial drawdowns. During retirement, there's an increased allocation to liquid assets like investment grade bonds, or alternative strategies like bond ladders may be used to meet liquidity needs. Exhibit 23 emphasizes the need to adapt asset allocation and liquidity strategies as life stages and financial goals evolve.

For many private wealth management clients, the client's largest asset is an illiquid, privately held business. The wealth and human capital of business owners is explicitly linked to the performance of the businesses. Relying on a single source for income and wealth carries inherent risks, and financial difficulties in the business can directly affect the owner's personal financial situation. Despite generating significant cash flow, such businesses make owners asset- rich but may remain cash poor due to the challenge of quick, fair-value liquidation.

To mitigate liquidity risks, business owners may keep reserves outside the business or use asset-backed short-term loans. Transactions, especially related-party ones, must adhere to arm's-length principles to mitigate tax or legal risks. For example, what initially appears as a loan may be reclassified as taxable compensation requiring repayment from taxed sources. Owners face liquidity challenges when supporting both the family and the business, particularly when liquidating personal investments to raise cash for the business. Consider the dynamic process involved in withdrawing funds from a business entity in which the initial withdrawal is structured as a loan arrangement. This loan may be reclassified as taxable compensation, thereby obligating repayment using taxed income sources. Such tax complications may arise, especially when funding an unprofitable business, effectively risking long-term wealth.

Tax planning comes with liquidity considerations: estate and inheritance taxes may necessitate liquidation of assets including family businesses. An alternative is insurance coverage that would provide the funds needed to pay such taxes upon the owner's death.

Explicit liquidity considerations are reflected in the investment policy statement, which should mirror the client's evolving liquidity needs by maintaining a portfolio with sufficient flexibility to accommodate reasonable short-term unexpected capital withdrawals.

In a portfolio, fixed-income investments, especially investment grade bonds, can provide liquidity, a modest level of income, some capital preservation, and typically low volatility. However, they generally cannot deliver consistently high returns or, with the exception of inflation-protected bonds, significant protection from inflation.

In general, publicly traded equities provide liquidity and also provide for potential capital growth, inflation protection, and the dividend income.

Other growth-oriented assets, such as hedge funds, direct real estate investments, private equity, and investment partnerships, have the potential for capital growth, inflation protection, and capital distributions yet may command substantial liquidity premia, thus trading liquidity for higher expected returns.

Matching a client's liquidity needs requires more than matching cash flow needs. A client's liquidity needs must also be matched with the price volatility of assets. During periods of extreme economic and market stress, investment liquidity may diminish for most asset classes. Such a decline of investment liquidity can pose a significant challenge for clients with non-discretionary spending needs when the portfolio's available income or liquidity are insufficient to meet immediate expenses. To preclude such illiquidity issues, a larger allocation to more liquid, lower yielding assets may be required. Holding additional liquidity, however, may lower the portfolio's long-term expected return.

Income

Financial planning and wealth planning shift clients' income from work to investments for future needs. This includes managing liquid assets for long-term growth. Even in countries with robust retirement plans, it's important to ensure that future income streams are available through various investment approaches.

Here, understanding a client's current and future income sources is key for wealth managers. Income sources must align with specific life-stage needs, optimize tax efficiency, and manage investment liabilities. Income mainly comes from employment, investments, and businesses before retirement and shifts to pensions and diverse investments after retirement.

Fixed Income

Fixed-income assets in a portfolio, particularly investment grade bonds, yield predictable income from interest payments and the repayment of principal at maturity. This makes such fixed-income instruments desirable to generate predictable income in the portfolio. However, fixed-income instruments are not risk free; specifically, there may be interest rate risk, credit risk, and reinvestment risks that influence the cash flow and return, Therefore, considering bonds' duration, credit quality, and the interest rate environment is especially important.

The taxation of income and capital gains from a fixed-income instrument in a portfolio reduces the funds available for reinvestment. This is especially relevant for retirees or others who depend on investment income as a main source of their income. A large portion of these returns often comes from interest income, making it essential for investors to understand and plan for the tax implications to maximize their income. Additionally, the return from fixed-income instruments may not offer sufficient protection from inflation.

- There are several fixed-income strategies to consider. Ladder, bullet, and barbell strategies are basic and common portfolio construction techniques.
- The *ladder strategy* spreads investments across short-, medium-, and long-term bonds, aiming to match the investor's cash flow needs. While a perfectly matched ladder can eliminate interest rate and reinvestment risks, there still may be unmet liquidity needs.

- The *bullet strategy* focuses on medium- or long-term bonds, avoiding short-term ones. It centers the portfolio's duration around a specific maturity, like 5, 10, or 20 years.
- The *barbell strategy* invests in both short-term and long-term bonds, skipping medium-term ones. This offers a mix of income, return, and reinvestment potential from short-term bonds along with higher yields and longer duration from long-term bonds.

The use of credit, yield curve, and sector rotation strategies often demands active management and may not be ideal for all private wealth management clients due to their relative cost and potential complexity.

- The *yield curve* strategy selectively invests in bonds to maximize returns based on anticipated changes in short- and long-term rates. For instance, it leans towards longer-term bonds if the yield curve is expected to flatten and shorter-term bonds if steepening is expected, adapting to different market scenarios.
- The *sector rotation* strategy shifts holdings to optimize returns based on market trends and economic cycles. It's an opportunistic approach aiming for higher interest payments and price appreciation.
- The *credit rotation* strategy balances bond investments across different credit ratings. High-rated bonds offer lower yields but lower risk, while low-rated bonds offer higher yields but come with more risk. This diversification balances income and risk.

Equity

Equity-based income strategies usually favor dividend-paying stocks over those that mainly offer capital appreciation. Yet most returns from equity often stem from price appreciation, which necessitates asset liquidation to realize gains and in turn reduces the future dividend income. Various equity investment approaches focus specifically on generating cash flow:

- The *dividend growth* strategy targets companies that consistently pay and increase dividends, offering both immediate income and potential for future growth.
- The *high-dividend yield* strategy focuses on stocks with high dividend yields, usually from mature, stable companies, but requires assessing dividend sustainability.
- The *preferred stock* strategy leverages fixed dividend payments from preferred stock, providing a more stable income compared to common stock dividends.

Alternative Assets

Typically, portfolios of wealthier private wealth clients include alternative assets that offer the potential for higher returns for clients with long investment horizons and ample liquidity to meet their short-term needs.

For instance, allocations to private equity in a client portfolio are motivated by long-term capital growth and not income; these types of investments usually do not offer regular income streams. The limited partners (LPs) contribute cash (via cash calls) to the private equity fund early in its life, which the general partner (GP) uses to invest in attractive portfolio companies. The goal is of the GP is to either grow and nurture a portfolio of companies in the start-up phase or to financially and/or operationally restructure a portfolio of companies in the mature phase. The GP then engineers an exit, creating a liquidity event at, hopefully, higher valuations, thereby generating capital gains. The investment returns, which consist of the net proceeds of exits, are then paid out to the LPs in the form of cash distributions. This pattern of early cash calls and later cash distributions is described as a "J," hence the J-curve effect.

Other illiquid assets, such as real estate, generate income through a combination of rents and property value appreciation (i.e., capital gains). Infrastructure assets, for instance, offer noteworthy portfolio diversification opportunities. Such investments generate project income typically from user fees and provide inflation protection if the project can raise prices during inflationary periods. Examples include, among others, bridges and tunnels that charge toll fees and airports and ports that charge passenger and airline or ship user fees.

Spending

Post-retirement income often comes from pensions, which are usually taxed as ordinary income unless there are specific exclusions or preferential rates for retirees.

Depending on the recipient's total income, income from government programs provided to retirees and disabled individuals may or may not be subject to taxation. In some jurisdictions, most of the post-retirement income comes from various types of pension schemes sponsored by governments, companies, or trade unions. Additionally, there may be payments that are excluded from taxes.

Exhibit 24 presents a summary of the 2022 results of the Mercer CFA Institute Global Pension Index. This index is comprised of subindices on three pension system dimensions (i.e., adequacy, sustainability, and integrity) and covers 44 retirement income systems representing 65% of the world's population. Iceland, the Netherlands, and Denmark highest for their robust, sustainable, and high-integrity pension schemes.

Exhibit 24: Mercer CFA Institute Global Pension Index: Summary of 2022 Results

Grade	Index value	Systems	Description
A	>80	Iceland, Netherlands, Denmark	A first-class and robust retirement income system that delivers good benefits., is sustainable, and has a high level of integrity
B+	75-80	Israel, Finland, Australia, Norway	A system that has a sound structure, with many good features, but has some areas for improvement that differentiates it from an A-grade system
B	65-75	Sweden, Singapore, UK, Switzerland, Uruguay, Canada, Ireland, New Zealand, Chile, Belgium, Germany	
C+	60-65	Hong Kong SAR, US, Colombia, France, Malaysia, Portugal, Spain, UAE	A system that has some good features, but also has major risks and/or shortcomings that should be addressed; without these improvements, its efficacy and/or long-term sustainability can be questioned
C	50-60	Saudi Arabia, Poland, Mexico, Brazil, Peru, Italy, Austria, South Africa, China*, Japan, Taiwan, Korea (South)	

Grade	Index value	Systems	Description
D	35-50	Indonesia, Turkey, India, Argentina, Philippines, Thailand	A system that has some desirable features, but also has major weaknesses and/or omissions that need to be addressed; without these improvements, its efficacy and sustainability are in doubt
E	<35	Nil	A poor system that may be in the early stages of development or non-existent

** Here "China" refers to the pension system in mainland China. The pension system in Hong Kong SAR and Taiwan are show separately, as they have different pension systems.*
Source: David Knox (2022).

In financial planning, special attention should be given to the adequacy and sustainability of retirement plans, particularly in countries where these programs may be at risk.

The 4% rule is a basic framework that advises retirees to allocate 4% of their initial investment portfolio for yearly expenses, adjusting that amount for inflation in the following years. For instance, a retiree with a EUR10 million portfolio would have a EUR400,000 spending budget in the first year. If inflation is 3% the next year, the budget would increase to EUR412,000. The return on the portfolio should mirror this rate. This guideline is rooted in the assumption that the retiree will live for another 30 years and sustain a certain investment return.

While this rule provides a helpful starting point, it's important to remember that it doesn't account for life's uncertainties or longevity risk. Clients must strike a balance between spending and saving to navigate the complex landscape of wealth management effectively. Therefore, the 4% rule should be tailored to fit each client's unique circumstances.

The amount one should save for retirement mirrors their lifestyle. A frugal individual has a vastly different spending pattern — and savings needs — compared to an individual who requires a luxurious lifestyle. Nevertheless, a relationship exists between the capital a client possesses, the capital they need to pursue their chosen lifestyle, and the capital they can afford to spend. Exhibit 25 shows main factors shaping such spending rules.

Exhibit 25: Main Factors Shaping Spending Rules

Planning horizon	Inflation	Asset allocation	Spending flexibility	Taxes
▪ What is the anticipated need? ▪ How much longevity risk is the client willing to assume?	▪ Are there sufficient hedges for inflation in the portfolio? ▪ Are the inflation premia in the investments sufficient for inflation in costs?	▪ What is the tradeoff between stability of asset values and growth? ▪ Will assets be reallocated over time? ▪ Is the portfolio sufficient to weather economic downturns or adjust to market conditions?	▪ What is the anticipated mix of non-discretionary and discretionary spending? ▪ Can spending be reduced when conditions warrant?	▪ What are the anticipated taxes on capital gain and ordinary income? ▪ How will spending be affected by changes in future tax rates?

Extinguishing one's financial resources during one's lifetime is a clear issue highlighting the risk of living longer than one's savings can support, also known as longevity risk. Life's uncertainties can upend even the most well-structured financial plans. Therefore, understanding the balance between spending and saving is key. Clients' attitudes toward longevity risk influence their planning horizon. For instance, planning for 30 years post-retirement may seem reasonable, but some may want to ensure they're covered beyond that period.

Spending flexibility is essential, allowing adjustments to both non-discretionary and discretionary expenditures as life circumstances change. Future spending may not be uniform, with some costs rising and others falling. Finally, spending guidelines should be based on after-tax earnings, especially if most wealth is held in taxable accounts. This necessitates understanding the tax implications of different income sources and the potential for tax laws to change.

It's vital to focus on real rates of return instead of nominal ones to account for inflation's impact on purchasing power over time. The chosen spending rate should align with the portfolio's income growth to minimize the risk of depleting capital. Moreover, the strategy should be adaptable to shifting market conditions, like economic downturns, which could affect asset values, particularly in equities. There are four various spending rules to consider:

1. The *essential vs. optional expenses rule* separates spending into essential, non-discretionary day-to-day living expenses and optional or discretionary expenses.
2. The *fixed percentage allocation rule* divides income into set percentages designated for various needs like essentials, discretionary spending, and savings.
3. The *adaptive spending rule* allows for adjustments in spending based on events or external conditions such as changes in investment portfolio performance or economic downturns.
4. The *spending limits rule* sets both lower and upper limits on expenses, for which the "floor" is the minimum needed to maintain the essential standard of living and the "ceiling" is a cap to prevent overspending.

CASE STUDY

Ms. Mirna Alfonso and Spending Rules

Ms. Mirna Alfonso is a 50-year-old entrepreneur with a net worth of USD25 million accumulated from selling a successful product design venture. Her investment portfolio yields an average annual after-tax return, approximately USD2 million, and allows her to maintain an upscale lifestyle, make further investments, and contribute to her legacy. The portfolio income and value are expected to keep pace with inflation. She currently has annual expenses of USD1 million to cover both non-discretionary and discretionary spending, which can be expected to change over time. To maintain her lifestyle and preserve wealth, Ms. Alfonso needs to decide on a spending strategy. The impact of the four rules would be the following:

1. Non-discretionary vs. discretionary spending:

   Ms. Alfonso's lifestyle comprises a luxury home, high-end cars, travel, and other upscale amenities. Her annual expenses total to USD1 million, and items included in each of these spending buckets are

- *Non-discretionary spending*: property taxes, utilities, health care, household staff salaries, car maintenance, and groceries, which amount to USD700,000; and
- *Discretionary spending*: holidays, art acquisitions, and donations to worthy causes, which amount to USD300,000.

Based on this rule, Ms. Alfonso would first ensure the USD700,000 non-discretionary expenses are covered from her USD2 million of portfolio income. Next, she would use USD300,000 for her discretionary spending. Finally, Ms. Alfonso would use the remaining USD1 million of available portfolio income for further savings, investments, and/or gifts to her nieces and nephews.

2. Percentage allocation rule:

   Ms. Alfonso wishes to allocate her portfolio income across essential, non-discretionary spending, leisure and other discretionary spending, investments, and legacy building. Applying this rule, from her annual portfolio income of USD2 million, Ms. Alfonso can do the following:

   - Dedicate 35%, or USD700,000, to cover non-discretionary spending on property taxes, utilities, health care, household staff salaries, car maintenance, and groceries
   - Dedicate 15%, or USD300,000, to cover leisure and other discretionary spending on travel, arts, donations to worthy causes, etc.
   - Dedicate 30%, or USD600,000, to cover investments in potential business opportunities, and portfolio investments
   - Dedicate 20%, or USD400,000, to cover legacy building such as contributions to trusts or funds meant for her nieces and nephews

3. Dynamic spending rule:

   Given Ms. Alfonso's significant investment portfolio, she could decide to adjust her discretionary spending based on the portfolio's performance. For example, she could decide that for every 10% gain in her USD25 million portfolio, she will increase her discretionary spending by 5% for the next year. Therefore, if her portfolio grows by 20% in a given year, she would increase discretionary spending by 10%. This would add an additional USD30,000 (= 0.10 × USD300,000) to her budget for the next year, when her discretionary spending would reach USD330,000.

4. Floor-and-ceiling rule:

   To ensure that her wealth is not eroded due to overspending, Ms. Alfonso could set spending limits. She establishes an annual spending floor at USD700,000 to cover her non-discretionary expenses and a ceiling at USD1.5 million. This means that regardless of how well her investment portfolio performs, she will limit her annual spending to a maximum of USD1.5 million. In tighter financial times, like during a recession, when her portfolio might lose value, Ms. Alfonso would curtail her discretionary spending, but, given the floor she has set, the USD700,000 of non-discretionary spending would always be met.

CASE STUDY

The Njord Family

Bjorn Bamse is a private wealth manager who has been asked to manage the Njord family account, which is a new relationship for the firm. Both Bamse and the Njord family reside in a politically stable country that uses the euro.

Odin and Frigga Njord have been married for 37 years and have two adult children, Vidar and Freya. Freya raises her son, Loki. Odin, 59, founded NjordMarine, a successful luxury boat company, and plans to retire soon, expecting to sell the business for around EUR55 million. Frigga, 57, is a homemaker and receives an annual, inflation-adjusted payment of EUR75,000 from a family foundation. Odin and Frigga's primary residence has a current value of about EUR1.2 million.

Odin holds EUR500,000 in gold bullion. He plans to spend EUR7 million on a luxurious second home, anticipates purchasing a minority interest (EUR5 million) in noted photography magazine *Exteriors*, and plans to provide support for Loki's health and education expenses and will begin a gifting program (EUR15,000/year subject to wealth transfer taxes) next year. Odin strongly wishes to ensure his family's financial security, and the sale of the business will realize this goal. However, he does not have any formal estate plan in place.

Frigga plans to take a more active role in managing the family's wealth. Odin and Frigga have agreed on a normal liquidity reserve of EUR1 million (equal to two years of Odin's current salary of EUR500,000).

Vidar, 30, works in the family business, while Freya, 25, is an artist raising a 5-year-old son. The family are the sole shareholders of NjordMarine and will divide the sale proceeds by their share.

Vidar is financially secure but risk-seeking. He plans to leave the family business after it is sold for a career that allows more free time. He's looking to buy a new home in the EUR500,000 to EUR700,000 range and make a risky EUR550,000 investment in a nightclub. Freya is an independent artist who has avoided relying on family wealth. She's looking to improve her financial situation to focus on her art career, as well as provide for her son, Loki.

The country's real GDP growth and inflation both average about 3% annually, resulting in nominal annual growth of approximately 6%. The country maintains a flat tax of 25% on all personal income and a net capital gains tax of 15%, with no distinction between short- and long-term holding periods. There is also a flat 50% wealth transfer tax on gifts and inheritances.

The long-term viability of the national pension plan has been questioned due to unfavorable demographics, so self-contributory, tax-advantaged individual investment accounts, retirement saving accounts (RSAs), have been created. Taxpayers may contribute up to EUR5,000/year of after-tax income to an RSA, investment returns are tax exempt, and participants can begin tax-free withdrawals of any amount at age 62.

Bamse summarizes the following financial information about the Njord family.

Exhibit 26: Njord Family Data

	Income (annual) in EUR
Odin salary[a]	500,000
Vidar salary	100,000
Frigga foundation payout	75,000

	Income (annual) in EUR
Freya (art sales)	50,000
Odin personal assets	
Home (fully paid for, held jointly with Frigga)	1,200,000
NjordMarine company equity[b]	56,400,000
Diversified equity securities	750,000
Fixed-income securities	1,000,000
Cash (money market fund)	1,000,000
Gold bullion	500,000
RSA[c]	50,000
Frigga personal assets	
NjordMarine company equity[b]	1,200,000
Vidar personal assets	
Home (net of mortgage)	200,000
NjordMarine company equity[b]	2,400,000
Diversified equity securities	200,000
Cash (money market fund)	100,000
Freya personal assets	
NjordMarine company equity[b]	1,200,000
Balanced mutual funds	75,000
Cash (money market fund)	25,000

[a] *Odin expects to receive a fixed annual payment of EUR100,000 (taxable as income) from the NjordMarine pension plan, beginning five years from now.*
[b] *NjordMarine equity values are pretax market values; the equity has a zero cost basis for purposes of taxation on capital gains. The company stock pays no dividend.*
[c] *Beginning at age 62, Odin plans to take a fixed annual distribution of EUR5,000 (tax exempt).*

The current needs of Odin and Frigga are mostly met by Odin's salary of EUR500,000. If the business is sold, they may require a return that replaces Odin's salary (a critical objective) and desire a return that will accommodate their major acquisitions and still leave their children financially secure (important but less critical objectives).

Return requirements are generally driven by annual spending and relatively long-term saving goals. To calculate the required return and to fully understand the cumulative effects of anticipated changes in income, living expenses, and various stage-of-life events, Bjorn creates a cash flow analysis.

The statement of cash flows in Exhibit 27 highlights a five-year horizon for Odin and Frigga Njord based on information gleaned by Bjorn. The value of the equity is expected to be sold at EUR61.2 million.

Exhibit 27: Odin and Frigga Njord's Five-Year Statement of Cash Flows (in EUR)

	Current	1	2	3	4	5
Inflows						
Salary: Odin (taxed as income)	500,000					
Trust payment: Frigga (taxed as income)[a]	75,000	77,250	79,568	81,955	84,413	86,946
Pension: Odin (taxed as income)[b]	—	—	—	—	—	100,000

	Current	1	2	3	4	5
Inflows						
RSA: Odin (tax free)[b]	—	—	—	5,000	5,000	5,000
Sale of company (taxed as gain)	—	61,200,000	—	—	—	—
Total inflows	*575,000*	*61,277,250*	*79,568*	*86,955*	*89,413*	*191,946*
Outflows						
Income tax (25%)	−143,750	−19,313	−19,892	−20,489	−21,103	−46,737
Gains tax (15%)		−9,180,000				
Second home	—	−7,000,000	—	—	—	—
Investment in magazine	—	−5,000,000	—	—	—	—
Support for Loki[a]	—	−15,000	−15,450	−15,914	−16,391	−16,883
Transfer tax on support payment (50%)		−7,500	−7,725	−7,957	−8,196	−8,442
Living and misc. expenses[a]	−500,000	−515,000	−530,450	−546,364	−562,754	−579,637
Total expenses	*−643,750*	*−21,736,813*	*−573,517*	*−590,724*	*−608,444*	*−651,699*
Net additions/withdrawals	−68,750	39,540,437	−493,949	−503,769	−519,031	−459,753

[a] *Assumed to increase with inflation at 3% annually.*
[b] *Fixed annual payments.*

Net cash flows for Odin and Frigga stabilize in Year 2 and decline in Year 5. Consequently, Bamse estimates their after-tax return objective dividing projected needs in Year 2 (EUR493,949) by net investable assets at the end of Year 1 (EUR42.3 million), which equals 1.17%. Adding the current annual inflation rate of 3.00% to 1.17% results in an approximate after-tax nominal return objective of 4.17%.

Exhibit 28: Odin and Frigga Njord's Investable Assets, Net Worth, and Required Return

Investable assets	Amount (in EUR)	Percent of net worth
Year 1 cash flow	39,540,437	77
Stock holdings	750,000	1
Fixed-income holdings	1,000,000	2
Cash equivalents	1,000,000	2
RSA account	50,000	0
Total	*42,340,437*	*83*
Real estate		
First home	1,200,000	2
Second home	7,000,000	14
Total	*8,200,000*	*16*
Gold	500,000	1
Net worth	51,040,437	100
Return objective		
Distributions in Year 2	493,949	1.17

Investable assets	Amount (in EUR)	Percent of net worth
Divided by investable assets	42,340,437	
Plus expected inflation	3%	4.17

Regarding liquidity, among other decisions, Odin and Frigga have agreed on a normal liquidity reserve equal to two years of Odin's current salary but will maintain an above-average reserve during their transition into retirement.

1. Identify and discuss key events and goals impacting liquidity available to the family.

   Solution:

   Significant liquidity events include

   - the sale of the business (after-tax proceeds likely to be EUR52.02 million [= EUR61.2 million – EUR9.18 million]);
   - the subsequent loss of Odin's salary (EUR500,000);
   - the purchase of a second home (approximately EUR7 million); and
   - the investment in *Exteriors* magazine (approximately EUR5 million).

   As the potential need for cash distributions increases, so too must the investment portfolio's commitment to assets that can be easily sold at predictable prices. Also, as noted, Odin and Frigga have agreed on a normal liquidity reserve of EUR1 million (equal to two years of Odin's current salary of EUR500,000). It appears that Odin and Frigga can afford to build their second home. Nonetheless, they should be mindful that the two homes will constitute 16% of their net worth.

2. Identify the Njord's short- to intermediate-term liquidity constraints and their relevant amounts, including illiquid holdings, by completing the missing entries in the following table.

Liquidity constraint	Amount (in EUR)
a)	b) 7,000,000
c) Investment in the magazine Exteriors (within one year)	d) 5,000,000
e) Emergency reserve	f)
g)	h) 500,000
i) Annual support for grandson (estimated to rise with inflation)	j)
k)	l) 61,200,000

Solution:

Liquidity constraint	Amount (in EUR)
a) Construction of a second home (next one to three years)	b) 7,000,000
c) Investment in the magazine Exteriors (within one year)	d) 5,000,000
e) Emergency reserve	f) 1,000,000
g) Annual expenses (estimated to rise with inflation)	h) 500,000

Liquidity constraint	Amount (in EUR)
i) Annual support for grandson (estimated to rise with inflation)	j) 15,000
k) Current value of the Njord's holdings in NjordMarine	l) 61,200,000

After the NjordMarine sale and construction of their second home, the Njords will have roughly 16% of their net worth committed to personal residences.

QUESTION SET

1. Liquidity risk is *best* described as:

   A. volatility around an asset's intrinsic value.

   B. the need to accept a lower return for greater liquidity.

   C. an inability to sell an asset quickly at its intrinsic value.

   Solution:

   C is the best answer.

   Liquidity risk is the risk that an investment cannot be sold quickly at its intrinsic value. It is distinct from normal volatility around an asset's intrinsic value. The higher return required for less liquid assets is known as a liquidity premium.

2. The primary risk for a bond ladder that closely matches cash flows to the investor's planned expenses is:

   A. default risk.

   B. interest rate risk.

   C. reinvestment risk.

   Solution:

   A is the best answer.

   Laddering strategically tailors a fixed-income portfolio to align with a client's expected cash flow needs, significantly mitigating reinvestment and interest rate risks compared to portfolios managed solely for value appreciation. However, default risk remains.

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PRACTICE PROBLEMS

The following information relates to questions 1-3

Vincent Chu is 50 years old and recently divorced. After working for 20 years as a schoolteacher, he quit to open a comic book shop. The shop has been fairly successful and generates USD150,000 per year in income for Chu. As a result of the divorce and starting his business, he has limited financial assets. USD100,000 is saved in a tax-deferred plan. His home is worth USD500,000, and the outstanding mortgage is USD385,000. He also has a USD100,000 small business loan due in five years. His current annual expenses are USD120,000.

Although he has no children of his own, Chu has set a high priority goal to cover USD50,000 per year of college expenses for his 10-year-old nephew. Chu currently plans to retire at age 70, at which point he expects to sell the comic book shop for USD1.5 million and pay off any remaining mortgage. During retirement, he anticipates annual living expenses of USD80,000 in real terms and will receive a teacher's pension of USD35,000 per year in real terms. Chu's grandfather lived to 103, outliving his savings by several years, which resulted in a burden for Chu's father. As a result, Chu wants to ensure that he has sufficient savings to live to 100 with 99% certainty. Any remaining funds at death will be left to his nephew.

Chu consults with Roger Chelmsford to develop a goals-based financial plan. Chelmsford begins by estimating Chu's extended life balance sheet in Exhibit 1.

Exhibit 1

Assets (in USD)		Liabilities and surplus (in USD)	
Tax-deferred plan	100,000	Mortgage	385,000
Home	500,000	Business loan	100,000
Business value	1,500,000	College expenses	175,000
Human capital	1,500,000	Lifestyle maintenance	3,800,000
Teacher's pension	1,000,000	Surplus	140,000
Total	4,600,000		4,600,000

Chelmsford then advises Chu on an appropriate portfolio in which to save his USD30,000 in annual discretionary income.

1. The value of Chu's implicit assets is *closest* to:

   A. USD1,500,000.

   B. USD2,500,000.

   C. USD4,000,000.

2. Complete the goal matrix for Chu.

	Short term	Intermediate	Long term
Essential			
Aspirational			

3. Which of the following portfolios is *most* appropriate for Chu's discretionary income?

   A. 100% bonds
   B. 100% equities
   C. 50% bonds and 50% equities

   Justify your response to question 3.

The following information relates to questions 4-6

Use the following information to answer the next three questions:

Roger and Yukio Libroff, both 55 years old, lead a financially stable life. Their family consists of their two children Amelia, who is 15, and Regis, who is 12. Roger is the CEO of a fertilizer business originally founded by his grandfather, and the Libroffs currently expect that their children will be involved in the business after they reach adulthood. This business serves as the family's primary source of wealth. Yukio works as an anesthesiologist at the local hospital and earns enough to comfortably cover the family's basic living expenses.

The family's financial assets are detailed below. There is no leverage except as noted.

- The fertilizer business valued on an arm's-length valuation, GBP25,000,000
- The primary residence, GBP2,000,000
- The various investment properties managed by Roger, valued at GBP4,000,000 (the properties are leveraged, and the equity proportion is GBP800,000)
- A 10% share of a start-up cosmetic business, valued on an arm's-length valuation, GBP 500,000
- Equity investments, GBP4,000,000
- Cash and short-term fixed income investment, GBP750,000

As the business has been in the family for three generations, the family has established clear governance structures around its operations. The Libroffs discuss the business in the children's presence and involve them in their philanthropic activity to instill family values and purpose. They have also been proactive in promoting financial literacy for the children.

The Libroffs consult a wealth planner, Sumita Smith. Smith observes that their current portfolio is consistent with the aspirational investor framework. She recommends that the Libroffs take out liability insurance and consider one additional aspect of managing their dynastic wealth.

4. Justify Smith's observation that the Libroff's portfolio is consistent with the aspi-

rational investor framework.

5. Justify Smith's recommendation regarding insurance.

6. Describe one additional dynastic planning objective the Libroffs should consider.

The following information relates to questions 7-10

Use the following information to answer the next four questions:

Sonia Patterson is a 55-year-old computer programmer. She has accumulated USD2 million of savings in a tax-exempt account and an additional USD1 million in a taxable account. Half of the money in her taxable account is in shares of her employer, and there are no restrictions on their sale. Patterson's tax rate is 30% on interest income and 20% on dividends and capital gains. In the current year she has already realized capital gains of USD200,000.

Following her father's death from cancer, she is also about to receive an inheritance of USD4 million, which will be added to the taxable account. To honor her father's memory, she wishes to donate USD500,000 to a cancer research organization once she receives the inheritance. She seeks the advice of Frank Whitemore on how to properly allocate her wealth in a tax-aware manner.

Whitmore begins by listing Patterson's assets, including those she is scheduled to inherit, in Exhibit 1.

Exhibit 1

Asset	Current location	Cost basis (in USD)	Current value (in USD)
Equity index	Tax deferred	N/A	1,000,000
Bond index	Tax deferred	N/A	1,000,000
Company stock	Taxable	100,000	500,000
Speculative stocks	Taxable	650,000	500,000
Cash (inherited)	Taxable	500,000	500,000
Bond index (inherited)	Taxable	1,000,000	1,000,000
Tax-exempt bonds (inherited)	Taxable	1,000,000	1,000,000
Equity index (inherited)	Taxable	1,500,000	1,500,000

After determining Patterson's risk and return requirements, Whitemore recommends a portfolio of 60% equities and 40% fixed-income securities. He gathers pretax and after-tax return estimates for the various asset classes in Exhibit 2. The expected returns on Patterson's company shares and speculative stocks are the same as those of the equity index. The tax-exempt bonds have similar risk to taxable bonds.

Exhibit 2

Asset class	Pretax return	After-tax return
Cash	1.0%	0.7%
Bonds	6.0%	4.2%
Tax-exempt bonds	4.5%	4.5%
Equities	9.0%	7.2%

7. If Patterson sells the speculative stock shares and reinvests them in other equities, would there be a tax impact?

   A. No.

   B. Yes, she would defer USD30,000 in taxes to a future period.

   C. Yes, she would permanently reduce her taxes by USD30,000.

8. The most tax-efficient way for Patterson to make her planned charitable donation is to give the charity:

   A. cash.

   B. her company stock.

   C. her speculative stocks.

9. What percentage of Patterson's tax-exempt account should be in bonds?

   A. 0%

   B. 40%

   C. 100%

10. Should Patterson own any tax-exempt bonds?

    A. No.

    B. Yes, in her taxable account.

    C. Yes, in her tax-exempt account.

SOLUTIONS

1. A is correct. In goals-based planning, both explicit and implicit assets and liabilities are included. Implicit assets include human capital, projected inheritances, and projected pension benefits. Chu has human capital of USD1,500,000 and a projected pension benefit of USD1,000,000 for a total of USD2,500,000 in implicit assets.

2. Solution:

	Short term	Intermediate	Long term
Essential	Pay off business loan	Assist with college expenses for nephew	Pay off mortgage Maintain current lifestyle
Aspirational			Inheritance for nephew

3. A is correct. Chu's financial assets are limited to his tax-deferred savings plan and his home equity, neither of which is readily accessible to meet short-term needs. He can save USD30,000 per year and needs USD100,000 in five years to repay the business loan and USD50,000 per year in Years 8 through 12 to assist his nephew in college. Meeting these obligations with a high degree of certainty requires a portfolio consisting mainly or entirely of bonds.

4. The aspirational investor framework is well suited to clients with significant internal assets such as the Libroffs. It divides assets into three portfolios: (1) a safety portfolio designed to meet up to five years' spending need with little to no risk, (2) a market portfolio to sustain long-term living standards holding a diversified selection of liquid stocks and bonds, and (3) an aspirational portfolio consisting of illiquid internally managed assets with significant idiosyncratic risks.

   Although the family's living expenses are not specified, we know that they are covered "comfortably" by Yukio's anesthesiologist salary. Further backup is provided by GBP750,000 held in cash and short-term investments and an unmortgaged primary residence worth GBP2,000,000. While this amount may not cover a full five years of expenses, it does represent a significant safety net behind a relatively bond-like income stream.

   The Libroffs also hold GBP4,000,000 in a market portfolio of investments that should generate long-term returns in the mid to high single digits. Without any near-term need to draw on this portfolio, it should be able to grow significantly by the time the Libroffs retire.

   Finally, the bulk of the Libroffs' assets are held in an aspirational portfolio. This consists of the fertilizer business, the real estate investments, and the stake in the cosmetics start-up. These could grow significantly in value but are not relied on for basic living expenses under the aspirational investor framework (or in the case of the Libroffs.)

5. Particularly for HNWIs, personal liability insurance can be important, as they can be targets for legitimate or frivolous lawsuits because of their wealth. Their assets, activities, and profile expose them to various risks.

6. Despite their desire for the children to become involved in the family business, the Libroffs should encourage independence and entrepreneurship. This would foster individual growth and help them avoid entitlement.

7. B is correct. Selling a security at a loss and reinvesting the proceeds in a similar security effectively resets the cost basis to the lower market value, potentially increasing future tax liabilities. In other words, taxes saved now may be simply postponed.

8. B is correct. The tax-aware approach to charitable giving is to donate highly appreciated stock, thus eliminating the need to pay taxes on the unrealized gains.

9. B is correct. After making the charitable donation, Patterson's total portfolio will be USD6.5 million, of which 40%, or USD2.6 million, would be bonds. As bonds are less tax efficient than equities, they should be held in the tax-exempt account to the extent possible. Thus, USD2.0 million of the USD2.6. million total should be held in the tax-exempt account.

10. B is correct. In the taxable portfolio, tax-exempt bonds provide a higher after-tax return (4.5% compared to 4.2%) than taxable bonds. Because her total bond allocation is greater than can be held in the tax-exempt account, she should allocate the remaining USD600,000 bond allocation to tax-exempt bonds in the taxable account.

LEARNING MODULE

4

Investment Planning

LEARNING OUTCOMES

Mastery	The candidate should be able to:
☐	recommend and justify portfolio allocations and investments for a private client
☐	discuss the tax efficiency of investment across various asset types and recommend various tax management strategies for asset allocation
☐	discuss and recommend appropriate wealth management planning approaches for retirement from legal, taxation, and jurisdictional perspectives
☐	evaluate the success of an investment program for a private client based on portfolio reporting and review

INTRODUCTION

1

Investment Planning is the process by which investors, asset managers, and wealth managers formulate their expectations for the risk and return of capital assets and markets, build portfolios that match investment objectives and financial commitments with assets available for purchase, and either accumulate or decumulate wealth in accordance with the investor's stage of life and goals.

This reading introduces candidates to the process of investment planning. The section titled "Asset Allocation" addresses the topic of asset allocation and describes how a wealth manager can create and justify its recommendations (including, but not limited to, portfolio allocations, investment vehicles, and hedges) for a private client.

In particular, "Asset Allocation" covers the creation of capital market expectations and shows how these assumptions are used for asset allocation. It then addresses portfolio construction and management and stresses the importance of surplus or the difference between assets and liabilities. It also addresses a range of practical issues that must be addressed when allocating assets, including considering the impact of inflation, exchange rate fluctuations, rebalancing, execution, and hedging, as well as the choice of investment vehicles.

Wealth managers typically employ two forms of portfolio optimization: mean–variance-based asset optimization, which optimally trades off portfolio return and portfolio risk, and surplus growth optimization. The first has been widely studied since the pioneering work of Harry Markowitz in 1952 and has long been used by asset managers, but the second is both more novel and potentially more relevant to high-net-worth clients: a client's assets and liabilities are first computed and then differenced to identify their surplus (the excess of assets over liabilities), and a portfolio that trades off surplus growth with surplus risk is then constructed. Wealth managers can reap significant benefits for their clients by expanding their investment perspective from a focus on assets to one that is centered around surplus.

The section titled "Taxation" focuses on the impact of taxes on investment strategies. These may include income and wealth taxes and may apply to some forms of income (e.g., dividends) and not to others (e.g., capital gains). In addition, some gains can be offset by losses, while others cannot. The fact that some countries tax investors' global income while others have a territorial tax system adds further complexity to the problem. Given the extraordinary diversity of tax rules around the world, we cannot create a set of easily applied rules in this reading, but we instead focus on illuminating the outlines of the problem and addressing a few special cases with broad appeal.

The section called "Retirement" addresses the twin problems of saving for, and decumulating savings in, retirement. Professor William Sharpe once called decumulation "the hardest and nastiest problem in finance," and it is not hard to see why—increasing **lifespans** with uncertain **healthspans**, or the expected length of one's life that is spent in good health, inadequate retirement savings, and the inability to forecast spending in retirement have made this an extraordinarily difficult problem. But help is now at hand with the increasing availability of deferred annuities, effective retirement planning tools, and the realization that working longer has multiple benefits. This section is even more vital to women, who outlive men by about five years on average.

Finally, in the section "Performance Evaluation and Attribution", we cover performance measurement and attribution, both of which are central to evaluating investment products and programs. While performance measurement is relatively straightforward for publicly traded securities, attribution is more complex. Accounting-based attributions tend to be straightforward, particularly for equities, but the factor models that dominate fixed income attribution are harder to operationalize due to their large data requirements. Performance measurement and attribution for alternative investments, including commodities, real estate, hedge funds, and private equity, are harder still due to a lack of quality data sets. Despite these limitations, it is imperative to fully measure and attribute performance given the general efficiency of capital markets, a lack of data almost always leads to poor performance going undetected and its root causes being poorly understood for far too long.

As in other readings in the Private Wealth Pathway, we use the terms "private wealth managers," "wealth managers," and "advisors" interchangeably. We also refer to "individual investors" as "private clients" or, simply, "clients."

LEARNING MODULE OVERVIEW

- Investment planning is central to successful wealth management.
- A thoughtful wealth manager will take into account both a client's assets and liabilities when choosing an asset allocation. Ideally, assets will be invested in a way that makes the client's surplus (or the difference between assets and liabilities) grow as fast as possible in the long run without taking excessive risk.
- Tax law is very dependent on locale, and the extreme variation in tax regimes makes it difficult to create a single, unified set of recommendations for tax optimization.
- All tax regimes levy taxes to varying degrees on income, wealth, and consumption. The taxes are not always uniform—capital gains are usually taxed more lightly than dividends and earned income, and tax-aware investment strategies take these differentials into account.

- The financial aspects of retirement can be split into two phases: accumulation, or the building of wealth during one's working life, and decumulation, or the spending of accumulated wealth in retirement. The decumulation problem is particularly hard to solve on account of the uncertainty in human lifespans and healthspans.
- Performance Evaluation is central to evaluating investment programs and has two components: performance measurement and performance attribution.
- Performance measurement focuses on measuring the return and risk of a portfolio, while performance attribution focuses on understanding the sources of risk and return.

ASSET ALLOCATION 2

☐ recommend and justify portfolio allocations and investments for a private client

We begin with an overview of the various types of investments available to a private wealth client and then discuss how to form return and risk expectations for multiple asset classes—that is, capital market expectations—including the impact of taxes on returns. Next, we cover, at a high level, the construction of optimal portfolios using those capital market expectations as inputs. Finally, we discuss the importance of managing the private wealth client's surplus, or the difference between their assets and their liabilities.

Private clients make investments in both public and private markets, but this reading focuses primarily on public markets, as private investments are harder to model and cover comprehensively within the confines of this reading. The complexity of modeling their returns is amplified by the complexity of their fee structures, which often include base fees, performance fees, and high-water marks. Computing their risk is more straightforward, and we illustrate a simple approach to estimating the risk of a private equity fund.

Utility Theory and Risk Tolerance

Thoughtful wealth managers have extensive discussions with their clients before any asset allocation exercise is conducted to better understand their goals, constraints, fears, and desires. As part of their initial and ongoing conversations, they will evaluate a client's *risk tolerance*, most often via a questionnaire such as that displayed in the exhibit "Sample Questions from a Risk Tolerance Questionnaire" in the CFA Institute's Level 3 Reading "Overview of Private Wealth Management." More subtly, a questionnaire can help identify any legal issues (e.g., suitability and eligibility) that must be taken into account when recommending an investment to a client.

It is unclear whether the answers provided on risk tolerance questionnaires truly characterize investor behavior, particularly in times of stress, so investment recommendations therefore require significant judgment from a wealth manager. Academic studies, including Sivarajan (2018), indicate a high degree of subjectivity in the client questionnaire approach, and this subjectivity increases the potential for the wealth manager's own views on risk to become an influential factor in making investment decisions for a client.

Moreover, studies by behavioral economists (see, for example, Thaler 2015) have demonstrated that investors' responses are sensitive to the way in which a question is framed. For example, a question that involves a small dollar loss on a small portfolio may elicit a different response than a question involving a significant dollar loss on a large portfolio, even if the percentage losses are the same.

Client Conversations Regarding Risk Tolerance

During the information-gathering process described earlier, conversations with the client can produce valuable insights into their risk tolerance that may not be evident from a risk tolerance questionnaire or even an assessment of their personality type. These insights may include the following:

- The degree to which friends or family members influence the client's financial decisions
- The financial experiences that have shaped the client's perspective: For example, individuals who lived through deep recessions or depressions, even in childhood, may bring that perspective to their present-day investment decisions
- The client's past investment mistakes and successes
- The process by which the client accumulated her wealth—for example, whether the client became wealthy through saving, inheritance, a liquidity event, such as the sale of a company built by the client, or some combination thereof
- The client's perception of investment risk—whether the client thinks of investment losses in absolute or in percentage terms or focuses on geopolitical risks, including, but not limited to, the risks of climate change, war, currency depreciation, and fiscal/legal risks

Conversations about risk tolerance enable the wealth manager to educate a client about investment risk, determine the extent of a client's investment knowledge, and create and expand an investment profile that will guide the choice of investments, with particular regard to suitability and eligibility.

For example, a wealth manager may demonstrate how specific risk factors (e.g., interest rate risk, credit risk, and equity risk) can produce incremental returns and losses. As another example, a wealth manager may ask clients to select their preferred portfolio from a menu of options with a range of expected returns and volatilities. The client's choice from this menu provides information about their risk tolerance. It is essential to keep in mind that a client's responses will often exhibit behavioral biases and can depend on how the question is framed.

Risk Tolerance with Multiple Goals

To this point, we have discussed a client's overall risk tolerance. But clients often have multiple goals or objectives and may exhibit different levels of risk tolerance for each of these goals. For example, a client may have low risk tolerance with respect to near-term goals (such as education costs) and a higher risk tolerance for longer-term goals (such as retirement needs). A challenge for wealth managers in managing client relationships is how to satisfactorily address conflicting levels of risk tolerance.

One way to do so is to break up the portfolio into a collection of *Mental Accounts*—one for education, a second for housing, a third for retirement, and so on. Each mental account is assigned a sub-portfolio that reflects the client's risk tolerance for the respective goal, and these sub-portfolios aggregate up to the investor's total portfolio.

CASE STUDY

The Need for Modeling and Simulation in Investment Planning

David Smith, age 76, supports a foundation that provides free education for children from low-income families. Every year, the foundation feeds and educates 100 children aged 2 to 20.

David wants to support this foundation after his death. His wealth manager tells him that he needs to perform an asset–liability study with simulations of future income and expenses to determine the size of the endowment he needs to dedicate to achieve this goal.

David has just made the necessary withdrawals from his bank account whenever needed and has not estimated such requirements.

1. Discuss why the wealth manager recommended an asset–liability study, including an assessment of future expenses, and why it might be needed by Smith to ensure that his goal is met.

   In particular, discuss why the wealth manager does not recommend using a simple mean–variance optimization supplemented with some rules of thumb to determine the size of the capital needed to support the foundation's work.

   Solution:

   Smith's wealth manager has likely recommended an asset–liability study, including a simulation, for the following reasons:

   1. The foundation finances education. Service industries such as education, medicine, and the performing arts have intrinsically low rates of productivity growth. Consequently, they experience greater inflation than manufactured goods (see Baumol and Bowen [1965] and Tabarrok [2022] for an explanation of this poorly understood fact). This implies that the size of the portfolio required to fund the foundation's future commitments and its expected return will necessarily be larger than if it were committed to funding purchases of manufactured goods.
   2. As tuition and other fees must be paid periodically, the portfolio must have sufficient liquidity to make these payments.
   3. Additionally, payments for tuition and other fees must continue to be made even during recessions when capital markets suffer significant drawdowns. This, too, requires a larger endowment than would be suggested by a simple mean–variance analysis, as tail risk can significantly affect the endowment and its spending plans.
   4. It is not possible to model all the cash flows analytically in a mean–variance framework. Rather, extensive simulation is needed to verify that the portfolio will be able to generate sufficient cash to meet its future spending commitments under a wide range of scenarios, both good and bad.

5. There is a great deal of uncertainty in the estimation of expected returns and the estimation of future cash flows, so a simulation and scenario analysis will allow Smith to understand the consequences of mis-estimation of all the central inputs to the model and to size the portfolio appropriately.

Formulating Capital Market Assumptions

After a client's risk profile has been identified, and before a portfolio can be constructed to reflect their needs, it is necessary to estimate the expected return and risk profile of the various capital markets in which the investor is likely to participate. Formulating capital market assumptions is a vital first step in portfolio construction but is often done haphazardly—surprisingly often, assumptions about prospective expected returns are formulated by extrapolating historical realized returns. This is particularly dangerous in periods of extreme exuberance and extreme distress—think of the period just before the technology bubble burst in March 2000 or during the depths of the Great Financial Crisis in March 2009. It also proves dangerous when structural changes engulf the economy, such as during the inflationary rising interest rate environment following the end of the COVID-19 pandemic.

The following example illustrates why historical returns are a poor estimator of future returns.

EXAMPLE 1

Historical and Prospective Returns of a Zero-Coupon Bond

Consider a five-year zero-coupon bond with a face value of 100 and annual compounding that is issued with a yield to maturity (YTM) of 5%. Its price at issuance is

$$100/(1.05)^5 = 78.352$$

Assume that yields decrease by 1% each year so that after a year has passed, the bond becomes a four-year zero-coupon bond with a YTM of 4%, after two years, it becomes a three-year zero-coupon bond with a YTM of 3%, and so on until it matures at par at the end of five years.Its price at the beginning of year n, is $1 \leq n \leq 5$

$$100 \Big/ \left(1 + \frac{Beg.\ YTM_n}{100}\right)^n.$$

Exhibit 1 shows this zero-coupon bond's price and YTM at the beginning of each year, its annualized return from inception to the end of the year, and its prospective return from the end of each year to maturity. The return of the bond each year is given by the change in its price divided by its initial price—there is no coupon income to supplement the price return. In the first year, for example, its return is

$$(85.48 - 78.353)/78.353 = 9.09\%.$$

Exhibit 1: Prices and Returns for a Five-Year Zero-Coupon Bond

Beginning of Year	Years to Maturity (n)	Beginning of Year YTM	Beginning of Year Price	Current Year's Return	Annualized Return from Inception to Year-end	Annualized Return from Beginning of Year to Maturity
1	5	5%	78.353	9.10%	9.09%	5%
2	4	4%	85.480	7.06%	8.07%	4%
3	3	3%	91.514	5.03%	7.05%	3%
4	2	2%	96.117	3.01%	6.02%	2%
5	1	1%	99.010	1.00%	5.00%	1%

Observe that the steady decline in "Beginning of Year YTM" in the third column causes realized returns ("Current Year's Return") to exceed the initial yield of 5% in the first three years and to fall below the initial yield in the two final years. If we use the past returns of the bond as an estimate of its future returns, we will consistently overestimate the prospective return of the bond. If we instead use the bond's current YTM to estimate its future returns, reported in the last column, we will accurately predict its return to maturity.

There is an important conservation law embedded in this example. If past returns exceed the initial yield, future returns must fall below it so that the annualized return over the entire period is equal to the initial yield. It is important to remember that this phenomenon is not restricted to zero-coupon bonds—it is true of every asset and asset class. The expected return of equities, for example, is constrained by their future growth in per-share earnings (which in turn is constrained by GDP growth) and their current price level and not in any way by their past returns.

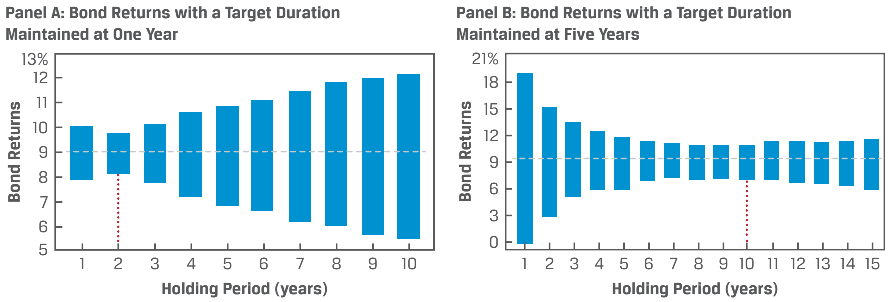
Thoughtful analysts consider the economic forces that drive future returns when they create capital market forecasts. They use historical returns to build forecasts only as a last resort when no other information is available, and even then, they will take care to ensure that their estimates are not biased.

Estimating the Expected Return of Fixed-Income Indices

Estimating the expected return of high-grade fixed-income indices with minimal default risk is a relatively straightforward task thanks to a theorem proved in Langetieg, Leibowitz, and Kogelman (1990): Over a period equal to twice its modified duration, the total return of a default-free constant-duration bond index is well approximated by its initial yield.

Exhibit 2, which is drawn from their paper, illustrates the range of returns for one- and five-year constant-duration bond indices over various holding periods when interest rates follow a random walk with a volatility of 150 bp/annum. The tight range of outcomes over a period equal to twice the duration of the index is very visible.

Exhibit 2: Returns vs. Holding Periods for Bond Indices



Source: Terence Langetieg, Martin Leibowitz, and Stanley Kogelman, "Duration Targeting and the Management of Multiperiod Returns," *Financial Analysts Journal* 46 (1990): 35–45.

For short-duration indices and cash, the path of future interest rates is hard to predict, and it is common to use the current YTM to estimate expected returns. Still, investors sometimes supplement this estimate with one based on the expected future rate of inflation, which can be obtained from the Federal Reserve Bank of St. Louis' FRED database at https://fred.stlouisfed.org/. The central insight is that the returns to cash should roughly mirror inflation over the long term.

CASE STUDY

Sonia Lam has two goals, one intermediate-term (buying a house in 10 years) and the other long-term (retiring and traveling around the world in 30 years), and she wants to create two portfolios to help her achieve these goals.

1. Assume she invests only in bonds. What durations would you recommend for her portfolios if she wants to minimize the uncertainty in the final value of her portfolios?

   Solution:

   To minimize the uncertainty in the final value of her portfolios, Sonia should follow the advice given in Langetieg, Leibowitz, and Kogelman (1990) and make the duration of her portfolio half the time to the eventual use of her funds. The duration of the portfolio allocated to the purchase of a house should be 5 years, and the duration of the portfolio allocated to travel in retirement should be 15 years. Alternatively, she can invest in zero-coupon bonds with maturities of 10 years and 30 years, respectively, but these are not as readily available.

2. If she is willing to invest some fraction of her portfolio in equities on account of their higher expected return, in which portfolio would she have greater exposure to equities and why?

   Solution:

   If Sonia wants to invest a portion of her portfolios in equities, she will have greater exposure in her retirement portfolio, as equities are more volatile than bonds, and a high equity exposure in the portfolio dedicated to the purchase of a house will increase the probability of her goal not being achieved. To determine the optimal allocation between stocks and bonds in the two portfolios, Sonia and her wealth manager will need to determine the expected return of both asset classes as well as the correlation between them, the autocorrelations of their returns, and the impact of reinvestment on their final values.

For high-yield indices, both the probability of default and loss given default must be considered. A rough estimate of the expected return of an index, $ER(Index)$, is its yield to maturity, YTM_{Index}, minus its default rate, DR_{Index} (the fraction of its bonds that default each year), times its loss given default, LGD_{Index} (or the average loss on a bond that defaults), as follows:

$$ER(Index) = YTM_{Index} - (DR_{Indexi} \times LGD_{Index}).$$

THE IMPACT OF DEFAULT ON THE RETURN OF A BOND INDEX

Consider a bond index with a five-year duration, a YTM of 10%, a default rate of 5% per annum, and an average loss given default of 50%. Assuming no coupon payments are received on the defaulted debt, the annualized return of the index over a 10-year horizon is approximately:

$$ER(Index) = Return\ on\ performing\ debt + Return\ on\ non - performing\ debt$$

(95% *x* 110%)–(5% × 50%) = 7.0%

These expressions are approximate because they do not consider index construction rules that govern when bonds enter and leave indices, changes in interest rates, and the shape of the yield curve. Such details are beyond the scope of this reading (for more information, see Ilmanen 2022).

Sometimes, a new fixed-income market segment arises that necessitates rethinking expected returns from the ground up. This was once true of mortgages and structured securities and is now true of private credit. Investors will need to review deals, prospectuses, covenants (which have changed dramatically over the past three decades), and issuance patterns to determine how these securities might perform in good times and bad.

Estimating the Expected Return of Equity Indices

Estimating the expected return of equities is more challenging than estimating the expected return of fixed-income indices. Equity investors, unlike fixed-income investors, capture a portion of the growth in corporate earnings, and this must be taken into account when estimating the expected returns of equities.

Surprisingly, per-share corporate earnings and dividends grow more slowly than the economy, as can be seen in Exhibit 3, which is taken from Bernstein's and Arnott's 2003 paper "Earnings Growth: The 2% Dilution." The authors provide data for dividends but not earnings on account of the unavailability of historical data on earnings in many countries.

Even more surprisingly, dividends consistently grew even more slowly than per-capita GDP in every country other than Sweden included in this study from 1900 to 2000. Additionally, as is made clear by the last line of Exhibit 3, this dilutive effect is seen even in countries that were not torn by war and is noticeably worse in war-torn countries. We expect these results to hold even after accounting for share repurchases, which were not widely employed during the period covered by the study.

Exhibit 3: Earnings Growth vs. Dividend Growth in 16 Countries

Country	Constituents of Real Stock Returns		Real GDP Growth	Dilution in Dividend Growth (vis-à-vis Real GDP Growth)	Real Per-Capita GDP Growth	Dilution in Real Per-Capita GDP Growth (vis-à-vis per-capita GDP growth)
	Real Return	Dividend Growth				
Australia	7.50%	0.90%	3.30%	−2.40%	1.6%	−0.70%
Belgium	2.50%	−1.70%	2.20%	−3.90%	1.8%	−3.50%
Canada	6.40%	0.30%	4.00%	−3.70%	2.2%	−1.90%
Denmark	4.60%	−1.90%	2.70%	−4.60%	2.0%	−3.90%
France	3.60%	−1.10%	2.20%	−3.30%	1.8%	−2.90%
Germany	3.60%	−13.00%	2.60%	−3.90%	1.6%	2.90%
Ireland	4.80%	−0.80%	2.30%	−3.10%	2.1%	−2.90%
Italy	2.70%	−2.20%	2.80%	−5.00%	2.2%	−4.40%
Japan	4.20%	−3.30%	4.20%	−7.50%	3.1%	−6.40%
Netherlands	5.80%	−0.50%	2.80%	−3.30%	1.7%	−2.20%
South Africa	6.80%	1.50%	3.40%	−1.90%	1.2%	0.30%
Spain	3.60%	−0.80%	2.70%	−3.50%	1.9%	−2.70%
Sweden	7.60%	2.30%	2.50%	−0.20%	2.0%	0.30%
Switzerland	5.00%	0.10%	2.50%	−2.40%	1.7%	−1.60%
United Kingdom	5.80%	0.40%	1.90%	−1.50%	1.4%	−1.00%
United States	6.70%	0.60%	3.30%	−2.70%	2.0%	−1.40%
Full-sample average	5.10%	−0.50%	2.80%	−3.30%	1.9%	−2.40%
War-torn Group 1 average	4.00%	−1.40%	2.70%	−4.10%	1.9%	−3.30%
Non-war-torn Group 2 average	6.40%	0.70%	3.00%	−2.30%	1.8%	−1.10%

Source: William Bernstein and Robert Arnott, "Earnings Growth: The 2% Dilution," *Financial Analyst's Journal* 59 (October 2003): 47–55.

Additionally, L'Her, Masmoudi, and Krishnamoorthy (2018) further Bernstein and Arnott's (2003) research in their paper "Net Buybacks and the Seven Dwarfs." Both articles focus on dividends instead of earnings, as there is more data available on dividends worldwide than on earnings.

While there are a number of dilutive mechanisms that slow down the rate of growth of per-share corporate earnings and dividends, the principal one is easily understood: economic growth comes from both the existing publicly traded economy (e.g., companies that have already gone public) and the new economy (e.g., young firms that are growing but are not yet public). Investors in public markets capture the growth of the first segment but not of the second, which they cannot, by definition, easily invest in. Bernstein and Arnott show that per-share dividends have grown about 2% slower than the economy, and L'Her, Masmoudi, and Krishnamoorthy show that in some cases, particularly in countries with large index reconstitutions, bankruptcies, and high rates of private-to-public conversion, the rate of dilution has been much larger.

Under the simplifying assumptions made by the Gordon Growth Model, it can be shown that

$$\textit{Expected Return} = \textit{Forward Dividend Yield} + \textit{Growth Rate of Dividends}$$

making clear that dilution impacts expected returns by reducing the contribution of the second term.

As there is no uniquely right way to estimate expected returns, it is wise to review the work of prominent researchers in the field to identify an approach that one is comfortable with. For example, in 2023, the CFA Institute's Research Foundation published the monograph *Revisiting the Equity Risk Premium*.

Two other approaches stand out for their utility. The first is Professor Robert Shiller's *Cyclically Adjusted Price Earnings Ratio (CAPE)*, which is the ratio of the current price of an equity index to the 10-year average of its real (i.e., CPI-adjusted) earnings. In essence, the 10-year average reduces noise in earnings and smooths the impact of the business cycle. High values of CAPE imply low expected returns and vice versa. Long-term historical data on CAPE for the S&P 500 can be found at Professor Shiller's website at Yale University.

The second approach is to reverse engineer the dividend discount model and extract the expected return. Estimates made using this technique can be seen at http://www.market-risk-premia.com, a site maintained by academics and practitioners in Germany, which publishes long-term estimates of expected return (also known as the Implied Cost of Capital) for several countries around the world. It uses a variant of the Gordon Growth Model using estimates of dividend growth derived from estimates of earnings growth and is an excellent starting point for analysts.

Estimating the Expected Return of Other Asset Classes

For asset classes other than equities and fixed income, data is less readily available. Estimates are derived either from first principles (e.g., biological growth for timber or spot versus futures relationships for commodities) or by adding and subtracting risk premia to baseline estimates of expected returns for asset classes that can reasonably be mapped to (e.g., stocks and bonds for private equity and private credit). When no information is available (e.g., for collectibles and art), analysts will reluctantly turn to historical estimates, keeping in mind that these estimates are often biased.

KNOWLEDGE CHECK

1. Expected returns are harder to estimate for equity indices than for bond indices because:

   A. investors who invest in equities differ from those who invest in bonds.

   B. bonds are impacted only by interest rates, while equities are impacted by economic events.

   C. the cash flows of many bonds are determined at issuance, while dividends and share buybacks for equities are not guaranteed.

   Solution:

   C is correct. The primary reason that the expected return of an equity index is harder to estimate than that of a bond index is that the future cash flows from equities are far more noisy, and far less certain, than those from bonds. A is incorrect because the investor base for an asset class has no bearing on the difficulty of estimating its expected return. B is incorrect because both bonds and equities are impacted by both interest rates and economic events, though to different degrees.

Estimating the Risk of Asset Classes

More often than not, the risk of an asset class is proxied by its variance as well as its covariance with other asset classes, and a wide range of estimators for covariance matrices are known and are described in a useful survey by Ledoit and Wolf (2021). Analysts typically use about five years of monthly returns to estimate a covariance matrix and adjust it using a statistical technique known as shrinkage to reflect their views on the future.

A simple example of shrinkage is to compute a sample covariance matrix using all available data, extract from this a set of estimates of security standard deviations and a correlation matrix, and then compute the weighted average of this sample correlation matrix and the identity matrix (i.e., a matrix with ones on the diagonal and zeros elsewhere) using the weighting scheme recommended by Ledoit and Wolf. The shrunk correlation matrix can then be multiplied appropriately by the estimates of security standard deviations to compute a shrunk covariance matrix.

A five-year lookback strikes a balance between focusing on the immediate past (which is likely to better reflect risk in the near term) and all available history, which reflects the broadest possible set of events. Asset class return histories often contain large positive and negative outliers, and it is, therefore, imperative to use a robust estimator for the covariance matrix. The R package *RobStatTM* has a variety of useful robust statistical estimators.

Particular attention must be paid to the estimation of the risk of illiquid assets, as they are not marked to market regularly, and returns-based estimates of their variance can grossly underestimate their true risk. As with expected returns, it is best to estimate the risk of these asset classes either from first principles (e.g., extreme weather events and the price volatility of crops for timber and farmland) or by adding and subtracting risk differentials to baseline estimates of risk for stocks and bonds with leverage taken into account (e.g., for private equity).

By way of example, if a private equity fund is invested in young, growing firms that it finances half with debt and half with equity (i.e., using 2:1 leverage), we might estimate the volatility of an investment in their portfolio by multiplying the risk of a small growth stock (say 40%) by the leverage employed (2×) so that the volatility of any given investment in the private equity fund is 80%. If the fund has 16 independent investments, and if all the investments are equally sized, the volatility of the fund can be shown to be given by the volatility of each investment divided by the square root of the number of investments, or $40\% \times 2 / \sqrt{16} = 20\%$.

In practice, of course, investments are not equally sized and independent, and the correlations between them must be taken into account, but this simple calculation illustrates one way in which to estimate the volatility of a private equity fund that is not traded on an exchange. When no information is available, analysts will reluctantly map the asset class to other asset classes with similar risk characteristics.

It is essential to keep in mind that variance and covariance are just one possible measure of risk. They have achieved their current dominance largely because a closed-form expression exists for the variance of a portfolio in terms of the variances and covariances of its constituent assets, allowing for the rapid construction of optimal portfolios.

Other useful risk measures include Value-at-Risk (VaR), Expected Shortfall (ES), and stress tests. Some risks are hidden and are evident only with hindsight: prior to the Great Financial Crisis, many AAA-rated mortgage securities were viewed as being essentially riskless. In 2008, this assumption was revealed to be hopelessly wrong, as supposedly riskless securities proved to be worthless; their true risk was hidden by unrealistic models underpinned by even more unrealistic assumptions.

Thoughtful wealth managers view risk multidimensionally, explore the impact of a wide range of unfavorable scenarios on the clients' portfolios, and determine the conditions under which their baseline view of risk breaks down. They will then make suitable adjustments to their client's portfolio to adequately protect them in bad times without giving up too much return potential in good times.

Portfolio Optimization and Asset Allocation

Following the creation of sound capital market assumptions, a wealth manager will create a portfolio that meets the client's goals and reflects the client's risk tolerance. This is done using Markowitz's mean–variance optimization formulation in the simplest and most common setting:

$$\max_{w}\left(\textit{Portfolio expected return} - \frac{\gamma}{2}\textit{Portfolio variance}\right)$$

where w is a vector of asset class weights, and γ is the client's coefficient of risk aversion for *quadratic utility*, or her preferred balance between reward (the first term) and variance (the second term). The factor of 2 in the denominator is merely a constant and is present only to simplify the form of the final solution. Levy and Markowitz (1979) show that γ can be chosen so that a quadratic utility function provides a good approximation to the majority of utility functions that are mentioned in the economic literature.

If γ is small, the client values high returns more than low variance. Correspondingly, if γ is large, the client values low variance more than high returns. Based on the outcomes of conversations that psychologists have had with investors, it seems unlikely that γ will fall below 1 or exceed 10—a typical value of γ is 3. It can be shown that $\gamma = 1$ corresponds to maximizing geometric return and median wealth in the future, and values of $\gamma < 1$ increase variance so much that the long-run performance of the portfolio is negatively impacted. Gamma increases as the optimal portfolio converges to the minimum-variance portfolio.

Constraints are conspicuously missing from this mean–variance formulation. Common constraints include:

- long-only positions or limited shorting as well as limitations on leverage,
- maximum and minimum exposures to asset classes and assets,
- maximum and minimum exposures to sectors and geographies, and
- turnover and trading constraints and limits on transaction costs.

Additionally, the optimization can be run using *any* measure of risk favored by the investor, though the computations are substantially more complex than those associated with mean–variance optimization. Sometimes, a simulation may be required if the risk measure cannot be computed using available data. Simulations can, of course, be made very realistic and can accommodate a wide range of constraints. That said, they tend to run far more slowly than an optimization and are best suited to solving problems with 100 or fewer assets and asset classes.

The case study below demonstrates the portfolio construction process for a fictitious wealth manager and private client, ultimately resulting in a recommended allocation of the client's portfolio and underlying investments.

CASE STUDY

Portfolio Construction Using the Mean–Variance Approach

Jonas Wilhelm has just added a new private client, Bettina Becker, who is 50 years old, lives in Switzerland, and has a time horizon of 20 years. Bettina is saving for retirement and has a portfolio with a market value of CHF 2 million, and she is willing to tolerate volatility of 10% per annum. She is most comfortable owning publicly traded securities and has expressed a strong preference for European equities on account of her familiarity with them, even though she acknowledges that their expected return might be lower than that of non-European equities. She does not wish to invest in private markets because she thinks the fees are excessive. She tells Jonas that her ideal portfolio will consist of a collection of exchange-traded funds (ETFs) or index funds to minimize costs and will have both bond and equity components for income and growth. She does not wish to engage in any hedging or short selling. In Exhibit 4, Wilhelm identifies appropriate asset classes and develops capital market expectations for his new client's portfolio.

Exhibit 4: Asset Classes and Capital Market Expectations

Asset Class	Expected Return (%)	Standard Deviation (%)
Investment-grade bonds	3.0	3.0
High-yield bonds	4.5	8.0
European equities	9.0	18.0
Global (ex-European) equities	10.0	20.0
Real estate securities	8.5	18.0
Commodities	6.0	20.0

Using five years of monthly return data and a robust statistical estimator, Wilhelm also develops a correlation matrix of these asset classes to determine portfolio allocations, as shown in Exhibit 5.

Exhibit 5: Asset Class Correlation Matrix

	IGB	HYB	EE	GEE	RE	COM
Investment-grade bonds (IGB)	1.00	0.84	−0.04	−0.01	0.14	0.02
High-yield bonds (HYB)	0.84	1.00	0.30	0.35	0.20	−0.04
European equities (EE)	−0.04	0.30	1.00	0.82	0.60	0.17
Global (ex-European) equities (GEE)	−0.01	0.35	0.82	1.00	0.52	0.36

	IGB	HYB	EE	GEE	RE	COM
Real estate securities (RE)	0.14	0.20	0.60	0.52	1.00	0.44
Commodities (COM)	0.02	−0.04	0.17	0.36	0.44	1.00

Based on Ms. Becker's risk tolerance assessment and in accordance with her expressed wishes, Wilhelm sets about the process of portfolio construction using these estimates of expected return, risk, S, and correlation.

He first performs a mean–variance optimization that produces an optimal asset allocation and then modifies the portfolio in accordance with his client's preferences to arrive at the recommended allocation that is shown in Exhibit 6. In particular, he increases the exposure to investment-grade bonds on account of their attractive yield while keeping the overall exposure to bonds roughly constant and reduces the exposure to real estate as the post-COVID increase in remote work might further reduce the value of commercial real estate. In addition, he overweights European equities relative to non-European equities as Ms. Becker has expressed a greater level of comfort with them. Finally, he rounds all allocations to the nearest percent before presenting his recommendation to his client. During the presentation, he tells Ms. Becker that he has taken into account her wishes with a minimal impact on the expected return and volatility of her portfolio.

Exhibit 6: Final Portfolio Allocation

	Portfolio Allocation from Mean–Variance Optimization (%)	Portfolio Allocation Recommendation (%)
Investment-grade bonds (IGB)	30.92	34.00
High-yield bonds (HYB)	10.00	7.00
European equities (EE)	15.74	31.00
Global (ex-European) equities (GEE)	25.00	17.00
Real estate securities (RE)	15.00	8.00
Commodities (COM)	3.34	3.00
	100.00	100.00
Expected return	6.77	6.69
Standard deviation	10.00	10.00

1. Suppose the currency risk associated with Asian stocks could be inexpensively hedged with Euros. Suppose also that their expected return was lower and their standard deviation was higher than those of European stocks. Would Asian stocks be included in Ms. Becker's portfolio?

   A. No, on account of their lower expected return.

   B. No, on account of their higher standard deviation.

C. The answer will depend on the correlation between Asian stocks and the other asset classes.

Solution:

C is correct. The answer will depend on the correlation between Asian stocks and the other asset classes. If the correlation is strongly negative, it is very likely that Asian stocks will be included, as their inclusion will reduce the volatility of the portfolio. They might even replace other fixed-income asset classes and commodities if their correlation was sufficiently negative. On the other hand, if they are strongly positively correlated with other asset classes, particularly with European and global equities, their low expected return and their high volatility will likely lead to them being excluded from the portfolio. A is incorrect, as the expected return of an asset is inadequate to determine if it will be included in a mean–variance efficient portfolio. B is incorrect as the volatility of an asset is inadequate to determine if it will be included in a mean–variance efficient portfolio.

2. After reviewing the proposed portfolio, Ms. Becker asks Jonas what the implications of replacing the high-yield bonds in the recommended portfolio with investment-grade bonds will be. In particular, she wants to know how much the expected return will change and whether the volatility is most likely to increase or decrease.

A. The expected return will not change, and the volatility is likely to decrease.

B. The expected return will decrease by 1.5%, and the volatility is likely to increase.

C. The expected return will decrease by 10.5 basis points, and the volatility is likely to decrease.

Solution:

C is correct. The difference in expected return between high-yield bonds and investment-grade bonds is 1.5%, and the portfolio has a 7% allocation to high-yield bonds. The decline in the expected return of the portfolio must therefore be 1.5% × 0.07 = 10.5 basis points. As the volatility of investment-grade bonds is lower than that of high-yield bonds, and as the correlation of investment-grade bonds with other asset classes is almost universally lower than that of high-yield bonds, it is likely that the volatility of the portfolio will decline.

A is incorrect, as the expected return of the portfolio must necessarily change: The expected returns of investment-grade bonds and high-yield bonds are not identical.

B is incorrect as the volatility of the portfolio is unlikely to increase: The volatility of investment-grade bonds is lower than that of high-yield bonds, and the correlation of investment-grade bonds with other asset classes is almost universally lower than that of high-yield bonds. Additionally, the difference in expected return must be weighted by the change in the allocation to high-yield bonds to obtain the impact on the expected return of the portfolio.

Asset Liability Modeling and Surplus Management

Asset-only optimizations are but a first step on the road to wealth management. Wealth managers need to understand a private client's assets and liabilities to engage in comprehensive financial planning. In many cases, private clients do not maintain and regularly update personal financial statements, such as a *personal balance sheet* (also known as a *net worth statement*), and one of the wealth manager's responsibilities is to piece together these financial statements for the client. When dealing with multi-jurisdictional families, the wealth manager will need to determine the laws that govern investments in each relevant country to determine their suitability and eligibility for each member of the family.

On a private client's personal balance sheet, assets typically include the following:

- cash, deposit, and brokerage accounts
- retirement accounts (e.g., employer-sponsored defined contribution plan accounts or the present value of defined benefit pensions)
- other employee benefits, such as restricted stock or stock options
- ownership interests (stock) in private businesses
- cash-value life insurance
- real property, including residences, rental property, and land
- other personal assets (e.g., automobiles, art, or jewelry)

Liabilities on a private client's balance sheet typically include the following:

- consumer debt, such as credit card balances and loans outstanding
- automobile loans
- student loans
- property-related loans, such as mortgages and home equity loans
- margin debt in brokerage accounts

The difference between the sum of the values of all assets and the sum of all liabilities is known variously as net worth, equity, discretionary wealth, or surplus.

Clients provide information about their assets and liabilities to wealth managers through copies of account statements and reports such as tax filings. A key challenge for wealth managers is that the information clients provide may not be sufficiently comprehensive. To fully understand a client's financial profile, a wealth manager must analyze and synthesize these statements and reports.

Even more importantly, a wealth manager needs to determine the present value of a client's future spending plans, often dominated by retirement spending, health care expenses, and bequests. As lifespans increase, retirement spending becomes an increasingly important liability, and if healthspans do not grow as fast as lifespans, health care expenses will also become important. Finally, bequests to children and charities can account for most of the remaining value of a client's surplus.

Determining the present value of future spending plans and bequests is not easy: Not only is it difficult to project what one will spend in retirement, but it is also challenging to decide on an appropriate discount rate for such spending plans. Projections of future health care needs and health care spending are harder still.

In practice, long-term spending commitments are often set to some initial value starting at some future time. They are then assumed to grow at the "expense-appropriate" measure of inflation (i.e., the assumed inflation rate for that particular commitment). Then, they are discounted conservatively at a treasury yield. Exhibit 7 shows a sample personal balance sheet for a fictitious married couple, Steven and Margaret McCarthy.

We note in passing that the McCarthys' human capital, or the present value of their future earnings, is not included in this balance sheet. The omission is deliberate: We have not specified the trajectory of their careers and the lifestyle choices they hold dear, and we therefore specify only their financial assets and liabilities as well as their known spending plans. Exhibit 7 is easily extended to include human capital as an asset, and for this asset to be a function of the life they choose to lead going forward. A full exploration of human capital must include a discussion of their skill sets and the economic opportunities they have available to them.

Exhibit 7: Sample Personal Balance Sheet

ASSETS	
Cash and Deposit Accounts	
Bank account	EUR 40,000
Brokerage and Retirements Accounts	
Steven's brokerage account	EUR 850,000
Margaret's brokerage account	EUR 1,200,000
Steven's retirement account	EUR 1,400,000
Private Investments	
Private stock for Margaret	EUR 2,000,000
Real Estate	
Personal residence	EUR 900,000
Rental property	EUR 350,000
Other Personal Property	
Automobiles	EUR 75,000
Miscellaneous assets	EUR 50,000

Other Personal Property	
Total Assets	**EUR 6,865,000**

LIABILITIES	
Consumer Debt	
Credit cards	EUR 30,000
Present Value of Future Spending	
Children's education	EUR 200,000
Living expenses in retirement	EUR 3,300,000
Health care expenses in retirement	EUR 500,000
Bequests	
Bequests to children	EUR 2,000,000
Mortgage Debt	
Mortgage 1	EUR 320,000
Mortgage 2	EUR 180,000
Total Liabilities	**EUR 6,530,000**
Total Net Worth/Equity/Surplus	**EUR 335,000**

QUESTION SET

1. What percentage change in their assets does it take to reduce their surplus to 0?

   Solution:

   The percentage change in assets required to reduce surplus to 0 is 335,000/6,865,000 = 4.88%. In other words, a 4.88% decline in assets creates a 4.88% × 20.5 = 100% decline in surplus, holding all else constant. An alternative solution, therefore, is 1/20.5 = 4.88%.

2. If their brokerage and private investment accounts are invested entirely in equities, what percentage change in the value of their equity portfolio alone does it take to reduce their surplus to 0?

   Solution:

   The value of their equity portfolio is the sum of the values of their brokerage accounts, retirement account, and Margaret's private investment account, or EUR 5,450,000. A reduction in its value by EUR 335,000, or 6.15%, will cause a 100% decline in surplus (i.e., make their surplus 0), holding all else constant.

3. If equities have normally distributed returns with a mean of 10% per annum and a volatility of 20% per annum, and a decline in surplus is caused solely

by a decline in their equity assets, what is the probability that their surplus becomes negative after 1 year?

Solution:

The probability that the McCarthys have a negative surplus at the end of one year on account of a decline in their equity assets is the probability that a normal random variable with a mean of 10% and a standard deviation of 20% has a return of –6.15% or worse. Using the Norm.Dist function in Excel [=NORM.DIST(–0.0615, 0.1, 0.2, TRUE)], this is seen to be 21%. Alternatively, this question can be approached by focusing on the mean return and volatility to surplus. In this case, the surplus mean return equals L × 10% = 20.5 × 10% = 205%. Volatility equals L × 20% = 20.5 × 20% = 410%. The threshold return is L × (–6.15%) = 20.5 × (–6.15%) = –126%. Using the Norm.Dist function in Excel [=NORM.DIST(–0.0615, 0.1, 0.2, TRUE)], the cumulative probability equals 21%.

4. If the McCarthys found that their surplus had turned negative, what could they do to make it positive again?

Solution:

The McCarthys can make their surplus positive by increasing their savings or reducing their planned spending in retirement or the size of the bequest they expect to leave their children. It is hard for them to increase their surplus by increasing the expected return of their assets as almost all their assets are already invested in equities. Moreover, increasing equity exposure or using additional leverage to achieve more equity exposure increases risk.

Among the things we can learn from Exhibit 7 are:

1. Focusing solely on the McCarthys' assets suggests that they are wealthy, but accounting for their liabilities makes clear that they are far less affluent than an asset-only perspective would suggest.
2. Their most significant liabilities are not their obvious mortgage debts but the difficult-to-discern costs of their life in retirement and the bequest they wish to leave their children and to charities.
3. Modest changes in the value of their brokerage accounts have a modest impact on the value of total assets but can significantly impact the value of their surplus.
4. Modest changes in interest rates can also significantly impact the value of their surplus, as the present value of their future spending plans, which are deferred well into the future, will change.
5. An asset-focused portfolio will likely make the surplus volatile, perhaps even negative. If the McCarthys are to have confidence in their spending plans, they need to adjust their asset allocation (most likely in their retirement accounts) to optimally balance the risk and return of their surplus and not of their assets.

The last point is important: Future market returns and spending plans cannot be known with certainty but unfold gradually over time. Consequently, wealth managers should advise their clients not to view their life's plans, dreams, and investment goals as unchangeable but rather to regularly review and update them, say, on an annual basis (or immediately following a significant event) to take into account the impact of changes that are bound to occur over time. At each point in time, the wealth manager will solve the following optimization problem:

$$\max_{w_a}\left(\textit{Surplus return} - \frac{\gamma_s}{2} \times \textit{Surplus variance}\right)$$

where w_a is a vector of asset weights (the liability weights, which are predetermined, will appear as short positions with negative weights in the expressions for surplus return and surplus variance), and γ_s is the client's coefficient of risk aversion for *quadratic surplus utility*, or their preferred balance between surplus reward (the first term) and surplus risk (the second term). The optimization is conducted only over w_a.

We can only begin to touch on the outlines of surplus management in this reading. For those interested in further details, we strongly recommend the book "Financial Advice and Investment Decisions: A Manifesto for Change" by Wilcox and Fabozzi (2013) as well as articles by Wilcox (2019) and Satchell (2021).

Beyond assets and liabilities, cash flows are highly relevant to a private client's financial situation. Sources of cash flows may include employment income, business profit distributions, government income benefits, pensions, annuity income, dividends, and capital gains. All of these are valuable inputs into a detailed simulation, as we saw in earlier in the McCarthy case study (Exhibit 7). Furthermore, keep in mind that projections of a client's annual expenses are valuable even if the client does not maintain detailed expense information or does not want to run a detailed simulation. For example, consider a young, modestly affluent couple, still working and accumulating wealth, and an older, retired couple who have accumulated wealth beyond their needs in retirement. For the young couple, expense information is vital for the wealth manager to determine how much they can save toward their goals through improved expense budgeting. By contrast, detailed expense information is likely unimportant for the older, wealthier couple who are not budget constrained.

KNOWLEDGE CHECK

1. Describe the two forms of portfolio optimization.

   Solution:

   1. Mean–Variance Optimization: Look at the trade-off between portfolio risk (as proxied by variance) and return. This has been around since the 1950s and has a lot of historical use by asset managers.
   2. Surplus Growth Optimization: a newer paradigm and (thought to be) relevant to the high net worth (HNW)/ultra-high net worth (UHWN) set—look at the client's net surplus (assets – liabilities) and then build a portfolio on the basis of optimizing surplus growth versus risk.

2. If a UHNW advisor achieved excellent returns for their client's portfolio, which of the following reasons would someone who ascribes to the viewpoint espoused by Ibbotson and Kaplan attribute the performance to?

   A. Great ability to choose individual investment opportunities (like "hot" stocks)

   B. This is just a result of luck—someone has to win the coin toss

   C. The manager might excel at timing the how to allocate across broad asset classes

   Solution:

   C is correct. Ibbotson and Kaplan, in their 2000 paper, support the idea that asset allocation is the primary driver of risk and return.

3. Which of the following best explains the dominance of the mean–variance framework in asset allocation?

   A. Ease of implementation and use

   B. Other frameworks fail to properly encompass the full scope of risk

   C. It has been proven that variance is the best risk measure over longer periods of time

   Solution:

   A is correct. Indeed, closed form, elegant solutions are possible with the mean–variance framework. These solutions are relatively easy to explain to broad audiences.

   B is false; in fact, variance actually fails to capture many facets of risk. C is false; this has never been shown or suggested—it would require a definition of “best” as well.

3 TAXATION

☐ discuss the tax efficiency of investment across various asset types and recommend various tax management strategies for asset allocation

Most institutional and pension portfolios are tax-exempt, but the majority of portfolios held by individuals, families, and businesses are not, and it has become increasingly important to examine the impact of taxes on risk and return. Broadly speaking, there are four kinds of taxes that are imposed on individuals and businesses: taxes on revenues and income, taxes on wealth, taxes on consumption, and taxes on gifts, inheritances, and estates.

Tax law is extraordinarily heterogeneous and ever-changing, with various preferences accorded to some types of income and not to others, and no reading can do it full justice, particularly in a global context. The approach developed here is intended to provide a framework that allows wealth managers to calibrate their thinking about taxes and to know when they require the services of a specialized tax professional. This approach has three advantages.

First, it can be applied in a broad range of circumstances representing different tax jurisdictions, asset classes, and account types. Second, it can provide a framework with which advisers can better communicate the impact of taxes on portfolio returns to private clients and develop techniques to improve their after-tax performance. Third, it provides the adviser with a foundation upon which changes to the tax code can be addressed.

Tax Jurisdictions and Investment Vehicles

The fact that different countries tax investment gains at different rates has given rise to an industry of investment products that are domiciled in one country but marketed largely to investors in other countries. They are collectively known as offshore investment vehicles, and the countries in which they are domiciled are referred to as offshore financial centers. According to the IMF, the largest offshore financial centers in 2018 were Bermuda, the British Virgin Islands, the Cayman Islands, Hong Kong SAR, Ireland, the Netherlands, and Singapore.

Offshore investment vehicles are often structured as private (or limited) partnerships that are controlled by a general partner (GP) that manages the investments. The asset owner becomes a limited partner in the private partnership. The limited partnership structure limits the investor’s liability to the amount of capital that she has contributed; she is not responsible for the actions of, or the debts incurred, by the GP.

As regulations evolve, other investment vehicles, including mutual funds, Undertakings for Collective Investment in Transferable Securities, ETFs, and separately managed accounts, are also available for offshore investing.

Sometimes a tax advantage can be achieved without any need to invest in an offshore investment vehicle. Many countries offer their citizens tax-deferred or tax-advantaged onshore vehicles for retirement savings. A taxable investor can meaningfully lower her tax bill by putting, for example, her bond investments (which generate taxable coupon income) in her tax-advantaged retirement account while keeping her equities, which tend to have a low dividend yield, in a taxable account. This arrangement gives the investor much of the benefit of investing in a tax-advantaged investment vehicle while taking advantage of the generally lower fees, and preserving the regulatory oversight, of her home country.

The Impact of Taxes on Expected Return, Risk, and Asset Allocation

Given the heterogeneity in tax law across tax jurisdictions, it is hard to write down universal rules for the impact of taxes on investment returns, but the following foundational equations form a useful universal baseline for investors:

$$\text{Post-tax expected return} \approx \text{Pre-tax expected return} \times (1 - tx) \tag{1}$$

$$\text{Post-tax standard deviation} \approx \text{Pre-tax standard deviation} \times (1 - tx) \tag{2}$$

$$\text{Post-tax variance} \approx \text{Pre-tax variance} \times (1 - tx)^2, \tag{3}$$

Where tx is the appropriate tax rate, and Equation 3 follows from Equation 2 due to the fact that variance is the square of standard deviation. The approximate equality in Equations 1, 2, and 3 follows from the fact that gains and losses in the client's investment portfolio can be offset by income and/or losses from other sources. If no offsets are available, and if losses cannot be carried forward for use in the future, the expressions become less accurate. For simplicity, we treat them as exact.

Somewhat counterintuitively, an increase in the tax rate can induce more risk-taking by clients. In the section on asset allocation, we saw that mean–variance investors choose portfolios that maximize the objective function $\textit{Portfolio expected return} - \frac{\lambda}{2}\textit{Portfolio variance}$, where, again, λ is the client's coefficient of risk aversion or her preferred balance between reward and risk. In the presence of taxes, this objective function becomes

$$\begin{aligned}&\text{Objective}\\ &= \text{maximize}\left(\text{Post-tax expected return} - \frac{\lambda}{2} \times \text{Post-tax portfolio variance}\right)\\ &= \text{maximize } (1 - tx) \times \left(\textit{Expected return} - \frac{\lambda}{2} \times \textit{Portfolio variance}\right)\end{aligned}$$

Multiplying the entire objective function by $(1 - tx)$ does not change the optimal solution, but multiplying the coefficient of risk aversion by $(1 - tx)$ lowers it—the taxable investor is less risk averse than the tax-exempt investor because the taxing authority absorbs some of the investment risk so that her optimal portfolio will be more biased toward equities and less biased toward bonds for the taxable investor.

THE IMPACT OF TAXES ON THE RETURN OF A BOND INDEX

Consider a default-free bond index with a five-year modified duration that is issued at par with a YTM of 5% in a country where the tax rate on interest income is 25%. Recall that, according to the Langetieg, Leibowitz, and Kogelman theorem, over a period equal to twice its modified duration, the total return of an index is well approximated by its initial yield. If we make the reasonable assumption that the duration of the bond is independent of the tax rate, then the annualized return of the index over a 10-year horizon is approximately

$$ER(Index) = YTM \times (1 - tx)$$

$$ER(Index) = 5\% \times (1 - 0.25) = 3.75\%$$

Turnover Management and Tax Loss Harvesting

When capital gains can be offset by capital losses, an investor can enhance her returns by selling securities that have declined in value to offset a realized capital gain. This process is known as tax loss harvesting.

EXAMPLE 2

Tax Loss Harvesting

Advising Hendrik Bruner, a wealth manager noticed that for this tax year, there is a capital gain of USD 1 million in Hendrik's portfolio. The advisor also observed that there are several securities in Bruner's portfolio that are at this time in a loss position, such that selling them will result in a loss of USD 400,000. If Bruner's capital gains tax rate is 20%, selling the securities with losses will reduce Bruner's tax bill from USD 1 million × 20% = USD 200,000 to USD 600,000 × 20%, or USD 120,000.

As capital gains are generally taxed only upon their realization, investing in low turnover investment strategies is a simple way to ensure tax efficiency. In fact, turnover is sometimes used as a proxy to evaluate the tax efficiency of an investment. Due to their relatively low turnover, index funds tend to be more tax efficient than higher turnover active strategies, though the relationship between turnover and tax efficiency is not straightforward. In particular, if a portfolio manager's investment insights are sufficiently good, it can become attractive to implement them in the portfolio, even if in doing so she incurs transaction costs and creates a capital gains tax liability.

Care needs to be taken with the implementation of tax loss harvesting strategies. In some jurisdictions, if a security is sold at a loss and then bought back before a certain length of time has passed (this is known as a wash sale), the loss on the sale cannot be used to offset realized capital gains.

A Non-exhaustive List of Tax Considerations for Taxable Investors

The list below in this section is provided to direct the investor's attention to themes in taxation as applicable to specific asset classes and types of investment income. It is not in any way a substitute for the counsel of a tax accounting expert or meant to analyze the intricacies of the tax code in any particular country. Even if the list may appear more readily applicable to tax payers in a particular jurisdiction, most of these considerations also apply to investors based or taxed internationally.

- *Short-term and long-term capital gains and loss.* Many tax jurisdictions incentivize long-term investments to promote economic growth and minimize aberrations in the investment markets that may cause economic stress in the financial system. Therefore, often, they tax gains of investments that are held for a longer period at a lower preferential tax rate.
- *Interest and discount or premium amortization for Government Treasury and Corporate Bonds.* Generally, taxation involves treating the discount as a compound imputed interest, a portion of which is taxed in each tax period. It should be noted that in this case taxation will occur even if there is no interest cash inflow to the investor. If a bond was purchased at a premium, the premium can be amortized over the bond life to offset other interest income.
- *Interest and discount or premium amortization of municipal bonds.* In various countries around the world, local governments like states, provinces, and municipalities issue debt in the form of bonds. In many of these jurisdictions, the income from such investments is taxed preferentially at either the level of the local government, the level of the sovereign government, or both. For example, many US municipal bond issues pay coupon interest that typically is exempt from federal and usually state income taxes, depending on the residence of the investor. Investors must be aware, though, that such bonds purchased at discounts will get taxed reflecting a capital gain due to the discount approaching par as the bond gets closer to maturity.
- *Qualified and ordinary dividends.* Similarly to the way long-term and short-term capital gains are treated differently for the purpose of taxation, certain countries also distinguish with regards to taxing dividends between a long- and short-term horizon over which a stock is held. In the scenario referred to as "qualified dividend," where the investor holds the stock for longer than a set period, the dividend tax rate is preferential. The alternative scenario is referred to as "ordinary dividend," which implies that the dividend is taxed at a higher rate, often the same as that of ordinary income.
- *Taxation of derivatives.* Taxation differs by the type of derivative contract. For example, in the case of futures contracts in the US, any profit or loss on a position is treated as a partly long-term and partly short-term gain or loss. Options do take into consideration the holding time horizon, but also make a distinction between trading, exercising, or letting the option expire to determine how it will be taxed. Under some of those scenarios, whether or not the underlying asset has been held is also a factor of importance to determine the way the position will be taxed.
- *Currency gains and loss taxation.* Currency positions in the spot market, either direct or implied, are generally taxed as ordinary short- or long-term gains and losses. Derivative foreign exchange positions normally fall under the general taxation rules for taxing derivative contract transactions.
- *Cryptocurrency gain and loss taxation.* Unlike conventional fiat currency, the tax treatment of cryptocurrencies is in a very early stage due to the nascent technology that supports their existence. Therefore, many jurisdictions have not yet developed clear guidelines for their tax treatment. One approach to taxing cryptocurrency transactions treats cryptocurrencies as property, subject to similar long-term and short-term gain rules as other property assets.

- *Directly owned real estate taxation, rents, and capital gains.* Just like other property assets, real estate investments are subject to tax distinctions between short-term capital gains, which are taxed as ordinary income, and long-term capital gains, which benefit from lower, preferential tax rates. However, investors should be aware of additional circumstances that are specific to the fact that this asset class is considered a "real" (physical) asset rather than simply a financial asset. Some examples are capital improvements, which will affect the cost basis for the purpose of calculating gains with respect to the eventual sale price, and depreciation recapture, which requires the investor to pay tax on accumulated depreciation up to the year of sale using the ordinary income tax rates. Another characteristic issue for real estate due to its physical nature is that it occupies space in local jurisdictions like municipalities, which subject it to additional tax, often simply referred to as "property tax," that varies across the geography within and across countries. Lease income from real estate investments is normally taxed as ordinary income, which can be reduced by claiming depreciation and other deductions, like property tax, for income tax purposes.
- *Pass-through treatment of certain funds versus assets held and managed in trust.* Most funds available to retail investors such as mutual funds and hedge funds receive pass through tax status, where the end investor is responsible for paying capital gains and investment income tax for their share of the investment pool. Sometimes, however, investments are held in dedicated trusts on behalf of individuals, families, or organizations like foundations for the purposes of safekeep, inheritance, or funding expenditure. Some of these trusts become their own taxable entities that are required to file their own tax returns. Oftentimes, the tax brackets of trusts are positioned much lower, meaning that a trust will pay higher rates for lower income compared to an individual under the same circumstances.
- *Pass-through taxation of private equity and other limited partnership investments.* Limited partnerships like most partnerships are business formations that are treated as pass-through entities for the purpose of income tax. In other words, the distributions for the funds are taxed at the hands of the limited partners. Special tax treatment is provided for general partners in a limited partnership who receive part of their income as carried interest—a fixed percentage of the profits generated by the fund for its limited partner investors. This income is taxed as a capital gain, reflecting the notion that it is a product of the GP manager skill that is treated like a financial asset.
- *Wash sale rules.* As noted, generating capital losses in some parts of the portfolio will offset capital gain in other parts of the portfolio, which will reduce the tax bill of the investor. Selling stocks that have accumulated losses and then buying them soon after again would possibly trigger what is known as a wash sale rule, which will disregard the sale for harvesting a tax loss. Buying the security after a longer period would potentially avoid this pitfall and would assure that the investor can harvest the tax loss on their current tax return.

Exhibit 8: Time Period That Would Trigger the Wash Sale Rules Across Some Jurisdictions.

United States	United Kingdom	Australia	Germany	Japan
Losses on securities repurchased within 30 days prior or 30 days after the sale of identical securities will be deferred.	Same as the US	Does not have a specified wash sale period. Tax authorities determine the intent of the investor and may impose penalties.	Allows for repurchase of securities without a wash sale rule limitation	Wash sales are limited and often disallowed at the exchange level.

- *Bi-lateral tax treaties on foreign withholding tax on dividends and other investment income.* Numerous countries around the world have engaged in signing agreements among each other to avoid double taxation of their subjects. Investors engaged in cross-border investment transactions should be aware of the complexity of the provisions of such agreements and what their impact is on the taxation of their portfolios. Moreover, despite attempting to be comprehensive, many of these agreements have loopholes and require interpretation that give rise to risk of taxation uncertainty. For example, the treatment of tax-deferred accounts may be quite complicated and sometimes ineffective when investors are domiciled in a different country from the account and the domicile country would not accept the preferred status of deferral account in another country.
- *Alternative minimum tax (AMT).* Some countries have implemented special taxation rules targeted at the preferential treatment certain income sources. The United States has the **alternative minimum tax (AMT)**, which targets these issues. AMT is particularly intended to close tax loopholes and the preferential treatment of certain investment benefits like trust income and investments with advantageous tax status, potentially limiting their effectiveness in reducing the investor's tax liability. For example, some municipal bonds and the exercise of employee stock options may be taxable under AMT.

KNOWLEDGE CHECK

1. Which source of income will be taxed at the ordinary income rate in jurisdictions that follow practices similar to the United States?

   A. Salary

   B. Payout from a life insurance policy

   C. Long-term capital gain

   Solution:

   A is correct. All wage income is taxable as ordinary income. C is incorrect because long-term capital gains are usually taxed at preferential lower tax rates. B is not correct because the payout from a life insurance policy is usually not taxable.

Centralized Portfolio Management

The idea of **centralized portfolio management (CPM)** was first proposed by DiBartolomeo (1992), who presented the numerous advantages of treating the assets of a single beneficiary with multiple active managers in a way that maximizes the cost, tax, and information efficiency. This would essentially occur if all managers used a single trading desk for executing their positions. Besides the ability to cross-validate alpha signals and cross trades, thereby minimizing turnover, the approach would also reduce the realization of capital gains, which, in turn, would minimize the tax liability of the portfolio beneficiary. The benefits of CPM were later empirically demonstrated in a research paper by Bouchey and Pritamani (2018).

Understanding Tax Implications for Families

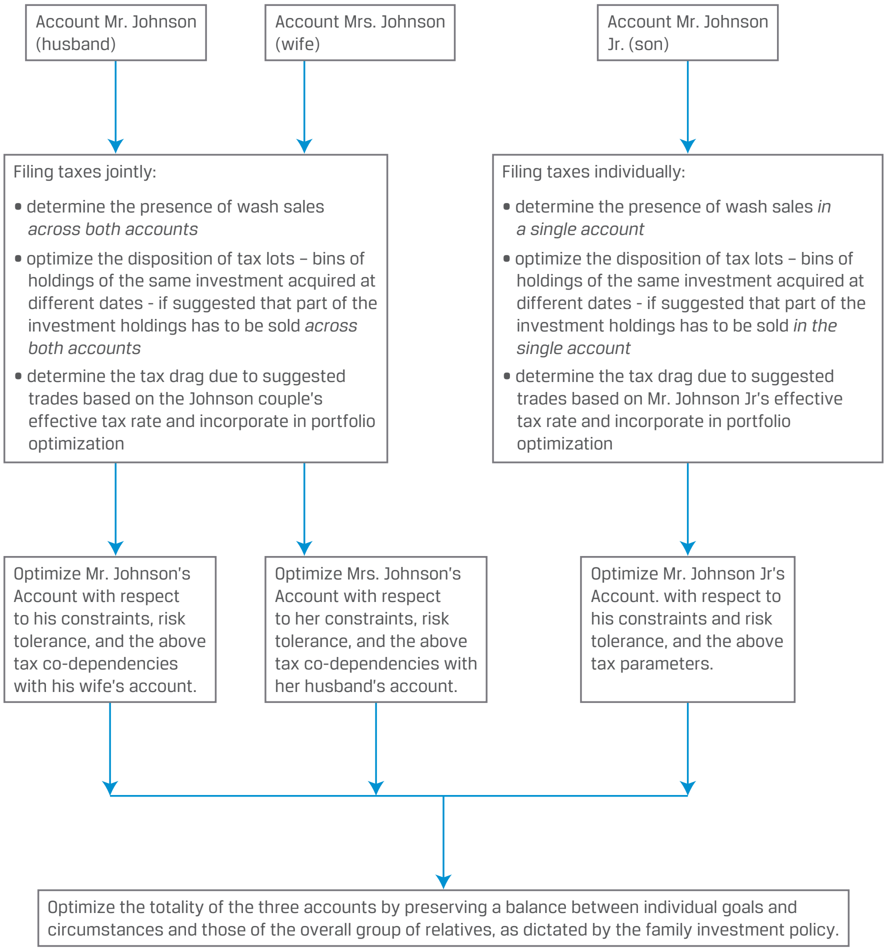
One of the most complex challenges of private wealth management for families is the desire to balance the objectives and constraints of various family members. This involves treating the subsets of the family portfolio as separate accounts and optimizing them individually but also optimizing them as a combination at the total family portfolio level.

While the intricacies of this process are beyond the scope of this text, several points must be made with respect to properly incorporating optimal trading for tax purposes in family portfolio management. First, it is likely that some of the related family members are filing taxes jointly or trade within the same investment account. For this reason, any wash sale concerns should be inspected at the level of each such account rather than the overall family portfolio. Moreover, relatives across the family may be in different income tax brackets which may change their optimal trades, irrespective of their ability to tolerate risk.

Also, some family members may have concentrated positions of stock (publicly or privately held) with significant capital gains accumulated over a long period of time. This combination of concentration and capital gains must be taken into account for each member individually to navigate a tax-optimal trading trajectory. These along with other tax considerations of investors that are beneficiaries should be properly reflected in the portfolio construction process.

Exhibit 9 details tax and investment considerations for a hypothetical family and considers whether taxes are filed jointly or individually, with the goal of optimizing the totality of the three accounts.

Exhibit 9: Strategic Tax Planning and Investment Optimization for Family Accounts



It should be noted that the principles of CPM are particularly relevant for family portfolio management. This is because it is common that the same manager administers all portfolios within one family, and they have the ability to identify tax-beneficial ways to limit turnover.

Future Allocations and Tax Optimization

The goal of private wealth management is not simply accumulation of net worth over an indefinitely long time horizon. Instead, it should be driven by the evolving needs of the investor, their life circumstances, and the approach or payoff of certain liabilities or earmarked expenditures. Investors and those they care about do age and their life balance sheet changes accordingly.

While change brings an extra dimension to consider, portfolio beneficiaries can share with an investment advisor their planned expenditures, life milestones, and other foreseeable financial events in the future. The importance of this information is that it makes possible the estimation of future optimal allocations considering planned expenditures and liabilities due at each point in time, which, in turn, define a unique set of evolving investor characteristics like liquidity needs, risk tolerance, and tax considerations (Wilcox 2003). In simple terms, knowing the future composition of a portfolio can guide current trades to a more efficient trajectory of turnover. Careful planning for realizing capital gains, rebalancing using cash income on the glide path to future allocations, usage of swaps, and other long-term derivative strategies can be more or at least as effective tax strategies as tax loss harvesting alone.

KNOWLEDGE CHECK

1. Which of the following is most likely to provide a tax benefit from forecasting future optimal asset allocations?

   A. Deferring capital gains on stock positions that are expected to rise further due to evolving risk aversion of the investor in the future

   B. Distributing all cash income generated by the portfolio given that future tax liabilities can be satisfied from the liquid assets held in any case

   C. Choosing not to acquire a direct real estate investment that will be illiquid over a time horizon longer than the time when a liability is due from the investor

   Solution:

   B is correct. Eliminating unnecessary capital gains taxes *is* one of the benefits of forecasting future optimal asset allocations.

   A is incorrect because forecasting future optimal asset allocations may suggest that it is prudent to use the current cash income to rebalance the portfolio rather than distributing it. This will avoid future liquidations to rebalance, possibly saving capital gains tax.

   C is incorrect because planning optimal future asset allocations includes the ability to avoid locking into illiquid positions that may require outsized disposition of liquid positions, which among other drawbacks can trigger significant capital gains tax.

Direct Indexing vs. Portfolio Customization

Direct indexing is a strategy designed to enhance tax efficiency in retail investing while also optimizing risk–return balance. This approach involves index-based investing but with a key distinction: It incorporates tax-aware strategies into the benchmark-relative rebalancing process. By employing techniques such as tax loss harvesting and minimizing the realization of short-term capital gains, direct indexing aims to surpass the benchmark in terms of after-tax returns. The integration of these tax-efficient practices allows for potentially better performance relative to the benchmark once taxes are considered.

While the combination of both objectives seems like a winning choice, in practice, this approach presents a challenge. The drive to follow the benchmark while minimizing portfolio-related taxes for the investor represents two competing objectives. The pre-tax relative benchmark performance is the more visible outcome of the two, and this may create an incentive for the manager to prioritize it. Even without this bias, the dynamic constraint in portfolio management to minimize tracking error on pre-tax basis often leaves too little "room" for trading to be made really tax efficient, unless the tolerance to increase tracking error in favor of more tax efficiency is high (DiBartolomeo 2018).

In similarity to direct indexing, another approach—portfolio customization—also aims at a tax-efficient portfolio construction approach. In contrast to direct indexing, it prioritizes all the investor goals and circumstances over benchmark-relative performance. Avoiding unneeded taxation is part of these objectives.

In some sense, portfolio customization epitomizes all the goals of private wealth portfolio management. The name of this approach derives from "mass customization"—a consumer product strategy of the early 90s, aiming to combine differing consumer preferences with operational efficiency. Since many wealth management firms often have hundreds or thousands of investor clients with separate portfolios, the ability to automate this process in a single set of procedures becomes essential in order for the wealth management firm to be profitable and financially competitive in the long run.

Dealing with Concentrated Positions from a Tax Perspective

Advising an investor with a concentrated position presents two distinct challenges. One is the fact that the investor is under-diversified. The other is that the investment, likely held for a long period of time, has accumulated sizable capital gains, which would trigger significant taxes should the position be traded in full in order to replace it with a more diversified set of investments.

One approach to help mitigate both challenges is the so-called complementarity portfolio (DiBartolomeo, Horvitz, and Wilcox 2006). Conceptually, the idea is relatively simple: fund a separate "sidecar" portfolio that is fully diversified and transition the total portfolio, inclusive of the concentrated position to that sidecar portfolio. The key benefit of this approach is to provide a buffer of capital losses in the sidecar portfolio for the capital gains in the main concentrated position portfolio. As trading to rebalance the diversified sub-portfolio occurs, stocks with short-term losses and investments with long-term gains from the concentrated position will be liquidated, and the proceeds will flow into the diversified portfolio. By having the capital gains from in the concentrated position offset by the realized losses from the complementarity position the tax impact of capital gains can be mitigated.

While anticipating losses, which is part of this strategy, seems counterintuitive, this is both part of reality in the financial markets as well as part of rational investor decision-making. If losses do occur, then the complementarity strategy will work as expected. Under the unlikely scenario that no losses occur, then the investor will have generated a strong return on the sidecar portfolio, where for each dollar of profit, they will pay only a fraction of a dollar in capital gains tax when they rebalance. In either case, the investor benefits. A key characteristic of this strategy is that it can take a long time to implement, as the diversified sidecar portfolio may generate losses slowly, restricting opportunities for offsetting gains from the concentrated position.

The Effective Tax Rate Across Borders

The discussion in this section up to this point has not yet explicitly addressed the income tax rate applicable to an investor. As much as it may appear like a straightforward task, in practice, determining the effective tax rate involves many variables that also diverge widely across jurisdictions. The noteworthy ones involve progressive tax brackets or flat taxation, specific deductions the investor can claim, and the presence of AMT. One of the responsibilities of the private wealth management professional is to determine the effective tax rate with the help of a tax expert before entering it as an input to the portfolio construction process.

The investor advisor must practice a discerning approach with regards to taxation implications when investing globally. Not only are varying tax rates and allowable deductions the norm across borders, but there also may be specific rules that benefit or make certain investments in particular countries less attractive. For example, investors in Australian companies would receive credits for taxes paid at the corporate level when they pay their dividend tax (franking credits). On the other hand, if an investor is also taxable in another country, that other country may disallow the credit since it was not a beneficiary of the corporate taxes paid in the first place. A further consideration is that tax laws and regulations may change over time, resulting in one more source of uncertainty in wealth management.

The examples for international considerations are numerous and not the objective of this reading. Instead, it should prompt the investor or the investment advisor to seek proper counsel on taxation details and expertise with local and international regulations and with respect to the particular jurisdictions that impact the investor portfolio.

A Primer on Taxable Portfolio Optimization

This section expands the ideas of incorporating taxes in portfolio construction by means of providing a stylized example of optimizing a portfolio. The optimization is performed with and without the effect of taxation to highlight some key differences and direction in which taxes can affect the optimal portfolio choice.

The reader is already familiar with the Markowitz mean–variance optimization, which aims to maximize the investor utility U by modifying portfolio holdings. In this function, R is the expected average return of the portfolio and σ^2 is its variance, i.e., the square of its standard deviation.

$$U = R - \frac{\lambda}{2} \times \sigma^2.$$

Earlier in this chapter, we introduced the consideration of taxes in optimization by modifying the Markowitz mean–variance optimization utility in the following way:

$$U = R_{after\ tax} - \frac{\lambda}{2} \times \sigma_{after\ tax}{}^2,$$

where $R_{after\ tax}$ and $\sigma_{after\ tax}{}^2$ are respectively equal to $R \times (1 - tax\ rate)$ and $\sigma^2 \times (1 - tax\ rate)^2$.

Note that a truly tax-aware optimization should account for two aspects of taxation. The first one is already reflected in the formulation provided immediately above—the effect on *future* taxes of return generated by the portfolio. The second one is the taxes *currently* triggered by trading—namely, capital gains taxes. Since those are deterministic, they only affect expected return but not variance. Therefore, we can further modify the tax-aware utility function as:

$$U = R_{after\ tax} - \frac{\lambda}{2} \times \sigma_{after\ tax}{}^2 - Capital\ gains\ tax\ rate.$$

Capital gains tax is effectively a negative return drag on the portfolio expected return.

The portfolio optimization demonstrated in Exhibit 11, 12, and 13 looks at a portfolio consisting of stocks and municipal bonds. In this and any portfolio, there are several important issues to consider from a tax perspective.

Portfolio construction requires a delicate balance: It should align the objective of return-risk with the reduction of capital gains taxes, especially those on short-term capital gains. Additionally, the process must be diligent in tracking and preventing wash sales.

Another important issue is the income tax effect on the return for the investor. A stock return, particularly the income portion consisting of dividends, must reflect the fact that the dividends are qualified or non-qualified. In parallel, coupon payments generated by municipal bonds may not be taxed depending on the investor circumstances. In both cases, the after-tax expected return of the investors will have to be adjusted accordingly as part of the inputs to the optimization.

It is crucial to monitor the trading of investment instruments, whether they're bonds or stocks. The optimization process needs to meticulously record the timing of both the acquisition and recent sale of investments within a portfolio. This is achieved through the organization of **tax lots**, which are sorted chronologically. A tax lot is created when a security is acquired and represents the quantity and cost basis of the security in a particular transaction. Multiple purchases of the same security will result in multiple tax lots and must be tracked separately for the purposes of calculating returns and potential tax liability. Also of note, while most municipal bonds pay coupon interest that is exempt from federal income tax, realized capital gains and losses on these bonds can have tax effects and consequently can influence how they will be treated in portfolio optimization.

The parameters of an illustrative tax-aware portfolio construction process are in Exhibit 10.

Exhibit 10: Tax-Aware Portfolio Optimization by Trade Date

	Variables
Enable tax optimization	Yes
Net capital gain YTD	USD 0.00
Maximum capital gain	USD 10,000,000
Invest tax refund	No
Short-term gain rate	39.60%
Long-term gain rate	20%
Days until long term	N/A
Days for wash sale	30

Source: Northfield Information Services Inc.

From an individual investment perspective, what would matter for the optimal portfolio when tax-aware optimization is enabled are the tax lots of the investments, not only the investments themselves. Tax-aware optimization requires the differentiation by tax lots based on different traded dates, whereas optimization without the tax awareness can group the securities held in the different share lots in simple percentage weights.

The same security in a different tax lot is treated differently by the portfolio construction process. In a tax-aware portfolio optimization, the tax lots are tracked because repurchases of the security can trigger a wash sale.

Understandably, this is due to the way the tax adjustments affect mean variance optimization and the utility of the investor discussed earlier in this section.

Exhibit 11 and Exhibit 12 contain partial results of our sample optimization, demonstrating the largest increases and decreases in securities weightings for both tax-aware and tax-unaware portfolios. While the specific details of each security and position influenced the change in weightings, it's worth noting that several tax advantaged securities were optimized out of the tax-aware portfolio. This highlights that security characteristics can be subordinate to historic costs and other factors.

Exhibit 11: Top 5 and Bottom 5 Weighting Changes—Tax-Aware Optimization

Security ID	Name	Initial Weight (%)	Optimal Weight (%)	Weight Change (%)
	Top 5 Holdings			
00206R102	AT&T	1.22	12.06	10.83
253363WS0	DICKINSON TEX INDPT SCH DIST; 5%; 2/15/2018	3.31	11.06	7.74

Security ID	Name	Initial Weight (%)	Optimal Weight (%)	Weight Change (%)
Top 5 Holdings				
254839L68	DISTRICT COLUMBIA REV; 5%; 10/1/2024	4.73	9.47	4.73
94106L109	WASTE MANAGEMENT	0.28	3.57	3.29
92343V104	VERIZON COMMUNICATIONS	0.00	2.45	2.45
Bottom 5 Holdings				
93978HKY0	WASHINGTON ST HEALTH CARE FACS AUTH REV; 5%; 3/1/2024	2.37	0.00	−2.37
040484LQ8	ARIZONA BRD REGENTS UNIV ARIZ SYS REV; 5%; 8/1/2026	3.31	0.00	−3.31
01179PY27	ALASKA MUN BD BK ALASKA MUN BD BK AUTH; 5%; 9/1/2020	3.55	0.00	−3.55
914378ED2	UNIVERSITY KY GEN RCPTS; 5%; 4/1/2021	3.55	0.00	−3.55
248866NT8	DENTON TEX; 4%; 2/15/2025	4.73	0.00	−4.73

Source: Northfield Information Services Inc.

Exhibit 12: Top 5 and Bottom 5 Weighting Changes—Tax-Unaware Optimization

Security ID	Name	Initial Weight (%)	Optimal Weight (%)	Weight Change (%)
Top 5 Holdings				
254839L68	DISTRICT COLUMBIA REV; 5%; 10/1/2024	4.73	15.37	10.63
00206R102	AT&T	1.22	11.81	10.59
94106L109	WASTE MANAGEMENT	0.28	4.65	4.37
253363WS0	DICKINSON TEX INDPT SCH DIST; 5%; 2/15/2018	3.31	6.84	3.52
858912108	STERICYCLE	0.39	3.82	3.43
Bottom 5 Holdings				
97023105	BOEING	1.09	0	−1.09
033161X96	ANCHORAGE ALASKA; 5%; 9/1/2022	3.55	2.21	−1.34
01179PY27	ALASKA MUN BD BK ALASKA MUN BD BK AUTH; 5%; 9/1/2020	3.55	0	−3.55
914378ED2	UNIVERSITY KY GEN RCPTS; 5%; 4/1/2021	3.55	0	-3.55
248866NT8	DENTON TEX; 4%; 2/15/2025	4.73	0	-4.73

Source: Northfield Information Services Inc.

Finally, we find that the turnover—the percentage of the portfolio that changes due to recommended trades—is significantly lower in the taxable portfolio optimization compared to that of the non-taxable version as shown in Exhibit 13. This can be easily explained by the observation that the more transactions, the higher the chance of triggering capital gains taxes, which, as previously indicated, is a dynamic drag on the expected portfolio return. Therefore, the portfolio construction process will try to avoid capital gain–realizing transactions as much as possible, which will also reduce the overall number of transactions.

Exhibit 13: Portfolio Turnover Comparison and Trade Summary

Tax Optimization Disabled	Yes
Turnover	110%
Number of trades	2,902
Tax optimization enabled	Yes
Turnover	73%
Number of trades	943

Source: Northfield Information Services Inc.

QUESTION SET

1. All of the following are advantages of taking a limited partnership stake in an offshore investment vehicle except:

   A. ability to control the allocation of the vehicle's assets.
   B. mitigation of liability.
   C. potential tax benefits.

   Solution:

   A is correct. In an offshore vehicle, the GP is the entity that has direct control over the investments.

2. What is a wash sale?

   A. The disposition of a security that was purely acquired for hedging purposes
   B. The sale and re-purchase of a security in a window that that disallows any tax write off for losses
   C. When dividends are re-invested, the sale of marginal new positions within a certain window

   Solution:

   B is correct. A wash sale occurs when a security is sold at a loss (resulting in a potential tax benefit) but then re-purchased before "enough" time has passed by. The setting of what constitutes "enough time" is particular to the prevailing tax jurisdiction.

3. What does it mean for a dividend to be "qualified"?

   A. The investor has not held the underlying security for a sufficient amount of time to receive tax deferment.
   B. The dividend is at a special rate for a certain period (even as low as one payment) usually due to some corporate tax restructuring.
   C. The underlying security has been held for a significant amount of time, allowing for preferential tax treatment.

   Solution:

   C is correct. A qualified dividend means that the underlying stock has been held "long enough" such that the prevailing tax authority allows the dividends to be taxed at a lower rate. This is done to incentivize longer-term investments.

4 RETIREMENT

- [ ] discuss and recommend appropriate wealth management planning approaches for retirement from legal, taxation, and jurisdictional perspectives

The concept of retirement as we now know it is relatively modern.

While this reading focuses primarily on the financial aspects of retirement, it is vital to pay attention to its social aspects as well. Human flourishing is a complex function of physical, mental, and spiritual health and activity as well as of connectedness, especially to friends and loved ones, but also to the broader fabric of society.

It proves helpful to decompose the financial aspects of retirement into two phases: **accumulation** and **decumulation**. The accumulation phase corresponds roughly to one's working life, during which funds are saved and invested. The decumulation phase corresponds roughly to retirement, during which savings are spent. The two phases are inextricably linked, and each phase comes with its challenges.

In the accumulation phase, wealth managers have to make forecasts of their clients' future spending plans, taking into account their desired bequests, as well as of asset class returns and correlations, and use them to create portfolios that will, with high probability, allow the spending plans and bequests to be realized. In the decumulation phase, spending plans must consider both longevity and inflation and adapt to changing circumstances and fluctuations in asset returns.

Professor William Sharpe, who won the Nobel Prize for Economics in 1990, once called decumulation "the hardest and nastiest problem in finance" on account of increasing and uncertain lifespans and healthspans, inadequate retirement savings, and our modest ability to forecast asset returns and spending in retirement. It is particularly challenging for women, who outlive men by about five years on average (see OECD 2021 and https://data.oecd.org/healthstat/life-expectancy-at-birth.htm) but tend to be in poorer health than men of similar age during the last few years of life.

Measuring Preparedness for Retirement Using Funding Ratios

In Part 1, we covered the creation of capital market expectations, personal balance sheets, and the allocation of assets to reflect a client's risk tolerance. In Exhibit 8, we also explained the importance of surplus as a measure of wealth and presented an example of a moderately wealthy couple, Steven and Margaret McCarthy, who had a positive surplus but not so large a surplus that they were immune to concerns about market fluctuations and their impact on retirement. We now explore this example further and derive from it a powerful way in which to think about an individual's (or a family's) level of preparedness for retirement at any stage of life.

The McCarthys' liabilities are dominated by the present values of their retirement living expenses (EUR 3,300,000) and health care spending (EUR 500,000) and the bequest that they wish to leave their children (EUR 2,000,000). They currently have an actuarial surplus of EUR 335,000, so their assets are adequate to support their goals in retirement. We can express this fact through their **funding ratio**, or the ratio of their assets to their liabilities.

$$\textit{funding ratio} = \frac{\textit{assets}}{\textit{liabilities}}.$$

The McCarthys have a funding ratio of

$$\frac{\text{EUR } 6{,}865{,}000}{\text{EUR } 6{,}530{,}000} = 1.051.$$

Put differently, they are overfunded by 5.1%. The power of the funding ratio as a measure of funding adequacy is immediately apparent: If the McCarthys' funding ratio declines by 4.9% (i.e., if their assets fall by 4.9% more than their liabilities, or if their liabilities increase by 5.1% more than their assets), they will only just be able to meet their goals. It is easily seen that so long as the McCarthys have *some* assets, their funding ratio must be positive (though it may be less than 1).

One way in which the McCarthys can increase their funding ratio over time is to reduce their spending and increase their savings. Another way in which to do so is to continue working, or even to take up new jobs, thus adding some human capital (the present value of future earnings) to their assets. The higher the McCarthys' funding ratio, the greater will be the probability of them meeting their goals.

The power of the funding ratio lies in the fact that it measures a quantity of interest (surplus) in percentage terms, making it universally applicable at any level of wealth. As funding ratios are always positive, the change in funding ratio from one period to the next can be expressed either as a difference or as a ratio, and the ratio form is particularly useful. The **funding ratio return**, or the ratio of the final funding ratio to the initial funding ratio, 1, is determined solely by the returns of the assets and liabilities:

$$\begin{aligned}\textit{Funding ratio return} &= \frac{\textit{Final funding ratio}}{\textit{Initial funding ratio}} - 1 \\ &= \frac{\textit{Asset return} - \textit{Liability return}}{1 + \textit{Liability return}}.\end{aligned}$$

It is important to keep in mind that the final value of the funding ratio must include the impact of contributions and disbursements (for assets) as well as the impact of additions and defeasements (for liabilities). Formally, we write

$$\textit{Asset return} = \frac{\textit{Final value of assets after adding all contributions and subtracting all disbursements}}{\textit{Initial value of assets}}$$

and

$$\begin{aligned}&\textit{Liaibility return} \\ &= \frac{\textit{Final value of liabilities after adding all new liabilities and subracting all defeasements}}{\textit{Initial value of liabilities}}.\end{aligned}$$

Importantly, the funding ratio return does not depend on the level of the funding ratio, making the funding ratio a universal measure of financial health independent of the level of wealth. Leibowitz, Kogelman, and Bader (1994) make an eloquent case for the use of the funding ratio in addition to surplus as a measure of financial health and argue that investors ought to build portfolios that make an optimal trade-off between growth in the funding ratio and the risk of it falling below some level. This can be expressed as a form of mean–variance optimization if we assume that funding ratios are approximately normally distributed and can be solved using simulation if they are not.

CASE STUDY

John and Sarah Chang—Funding Ratios

A wealth manager has two clients, John Lee and Sarah Chang, both aged 60 and who have identical liabilities with a present value of SGD 5,000,000. However, they have very different amounts of assets, largely because John saved conscientiously since he started working, while Sarah started saving only at age 40. John has assets of SGD 10,000,000, while Sarah has only SGD 3,000,000.

Next, we explore the impact of a shock to markets on John's and Sarah's funding ratios. On account of a global recession, the global stock index loses 20% of its value while the global bond index gains 12%. We have no information about the returns of the liability.

1. Based on their wealth manager's advice, both John and Sarah have invested half their assets in a global stock index fund and the remaining 50% in a global bond index fund. What are their funding ratios?

   A. Neither funding ratio can be computed.

   B. The two funding ratios are identical because their liabilities are identical.

   C. John's funding ratio is 2, while Sarah's funding ratio is 0.6.

   Solution:

   C is correct. The funding ratio is the ratio of the present value of assets to the present value of liabilities. John's funding ratio is SGD 10M/5M, or 2, while Sarah's is SGD 3M/5M, or 0.6.

   A is incorrect because both funding ratios are easily computed from the data given.

   B is incorrect because John and Sarah have different amounts of assets (SGD 10,000,000 and SGD 3,000,000, respectively) and the same amount of liabilities (SGD 5,000,000). Their funding ratios must therefore be different.

2. Did John and Sarah experience the same funding ratio return?

   A. No, they did not. John's funding ratio return was higher than Sarah's because his initial funding ratio was higher.

   B. No, they did not. Sarah's funding ratio return was higher than John's because she has fewer assets and thus suffered lower losses in SGD terms.

   C. Yes, they did. The two funding ratio returns must be identical.

   Solution:

   C is correct. John and Sarah have identical liabilities (and therefore identical liability returns) and identical asset allocations (and consequently identical asset returns), and the funding ratio return depends only on asset and liability returns.

   A is incorrect because the funding ratio return does not depend on the level of the funding ratio.

   B is incorrect because the funding ratio return does not depend on the level of assets or liabilities.

Saving for Retirement

While many persons will inherit wealth, a wise person will start saving for retirement early to benefit as much as possible from the power of compounding. Compound interest is described by many as the eighth wonder of the world, and that "he who understands it, earns it; he who doesn't, pays it."

The Rule of 72, which asserts that "with annual compounding, money invested at a rate of r% per annum doubles in 72/r years," is a useful approximation that enables us to visualize the power of compounding, and Philips (2010) shows that it applies to periodic savings as well: If we save USD 1 (or INR 1 or SGD 1) each year, approximately half the terminal value of our savings comes from investments made in the first 72/r years of our working life, making clear the need to start saving early in our careers for retirement.

CASE STUDY

Jenny Yu (Part 1): The Power of Compounding for Retirement Savings

Jenny Yu is 25 and has just started working as an airline pilot. She is in excellent health and would like to retire and travel for pleasure when she turns 70. After discussing her goals with her financial advisor, she decides to save SGD 1,000 at the start of every year to fund her travel in retirement. How much money can she expect to have in her travel fund at the end of the year in which she turns 70 under the two scenarios listed below if the expected return of her portfolio is 5% per annum?

1. She saves SGD 1,000 at the start of every single year until she turns 70 (i.e., she makes 46 contributions).
2. She does not save anything for the first 12 years but then starts saving SGD 1,000 at the start of every year until she turns 70 (i.e., she makes 34 contributions).

To determine the size of Jenny's savings account at age 70, we must first compute the expected future value of SGD 1,000 invested each year at 5% over this 46-year period. A straightforward calculation shows that she contributes a total of SGD 46,000 to her travel fund, the expected value of which at age 70 is SGD 177,119. A similar calculation shows that if she starts contributing to her travel fund at age 37, she will have contributed a total of SGD 34,000 and that the expected value of her travel fund at age 70 is SGD 89,320. It is striking that a mere 12-year delay in contributing to the travel fund leads to a 50% reduction in its expected final value! Keep in mind that Jenny will have to pay taxes on her withdrawals, and these will depend on Singapore's tax laws when she actually makes withdrawals to fund her travels.

It is easy to derive an expression for the terminal value of an investment strategy. Formally, assume Jenny saves SGD 1 (or any other unit of currency such as USD 1, JPY 1, or INR 1) at the start of each year in a portfolio with a constant annual expected return of $E[r]$. The expected value of her portfolio at the end of N years is:

$$V_N = \textit{Annual savings} \times (1 + E[r])\frac{(1 + E[r])^N - 1}{E[r]}. \tag{4}$$

The power of compounding is clearly visible in the numerator of Equation 4, which can be put to good use when determining required savings rates. If a client knows how much money she wants to have at a particular age, she (or her wealth manager) can determine the appropriate level of savings needed to achieve her goal based on her current age, her age at retirement, and the expected return of the portfolio that best reflects her risk tolerance. Ignoring the impact of taxes, the required level of savings is given by solving Equation 3. (Note that this equation differs slightly from the standard formula for an annuity because contributions are made at the beginning of each year, and wealth is measured at the end of the final year.) Also, this relationship makes the simplifying assumption of no volatility. This drastically underestimates the target capital or, alternatively, overestimates the terminal wealth. Hence, such predictions need to consider this limitation.

$$\textit{Annual savings} = \frac{1}{(1 + E[r])} \times \frac{\textit{Target wealth} \times E[r]}{(1 + E[r])^{\textit{Retirement age} - \textit{Current age}} - 1}. \tag{5}$$

If, on the other hand, a client has inherited (or created) sufficient wealth that her funding ratio is over 1, the wealth manager can recommend an asset allocation that makes an optimal trade-off between surplus growth and surplus risk or funding ratio return and funding ratio risk as suggested by Leibowitz, Kogelman, and Bader (1994).

The Many Challenges of Retirement

Retirement can bring with it a wide-ranging set of challenges: some physical (on account of unexpected changes in health), psychological (on account of the lack of an animating purpose to one's life), social (on account of less frequent interactions with colleagues, friends, and relatives), and financial (on account of uncertainty in lifespans, healthspans, spending needs, and asset returns).

While we focus on the financial aspects of spending one's savings in retirement (also known as *decumulation*), it is imperative to understand that a successful retirement must address all the above issues. We encourage both wealth managers and their clients to think of retirement expansively and not just through a narrow financial lens.

The Decumulation Problem

The problem of decumulation is easily stated but is surprisingly hard to implement. A perfect decumulation strategy would take a retiree's wealth at retirement and translate it to a stream of periodic payments that are as large as possible, keep pace with inflation, and last for as long as the retiree and their partner live, even if their lifespans greatly exceed the population average. Finally, the entire value derived from the retiree's wealth should have been transferred to the retiree at death, leaving only any desired bequest to satisfy.

The primary reason that the decumulation problem is so complex is that lifespans are more variable than we commonly understand, and it is not possible to hedge uncertainty in individual mortality (or joint mortality in the case of a couple). This leads to some individuals over-saving during their working lives to plan for a worst-case outcome (say living to 100) and to others underspending in retirement to protect against the possibility of running out of money during their lifetime.

Social security programs are natural solutions to the decumulation problem and have the great advantage that they benefit from the law of large numbers—their payments reflect the distribution of lifetimes across the population, which is far more predictable than the lifetime of an individual. Unfortunately, these programs have come under increased pressure on account of their relatively static retirement age (often 65, but sometimes younger), which has not risen even as life expectancies have increased, as well as the changing balance between the size of the working age and retired populations, significantly increasing their cost to societies and slowly making them unsustainable without imposing an undue burden on the working population.

For many years, firms provided their employees with defined benefit pension plans, but these have declined in number, mainly because of the same forces that have pressurized social security systems worldwide. This has made individual saving and decumulation the primary means of retirement security for many people. The Netherlands, which has one of the world's best-ranked pension systems in the Mercer CFA Institute Global Pension Index Report, is rapidly transitioning to a personal saving system for precisely these reasons as well as those mentioned earlier.

Exhibit 14 illustrates longevity risk using a subset of the mortality and life expectancy table used by the United States Social Security Administration in 2023 (see https://www.ssa.gov/oact/STATS/table4c6.html for the complete table). The gap between men and women in life expectancy and one-year mortality rates at every age is evident, as is the steady decline in remaining life expectancy and the corresponding increase in the mortality rate.

Exhibit 14: Remaining Life Expectancy and One-Year Probability of Death (US)

	Male		Female	
Age	**P[Death in 1 yr]**	**Life Expectancy**	**P[Death in 1 yr]**	**Life Expectancy**
0	0.005837	74.12	0.004907	79.78
10	0.000127	64.67	0.000092	70.27
20	0.001398	54.97	0.000485	60.41
30	0.002275	45.86	0.000976	50.79
40	0.003333	36.97	0.001735	41.38
50	0.005998	28.33	0.003476	32.24
60	0.013485	20.47	0.007926	23.67
70	0.026137	13.59	0.016634	15.82
80	0.065568	7.74	0.047148	9.1
90	0.182632	3.72	0.146985	4.41
100	0.384967	1.93	0.33361	2.23
110	0.627071	1.05	0.597445	1.12
119	0.972793	0.53	0.972793	0.53

There are two dominant approaches to decumulation:

1. Invest one's assets in a portfolio that is likely to earn a positive real return and spend down this portfolio at a steady pace, taking into account expected longevity
2. Transfer one's assets to an insurer in exchange for an annuity or a stream of payments over one's lifetime

Both methods have strengths and weaknesses. The first is subject to market fluctuations: If a person were to have retired on the eve of the Great Financial Crisis, or worse still, the Great Depression, the value of their portfolio would have plummeted, permanently lowering their living standards in retirement. A similar fate would await them if they retired on the eve of an inflationary spiral. The second is subject to credit risk: If the insurer goes bankrupt on account of unexpected losses or bad investment decisions, the annuity will stop making its promised payments, potentially leaving the annuitant destitute.

While no perfect solution to these problems exists, and while new approaches to retirement security are being created, it is worth studying both these approaches in some detail before presenting some emerging solutions to the decumulation problem.

A Simple Decumulation Rule

In early work, Bengen (1994) used data for the US stock and bond markets and simulated retirement spending starting in every year from 1926 to 1989. He determined that retirees who withdrew 4% of a 50% US stocks/50% US bonds portfolio in the year following retirement and adjusted the withdrawal for inflation in subsequent years could expect their portfolio to last at least 30 years, and possibly much longer. The study was substantially expanded in Cooley, Hubbard, and Walz (1998) (also known as the Trinity Study), and this is now used as the basis for most such withdrawal rules.

Anarkulova, Cederburg, O'Doherty, and Sias (2023) repeat the Bengen and Trinity studies using a 38-country sample, along with data on US male and female life expectancies from the Social Security Administration, to simulate a decumulation strategy for 65-year-olds starting in 2022. They find that the safe initial withdrawal rate is only 2.26% if future adjustments for inflation are allowed. A good rule of thumb is that the safe withdrawal rate should not be much larger than the real expected return of the portfolio.

An alternative rule of thumb that allows for a higher level of spending but with more variation from one year to the next is to divide the value of a client's retirement savings by her remaining life expectancy (or the expected length of time that at least one person is alive in the case of a couple) and update this calculation every year, but never withdraw more than one-fifth of the portfolio in any year. Setting the maximum withdrawal rate to 20% is a simple and practical way in which to manage longevity risk, and we can write:

$$\textit{Maximum safe withdrawal rate} = \frac{1}{\max(5, \textit{Joint life expectancy})}.$$

Naturally, a client who wishes to leave a bequest can apply the maximum safe withdrawal rate to the difference between their assets and their desired bequest.

Despite their many limitations, these simple rules will likely prove to be all that a sufficiently wealthy client needs, though they should always be coupled with thoughtful tax advice; some portion of an investor's wealth is likely held in a tax-advantaged vehicle, and it can often (but not always) help to defer one's withdrawals from such vehicles.

Annuitization

An **annuity** requires its purchaser to make an upfront lumpsum payment in exchange for periodic (i.e., monthly or yearly) payments. It may offer constant payments in nominal or real terms over a fixed term or the length of one's life and is well suited to individuals who desire a steady income stream. Each variation on its terms will affect its price.

Annuities are arguably the ideal retirement vehicle for individuals because they address longevity risk but have long been shunned because of the high fees that they have charged in the past and because the bankruptcy of an annuity provider (often an insurance company) can leave an annuitant destitute. Insurers, likewise, have been reluctant to offer competitively priced annuities because they face an adverse selection problem—the persons who are most likely to purchase an annuity are those who are likely to live the longest, making the sale of an annuity a losing proposition from the outset.

That said, two emerging trends have started to make annuities more appealing. The first is the increasing popularity of annuitization, making adverse selection less of a problem and allowing insurers to offer more attractively priced annuities with confidence. The second, potentially more interesting, trend is the emergence of a market for deferred annuities that start at a future date. These can be bought relatively inexpensively if they start sufficiently far in the future and can act as a longevity hedge.

It is a relatively simple matter for a retiree to purchase two annuities—the first to cover the time from retirement to the expected life (say age 85) and the second from age 85 to death. As many people will not collect payments from the second annuity, it can be attractively priced. Totten and Siegel (2019) use this fact to propose a cost-effective alternative to a traditional pension plan: They recommend that individuals save enough to allow them to live from retirement to age 85, after which an inexpensive deferred annuity supports them until their death. The age at retirement and at the start of the deferred annuity will evolve over time: the first on account of the increasing ability of humans to work longer and the second on account of advances in health care.

If the lump sum payment for an annuity is invested in a portfolio with expected return $E[r]$, and if the payment from a fixed-term annuity grows at a rate g per annum and is made at the end of each year for N years, the initial payment from the annuity is

$$Initial\ payment\ =\ \frac{Lump\ sum\ \times\ (E[r]-g)}{1-\left(\frac{1+g}{1+E[r]}\right)^N}. \qquad (6)$$

In the special case when the growth rate is exactly equal to the expected return, Equation 6 gives an indeterminate answer, and the initial payment from the annuity can be shown using L'Hospital's rule from calculus to be

$$Initial\ payment\ =\ \frac{Lump\ sum \times (1+E[r])}{N}. \qquad (7)$$

CASE STUDY

Jenny Yu (Part 2): Decumulation With Steady Growth in Withdrawals

1. Jenny Yu, whom we met in an earlier case study, expects her travel fund to grow to SGD 177,119 when she retires at age 70. Jenny also expects that its expected return will then drop to 3%. She decides to travel for 15 years until she turns 85 and wants her travel budget to grow by 3% annually. What amount can she expect to receive at the end of the first year and at the end of the 15th year?

   Solution:

   As the expected return of Jenny's portfolio is identical to the desired growth rate of her payments, the payment that Jenny expects to receive at the end of the first year is governed by Equation 7:

   $$\text{Initial payment} \ = \text{SGD}\ \frac{177,119 \times\ (1+0.03)}{15} = \text{SGD}\ 12,162$$

   In the 15th year, she can expect to receive

   $$\text{Final payment}\ =\ \text{Initial payment}\ \times\ 1.03^{14}$$

   $$= \text{SGD}\ 12,044 \times 1.5126$$

   $$= \text{SGD}\ 18,396$$

   As in the earlier example, we need to keep in mind that Jenny will have to pay taxes on her withdrawals, and these will depend on Singapore's tax laws when she actually makes withdrawals to support her travels.

Innovations in Retirement Planning

Traditional pension plans, like social security, promise retirees a certain monthly income after they retire and until their death so that employees focus on the level of income they would receive in retirement. The emergence of private savings plans, such as the 401(k) plan in the United States, induced a change in thinking—people started to think about their level of wealth at retirement instead. But translating wealth to income is not easy, as we have seen, especially if asset returns and spending patterns prove volatile, and there is evidence both of over-saving and under-saving for retirement as well as of overspending and underspending in retirement, none of which are desirable.

Over-saving for retirement and underspending in retirement both appear to be driven by a fear of outliving savings. Under-saving for retirement, in contrast, appears to be driven by a failure to understand the power of early saving and compounding, while overspending in retirement appears to be driven by the failure to understand the level of lifetime income that any given level of wealth can support. Restoring the focus on retirement income instead of wealth can help address these issues and allow for a more secure retirement.

Three insights underlie almost all innovations in retirement security.

1. Pooling transforms highly variable individual mortality risk to the average mortality risk of a population, and longevity risk can be cost-effectively managed using deferred annuities. In the United States, Collie (2016) shows that the risk associated with uncertainty in lifetimes is greater than the risk associated with being fully invested in equities by age 75.

   To show this, he starts by fixing the expected return of the portfolio at 6%, equates the annuitization period to a person's expected remaining life, and computes the annuity payment. He then computes the annual payments from an annuity when the annuitant's life lies at the 90th percentile of its distribution with the portfolio's return fixed. Call this number, which is necessarily lower than the base case annuity payment, X.

   Next, with the annuitant's remaining life fixed at its expected value and portfolio returns being variable, he computes the distribution of annuity payments and finds the standard deviation of portfolio returns that results in annuity payments that equal or exceed X with 90% confidence. This standard deviation can be thought of as equivalent standard deviation for longevity risk. He then compares the actual standard deviation of portfolio returns to the equivalent standard deviation for longevity risk to determine which one is larger. Below age 75, the standard deviation of equities is higher than the equivalent standard deviation of longevity risk. Above age 75, the relationship is reversed.

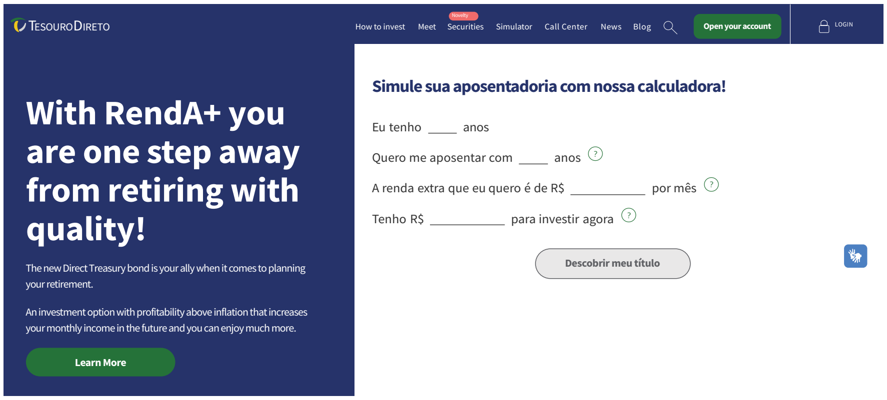
2. Institutions manage assets more cost-effectively than most individuals. Minor differences in management costs accumulate over time and translate to significant differences in retirement benefits.

3. Some risks are natural hedges for each other. For example, long-term care needs and life expectancy in retirement are negatively correlated and can therefore be combined into a single insurance product.

With this in mind, we briefly introduce three innovations that can significantly enhance retirement security. Some have been implemented in some countries, but none on a global scale, and their early implementation offers an excellent learning opportunity for governments, wealth managers, and the retirement savings industry.

1. **Modern Tontines** (McKeever 2010) allow a group of individuals to invest a pooled lumpsum amount in a portfolio and receive distributions for as long as they live. As members of the group die, a portion of the remaining value in the portfolio is returned to their heirs, and the remainder is used to keep providing payments to the survivors. When the last survivor dies, any remaining funds are distributed to his or her children. **Tontines** have long featured in murder mysteries in which one of the participants schemes to murder his co-participants in order to be the last living member of the pool, but the truth is more mundane: A tontine is far closer to an annuity than to a lottery.
2. **Retirement Security Bonds** (Merton 2014) allow individuals to purchase small amounts of a forward starting annuity whose purchasing power is protected in real terms. This has been a great success in Brazil, where citizens can buy RendA+ bonds that pay a monthly benefit starting at age 65 for 20 years directly from the Treasury's website. As shown in Exhibit 15, a participant need only answer four questions, after which the website computes the amount of the bond to be purchased, takes the payment from the participant's bank account, and credits their account at the Treasury with the purchase. It also appropriately credits their bank account every month once the person turns 65. The questions are:
   - **a.** I am _____ years old.
   - **b.** I want to retire at age ______.
   - **c.** The extra monthly income that I wish to guarantee is R$ _______.
   - **d.** I have R$ _______ to invest now.
3. **Combined offsetting insurance** (Hieber and Lucas 2022) combines long-term care insurance and retirement income into a single policy. A participant in poor health will use significant amounts of long-term care but is unlikely to receive much retirement income before death. Correspondingly, a participant in robust health will use relatively little long-term care but will receive a significant amount of retirement income. By carefully balancing the types of risks that are combined, a low-risk insurance product can be created that is well-suited to the needs of retirees and is robust to adverse selection effects.

Exhibit 15: The Brazilian Treasury's Website for RendA+ Bonds



QUESTION SET

1. Consider the possibility of creating a national auxiliary retirement savings plan. Assume the government starts a national savings plan that gives each child 1,000 units of their national currency at birth and on every single birthday. Furthermore, assume that the money is invested in an account that earns 3% per annum. How much money will each child accumulate in the account just before their 1st, 2nd, 3rd, …, or 18th birthday?

   Solution:

   The value of the account just before the child's Nth birthday is $V_N = 1{,}000 \times \frac{1.03^{N+1} - 1.03}{0.03}$. The following table, Exhibit 16, shows the evolution of the value of the account immediately before the annual contribution is made.

Exhibit 16: Projected Growth of Retirement Savings from Birth to Adulthood in Auxiliary Plan

Age	Annual Contribution	Account Value
0	1,000	0
1	1,000	1,030
2	1,000	2,091
3	1,000	3,184
4	1,000	4,309
5	1,000	5,468
6	1,000	6,662
7	1,000	7,892
8	1,000	9,159
9	1,000	10,464
10	1,000	11,808
11	1,000	13,192

Age	Annual Contribution	Account Value
12	1,000	14,618
13	1,000	16,086
14	1,000	17,599
15	1,000	19,157
16	1,000	20,762
17	1,000	22,414
18	1,000	24,117

2. Acme Widgets Inc., an American manufacturer, offers its employees a deferred annuity that will pay them USD 10,000/year at the end of each year after they turn 80, but only if they are alive at that time. Jane Sultz, Acme's Head of HR, makes a rough calculation of the cost of providing this benefit to a 25-year-old employee. Based on current trends in life expectancy and expected future improvements in health care, she determines that 75% of her new 25-year-old employes will live past 80 and will receive benefits for 10 years on average. If very-long-term interest rates are 5% and the interest rate used to price annuities is 4%, what is the approximate cost of the benefit? (Assume that all those who live past 80 will live for exactly 10 more years).

   Solution:

   Jane can value a 10-year annuity that pays USD 10,000 in the first year with a growth rate of 0 and an interest rate of 4%. It is

   $$\frac{\text{USD } 10,000}{0.04 - 0} \times \left(1 - \left(\frac{1}{1 + .04}\right)^{10}\right) = \text{USD } 81,109$$

   As only 75% of the employees are expected to collect the benefit, its expected value is $0.75 \times \text{USD } 81,109 = \text{USD } 60,832$, and its present value for a 25-year-old is

   $$\text{USD } 81,109 \times 0.75 \times \left(\frac{1}{1 + .05}\right)^{80-25+1} = \text{USD } 3,958.$$

   We discount for one extra year as payments are made at the end of each year. If the payments grow at 4%, matching the interest rate, Equation 7 applies: The value of the annuity is $\text{USD } 10,000 \times 10 / 1.04 = \text{USD } 96,154$, and its value today is

   $$\text{USD } 96,154 \times 0.75 \times \left(\frac{1}{1 + .05}\right)^{80-25+1} = \text{USD } 4,693.$$

   This is a remarkably inexpensive form of longevity insurance, particularly as it likely will result in a tax deduction for the employer, further lowering its cost.

3. All other things equal (e.g., income, need to provide for heirs, total wealth), what would distinguish the problem of decumulation for a woman over a man?

   Solution:

   The biggest differential here that needs to be addressed is the fact that women will tend to outlive men by about five years on average. This creates significant issues of how to plan sufficient resources for end-of-life planning as well as pricing of appropriate insurance policies to cover such exposures.

4. Discuss some of the challenges in projecting future spending plans.

Solution:

Future spending plans are difficult for not only the unknowable key factors but also the fact that an individual will have evolving priorities. Life expectancy is notoriously difficult to forecast, and the fact that the trend is for longer lives introduces more risk of shortfalls. Inflation offers huge uncertainly overall, and the particular inflation around medical and elder care is feared to continue a more aggressive trend (with respect to simple CPI). People do change their future plans, both on account of their circumstances and because things that once seemed important to them no longer seem important.

5. As employers moved away from defined benefit to defined contribution plans, what happened to the individual decumulation problem?

A. Decreased

B. Increased

C. Remained the same

Solution:

B is correct. Defined benefit typically calls for a pension (the "benefit") to be paid out until the end of life expectancy. Therefore, the demise of traditional pensions put the onus of managing the financial position through retirement on the individual.

6. Describe a modern tontine and why it is a useful tool for retirement management.

Solution:

A modern tontine is a scheme in which a group of individuals pool funds into a common portfolio, and payments are generated to the individuals for as long as they live. Upon the death of any individual, a portion of their "share" is paid out to their heirs/designees and the rest kept in the tontine structure. This is a useful tool for retirement planning in that it helps to mitigate longevity risk by pooling that risk across several individuals. From the viewpoint of the participants, they receive consistent, annuity income at perhaps a more aggressive pace then if they needed to separately manage a portfolio and draw funds, as they would need to always keep an eye on the risk that they will live longer than expected.

5 PERFORMANCE EVALUATION AND ATTRIBUTION

☐ evaluate the success of an investment program for a private client based on portfolio reporting and review

Performance evaluation is central to the assessment of investment programs and can be split into two streams: performance measurement and performance attribution.

Performance measurement is the process by which the overall results of an investment program are quantified, both in absolute terms and relative to various benchmarks, and with or without suitable adjustments for risk. Performance attribution, in contrast, drills deeper: It disaggregates the portfolio along one or more dimensions into an additive set of sub-portfolios or economic exposures, conducts performance analyses on each of these slices, and then re-aggregates these individual analyses in a way that makes clear the sources of return as well as the strengths and weaknesses of the investment process.

There is no uniquely right way to do these analyses, which are made even more challenging by the extreme noise level in financial markets. By way of example, the standard deviation of most financial market returns exceeds their mean return, while the noise associated with deep-space communication is typically less than half of the received signal's strength. As strange as it may sound, there is less noise (and uncertainty) when communicating with an unmanned mission to Pluto than there is to draw conclusions from return and return distribution about the performance of a financial market!

Consequently, performance evaluation has developed many tools and techniques, often specialized and attuned to the needs of particular types of investments. It is a deep subject, and it is impossible to do it justice within one portion of a single reading. This section extends other readings on Performance Measurement and Manager Selection.

It is important that performance analyses and attributions be reported to clients regularly (often quarterly, but at least once a year) and in a clear, simple format that encourages conversation, discussion, and debate, often with the manager in attendance.

Performance Measures Based on Return

Computing returns in the presence of cash flows is a surprisingly subtle and sophisticated process whose best practices are defined in the Global Investment Performance Standards (2020). We shall assume that all returns are measured in accordance with these voluntary standards.

Consider a portfolio P with a benchmark B. The portfolio manager might, for example, be tasked with investing in Asian USD-denominated bonds, and her portfolio's benchmark might be the iBoxx Asian USD Bond Index, denominated in US dollars. The portfolio and the benchmark must be well matched if any analysis of its performance is to be relevant: The market, asset class, and underlying currency are the same. Hence, it would be an error of judgement to change the portfolio's benchmark to the MSCI European Union Small Cap Index (EUR), which includes only small-capitalization EU stocks and is denominated in EUR.

Let the total return of a portfolio in period t be denoted by $r_{P,\,t}$ and that of its benchmark by $r_{B,\,t}$. Total returns include the impact of price changes and cash flows such as coupon and dividend payments. The risk-free return, which is typically taken to be the return of short-term government debt instruments such as T-Bills denominated in the same currency as the portfolio, is denoted by $r_{f,\,t}$.

The **arithmetic active return** of the portfolio in period t is defined to be

$$R_{A,\,t} = R_{P,\,t} - R_{B,\,t},$$

and its **excess return** is similarly defined to be

$$R = R_{P,\,t} - R_{f,\,t}.$$

Correspondingly, the **logarithmic active return** of the portfolio in period t is defined to be

$$\widetilde{R}_{A,\,t} = \ln\left(1 + R_{P,\,t}\right) - \ln\left(1 + R_{B,\,t}\right),$$

and its logarithmic excess return is similarly defined to be

$$\widetilde{R}_{E,\,t} = \ln\left(1 + R_{P,\,t}\right) - \ln\left(1 + R_{f,\,t}\right).$$

Even though arithmetic active and excess returns gather the most attention in textbooks, logarithmic active and excess returns are preferred because they correctly account for the impact of compounding. Additionally, both standard and logarithmic active returns give us a useful way by which to check the validity of a benchmark: A portfolio's returns relative to a well-specified benchmark will appear to have been drawn from a reasonably stable distribution and will be serially uncorrelated because the primary differences between the exposures of the portfolio and its benchmark will be largely idiosyncratic, not systemic. By way of example, the country and sector exposures of the portfolio will be roughly the same as those of a well-specified benchmark, and the portfolio's beta with respect to the benchmark will be about one.

KNOWLEDGE CHECK

1. A portfolio has returns of +10%, −10%, and +15% in January, February, and March, respectively. The return of its benchmark is 5% in each of these three months, and the risk-free rate is a constant 1% per month. Did the portfolio outperform its benchmark over the entire quarter?

   A. The performance of the portfolio and its benchmark are identical because they both add to 15% over the quarter.

   B. The portfolio outperforms its benchmark because its return in March is greater than the return of the benchmark in each of the three months in the quarter.

   C. The portfolio underperforms its benchmark over the quarter because the greater variability of its monthly returns lowers its cumulative return.

   Solution:

   The return of the portfolio over the quarter is $(1 + 0.1)(1 - 0.1)(1 + 0.15) - 1 = 13.85\%$, while that of the benchmark is $(1 + 0.05)^3 - 1 = 15.76\%$.

   C is correct because variability hurts long-run returns as the following (extreme) example illustrates. Consider a portfolio whose returns in two consecutive months are +100% and −100%. Its cumulative return is −100%, but the sum of monthly returns is 0. The negative impact of return variability on long-term performance is a consequence of the arithmetic–geometric inequality, which states that for any set of positive numbers, the arithmetic mean of those numbers is always greater than or equal to the geometric mean.

   A is incorrect because the arithmetic sum (and, by implication, the arithmetic average) of the three returns does not correctly account for compounding.

   B is incorrect because the cumulative return depends on all three months' returns, not just the highest return.

   From Exhibit 17, we see that the logarithmic returns of the portfolio in January, February, and March are 9.531%, −10.536%, and 13.976%, respectively, while the logarithmic return of the benchmark is 4.879% in each of the three months. It is easily seen that the cumulative logarithmic return of both the portfolio and the benchmark is exactly equal to the sum of their monthly logarithmic returns and that $9.531\% + 10.536\% + 13.976\% = 12.971\% < 3 \times 4.879\% = 14.637\%$.

Exhibit 17: Monthly and Cumulative Returns and Logarithmic Returns of a Portfolio and its Benchmark

Month	$r_{P,t}$	$r_{B,t}$	$\ln(1 + r_{P,t})$	$\ln(1 + r_{B,t})$
January	10%	5%	9.531%	4.879%
February	−10%	5%	−10.536%	4.879%
March	15%	5%	13.976%	4.879%
Cumulative return	13.85%	15.76%	12.971%	14.637%

Risk-Adjusted Measures of Performance

As leverage (i.e., borrowing funds to purchase securities in excess of the capital allocated to a portfolio) can amplify both risk and return, it is imperative to account for differences in risk when measuring returns, and it proves helpful to combine a measure of return and a measure of risk into a single measure of performance. The most popular risk-adjusted performance measures are the Sharpe Ratio, or the ratio of the average *excess* return to the standard deviation of the *excess* return, and the **Information Ratio**, or the ratio of the average *active* return to the standard deviation of the *active* return.

The Sharpe Ratio and the Information Ratio are useful ranking measures. All else being equal, investors will prefer portfolios with high Sharpe and Information Ratios to portfolios with low Sharpe and Information Ratios, as the portfolio with the higher Sharpe Ratio can be levered using borrowed funds to generate the same return as the portfolio with the lower Sharpe Ratio but with less risk. Additionally, with some use of probability theory, the Sharpe Ratio can be interpreted as a measure of the probability that the portfolio's return exceeds the risk-free rate or the return of its benchmark.

Just as logarithmic returns offer important advantages when measuring performance, so do they offer advantages when computing risk-adjusted measures of performance such as the Sharpe Ratio and the Information Ratio, as they naturally account for the impact of compounding on the numerator. Formally, we write

$$Logarithmic\ Sharpe\ Ratio\ =\ \frac{Mean(Excess\ logarithmic\ return)}{Standard\ deviation\ (Excess\ logarithmic\ return)}$$

$$Logarithmic\ Information\ Ratio\ =\ \frac{Mean(Active\ logarithmic\ return)}{Standard\ deviation\ (Active\ logarithmic\ return)}.$$

We need not restrict ourselves to use standard deviation as the measure of risk in the denominator: The portfolio's risk can be captured in ways that reflect the asymmetry of returns. Popular downside risk measures include VaR, ES (also known as cVaR or conditional VaR), and Semi-standard Deviation, and a brief exploration of them is instructive.

VaR is a percentile of the loss distribution of an asset or a portfolio: For example, the 95% one-day VaR is the loss that is not exceeded on 95% of all trading days. Analogously, a 95% one-month VaR is the loss that is not exceeded in 95% of all months. But on those 5% of days (or months) when the VaR is exceeded, two portfolios with the exact same VaR can have very different loss distributions, particularly if they are exposed differently to securities with embedded options. ES usefully captures this potential difference in tail risk: It is the expected loss in only those periods when VaR is exceeded and has garnered a great deal of attention following its eclipse of VaR as the primary measure of losses by the Basel Committee in 2016. By convention, losses are expressed as a positive number.

EXAMPLE 3

By way of example, consider a portfolio that is long USD 1,000,000 in an S&P 500 index fund and short 1,000 out-of-the-money options on the S&P 500 at strike that is lower than its 95% VaR. The impact of these options will not be reflected in its 95% VaR, but if the S&P 500 has a very sharp decline (as it did during the crash of 1987), the options will come into the money, leading to enormous losses. In fact, given the relative magnitudes of the two positions, it is likely that the losses will be so large that they will completely wipe out the equity value of the portfolio. The risk of the options will be reflected in the portfolio's expected shortfall but not in its VaR.

Semi-standard Deviation is the downside analogue of standard deviation, and its computation is almost identical to that of standard deviation: It is the square root of the mean squared deviation from the average return when all below-average returns are taken fully into account and when all above-average returns are set to the average return so that their associated loss is 0. The Semi-standard Deviation reflects the fact that investors tend to view only below-average returns as risky. Above-average returns, even if they are volatile, tend to be thought of as good fortune and not as risk.

Downside risk-adjusted measures of performance are easily constructed by dividing a measure of return by a measure of downside risk, and the Sortino Ratio is a particularly popular such measure. Its numerator, like that of the **Sharpe Ratio** and the Logarithmic Sharpe Ratio, subtracts the client's *minimum acceptable return* (MAR), which is not necessarily equal to the risk-free rate, from the mean return or the mean logarithmic return. The MAR reflects the client's return objectives and risk tolerance and is best determined collaboratively by the wealth manager and the client. The denominator is the Semi-standard Deviation computed with the mean replaced by the MAR and is known as the Semi-Deviation. All returns below the MAR are taken fully into account, and all returns above it are set to the MAR so that their associated loss is 0. Formally, we can write

$$Sortino\ Ratio\ =\ \frac{Mean(Return)\ -\ MAR}{Semi-Deviation\ (Return-MAR)}$$

$$Logarithmic\ Sortino\ Ratio\ =\ \frac{Mean(Logarithmic\ return)\ -(\ Logarithmic\ MAR)}{Semi-Deviation\ (Logarithmic\ return - Logarithmic\ MAR)}.$$

The Logarithmic Sharpe and Information Ratios are useful baselines to start an analysis of a portfolio, and their downside risk-based analogues such as the Sortino Ratio and the Logarithmic Sortino Ratio are useful supplements, particularly for portfolios with options and for clients who can specify their minimum acceptable return.

The returns of a portfolio are known to have a uniform distribution with limits of −50% and +50% every day (this is admittedly unrealistic, but it greatly simplifies our illustrative example). The 90% VaR is the 10th percentile of the return, or −40%. By convention, we report this as a 90% VaR of 40%. If the loss exceeds 40%, the return distribution is uniform on the interval [−50%, −40%] with an average value of −45%. Again, by convention, we report this as a 90% ES of 45%, only slightly larger than the 90% VaR.

Turning next to Semi-standard Deviation, the average return is 0, the probability that the portfolio's return exceeds its mean is 0.5, and the Semi-standard Deviation is

$$\sqrt{.5 \times 0 + \int_{-0.5}^{0} r^2\,dr}\ =\ \sqrt{\frac{1}{24}}\ \approx\ 20.4\%.$$

The Semi-standard deviation is easily computed in this case because returns are assumed to be uniformly distributed. If their distributions were not uniform (or normal), the calculation would be much harder.

If the portfolio had a short position in a large number of out-of-the-money options, its Semi-standard Deviation would not be affected significantly relative to its standard deviation, but its expected shortfall could be many times larger than its VaR, making clear the attractiveness of ES as a risk measure to regulators and risk managers.

It is essential to keep in mind that virtually all performance measures expressed as a ratio are best applied to liquid investments that are priced continuously in well-functioning capital markets. If they are applied to illiquid priced portfolios (such as private equity), their values will almost certainly be overstated, as the measure of risk in their denominators will be underestimated, and often by a significant margin.

Also, they are usually computed using monthly returns and are approximately annualized by multiplying them by $\sqrt{12}$ to facilitate comparisons with other published numbers. The factor of $\sqrt{12}$ arises because the annual return is approximately equal to the sum of 12 monthly returns, and the standard deviation of the sum of 12 independent monthly returns, each with the same standard deviation, is $\sqrt{12}$ times the standard deviation of each one.

LOGARITHMIC SHARPE AND INFORMATION RATIOS

We can write down the following sequences of monthly returns for the portfolio we explored in the earlier Knowledge Check. All computed values are rounded to three decimal places.

1. Excess return: 9%, −11%, 14%. Mean = 4%, standard deviation = 13.229%
2. Active return: 5%, −15%, 10%. Mean = 0%, standard deviation = 13.229%
3. Excess logarithmic return: 8.536%, −11.531%, 12.981%. Mean = 3.329%, standard deviation = 13.059%
4. Active logarithmic return: 4.652%, −15.415%, 9.097%. Mean = −0.555%, standard deviation = 13.059%

Note: #3 and #4 are calculated using the logarithmic risk-free return (ln (1.01))

Exhibit 18: Risk-Adjusted Performance Measures for a Portfolio

Performance Measure	Value	Annualized Value ($\times \sqrt{12}$)
Sharpe Ratio	4%/13.229% = 0.30	1.047
Information Ratio	0%/13.229% = 0.00	0.000
Logarithmic Sharpe Ratio	3.329%/13.059% = 0.25	0.883
Logarithmic Information Ratio	−0.555%/13.059% = −0.04	−0.147

We can see from Exhibit 18 that the Logarithmic Sharpe Ratio is lower than the Sharpe Ratio, reflecting the fact that the variability in returns lowers their cumulative value, and, more importantly, that the Logarithmic Information Ratio is negative, reflecting the fact that the cumulative return of the portfolio is lower than that of its benchmark. Using logarithmic returns as inputs to the Sharpe and Information Ratios has usefully clarified the portfolio's performance, particularly in relation to its benchmark.

KNOWLEDGE CHECK

1. All else being equal, which of the following might be expected to occur as the risk-free rate increases?

   A. Both the Information Ratio and the Sharpe Ratio increase.

   B. Both the Information Ratio and the Sharpe Ratio decrease.

   C. The Information Ratio stays constant and the Sharpe Ratio decreases.

   Solution:

   C is correct because an increase in the risk-free rate lowers the Sharpe Ratio; it decreases the magnitude of the excess return (the numerator of the Sharpe Ratio) but does not change its standard deviation (the denominator of the Sharpe Ratio). The Information Ratio does not change because a change in the risk-free rate has no impact on the return of the benchmark.

   A is incorrect because the Information ratio is not impacted by a change in the risk-free rate, and the Sharpe Ratio decreases, not increases, with an increase in the risk-free rate.

   B is incorrect because the Information ratio is not impacted by a change in the risk-free rate.

Accounting-Based Attribution

The next step in understanding the drivers of a portfolio's performance is **performance attribution**, or the identification of the contributors to and detractors from performance. This is done by deconstructing and projecting a portfolio's return along axes relevant to the investment process. An appropriate choice of axes is as essential to attribution as an appropriate choice of benchmark is to performance measurement.

The Brinson–Hood–Beebower (1986) additive (or accounting-based) decomposition is the most widely used attribution scheme. In essence, Brinson, Hood, and Beebower create two auxiliary portfolios, an allocation effect portfolio $\mathscr{A}$ and a selection effect portfolio $\mathscr{S}$, that capture two different aspects of the investment process: $\mathscr{A}$ captures the effect of aiming to overweight sectors that perform well and underweighting sectors that perform poorly, while $\mathscr{S}$ captures the effect of overweighting individual securities that perform well and underweighting individual securities that perform poorly. We need some notation to attribute the returns of a portfolio P relative to its benchmark B during a period starting at time t. Let

r_t^P and r_t^B be the return of P and B respectively during period t,

$w_{i,\,t-1}^P$ be the weight of P's holdings in sector i at the end of period $t-1$,

$w_{i,\,t-1}^B$ be the weight of B's holdings in sector i at the end of period $t-1$,

$r_{i,\,t}^P$ be the return of P's holdings in sector i during period t, and

$r_{i,\,t}^B$ be the return of B's holdings in sector i during period t.The returns of portfolios P, B, $\mathscr{A}$, and $\mathscr{S}$ in period t are

$$r_t^P = \sum_i w_{i,\,t-1}^P \times r_{i,\,t}^P \quad (8)$$

$$r_t^B = \sum_i w_{i,t-1}^B \times r_{i,t}^B \tag{9}$$

$$r_t^{\mathcal{A}} = \sum_i w_{i,t-1}^P \times r_{i,t}^B \tag{10}$$

$$r_t^{\mathcal{S}} = \sum_i w_{i,t-1}^B \times r_{i,t}^P \tag{11}$$

The **allocation effect**, which captures the insights embedded in the portfolio's allocation decisions, is defined to be

$$A_t = r_t^{\mathcal{A}} - r_t^B . \tag{12}$$

Likewise, the **selection effect** captures the insights embedded in the portfolio's security selection decisions and is defined to be

$$S_t = r_t^{\mathcal{S}} - r_t^B. \tag{13}$$

Unfortunately, the allocation and selection effects do not add up to the active return of the portfolio, and the gap is not always small. There is a third term, the **interaction effect**, which bridges the gap and is given by

$$I_t = r_t^P - r_t^{\mathcal{A}} - r_t^{\mathcal{S}} + r_t^B. \tag{14}$$

The interaction effect is not particularly intuitive: It is the extra return earned by overweighting sectors in which the selected assets outperform their sector and underweighting sectors in which the selected assets underperform their sector. The Brinson–Fachler (1985) attribution simplifies the Brinson–Hood–Beebower scheme by folding the interaction term into the selection term. It is customary to refer to each term in an attribution as the *contribution* from a specified source. The allocation effect, for example, is referred to as the contribution from allocation.

CASE STUDY

Attribution for a Simple Stock–Bond Portfolio

In an earlier section, we met John Lee and Sarah Chang, both of whom invested half their assets in a global stock index fund and the remaining half in a global bond index fund. A year ago, their wealth manager had suggested changing their allocation to 60% in global stocks and 40% in global bonds, both managed actively, but they decided to stick with their 50/50 indexed strategy. A year later, John and Sarah look up the performance of both indices and the actively managed funds for the prior year and find that their net of fee returns are as follows:

Global stock index: +10%

Global bond index: −5%

Global stock fund: +9%

Global bond fund: −4%

1. What would the performance of their portfolio have been if they had acted in accordance with their wealth manager's recommendation a year ago? What would have been the drivers of the return differential for the proposed portfolio relative to its actual implementation?

   Solution:

   We can think of the actual implementation as a benchmark for the proposed implementation, so that

$$r^{B}_{Prior\ Year} = 0.5 \times 10\% + 0.5 \times (-5\%) = 2.5\%$$

$$r^{P}_{Prior\ Year} = 0.6 \times 9\% + 0.4 \times (-4\%) = 3.8\%$$

The recommended strategy would have outperformed the actual strategy by 1.3%. We next explore the sources of return by computing the returns of the allocation and selection portfolios and using these to compute the allocation, selection, and interaction effects.

$$r^{\mathscr{A}}_{Prior\ year} = 0.6 \times 10\% + 0.4 \times (-5\%) = 4\%$$

$$r^{\mathscr{S}}_{Prior\ year} = 0.5 \times 9\% + 0.5 \times (-4\%) = 2.5\%$$

so that

$$A_{Prior\ year} = r^{\mathscr{A}}_{t} - r^{B}_{t} = 4\% - 2.5\% = 1.5\%$$

$$S_{Prior\ year} = r^{\mathscr{S}}_{t} - r^{B}_{t} = 2.5\% - 2.5\% = 0\%$$

$$I_{Prior\ year} = r^{P}_{t} - r^{\mathscr{A}}_{t} - r^{\mathscr{S}}_{t} + r^{B}_{t} = 3.8\% - 4\% - 2.5\% + 2.5\% = -0.2\%$$

The attribution makes clear that the increased exposure to equities (i.e., the allocation effect) drove the increase in return from the wealth manager's recommendation. The selection effect is 0, and the interaction effect, which is merged into the selection effect in a Brinson–Fachler attribution, is negative. John and Sarah would have done well to take their wealth manager's advice on asset allocation and stick with their own choices of funds. By doing so, they would have increased their return from 2.5% to 4%.

Factor-Based Attribution

Sometimes, detailed breakdowns of portfolio holdings and returns are unavailable, and analysts then compute factor-based attributions by regressing the portfolio's returns on the returns of a suitable collection of factors. Different factor models give rise to different attributions, as shown by Madhavan, Sobczyk, and Ang (2020).

A particularly good example of factor-based attribution is found in Ang, Goetzmann, and Schaefer (2009), which analyzes the performance of the Norwegian Government's Pension Fund following the Great Financial Crisis. Exhibit 19, which is taken from the report, shows the correlation of the fund's active returns with a curated collection of factors. Observe that (with one exception) the fixed income factors and the equity factors are different.

For example, if the Aa spread factor (or the difference in return between Aa-rated bonds and Treasury bonds) increases by 1 standard deviation, the active return of the fixed income portfolio is expected to increase by 0.35 standard deviations. Similarly, if the difference in return between value stocks and growth stocks increases by 1 standard deviation, the active return of the equity portfolio is expected to decline by 0.56 standard deviations. The fixed income portfolio was more exposed to high-quality bond returns than its benchmark over the period of the analysis, while the equity portfolio was more exposed to growth stock returns than its benchmark over the same period.

Both accounting and factor-based attributions can give a thoughtful wealth manager exceptionally powerful insights into the sources of a portfolio's returns and allow her to think intelligently about whether a manager's actual investment process accurately reflects their stated investment philosophy.

Additionally, attributions allow portfolio managers to think about how factors might behave in the future and how they might want to position their portfolios going forward to take advantage of their forecasts.

Exhibit 19: Correlation of the External Active Returns of the Norwegian Government's Pension Fund with Various Factors

Factor	Correlation: Fixed-Income Portfolio	Correlation: Equity Portfolio
Term Spread	−0.21	
Aa Spread	0.35	
Baa Spread	−0.33	
High-Yield Spread	−0.01	
FX Carry	−0.04	
Liquidity	0.35	
Value vs. Growth		−0.56
Small vs. Large		0.41
Momentum		0.02
Implied vs. Realized Volatility	0.37	0.28

Statistical Significance and Manager Monitoring

We now quantify our earlier observation about the high noise level in financial markets. Under some simplifying assumptions, and with N independent observations, the t-statistic associated with a t-test to determine if the true mean of a random variable is greater than 0 is given by

$$t-statistic \ = \ \frac{Sample\ mean}{Sample\ standard\ deviation} \times \sqrt{N}.$$

If the return of a portfolio is 10% per annum, and its standard deviation is 20% per annum, we need $N > 16$ years for the t-statistic to exceed 2. (The t-statistic is a common measure of significance. A t-statistic of 2 translates roughly to a 95% probability that the true mean of the return distribution is positive.) This exceeds the length of most careers at a single firm and makes clear the need for extensive performance and attribution analyses to determine the drivers of a portfolio's returns. Furthermore, these analyses must be continually updated and monitored to ensure rapid detection of problems, and clients must maintain an active and ongoing dialogue with their portfolio managers to understand the link between various analyses and the state of the investment processes.

Philips, Yaschin, and Stein (2003) show how a Statistical Process Control scheme known as the CUSUM (an acronym for CUmulative SUM) can be used to monitor a portfolio's performance and attribution components and to raise an alarm when sufficient statistical evidence of underperformance accumulates. Remarkably, the CUSUM detects underperformance faster than any other algorithm for any given level of false alarms. The associated algorithm is made freely available for use by analysts in the open-source R language package PCRA. Philips, Yaschin, and Stein (2003) show that it takes about 3.5 years to confidently identify an underperforming manager, not the 16 years as suggested by the above calculation.

Once underperformance has been identified, a thorough and impartial investigation into the reasons for it must be launched. Often, it will have no root cause other than the fact that a portfolio cannot perfectly replicate its benchmark and will therefore be subject to noise in markets. But sometimes a cause can be identified—poor country, sector and security selection, ineffective currency hedging, poorly-judged duration and curve mismatches, and unanticipated credit downgrades are among the many possibilities that can impact performance.

If a causal explanation for the underperformance is found, it should be correlated with the manager's stated investment philosophy and process to determine if it was caused by a flaw in the investment process or a deviation from it, and a course of action should be decided upon. A full gamut of options, ranging from no action at all to termination, is available, and a choice must be made dispassionately. Regardless of the decision, the results of the study should be shared with the manager so that their investment process can improve.

Manager Selection

Performance measurement, attribution, and monitoring are just three of the many inputs into a thoughtful manager selection process, which is covered in detail in the CFA Institute's Level 3 Reading on Investment Manager Selection. In this section, we touch briefly on a few essential points and refer the interested reader to the Level 3 Reading for its greater depth.

First, given the widespread availability of low-cost index funds, the decision to use an active manager must meet a test of reasonableness: What can the manager provide that an index fund or ETF cannot? For instance, S&P allows investors to compare the performance of active managers against various indexes in markets around the world using its SPIVA (S&P Indices vs. Active) reports.

Second, any manager considered for a role must have a well-thought-out and defensible investment process that adapts to changes in markets and investment opportunities and can at the same time appropriately reflect the client's constraints and risk limits. There must be no difficulty in obtaining time series of investment returns, benchmarks, holdings, and risk reports for portfolios run for the benefit of current and prior clients, even if they are not identified by name.

Third, the manager's fee structure must be reasonable and result in rewards proportionate to the long-term value added. In particular, the fee schedule must not induce an option-like incentive for the manager to take risks that result in a payoff to it without a corresponding gain to the client. Many performance fee schedules suffer from this problem—the manager is rewarded for sporadic outperformance, but overpayments are not clawed back, leading to a poor alignment of interests between the manager and the client.

Davanzo and Nesbitt (1987) and Kritzman (1987) discuss many of the issues surrounding performance fees, and Bailey (1990) offers a practical suggestion for the payment of performance-based fees: He advocates for creating a phantom account that is invested in the benchmark and experiences all the cash inflows and outflows experienced by the managed portfolio. The difference in the value of the two accounts is the cumulative active profit of the portfolio, and each month, some fraction of the account's value (say 3%) is paid to the manager. If the cumulative active profit is negative, no payment (or only some small base fee payment) is made.

Finally, once a manager is hired, their portfolio's holdings, performance, risk, and attribution must be monitored regularly (typically monthly), ideally using statistical process control. If and when signs of distress appear, a thorough and impartial investigation must be conducted to determine the causes of underperformance and suitable corrective action taken once they have been identified. All this is easier said than done, and despite a vast body of work on performance evaluation, manager selection remains an exceptionally difficult problem, even for well-informed and thoughtful investors, as the past holds little predictive power for the future.

QUESTION SET

1. We showed that it would take at least 16 years to obtain a *t*-statistic of 2 when estimating the average annual return of a portfolio with the parameters used earlier (expected return of 10% per annum, standard deviation of 20% per annum). Suppose the portfolio manager has an Information Ratio of 1 so that both the mean and standard deviation of her active return are 2%. What is the minimum period required to obtain a *t*-statistic of 2 for active returns?

   Solution:

   The *t*-statistic is given by

   $$t - statistic \;=\; \frac{Sample\ mean}{Sample\ standard\ deviation} \times \sqrt{N}$$

   Setting the left-hand side to 2, plugging 2% into the numerator and denominator of the right-hand side, and squaring both sides gives $N = 4$, so we need at least four years to obtain a *t*-statistic of 2.

2. In an earlier Knowledge Check, the standard deviation of the active return is identical to the standard deviation of the excess return even though the benchmark's return is always greater than the risk-free rate. Why is this so?

   Solution:

   The benchmark has a constant return of 5% per month, while the risk-free rate is 1% per month. The return of the benchmark is just the risk-free rate + 4%. As adding or subtracting a constant from a random sequence has no impact on the standard deviation, the standard deviation of the excess return must be exactly equal to that of the active return. The mean excess return, however, is 4% larger than the mean active return. The same argument applies to logarithmic returns.

3. Within the Brinson–Hood–Beebower approach to performance evaluation, describe the allocation effect portfolio and the selection effect portfolio.

   Solution:

   The allocation effect portfolio examines the impact of how the portfolio deviates from the allocations set within the benchmark. It assumes that there are sub-investments into the constituent pieces of the benchmark.

   The selection effect portfolio is constructed to help understand the security selection process—it will be reflective of over-/under-investments into individual securities. It is constructed by looking at the benchmark's weight in the respective sectors taken to be invested in the master portfolio's selections for that sector.

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PRACTICE PROBLEMS

The following information relates to questions 1-4

Gary Shepard is a wealth planner working with his client Annie Washington to develop appropriate portfolio allocations. Washington recently turned 50, and in their annual update, she explains that for the last ten years, she was very concerned about saving aggressively and earning strong returns to fund her retirement at age 65, at which time she intends to move to Portugal. She has recently achieved a level of wealth that will likely be sufficient to meet her basic needs and has noticed that each new increment of wealth seems less important to her than it did previously.

Up until now, Washington has invested solely in stocks and bonds. Shepard encourages her to also consider small allocations to commodities and real estate to improve diversification benefits and provide some inflation protection. Being unfamiliar with such investments, Washington agrees to a smaller allocation than was suggested.

Given that Washington still has considerable time before retirement, Shepard approaches asset allocation using a 10-year time horizon. To estimate the return on bonds he considers the current yields on high-grade bonds of various maturities in Exhibit 1.

Exhibit 1

Target Duration	Current Yield
5 years	4.5%
10 years	5.2%
20 years	5.4%

Shepard uses a mean–variance analysis to create an optimal portfolio (Portfolio A) and then makes some adjustments to illustrate two other portfolios with the same standard deviation of returns but with different allocations. These are presented in Exhibit 2.

Exhibit 2

	Portfolio A	Portfolio B	Portfolio C
High-grade bonds	25%	30%	30%
US equities	35%	45%	30%
European equities	20%	25%	30%
Real estate	10%	0%	5%
Commodities	10%	0%	5%
Expected return	7.3%	7.1%	7.1%

1. Washington's utility function is *best* described as:
   - **A.** risk averse.
   - **B.** risk neutral.
   - **C.** risk seeking.

2. Shepard's suggested allocation to commodities and real estate is *best* supported by Washington's:
   - **A.** risk capacity.
   - **B.** risk tolerance.
   - **C.** risk perception.

3. Over Washington's forecast horizon, the *best* estimate of returns on high-grade bonds is:
   - **A.** 4.5%.
   - **B.** 5.2%.
   - **C.** 5.4%.

4. Which portfolio is *most* appropriate for Washington?
   - **A.** Portfolio A
   - **B.** Portfolio B
   - **C.** Portfolio C

The following information relates to questions 5-8

Efrem Calabria is a wealth planner meeting with a new client, Thomas Foy. Foy is 40 years old, and his investment portfolio is entirely held in a tax-exempt retirement account. Before seeking Calabria's advice, Foy modeled his portfolio on the optimal portfolio an advisor recommended for his twin brother. Because his time horizon, income, and savings were virtually identical to those of his brother, he believed that the optimal portfolio would be the same as well. The only significant difference was that his brother's investments were held in a taxable account.

To better understand Foy's current situation and potential risk capacity, Calabria next develops the condensed extended balance sheet for Foy presented in Exhibit 1. He considers the sensitivity of Foy's surplus to the returns on his investment portfolio.

Exhibit 1

Assets		Liabilities	
Bank accounts	USD 100,000	Consumer debt	USD 23,000
Home	USD 1,200,000	Home mortgage	USD 700,000
Investment account	USD 1,500,000	Future spending needs	USD 3,000,000
Human capital	USD 2,500,000	Planned bequests and philanthropy	USD 1,000,000
Other property	USD 100,000	**Total liabilities**	**USD 4,723,000**
Total assets	**USD 5,400,000**	**Surplus**	**USD 677,000**

To develop an appropriate portfolio for Foy, Calabria estimates the risk and return for various asset classes. High-yield bonds are currently yielding 9.0%. He estimates a 5% annual default rate and an average 40% loss given default.

5. Compared to that of his brother, Foy's optimal portfolio will be:

   A. less risk averse.

   B. equally risk averse.

   C. more risk averse.

6. Foy's funding ratio is *closest* to:

   A. 0.61.

   B. 1.00.

   C. 1.14.

7. The decline in Foy's surplus resulting from a 30% decline in his investment portfolio would be *closest* to:

   A. 26%.

   B. 30%.

   C. 74%.

8. The expected return on high-yield bonds is *closest* to:

   A. 5.0%.

   B. 6.0%.

   C. 7.0%.

The following information relates to questions 9-12

William Thompson is the wealth advisor for Johnny and Ellen Hung, a married couple who file taxes jointly. Their income, including interest income, amortized bond discounts, and capital gains on assets held less than one year, is taxed at a 24% rate. Dividends and realized long-term capital gains are taxed at a 15% rate. Capital losses can be used to offset capital gains. However, if a security sold at a loss is repurchased within 30 days, it is considered a wash sale and cannot be used to offset gains.

Thompson has chosen to manage the Hungs' assets under a portfolio customization approach rather than a direct indexing approach. The Hungs have three investment accounts, each of which has USD 1 million in assets.

1. A joint account that is taxable
2. Johnny's retirement account, for which contributions are taxed as income but withdrawals are tax exempt
3. Ellen's retirement account, for which contributions are tax deductible and withdrawals are taxed as ordinary income

They are currently considering the investments presented below.

	Description	Expected Pre-tax Return	Expected Pre-tax Standard Deviation
Fund A	Equity index fund	8.0%	15.0%
Fund B	Zero-coupon Treasury bonds	4.0%	6.0%
Fund C	Hedge fund targeting short-term opportunities	10.0%	23.0%

Thompson wants to purchase shares of Advanced Repair Corp. in the Hungs' joint account. Thompson also manages the taxable account for the Hungs' adult son, and sole beneficiary, Edward. Edward recognized a loss selling shares of Advanced Repair one week ago.

9. Compared to the alternative, the approach Thompson has chosen for managing the Hungs' accounts is:

   A. focused on pre-tax returns.

   B. focused on after-tax returns.

   C. subject to greater tracking error.

10. When optimizing the Hungs' asset location for tax efficiency, which of the following assets is *best* located in the joint account?

    A. Fund A

    B. Fund B

    C. Fund C

11. The post-tax standard deviation of Fund C is *closest* to:

A. 17.5%.

B. 19.6%.

C. 23.0%.

12. Regarding shares in Advanced Repair, would a purchase in the joint account trigger the wash sale rule?

A. No

B. Yes, because it is a jointly held account

C. Yes, because he is the ultimate beneficiary

The following information relates to questions 13-16

David and Olivia Engel are 66 years old and entering retirement. Their wealth manager, Clifford Rouch, has determined that meeting their goals requires a minimum real compound annual return of 2%. To better understand their performance in the most recent year, Rouch collects the data in Exhibit 1.

Exhibit 1

	Equities	Bonds
Target weight	0.6	0.4
Actual weight	0.7	0.3
Benchmark return	6.0%	5.0%
Manager return	5.0%	6.0%

Because the equity manager underperformed its benchmark, Rouch gathers five years of arithmetic monthly returns for the manager, the benchmark, and the risk-free rate. The annualized averages for each of these are presented in Exhibit 2.

Exhibit 2

	Annualized Arithmetic Return
Risk-free rate	5.2%
Benchmark return	6.2%
Manager return	7.3%

Over the same period, the bond manager's logarithmic active return was 0.5%, with a Sharpe Ratio of 0.7 and an Information Ratio of 0.6. The Engels ask Rouch whether this is sufficient data to determine that the return is statistically significant. Rouch estimates the length of time needed to determine skill based on a *t*-statistic of 2.0.

13. The *most* appropriate risk-adjusted performance measure for the Engels is the:

    A. Logarithmic Sharpe Ratio.

    B. Logarithmic Sortino Ratio.

    C. Arithmetic Information Ratio.

14. The selection effect for the Engels' portfolio in the most recent year was *closest* to:

    A. –0.3%.

    B. –0.2%.

    C. 0.1%.

15. The equity manager's compound active return over the last five years is best estimated as:

    A. 1.0%.

    B. 1.1%.

    C. 2.1%.

16. Is five years of data sufficient to confidently estimate the bond manager's active return?

    A. Yes.

    B. No, a minimum of 8 years of data would be needed.

    C. No, a minimum of 11 years of data would be needed.

SOLUTIONS

1. A is correct. A risk-averse investor will have a concave utility function that flattens out as wealth increases so that each additional unit of wealth gives rise to a smaller increment in utility than the prior unit of wealth. Washington has reached a stage where each new increment of wealth seems less important than it did previously.

2. A is correct. Clients with greater risk capacity can tolerate greater financial losses without compromising current or future consumption goals. As Washington now likely has enough to meet her basic needs and has 15 years to recover from any losses, she has adequate risk capacity. Her reduced utility from additional wealth suggests limited risk tolerance, and her lack of familiarity with these asset classes indicates a risk perception that is not aligned with their inclusion.

3. A is correct. Over a period equal to twice its modified duration, the total return of an index is well approximated by its initial yield. Therefore, the best estimate for a 10-year horizon is the initial five-year yield, in this case, 4.5%.

4. C is correct. Although Portfolios B and C have lower returns for the same expected standard deviation compared to the mean variance optimization (MVO) portfolio, Washington's other preferences argue for some modest adjustments. Specifically, she will be retiring in Portugal, so her lifetime expenses will be denominated in Euro, and she perceives real estate and commodities to be high risk. Furthermore, her risk-averse utility function argues in favor of conservatism. Portfolio C has modest allocations to real estate and commodities, is underweight US stocks, and overweight bonds and European stocks. All of these positions are aligned with Washington's preferences. Although Portfolio B avoids real estate and commodities entirely, it is significantly overweight US stocks and is only slightly overweight European stocks, suggesting a possible mismatch.

5. C is correct. All else equal, a tax-exempt investor should be more risk averse than a taxable one. Mean–variance investors maximize the objective function Portfolio Expected Return – λ/2 Portfolio Variance, where λ is the client's coefficient of risk aversion, or her preferred balance between reward and risk. In the presence of taxes, this objective function becomes Objective = maximize(Post-tax Expected Return – λ/2 × Post-tax Portfolio Variance) = maximize (1 – tx) × (Expected Return – (λ(1 - tx))/2 × Portfolio Variance). Multiplying the entire objective function by (1 – tx) does not change the optimal solution, but multiplying the coefficient of risk aversion by (1 – tx) lowers it; the taxable investor is less risk averse than the tax-exempt investor. In this case, because Foy is the tax-exempt investor, his optimal portfolio would be more risk averse than that of his brother.

6. C is correct. The funding ratio is calculated as assets/liabilities. In this case, 5,400,000/4,723,000 = 1.143.

7. C is correct. A 30% decline in Foy's investment portfolio would amount to 1,500,000 × 0.3 = 500,000. USD 500,000/USD 677,000 = 73.86%.

8. C is correct. The return on high-yield bonds can be estimated as the current yield less the product of the default rate and the loss given default. In this case (95% × 1.09 + 5% × 0.6) – 1 = 6.55%, which is closest to 7%.

9. C is correct. Both direct indexing and portfolio customization aim for a tax-efficient portfolio construction approach. However, by emphasizing the

totality of the investor's goals over benchmark-relative performance, the portfolio customization approach is more tolerant of tracking error.

10. A is correct. The equities (Fund A) are generally taxed more favorably than bonds, especially if held for longer periods. In particular, non-coupon bonds are taxed based on the amortization toward the par value and therefore incur tax liabilities even without generating cash flows for the investor.

11. A is correct. Post-tax standard deviation ≈ Pre-tax standard deviation × (1 – tx). Because the hedge fund invests in short-term opportunities, its returns would likely be taxed at the 24% income tax rate rather than the more favorable 15% rate for long-term gains. As a result, Post-tax standard deviation ≈ 23% × (1 – 0.24 ≈ 17.48%.

12. A is correct. The wash sale rules apply to people who have tax dependencies, either because they file taxes jointly or because they trade within the same investment account. Neither of these apply in Edward's case, so his parents purchasing shares in their account would not trigger the wash sale rule related to Edward's sale.

13. B is correct because Rouch has specified a minimum acceptable compound return. The Sortino Ratio compares performance to the minimum acceptable return, and using a logarithmic scale incorporates compounding. Neither the Sharpe nor the Information Ratio incorporates a minimum acceptable return, and the arithmetic versions of them do not incorporate compounding.

14. B is correct.

$$r^{B}_{Prior\ year} = 0.6 \times 6\% + 0.4 \times 5\% = 5.6\%$$

$$r^{S}_{Prior\ year} = 0.6 \times 5\% + 0.4 \times 6\% = 5.4\%$$

$$S_{Prior\ year} = r^{S}_{t} - r^{B}_{t} = 5.4\% - 5.6\% = (-0.2\%)$$

15. B is correct. To get the compound active return requires using the logarithmic active return, defined as:

$$\tilde{r}_{A,\,t} = \ln\left(1 + r_{P,\,t}\right) - \ln\left(1 + r_{B,\,t}\right) = \ln(1.073) - \ln(1.062) = 1.0\%.$$

16. C is correct.

$$t - statistic = \frac{Sample\ mean}{Sample\ standard\ deviation} \times \sqrt{N}$$

Given an Information Ratio of 0.6 and a t-statistic of 2.0, N = 11.11.