

# WEALTH MANAGEMENT

VOLUME 5, NUMBER 4

SPRING 2003

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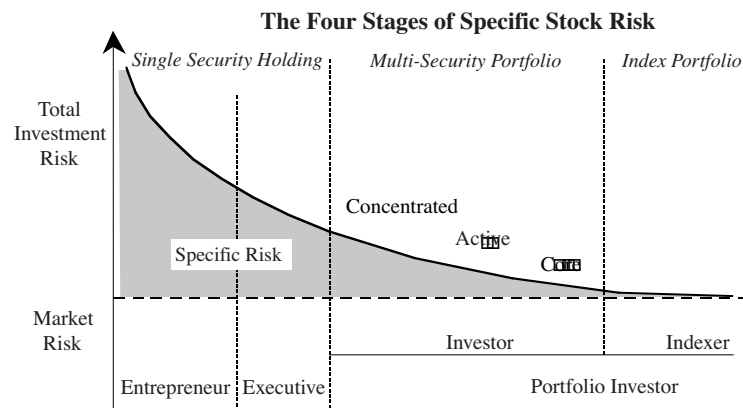
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The three-year-long U.S. equity market decline is having a number of predictable consequences for a great many investors. Yet, one of the most perverse may be that it is hindering the diversification of highly concentrated holdings for a number of very wealthy families. At the same time, though, it is providing increasingly clear evidence of validity of the proposition that derivative instruments—appropriately understood and used—can help individual investors in many ways.

Diversification has always been a highly challenging exercise for individuals many of whom have made the fortune they now have through a single, highly concentrated bet. Note that the problem is highly similar to the one faced by individuals whose fortune may now be somewhat diversified, but whose equity portfolio may still be quite concentrated, as a result of years of buy and hold strategies in a rising equity market environment. Indeed, of the three ways in which concentrated, low basis holdings can be acquired—entrepreneurial success, executive success, or investment success—the first two clearly involve accepting a high concentration in a single investment for some period of time. In my book *Integrated Wealth Management*, I proposed a simple way to visualize the stages of an investor's investment life together with specific risk in his or her portfolio.

The insight behind that chart is that the life of any investor should be viewed as encompassing four different phases—through which certain people cycle in full, while others only experience one of the latter two. The chart simply illustrates the idea that investors'



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appetite for specific equity risk ought to vary according to the life phase in which they are at the time. For instance, they ought to be seeking high specific risk when they are building wealth as entrepreneurs or senior corporate executives. By contrast, it also suggests that the further away the investor moves from control over the fortunes of the company whose fundamentals underpin the prices of the low basis stock, the more the investor ought to seek to diversify away that concentrated risk.

Facilitating as it does the development of an understanding of the nature of the two components of equity risk, the chart helps educate individuals about the nature of the investment problem they face. Thus, setting out clearly the simple investment rationale for and against diversification, the process leads individuals to focus on the psychological nature of the objections that may be raised as to the advisability of a well-designed diversification process. It is indeed crucial to understand the difference between rational investment objections to a particular strategy (usually involving the sale of some legacy stock) and issues that arise out of the psychological makeup of the investor. This is an important distinction, as the advisor should always remember that his or her role is not to force the investor toward the best strategy, but rather is to help the investor select the best strategy he or she can handle, having first provided him or her with a firm, but understanding professional opinion as to what the ideal solution might be.

Individuals often respond to the well-studied behavioral finance findings that make it especially difficult for them to execute the diversification strategy. They tend to retain an emotional attachment to the company that contributed to making their fortunes, whether the most recent family involvement in management was terminated recently or generations ago. They tend to confuse the quality of a company—its management, its industry, and its markets—with the prospects for its stock: they thus tend to be overconfident. They tend to display optimism about short-term price movements, effectively using the wrong framing: they often view the most recent high as fair value and thus expect the price

of the stock to regain that level soon, effectively irrespective of overall market conditions. Occasionally, they take it further, talking of “taking losses,” when selling a low basis stock at a price that seems “low” in relation to some historical high!

The equity bear market has in fact exacerbated these tendencies, with many concentrated holdings today worth less—and at times substantially less—than they were a few short years ago. Thus, families who had either embarked on a diversification strategy or at least started the process of thinking about diversifying may now be faced with a more difficult decision. With psychological issues taking a more prominent place, they find it virtually impossible to “pull the trigger,” with their wealth apparently so much lower today than it had been.

Yet, one could argue that, irrespective of recent stock price moves, the relative behaviors of their legacy holdings and the market as a whole should serve as a powerful incentive to consider the need to diversify:

- For families whose stocks have outperformed the market, they should now be asking themselves whether equities that have underperformed do not now represent better relative value. This should lead them to ask themselves whether now is not the time to “cash in” some of their “relative gains.”
- For families whose stocks have underperformed the market and thus lost substantial value, they should now be asking themselves whether the unpredictability of some of those savage price falls is not exactly the strongest rationale for being more diversified.

This is where derivative strategies have come into the picture and made it easier for a number of families, if not to stay the course, at least to remain on the course and keep on some diversification track. Whether they be collars or variable forward sales, discussed in this journal a couple of years ago, many derivative strategies incorporate option-like characteristics, which directly appeal to individual investors. Behavioral finance specialists have noted that individuals

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are naturally attracted to options, which provide for well-specified payoff functions, with set downside risk (defined as the risk of being wrong) and unlimited upside potential (when we are right). In that, individuals differ from “professional investors” who might be tempted to look at the way in which the option is priced and to evaluate whether volatility is priced cheaply or expensively, or whether its time value is reasonable. Individuals like options because they offer a gamble to which they are naturally attracted.

These derivatives-based diversification strategies have two important psychological features, which make it easier for families to continue on the diversification road:

- Preserving as they do some—at times substantial—upside potential, they cushion the emotional blow associated with selling a stock at a price that could appear quite low in relation to some historical reference level.
- Involving as they do a transaction that does not close until some time in the future—and that time can be quite far away—they also cushion the psychological impact of the sale, which appears somehow deferred.

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This Spring 2003 issue of *The Journal of Wealth Management* is somewhat thicker than usual, as we have been receiving numbers of great submissions and wanted to bring them to our readers as rapidly as feasible.

The first two articles are by two members of our Board of Advisors, both of whom are very well recognized for their unusual insights with respect to issues of family management. Jay Hughes proposes a very interesting discussion of the roles of a mentor, while Sidney Dickstein discusses the need to create a family council and its role.

The next four articles fall under the broad category of fundamental investment issues. First, Arnaldo Oliveira synthesizes, compares, and contrasts four general investment theories and proposes a holistic approach for future financial

research. Susana Yu and Avner Wolf turn their attention to the notion that, balancing equal dollar amounts, long and short takes full advantage of the spread of returns, comparing long, short, and long/short portfolios under different trading methods. Brett Wander investigates the challenges associated with determining the relationship between a manager’s skill and his or her observed level of value added. Finally, John Mensack evaluates the long/short equity strategy and how it fits into the grand scheme of a portfolio.

The next two articles deal directly with the issue of managing a portfolio as Tharan Cook, Michael Seiler, and Sorin Tuluca evaluate the usefulness of the growth flow valuation method in identifying innovative high-tech companies earlier than the market and in evaluating profitable investments. Then, David Stein, also a member of our Board of Advisors, and Greg McIntire introduce a tool that allows tax-efficient investors to combine multiple active portfolio managers without suffering many of the traditional drawbacks associated with multi-manager stables.

The final three articles are more specifically dedicated to hedge funds. First Harry Kat summarizes a lot of the research which has been conducted in the sector over the last several years, offering 10 keys to understanding hedge funds. Anne Shumadine then proposes a commonsense approach to answering key questions when considering a hedge fund investment, addresses some of the risks related to investing in hedge funds, and offers suggestions about how to incorporate hedge funds into investment portfolios. Finally, Greg Gregoriou applies data envelopment analysis (DEA) and uses the basic, cross-evaluation, and super-efficiency models to evaluate the performance of the fund of hedge funds classification.

**Jean L.P. Brunel**  
Editor