CHAPTER 1

THE WEALTH MANAGEMENT PROCESS

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

—Jean Brunel

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

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

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

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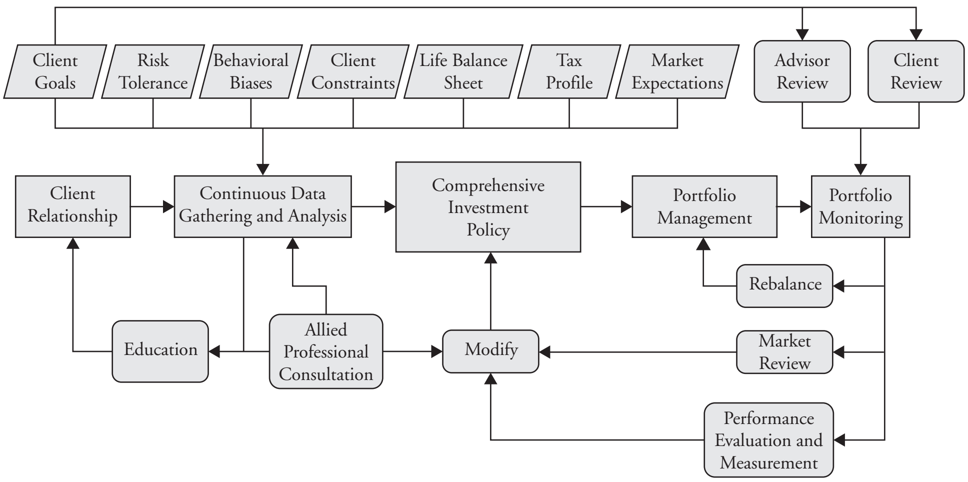
EXHIBIT 1.1 The Wealth Management Investment Process



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

THE CLIENT RELATIONSHIP

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

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

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

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

THE CLIENT PROFILE

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

Client Goals

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

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

Risk Tolerance

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

EXHIBIT 1.2 Risk Tolerance versus Risk Capacity

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

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

Behavioral Biases

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

Client Constraints

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

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

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

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

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

Life Balance Sheet

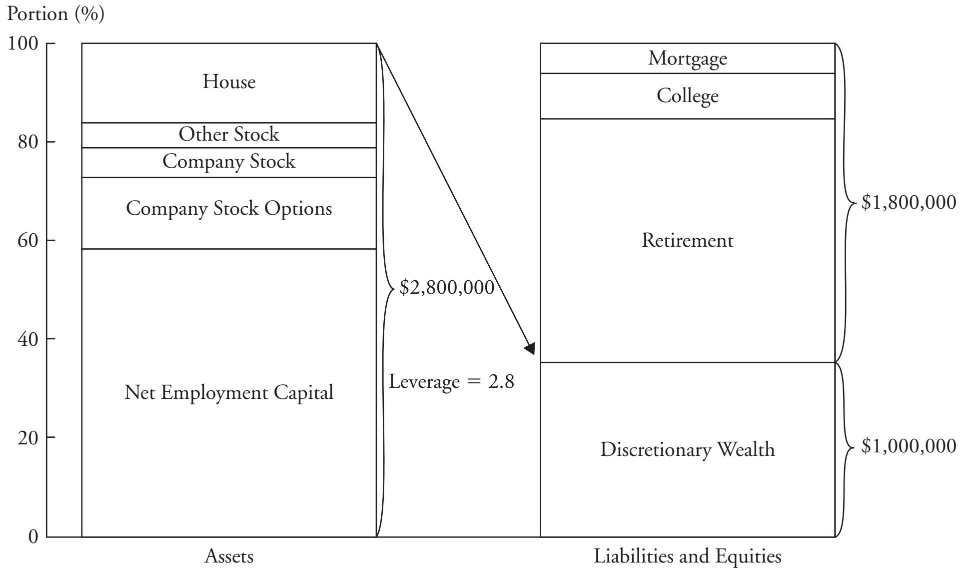
No chief executive officer (CEO) can effectively run a business without understanding its financial position. Similarly, wealth managers need a framework to assess their clients' overall financial status. A "life balance sheet" is one such framework that provides a comprehensive accounting of a client's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

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

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

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

EXHIBIT 1.3 Hypothetical Example of a Life Balance Sheet

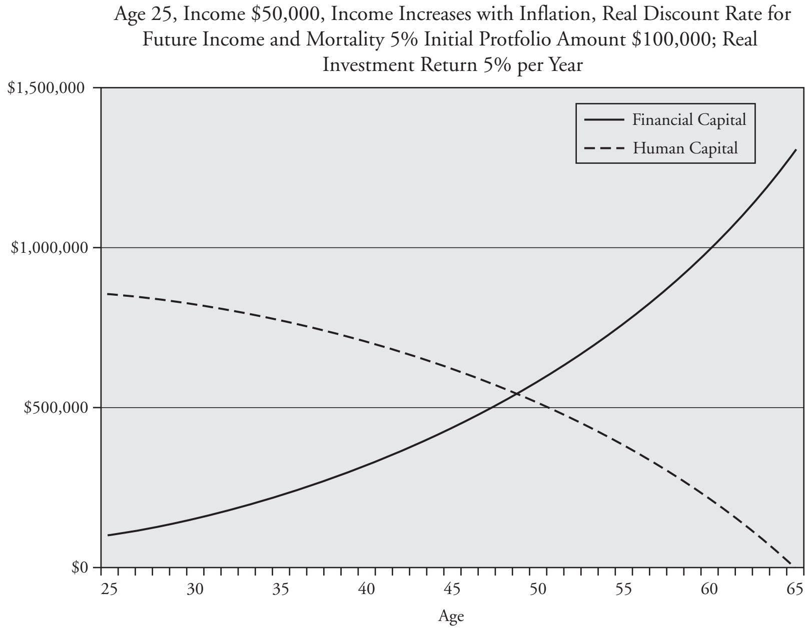


Source: Adapted from Wilcox, Horvitz, and diBartolomeo (2006, 18).

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

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

EXHIBIT 1.4 Stylistic Depiction of Financial Capital and Human Capital



Tax Profile

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

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

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

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

Market Expectations

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

WEALTH MANAGEMENT INVESTMENT POLICY

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

EXHIBIT 1.5 Investment Policy Statement

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

Investment risk management should be a focus of attention for the wealth manager. The first step, of course, is identifying the series of risk exposures. Clients with little excess capital or discretionary wealth, as described in the previous section, typically face longevity risk. That is the risk that their assets will be insufficient to fund their retirement needs due to unexpectedly poor investment performance, inflation erosion, and/or an unexpectedly long life span. Yes, living too long is a risk, but it can be managed in a number of ways, including the use of immediate annuities. Alternatively, one may not live long enough to convert one's human capital into financial capital and therefore face disability and mortality risk (the risk of dying too soon). The concentration of assets allocated toward human capital in the life balance sheet is typically significant for younger clients, and life/disability insurance is commonly used to manage this risk.

For wealthy investors or families with plenty of assets to fund their spending needs and hence plenty of excess capital, longevity risk and mortality risk may be inconsequential. However, they face other investment risks in connection with executive stock options, restricted stock, deferred compensation plans, or other concentrated stock positions. Protecting assets and income against the dilutive effects of inflation is also a common concern for all investors, including affluent and high-net-worth investors.

The three basic investment risk management strategies are diversification, hedging, and insurance. The financial advisor has different tools from which to choose to implement each of them. For example, an investor wanting downside protection in the stock market can purchase a structured product, such as an annuity that provides a minimum cash flow but also allows the investor to participate in some market appreciation or use an options-based strategy. The wealth manager chooses the proper tool based not just on the size of the client's assets and liabilities, but also on the risk profile of those assets and liabilities. Examples of investment policy statement excerpts are presented in Chapter 13.

Some wealth managers also become actively involved in aspects of planning beyond investments. For example, it may be appropriate to incorporate estate planning and charitable giving plans, ensuring that strategies in one area are consistent with the other. For entrepreneurs, a broader wealth management policy would also consider business succession plans or plans to liquidate or sell a business. Like many tax, estate planning, and legal issues, these require the expertise of other investment professionals, such as investment bankers. Consideration might be given to creation of a broader wealth management policy statement that could become the center of the wealth management process and govern wealth management decisions.[2] Such a statement would incorporate the investment policy statement as well as other concepts, such as risk management and wealth transfer goals, as outlined in Exhibit 1.6.

PORTFOLIO MANAGEMENT, MONITORING, AND MARKET REVIEW

How investment policy is executed is represented by the system in the right-most part of Exhibit 1.1. It requires that the parties involved (e.g., client, manager, custodian, allied professionals) have an understanding of each other's responsibilities as well as their own. One way of implementing investment policy is to construct portfolios by selecting individual

[2]Most advisors simply refer to this as an investment policy statement even when it includes non-investment-related goals.

EXHIBIT 1.6 Wealth Management Policy Statement

1. Investment policy statement
   a. Brief client description
   b. Client goals
   c. Investment objectives
      i. Return objective
      ii. Risk objective
   d. Investment constraints
      i. Time horizon
      ii. Tax considerations
      iii. Liquidity needs (e.g., cash flow management)
      iv. Legal and regulatory concerns
      v. Unique circumstances
   e. Strategic asset allocation
      i. Asset class constraints
      ii. Investment constraints (e.g., margin restrictions)
      iii. Investment strategies
      iv. Investment styles
   f. Implementation, monitoring, and review
      i. Responsibilities of client, manager, custodian, and other parties involved
      ii. Performance measures, evaluation, and benchmarks
      iii. Review schedule
      iv. Rebalancing guidelines
2. Risk management and insurance
   a. Longevity risk (i.e., the risk of living too long)
   b. Mortality risk (i.e., the risk of dying too soon)
   c. Medical, disability, and long-term care (i.e., the risk of living with costly illness)
      i. Living wills
      ii. Health care proxies
   d. Property risk (e.g., asset protection from creditor claims)
   e. Business risk
   f. Political risk
   g. Legal risk
3. Wealth transfer goals
   a. Estate planning (e.g., transfers to heirs)
   b. Philanthropy
   c. Business succession

assets. Alternatively, the wealth manager may select mutual funds, exchange-traded funds (ETFs), or asset managers who are responsible for picking individual assets. These issues are discussed in Chapters 14, 15, and 16. In either case, the wealth management investment process is never complete. After initial plans are implemented, the portfolio and policy are monitored periodically by both advisor and client. In addition to measuring performance, the wealth manager needs to measure and monitor a portfolio manager's investment style, portfolio manager changes, asset size, and other factors that can affect the consistency of expected investment performance.

Accountability requires performance measures and benchmarks that are agreed on at the beginning of the process. Measuring and evaluating investment performance is its own field of study and is what naturally comes to mind when one thinks of investment performance measurement. For the wealth manager, performance is measured by whether the client is able to meet his or her life goals.

Performance can and should, however, include other factors such as the receipt of agreed-upon information, the delivery of statements, and the completion of scheduled reviews. This review process is informed by updates and changes to the client's profile as well as developments in the marketplace. Sometimes the review process requires only that the portfolio be rebalanced. Other times, depending on the extent of changes and developments, the investment policy statement may need revision, perhaps in consultation with other investment professionals.

Part of this review involves examining how the whole process functions, ensuring that it is effective and that accountability is built into the system—a process that involves coordination with other professional advisors as in the beginning. The review process often triggers the need for ongoing education for the client as circumstances change and new issues need to be addressed. Armed with this information, as well as a review of the market and portfolio performance, the wealth manager can modify the process as needed. In any case, the wealth management investment process is nonlinear and recursive.

PARTING COMMENTS

This process has clear implications for how wealth management is practiced. It is a client-centric endeavor rather than a product- or sales-oriented activity. The implications for the business of wealth management and the practice philosophy are outlined in Chapter 17. One should recognize, however, that the framework for sound wealth management is inextricably tied to the way in which the advisor practices. In the following pages, we provide the analytical framework around which you can build a practice and provide enduring value to the clients you serve.

RESOURCES

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