

Active and Passive Wealth Creation

Personality Type Classifications

Stages of Life

Benefits of the IPS

- **Foundation** is seeking to accumulate wealth through a job and savings, seeking education, or building a business. Long time horizon can increase risk tolerance. But often have little wealth to risk which may reduce ability.
- **Accumulation** is when earnings or business success rise and assets can be accumulated. Demands such a house or kids' college may rise. Could be a time of maximum savings and wealth accumulation with a higher ability to bear risk.
- **Maintenance** phase often means retirement. Preserving wealth and living off the portfolio are important. Ability to bear risk is declining, but not low. Life expectancy can be long and being too conservative can decrease standard of living.
- **Distribution** stage means assets exceed needs and a process of distributing them to others can start. Might involve gifts or making plans for death. Objectives may extend beyond death so time horizon remains long and ability to bear risk could remain high.

- **Active wealth creation.** Wealth that has been accumulated through entrepreneurial activity may be the result of risk taking. Thus, this individual could have willingness to take risk. However, they may treat business risk different from investment risk.
- **Passive wealth creation.** Wealth acquired through windfall or inheritance could indicate a lack of knowledge with investment decisions. Thus, this individual may have below-average willingness to tolerate risk.

- For the client
  - Identifies and documents objectives and constraints.
  - Dynamic, allowing changes in response to changing circumstances or market conditions.
  - Easily understood, giving the ability to bring in new managers without disruption.
  - Developing helps clients learn more about themselves and investment decision making and are better able to understand investment recommendations.
- For the advisor
  - Greater knowledge of the client.
  - Guidance for investment decision making.
  - Guidance for resolution of disputes.

- **Cautious investors**
  - Have strong desire for security.
  - Prefer safe, low-volatility investments with little potential for loss.
  - Do not like making their own investment decisions but are difficult to advise.
  - Portfolios have low turnover.
- **Methodical investors**
  - Diligently research markets, industries, and firms to gather information.
  - Decisions tend to be conservative.
  - Rarely form emotional attachments to investments.
  - Seek confirmation of decisions and constantly on the lookout for better information.
- **Individualistic investors**
  - Do their own research and are confident in their ability to make decisions.
  - When faced with contradictory information, will devote time to reconcile.
  - Have confidence in their ability to achieve long-term investment objectives.
- **Spontaneous investors**
  - Constantly adjust portfolios in response to changing market conditions.
  - Fear failing to respond to changing market conditions will negatively impact portfolios.
  - Acknowledge lack of investment expertise, but also doubt advice.
  - Have high turnover and trading costs.

Return Objective

Risk Objective

Time Horizon Constraint

Tax Constraint

- **Ability to take risk** is the ability to sustain losses with jeopardizing goals. How much volatility the portfolio can withstand and still meet expenditures. Significantly affected by time horizon and relative size of expenditures.
  - As time horizon increases, ability to take risk increases.
  - Large relative expenditures, reduce ability to take risk.
  - As the importance of an expense increases, ability to take risk decreases.
  - If a goal or amount can be changed, the client has flexibility, increasing ability.
  - If still working or has other assets, this increases the ability.
  - Liquidity needs can reduce ability.
- **Willingness to take risk** is subjective and determined by analysis of a psychological profile. Rather than accept the client's statement, you should look for confirming or contradicting evidence.

Often can be divided in to desired and required components. Required is what is necessary to meet critical goals. Might be living expenses, education or healthcare. Desired might be buying a second home or travel.

Some managers distinguish between income and growth sources, but this is suboptimal to a total return approach. As long as sufficient return is earned over the long run, funds can be available to meet needs.

Return objective should specify whether it is nominal (including inflation) or real, and pretax or after-tax.

- **Tax deferral.** Minimize potentially compounding effect of taxes by paying them at the end of the investment period. Strategies focus on long-term capital gains, low turnover, and loss harvesting.
- **Tax avoidance.** Invest in tax-free securities. Special savings accounts and tax-free municipal bonds are examples of securities with tax-free returns.
- **Tax reduction.** Invest in securities that require less direct tax payment. Capital gains may be taxed a lower rate than income. Annual taxes should be reduced through loss harvesting, when available.
- **Wealth transfer taxes.** Minimize transfer taxes by planning the transfer without utilizing a sale. Often quite specific to the jurisdiction. Considering the timing of the transfer is also important.

Important because it affects ability to bear risk. Most basically, it is the expected remaining years of life. Total number of years the portfolio will be managed to meet the investor's needs. Fifteen years or more is long-term, and short-term is three years or less.

Many horizons are multistage. A stage is indicated by changes in circumstances or objectives significant enough to require evaluating the IPS and reallocating the portfolio.

Liquidity Constraint

Legal and Regulatory Constraint

Unique Circumstances Constraint

Monte Carlo Approach to Retirement Planning

Trusts are formed legal devices for transferring personal wealth to future generations. In a revocable trust, the grantor retains ownership and control over the assets and is responsible for taxes. Often manages the assets personally or hires a manager.

In an irrevocable trust, the grantor confers ownership of the assets to the trust. The assets are considered immediately transferred and can be subject to wealth transfer taxes. The trust is a taxable entity and will file tax returns and pay any taxes due. The original grantor no longer has control of the assets and is not taxed on them.

Family foundations are another vehicle, similar to an irrevocable trust, used to transfer assets to future generations. Family members frequently remain as managers of the foundation's assets.

- Ongoing needs for distributions such as living expenses.
- Emergency reserves for unanticipated distributions if agreed to in advance. Otherwise they create cash drag.
- One-time or infrequent negative liquidity events requiring irregular distributions should be noted.
- Positive liquidity events not due to assets should also be noted.
- Illiquid assets, restricted from sale or causing a large tax bill on sale, should be noted.
- Ownership of a home is generally an illiquid asset and could be noted.

- Advantages

- Considers path dependency.
- More clearly displays tradeoffs of risk and return by ranking paths.
- Properly models tax analysis, which considers actual tax rates as well as account types (taxable or tax-deferred).
- Clearer understanding of short-term and long-term risk.
- Superior in assessing multi-period effects. Can model the stochastic process where return over time depends on the starting value of the period as well as additions and withdrawals.

- Disadvantages

- Simplistic use of historical data for inputs. Returns change and have major effects on projected future values of the portfolio.
- Models that simulate the return of asset classes but not the actual assets held.
- Tax modeling that is simplistic and not tailored to the investor's situation.

- Special investment concerns (e.g., socially responsible investing).
- Special instructions (e.g., gradually liquidate a holding over a period of time).
- Restrictions on the sale of assets (e.g., a large holding of a single stock).
- Asset classes the client specifically forbids or limits (e.g., position limits on asset classes or totally disallowed asset classes).
- Assets held outside the investable portfolio (e.g., a primary or secondary residence).
- Desired bequests (e.g., the client intends to leave his home or a given amount of wealth to children or charity).
- Desired objectives not attainable due to time horizon or current wealth.