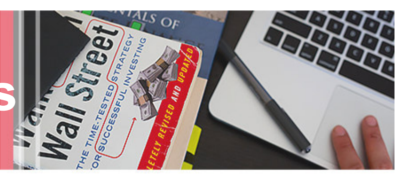
6 Private Wealth Management

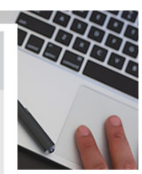
Private Clients vs. Institutional Clients



	Private clients	Institutional clients
Investment Objectives	• wide range of investment objectives • may not be precisely defined • can change over time • certain investment objectives may be difficult to reconcile,	• clearly defined objectives • stable over time
Constraints - Time Horizons	Horizons: • shorter time horizons • different time horizons for different investment objectives Scale/Size: Smaller Tax: significant & complex	Horizons: • longer time horizons • a single time horizon for a clearly defined objective Scale/Size: Bigger/larger Tax: may have tax exemption

Private Clients vs. Institutional Clients

	Private clients	Institutional clients
Other Distinctions	• Less formal governance structure • emotional biases • The regulatory environment varies greatly by jurisdiction • individuals with similar investment objectives may choose very different investment strategies because of their different concerns and backgrounds	• formal governance structure • more sophisticated • The regulatory environment varies greatly by jurisdiction



EXAMPLE 1

Private versus Institutional Clients

1. Garrett Jones, age 74, is a member of the investment committee for a local non-profit endowment. The endowment portfolio includes sizable allocations to less liquid and more volatile asset classes, such as hedge funds and private equity. Jones's personal portfolio, which is modest in size, contains no exposure to hedge funds or private equity. Jones asks his wealth manager about the lack of exposure to these asset classes.

   Discuss why the wealth manager has likely not recommended investments in hedge funds and private equity to Jones.

Solution:

Jones's wealth manager has likely not recommended these investments because of certain private client constraints. First, as an individual investor, Jones likely has a shorter time horizon and/or greater liquidity needs than an institutional investor (such as the endowment for which Jones is a committee member). Second, the relatively small size of Jones's personal portfolio will most likely preclude investing in certain asset classes, such as hedge funds and private equity, which require a significant investment and would result in an imbalanced portfolio. Finally, Jones's personal tax considerations may make these investments relatively unattractive.

Understanding Private Clients

Information Needed in Advising Private Clients

Personal Information	• Family circumstances, including marital status and the number and age of dependents. • Proof of client identification. • Employment information, including future career aspirations. • Retirement plans. • Sources of wealth. • Specific return or investment objectives. • Risk tolerance. • Investment preferences (e.g., liquidity or unique concerns).
Financial Information	• Net worth statement of a private client: financial profile in terms of assets and liabilities. • Annual income and expenses. Sources of income cash flows include a client's salary, pension income, business profits, and investment income. An analysis of income versus expenses is especially important for private clients who need to carefully budget in order to save toward their retirement goals.

Understanding Private Clients

Information Needed in Advising Private Clients

Tax consideration	• Tax categories: taxes on income, wealth-based taxes, taxes on consumption/spending • Tax strategies: tax avoidance, tax reduction, tax deferral
Other relevant information	• Wills and trust documents for estate planning. • Insurance policies that the private client has taken out (e.g., life, disability). • Service guidelines (e.g., whether the wealth manager is authorized to modify investment strategy and make trading decisions). • Portfolio reporting requirements. • Periodic liquidity requirements. • Communications and information to share with other financial services professionals on behalf of the private client

The Investment Policy Statement

The **investment policy statement** (IPS) is a written planning document that describes a client's *investment objectives and risk tolerance* over a relevant time horizon, along with the *constraints* that apply to the client's portfolio.

A wealth manager typically produces this document prior to constructing and implementing the client's investment portfolio.

The Investment Policy Statement

•The IPS creates a link between the client's unique considerations and their strategic asset allocation. The IPS is also an operating manual, listing key ongoing management responsibilities.

•The client and wealth manager should review the IPS regularly and update it whenever changes occur either in the client's circumstances or in the capital markets environment that impact the client's investment strategy.

Need for Policy Statement

Understand investor's needs and articulate realistic investment objectives and constraints

- What are the real risks of an adverse financial outcome, and what emotional reactions will I have?
- How knowledgeable am I about investments and the financial markets?
- What other capital or income sources do I have? How important is this particular portfolio to my overall financial position?
- What, if any, legal restrictions affect me?
- How would any unanticipated portfolio value change might affect my investment policy?

Need for a Policy Statement

Sets standards for evaluating portfolio performance

- Provides a comparison standard in judging the performance of the portfolio manager
- Benchmark portfolio or comparison standard is used to reflect the risk and return objectives specified in the policy statement
- Should act as a starting point for periodic portfolio review and client communication with the manager

Need for a Policy Statement

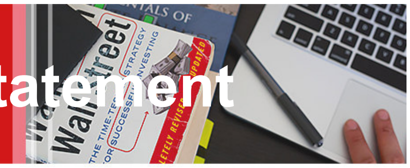
Other Benefits

- Reduces possibility of inappropriate or unethical behaviour of the portfolio manager
- Helps create seamless transition from one money manager to another without costly delays
- Provides the framework to help resolve any potential disagreements between the client and the manager

Input to the Policy Statement

Constructing the policy statement begins with a profile analysis of the investor’s current and future financial situations and a discussion of investment objectives and constraints.

Parts of the Investment Policy Statement



1. Client Background and Investment Objectives	
	Name, age, children, family status, salary, income … (relevant personal and financial information)
	Objectives: *planned and unplanned financial goals* and objectives - funding lifestyle needs during retirement, supporting family members, funding philanthropic activities, meeting bequest goals … → should be detailed and quantified whenever possible. Multiple objectives→ which of the objectives is primary.
	market value of the portfolio and of the accounts that make up the portfolio
	Tax status of the account.

Goals

Planned Goals	• goals that can be reasonably estimated within a specified time horizon • retirement goals (e.g., funding a comfortable existence post-retirement), specific purchases (e.g., primary or secondary residence), funding the education of dependents, funding significant family events (e.g., wedding celebrations), charitable giving, wealth transfer during a private client's lifetime or at death…
Unplanned Goals	• unexpected financial expenditures • difficulty of estimating the timing and the amount of funding needed. • E.g: property repairs, medical expenses, other unforeseen spending

Private wealth managers can assist their clients in formulating their financial goals by:

- Quantifying goals
- Prioritizing goals
- Changing goals

Return Objectives

Return Objectives

– May be stated in terms of an absolute or a relative percentage return

– Capital Preservation:

  - Minimize risk of real losses

Return Objectives

– Capital Appreciation: Growth of the portfolio in real terms to meet future need

– Current Income: Focus is in generating income rather than capital gains

– Total Return: Increase portfolio value by capital gains and by reinvesting current income with moderate risk exposure

Example

Formulating client goals Bonnie DuBois, a 60-year-old U.S. citizen, has just retired after a 35-year career in the fashion industry. Through a modest lifestyle, disciplined saving, and the help of a private wealth manager, she has accumulated a $2,000,000 diversified portfolio. DuBois resides in a house that has been paid off for several years. She estimates she will need $60,000 per year, with annual increases for inflation, to fund her lifestyle in retirement. One of the benefits of DuBois's past employment is comprehensive health insurance in retirement, but she is concerned that she might need long-term care in the future.

In a recent conversation with her wealth manager, she mentions her desire to help support her son Barry, his wife Betty, and their three children (ages 14, 12, and 10). Barry's and Betty's combined salaries barely meet their living expenses currently as they hold relatively junior roles in their respective employment. DuBois expects to provide them with $30,000 per year for the next five years and states that supporting her son and his family is the most important priority for her because of its proximity timewise.

She also wishes to purchase a vacation property in five years, although she is unsure how she will fund the purchase. She has informed Barry and her wealth manager that, at her death, her estate will be gifted to a local museum.

1. Identify DuBois's planned and unplanned goals.

2. Discuss how DuBois's private wealth manager can assist her with quantifying and prioritizing her financial goals.

Taxes

Taxes on income. These taxes apply to individuals, corporations, and often other types of legal entities. For individuals, income types can include salaries, interest, dividends, realized capital gains, and unrealized capital gains, among others. Income tax structure refers to how and when different types of income are taxed.

Wealth-based taxes. These include taxes on the holding of certain types of property (e.g., real estate) and taxes on the transfer of wealth (e.g., taxes on inheritance).

Taxes on consumption. These include sales taxes (which are taxes collected in one step from the final consumer on the price of a good or service) and value-added taxes (which are collected in intermediate steps in the course of producing a good or service but borne ultimately by the final consumer).

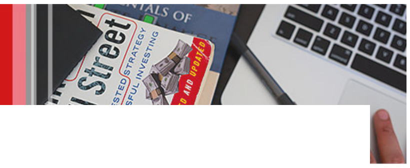


Figure 29.2: Seven Global Tax Regimes

Tax Regime	Ordinary Income Tax Structure	Favorable Treatment for Interest Income?	Favorable Treatment for Dividend Income?	Favorable Treatment for Capital Gains?
Common Progressive	Progressive	Yes*	Yes	Yes
Heavy Dividend Tax	Progressive	Yes*	No	Yes
Heavy Capital Gain Tax	Progressive	Yes*	Yes	No
Heavy Interest Tax	Progressive	No	Yes	Yes
Light Capital Gain Tax	Progressive	No	No	Yes
Flat and Light	Flat	Yes*	Yes	Yes
Flat and Heavy	Flat	Yes*	No	No

* Some countries may provide favorable tax treatment or exemption for some types of interest (e.g., tax-free bonds in the United States).

Country	Income Tax	Gains Tax	Wealth Transfer Tax
Brazil	27.5%	15.0%	8.0%
Canada (Ontario)	46.4%	23.2%	0.0%
Chile	40.0%	17.0%	25.0%
China (PRC)	45.0%	20.0%	0.0%
Egypt	32.0%	0.0	0.0%
France	48.1%	27.0%	60.0%
Germany	42.0%	50.0%	50.0%
India	30.0%	20.0%	0.0%
Israel	49.0%	25.0%	0.0%
Italy	43.0%	12.5%	0.0%
Japan	37.0%	26.0%	70.0%
Jordan	25.0%	0.0%	0.0%
Korea	35.0%	70.0%	50.0%
Mexico	30.0%	30.0%	0.0%
New Zealand	39.0%	0.0%	25.0%
Pakistan	35.0%	35.0%	0.0%
Philippines	32.0%	32.0%	20.0%
Russian Federation	35.0%	30.0%	40.0%
South Africa	40.0%	10.0%	20.0%
Taiwan	40.0%	0.0%	50.0%
United Kingdom	40.0%	40.0%	40.0%
United States	35.0%	35.0%	47.0%

Source: "The Global Executive," Ernst & Young, 2005

Tax Free Investments

- Earn income that is NOT subject to income taxes
- Tax Free Savings Accounts (TSFA)
  - tax-free investments

Tax Deferred Investments

- Tax deferred investments
  - compound tax free but when withdrawn are subject to taxes
- Registered Retirement Savings Accounts (RRSP)
  - individuals can deposit money into and earned tax deferred income
- At withdrawal, all funds are subject to tax

Parts of the Investment Policy Statement

2. Key Investment Parameters	
Risk tolerance	• willingness and ability to accept investment risk • a low risk tolerance for more important goals but higher risk tolerance for lower priority goals • near-term goals associated with lower risk tolerance compared to longer-term goals
Time horizon	• 15 years for a long investment horizon or less than 10 years for a short horizon • multiple objectives: can also have a different time horizon for each objective
Asset class preferences	list the acceptable asset classes for the client’s portfolio (or alternatively asset classes that are unsuitable for the client), together with the risk-return characteristics of each asset class

Parts of the Investment Policy Statement

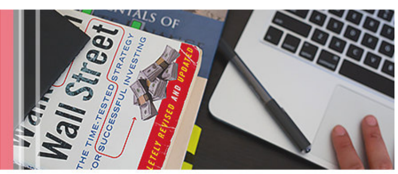
2. Key Investment Parameters	
Liquidity preferences	• maintain a cash reserve in their portfolio, • initiate a portfolio distribution when encounter an unanticipated cash need.
Other investment preferences	include a concentrated position in a single stock (due to past employment or inheritance)…
Constraints	• investment options in certain accounts • investments that have large unrealized capital gains & would create significant tax liabilities upon disposition • prohibiting investment in certain sectors or individual securities • ethical investing

Risk Tolerance

Risk Tolerance

– Should be based on investor's ***ability to take risk*** and ***willingness to take risk***

Risk Tolerance



Risk tolerance	• This reflects both the client's willingness and ability to take risks. • the willingness to engage in a risky behavior in which possible outcomes can be negative. • relates to an attitude • The opposite of risk tolerance is risk aversion
Risk capacity	• ability to take financial risks, based on the client's wealth, income, investment horizon, liquidity requirements, importance of goals, and other relevant considerations. • a more objective measure compared to risk tolerance • Clients with greater risk capacity can tolerate greater financial losses without compromising current or future consumption goals
Risk perception	• a subjective measure of investment risk (e.g., whether a private client thinks of investment losses in absolute or percentage terms). • Risk perception varies from one private client to the next; • a wealth manager can play a part in influencing a client's risk perception.

Risk tolerance

- Risk tolerance depends on an investor's current net worth and income expectations and age
  - More net worth allows more risk taking
  - Younger people can take more risk
- Careful analysis of client's risk tolerance should precede any discussion of return objectives

Risk tolerance

Generally, the ability to bear risk is decreased by:

- A shorter time horizon.
- Large critical goals in relation to the size of the portfolio.
- Goals that are important to the client or those that cannot be deferred.
- High liquidity needs.
- Situations where the portfolio is the sole source of support or there is an inability to losses in value.

How much risk is right for you?

Time Horizon

– Influences liquidity needs and risk tolerance
– Longer investment horizons generally requires less liquidity and more risk tolerance
– Two general time horizons are pre-retirement and post-retirement periods

Liquidity

– Liquidity
- Vary between investors depending upon age, employment, tax status, etc.
- Planned vacation expenses and house down payment are some of the liquidity needs.

Parts of the Investment Policy Statement

3. Portfolio Asset Allocation	
Strategic	• long-term target allocation for each asset class, • the portfolio being rebalanced periodically to maintain the target allocation
Tactical	• active management strategy that normally specifies a range for each asset class rather than a specific target allocation percentage

Parts of the Investment Policy Statement

4. Portfolio Management and Implementation	
Discretionary authority	• ability of the private wealth manager to take investment actions without first seeking the client's approval
Rebalancing	• A time-based rebalancing (e.g., quarterly, semiannual, or annual rebalancing) • a threshold-based rebalancing approach - the portfolio is rebalanced once actual asset class weights deviate from target weights by a prespecified amount
Tactical changes	• if a private wealth manager is given discretionary authority to undertake tactical asset allocation changes. The IPS should clearly state the acceptable range of weights for each asset class as well as the extent to which the manager is allowed to go beyond the upper or lower bounds when making tactical changes
Implementation	• acceptable investment vehicles (e.g., the use of in-house and/or external money managers, ETFs, mutual funds) • the due diligence process for making investment decisions

Parts of the Investment Policy Statement

5. Duties and Responsibilities of the Private Wealth Manager	
Wealth manager responsibilities	• List of responsibilities of wealth manager & third-party service provider
IPS review	• how frequently the client and wealth manager will review the IPS • important for the client to affirm that the investment objectives remain accurate. • important for the manager to confirm that the strategy remains likely to meet those objectives.
6. IPS Appendix	
Modeled portfolio performance	• This typically describes a range of possible portfolio outcomes over different investment horizons as well as a distribution of returns at specific percentiles
Capital market expectations	• This covers the expected return, risk, and correlations of the asset classes that the private wealth manager can include in a client's portfolio

Portfolio allocations

Traditional Approach to Portfolio Construction

Overall portfolio context and consists of the following steps:

- Identify appropriate asset classes for the client's portfolio.
- Develop capital market expectations (i.e., expected returns, standard deviations, and correlations of asset classes).
- Determine asset class weights for the portfolio, consistent with the client's risk tolerance for the overall portfolio.
- Assess investment constraints (e.g., a client's preference for ethical investing) that may limit the wealth manager's choice of investments.
- Implement the portfolio.

Sample Investment Policy Statement for a Private Client

A case from CFA 2024 Level 3, Volume 4

Exhibit 5 Sample Investment Policy Statement

Investment Policy Statement Prepared for David and Amelia King

Background and Investment Objectives

This Investment Policy Statement (IPS) is designed to assist David and Amelia in meeting their financial objectives. It contains a summation of their objectives and expectations, sets forth an investment structure for attaining these objectives, and outlines ongoing responsibilities.

The purpose of this portfolio is to support the continuation of David and Amelia's current lifestyle, provide for their family's needs, and fund their philanthropic objectives. Maintenance of their current lifestyle is their primary objective, followed by support for family members and charitable aspirations, in that order. To meet these objectives, they anticipate needing approximately \$350,000 per year in inflation-adjusted portfolio distributions. In addition, they intend to purchase a second residence within the next two years. They expect the purchase price for the second residence to be approximately \$1.5 million. David and Amelia have not articulated a specific dollar amount that they intend to leave to their children, nor a specific dollar amount that they wish to leave to charity at their death. The wealth manager will continue to work with them to quantify these objectives.

In establishing their asset allocation, David and Amelia have considered their current assets and expected cash needs. They are seeking to achieve a higher long-term rate of return and are willing to assume the associated portfolio volatility.

Portfolio Accounts

Taxable joint account for David and Amelia

Tax-deferred account for David

Tax-deferred account for Amelia

Current Combined Market Value

\$12,250,000

Investment Parameters

Risk Tolerance

The wealth manager has determined that David and Amelia are able and willing to withstand short- and intermediate-term portfolio volatility. They recognize and acknowledge the anticipated level of portfolio volatility associated with their asset allocation (as illustrated in the Modeled Portfolio Behavior section of the Appendix).

Investment Time Horizon

David and Amelia have an investment time horizon that exceeds 15 years.

Portfolio Accounts

Taxable joint account for David and Amelia
Tax-deferred account for David
Tax-deferred account for Amelia

Current Combined Market Value

$12,250,000

Investment Parameters

Risk Tolerance

The wealth manager has determined that David and Amelia are able and willing to withstand short- and intermediate-term portfolio volatility. They recognize and acknowledge the anticipated level of portfolio volatility associated with their asset allocation (as illustrated in the Modeled Portfolio Behavior section of the Appendix).

Investment Time Horizon

David and Amelia have an investment time horizon that exceeds 15 years.

Asset Class Preferences

The Kings and their wealth manager have selected the following asset classes:

- Short-term debt investments
- Intermediate-term bonds
- US stocks

- Non-US stocks
- Global real estate securities

Other Investment Preferences

The Kings wish to maintain their positions in Acme Manufacturing, Inc., which Amelia received through inheritance, and Artful Publishing, Ltd., which is her former employer. Neither position represents significant concentration risk in the context of their broader portfolio.

David has an interest in a private real estate limited partnership that invests primarily in office buildings throughout Asia. The wealth manager has taken this exposure into consideration in designing the broader asset allocation.

Liquidity Preferences

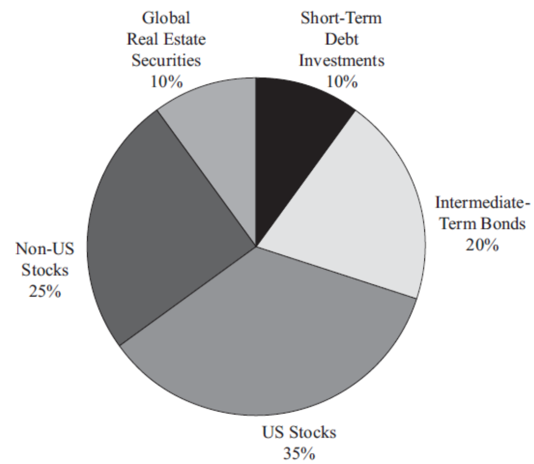
David and Amelia wish to maintain within their portfolio a minimum cash balance of $50,000. They typically maintain a more sizable cash balance at their primary bank.

Constraints

Amelia's position in Artful Publishing, Ltd., has significant embedded capital gains.

Portfolio Asset Allocation

	Lower Rebalancing Limit	Strategic Allocation	Upper Rebalancing Limit
Short-term debt investments	8%	10%	12%
Intermediate-term bonds	16%	20%	24%
US stocks	30%	35%	40%
Non-US stocks	20%	25%	30%
Global real estate securities	8%	10%	12%



Portfolio Management

Discretionary Authority

The wealth manager will implement discretionary portfolio changes related to rebalancing the portfolio, investing new deposits, and generating liquidity to meet withdrawal requests.

The wealth manager will review with the client, prior to implementation, the addition of new positions or the elimination of existing positions.

Rebalancing

The wealth manager will review the portfolio on at least a monthly basis. Rebalancing will be determined by the lower and upper asset class limits set forth in the Portfolio Asset Allocation section of the IPS.

Implementation

To implement the investment strategy, the wealth manager will utilize third-party money managers via mutual funds, exchange-traded funds (ETFs), and separate accounts of individual securities. The wealth manager conducts a quarterly due diligence process to evaluate recommended managers as well as the universe of other available managers. This process involves quantitative risk and return comparisons to appropriate indexes and peer groups, as well as qualitative assessments of other factors that may impact a manager's ability to perform in the future. More information about this process is available at the client's request.

Duties and Responsibilities

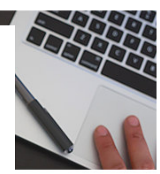
Wealth Manager Responsibilities

The wealth manager is responsible for the following:

- Developing an appropriate asset allocation
- Selecting investment options
- Implementing the agreed-upon strategy
- Monitoring the asset allocation and rebalancing when necessary
- Monitoring the costs associated with implementing the investment strategy
- Monitoring the activities of other service vendors (e.g., custodians)
- Drafting and maintaining the IPS
- Performance reporting
- Tax and financial accounting reporting
- Proxy voting

IPS Review

The client will review this IPS at least annually to determine whether the investment objectives are still accurate. The wealth manager will review this IPS at least annually to evaluate the continued feasibility of achieving the client's investment objectives.



IPS Appendix

Modeled Portfolio Behavior[5]

Modeled Compound Return: 6.23%

Modeled Distribution of Returns

Year	10th percentile	25th percentile	50th percentile	75th percentile	90th percentile
1	−10.45	−2.89	6.23	16.21	26.01
3	−3.75	0.86	6.23	11.88	17.24
5	−1.58	2.05	6.23	10.58	14.66
10	0.64	3.25	6.23	9.29	12.12
15	1.65	3.79	6.23	8.72	11.02
25	2.66	4.34	6.23	8.15	9.92

Portfolio downside risk, 1-year horizon:

- 25% likelihood of a return less than −2.89%
- 10% likelihood of a return less than −10.45%

Portfolio downside risk, 15-year horizon:

- 25% likelihood of a compound annual return less than 3.79%
- 10% likelihood of a compound annual return less than 1.65%

Modeled Portfolio Statistics

	Expected Return (%)	Standard Deviation (%)	Modeled Compound Return (%)
Short-term debt investments	2.5	2.0	2.5
Intermediate-term bonds	3.5	8.0	3.2
US stocks	8.5	22.0	6.1
Non-US stocks	10.0	26.0	6.6
Global real estate securities	7.5	23.0	4.9

					)	(5)
2	Intermediate-term bonds	0.79	1.00			
3	US stocks	–0.08	–0.03	1.00		
4	Non-US stocks	–0.29	–0.27	0.76	1.00	
5	Global real estate securities	–0.15	0.08	0.42	0.39	1.00