

Managing your portfolio

Amid continued economic uncertainty and rising tax rates, it's critical to understand the basics of investment planning, investor behavior, asset location, and documentation of investment decisions. These fundamental principles form the foundation upon which successful individual investment and wealth management plans are built.

If nothing else, the macroeconomic events of the past 12 months have demonstrated that the world's financial markets are tightly connected. As the US economy began to slide into recession, almost all countries around the world became deeply affected. And as investors experienced the pain of declining asset values, everyone was hurt, but those with portfolios less concentrated in equities were hurt less. Two things became very clear: asset allocation does matter, and diversification helps manage portfolio risk.

One consequence of the financial crisis and the US government elections of 2008 is almost certain: income tax rates will be rising. For individuals in the highest tax brackets, it becomes even more important to invest in a tax-aware manner and pay close attention to the location of their investment assets. Increasing the tax efficiency of their portfolios will have a direct positive impact on bottom-line returns.

In this environment, it's worthwhile to review the basics of investment planning, investor behavior, asset location, and documentation of investment decisions.

Investment planning: The basics

The investment-planning and decision-making process is a logical sequence of actions that you should perform before choosing an investment vehicle. These actions include:

- / Identifying goals, objectives, and constraints
- / Analyzing the risk/return trade-off and how to improve it
- / Allocating assets and implementing your investment strategy
- / Reviewing performance

Goals, objectives, and constraints

The first step is to identify your investment goals, objectives, and constraints. Goals can be short-term—such as investing to fund the purchase of a vacation home within a year or two—or long-term, such as investing to fund retirement. Investment objectives would include such things as investing to grow capital, preserve capital,

or create a moderate yield. In addition, you need to take into account the constraints you face in implementing the strategy, such as the dollars available to invest, your risk tolerance, and your need for liquidity.

Risk/return trade-off

The next step is to focus on the risk/return trade-off and go beyond the expectation of taking more risk in order to achieve higher returns. Since your “real” return (nominal return minus taxes and inflation) is the true measure of your wealth gain, you need to track your real investment return.

Just as understanding that real return is important in your analysis of risk and return, it is also important to understand the type of risk you are dealing with. Most people focus on return volatility, but there are many risks to consider when developing an investment strategy. Because investors each weigh each risk differently, there is no one portfolio that fits all investors. The following describes some of the risks most investors consider when making investment decisions.

Asset allocation

This technique is considered the underlying principle of modern portfolio theory, as follows: Asset classes are groups of various investments with similar characteristics. Since asset classes will react differently to similar economic conditions, it is possible to combine several asset classes whose performances are not closely related. This creates a portfolio return that will be less than that of the return of the best-performing asset class but above that of the worst-performing asset class while reducing the volatility of the overall portfolio.

Most investment managers acknowledge that the asset allocation decision accounts for over 80% of performance variability over time and is much more important than individual security selection and other factors in control of risk. Therefore, it makes more sense to concentrate on asset allocation and asset class selection than trying to pick the individual security that will produce the best desired performance.

Systematic risk

The following are classified as systematic risk—meaning, they are nondiversifiable.

/ *Purchasing power (inflation) risk*

Inflation is a serious risk to your long-term financial security. As inflation increases the prices you pay for goods, you need to increase income or generate investment growth to meet the increased cost of living. If there is no growth, then you will have to consume your existing assets in order to generate the income needed to meet the increased costs if you desire to maintain your standard of living.

/ *Deflation risk*

Deflation risk is just the opposite of inflation risk. It is the risk that asset values will decline at a greater rate as general price levels fall during periods of severe recession or depression.

/ *Interest rate risk*

Interest rate risk is the tendency of securities, especially a fixed-income instrument, to move inversely with changes in interest rates. Rising interest rates decrease the current market price of fixed-income securities because current purchasers require a market-competitive yield.

/ *Exchange rate risk*

Exchange rate risk occurs when one currency is converted into another. This risk is relevant only for clients who acquire securities denominated in a foreign currency.

/ *Political risk*

Political risk is an important concern, particularly when investing in countries where political and social unrest has long been part of the landscape. Political actions can wreak havoc in the financial markets.

Unsystematic risk

This is company-specific or industry-specific risk and can be reduced only through proper diversification. Company-specific risk is the chance that some event might occur that negatively impacts the financial performance of the company.

Two of the risks worth highlighting because of their impact in 2008 are event risk and liquidity risk.

/ *Event risk*

Event risk is the risk that some uncontrollable event (political, environmental, financial, social, and so on) will occur that could have a significant impact on your portfolio. The market crash in the second half of 2008, for example, qualifies as such an event: The broad equity market as measured by Standard & Poor's 500 Index dropped 53% in 83 days during that period. Even the best-constructed equity portfolio was negatively impacted by such a dominant market decline.

/ *Liquidity risk*

Liquidity risk is the chance that an investment cannot be sold easily or efficiently. Some investments might be hard to sell because they are less liquid and difficult to find a market for, particularly during down markets. Such was the case in 2008: As the stock market declined and credit became virtually impossible to secure, these events helped create the perfect liquidity storm. Many investors grew to rely on home equity loans as sources of liquidity but have since found that source virtually dried up. Some investors turned to their money market and bank accounts, and some found they could not make withdrawals. When the same investors tried to sell assets (stocks, bonds, alternative assets, and the like), they found that the price was too low or there were no buyers. This continues to be the case for certain asset classes such as real estate.

Many investors ignored the basic rule of personal liquidity risk management: Have a cash pot available to pay living expenses in the event of a personal crisis. Instead, they invested in other assets in search of higher returns, with the expectation that they could always borrow to meet short-term liquidity needs. Advisers differ, but depending on each investor's situation, cash on hand to cover one to three years' living expenses is a prudent investment strategy.

Asset allocation is a form of diversification, since you're not putting all your eggs in one investment basket. By having several asset classes, you have several baskets. However, you also need to diversify *within* your asset classes. For example, if you owned one cash account, one intermediate-term government bond, and one stock, your portfolio would be allocated but not diversified. You would achieve more diversification by owning a portfolio of bonds or stocks such as can be obtained through the purchase of a mutual fund.

The market crisis of 2008 confirmed that asset allocation does matter. Although all portfolios experienced the wrath of the markets' downturn, those that were diversified (invested in bonds, stocks, cash, and alternatives) performed better than those heavily concentrated in equities. Portfolios diversified within a variety of asset classes (including alternatives when appropriate), as well as diversified geographically, are necessary to help manage risk in today's investment world.

Reviewing performance

It is likely that personal financial goals and objectives will change as time passes. Therefore, revisit your financial plan on an annual basis and decide whether your investment portfolio is still suited for achieving those goals and objectives or whether changes should be made.

Part of the review process will involve rebalancing the portfolio. Rebalancing will be necessary as the portfolio grows disproportionately for each asset class and/or as new cash is added to the mix. Either of these events will change the original asset allocation, which can materially change the portfolio's risk. By rebalancing the portfolio, you'll be restoring it to the original asset allocation that was established during the planning process.

Investor behavior

The investment-planning and decision-making process may be a logical sequence of actions, but an investor's psychology can disrupt the best-laid plans.

Generally speaking, investors tend to mirror the current state of the economy and the business cycle. If things are looking good, they tend to be positive; if things begin a turn for the worse, their attitudes turn negative. Most investors tend to focus on the present (current job situation, current economy, recent stock movements, and so on) and begin to make decisions that are very short-term focused and often counterproductive.

The difficult task for the investor is to be slightly ahead of the crowd by selling before markets fall and buying before they begin to rise. Unfortunately, the skill of timing the markets' movements is extremely difficult to master.

A more reliable strategy that has proved effective in managing risk and capturing reasonable returns is the discipline of a systematic strategic asset allocation focused on achieving long-term goals. When combined with tactical rebalancing, it can go a long way to help keep an investor's behavior in check and avoid going too far off course.

Asset location

Up to this point we have not mentioned much about the impact of income taxes on investment decisions. Make no mistake: Income taxes matter in the investment process, and with the prospect of increasing tax rates, they'll matter even more.

One way to help improve the tax efficiency of your investment portfolio is by what is often referred to as asset location. Essentially, asset location is the process of determining where the best place to own an investment is, given your goals for the investment. Wealthy individuals' investments are rarely held in one account or entity. They're usually held in different buckets that have been established to help implement their financial and wealth transfer planning over time.

As of this writing, tax reductions enacted in 2001 and 2003 are scheduled to sunset at the end of 2010. In addition, new legislation has been proposed that will increase income tax rates and limit

deductions for individuals. Therefore, the asset allocation decisions you make must take into account the impact of income taxes on portfolio return.

Each investor bucket is established for a particular purpose and therefore requires a specific investment strategy. Each bucket can be invested in either taxable or tax-deferred accounts—such as individual retirement accounts (IRAs), 401(k)s, and deferred compensation plans—that delay income taxation. They may also be invested in accounts such as Roth IRAs and college savings plans, which offer potentially tax-free investment opportunities.

Which investments to own inside these accounts depends on the investment purpose for that bucket. For example, taxable bonds generate interest income that is taxed at ordinary income tax rates and for that reason are often held in tax-deferred accounts. Stocks may distribute qualified dividends that are taxed at favorable rates (currently, 15%; proposed, 20%) or nonqualified dividends taxed at ordinary income tax rates. Stocks also generate capital appreciation that could be taxed at ordinary income rates (if held less than one year) or favorable tax rates (currently, 15%; proposed, 20%) if held longer than one year. For this reason, stocks have generally been held in taxable accounts. Of course, if the investment holding period is very long, owning stocks inside tax-deferred accounts may make more sense because their potentially higher returns could make up for the ordinary income tax rate at distribution.

Asset location decisions are often very complicated and must take into account many variables besides income taxes. Other issues—like estate and gift-planning goals, income and liquidity needs, age of the investor, and investment time horizon for the portfolio—will all need to be considered before deciding on which asset location would produce the most tax-efficient investment environment and still meet the desired goals.

For rates and other information related to capital gains, visit pwc.com/pfs.

Documenting the investment decisions, strategy, and process

The investment strategy and process are typically documented by creating an investment policy statement (IPS).

There are a number of excellent reasons that a well-thought-out and formally written IPS is so important. Unfortunately, it often is created without much thought or often gets forgotten.

Two reasons for creating an IPS are that:

- / The IPS can be an invaluable communication tool between family members and close professional advisers such as accountants or attorneys. It provides documentation of the investment process for the portfolio and evidence for the reasons investment decisions were made. It will also help with transition planning in the event of a death, since all parties would understand why assets were invested as they were.
- / The IPS forces the investor to think long term and create a well-thought-out investment plan. It also helps stop the second guessing of investment decisions in the future. During a bull market, most investment strategies generate impressive results. However, it's during a bear market that the IPS can have a calming effect: by reminding the investor why the investment portfolio is structured as it is and helping avoid emotional, short-term investment decisions.

The investment policy statement should be simple, forthright, and understandable. It should (1) provide background on the purpose of the investment portfolio and how the assets will be used in the context of your financial plan, (2) detail the desired asset allocation, (3) provide a strategy for automatically rebalancing the assets, (4) set out clear and definable performance standards for the portfolio managers, and (5) define the duties and responsibilities of all parties involved in the management of the portfolio's assets.

Conclusion

Investment planning and wealth management are complex undertakings that, while rooted in a foundation of fundamental principles, must be approached differently to address the unique needs and expectations of each individual or family.

It is not uncommon, when managing wealth, to discover that several competing goals must be considered. Developing strategies to meet those competing goals requires careful thought, and, often, several meetings with your adviser to model the potential solutions before choosing the one that works best for you.

Example

A couple has investable assets of \$20 million and spends approximately \$250,000 annually on their living expenses and lifestyle. The couple wants to maintain that standard of living during retirement as well as provide inheritances for their two children. In addition, the couple would like to make charitable gifts with the assets that are not required to support their lifestyle or to meet their inheritance goal for their children.

The investment strategy for this couple will need to take into account many factors such as:

- / Income and spending levels
- / Legacy objectives
- / Charitable goals
- / Taxation
- / Investment time horizon

The solutions for these goals are best crafted by breaking the wealth into buckets.

Bucket 1: Liquidity

Based on the annual \$250,000 lifestyle need, there should be liquid assets (such as cash and equivalents) set aside to be able to meet one to three years of lifestyle needs. Therefore, approximately \$1 million should be invested in tax-efficient (possibly tax-exempt short-term municipal bonds) cash and equivalents.

Bucket 2: Lifestyle

These assets should be invested to help provide the living standard required by the family. Approximately \$15 million will be allocated to help achieve that goal. The strategic asset allocation for this portfolio should create only moderate risk, since these assets are needed to provide for the family's living needs. Approximately 50% in cash and fixed income, 45% in equities, and 5% in alternatives might make sense. The assets will be held in IRAs, 401(k)s, and deferred compensation plans as well as other accounts; and therefore, careful thought will be needed for the asset location decision. Tax efficiency is very important, since it is likely that this family will be paying income taxes at the highest marginal tax rates. Planning must also be done on how to create the \$250,000 that the family needs annually for living expenses. Will the money come from interest, dividends, or principal distributions? Will distributions be taken from the IRAs, 401(k)s, or deferred compensation accounts?

Example continued

It may make sense to hold the tax-inefficient hedge funds inside the tax-deferred accounts and consider using tax-exempt municipal bonds for the fixed-income allocation that is held in taxable accounts. For the equity allocation, they should consider using exchange-traded funds, low-turnover mutual funds, index mutual funds, and tax-aware, separately managed accounts for those investments held in taxable accounts. Alternatively, they should consider taxable bond investments and higher-turnover equity investments for the tax-deferred accounts, since generating short-term gains will not be an issue.

Bucket 3: Children's inheritances

These assets (\$1 million per child) are earmarked for the children's inheritances. The investment time horizon is long-term, since the money will be invested over their lifetimes. Therefore, a more aggressive investment strategy (e.g., 60% equities, 30% fixed income, and 10% alternatives) may be warranted. Asset location is still important because the family's estate plan may dictate that these assets be held in trust for the children's benefit. If that's in the form of a grantor trust, the tax consequences of the investments will flow back to the grantor (the parents) and be taxed just as any other taxable investment would be.

Bucket 4: Charitable giving

The remaining \$2 million of assets is earmarked for charitable giving. How those assets are invested can get very complicated based on how the family intends to make these charitable gifts. Things to consider would be the timing of the gifts; the charitable giving strategy to be used (charitable remainder trust, charitable lead trust, donor-advised fund, foundation, etc.); the taxable beneficiary of the trusts, if used; and the target amount of charitable gifts. If the assets were not held in one of the charitable trusts but in a taxable account that was set aside for the charitable giving, the investment income would flow back to the couple. At that point, investments like those discussed for bucket 2 may be appropriate.

For more information on managing your portfolio, please visit pwc.com/pfs or contact:

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