

Section VII. Wealth Cycle Management
Chapter 15. Wealth Life Cycle Strategies

*When You Come to a Fork in the Road,
TAKE IT !*

-Lawrence A. (Yogi) Berra

Key Points

- Risk awareness (self/asset/markets) is vital
- Resource capital (human/financial) shapes wealth (accumulation/distribution) cycle
- Wealth process counts in long time horizon
- Objectives lead to strategies, which should be tested with scenario analysis

Section Overview

Section VII, Wealth Cycle Management, is the concluding part of the *Lifetime Wealth Flow Guide*. Here, the concepts developed in the previous six sections are woven together in four chapters that present wealth life cycle strategies and scenarios, tactics for risk adjustment, the orchestration through the risks and uncertainties of life, and an epilogue, which emphasizes following an alert, relaxed process. The guide provides the self disciplined, educated individual organized approaches to consider in developing a personal wealth process. As Yogi^{1,2}, the fearless New York Yankee catcher in the 1950's and later day folksy American common sense thinker noted: strategic decisions should be made after observing and coming up with a good plan.

Chapter Overview

Personal behavior biases must be considered in developing habits and unique wealth life cycle strategies. All individuals have decision making limitations, primarily due to emotional biases. Processes are presented here to support habits that reduce the impacts of negative financial behavior biases. Quantified risks and unknown uncertainties were considered in decision making, operating assets, and market valuations (Sections II, IV, V, and VI) to make steady progress toward meeting goals and objectives (Section III, Wealth Foundations and Factors).

Wealth Cycle strategy (Chapter 12) results are time horizon dependent. Over a generation (30 to 35 years) of wealth accumulation, rational strategies within one's emotional risk tolerances can be formed to confidently achieve reasonable objectives. There will be periods of asset overvaluations (unsustainable gains and bubbles) and asset under valuations (large losses during crashes) over a one or two generation adult life

time. Simple scenarios of economic wealth cycle changes with stable asset portfolios are presented to show the changes that uncontrolled luck (good and bad) can bring. In either case, the steady processes and implementation of strategies offered are focused on wealth development through investment efforts. They contrast from speculation on disjointed opportunities (the next Microsoft Initial Public Offering) or gambling without knowing the true odds on the prettiest horse in the field. The desire of this book is to make the wealth cycle journey as understandable and tranquil as possible.

Self discipline and steady strategy processes deal with unpredictable luck

Over a full life with risks, uncertainties, and decisions, lucky and unlucky outcomes tend to balance out for the perseverant. His or her sound processes are built on first being aware of personal emotional and cognitive behavior biases that were analyzed in Chapter 4. The issue is complex because often an emotional bias (greed) occurs with a cognitive bias (over-confidence). Similarly an emotional bias (prospect of avoiding transaction losses) may happen with a cognitive bias (following a crowd trend). Corrective broad character traits (prudence, humility, and independence) are honed through pre transaction research, thoughtful scenario aware decisions, and post transaction analyses using rules based checklists. The rational research suggested in Chapter 7 described elements of pre purchase research to determine if an asset is over valued or under valued relative to the market price. Later selling overvalued assets in clear negative price trends (at either losses or gains) requires humility. Sales should be based on enough calculations to minimizing emotional and short cut rational biases. That is not easy.

Calculated asset operational values provide information to reflect and deduct likely scenarios. Otherwise, qualitative analysis of behavioral idle talk may be insightful. Observing giddy or smug comments about investment successes may indicate that "if they seem too good to be true", then intuitively they likely are. In other words, asset values may be built on a risky bubble that should be avoided. Careful observations and recording details help to detect if the so called dots are not connected. Independent thinkers find catalysts that may imply a more costly potential downside scenario loss (asymmetric) than upside scenario gain.

Post transaction analysis checklists that reduce reflexive feelings provide valuable information. If a sale is made at a defined risk boundary condition, then further risks of loss are stopped. The asset price will either rise or fall thereafter. Over time predetermined rules should replace stress and limit biases in making transaction decisions. In the short term, the asset price may pop back up. New information may also change buy or sell decision points at times. However, a process should rely on reflective thinking, instead of stress and reflexive biases. Over time, the size of individual transaction losses should be smaller than the size of transaction gains, the wealth management process should become less stressful, and year to year gains and losses should be less variable (more predictable).

A broad psychological, as well as economic, definition of wealth is valuable. As discussed in Chapter 4, happiness is shaped by an optimistic attitude that views life as a significant journey, instead of an overly focused drive for a defined destination. Enjoy the journey. Prudence or balanced expectations reduce the risks and frustration of stretching too far for the trophy asset destination or other symbol of economic wealth. Ultimately, the psychological price may be too high. Steady achievements of incremental milestones within risk tolerances often increase long term self confidence and happiness.

Analysis does not guarantee results. It leads to personal rules and principles used to reduce lost wealth due to personal emotional and cognitive behavior risks, estimated operational and market risks, and the impact of uncertain unknowns. Bias risks and majority owned operating asset risks are somewhat controllable. Passive asset holding operational risks and market risks are less controllable. So called good or bad luck will naturally occur as assets perform nearer to the best or worst case scenarios, instead of the expected scenario. Good cognitive habits and limited personal bias risks relate to values that are reflected in selected wealth goals.

Risk control habits reflect values

Values were discussed in Chapter 5 prior to goals and objectives because core attitudes and beliefs are closely aligned with risk control habits (sometimes called virtues). Household discussions about shared dreams, life plans, and wealth goals are about as meaningful as thoughtful discourse gets. Trusting talks implicitly value accountability. Tolerance for

complexity and stress normally show when communication is open and flowing. The openness and trust should result in agreeing on a household economic wealth risk manager. Yet the household together defines goals and objectives based on human and financial capital resources, risk tolerances, and planned life time horizons. The broad character traits or habits reflect values over time that naturally evolve into the wealth risk control system.

Goals set over a time horizon make objectives feasible

Wealth setting goals can be boiled down to reasonable expected objectives based on capabilities and time. An objective of being selected as a Noble Prize winner is unreasonable for an individual with normal intelligence and general interests. Necessary human capital and focus are missing. Yet an objective of retirement from daily work, independent time at a defined age, and spending accumulating wealth through end of life is reasonable for most self reliant households. The wealth time horizon is based on the household's view of its life time or that of children. That is the household life time or the legacy life time including children or more expansive causes. A longer time horizon allows tradeoffs between the level of risk taking and specific strategy selected. For example, a long wealth accumulation period and short wealth distribution period may allow a strategy of constant purchasing power spending through retirement to be achieved with risk free retirement assets. That is to receive acceptable SSA and pension or annuity payments for life time retirement spending.

Pie Charts and Extrapolations

Simple asset allocation pie charts and projected economic wealth accumulation and distribution cycles over time are incomplete. They overlook dynamic surprise changes in cash flow needs and the mix between unfavorable and favorable periods for growing wealth over time. Yet for many people, when used with scenario analysis, they visually portray the impact of risk taking better than simulating portfolio performances based on random asset return generators. The objective of so called Monte Carlo simulations is to estimate a minimum acceptable portfolio terminal value at an acceptable confidence (e.g. 90%) level. However, simulations are flawed due to limited referenced databases, unexpected return illiquidity impacts, and the inability to include variable interim cash outflows.

Scenario Analysis – Asset Returns & Structure

The following analysis illustrates that a sound wealth management strategy and risk control process can cope with significant differences in asset returns over a life time. It ignores the unpredictable number of possible retirement spending budget changes. Asset allocation pie charts and economic wealth graphs over time are used that rely on diversification. The analyzed wealth cycle time horizon is 50 years; i.e. the last 20 years of pre retirement wealth accumulation and 30 years of retirement spending wealth distribution. Two broad retirement spending resource strategy structures are presented; 100% investment accounts and 50% pension (annuity)/50% investment accounts.

Simple asset classes and expected returns

Five simple security assets are used:
 money market (MM) funds (CD’s, T Bills, etc.);
 bonds (BD) (Treasury, top investment grade);
 U.S. large capitalization (LC) stocks,
 U.S. mid/small capitalization (SC) stocks;
 foreign (developed and emerging market per capitalization weight) (INTL) stocks.
 For simplicity, inflation is not considered.
 All expected returns are real (inflation adjusted) with standard deviations (risk) shown in Table 1. Normal returns reflect annual increased global economic growth and the real cost of capital (debt and equity). Alternatively, asset returns reflect long term real risk premiums.

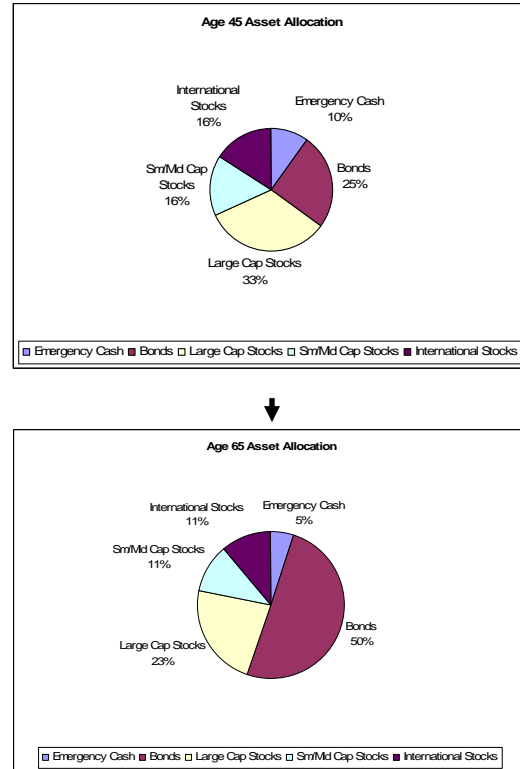
Table 1. Asset classes, annual returns, risk

Asset Class	Normal Return (%)	Std. Dev. σ (%)
MM	0	0
BD	1.5	0
LC	4.0	4.0
SC	6.0	6.0
INTL	6.0	6.0

Asset Allocation Strategy

The strategy reduces investment portfolio risk annually by shrinking equity asset (LC, SC, and INTL) weights. The portfolio equity proportion (50% LC, 25% SC, and 25% INTL) is held stable and its volatility (net risk $\sigma = 5\%$) is steady based on annual rebalancing. At age 45 the investment portfolio is weighted 65% equities and 35% bonds (including a 6 mo. salary emergency money market fund.) Each year the portfolio equity weight declines 1%, the bond weight rises 1%, and total portfolio risk declines. Therefore, at age 65 an all investment account is weighted with 45% equities in the above defined asset class proportions as shown in the Fig. 1 allocation pies charts.

Figure 1. Asset Allocation



Notice that at retirement, the emergency cash is 5% of the portfolio assets set aside for the budgeted annual spending. Part of the remaining 50% bond portfolio includes certain cash flows of bonds laddered to mature over the following 4 years. As the retiree ages, the number of certain future annual cash flows should increase. Also be aware that the age 65 retirements spending portfolio investment pie including savings (about \$1.45M) is expected to be nearly three times larger than at age 45 pie (\$0.55M).

Secular (Long Term) Good and Bad Scenarios

The long term investment return horizon is not certain. Secular (5 to 15 years) periods of generally favorable and unfavorable asset returns occur. Some financial analysts relate secular unfavorable periods to back to back recessions (e.g. 1969-1970 and 1973-1974 or 1980 and 1982.) While others take a longer view of unfavorable secular periods (e.g. 1969 to 1982) that include a series of recessions, multiple economic uncertainties (stagflation), and equity valuations (P/E ratios) falling from peak to nadir points. The period beginning in 2000 may include an extraordinary equity valuation that takes more than a decade to fully correct. The

favorable secular periods include robust economic growth interrupted by shallow recessions, and increasing equity valuations. The length of a full cycle is variable, usually spans approximately 30 years, and the favorable periods (above average returns) tended to last longer than unfavorable periods during the past 200 years of recorded data. Unfavorable periods often have sharper downturns than the steadier favorable upturn periods. Countries, which suffered defeats during the world wars of the past century, include many in Europe and Japan, experienced more dramatic past economic dislocations and more negative unfavorable equity return periods than the United States.

The following scenarios assume no major world war economic dislocations. Favorable and unfavorable equity return periods are the same five year duration and a normal return period is postulated between extreme periods. Since no one knows, if they will begin accumulating wealth during favorable or unfavorable periods, the scenarios provide a sense of achieving objectives during different times. The scenarios include: all normal asset return periods (expected case), 2 unfavorable periods and 1 favorable period (worst case), 2 favorable periods and 1 unfavorable period (best case). They cover the initial 35 years of the wealth cycle, where some investment assets are allocated to equity assets.

Real annual equity returns, as allocated in the above stated proportions, are expected to be 5%, 0%, and 10%, during expected, unfavorable, and favorable, respective 5 year periods. Unfavorable scenarios include two unfavorable periods (e.g. 1979-1983 and 1999-2003) and favorable scenarios include two favorable periods (e.g. 1984-1988 and 1994-1998) of real inflation adjusted after tax returns. Bond returns are expected to be a steady 1.5% throughout the wealth cycles based on the ability to ladder maturities regardless of inflation/disinflation surprises. Table 2 shows normal (expected), unfavorable (worst), and favorable (best) equity 5 year annual returns beginning at age 45.

Table 2. Equity Return Scenarios

Scenario/Age	45	50	55	60	65	70	75
Expected Annual %	5	5	5	5	5	5	5
Worst Case Ann %	5	0	5	10	5	0	5
Best Case Annual %	5	10	5	0	5	10	5

At age 80, the retired household is expected to take no further asset risks and simply invest in all intermediate term Treasury bonds that result in simple 1% to 0% real annual returns with time.

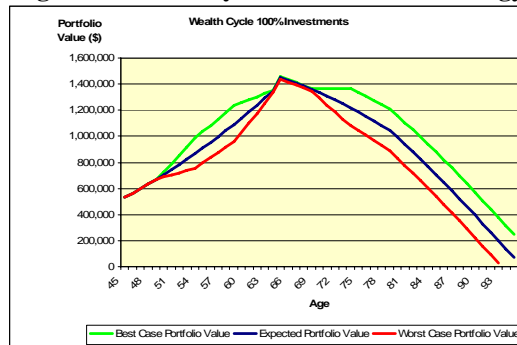
Personal Starting Net Worth & Spending Plan

The wealth cycle scenario graphs are based on regular savings (10% of gross income + 3% employer match), a constant real gross annual income (\$100,000), annual asset allocation risk reduction (and portfolio return reduction) as previously discussed, and \$65,000 annual retirement spending budget (in addition to \$20,000 Social Security payment and without \$10,000 annual savings.) Personal household wealth cycles vary widely and specific parameters will be much different than the analysis. The analysis provides a general order of magnitude approach for considering changes in a household’s life time wealth cycle.

All Investment Account Wealth Scenarios

The first set of expected, worst, and best case scenarios is based on a household assuming all investment risks. Neither member of the household has an employer pension or plans to purchase an annuity (which effectively transfers some retirement spending cash flow (return) risks irrevocably to an insurer). At age 45, the scenario postulates that a household has accumulated \$500,000 investible net worth and has an emergency spending account of \$50,000 (½ year income). About 5 years of spendable cash flows are assumed to be accumulated at age 45, which implies simple, but unusual discipline. The proposed portfolio does not included real estate or a small business, but those asset class equity interests can conceivably replace equity security assets if the home (or other real estate) or business valuation is adjusted quarterly and illiquidity risks are accounted for.

Figure 2. Wealth cycle – Investment Strategy



The Figure 2 100% Investment Accounts Wealth Cycle graph is also shown as a full page chart for better viewing in the attachment³ with detailed data. There are a number of conclusions to take away from the scenario analysis. A wealth cycle, which begins with a favorable period, and has more favorable period returns, will naturally accumulate more wealth and exceeds the goal of not running out of spendable funds by the age 95 time horizon date. However, if one favorable period and one unfavorable period occurs, the order of the periods makes a small difference of accumulated wealth at retirement (\$1.450M, \$1.439M, and \$1.455M for the expected, worst, and best case, respectively) at age 65. Regular savings is an important accumulated net worth smoothing factor. The best case scenario with an initial favorable period has a slight (<2%) advantage because portfolio risks and returns are higher at younger ages. That is likely a much smaller amount than most people would expect.

During retirement the initial withdrawal rate is about 4.5% (0.065/1.45). From a cash flow perspective, approximately 22 cash flow years of economic wealth are available at age 65 to spend during a goal of 30 years in retirement. The unfavorable equity return (0) period beginning at age 70 does have a noticeable impact as shown by the steep drop in the **worst case red line** on the graph. Remain aware that although no savings compensates for the unexpected lack of equity returns, only 40% of assets are held in equities at age 70. During the age 75 to 80 period normal annual (5%) returns are expected. Thereafter, no equity risks are assumed in any scenario. Even the worst case scenario results in retirement spending resources through age 93. The constant expected return wealth cycle is an unrealistic reference scenario. Good times, favorable bubble euphoria, and subsequent corrections occur in free market societies and will continue. Controlled societies (Communist, Fascist, Socialist) lack incentives that result in risks, opportunities, and free market higher societal wealth. The constant expected return reference does show a small buffer of about 1 year cash flow remaining at age 95. The **best case green line** favorable scenario returns provide a modest gift of 4 extra years of cash flow (\$246,600) at age 95. Notice on Figure 3 that the best case favorable returns nearly paid for all retirement spending between age 70 and 75. The unexpected resources can be spent on four more years of living or left as an estate gift, if the last member of a household dies at age 95.

Pension/Investment Split Wealth

Some households prefer to transfer investment risks. Pensions and annuities offer opportunities to transfer risks that relate to their expected life span (longevity risk). The issuer spreads risk over a large number of pension (annuity) contracts, so that average mortality life spans act as reference points for cash flow (asset/liability) management. An issuer's total asset/liability risk is effectively smaller than a household's individual longevity risk. If the household far outlives the average expected mortality, then unexpected long life cash flows are received. Behavioral biases lead more individuals to take a pension opportunity than to convert an investment account (401K, etc.) to an annuity. This appears to be due to focusing on possible lost remainder wealth to an annuity insurer, if the household members die before the current mortality table sample expected date of death. Nevertheless, pensions (if available) and annuities should be considered to reduce risk, as analyzed in the second set of wealth scenarios.

Charitable Remainder Trust Annuities

A purchased annuity can also be made through a gift to a non-profit organization, such as a health research institute or educational institution. The gift may be structured as a charitable remainder trust (CRT). Based on one's age, certain monthly annuity payments for life may be received with an institutional trust agreement. Charitable gift tax deduction benefits are also probable. You may check with your advisor to see if part of your combined retirement spending/gift objective may be achieved through a CRT.

Pension/Investment Split Wealth Scenarios

The second set of wealth scenarios split accumulated wealth into a pension (50%) and an investment account 50%. The household splits savings between a 3.5% contributory pension plan and 6.5% of gross income to tax deferred accounts, such as IRAs. The pension is expected to effectively grow a fairly standard corporate plan rate of 6.5% to age 65 net present value (NPV) each year. The IRA is expected to be invested similarly to the all investment account strategy described, where risk and returns are reduced with age. The household spouses are assumed to have worked for an employer for 15 years by age 45, accumulated a pension age 65 NPV of \$225,000, and plan to continue working for the employer until age 65. At that time, the pension NPV of more than \$750,000 is expected to pay cash outflow of \$45,000 annually for life.

The investment account IRA at age 45 is also valued at \$225,000 and an emergency cash account is valued at \$50,000. The total split wealth scenario assets, income, and investment returns are nearly equal to those of the all investment account scenario.

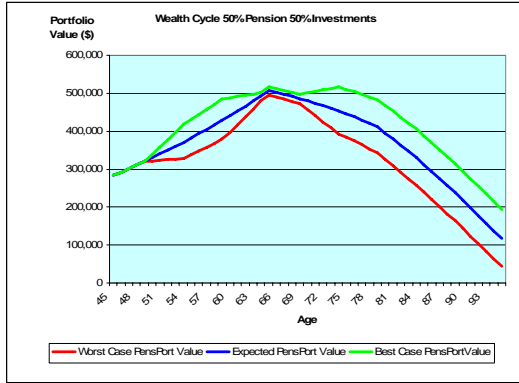


Figure 3. Wealth Cycle Split Pension / Investment Strategy

Figure 3 plots the change in investment account wealth only. The 50% Investment Accounts wealth cycle graph is also shown as a full page chart for better viewing in the attachment. The annual \$45,000 pension life time payments NPV would look like a straight line (if plotted) from age 65 to the date of death. Assuming death at age 95, over 30 years the issuer effectively converts \$25,000 of risk free cash flows into \$45,000 annual payments. Yet, at 2004 mortality table expected life of 17 years from age 65, the total of \$45,000 risk free cash flows are paid out without any residuals to the issuer or the pension (annuitant) receiver.

The 50% investment portfolio only is shown in Fig. 3. Note that the at-risk investment account accumulates to only about \$500,000 at age 65 retirements in the expected, worst, and best case scenarios. To achieve a total annual retirement spending plan of \$65,000, the investment account must provide only \$20,000. The initial withdrawal rate is 4.0% (0.02/0.50). From a cash flow perspective approximately 25 cash flow years of economic wealth are available at age 65 to spend during a goal of 30 years in retirement. By comparison, to the all investment account strategy, the split pension/investment strategy has more economic assets at retirement (age 65).

The investment account portion of wealth resources shows the same accumulation pattern as the all investment account strategy, as

expected. Yet, there are less total wealth assets at risk. Similarly, due to the age 65 accumulated investment assets slower withdrawal rate, it should be expected that the worst case unfavorable return scenario does not run out of resources at age 95. About 2 years of \$20,000 cash flows are available at age 95 in the worst case scenario and nearly 10 years of annual cash flows (\$194,600) are available in the best case scenario. (I don't personally know anyone yet, who lived to age 105.) For completeness, note that the all investment account best case scenario is estimated to have about 25% more accumulated wealth (\$246,600) than the split pension/investment strategy at age 95.

Disciplined illiquid strategies for consideration

A wealth strategy based on illiquid assets may be more or less risky than one based on a diverse portfolio of liquid, easily marketable assets. The key factor is the amount of control and profitability of the asset. A well run business with an exclusive franchise in a patented good or hard to duplicate services may expect long term 5% annual after tax returns. Cash flow and a significant reserve account will be the key to adjusting to broad economic downturns or specific new forces as discussed in the Chapter 7 Porter Competitive Advantages model. A key risk with illiquid assets is financing. Highly leveraged assets, such as real estate, are very vulnerable to the relatively long 5 or more year periods of stagnant or declining property valuations. If operating losses can not be sustained, then property sales at large losses or a bankruptcy process may be necessary to legally terminate the business at a loss to both owners and creditors.

The scenario analysis provides a working model to consider an appropriate wealth cycle strategy based on approaches for assuming or transferring risks. There is no absolute correct answer. Each household has its own emotional and rational biases to consider in a life time full of risks. The attached spreadsheet allows asset market returns (related risks) to be changed. Adjustments may include for example expected returns, annual spending, or nominal (inflation estimations) changes. More critically, consider changing the savings amount in the spreadsheets and notice the difference between changes at an earlier age and a later age. All the great scientists (Newton, Einstein, etc.) noticed the impact of compounding by either asset rates of return or annually adding more assets to the growing sum.

Legacy Strategies – Time Horizons

It is simplest to consider retirement spending objectives separately from legacy family or special cause objectives. Although parents generally want the best for their children, their capacity and determination to actually set the conditions for a self sufficient family wealth legacy are limited. Premature death or spousal irreconcilable differences may overwhelm the family legacy goal. Usually economic survival for an independent retirement phase of life takes priority over a family legacy or providing gifts to special causes. However, that does not mean that dual objectives and related wealth strategies should be mutually exclusive. The strategies may even complement each other, if considered creatively.

The family legacy strategy may be supported with start up or project funds for a child's business endeavor. Common sense would encourage including independent (arms length) sources of funds as well as a child's own funds in order to keep him or she focused. In due course, parents normally modify agreements faster than banks, which are accountable to shareholders. Nevertheless, the process may both increase family (child's) legacy human capital, as well as ensure payback cash flows for retirement spending. The wealth cycle will not be as smooth as shown in the examples. However, the key is to remain flexible and accumulate enough resources to deal responsibly with inevitable changes along the journey.

The gifting or special cause legacy strategy may also complement and not necessarily be secondary to the retirement spending strategy. It is normal to plan to do something in honor of a loved one, who suffered and died of a cancer, heart attack, or other disease.

Not everyone has the capacity of Lance Armstrong to raise considerable resources to better understand and consistently neutralize the type of cancer that he overcame in order to dominate the bicycling sport. However, his process of gifting, monitoring, and measuring progress is instructive. He likely develops added human capital in terms of focus, communication skills, and inspiration while proceeding with both raising funds for his cause and training to return to compete in the cherished sport of Europe.

There is no guarantee that the retirement spending objective will be fully achieved, if cash flows are concurrently routed to a gifting objective. Yet it may be worth considering, instead of making the gifting objective an end of life estate bequest. Concurrent gifts imply parallel periodic cash outflows to retirement spending and the selected charitable cause. Time horizons or the duration of total cash outflows would be shorter, since all resources are planned to be spent prior to death. Therefore, the investment resources for the gifts would be managed with moderate to low risk taking, similar to the retirement spending investments. The previously discussed CRT's are a lower risk strategy to achieve both annuity retirement spending cash flows and fund a selected charitable cause. In any case, similar to family legacy wealth building, long term gifting develops a non- economic bond. Periodic visits to the institution develop a better understanding of and involvement with the cause. A sense of fulfillment and the elusive concept of happiness or sense of achievement may result in a cerebral wealth during an extended retirement period.

An Active Investor's Strategies

The focus of this wealth guide has been for educated individuals, who are interested in a simple wealth cycle process, instead of an avocation that requires significant time and effort. Yet for those active investors, who want more dynamic ideas, core and satellite strategies were discussed in Chapter 13 Asset Allocation – Strategic Decisions. The satellite active strategies were suggested for no more than 50% of investment assets. If the active strategies use assets that are traded daily on exchanges, then tactical rules will require as much effort to master as the overall asset allocation strategy. The major trading desks of investment bankers, such as Goldman Sachs and J. P. Morgan, make profits with sophisticated trading algorithms that spread risk over baskets of assets with fast computer transactions. They are the competition of active strategists, who often turnover all portfolio assets more than once a year.

A good idea is to compare the quarterly performance of the active portfolio with the passive mutual funds (market) portfolio. If the active account grows more than the passive account over time, then the avocation provided a profitable reward for the effort. In the investment world, that is called alpha, α , which most people do not take away from the market

(or from those whose performance accordingly lags the market.) Otherwise, the comparison to real market assets gives clues as to when and why the active strategy is strong or weak.

Active decision investing

An area of active investing expertise often relates to market inefficiencies. That is relatively low trading volume (under the radar of professionals) assets, where selling is most likely to occur for economic, tax loss harvesting, or psychological reasons. It is also where buying is limited because the float of shares outstanding is too small for big investors to take a meaningful position or the potential long term profitability of the asset is not yet recognized by the market. Some opportunities for the knowledgeable investor relate to seasonal factors (e.g. tax loss selling) that cause the supply of an asset to be abnormally high. The asset may be purchased (on sale) and sold back to the market a few months later during normal supply/demand balances at perhaps a 10% gain without any change in underlying asset operational value. Other opportunities may be referred to as ten baggers, based on their potential to increase ten fold (e.g. from a price of 10 to 100) in value over a long period (e.g. 10 years or about a 26% compounded annual growth rate). There will likely be many more losing positions than big winners, when dealing in the field of small capitalization potential high growth stock assets. Reading SEC filing and having actual experience in an industry may provide the information edge to profit in areas of somewhat illiquid and inefficient markets. Special knowledge about an asset or the market of potential buyers and sellers may also provide the information edge to profitably invest a satellite portion of one's investment portfolio.

Active management selection

Owning actively managed mutual funds is a different strategy than holding passively managed index (asset category universe) mutual funds. In the context of wealth strategies, owning actively managed mutual funds is a satellite subset to owning core passive index mutual funds. Holding hedge funds and various types of partnerships are also satellite subset strategies. Actively managed funds share the characteristics of greater annual expenses, higher asset turnover (distribution taxable gain expenses); and strategy risks are normally higher than passively managed index mutual funds. The behavioral bias of following the herd to purchase

a fund that dramatically increases assets under management after very good recent returns usually results in below passive asset comparable future market returns.

The following guidance for selecting active asset fund managers is suggested.

1. Understand how the characteristics of the asset class (small stocks, international, hedge) fund to be considered fit into your overall investment portfolio strategy. Does it increase expected portfolio returns, while holding overall risks the same?
2. Read the active asset fund prospectus, statement of supplemental information, most recent annual and semiannual reports. Do you think the objectives and strategy statements rely on a superior process and information to exceed the passive asset fund over the next 5 years? (They should.) Has the current fund manager been responsible for the past 5 year results and does he/she plan to manage the fund in the future?
3. Have the majority of recent year returns beat the benchmark index and has the volatility (σ) of the past 5 year returns been less than the asset category active manager average?
4. Are the operating cost statistics favorable? Annual expenses and portfolio turnover less than 50% of similar asset active managers?
5. Plan to hold a fund for about 20 years, if the above criteria and your overall portfolio construction criteria remain favorable. Find a fund that you expect to perform 2% annually better than the reference passive fund. That is a fund that should outperform the passive fund total return by 50% over the next 20 years. (That is a reasonable expectation.) Initially hold no more than 5% of your total portfolio in a single active fund. Add no more than 5% to an active fund that exceeds expectations.

Remember less than 20% of active mutual fund total after tax returns exceed reference passive index fund returns over 10 year periods. Many poor performing funds do not survive and are either merged into other funds or are terminated. A satellite investment portfolio strategy may be to select five superior well diversified actively managed funds. Hedge fund selection is complex and arduous for most individuals. Successfully selecting active funds that exceed the passive reference funds is very difficult for professionals and everyone else alike!

Summary

- Decide on wealth strategy accumulation and distribution time horizons carefully.
- Select investment portfolios, pensions, and annuity weights based on personal risk tolerances and risk boundary stress reduction points.
- Input your investment and annuity portfolio at the appropriate age into the attached wealth cycle spreadsheet. Play with it. Does your strategy meet your wealth objectives?

References

¹Berra, Lawrence A. Yogi, *When You Come to a Fork in the Road, TAKE IT!*, 2001

²Berra, Lawrence A. Yogi, *You Can Observe a Lot by Watching*, 2008

³Banach, Joseph, *WealthCycData.xls*, 2009