



The Paradox of Wealth

Why effective investment gets more difficult when it should be getting easier

Your many years of hard work pay off. Your net worth leaps forward. Your assets reach eight digits. It's the American dream fulfilled.

And now, firmly entrenched in the ranks of the wealthy, it seems that investing should be easier than ever. But it's not. Unfortunately, just when it seems that investing should become less demanding, it become more difficult, or at least more confusing.

Let's take a look at five key factors that conspire to confound wealthy investors...and what can be done to relieve the confusion.

1. Investment Sirens. Odysseus faced the lilting voices of the Sirens on the rocks. The wealthy face similar dangers: the relentless sales pitches of brokers, personal bankers, investment advisors and money managers. A high net worth is sure to draw considerable attention from all corners of the investment industry; and while the attention may be flattering, it may not be very helpful.

Here's why. Much of the mainstream investment industry is built on a foundation of intricate interrelationships – a fancy term for conflicts of interest. For instance, advisors are commissioned to sell proprietary or “preferred” families of investment funds, which often carry unnecessarily high costs. Broker-dealers recommend a short list of money managers who agree to run trades through the recommending brokerage. Personal bankers are often beholden to large hierarchical corporations that set targets for new business and fee revenues.

And then there are “soft-dollar” arrangements. These practices, while legal (at least for now), are clearly counter to the interests of investors. In a soft-dollar scenario, the trader charges the broker or investment advisor an inflated commission for making trades. The trader, in turn, uses the windfall to pay for services (such as computers, data feeds or research) on behalf of the broker or advisor. The inflated commission, of course, is passed on to the investment client. The net outcome is that the investor pays too much for trades (the real cost of trading is very close to zero), with the proceeds being used to pay for services that the broker should be paying on its own. Until the SEC closes this door, the investor suffers.

Clearly, these various conflicts of interests may lead to investment recommendations that are optimal for the service provider, not for the client. At minimum, the many competing suggestions will confuse, as the portfolios recommended by different advisors will vary widely.

2. Financial corkscrews. Today's wine enthusiasts can choose from dozens of devices to uncork bottles of pinot and cab, many priced at fifty to two hundred dollars. The most elaborate devices may be minor marvels of design and engineering, but ultimately they serve the same function as a utilitarian three dollar corkscrew.

It's the same story in the financial world. The greater one's resources, the greater the range of available investment vehicles, from sophisticated private equity funds and elaborate hedges to tempting offshore offerings. In sifting through the options, it is easy, even natural,



to be attracted to needlessly intricate or complex plans and products. But paying more for fancier investment structures not only reduces the ultimate returns, it also diverts time and attention that would be better spent on the basics of sound portfolio creation.

3. Affinity for risk. Many successful entrepreneurs attain wealth by embracing business risks that others shun. This risk habit can be a tough one to shake; it follows some investors into the financial markets where it may lead to poor investment choices.

In truth, for most wealthy individuals, capital preservation is a more appropriate goal than trying to generate the highest possible return. Making the mental shift toward a more prudent, less risky strategy is a challenge for many, but an important one nonetheless.

The shift can be especially difficult as many of the most risky investment options are open only to people of considerable net worth (who are, presumably, better prepared for significant losses). The exclusive nature of these extremely risky investments may appeal to the entrepreneurial personality, but the high risk level is rarely compensated with sufficient return.

4. Tax blindness. Any wealthy individual can attest to the huge impact that taxes have on personal financial matters. Ironically, much of the investment industry pretends to ignore this reality.

Because pre-tax returns are generally much more attractive than after-tax results, it is convenient for sellers of many financial products and services to approach the world as if taxes were just a theoretical nuisance. Even though evaluators like Morningstar are able to compile and report after-tax returns, the investment companies generally prefer to stay mum. Money management advertisements and marketing materials, for instance, routinely tout pre-tax results, even though high-turnover trading tactics employed to generate those returns may create significant capital gains tax obligations for investors. Many money managers take the same don't-ask/don't tell stance on taxes. Likewise, brokers who make any investment recommendations without fully understanding the client's tax status are ignoring a critical aspect of the equation.

In the real world all that really matters is what's left after taxes. Given that the financial industry does too little to reveal after-tax results, the wealthy investor must work harder to fill the tax information gap or find someone who will do it for him.

5. Do-it-yourself syndrome. Managing a successful global business and managing one's sizable investment portfolio are two very different tasks, requiring different knowledge, skills and relationships. This is the lesson quickly learned by wealthy individuals who, having earned their fortune through intensive, hands-on leadership, attempt to rule their own investment empires in the same way.

Do-it-yourselfers are prone to a long list of mistakes, including poor asset allocation, inadequate diversification, reliance on past performance in selecting investments, insufficient focus on costs and fees, overconfidence in areas of limited experience and the tendency to chase investment fads. While all of these performance problems can be improved through experience, the time and learning commitment necessary to do so is prohibitive for all but the most dedicated investors.



Securing professional help is a better option for most wealthy individuals – in the same way that serious illness is better treated by healthcare professionals than through do-it-yourself alternatives.

Finding the right advice

Because investing becomes more difficult when it seems like it should be getting easier, wealthy individuals can enhance their results and avoid many potential headaches by working with a trusted advisor. The trusted advisor helps the investor set appropriate financial goals and build a portfolio of investments likely to attain those goals with an appropriate level of risk.

Finding a truly unbiased, conflict-free, non-commission advisor can be a challenge, but the effort is worth it. Such professionals *are* out there, but are most likely to be found outside of the large, brand name financial institutions, which, by their very structures and business models, are prone to conflicts.

As an alternative, the family office model – where a small staff, supported by an extensive network of specialists, manages the financial assets of the family in accord with the goals and needs of family members – is an appealing choice for many. Family offices are compensated by the family, not through commissions, kickbacks or soft-dollar arrangements. And because they are independent firms rather than divisions of brokerages or banks, family offices are beholden only to the families they serve, not to shareholders or multiple layers of executive management. This structure allows a true long-term approach to wealth, where success is measured over generations, not on a monthly or quarterly basis.

Family offices, because their goals are fully aligned with their clients', can provide true transparency on expenses, after-tax returns and the rationale behind any investment recommendation.

Yes, managing wealth is a considerable challenge, but it need not be a personal burden to a wealthy individual. Powerful unbiased and service-oriented guidance is available. Which means that Sirens and corkscrews and other pitfalls of personal wealth management can be completely avoided.