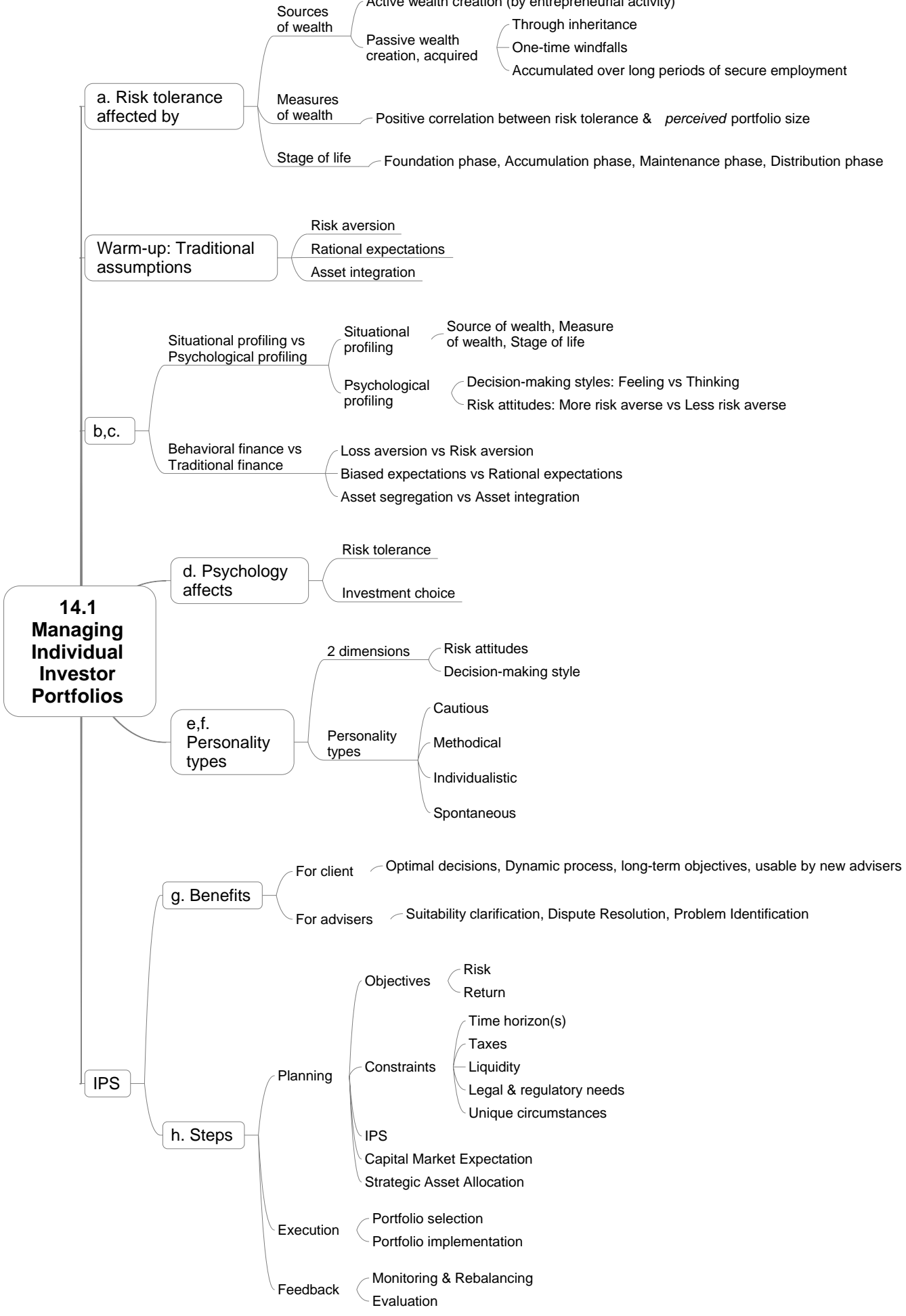


CFA LEVEL 3

STUDY SESSION 4

PRIVATE WEALTH  
MANAGEMENT



**14.1 Managing Individual Investor Portfolios**

a. Risk tolerance affected by

- Sources of wealth
  - Active wealth creation (by entrepreneurial activity)
  - Passive wealth creation, acquired
    - Through inheritance
    - One-time windfalls
    - Accumulated over long periods of secure employment
- Measures of wealth
  - Positive correlation between risk tolerance & *perceived* portfolio size
- Stage of life
  - Foundation phase, Accumulation phase, Maintenance phase, Distribution phase

Warm-up: Traditional assumptions

- Risk aversion
- Rational expectations
- Asset integration

b,c.

- Situational profiling vs Psychological profiling
  - Situational profiling
    - Source of wealth, Measure of wealth, Stage of life
  - Psychological profiling
    - Decision-making styles: Feeling vs Thinking
    - Risk attitudes: More risk averse vs Less risk averse
- Behavioral finance vs Traditional finance
  - Loss aversion vs Risk aversion
  - Biased expectations vs Rational expectations
  - Asset segregation vs Asset integration

d. Psychology affects

- Risk tolerance
- Investment choice

e,f. Personality types

- 2 dimensions
  - Risk attitudes
  - Decision-making style
- Personality types
  - Cautious
  - Methodical
  - Individualistic
  - Spontaneous

g. Benefits

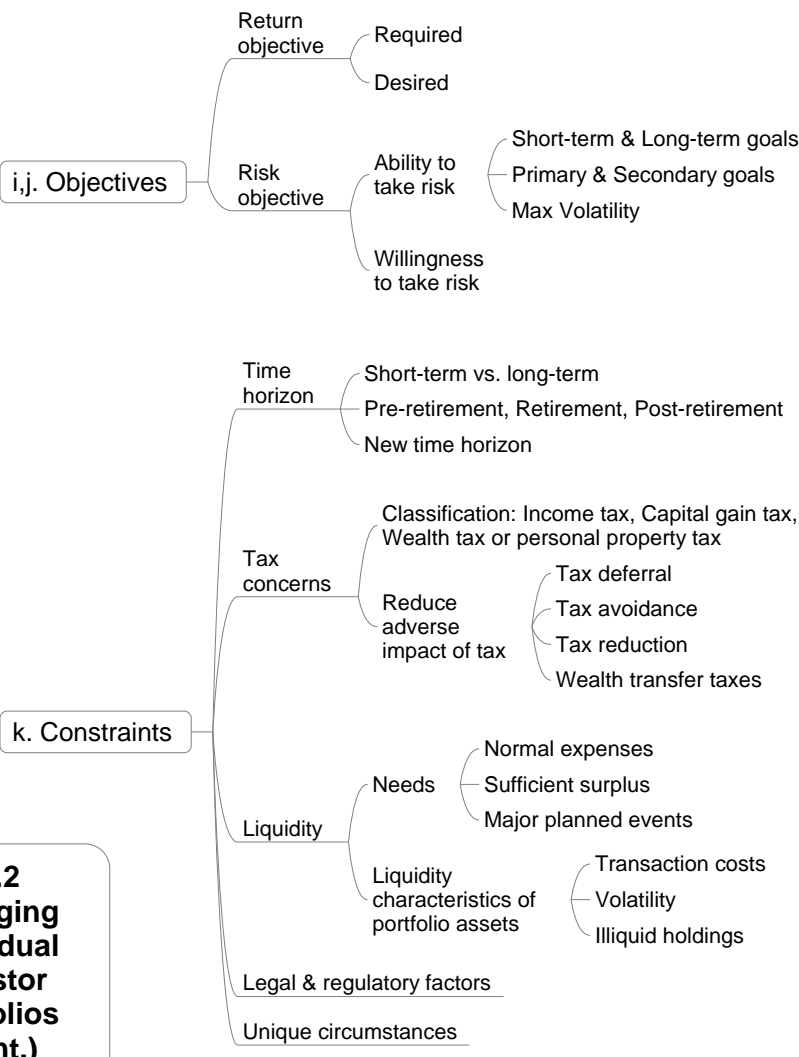
- For client
  - Optimal decisions, Dynamic process, long-term objectives, usable by new advisers
- For advisers
  - Suitability clarification, Dispute Resolution, Problem Identification

IPS

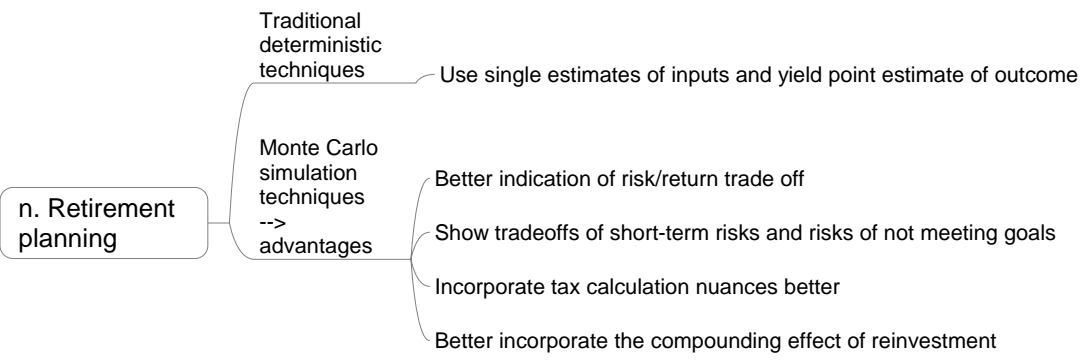
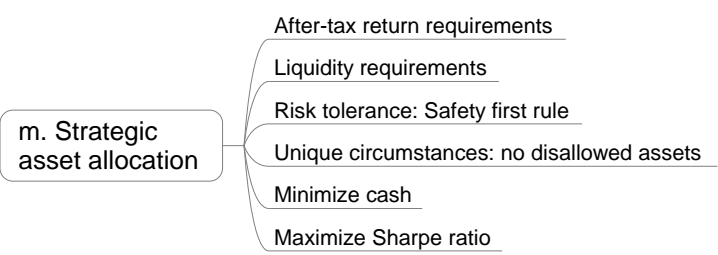
h. Steps

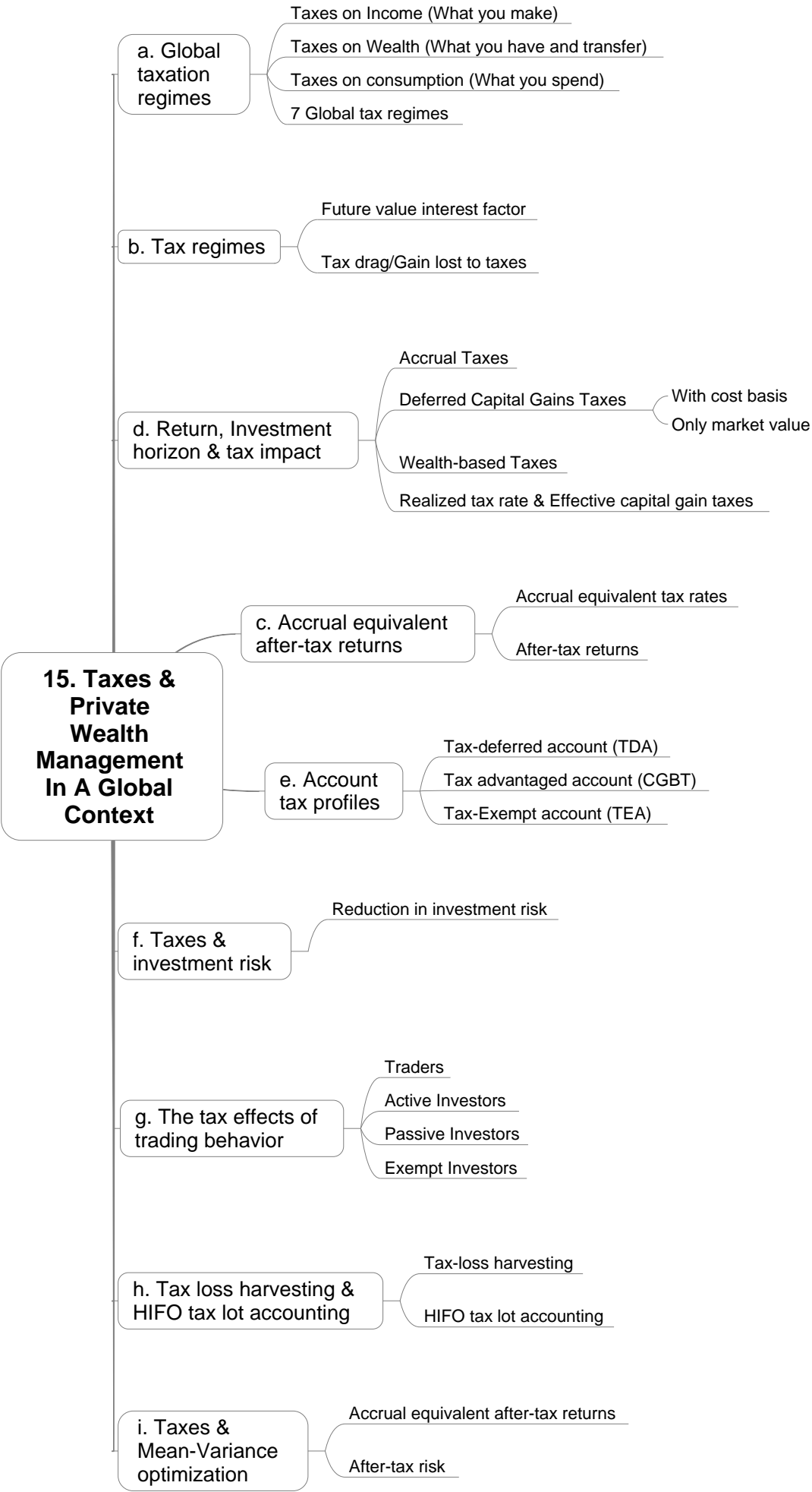
- Planning
  - Objectives
    - Risk
    - Return
  - Constraints
    - Time horizon(s)
    - Taxes
    - Liquidity
    - Legal & regulatory needs
    - Unique circumstances
  - IPS
  - Capital Market Expectation
  - Strategic Asset Allocation
- Execution
  - Portfolio selection
  - Portfolio implementation
- Feedback
  - Monitoring & Rebalancing
  - Evaluation

# 14.2 Managing Individual Investor Portfolios (Cont.)



I. Formulate & justify an IPS for an individual investor





a. Global taxation regimes

- Taxes on Income (What you make)
- Taxes on Wealth (What you have and transfer)
- Taxes on consumption (What you spend)
- 7 Global tax regimes

b. Tax regimes

- Future value interest factor
- Tax drag/Gain lost to taxes

d. Return, Investment horizon & tax impact

- Accrual Taxes
- Deferred Capital Gains Taxes
  - With cost basis
  - Only market value
- Wealth-based Taxes
- Realized tax rate & Effective capital gain taxes

c. Accrual equivalent after-tax returns

- Accrual equivalent tax rates
- After-tax returns

**15. Taxes & Private Wealth Management In A Global Context**

e. Account tax profiles

- Tax-deferred account (TDA)
- Tax advantaged account (CGBT)
- Tax-Exempt account (TEA)

f. Taxes & investment risk

- Reduction in investment risk

g. The tax effects of trading behavior

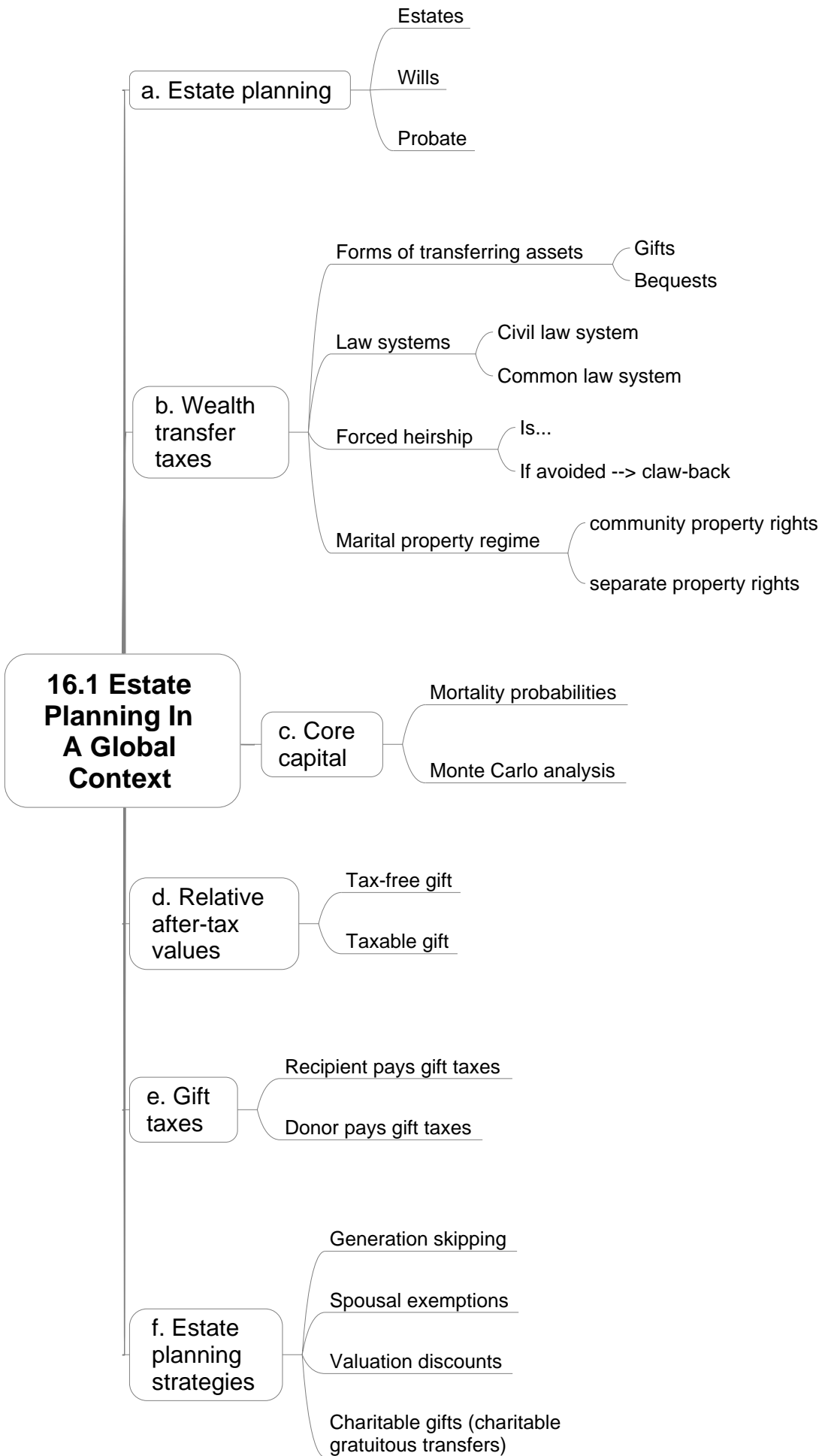
- Traders
- Active Investors
- Passive Investors
- Exempt Investors

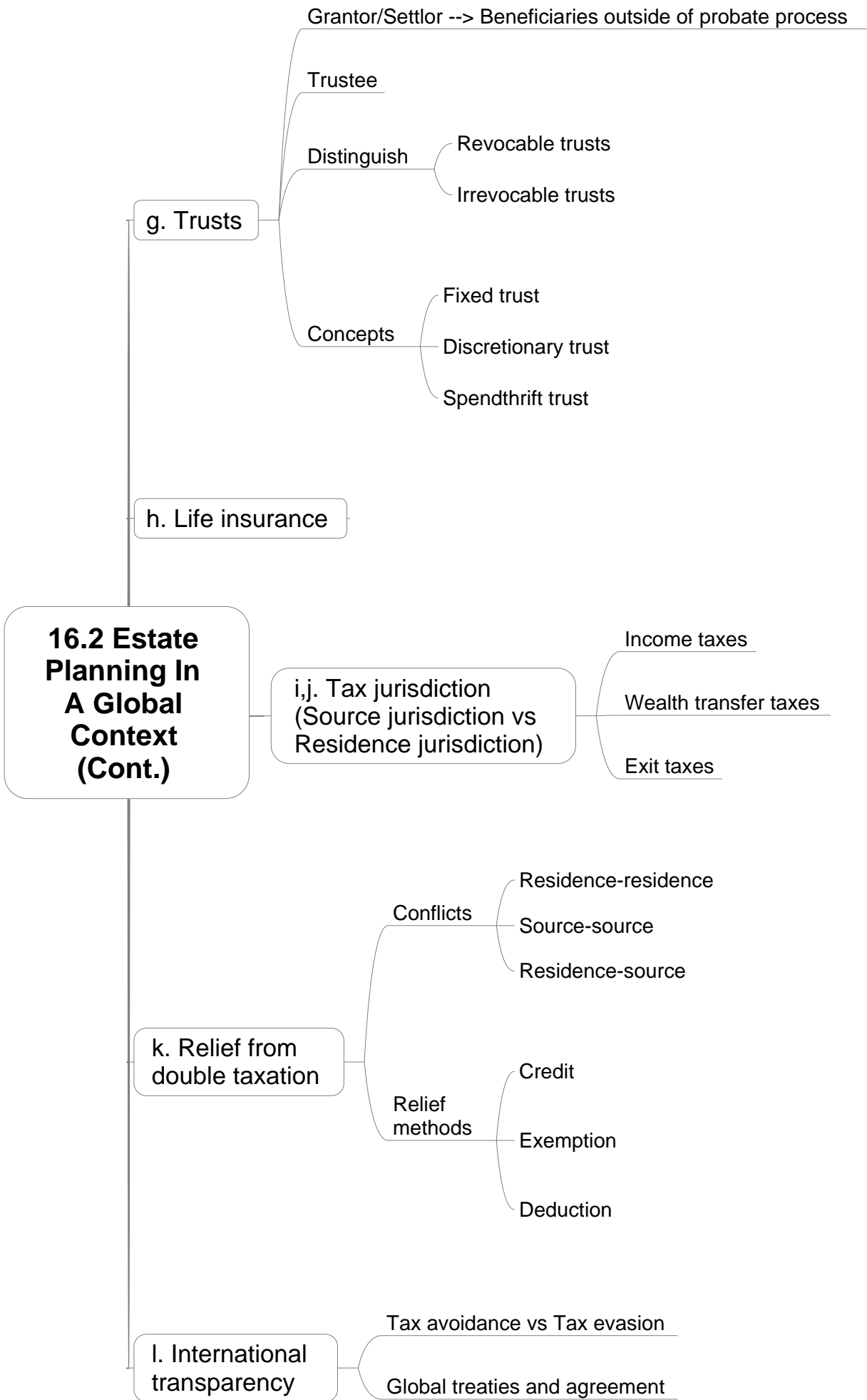
h. Tax loss harvesting & FIFO tax lot accounting

- Tax-loss harvesting
- FIFO tax lot accounting

i. Taxes & Mean-Variance optimization

- Accrual equivalent after-tax returns
- After-tax risk





Source of wealth    Psychological Issues    Risk Considerations

Entrepreneurs

a,b,c.

Executives

Investors

Equity holding life

## 17. Low Basic Stock

d. Diversification techniques

Outright sales

Exchange funds

Public exchange funds

Private exchange funds

Completion portfolios

Hedging

Equity collars

Sell calls and Buy puts

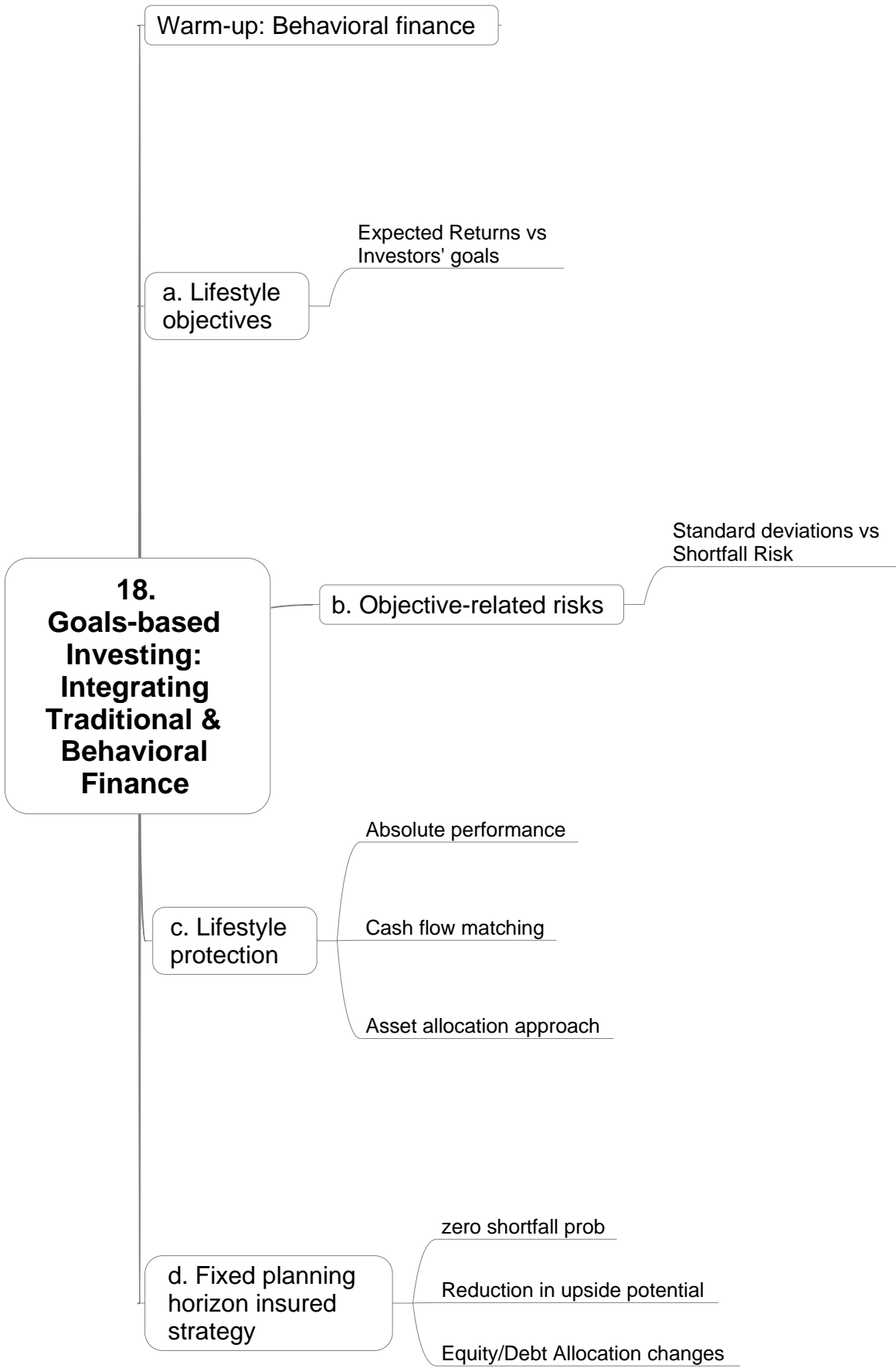
No constructive sale

Short identical securities

Swap of the same notional amount

Forward contract of same/identical assets

Variable pre-paid forwards



# 19. Lifetime Financial Advice: Human Capital, Asset Allocation & Life Insurance

a. Human capital

- Formulation
- Human Capital vs Financial Capital
- Equity-like vs Debt-like

b.

- Earning risk
  - Savings rate
  - Correlation of human and financial capital
  - Relative risk
- Mortality risk
- Longevity risk

c. Asset allocation policy

- Total return perspective
- Risk allocation

d. Life insurance

- Formula:
- Probability of death
- Bequest desire
- LIPO (Life Insurance Payout)
  - Financial wealth & demand for life insurance
  - Human capital volatility & demand for life insurance
  - Risk aversion & demand for life insurance
  - Probability of death & demand for life insurance

e. Risk in retirement

- Financial market risk
- Longevity risk
- Savings risk

f. Longevity hedges

- Fixed annuities
- Variable annuities

g. Exam review