

Do You Perceive a Contradiction?

Examining the Premises of Financial Advising

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“Everything that can be invented has been invented.”
- Charles Duell, Commissioner U.S Patent Office 1899

How is that for talking yourself out of a job! It is easy to become smug with our knowledge. When it comes to investing, there are many that think we have already invented all of the “best practices” financial advisors should apply and it is just a matter of getting advisors and their clients to execute the “proper” steps of these practices.

There are industry associations that promote, train and educate advisors to apply these “best practices.” Boards and councils of these organizations establish “standards of practice” amongst the various “best practice” disciplines. These organizations promote these “best practices,” offer certification programs and grant designations to those that complete coursework that demonstrates competency in these disciplines. Many also require continuing education focused on deepening an advisor’s knowledge within the respective discipline.

Have all of the best ideas already been created? Has the market at large adopted these practices? Do these disciplines perform as advertised...that is, when clients buy the services of an advisor that applies one of these disciplines, do they actually receive what the advisors purport to deliver? Finally, do investors truly understand what they are buying with these services and if they did completely understand it, would it be something they would value?

“If you perceive a contradiction, check your premises.”
- Francisco to Dagny in Atlas Shrugged by Ayn Rand

In this paper, I will systematically and objectively examine the premises that serve as a foundation of the financial services industry’s best practices. I will expose obvious contradictions within these disciplines that are generally either ignored or evaded. Finally, I will propose new premises that resolve the contradictions. All of this will be done from only one perspective...the end client.

This means that I will not be serving any influence peddler of a powerful association, nor any academics or Nobel Laureates. Instead I will stay laser focused on what a rational consumer of financial services should reasonably expect from their advisor. Providing value to the client is what the industry is *supposed* to be about.

Perhaps we have not yet invented everything that could be invented to serve our financial services clients.

It may be helpful at this point for you to understand a bit about the author of this paper. I’ve been in the financial services business for twenty years, starting as a financial advisor and then moving into management when I couldn’t sell in good conscience what I was asked to sell. In the late 1980’s, I had the good fortune of landing a position with a consulting firm that was an early leader in the discipline of Investment Consulting (wrap programs). This firm helped many major brokerage firms enter the more objective asset based fee businesses. I ended up accepting a position with a major regional brokerage firm that was one of their clients to ultimately lead their Investment Consulting Department.

As Managing Director of Investment Consulting for a major firm, I became very active in various industry associations and organizations including the Institute for Certified Investment Management Consultants (ICIMC), the Investment Management Consultants Association (IMCA - ICIMC and IMCA have since merged under IMCA), and the Asset Consulting Roundtable which was composed of my peers from

several other firms. I obtained the certifications offered by both investment consulting organizations (Certified Investment Management Consultant - CIMC, and Certified Investment Management Analyst - CIMA which IMCA offers through a program at Wharton).

As the department I managed grew to several billion dollars in assets (it was a lot of money at the time) through our efforts to train the firm's commission based brokers to become fee-based advisors, I became even more active in the industry. IMCA invited me to serve on their Advisory Council which I did for several years and ultimately was serving as chairman of the Advisory Council at the time of my resignation a few years ago.

I also was offered the opportunity to serve on the Investment Advisory Committee of the \$30 billion Virginia Retirement System and I served on the committee for several years.

After spending over a decade studying, promoting, training advisors and generally advocating the industry "best practice" of the Investment Consulting process, I took a step back to objectively examine what we had accomplished *for our clients*. It was difficult. There was no doubt that in general their portfolios were more diversified than they would have been with a traditional broker. Other than this fact though, from the client's perspective was there any other evidence that we accomplished something for them, based on what *they valued*? The answer in most cases was a resounding No and in the cases where value existed its cause could have been luck rather than skill. There was no definable proof of value other than diversification.

It has been a long and hard road. There were six hundred thousand registered brokers in the country, and less than 1% of them were members of an Investment Consulting association. I started examining the Financial Planning industry and while its history as a discipline at the retail level spanned a longer time frame than Investment Consulting, and it had grown to encompass forty thousand members; together these two best practice disciplines still accounted for less than 8% of the financial advisors in the country.

With a twenty year history promoting these two disciplines, with trade magazines constantly extolling the virtues of these best practices, with firms investing millions in training programs, technology, incentive payments and recognition conferences, how many clients and how many advisors actually ended up *practicing all of this preaching*? The answer was an embarrassingly small percentage.

How, after two decades of investment, could these disciplines merely scratch the surface of the industry? I perceived a contradiction. I didn't have much of a history in Financial Planning, so I did more research on it. I learned in detail the steps generally utilized, the information generally gathered, the technology utilized and the advice generated. I also sought feedback from actual financial planning clients and those that rejected planning to better understand their perspective.

There was definitely a contradiction here, but how could this be? The industry consistently acknowledged these disciplines as best practices. I thought to myself, "Who am I to question the wisdom of an entire industry?" I had an open mind; after all I listened to the experts that taught me these disciplines well before they were popularly labeled as best practices. Like a young puppy learning new tricks, I recited the words that my open mind absorbed from these experts. In years of reciting these words, I actually became one of those experts and created a legion of open-minded advisors that recited the words I spoke.

But an open mind (accept statements without necessarily considering them) is not necessarily the same thing as an *active mind* (consider if statements are reasoned). While an open mind listens, and generally

accepts “expert statements” as facts (after all they are from “experts”), an active mind will *attempt to understand the rationale* of the statement. An open mind might accept the statement from the Commissioner of the US Patent Office that said everything that can be invented, has been invented...or that the earth was flat...or that the sun revolved around the earth. I realized that while an open mind in society is generally viewed as a positive thing, it does not advance us to find *truth*. Sometimes experts are wrong.

Throughout history, mankind’s advancement has come from *individual active minds* that were willing to challenge expert conventional wisdom. Whether we consider Copernicus, Galileo, or the inventors since 1899 that proved new inventions were possible (despite the patent office commissioner that said otherwise), their accomplishments came from an unwavering *focus on the truth* and *using their active mind* to overcome the inaccuracies of the expert conventional wisdom of their day, based on *their active mind’s* perception of a contradiction.

I perceived the contradiction in our industry, but that was only the first step. There was no expert to go to discover the truth. They all “knew” they were right. Like the experts that said you would sail off the end of the earth if you tried to prove them wrong, they responded by saying “everyone knows” these are best practices (evading considering the contradiction posed). When they were asked why few were applying these disciplines, “The reason so few use the best practices is we ‘need’ more training, more incentives, more technology, and more time,” they defensively cried.

To see your way through this, you will need an active mind. An open mind here will not help because the experts you listen to will tell you there are no contradictions. Like the difficult step I had to take, you will need to use your active mind and think about what makes sense, what is a contradiction, and what premises resolve the contradictions. So as you read through my examination of the contradictions of the industry’s best practices, do not open mindedly accept the words I composed on the page, use your active mind and form your own judgment.

Taking a Step Back

With the industry and their clients charging forward at a snail’s pace in terms of adopting the best practices, I thought the first place to start would be at the very beginning of what makes *any* product or service successful. Perhaps I might discover some contradictions here that caused advisors to be slow at adopting (and clients almost absent from demanding) these services. Maybe if I forgot that we are talking about financial services and looked at it from the perspective of what it takes for ANY product or service to be valued, some explanation for the cause might be within my grasp.

So what does it take for a product or service to make it in the market? We are talking about people parting with their money (something they value) to obtain something they value more. One might surmise therefore, that they must either have a *need* for the product or service (we part with our money to obtain food, shelter or medical services...all needs of sustaining our life, something we wish to keep), or a *desire* for the product or service (nice-to-haves that are not required for survival, but make life more pleasant like a microwave, a stereo, artwork or a housekeeping service, something we wish to obtain).

Is this a reasonable premise? Does a product or service “make it” in the marketplace if it is not needed or desired? I struggled to find something that had a market demand...i.e. people voluntarily parting with their money to obtain it in the absence of a threatening demand (taxes) or guilt (charity). I concluded that people do not *voluntarily* seek a means of parting with money they value for a product or service they do not need or desire.

Products and Services Must Meet a Target Market Need or Desire

If I invent a new product or service that meets a need or desire in the market place, what do I have to do to succeed with it? Perhaps I am in my garage having just discovered a machine that sucks green house gases from the air and converts them into energy. That would be quite a discovery! I disconnect my electrical service and hook up my invention to my circuit box and I never pay another electric bill again. If that is all I did with the invention, if I didn't tell anyone about it, if I evaded my neighbors' curious inquisitions as to why the lights in my house remained on during a recent power outage ("Do you have a generator?" they ask, and I say, "Well, sort of."), I would be the only one that benefited from my invention.

Clearly this product has value and everyone should know about it and I could get rich selling these things! So I call up the local newspaper and say that I am a stockbroker that just invented a machine that sucks green house gases from the air and converts them into energy. CLICK! Hello? Are you still there? Heelllloooo?

I try the local TV station and while they do not immediately hang up on me, their patronizing tone shows they are more than skeptical and I start to become worried they are asking for my address not for a feature story, but instead to send someone over with a strait jacket.

This is a story that has national interest, so I think perhaps I should try a major network but before I do, I better make sure I am thoroughly prepared to describe how my machine works. Let's see...through a precipitation process, O₂ compounds are separated from the air and collected into a cyclotron chamber that excites their quarks similar to what happens in a particle accelerator as a collision occurs which vaporizes their structure. This releases energy while removing these components from the air. Well...at least this sort of explains it...so I try this approach with the person that answers the phone at the network.

The person that answers the phone at the network carefully listens and says, "I'll transfer you to our environmental reporter." FINALLY, I think to myself, now we are getting somewhere!

The person that answered the phone introduces me to the reporter, "Miss Greenspace, this gentleman is Mr. Leper (they always butcher my name) and he is a stockbroker with serious environmental concerns." She continues, "He has invented a machine that cleans the air of greenhouse gases and I thought you might like to speak with him." Miss Greenspace says, "Absolutely."

She continues, "Mr. Leper how many of these machines would it take to rid the earth of greenhouse gases?" I respond that I haven't really calculated that and I have no idea how much greenhouse gas is in the atmosphere, but it would probably be a lot.

She says, "I understand, but do you suppose if everyone bought one of these from you it might solve the problem of global warming?" I respond, "Yes, I suppose it might."

She continues, "How much are you selling these greenhouse gas suckers for?" I respond that I hadn't really thought about it, but I suppose I could mass produce them for about \$2,000 apiece.

She says, "That's terrific! I'll do my part and run a feature on it tonight. I'll get the word out and soon we will all be free from the terror of the destruction of our planet!" She continues, "Thank you so much for calling Mr. Leper, where did you say you are from?"

I say, "It is Loeper and I'm a stockbroker from Richmond, Virginia, but the machine produces energy when the greenhouse compounds are destroyed." She responds, half listening and completely not thinking, "Does the energy produced destroy our sacred planet?" I respond, "Not necessarily, unless you are using it to power a weed-whacker."

She says, "That's ok, we won't talk about that because I'm sure people would want to do their part just like I am...to clean our world...I think my segment is on at 6:00 p.m. in your time zone."

I tune in a few minutes before six. At 6:58 she says, "In an interesting environmental development, a Mr. Loeper (they got it right!) from Richmond, Virginia told me today that he has invented a machine that cleanses the air of greenhouse gases. He is selling these machines for \$2,000 apiece and all concerned environmentalists should do their part in buying one of these machines to save our planet. As it turns out, he is a stockbroker so apparently our environmental movement has finally touched the hearts of greedy capitalists."

I get three phone calls. Two are from owners of electric cars. The other is a threatening call from some member of Green Peace saying that HE is the leading authority on green house gases and it is not possible to build a machine that destroys these gases. Also, I should stop misleading the public by trying to profit on a fake machine and as an advocate of a non-profit organization; he is focused on their "common good."

I know I used a whole page on this (it was fun to write it), but I can tell you this is about the same as my experience in telling the media about our financial services invention. What is necessary for any product in addition to meeting a need or desire of the market is that it must be easy to understand its value proposition and it must be easy to use, or convenient. The story above is a good example of two problems in communicating a new invention. Often the value proposition is completely missed because the listener doesn't "get it" which is usually caused by the inventor trying to explain how it works, and not what it does or how it personally benefits the buyer.

Remember when microwaves first came out? No one knew or could conceive of the value of "zapping" our cup of coffee for 60 seconds, putting a BAG of un-popped popcorn in a machine for three minutes or electronically defrosting a chicken breast. In fact, when they first came out, people complained you couldn't fit a turkey in them, so they responded by making them bigger. When the turkeys turned out grey, they added browning elements. Neither of these represented the real value of the invention, of the convenience, they were caused by not understanding what life would be like with something that had not existed before.

People do not always know they should desire something...like the convenience of a microwave. Nor will many of them part with their money to buy a product or service that is a great idea, but is inconvenient. It is inconvenient to explain to your Thanksgiving guests why the turkey is grey, even though it was done in 90 minutes.

Products and Services Must Be Easy to Use and Understand - Convenient

Perhaps this could have been covered with fewer words, but think about how many times you have sought complexity, difficulty and inconvenience in your product or service purchases. Products and services will not make it in the market without ease and simplicity.

I now have a product or service that meets a need of a market of buyers, its potential value is easy to both understand and use, so do I have a winner? Not yet.

The product must also meet some practical standard of quality...i.e. it must be "good." In the case of physical products like microwaves or cars, we know they are not going to last forever but they last a sufficiently long period of time that we benefit from them far more than any inconvenience we experience when they fail. A microwave manufacturer would fail if their product had to be replaced every month under normal use, as would an automobile manufacturer. We even have "lemon laws" that regulate what a manufacturer must do in the case of a shoddy product.

Services are evaluated in a similar manner. Are you a repeat buyer of a contractor that stands you up for three appointments in a row when you took a day off from work to meet them? That is non-delivery of the service being purchased and an inconvenience. If your cleaning service consistently "forgets" to empty the trash when they are done and leaves a bag of garbage in the middle of your kitchen each time they visit for YOU to take out, how long do you keep buying their service before you seek someone that delivers convenience?

These all represent one main final premise that is required for any successful product or service...that is, there must be a reasonable measure of reliability or confidence. Consistent contrary evidence in regards to this will cause the product's ultimate failure.

Products and Services Must Be "Good" or Reliable

If I have a service that meets a need or desire of a market, where people can easily understand the value it has to offer them (value also means it is priced reasonably), is convenient to acquire and use, and is reasonably reliable in actually delivering that value, I probably have a winning service. In the absence of these premises, no service will make it.

We do not buy things we do not want or need, we do not endeavor to make our lives difficult for things we do not understand, nor do we subject ourselves to repeated mistakes of repurchasing products that do not deliver what they were supposed to with some level of confidence.

Would Financial Services "Best Practices" Meet the Criteria Any Other Product or Service Must Deliver?

Confident that I had sound rationale for the basic premises of what makes a product or service successful, I then needed to examine the basic premises of the industry's best practices.

In the case of Investment Consulting, as a leading proponent of the process for over a decade, I merely could ask myself what the core premises are to this process. First, the process is based on the Nobel Prize winning work of Modern Portfolio Theory (MPT) which proposed that investors will seek the most efficient portfolios possible. An efficient portfolio is the portfolio that produces the highest return possible for a given level of risk. Therefore, investors will seek the highest return for the risk they can tolerate. This is the core premise.

The process the experts taught me, and adopted by the industry as a “best practice” had its own premises to deliver this core value to clients.

If we are going to deliver to clients a portfolio that produces the highest return for the risk they can tolerate we must therefore:

- 1- Determine the level of risk an investor can tolerate
- 2- Design the most efficient portfolio (asset allocation) for that risk tolerance
- 3- Find the best minds in the business to manage the assets for each asset category
- 4- Closely monitor the performance of the accounts and make corrections as needed

Investment Consultants often refer to this four step process as “the investment services ring.”

In the case of Financial Planning, I had to do more research since I was not an expert at that industry best practice. The premise of Financial Planning, as best as I could determine, was that in order to achieve your financial goals, you must have a plan to get there. That seemed to make sense. I’m certainly not going to consciously get somewhere by randomly accepting what comes or aimlessly living my life without direction.

If we are going to deliver to clients the achievement of their financial goals through a well thought out plan, we must therefore:

- 1- Gather as much of their financial information as possible to get a complete picture
- 2- Determine the goals the client wishes to achieve so we know what we are planning for
- 3- Project the future value of the resources they might have available based on conservative return assumptions
- 4- Solve for the savings shortfall necessary to close any gaps between those values and their goals

Both of these sound as though they make sense. The industry has adopted these as best practices. In fact, the very best advisors apply BOTH of these disciplines. Their foundation is based on Nobel Prize winning theories. Each year, more experts are certified to deliver these services. Is this the best we can come up with? If it is, then why have so few advisors and an even smaller percentage of investors adopted these generally acknowledged best practices?

Do You Perceive a Contradiction?

Have we ever objectively evaluated these core premises from our generic product/service perspective of what it takes for ANY product/service to be successful? Do the premises of these disciplines meet a need/desire of a market AND are they easy to use and understand AND do they reliably and confidently deliver what they purport? We already examined how no product or service will meet broad adoption or widespread success without ALL of these attributes being met.

While on the surface, the packaging of these disciplines’ premises sounds rational, an active mind might discover there are serious contradictions in comparison to the basic tenets of what makes any other product or service successful.

For example, take the starting premise of Investment Consulting that investors will seek the highest return possible for the maximum risk they can tolerate. This premise therefore requires the first step in the process of determining the investor’s tolerance for risk. In over a decade of applying the Investment

Consulting discipline, determining an investor's risk tolerance has perhaps been the greatest challenge. In fact, the entire industry has been struggling with this for years.

The original Nobel Prize work used standard deviation as a measure of investment risk. Ironically, investors did not know off the top of their heads their tolerance for standard deviation. Think about the basic premise here. How can I find the most efficient portfolio for an investor's risk tolerance if they do not know what their tolerance is? Why don't they know their standard deviation tolerance? A lot of people are not comfortable with math, so maybe we need a different measure of the risk they can tolerate. Enter Sortino ratios, Sharpe Ratios, semi-variance and downside risk measures. Downside risk, measured as the maximum portfolio decline, was the most understandable to the majority of people.

Yet, it still did not work. People didn't like talking about the absolute maximum risk...it was too scary...like the 49% decline of 1973-1974, so we started eliminating the bottom 5% (only a one in twenty chance of doing worse) which generally would show equity portfolios with 20-25% downside at the 95th-percentile. This happens to be the same downside as a balanced portfolio with 60% in stocks and 40% in bonds at the 98th percentile, but we will tell them the balanced downside is 12% at the 95th%-tile.

Then the psychological community entered the equation saying risk is a "feeling" and it would be much easier if we talked about risk in conceptual terms like "a lot," or "moderate," or "little." We could toss in words like "conservative" and "aggressive" as further refinements. This would completely eliminate the problems with people not understanding math but through a Meyers Briggs type of profiling, we could discover their "risk attitude." Behavioral finance was born.

These refinements have not worked, nor will any amount of further refinements help **BECAUSE THEY ARE ALL TRYING TO SOLVE A PREMISE THAT IS FLAWED IN THE FIRST PLACE.**

In all these attempts to work toward solving the problem of identifying an investor's tolerance for risk, (under the premise that MPT was right...investors will seek to achieve the highest return for their risk tolerance) we are evading questioning the core premise that is the root of this problem. The problem isn't math, psychology, statistics, or attitudes. **The problem is that no one endeavors to experience their maximum tolerance for pain.**

Risk is something that people naturally want to avoid if possible. Investors have been telling us this over and over again, but under the notion that we as "experts" understand this Nobel Prize winning theory and the investor does not, their plea to us of "I'd like to take as little risk as possible" falls on completely deaf ears.

Do you perceive a contradiction about risk? The industry best practice of determining an investor's tolerance for risk, results in positioning investors to experience the maximum pain they can bear.

Ongoing Monitoring...

Another step in investment consulting and a supposedly high value service is ongoing performance monitoring versus market benchmarks. On the surface, this "report card" of investment performance seems as though it might be useful. After all, if I hire an investment manager to beat the small cap growth stock index, shouldn't I monitor whether he or she is doing so? If my investment consultant was employed to design an asset allocation strategy appropriate for my risk tolerance and assist me in selecting managers that together will create some excess reward for this effort, shouldn't I monitor whether I'm getting that extra value?

Without deeper thought, this bromide appears to make sense and we all chant, "of course we should monitor our performance." But, what information do we really garner from this?

Can we go backward in time and change the performance that already happened? If we underperformed our index benchmark, does that mean that our manager was smart when we hired them, but is now dumb? If we outperformed do we know whether it was luck or skill or if it will continue? If my mid cap value manager outperformed, my large cap value underperformed, my small cap growth outperformed and mid cap growth underperformed, WHAT DOES THIS MEAN?

Performance reporting is the high value ongoing service? It is like going to the Doctor after you are already DEAD!

Your past performance cannot be changed (since it already happened) and it evades answering any question of forward looking advice or what those results mean to your life. When we talk to investors about their goals, do they articulate them in terms like “a comfortable retirement” an “education for their children” and getting a “beach house?” Or, do they say that what they value in their life is beating a blend of style indices provided their tracking error is low and their Sharpe ratio demonstrates high efficiency? Is beating the benchmark their goal? What does it buy them?

Would they be happy if all of their managers beat their benchmarks but the lifestyle that afforded them had them sleeping under a bridge next to smelly people?

When a client asks the simple question of “how am I doing” (observe this is present tense) should we answer it by explaining what happened (observe that performance reports are past tense) and evade what the performance means to their life (advice about the future...you can still buy your beach house)?

Savings Shortfall - the GAP in GAP analysis

Moving on to the tenets of financial planning the application of which often results in solving for how much the client needs to save to achieve their “goals,” we observe another contradiction. Many in the planning industry think it is their job to get their clients to save more. Often, their analysis solves for the increase in savings needed to meet the client’s goals. Normally, their questionnaires will ask the question of how much more can you save.

As the buyer of this “service” though, what if one of my goals is to save less? How does a process that is designed around getting clients to save more and therefore solves for how much more to save answer my question as a consumer of what can I do to reduce my savings? Isn’t this a choice that some consumers might want? Why do the questionnaires ask me how much more I could save, but completely evade asking me whether I would like to reduce my savings? Isn’t reducing my savings a goal I might have as well? If it goes unasked and the solution is always how much more I should save to meet some retirement age (or financial independence age) that I personally do not value because I like my job and probably will always work, what value was provided to me in this service?

If we objectively examine each of these contradictions and explicitly articulate them, we would summarize these premises as my service will:

- 1- Identify how much pain (risk) you can bear and position you to experience it.
- 2- Tell you what happened but evade what it means to you in terms of your lifestyle.
- 3- Get you to sacrifice your lifestyle as much as possible or is “needed” to meet goals you may or may not value.

Use your active mind and think about this from the perspective of what ANY product or service requires...that is... do these premises meet a NEED OR DESIRE OF THE TARGET MARKET FOR THE SERVICE? Do you truly think that there is a market for a service designed around positioning you to experience the most pain you can bear, tell you what happened but evade what it means to you and getting you to sacrifice your life? Would YOU BUY THIS?

Our best practices contradict what our target market needs or desires.

What about the idea of gathering all of your personal financial information? The best practice in financial planning requires a complete analysis of your spending budget, detailed information about all of your insurance and benefits, your tax returns, etc. all of which is gathered in a 20-30 page questionnaire. Somewhere, in an attempt to create more value to financial planning, a board or a council determined that a financial plan is “incomplete” if we did not determine whether you could save \$82 dollars a year on your homeowners insurance, discover that you spend \$18 “too much” each month on pay-per-view movies for your cable bill, or thoroughly analyze the impact of the 45 day waiting period for your employer’s short term disability income policy versus a more typical 30 day waiting period.

In terms of the things you really value, are these items material? Will an extra \$300 a year made available by sacrificing your pay-per-view movies and switching casualty carriers buy you a \$12,000 annual travel budget throughout retirement? This is not meant to imply that some people may not benefit from examining these items as it may be needed just to get a handle on what they are saving. If the premise were to examine a client’s detailed spending when necessary, this would make sense. But, that isn’t the premise. We subject all clients to this inconvenience because we might find value in doing so.

Think about your ideal client. They might earn \$300,000 a year and have a \$2 million portfolio. To model their future, one of the things I need to know in addition to numerous goals, is how much they could save (might be more than they currently are saving) and how little they would like to save (would they spend more now if they could?) One of the things they want advice about is how much they should save based on what they value. They know they probably aren’t saving the right amount...they want you to tell them what that amount should be. I really don’t even need to know what they are currently saving to advise them of the correct amount *other than to reflect back to them the price to their lifestyle of what I recommend...* saving \$10,000 more a year now until retirement buys you one year earlier retirement or, if their goal is to travel, the price of reducing your savings by \$10,000 a year now to start taking some vacations will cost you a two year delay in your retirement. If your job is to include giving advice about what the right amount of savings is based upon their goals (presumes the current amount is not the right amount) then the current savings rate only serves as a “current lifestyle benchmark.”

What do I need to know to understand their “current lifestyle benchmark?” The client earns an annual income of “i”, there is “t” in taxes confiscated from their income, they save “s” in various savings which leaves “l” spent in their lifestyle. Mathematically, their current lifestyle = their income less taxes and savings or $l = i - (t+s)$. I can get to this lifestyle number from this simple high level, or, presumably to discover hidden values like their pay-per-view habits or excess homeowner’s coverage, I can find out where every nickel of that lifestyle dollar is spent. Is it convenient to ask a client where every nickel goes? Is it really a best practice to inconvenience every client because some clients benefit from it? We could advise them that their habit of stopping at a full service station instead of fueling their own vehicle is costing them \$240 a year. Why is this question not asked in an advisor’s 30 page interrogation form?

It is not asked because it is a stupid question relative to the value it provides. It is the equivalent of going into a super store to buy a microwave, primarily so you can zap your coffee and make instant oatmeal in the morning, but before they sell you a microwave you have to provide them with your detailed menus for the last two months. THIS IS INCONVENIENCE.

What about the premise of seeking the best managers to manage the money? Forgetting the debate on active versus passive and looking at it only from the perspective of what the client values, think about your presentations on investment suggestions. They are loaded with industry jargon and statistics. Clients come into your office and say they want a comfortable retirement and educate their kids and you tell them that this fund with an alpha of 1.2%, a beta of .95 and a positive delta relative to the market for risk adjusted return will help them meet their goals. Look at these words...they are in GREEK...*literally GREEK*.

Is it convenient to the client to speak in foreign tongues? Should we expect our clients to learn and adopt our language and jargon or should they expect us to communicate in their terms? They ask us what time it is and we tell them how to build a watch...kind of like me explaining my greenhouse gas sucker to the receptionist at the network.

These elements of our best practices (profiling in excruciating immaterial details and focusing on our jargon relative to market averages instead of communicating in terms of the client's goals) are not convenient or easy to use and understand.

Of the eight premises of our industry's best practices, I have so far identified contradictions among six of them as outlined below:

<u>Best Practice</u>	<u>Contradiction</u>
Identify Risk Tolerance	How much pain (risk) can you bear?
Design Efficient Allocation	Position you to experience your tolerance for pain.
Monitor What Happened	Can't be changed, evades what it means to your life.
Solve for Saving Shortfall	What if my goal is saving less? Sacrifice your life.
Gather ANY and ALL data	Inconvenience ALL clients even if unnecessary
Pick investments on performance	Confusing jargon and statistics

The two premises of our "best practices" yet to be examined are:

- Determine client goals so we know what we are planning for
- Project future values of resources based upon conservative return assumptions.

We will save examining client goals for last since that is what our services are supposed to deliver and is therefore the most critical issue to explore. But clearly, with all the academic and Nobel Prize winning theories as a foundation, surely projections based on conservative return assumptions with our "advanced" understanding of markets must survive our objective examination.

Let us examine the resulting projections for a sample client who had the "good fortune" of hiring an advisor that consistently applied both of the industry's best practices as his discipline.

It is January of 2000 and our sample client, Harry Abernathy, meets with his advisory firm, "Best Practice Advisors." The advisor describes his process to Harry.

Advisor:

"Mr. Abernathy, we here at Best Practice Advisors apply a very disciplined approach in serving our clients. We have been trained and certified by two different industry associations for both investment management consulting and financial planning."

"We start with a complete examination of your finances to determine where you stand, how much you are saving, how your portfolios are positioned as well as examining your employee benefits and insurance protection. Once we understand where you stand, we determine your financial goals so we can assess what it is that you want

to achieve with your finances. From there, we examine your tolerance for investment risk and we design an asset allocation that is efficient...that is one that would produce the highest return for the risk you can tolerate. We then actually write this down in a written investment policy statement that outlines your stated tolerance for investment risk, your asset allocation policy and the appropriate benchmarks to use for measuring your investment performance.”

“Once we have determined your goals, risk tolerance and investment policy, we then project the future values of all of your resources and we calculate any additional savings that may be needed to achieve your goals based on a conservative return assumption tied to your asset allocation from your investment policy. From there, we select from among the best money managers and mutual funds to fulfill your asset allocation strategy and on a quarterly basis we report to you your investment performance relative to the stated benchmarks. Finally, each year we do a complete review of all of these steps to make sure we are on track to meeting your goals.”

For the moment, let us ignore the contradictions of the complexity and inconvenience of this process. We will ignore the contradiction Harry feels when questioned about his risk tolerance thinking to himself... “I want to avoid investment risk, why is he asking me how much risk I can tolerate when I want to take as little as possible?!” We will ignore the contradictions of all of the confusing jargon and statistics, the contradiction about how showing what has happened (performance) has nothing to do with what will happen. We will also ignore the contradictions in the goal setting session as we have yet to examine this step in the process. Finally, we will even ignore the contradiction in solving for the savings shortfall when Harry’s goal was to reduce savings, since the projection his advisor shows him (based upon conservative return assumptions) shows that Harry has all the money he will ever need.

Here is what this disciplined, trained and certified, best practice advisor determines. Harry and his wife have \$900,000 in their 401Ks; they are nearing 55 years old and are saving \$16,000 a year including their employer’s matching contributions. They want to retire at age 61 and based on their current earnings of \$150,000; their advisor assumes they will need \$112,500 a year in pretax retirement income (75% of pre-retirement income rule of thumb). Based on their current ages and normal mortality, there is less than a 20% chance they will live beyond age 94. He probes their psyche to determine their tolerance for investment risk and determines that the most efficient portfolio, based on their 40 year time horizon, was 55% large cap stocks, 25% small cap stocks, 18% bonds and 2% in cash. A portfolio allocated in this manner over the ten years ending in 1999 produced a compound annualized return of 15.4%. This seems too aggressive as a long term assumption to this advisor based on the bull market of the 1990’s.

The advisor thinks that it would be more prudent to examine the returns over a longer time frame, like the inflationary and weak markets of the early 80’s and including the stock market crash of 1987. In looking at the last twenty years (1980-1999) instead of the last ten (1990-1999) he discovers that this allocation produced a compound return of 15.8%, even higher than the ten years ending in 1999! Asset allocation works! The bull market in bonds in the 80’s made up for the weaker years of the stock market and the strong stock market of the 90’s made up for the terrible bond market of 1994.

Thinking he should be more conservative and recognizing that while the ten and twenty year returns cover a pretty long period of time, this client’s time frame is forty years. After all, the Abernathy’s are just turning 55 and there is nearly a 20% chance that one of them will live to age 94. The compound annualized return of this portfolio over the last 40 years (1960-1999) was “a much more conservative 12.23%” since it included the horrendous 49% market decline in ‘73-’74, the Vietnam Era, Arab Oil Embargo and the assassination of President Kennedy. This 12.23% return seems conservative...it is more than 3.5% a year less than what the allocation had done over the last twenty years!

So, the advisor projects the portfolio values assuming 12.23% each year. Based on Harry’s goals, this return assumption shows that there is no savings shortfall at all. In fact, if either Harry or his wife lives

to age 94, they not only will achieve their estate goal of \$1 million dollars, they will actually end up with more than \$23 million! It appears as though the only problem they will have is an estate tax problem. One point the advisor brings up is that inflation will erode the spending power of their portfolio, but even assuming a 3% inflation rate, that \$23 million future value will spend like \$7 million, still seven times their estate goal!

Of course, the market will not produce that exact 12.23% return each year. That average return included the bull market of the 90's and the bear market of the mid 70's. Since we needed the return of each year from 1960-1999 to determine the compound return over this period, do you think the advisor could have bothered to see what would have happened if instead of *assuming the average return over the forty years* he instead modeled the plan based on using *each of the actual forty returns*? Unfortunately, NO INDUSTRY ASSOCIATION requires this common sense approach as a "best practice." The result is a little different.

Using the returns as they occurred instead of the average of all the returns shows that the Abernathy's would have been **BROKE** at age 85. You are reading this correctly. Do you think it is wise to call this a best practice? Using the same returns, in one case assuming the average is achieved each year leaving a huge estate tax problem (a \$23 million estate) and the other just using the returns as they occurred (still averaging the same return) show them bankrupt at age 85 should not be a **best practice...it should be called MALPRACTICE!**

For all our attempts to time and outsmart every other smart investor, achieving one's goals is VERY sensitive to this timing of returns effect. In fact, if the Abernathy's would have waited a year to visit this advisor and the advisor included the decline of 2000 in the analysis, the forty-year average would have been a little bit lower, 12.09% instead of 12.23%. This wouldn't materially change the misleading result of ending up as a multi-millionaire with serious estate tax problems (\$6.5 million in today's dollars instead of \$7.0), but that pattern of returns would have them leaving a \$1.5 million estate (\$474,000 in today's dollars) instead of being broke nine years earlier.

Think about this...identical goals using 40 actual market returns (1960-1999) would have them broke at age 85, but using 40 actual market returns (1961-2000) while producing a lower average return (12.09% versus 12.23%), and recognizing that 38 of the 40 returns are identical (dropped 1960 and included 2000) and occurred in the same order, results in their *money lasting for nine more years of retirement and leaving more than a \$1 million estate!*

For all those advisors that fancy themselves as market, style or money manager selection forecasters, look at what being **wrong** in only 2 of 40 years means **TO YOUR CLIENT**.

This effect is so extreme, that if the Abernathy's were to average a terrible 9.7% return (1935-1974) with this allocation they would have ended up with an estate worth over \$5 million.

It is interesting to note that in less than 18% of all 40 year actual historical market periods going back to 1926 would the Abernathy's have ended up achieving what their advisor's "best practice conservative assumption" projected.

Any advisor that understands the basic idea behind MPT, knows that a portfolio with less volatility (standard deviation...or, average difference from the average return) is "more efficient." Most of them also know that every portfolio has some standard deviation. Yet, somehow it is a "best practice" and regulator approved practice to assume your portfolio (since we are now talking about client goals) will produce the exact same return each year. What is the standard deviation of a portfolio that produces the same return each year? ZERO! Where would that fall on my risk versus return chart? SUPER EFFICIENT! Could

an advisor please give me one of these portfolios? NO...THEY DO NOT EXIST! Didn't we identify my risk tolerance? SURE...BUT WE WILL PROJECT YOUR FUTURE ASSUMING NO RISK ANYWAY!

Since we identified the portfolio risk, shouldn't we INCLUDE IT in their projections? No association board, council, standard bureaucracy or even regulators require modeling the risk identified. In fact, until recently, regulators actually FORBADE including this risk in financial planning projections.

Using assumed returns (even conservative assumptions) provides no confidence and little reliability.

Any math nerd (like me) knows how to model the impact to client's goals of this previously evaded risk by using probabilities (Monte Carlo simulation). Unfortunately, like a kid in a candy store that eats too much of a tasty treat, most users of Monte Carlo simulation are reversing the problem.

We have gone from having a high amount of uncertainty in meeting client's goals to nearly certain sacrifice of the only life our client has the way Monte Carlo simulations are typically used. Maybe advisors are misusing Monte Carlo out of guilt for having been so stupid for so long in ignoring how sensitive a client's lifestyle is to the uncertainty of the timing of investment returns. Or, perhaps after evaluating their client's existing plans (now considering timing risk) and learning that most had only a 40-60% chance of achieving what they had originally projected, they are overcompensating for past mistakes by maximizing the odds; even if it is at the price of their clients' lifestyle.

Monte Carlo simulation *can be* effective at assessing the probability of the *markets* producing returns sufficient and at the right time to achieve a client's goals. This is new knowledge relative to ignoring the risks as they had previously done and so they work to *increase the probability to as high a level as possible*. **What is ironic about this is that the very tool they use to try to get near certainty in achieving a client's goals isn't necessary to achieve certainty.** One might argue if you were to SACRIFICE your lifestyle to whatever level a zero percent return would provide, yet invest in T-bills, you would have certainty in achieving those goals. You don't need Monte Carlo to know that.

But just as accepting risk has a price, avoiding any risk also has a price that goes with it. We can avoid the risk of slipping in our bath tub by avoiding bathing; we can avoid the risk of travel by staying in our house and even avoid the risk of food poisoning by ceasing to eat. To most, these risk avoidance actions would be irrationally psychotic. And, at least in one of these examples the person is avoiding one risk of dying (food poisoning) by insuring they will die (starving)...or, avoid a remote rational risk by accepting certain sacrifice (one's life).

This has been the problem with how advisors have used (misused?) Monte Carlo simulation. It may sound comforting that you have a 98% chance of achieving your goals, *but that ignores the 90% chance that you will be dying on a death bed stuffed full of money that you wish you would have spent!*

Projecting future values based on assumed returns ignores risks that are known to exist. Correcting for this by maximizing probabilities with conservative return assumptions causes clients to sacrifice the only life they have to achieve a high probability of leaving behind an estate of far more than they wanted.

Dreams, Dollars, and Deadlines...Goals...

We have examined and identified contradictions in all of the industry's best practices except for identifying goals. Unfortunately, the way the rest of these contradictions exist in these disciplines, we are forced to miss the mark once again.

Achieving goals each client uniquely values is what we are supposed to deliver. Clients and prospects love to hear it. Wall Street ad agencies know it and cover the media with the message. How do we deliver on it?

Our traditional process treats goals like impersonal data points on our 30 page interrogation form. They are required inputs needed to let computers do our job and tell us a “better” portfolio and “how much” the client “needs to” save. We need that data point. A best practice advisor queries, “What is your desired retirement age?”

“I’m not sure I will ever retire,” responds one client that likes his job. But, the advisor needs an age to go on, so instead of acknowledging what the client wants...to keep on working as long as they are able, they EVADE the client’s desire and repackage it into a bromide so they can fill the data point.

“Mr. Client, a lot of my clients continue working long after it is no longer necessary. What I’m looking for is the age at which you wish to achieve ‘financial independence’...having the choice to not work if that is what you desire someday. If you could have that choice, wouldn’t you like it?”

The client, sensing a kind of irrationality of not accepting a choice if offered says, “Well, I really don’t know what I would do if I were to retire, but I guess having the choice at normal retirement age would be ok...is that age 65?”

The advisor locks in on age 65 and moves on. Is this the client’s goal? Look at the brief exchange between the advisor and the client. Recognize that this client’s priority was not to retire at 65 but he is going to be getting advice...how much more to save, how much portfolio risk is needed to achieve “financial independence” the client has NO INTENT OF USING!

Our flawed processes based upon contradicting premises put us in this situation. The same goes for many goals. What income would you like in retirement? “I hadn’t thought about it...enough to be comfortable I guess. I make \$80,000 a year plus an annual bonus of \$70,000 now, how much do you think it would take to maintain my lifestyle?”

The advisor dusts off his rules of thumb from his “common book of best practice prayer” and says, “Normally around 75% of your pre-retirement income,” forgetting that the client is saving his entire bonus and won’t be doing that in retirement. Or, even worse, he asks the client to forecast what his phone bill will likely be ten years from now.

Some advancement in goal setting has been made in recent years discussing things like ranking priorities. Ranking priorities enables advisors to continue to rely on their computers to do their job. Instead of solving for a savings shortfall, the computer throws out goals one by one based on how the client ranked the goal, until enough goals have been thrown out to leave the client with a high enough probability of achieving what ever goals remain.

The problem here is that there is no advice, only sacrifice or what I like to call “sacri-advice.”

Our clients are reasonable but reason is thrown out when we leave our job to a computer. They can solve, calculate, simulate, and model but they cannot judge nor do they have reason. Most clients, assuming they wish to retire at some point “comfortably”, rank *when they retire* lower than *achieving a comfortable retirement income*. Almost certainly, investors will rank what they feel is a “frivolous” travel budget before retirement as a lower priority than their children’s education, when they retire or a comfortable retirement income. With a low ranking, that travel budget may as well never be discussed in most cases.

But shouldn't there be some value assessment in a priority? Maybe it might be worth waiting a year or two to retire, or reducing that retirement income a bit to enjoy travel for the next six years before they retire. Ranking is a start, but the real problem is that each goal has only *one value that was determined in isolation* and its *reasoned value* is never examined again. What makes sense based on the price of the goal is completely evaded.

We talk about "goals" but deliver sacrifice...or "sacri-advice"

Think about each of the premises of the best practices. Objectively think about them from the perspective of what it takes for ANY product or service to make it in the marketplace. Witness the brilliant marketing that has managed to make the financial services industry a huge part of our economy, despite its contradictions. Observe the lack of need/desire for what it has to offer. Witness the complexity, inconvenience and difficulty to understand financial advice. Finally, recognize the reality that in most cases there is little if any evidence of reliability and whatever confidence provided in the process in reality is based solely on hope, not reason.

We need a better process...better than the best practices

While we have learned a lot from these best practices, we do not think that everything that could be invented, already has been invented. We seek to improve, to rethink and perhaps most of all...objectively resolve contradictions that are generally evaded.

The premises that resolve these contradictions result in a new discipline, we call Wealthcare.

Wealthcare's value proposition is:

- Make the most of the only life the client has

Therefore, the premises required to deliver this value position are:

- o Confidence in achieving the goals each client uniquely values
- o While avoiding undue sacrifice to their lifestyle
- o And avoiding unnecessary investment risks

If one is consistent in applying these premises in their financial advising discipline, AND focuses on making their service convenient while speaking in the client's language and terms, the contradictions present among the best practices can be resolved.

<u>Best Practice</u>	<u>Contradiction</u>	<u>Resolution</u>
Identify Risk Tolerance	How much pain (risk) can you bear?	Avoid unnecessary risk
Design Efficient Allocation	Position you to experience your tolerance for pain.	Efficient allocation for risk
Monitor What Happened	Can't be changed, evade what it means to your life.	Forward looking confidence
Solve for Saving Shortfall	What if my goal is saving less? Sacrifice your life.	Solve for best choices based on what each client values
Gather ANY and ALL data	Inconvenience ALL clients, even if unnecessary	Focus on what matters, make it easy and convenient
Pick investments on performance	Confusing jargon and statistics	Speak in clients' language, avoid additional uncertainty of underperforming markets
Project values using conservative return assumptions	Ignores known volatility, and if not ignored, then deliver nearly certain sacrifice	Measure uncertainty of returns and balance between too much uncertainty and undue sacrifice... provide comfort
Define each goal and rank	Ignores reasoned choices, sacrifice goals without consideration of relative value or reasoned compromise	Identify ideal and acceptable goals & priorities, judge reasoned tradeoffs and choices

These new premises of financial advising resolve the contradictions, but they require us to change everything in our process...our value proposition, our profiling, how we design recommendations, our implementation of portfolios and our ongoing service. Other than these, everything else remains the same!

Observe that one cannot fix one element or solve one contradiction without it causing contradictions to the rest of the premises. If we solve the problem of ignoring the uncertainty of investment returns by applying Monte Carlo simulation and balancing uncertainty versus certain sacrifice, but our profiling evades identifying the client wishes to reduce their savings to save their marriage by finally using their vacation time, what have we accomplished?...comfort and confidence in meeting a retirement age or retirement income goal ALL ALONE IN LIFE?

If we show them that the value confidently obtained in accepting their maximum tolerance for investment risk offers them only 3% more in retirement income (a very common scenario), and then we gamble their future on investment picks that do not track the markets and end up underperforming the markets by 1.5% (costing them 20% of their retirement income) did we really deliver comfort and confidence in meeting goals they value? Did we avoid unnecessary market risk but accept unnecessary implementation risk?

In changing our core value proposition from gambling on our ability (or luck) to outsmart all the other smart investors to making the most of the only life the client has, we must change the value proposition we present to our clients.

We have to change the way we profile clients, making it easy for them (and us) to understand their dreams (ideal goals) and what they might compromise if needed (acceptable goals). We must understand their priorities and their relative value judgments in examining the choices, tradeoffs and relative value of each to achieve something greater in either priority (dreams), size (dollars), or timing (deadlines).

The way we build recommendations for our clients can no longer be left to a programmer's choice of priority or a ranking coerced from the client against their will, but instead must be rationalized using

our mind's understanding of what the client values and why, and what makes sense. Our recommendations need to strike a rational balance of avoiding BOTH too much uncertainty and nearly certain sacrifice...balance between these two is comfort. Our recommendations to accept investment risk should be based on the client's value judgment of the goal the risk might buy, and also avoid investment risks, even though tolerable, if what they buy is of little value to the client.

The way we implement portfolios needs to be representative of the model allocations we base our recommendations upon. We can no longer needlessly risk relative underperformance for the hope of superior performance and pretend that neither will happen. We must objectively disclose risks that are present, the choices available to avoid such risks and recommend avoiding gambling our clients' lives if taking such risks is unnecessary.

And finally, we must change the way we service clients. We must look forward rather than backward. We must communicate what the market's performance means to their life instead of what their performance was relative to the market. We must accept that it is our job to service clients based on what they value, which changes. Through probability analysis we know that the uncertainty of market returns means that nearly any client has some chance of falling between bankruptcy and a multi-millionaire over the course of their life. Instead of focusing on being right about a projected value 30 years in the future that was based on goals and priorities that have changed many times over that span of the client's life, we need to provide them comfort that they have choices as their goals and priorities change. Also, and perhaps more importantly, we must be there to help them determine the best choices to make the most out of the only life they have. This IS a NEED/DESIRE of our target market.

So what does this process look like in practice? After presenting the new value proposition of this process, our new profiling defines a range of client goals, in their words. Goals are defined by what it is (the dream), how much it costs (the dollars) and when they would like it to happen (the deadline)...under the following assumptions:

- 1- It is ok to dream (we cannot achieve dreams without knowing about them)
- 2- And that the client wishes to:
 - a. spend as much as possible
 - b. retire as soon as possible
 - c. save as little as possible
 - d. leave behind as much as possible
 - e. take as little investment risk as possible

Together, these represent the client's "Ideal" goals. For each of these "Ideals" we also need to identify what the client might find as "Acceptable." **This is not the opposite of our above assumptions...we are NOT asking them to save as much as possible, retire as late as possible, save as much as possible, leave behind as little as possible and take the most risk as possible. That would be a contradiction to our premises!**

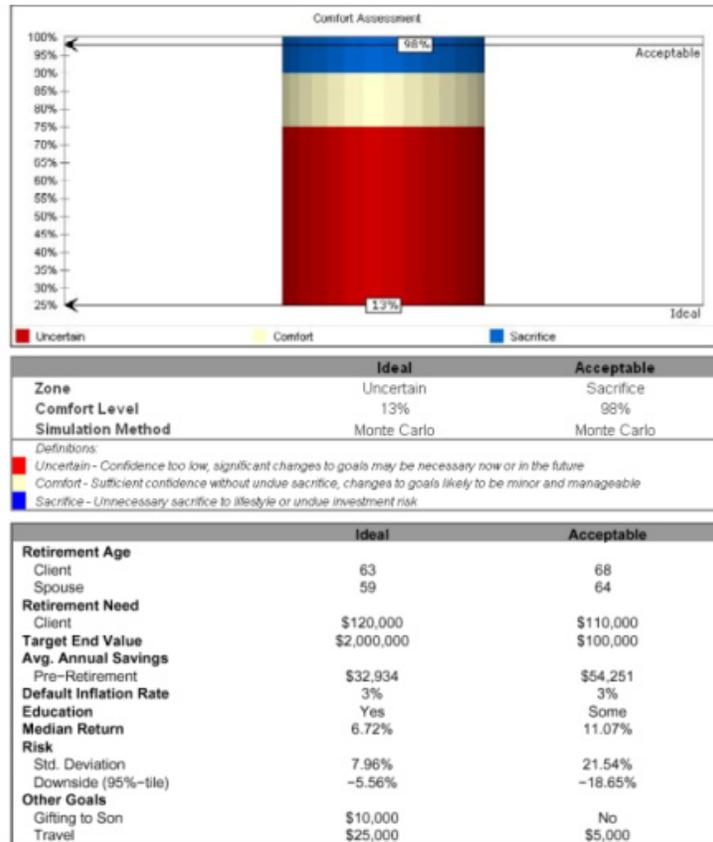
Instead, we are merely asking them that if it were necessary to spend a little less (save a little more, delay a goal for a while) what would **they still be satisfied with** if such changes were *necessary to achieve another goal they valued more?*

The profiling is fairly simple and does not require a lot of details. Most people know this information off the top of their head (observe the data collected in *Exhibit 1*). What is unique about this though is that even if two clients have identical profiles and ranges of ideal and acceptable goals, your advice will differ based on their **PRIORITIES**.

Understanding a client’s priorities is understanding what price would they pay in one goal to achieve another (the *price* can be *risk accepted*, *elimination of an entire goal*, the size of the goal in dollars or the *timing* of when a goal happens). Each client is unique in these value judgments. *Your advice should be equally unique*. It isn’t a matter of splitting the difference down the middle of all the goals, or tossing out goals that have a low “rank.”

For example, say we have two clients with completely identical profiles. Traditional “best practices” would have the computer giving identical advice since their “data” is the same. But with our process we are making relative value judgments, based on the interplay of the goals and priorities.

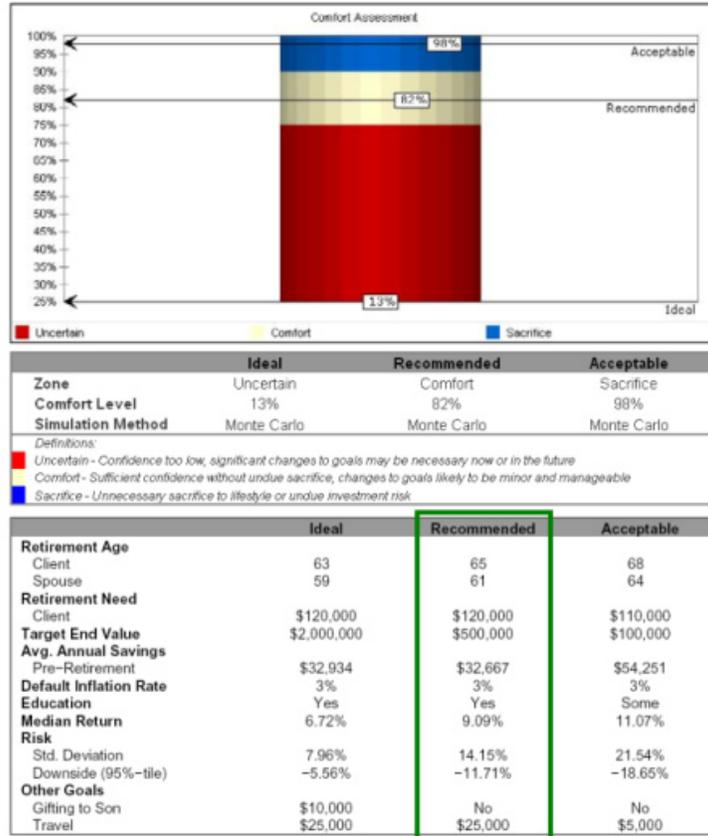
Exhibit 1- Sample client with \$2 million and their range of goals



As is often the case, it is unlikely that the market will produce returns sufficient to provide for all their ideal goals (only a 13% chance). Yet, it isn’t necessary for them to compromise all of their goals to “Acceptable” levels as this leaves them a 98% chance of exceeding their estate goal and a 100% chance of compromising their life.

Now, what if one client prioritized maximizing their retirement income, minimizing savings, educating their son through graduate school, and maximizing their travel budget? If they were able to achieve these goals that THEY VALUED, might they be willing to delay retirement a bit? Take a little more than their ideal minimized investment risk? Compromise the estate they leave behind to their son? Compromise a gifting program that is 30 years away? Some clients might prioritize their values in this way. Our recommendations would reflect their priorities as shown in *Exhibit 2*.

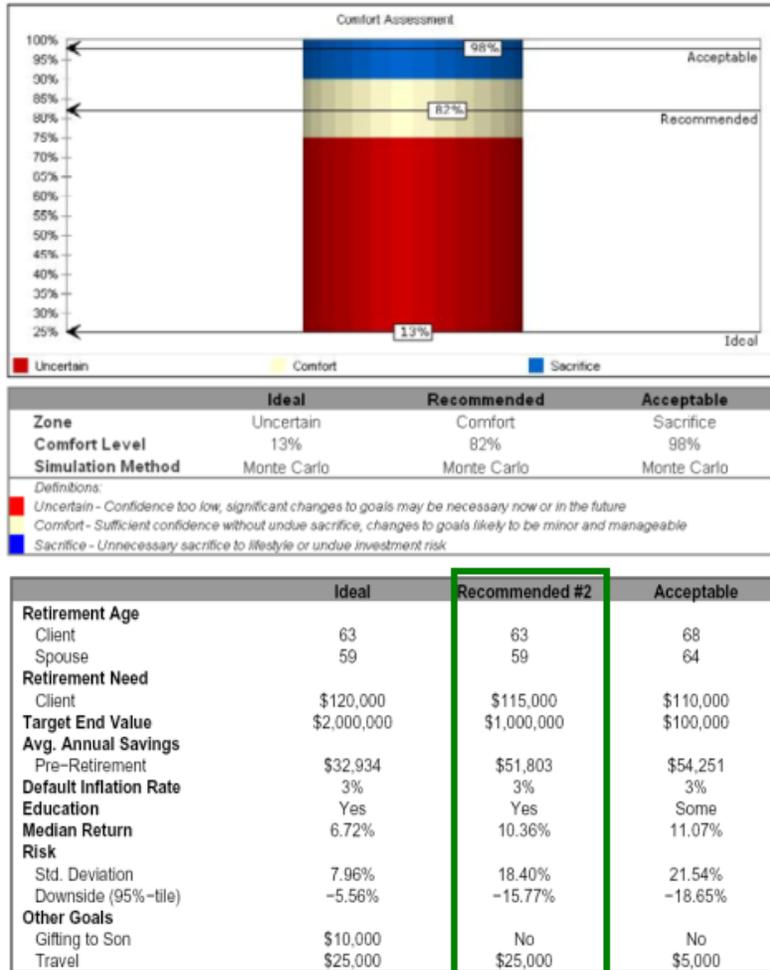
Exhibit 2 - Prioritized retirement income, reduced savings, education and travel



This recommendation achieves their priorities and compromises only a portion of their acceptable goals they valued less.

Another client with this same profile and range of goals may have completely different priorities. What if they hate their job and want to get out of the rat race? What if they are willing to save more to escape their job? What if they are more comfortable with investment risk? What if they promised their father on his death bed they would pass on the \$1 million they inherit from him to his grandchild? *Exhibit 3* shows how we can meet the priorities *this client values* resulting in completely different recommendations despite their profile being identical to the prior example. Here again, we only partially compromise those goals the client does not view as a material compromise.

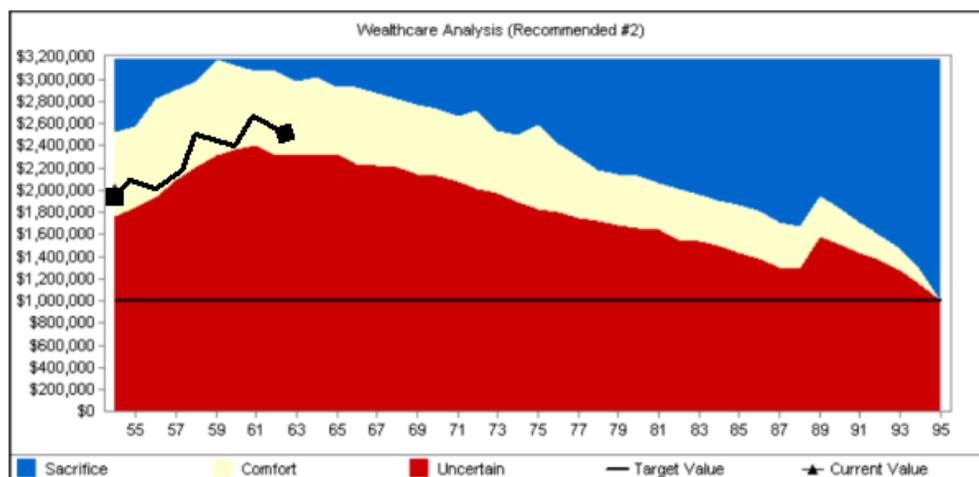
Exhibit 3 - Identical Profile but prioritize \$1 million estate and retirement age



Once we determine the proper “package” of goals based on the client’s priorities and values, (designed in a manner to avoid too much uncertainty, but also avoid nearly certain sacrifice by providing a comfortable balance) we need to understand what we need to pay attention to in the future...forward looking monitoring.

We know the future is uncertain yet we accept some amount of risk knowing that the price to our lives of avoiding all risks is certain sacrifice. To monitor how *the market’s behavior* impacts our lifestyle, we first need to understand the future portfolio values that would put us below our comfort zone...i.e. too much uncertainty or irrational sacrifice...i.e. above the comfort zone. These values are not a projection of what will happen (see *Exhibit 4*), or even what is likely to happen, but instead represent the range of portfolio values *needed* to maintain that comfortable balance between uncertainty and sacrifice. The band represents required decision points if the market’s behavior causes us to drift outside of our comfort zone. This permits us to take actions now (spend more, reduce risk, add goals previously compromised if we fall into sacrifice OR spend less, delay spending, increase risk, etc. if we fall into the uncertain zone) to prevent the “surprise” of more severe consequences later.

Exhibit 4 - Monitoring the impact of the market's behavior on comfort level



In this client's case, if their goals and priorities remained unchanged from their current age of 54 through age 63 (which is unlikely) it appears as though the market's behavior, despite several down years along the way, still leaves them with sufficient confidence in proceeding with their plan to retire.

It is very unlikely that nothing would change in the client's life goals or priorities over this nine-year period. Their son's education might never happen if he has no intention of going to college, or he might get a scholarship to cover the costs, thus freeing more resources. Our client might get promoted and the increase in compensation would change their lifestyle, requiring increases in planned retirement income or his employer might get acquired and he gets "right-sized" out of a job. He might get a new boss which changes his whole perspective on early retirement since he now likes his job or he may find a new passion that causes him to want to speed up the retirement date. He and his wife may find a new travel destination they love requiring increases in the travel budget or one of them may become ill making travel unlikely. His only son might be killed in a car accident making the estate goal...that promise he made to his father, a moot point. We cannot forecast these things, nor can we play the odds of these outcomes. We should be there to give advice as to what the client's best choices are in the face of these numerous random occurrences over the course of their life.

Therefore, the value in monitoring IS NOT really monitoring whether the client is on track (were we "right" about projecting uncertainty?) but instead making sure the goals we are working toward achieving are the RIGHT GOALS. While the markets are uncertain, we can consider and plan on the impact of a lot of the market's uncertainty, but these random life occurrences, changes in values or goals, these are even MORE uncertain and useless to try to plan for in our advice.

This monitoring of goals and providing *constant advice* about the choices the client has to strike that comfortable balance between too much uncertainty and nearly certain sacrifice is consistent with our new premises of financial advice.

It is rather useless to be "on track" to achieve goals you do not value, is it not? The best example of this is the bear market of 2000-2003. Many investors, overconfident from the euphoria of the '90s stated that their tolerance for risk was much higher (when risk didn't appear to exist) than what they really could tolerate when they started to experience that risk. If our value is being right in forecasting uncertainty, we will almost certainly fail. Instead of solving today's problems, we spend a lot of time fighting with our clients. This goes both ways.

Clients call us concerned about declining markets, and we yell at them to “stick with it long term” and guilt them into accepting past mistakes “you said you could tolerate a 20% loss.” Instead of fighting with them or holding them to past decisions waiting to see who will be right and who can tough it out longer, why not solve the present problem?

For example, say your client is concerned about risk...how about saying, “I’m concerned about the losses in the market too, why don’t we get together to see what choices you have to reduce your portfolio’s risk?” This is not stated in ignorance that the client may be responding emotionally to the present market environment. In fact, because it very well could be an emotional response it is critical to *apply reason*, i.e. the price to their life of reducing risk. **It is not reasoned to say to a scared client, “suck it up and stick with it because we are long term investors!”**

If you examine the choices of reducing risk and the price to the client’s life is two more years of working and \$10,000 more in savings each year and they prefer that over the fear they are experiencing, you are obligated to DELIVER the lower risk portfolio and correct what was obviously a mistake. Does it really matter whether the false impression of their risk tolerance was caused by your misinterpretation or their overestimation of their tolerance? Would you rather spend your time proving they were wrong about their risk tolerance? Or, might it be better to get them comfortable that you are there to solve their problem?

Summary

I think, based on experiencing the contradictions of the best practices, that these premises make more sense. I think that our discipline provides a service that meets the needs and desires of our target market. I know it is more understandable, easier and more convenient to clients (and advisors). And, while we are not looking to pay the price of absolute certainty (nor would we pay the price of a car that would be guaranteed to last forever) we have a service that meets a reasonable standard of quality, reliability and confidence that our current best practices evade.

I also know we have not yet invented everything and that each year we can build on our knowledge. Since designing this process nearly five years ago, we have made numerous other “discoveries” by objectively examining contradictions we perceived. These include questioning how capital market assumptions are built, as well as the debate of active versus passive management among others. It is difficult to take things you accepted and practiced for a long time and objectively consider contradictions. It is however, what we do, and will continue to do. This is the future of financial advising...