# Advising in a Volatile Market
# - The New Uncertainties.

**Part 1: Why your clients are feeling the way they do and what you can do about it.**

The key messages in this article are:

- Behaviour is a function of risk tolerance, the perceived risk and the goal being sought.
- Many clients are feeling some degree of unease in the current market.
- It is very important to distinguish between those who are unhappy with the returns but not the advice and those who are unhappy with both returns and advice.
- If clients are in shock, it will most likely be because they didn't understand the risks they were taking, which reflects badly on the advice they were given.
- If the original advising process was sound, taking clients back over that process will help.
- Clients who have been following the same investment strategy for some years will most likely still be better off today than if they'd followed a less risky strategy.
- A complete review of the client's plan will re-anchor their expectations and commitment, and shift their focus from the present and past to the future.

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# Advising in a Volatile Market

## Part 1: Why your clients are feeling the way they do and what you can do about it.

For many clients and many advisers, this is their first choppy market, for everyone else its been a long time since markets were so uncertain.

Even those who accepted intellectually that returns could be negative may be having emotional difficulty dealing with the reality of the day to day or even intra day price movements.

At the other extreme, those who believed that the irrational exuberance of the last 5 years was the norm are likely to be devastated.

Those in-between will be experiencing various degrees of discomfort.

And many - whether anxious, devastated or only mildly discomforted - will be wondering what to do next.

**The best opportunities for cementing trust in relationships occur when times are tough.**

The new uncertainty is a future that advisers must confront on a daily basis.

This first part considers why your clients are feeling the way they are and what you can do about it.

While difficult times such as the present pose challenges in dealing with clients, they also do provide a real opportunity to demonstrate the value you bring to the relationship – much more so than when everything is rosy.

### Are your clients in shock?

Imagine your client is driving to a country wedding and they have just had a near miss. Suppose that halfway through a tight bend, the bitumen suddenly changed to gravel and they nearly crashed.

Your client's immediate reaction will depend on how shocked they were. And that depends on how risky they thought it was to be driving on that road, at that time, at that speed.

Before the near miss they will have been travelling at a speed that balanced their driving risk tolerance, their perception of the driving risk and their goal of arriving on time for the wedding.

### Risk tolerance is relatively stable but perceptions of risk can change in an instant.

If badly shocked by the near miss, your client may actually pull over until their heart stops racing. Or perhaps they'll proceed but more slowly than before. Eventually they may get back to the speed at which they were travelling but possibly not through bends.

**Our expectations about the possible outcomes determine how risky we judge a course of action to be.**

If they change their driving speed, it will most likely be because their perception of the driving risk has changed. They simply didn't realise there were unsealed sections in the road.

### Behaviour is a function of risk tolerance, the perceived risk and the goal being sought.

In what they now perceive to be a more risky situation, your client must decide whether to proceed at the old pace and risk more shocks or slow down and risk being late for the wedding.

Before considering how you should advise your client in these new circumstances, it's worthwhile considering how they could have been avoided in the first place – even if only for how you should now advise new clients.

### Could the shock have been avoided?

Imagine you were a professional trip planner. It would be expected that you were familiar with the possible routes and the conditions the client would encounter on those routes.

### How would you have advised the client?

You'd start by doing a fact-find (know the client). You'd identify the goal (to arrive at the

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wedding on time.) You'd check what resources the client was prepared to devote to achieving the goal (how much time was being allowed for the trip.) You'd assess the client's driving risk tolerance (the speed at which they'd be comfortable driving in the conditions they'd encounter.)

**Gap analysis.**

If there was a gap between what the client desired and what was possible - if the goal wasn't going to be achievable at a speed they'd find comfortable and within the time allowed by any of the possible routes, you'd tell them that something's got to give - either they start earlier (add more resources), drive faster than they're comfortable with (take more risk) or arrive late (revise the goal.)

**Trade-offs are inherent in the planning process ... but they are the client's trade-offs to make based on their goals, their resources and their risk tolerance.**

Where there's a gap, there's a decision to be made.

**Whose decision?**

It is the client's decision, not yours. Just because you might be comfortable driving at a speed that would achieve the goal, that doesn't mean it's the right thing for the client. Or, just because other wedding guests would drive faster, doesn't mean the client should. Similarly, though you might be willing to plan to arrive late, the client may find that unacceptable.

**Explaining the risks**

Once the client had decided on a travel plan, using the information and guidance you'd provided, your final task would be to make sure they understood the conditions they were likely to encounter (know the product.)

Now let's fast forward to the present.

**Being an adviser right now is hard – here's how to make it easier.**

With new clients, follow the "trip-planning" procedure described above. Namely, evaluate their financial resources, test their risk tolerance and see whether their goals are achievable from their resources within their risk tolerance. If not, help the client evaluate the alternatives. Then make sure they understand the risks of the alternative they choose. Finally, make sure you get their signoff on this process.

If you followed the "trip planning" procedure when your existing clients embarked on their current plan they should not now be in a state of shock. They may be unhappy with recent returns but they have no reason to be unhappy with your advice - *"That unsealed section was a bit scary but you did warn me."*

**The skilled adviser looks beyond a client's unhappiness at losing money to see if the client is also unhappy with the advice.**

**It is very important to distinguish between those clients who are unhappy with the returns but not the advice and those who are unhappy with both returns and advice.**

For clients who are unhappy with the returns but not the advice, take them back over the decision-making process they went through and your explanation of risk. Review the plan: re-test their risk tolerance, re-evaluate their resources and re-confirm their goals. If there have been changes, adjust the plan and get them to sign-off on the adjustment.

The reassurance they will derive from this review should be sufficient to calm any anxiety – *"OK. I did get a scare on the unsealed section. It was my first experience of gravel. But I do want to get to the wedding on time so I'll keep going at the same speed"* or *"I really didn't like that unsealed section. It's better to arrive late than risk an accident. I'm going to slow down."* or any one of a number possible Plan Bs the client may now choose.

**You cannot inform a client that they are embarking on a plan outside their risk tolerance if you have not separately assessed their risk tolerance.**

**Clients in shock.**

If your existing clients are in a state of shock, it will be because they didn't understand the risks - *"I thought the road was sealed. I wasn't expecting unsealed sections. Suddenly finding myself travelling at that speed on gravel was a very nasty surprise."*

If they've been following the plan for some time, say three years, they should still be better off than if they'd adopted a less risky strategy – *"In the early stages, the road was much better than I'd expected and I got ahead of my schedule. I've just had a scare but I'm still on target for my*

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*goal."*

**A litmus test on the advice you gave.**

The real danger is with the client who has been following their plan for only a year or two. You have a potential claim on your hands if they can say *"You told me to drive at a speed you should have known I wouldn't be comfortable with. I relied on your advice. What's more, I didn't understand the risks because you didn't explain them properly. If I'd known then, what I know now, I would have started earlier or given the wedding a miss and gone straight to the reception or … whatever."*

With such a client, you're best bet is to get them to see what has happened as a "hiccough" and to focus on helping them regroup and replan in the new circumstances.

**Gut-reactions can be wrong.**

Another driving metaphor may be helpful here. If, in the middle of a sharp bend, your client suddenly felt they were driving too fast, the natural tendency is to ease off on the accelerator and, perhaps, even to brake. Experienced drivers know that this is a mistake. It's best to keep the power on and, maybe, even to apply more power.

Additionally, a persuasive case may be made that, contrary to popular sentiment, markets are in reality less risky today than they were.. In effect, having fallen as they have, they are now far more likely to be better priced than they were.

The next part of this series will be a Risk and Return Guide. FinaMetrica has a detailed analysis of thirty five years of month-by-month portfolio performance. The Risk and Return Guide draws on this analysis to provide a best practice explanation of risk and return issues at the portfolio level. You will be surprised by some of the implications.

**The madness of crowds**

Well-regulated investment markets are generally efficient, most of the time. But every now and then crowd-madness – mania or panic - distorts them. Of course, not all investors are sucked in but it can be difficult to keep your head when everyone else seems to be losing theirs.

**"I can calculate the motions of the heavenly bodies, but not the madness of people."
- Sir Issac Newton, losing investor in the South Sea bubble.**

If the wedding-guest client had found that other guests were continually zooming past, it would be difficult not to be dragged along.

It is important to realise that market conditions reflect the views of active participants. Those (the majority?) who are following a buy-and-hold strategy do not influence market directions except when they are making new investments. For those who are merely adjusting portfolios, market conditions reflect the adjustments not the portfolios as a whole.

Nonetheless, the frantic few will charge off in one direction or another, and others (even fund managers who should know better) will be inclined to follow. The media jumps on the bandwagon and markets become irrational.

A FinaMetrica research study involving 20,000 completed risk profiles indicates that market sentiment has less effect on investors than is commonly thought, particularly where investors are clients of advisers. FinaMetrica analysed risk tolerance scores over the period May 1999 to Feb 2002. Though market sentiment soared then dived, there was no marked change in risk tolerance scores across the period, and for clients of advisers the average score in any quarter was within a few points of the average across the period and followed no discernable pattern.

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