Advising in a Volatile Market
- The New Uncertainties.

Part 2: How to manage your client's expectations so that unrealistic expectations don't cause either of you grief.

In summary, the key messages of this article are:

- When explaining 'risk', remember that what risk means to you is probably quite different to what it means to your client – a dangerous potential cause of mismanaged expectations.
- Explaining portfolio risk in meaningful terms is the key to avoiding unhappy clients. They must understand the risks at the investment strategy level.
- You are not expected to have a crystal ball, and a client with well-managed expectations will know you don't have one. But they will expect you to make the potential downside clear - how often, how deep and how long!
- The more downside risk can be personalised the better. Explain what can happen (in dollar terms) to the client's money – tomorrow!

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Advising in a Uncertain Market

Part 2: How to manage your client's expectations so that unrealistic expectations don't cause either of you grief.

One of life's most unpleasant surprises for clients is to discover that they have been exposed to a level of risk they would not have chosen to accept. All the more unpleasant if this discovery has occurred because they actually suffered a loss outside the range of what they thought was possible.

On the other hand, it can be similarly disappointing for them to discover that their "upside" expectations have been overly optimistic ... that they have been following a path they thought would get them to their chosen destination in their chosen time frame, when, in reality, there was not much chance of this occurring.

Most client fallout comes from mismanaged expectations – and you can control expectations.

Your clients will look to you for guidelines as to the expected outcome and the likely range of outcomes for the course of action they will be following. You have the opportunity to mould their expectations and it is surely in your interests to see that their expectations are realistic.

Unrealistic expectations can quickly become unfulfilled expectations and unfulfilled expectations tend to cause grief for all concerned ... except the lawyers and the bureaucrats.

In an Uncertain Market it is natural to focus on the "downside" aspects of unfulfilled expectations and this article will do that.

However, over the long run, memories of intermittent "downside pain" become blurred as the focus shifts to achievement of the purpose for which the journey was commenced.

For most clients and many advisers, this is their first Uncertain Market and all the more scary for that.

It's a bit like the first time your car starts to slide sideways. You might know it can happen. You might have seen it happen to others. But when it's happening to you the first time, your gut lets you know in no uncertain terms.

Nonetheless, while this Market will be scary for first-timers, it should not be outside the range of expectations. In recent times, in fact during the adult life of many, there has been a deeper and longer fall, 1973.

So, if your clients are unhappy with the advice they were given, as distinct from the results they are experiencing, something's gone wrong.

Remember, our expectations about the possible outcomes determine how risky we judge a course of action to be.

Part 1 of this series examined how the client's journey should be planned and, in particular, the role of risk tolerance in that planning process. Once the optimal plan has been identified, the final task before embarking on the journey is to confirm that the risks are understood.

If the risks were explained properly, this Market should not be causing your clients to question your advice.

If your clients are unhappy with your advice then either risk was never properly explained or they didn't understand the explanation or the explanation has been forgotten.

In the first scenario, you have a potential claim on your hands that will be difficult to defend. In the second, you could be subject to such a claim - advisers have a responsibility to explain risk in terms their client can understand. In the third, providing you can prove that risk was properly explained, then there is no basis for a claim - but that won't necessarily prevent one being made.

In any event, no-one enjoys having unhappy clients.
Even if you're blameless, it's stressful and bad for business.

So, how should you go about explaining risk?

It's not easy. Some of the reasons for this are obvious, but others are not.

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The term itself is a problem. It means different things to different people, and even within the industry we don't use it consistently - its meaning often depends on the context in which it's used. The linguistic knots we tie ourselves in because of a reluctance to talk about "insurance" don't help.

'Risk' is a loaded term. When you say 'risk', what does your client hear … 'danger', 'uncertainty', 'opportunity'?

When we talk about investment risk in the context of an overall strategy, we mean that there is uncertainty about the real future value of the investment and the real rates of return that will be earned. Unfortunately, what clients tend to hear, new clients in particular, is that there is a danger of losing (all) their money.

What is it that your client needs to understand about investment risk?

First and foremost, your client needs to understand the risks at the investment strategy level. This, in effect, means understanding "portfolio risk".

Your client's investment strategy is implemented through one or more portfolios. A portfolio should be more that a collection of individual investments. In theory, at least, diversification means more than simply making multiple individual investments. Unless the individual investments are chosen with an eye to their covariance the benefits of diversification will not be fully realised.

It is important for clients to understand that in a properly diversified portfolio, the individual investments should perform out-of-sync with one another.

While clients might be pleased to see all their investments performing well simultaneously, this should ring warning bells for you both because it implies that, in future, they could all be performing poorly simultaneously.

While this article is not intended to be a dissertation on diversification, some discussion of diversification is required for clients to understand portfolio parameters. In this regard, the example of the benefits from blending an investment in a AAA company that makes Sunscreens with an investment in a AAA company that makes Wet Weather Gear, will usually illustrate the point.

There are two different types of risk for your clients arising from the uncertainty surrounding future values and returns.

The first is that falls in value and/or poor returns can cause your clients to feel anxiety about their financial safety. No client wants to feel that their financial well-being might be in serious danger. What constitutes serious danger (as perceived by your client - and it's your client's perceptions that matter here) will vary from client to client.

Clients who find that their investment portfolio is performing below what they thought was possible, will feel anxious. In some cases such anxiety can be so great as to cause physical illness. So there can be physical damage as well as psychic damage. And, of course, if the client sells the investment, this converts what was poor performance on paper into a real financial loss … with a very real chance of your client becoming The Plaintiff.

Each of your client's has an individual comfort zone for risk … not yours, not what you think theirs should be, not their partner's but their own. – knowing this enables you to properly set expectations.

What sort of information does a client need to have in order to form a meaningful understanding of "downside" risk?

Let's suppose you're considering moving to a new city in a foreign country and that you really don't like wet weather. What would you need to learn about the rainfall pattern in that city to know if you'd be comfortable living there?

You might start with the average annual rainfall. Perhaps, also, the average number of rainy days annually. And, you'd probably want to know the average number of days on which it rained more than a specific amount.

Then, what about patterns and extremes? For instance, over the last ten years, what has been the greatest number of successive rainy days, the wettest month, the wettest day and so on?

If there's been flooding, you might want to know how long it took for the floodwaters to drain

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away – hours, days or weeks?

But would you be interested in the mean and standard deviation, and 95% confidence level for daily, monthly, yearly rainfall? Not unless you were a meteorologist. That sort of information would be helpful in comparing one city with another but not in easily capturing the experience of living in a particular city.

Statistical information is only ever a pale cipher of the richness of real-life experiences. Yet, isn't that predominantly the sort of information we give clients about their investment portfolios?

Applying statistics mechanically would have a client who dislikes rain living in a desert!

Why does this happen? Well, fund managers and research houses prepare this information for industry professionals so that we have ways to do comparisons, make forecasts and the like. But we're the "meteorologists" in this picture. It's up to us to put the information into a context that is meaningful for our clients.

And, it must be remembered that clients (new clients in particular) know less about investing than non-meteorologists know about the weather. After all, everyone, meteorologist or not, has considerable personal experience of weather.

So what is it that a client really needs to know about "downside" portfolio risk?

This was one of the key questions we had in mind when preparing the FinaMetrica Risk and Return Guide and Charts whose aim is to provide advisers with resources that enable best practice in educating clients about risk and return, and in managing their risk and return expectations. To download the FinaMetrica Risk and Return Guide and Charts, visit www.riskprofiling.com. This document combines the results of two separate pieces of research:

- analysis of 20,000 completed risk profiles, and
- historical back-testing of a representative set of seven investment portfolios on a month-by-month basis for the period January, 1972 – June, 2007.

Information about Portfolio 4, a typical 50/50 balanced portfolio, is used to illustrate the balance of this article.

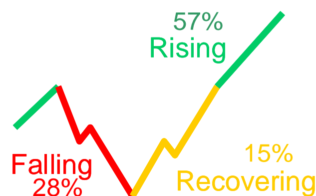
As an aside, it is interesting to note that in looking for information about future rainfall patterns, it was natural to start with the past. Once the past is understood, it can then be asked how the future might differ from the past. More on this later.

The very first thing clients must know is that there is a downside to any portfolio. No portfolio will provide positive returns day after day, month after month, year after year, indefinitely.

Sometimes a portfolio will be falling (from a previous high.) Sometimes recovering (from a previous low) and sometimes rising (from a previous high.)

Once this is accepted, the obvious questions are how often, how far and for how long is my portfolio likely to fall?

To answer these questions it is not sufficient to consider just fixed time periods, even rolling periods. A fall can start at any time and has no fixed length. Investors experience falls as they happen, not in any fixed time frame.



How often will the portfolio be falling?

To accommodate reality as experienced by investors, the value of the portfolio was tracked month-by-month with each month being categorised as Falling, Recovering or Rising.

The pie-chart shows the frequency of each over the 35.5 year period.

So, the portfolio was falling 28% of the time, which answers the "How Often?" question.

Next, let's look at the "How Deep?" and "How Long?" questions.

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Length of Fall (Months)	Depth of Fall					Total
	< 10%	10% to 19%	20% to 32%	33% to 49%	=> 50%	
1	35					35
2	8	1				9
3	4					4
4-6						
7-12	2					2
13-24	1		1			2
>24						
Total	50	1	1			52

Analysing changes in portfolio value over successive months showed that there were 52 periods of one month or longer during which the portfolio's value was falling.

The table opposite categorises these by Length of Fall and Depth of Fall.

Of the 52 falls, 44 lasted two months or less and 50 were of less than 10%.

Finally, there is the "How long does it take the floodwaters to recede?" question.

Depth of Fall	Started Falling	Months in Fall	Months to Recover	Completed Recovery
-20.2%	Feb-73	20	13	Oct-75
-18.1%	Oct-87	2	19	Jun-89
-7.8%	Feb-94	10	4	Mar-95
-6.3%	Jun-81	10	4	Jul-82
-5.8%	Mar-80	1	2	May-80
-4.5%	Jan-02	14	2	Apr-03
-4.3%	Aug-98	1	1	Sep-98
-4.2%	Aug-90	2	3	Dec-90
-4.2%	May-84	1	1	Jun-84
-3.4%	Oct-97	1	1	Nov-97

The 'TopTen' Falls by Depth are shown in the table opposite, along with the month in which the Fall began, the duration of the Fall, the duration of the Recovery and the month in which Recovery occurred.

The 20.2% fall that began in February 1973 didn't bottom out until October 1974 and the portfolio didn't get back to its pre-fall value until October 1975. A long, slow fall with a slowish recovery.

TV weather presenters get statistics from a meteorologist – but they tell you it's a good weekend to go to the beach, not that there's a 90% confidence level of zero precipitation.

By way of contrast, the portfolio's value on 1st October 1987 reflected the crash of the previous month from which there was a drawn-out recovery.

Taken as a whole, the information described above should give your client an answer to all the relevant "rainfall" questions about this 50/50 balanced portfolio. However, one final step is well worthwhile and that is to personalise the information by applying it to the client's current position.

"What this means in your situation is, for example, if a once-in-35-years fall (like the one that began in February-1973) were to start now, then the $100,000 you're about to invest would lose value progressively over the next 20 months to a low of $79,800 and would not have recovered to $100,000 until nearly three years from now."

Our Risk and Return Guide and Charts provides historical "rainfall" patterns for each of seven progressively more aggressive portfolios. Your client can see how many falls there were, how far the portfolios fell and for how long, and the time it took to recover to the pre-fall value. By comparing portfolios it is easy to see that the more aggressive the portfolio, the more frequent and the deeper were the falls.

"Past performance is no guarantee of future performance" has become an industry mantra. But it is at best a half-truth propagated by those whose primary concern is to limit their liability with regard to promotional claims rather than actually inform investors.

Any understanding we have about what might happen in the future is based on what we have learned from the past. Unless we understand the past, we have no basis for predictions about the future.

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Returning to our rainfall example, it would be reasonable to assume that global warming would have some effect on future rainfall patterns. But exactly what effect in any particular location is not an easy question.

With investment we can be sure that the future won't be a mirror image of the past but we can be highly confident that it will be similar.

Unfortunately, there are no guarantees. Life's not that easy. But we have all learned to live with the day-to-day uncertainties of the weather.

By making sure your client has a meaningful understanding of past investment performance, you can help them live with the uncertainties of whichever portfolio best suits them personally.

More importantly, you have provided a sound basis for them to have realistic expectations of the "downside" risk.

The most dangerous period in a client relationship is the first few years. If there is a setback here, before the client has experienced the benefits of your advice, their confidence in you can be severely shaken, particularly if the setback comes as a surprise. At the very least, the relationship will require rehabilitation and it may sour completely, with unpleasant consequences for you and your (ex)client.

Beyond question, it is in both your and your client's interests to ensure that their expectations are realistic.

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