Effective Use of Technology:

Adding Critical Consistencies to the Financial Planning Process

With reliance on unscientific methods alone, many advisors may fail to help investors' understand financial risk appropriately. The essence is to meaningfully establish investors' investment expectations and in the current times technology is aiding the advisory processes, by providing more reliable and scientific tools, for accurate risk evaluation and for enabling right communications with the clients.

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The first part of this article identifies four of the major consequences and benefits of better managing investors' expectations. The second outlines four of the critical components of the financial planning process that are currently delivered with low levels of consistency. The third part discusses how these critical components are being integrated into turnkey solutions for financial advisers. This argues that by rigorously seeking to apply five proofs to the client advice process advisers can obtain the client's properly informed commitment to both their financial plan and the risks in their investments.

Personalising the Truth about Investments

The benefits of adding higher levels of consistency to the planning process are based on the establishment of realistic investor expectations of future investment outcomes at the portfolio level. Technology developments linking the various components of the planning process can assure practice owners that risk is being dealt with consistently. The benefits of consistency include:

- Improved business profits because clients who are surprised by market and portfolio volatility can often take inordinate amounts of adviser's time to manage and may become plaintiffs. Adviser productivity is increased by reducing the time spent dealing with clients' investment dissatisfactions.

- Enhanced investor satisfaction with their investments and ultimately their adviser experience. Happy clients are almost invariably more likely to remain as long-term fee paying clients and can usually be encouraged to refer their peers.

- Improved regulatory compliance through more clearly showing the link between an investor's financial risk tolerance and the recommended portfolio. Happy regulators leave management to spend more time managing and improving the practice.

- Improved investment persistency. Investors are less likely to sell at the bottom of the market cycle and less likely to buy at the top of the cycle. These are arguably the two single behaviours that are the largest destroyers of investment value for poorly educated and managed investors.

Overall the combination reduces reputation and business risk, and consequently leads to growth in enterprise value for practice owners.

Four Key Inconsistencies

As the planning profession matures and advisers gather together in larger professional groupings a number of poor practices are becoming more obvious:

- Advisers inaccurately and inconsistently assess their clients' tolerances for financial risk. A useful definition of risk tolerance is "the level of risk an individual would accept in their financial affairs if goal achievement was not an issue". For couples acting jointly, the risk tolerance of each is relevant. It is rare to find psychometrics being applied to the assessment of risk tolerance. Lacking the discipline of psychometrics it is highly unlikely the typical risk questionnaire can accurately assess risk tolerance at all. More often than not there are questions relating matters such as goals and time horizons that, while relevant to financial advice, are irrelevant to an assessment of the client's psychological attitude to risk.

Further, it's not uncommon to find individual advisers in a collective using different assessment tools. In fact it's very rare for larger practices to be utilising a consistent enterprise-wide solution.

- When it comes to explaining investment risk it seems every investment manager uses a different set of explanations. The most insidious of these is what is often called the "funnel of uncertainty" which shows volatility diminishing over time. This is intended to mollify investors concerns about the possible variations of value generally associated with equities, properties and longer term bonds. They usually show two standard deviation performance ranges diminishing in three steps: 1 year, 5 years and 10 years. Of course these explanations are the opposite of what the investor is likely to experience. In fact the funnel should be reversed if good communication was the goal. The range of outcomes actually increases over time. For instance, applying the same standard deviations by year 10 on an initial investment of $100,000 might reveal a value as little as $62,000 or as much as $163,000. And of course this does not explain the consequences on investor monies of the outlier events sometimes called 'black swan' or 'fat tails' that are beyond the two standard deviations.

- It's hardly surprising given the challenges created by the first two points - the inaccurate assessment of risk tolerance and the incorrect explanation of investment risk - that more often than not each adviser in a planning practice explains financial risk to clients in their own idiosyncratic way. Whilst there is something to be said for taking individual circumstances into account and personalising explanations this is not an ideal way to run a business. Almost all successful businesses have a core belief in standardising, setting and at least meeting client's expectations. Traditional financial advising businesses on the other hand seem to have an almost perverse preference to do the opposite.

- The principals of planning businesses tend not to enforce a defensible and rigorous method for their advisers to arrive at portfolio recommendations. A vast number use simple "portfolio-picker" quizzes. Usually around 10 questions. Half to [inaccurately] assess risk tolerance and the other 5 to take into account time horizons, risk capacity, investment knowledge and client preferences. An opaque algorithm that owes more to astrology than it does to common sense is applied to generate a portfolio recommendation. If it actually matches the client's needs it's more by luck than skill. More often than not couples are assessed as one entity, merging any differences they may have without any opportunity for exploration by advisor or client. The score then converts to an investor description such as "you are a conservative investor who appreciates capital security and a steady and reliable income" and suggests a portfolio mix to do so. Consequently the risk is that the 'advice' ignores personal circumstances, lifestyle needs, longevity and emotional needs. Because this is so obviously nonsense many advisors undertake such process just to make their files look tidy. Often they then ignore the outcome altogether. The whole empty exercise becomes a mere lip service to compliance. This often leads to adviser-centric advice where the risk tolerance of the advisor is projected on to the client.

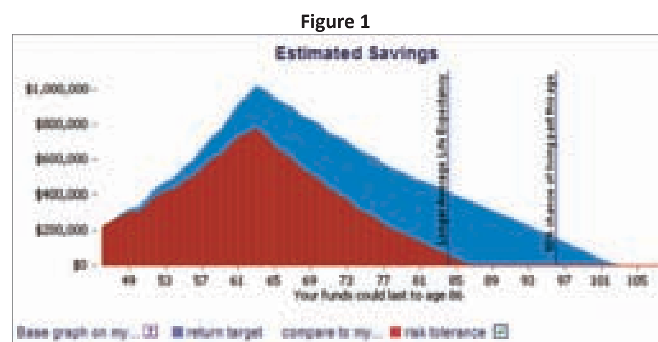
In smaller individual practices the consequences of these four inconsistencies are rarely extreme. However as larger collections of advisers develop it is no longer possible to ignore their value-destroying outcomes. Technology enables the practice to both standardise the planning experience and record its process. For instance, in recent times CRM systems have begun incorporating all client conversations, both face to face and telephone, between clients, advisers and practice support staff into client files.

The Five Proofs – The Route to Informed Consent

Good advisory businesses serve their clients while protecting themselves by rigorously seeking to apply five proofs to their client advice process:

- They can prove know-their-client: current situation (assets and liabilities), present and future cash flows, aspirations, risk tolerance and risk capacity. Best practice tells us that advisors should be able to illustrate this to clients with words, numbers and pictures. For instance,

Figure 1



in Fig 1, the client needs to decide if they will take the investment risk required to meet their goal of leaving an estate to their children of approximately $200,000 at age 96 or run out of money at age 86 by accepting the investment risk consistent with their risk tolerance.

- They can prove that they have explored the range of alternative plans and strategies with the client. These strategies may include a need to work longer and harder, spend differently, change jobs or perhaps set up a business. The overall goal is to improve the client's lifetime cash flow position. Good planning software will

allow multiple what-if scenarios to be explored, storing the results of each exploration.

- They can prove know-the-product for the products that they have selected to implement the client's strategy. Once they have decided on the strategy and relevant products they need to understand those products so they can argue that they appropriately meet the client's needs. They may use external research to assist in making those decisions but the advisor is responsible for the final recommendation. The key issue, revealed by the current global melt down, is to understand how the product or service will behave when the markets fluctuate. Many products work well in good times but have a history of failing in bad times. A good understanding of economic history is needed when stress-testing products.

- They can prove that they have explained the risks in the strategy and in the products, particularly to establish performance and down side expectations. The advisor can then determine with the client the level of financial risk that the family is prepared to accept in pursuit of its goals. Generally risk is translated through to the amount and type of risky assets such as shares and property held compared to safe assets such as cash in the bank. Some may choose to hold more non-risky assets even though they might have less chance of achieving their future goals. Critical here is both an education of the client - illustrating what can be lost - and an understanding by the client of the impact on their plans if that loss occurs. For instance, in the forty years since 1970, the top ten falls in value experienced by UK investors in a portfolio consisting of indexed funds with a 50% exposure to growth assets are shown in Fig 2. By comparison, investors in a portfolio with 85% exposure to growth assets would have seen greater drops in value, Fig 3. What is the correct portfolio for the client? The one that meets their needs and for which they understand the risks.

Figure 2

Depth of Fall	Started Falling	Months in Fall	Months to Recover	Completed Recovery
-18.7%	Jan-08	14	2	Apr-09
-17.0%	Apr-92	8	11	Oct-93
-15.8%	Mar-00	19	14	Nov-02
-8.1%	Oct-90	3	1	Jan-91
-8.1%	May-98	4	4	Dec-98
-6.8%	Aug-97	6	1	Feb-98
-6.2%	Sep-94	6	9	Nov-95
-5.9%	Jan-04	5	5	Oct-04
-5.7%	Jul-96	5	2	Jan-97
-5.3%	Jan-90	2	2	Apr-90

- They can prove that they received the client's informed consent to accept those risks in pursuit of their goals.

Figure 3

Depth of Fall	Started Falling	Months in Fall	Months to Recover	Completed Recovery
-40.7%	Jan-08	14	9	Nov-09
-36.4%	Mar-00	19	26	Nov-03
-26.9%	Apr-92	8	13	Dec-93
-14.3%	May-98	4	4	Dec-98
-14.1%	Oct-90	4	2	Mar-91
-13.2%	Sep-94	8	11	Mar-96
-10.6%	Jul-96	5	2	Jan-97
-10.4%	Aug-97	6	1	Feb-98
-9.5%	Jan-04	5	5	Oct-04
-9.4%	Jan-90	2	2	Apr-90

As well as illustrating the more probable outcomes they need to explore the worst case scenarios. They must be able to illustrate extreme events and explore clients' risk capacities. They must be able to show the consistency of the financial plan with the client's risk tolerance. They must have established processes for setting performance expectations and for ongoing management. Obtaining the client's informed consent is an ongoing responsibility. This lies at the heart of the value of the relationship, but is not always understood by advisors or clients. Ongoing informed consent is about ensuring that the advisor continues to understand not just the client's risk tolerance – which is relatively stable – but risk perception, which can change in a heartbeat, and risk required, which can change in time, and risk capacity, which also varies over time.

Summary – the Overall Objective

Technology applications integrating the various components of the planning process as described are now regularly appearing around the world. Advisory businesses that have a reliable methodology for establishing clear client expectations and meeting those expectations will continue to grow. This may well be at the expense of those that rely on investment outperformance as their primary offer. Clients and those that refer clients to an advisory business need to be confident that the advisory business will be there in both good and bad times. A robust advisory process and a high level of client persistency will ensure a higher eventual business value and, more importantly, a better overall client experience.

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