Increasing Cross Referrals and Profits by Reducing Portfolio Surprises

By Geoff Davey

Editor's Note: This is the final article in Geoff Davey's series on risk tolerance. All previous articles can be found online in the Personal Financial Planning (PFP) Member Section's Planner archives.

Despite the obvious benefits from cross referrals, an accounting firm's financial planning practice is often only able to engage with a small number of its staff. It seems many partners and senior managers fear risking professional and personal relationships because of the uncertainty around investment risk. They simply do not want to face clients who are unhappy about the planner's advice because their investments have fallen—and as we all know, they *will* fall.

Clients will become unhappy if they discover in a falling market that they were exposed to what, for them, is too much risk. Previous articles explained that avoiding this situation requires valid, reliable, and accurate risk tolerance assessment, as well as a rigorous, defensible process for arriving at portfolio recommendations in which proper regard is given to the client's risk tolerance.

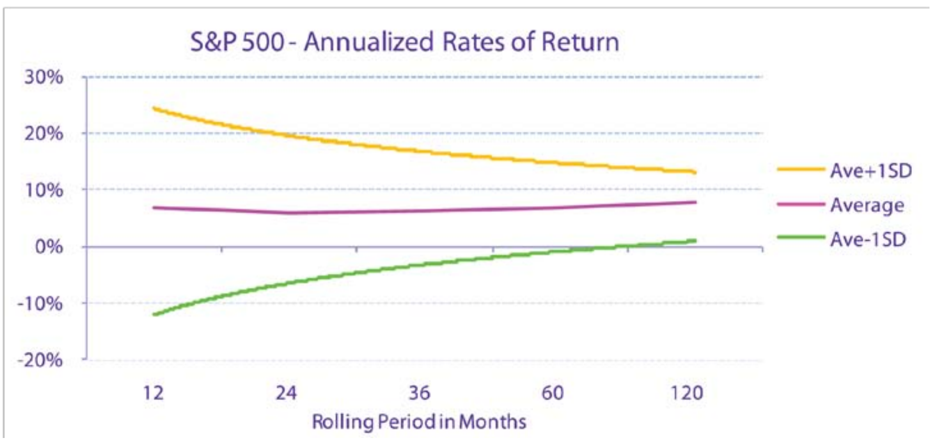
Clients will also be unhappy if they discover that they didn't understand the risks they were taking. Again, they will feel that they were badly advised. It's up to us to help them; but, along the way, there should be no surprises. Here's how to ensure that happens.

Investors Are Unprepared

Everyone knows that investments are volatile, but a diversified portfolio's risk is predictable. Yet, very few professionals in the financial services supply chain explain portfolio risk from the investor's perspective, a result that has led the media, governments, regulators, investors, and the public to look at investment products as failures. In most cases, these products perform as experts would expect, but not as investors expected because they didn't understand the risks they were taking. This, of course, plays out in a lack of confidence in the integrity of investment advice everywhere, not just in an accounting practice.

Unfortunately, investment managers are of little help; the information they provide is not necessarily wrong, but it is misleading. Consider the example in figure 1 of how investment managers frame volatility.

Figure 1

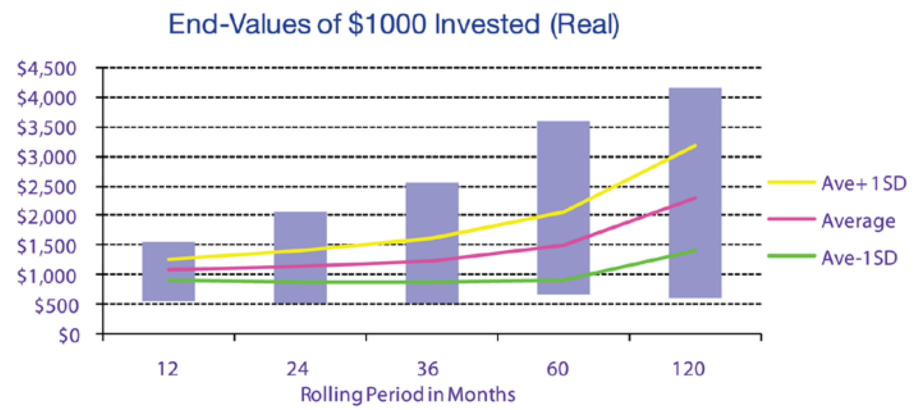


Although the rates of return in figure 1 may be statistically correct, the rates do not provide useful insights for investors because they

- suggest that the volatility of investment outcomes reduces over time, which is simply untrue;
- concentrate on rates of return instead of end values, which are what investors can spend;
- ignore the consequences of inflation;
- focus on one, or sometimes two, standard deviations, which misses outlier events in fat tails; and
- do not help prepare clients avoid excess optimism when markets rise beyond normal—or excess pessimism when markets fall beyond normal.

Instead, what investors care about is the real value of their investment; figure 2 presents this very different picture. The variability of outcomes actually increases over time; over one year, the standard deviation is 21% of the mean compared to over 10 years, when the standard deviation is 39% of the mean—almost double.

Figure 2



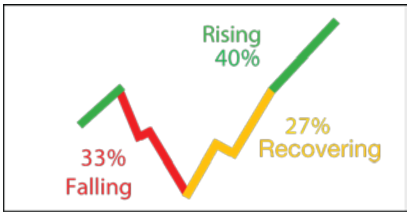
It also should be noted that over 10 years, an investment may actually lose purchasing power, with the average outcome being marginally better than a doubling of purchasing power. Very few investors would have experienced a four-time increase.

Explaining Portfolio Risk Meaningfully

To be prepared for their investment experience, investors need to know how often the value of their portfolios will fall, how deep those falls can be, how long they last, and how long it takes to recover.

Figure 3 shows the frequency of falls, recoveries, and rises based on 40 years of historical performance data on a monthly basis for a portfolio made up of 50% stocks. The complete analysis for a range of portfolios is available for download.

Figure 3



Risk Tolerance Resources

Geoff Davey's presentation on risk tolerance from the AICPA's PFP Conference in January 2011 is available online. The 2011 Advanced Personal Financial Planning Conference audio recordings and presentation materials are now available at the AICPA's Online Library. Registered attendees for the 2011 conference will have complimentary access when they log into the site. Conference attendees, click here for instructions on how to access the materials. Those who did not attend can create an account to purchase audio recordings and presentation materials.

In addition, PFP section members may register for a free 30-day trial of the FinaMetrica system and are eligible for a 10% discount. The FinaMetrica methodology can be seen in full in the QuickStart guide, the linking spreadsheet and its guide, and the Risk and Return Guide, all available as free downloads under the Resources tab at www.riskprofiling.com.

When investors check the value of their portfolio, a one-in-three chance exists that it will be falling. Does the typical investor know this? Interestingly, the frequency of falls is relatively constant from low-risk portfolios to high-risk portfolios; the difference is in the magnitude of the falls.

Of course, the frequency of falls is only part of the picture. Over the 40-year period, there were many different falls. Most were small and quickly over, but some were not. Table 1 shows the top 10 falls over the 40-year period. Does the typical investor know that this is the historical picture for a portfolio made up of 50% stocks?

Table 1

Depth of Fall	Started Falling	Months in Fall	Months to Recover	Completed Recovery
-37.4%	Nov-07	16	22*	Dec-10*
-27.8%	Sep-00	25	25	Oct-04
-26.8%	Jan-73	21	15	Dec-75
-18.6%	Sep-87	3	13	Dec-88
-11.0%	Aug-90	2	4	Jan-91
-9.9%	Jul-98	2	2	Oct-98
-9.3%	Apr-81	6	1	Oct-81
-8.5%	Feb-80	2	1	Apr-80
-7.1%	Jan-90	4	0	Apr-90
-7.1%	Dec-81	4	4	Jul-82

* Recovery not completed

Next is the question of equity risk premium. What are the rewards for taking additional risk? Is the better financial outcome worth the bumpier emotional ride? In Table 2, moving from a 30% stock portfolio to a 70% stock portfolio increases the end-value by less than 20%, but triples the size of the falls!

Table 2

Seven Portfolios - Low Risk to High Risk

% Stocks	0	15	30	50	70	85	100
	Top 3 Falls (1972–2010)						
	-9.1%	-8.5%	-14.3%	-26.4%	-37.4%	-45.1%	-52.5%
	-5.4%	-7.1%	-9.8%	-17.7%	-27.8%	-36.0%	-44.4%
	-3.9%	-4.3%	-8.2%	-15.7%	-26.8%	-33.8%	-40.4%
	End-Value of $1,000 Invested Over Rolling 10 Years (Real)						
Maximum	$2,394	$2,619	$2,852	$3,068	$3,486	$3,854	$4,149
Avg +1 SD	$1,826	$2,003	$2,198	$2,429	$2,722	$2,968	$3,180
Average	$1,512	$1,630	$1,752	$1,888	$2,053	$2,186	$2,291
Avg - 1 SD	$1,199	$1,257	$1,305	$1,348	$1,384	$1,403	$1,403
Minimum	$727	$764	$773	$787	$769	$702	$600

When we look at investment performance over the last 40 years, three key mismatches exist:

1. Portfolios fell in value more often (and there were more falls) than most would expect.
2. The magnitude and frequency of the large falls is likely to be a surprise.
3. Better end-values may be achieved by taking more risk, but at the cost of a considerable increase in the pain along the way.

No (Unpleasant) Surprises

Nothing destroys an investor's confidence faster than experiencing negative events well outside the range of expectations provided by his or her adviser. In a financial planning practice within an accounting firm, this comes back to haunt not only the financial planner, but the referring partner or manager as well.

There should be "no surprises." At the start of the engagement, planners must ensure the following:

- They have a proper understanding of the client's risk tolerance.
- The investment strategy is consistent with the client's risk tolerance.
- The client has a proper understanding of the risk and reward parameters for his or her investment strategy.

Explanations should be couched in the context of the client's circumstances. For example, the planner might say, "In the past 40 years, portfolios such as the one I recommend experienced falls of more than 20% on three separate occasions. If such a fall occurred in the near future, your $1 million could become $800,000. Could you live with that?"

Throughout the engagement, the planner's advice and client's understanding must be regularly reviewed. Although risk tolerance is stable, it does decrease over time and can be changed by life events. As a result, risk tolerance should be tested regularly. When investments are reviewed, the risk and reward profile should be explained again. Don't just focus on recent performance; make sure your client has a clear understanding of the downside, particularly when markets are up, and of the upside, particularly when markets are down.

Managing these relationships shows due respect for the individuality of the client, enhances investor satisfaction by establishing realistic investment expectations, and reduces reputation and business risk. Within a firm, educating the staff about investment risk and reward, and the processes to be followed with clients, will do much to allay the anxieties that inhibit cross referrals within a practice. ■

About the Author

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