Bonsai

An Obsession for Determined Outcomes

A FIVE-PART SERIES FOR FINANCIAL ADVISORS

Navigating the Financial Outcome Puzzle

Very few jobs in financial services have changed as radically as the financial advisor's. Instead of a sales rep, clients increasingly want their advisor to serve as their personal CFO, guiding them through nearly every aspect of their financial lifecycle.

1. It's Not the Balanced Fund, It's The Balance Sheet
2. Have You Ever Seen Your Client Cry?
3. Protect Me From Myself
4. Cash Is Not King
5. Timing Is Everything

The relationship has become simultaneously more intimate and more far-reaching, helping the client set goals, tailor an investment portfolio to fit those goals, rebalance it to maintain that focus, and—critically—manage risk. Guiding the client away from inappropriate investment choices, such as holding too much of his/her assets in cash, can be just as important a part of the advisor's job as helping him/her make the right ones.

The job doesn't end when the client gets ready to stop working, either. Instead, it becomes more challenging, as the advisor helps him/her to time his/her retirement, set his/her lifestyle goals and expectations, and match these to a sequence of withdrawals. On top of this, the job is literally becoming bigger as the "age wave" of Baby Boomers retires, ushering in a complex new period of decumulation.

Mastering the skills needed to succeed in this rapidly evolving role is not easy, but the advisor who succeeds can offer a more valuable service than the traditional sales rep, built on a stable, lifetime relationship with the client and, possibly, his/her heirs. "Navigating the Financial Outcome Puzzle" is a series of five papers exploring the challenges of this new role and how you can thrive in it.

1 It’s Not the Balanced Fund, It’s the Balance Sheet

The old model of the “rep as portfolio manager,” earning fees by managing a pool of assets, is becoming less viable. Investors today are intensely cost-conscious, and portfolio management itself is becoming commoditized. Meanwhile, the digital revolution is overtaking advisors themselves. Cerulli Associates recently estimated the digital advice market at $295 billion, projected to top $1 trillion by 2023. Charles Schwab expects 58% of Americans will be receiving robo advice by 2025.

But investors are concerned about their level of economic preparedness, especially for retirement. To tackle these concerns, they want the help of an investment advisor—and a human one. According to a 2018 Harris poll, 85% would prefer to work with a human financial advisor rather than a robo advisor.

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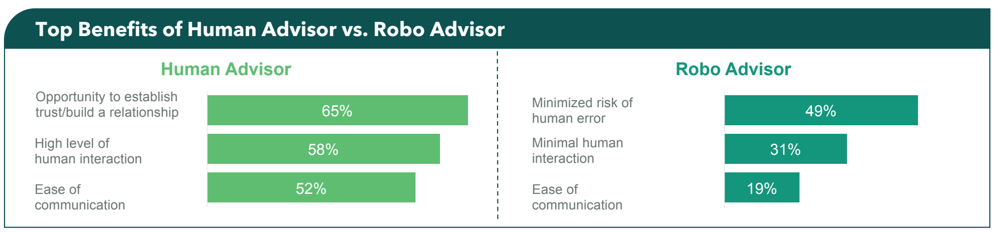
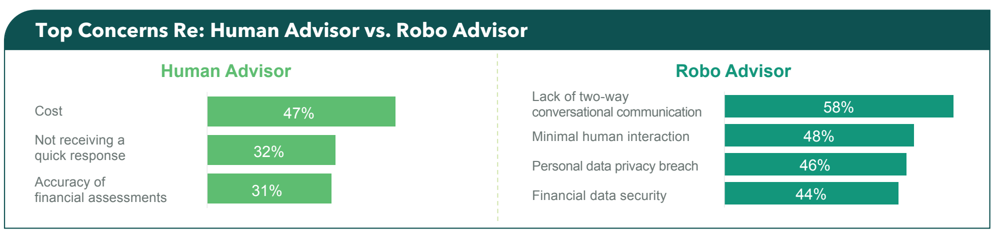




Envestnet 2019 Compendium of Industry Trends

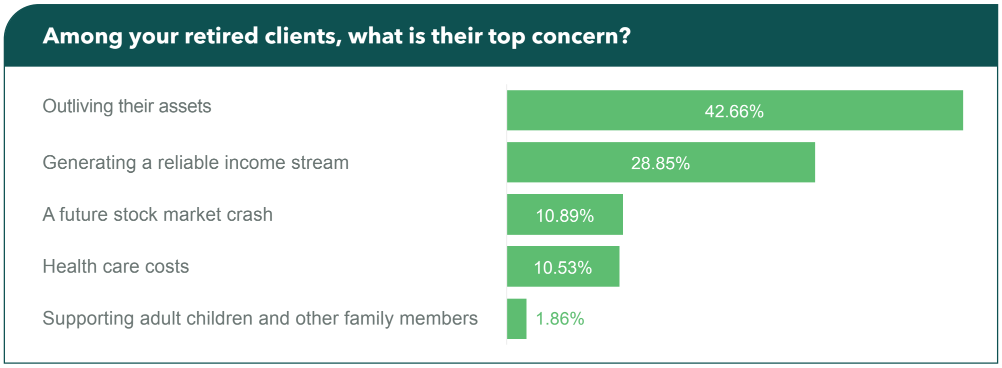
To seize the opportunity, advisors need to shift their focus from portfolio management to financial management, from the balanced fund to the balance sheet. They need to ramp up the level of customization they offer and build their service around a broader range of advice, from investment contribution levels to consumer spending to education and job experience to tax strategy to charitable giving. In short, they need to help their client make life choices, not just allocate investments.

This starts with helping the client articulate their personal and career expectations and write an investment policy statement that facilitates these goals, not just constructing a broad retirement portfolio.

2 Have You Ever Seen Your Client Cry?

Have you ever seen your client cry? If you haven't, there's a high probability that you don't know everything you need to know about him/her.

Financial decisions almost always involve tradeoffs between an individual's multiple goals, preferences, and aspirations, of which a secure retirement is only one if often the most important. As such, they can be a long-term source of anxiety and vulnerability.



Financial Advisor Magazine: "Outliving Assets No. 1 Client Worry"

One reason that robo-advisors have seen their assets under management explode in just a few years may be that individuals feel less vulnerable revealing all relevant information to a database supported by an algorithm than to a human being who may or may not empathize with their particular fears and desires.

Understanding how to get past this barrier is going to be one of your greatest challenges going forward—and one of the most promising routes to closer, more lasting and successful client relationships. You need to understand not just your client's portfolio or investment targets, but your client as a person. While markets may be volatile and unpredictable, individuals can focus on the things they can control: their lifestyle goals, their plans for their children's education, for retirement, for travel, for charitable giving. Helping them to do so is as much the advisor's job as managing client portfolios. But first, you need to know your client.

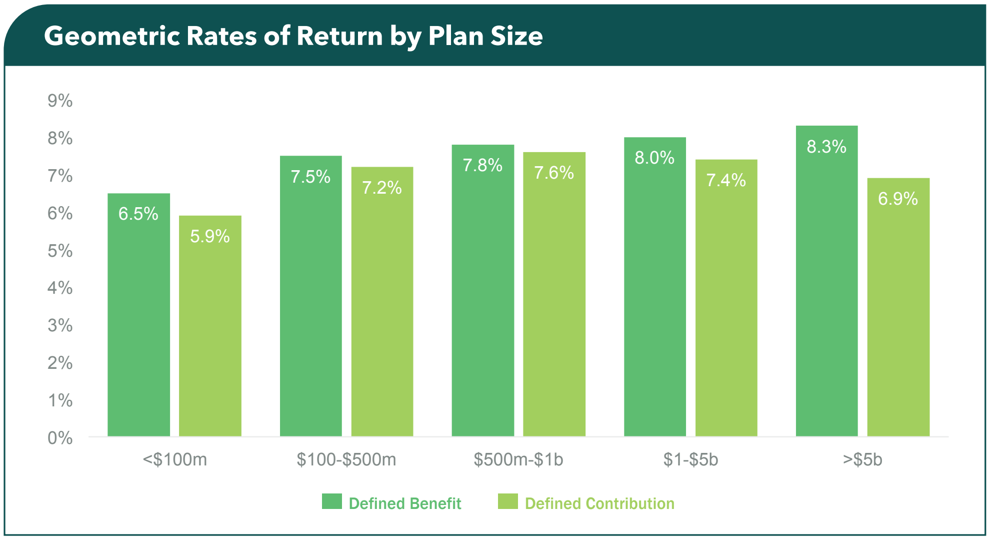
Have you ever seen your client cry? If you haven't, there's a high probability that you don't know everything you need to know about him/her—including his/her assets or relationships with other financial institutions or providers. To be the most successful at your job, you need to give your clients a safe space for vulnerability: to let go of who they think they should be and embrace who they authentically are. This allows them to make a real connection with the Advisor, opening the way for a more frank, practical, and successful relationship.

3 Protect Me from Myself

One thing you can do to protect your client from his/herself is to help him/her create an investment policy statement customized to his/her situation and preferences.

For the advisor, the most immediate benefit of this connection is the ability to design an investment strategy that helps achieve the client's goals.

In theory, a retirement account like an IRA or 401(k) is no different from a traditional employer-sponsored pension plan. Both have the same goal: to make sure the beneficiary has a stream of payments sufficient to fund a comfortable retirement. But individual investors are vulnerable to other pressures that institutions like pension funds are not, leading to ill-judged decisions—and this continues after they retire. Outright fraud is spreading as well.



Center for Retirement Research: Investment Returns: Defind Benefit vs. Defined Contribution Plans, 1990-2012

One thing you can do to protect your client from his/herself is to help him/her create an investment policy statement customized to his/her situation and preferences. Institutions typically operate in accordance with an IPS, which is designed to keep them on track to meet current and future liabilities. Individuals can keep similarly focused if they craft their own IPS and stick to it.

Helping your client to do so means gathering complete and accurate data, establishing his/her investment philosophy – how important is it to him/her to keep trading and other costs low? – establish the appropriate level of risk, and select appropriate investments. And you'll need to review your client's IPS with him/her periodically, in case the facts—or his/her personal circumstances—have changed.

Of course, individual investors are not obliged to abide by an IPS, as pension funds and other institutional investors often are. And here again, a close personal relationship and deep familiarity with your client's aspirations are of the utmost importance.

4 Cash is Not King

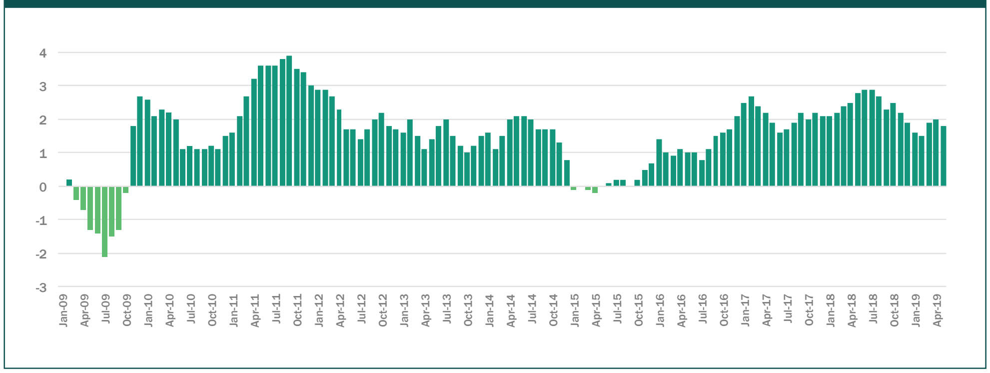
Keeping an excessive share of assets in cash, let alone making cash the principal component of one's retirement savings, is the most financially devastating decision your clients can make.

As an advisor, helping your client implement a successful strategy for managing risk is one of your most important tasks. There are three ways to address risk: accept it, avoid it, or transfer it.

Accepting risk means focusing solely on return: loading your portfolio with high-flying and speculative stocks in the hope of hitting the jackpot. Avoiding risk means concentrating your assets away from the uncertainties of the stock market. For many people, this means keeping it in cash.

But what seems like prudent behavior—in case of bad times, who wouldn't want to be liquid?—is nothing of the sort. In fact, keeping an excessive share of assets in cash, let alone making cash the principal component of one's retirement savings, is the most financially devastating decision your clients can make. The less the individual keeps in stocks, the more the market needs to outperform to compensate for the slow appreciation of cash: an unrealistic expectation. And cash itself veers between extreme highs and lows; even a relatively low inflation rate can spell trouble.

United States Inflation Rate: 10 Years



Trading Economics: United States Inflation Rate

At the same time, life expectancies are going up; about one out of every three 65- year-olds today will live past age 90, and roughly one out of seven will live past 95, according to the Social Security Administration. Retirement, for these individuals, will last almost as long as some of their working careers, and they will need the assets to support them through that period. Avoiding risk, for them, amounts to taking risk, and a long-term preference for liquidity works against the imperative to accumulate assets.

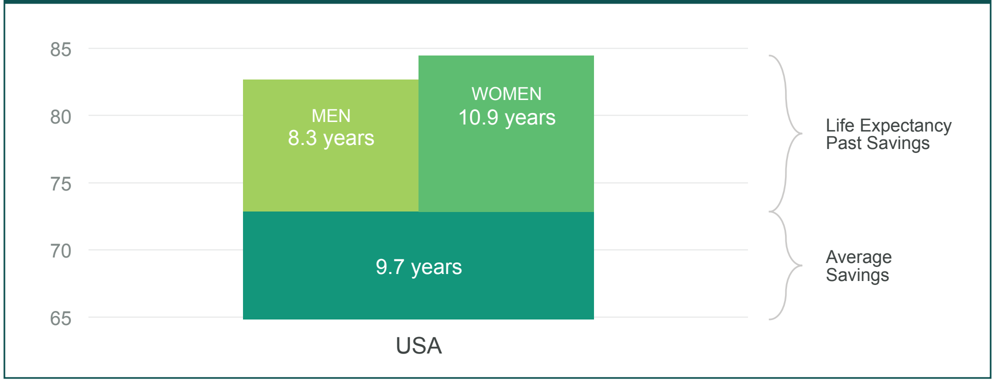
5 Timing is Everything

The risks your clients face in retirement are dramatically different from those that command their attention during their working years. Timing, largely ignored pre-retirement, is suddenly everything.

In our last paper, we discuss the third way to address risk in a plan for retirement: to transfer it.

The risks your clients face in retirement are dramatically different from those that command their attention during their working years. Timing, largely ignored pre-retirement, is suddenly everything, particularly the decision when to begin drawing from their investments and at what rate. According to an analysis by the World Economic Forum, on average, Americans can expect to live roughly twice as long after they stop working as their savings will cover.

Retirement Savings Deficit: Years Saved vs. Life Expectancy



World Economic Forum: Investing in (and for) Our Future, June 2019

Much will depend on where the market stands in its cycle at the time your client stops working. Should he/she work a few years longer? Lower his/her income expectations going forward? Move to a more tax-favorable state?

Transferring risk, for example by purchasing an annuity, could help your clients to address longevity risk by assuring them of a consistent income flow in retirement. Another option is to make sure your clients rebalance their portfolio regularly, maintaining exposure to each asset and asset class at the level specified in their investment policy statement. That means they continually transfer out risks they didn't intend to take.

Remember that for your clients, discussing these options and contingencies can be at least as uncomfortable if not downright fearful as their earlier efforts to decide how much they needed to accumulate to retire. But understanding the risks involved—longevity, inflation, sequence in retirement—and their interdependencies can also be empowering, since it removes the mystery from what might otherwise seem like an unfathomable set of decisions. With your help in tackling these issues, your clients can become stewards of their own pension plan, rather than passive recipients.