Bonsai

An Obsession for
Determined Outcomes

NAVIGATING THE FINANCIAL OUTCOME PUZZLE

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

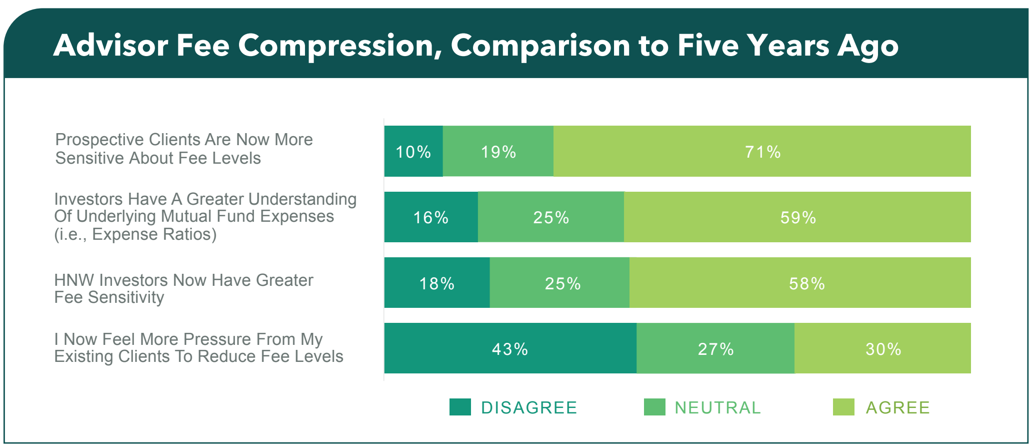
These are revolutionary times for investment advisors; client preferences and practices are changing radically, upending the value proposition that advisors long thought was working well for them and forcing them to reconsider how to attract and retain business.

65% of percent of investment advisors expect to experience fee compression in the next five years, according to Cerulli Associates.

The numbers tell us that 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. As of September 2019, holdings in U.S. stock index funds had reached $4.3 trillion, just short of the $4.2 trillion in active U.S. equity funds, according to Morningstar[1]. Total assets in balanced funds, another low-cost vehicle, soared to over $1.7 trillion, according to EPFR Global[2].

Active fund mangers are responding by lowering their fees. The average asset-weighted expense ratio for actively managed U.S. large-cap stock funds has dropped by almost a third, from 0.92% in 2004 to 0.65% today, Morningstar[3] reports.

Meanwhile, the digital revolution is overtaking advisors themselves. Charles Schwab expects 58% of Americans will be receiving robo advice by 2025. Sixty-five percent expect to experience fee compression in the next five years, according to Cerulli Associates.



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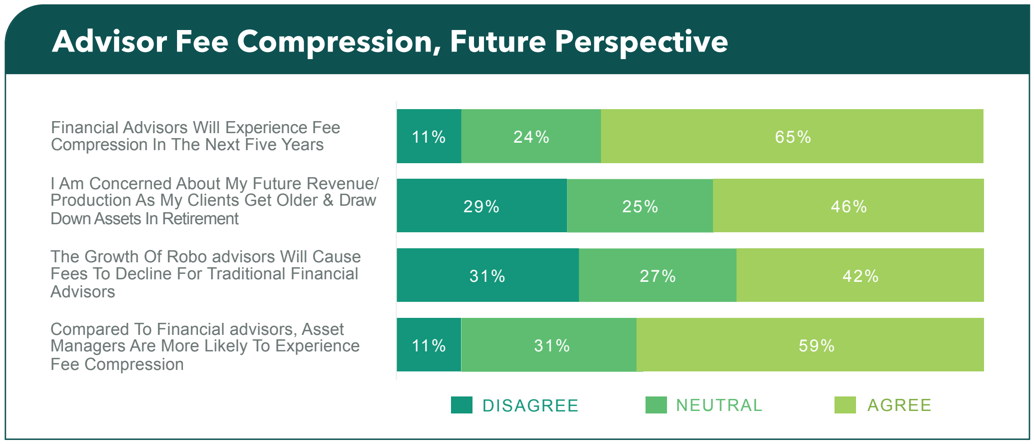
[1] Quartz: “Half of US Stock Fund Assets Are Now Invested in Index Funds”
[2] New York Times: “Balanced Funds Don’t Inspire Fear or Greed. That’s Why They Are So Useful.”
[3] Money: “Actively Managed Mutual Funds Are Getting Cheaper. Here Are Five That Are Worth the Money”



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But the numbers tell another story as well.

Investors are concerned about their level of economic preparedness, especially for retirement, and they want good, holistic advice on how to plan their financial lives. Almost three out of four Boomers (73%) say they expect to delay retirement, according to the NHP Foundation, and 40% of defined contribution plan participants say they do not feel "on track" to retire with their desired lifestyle, according to a BlackRock study.

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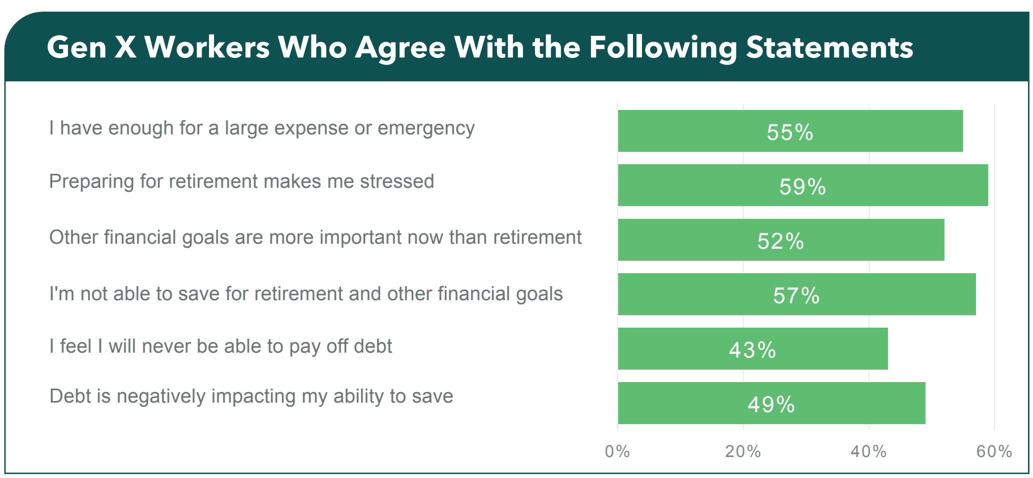
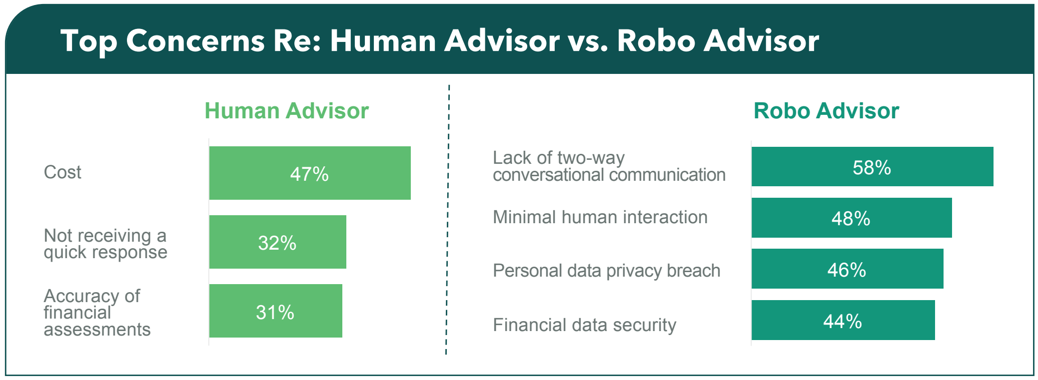
Gen Xers, who now age 43 to 54—generally considered the top earning years—are especially jittery when it comes to retirement, according to a recent survey by the Employee Benefit Research Institute and Greenwald & Associates. While 65% are saving for retirement, only 31% say they've figured out how much they need to save to meet that goal, 63% consider debt at least a minor problem, and 82% say the same about having enough money to live comfortably in retirement is at least a minor problem.



EBRI & Greenwald 2019 Retirement Confidence Survey: Generation X Report

To tackle these concerns, investors want the help of an investment advisor—and a human one. In a survey of over 2,000 US adults conducted by The Harris Poll, 85% stated that they would prefer to work with an individual rather than a robo advisor. Tellingly, 24% of U.S. households say they need more financial advice and are willing to pay for it, Cerulli found.



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While clients are revolutionizing the fee arrangements that used to underpin investment advice, then, Advisors have the opportunity to bring about a revolution of their own: one that will enable them to offer a much more valuable and lasting service.

To seize the opportunity, advisors need to shift their focus from portfolio management to financial management, from the balanced fund to the balance sheet. Instead of concentrating exclusively on growing a set of investments, they need to take into consideration the other four things an individual can do with his or her money: save it for a rainy day, spend it, pay taxes on it, and give it away in charitable contributions. All or most of these every individual will do in the course of their working life, and all will help determine whether they can support their preferred lifestyle in retirement.

> The main reason investment advisors are shifting toward fee-based arrangements, according to DST Research, Analytics, and Consulting, is that they want to take a more holistic approach to managing client assets.

But to do so, they need to change the way they think about the service they provide. 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.

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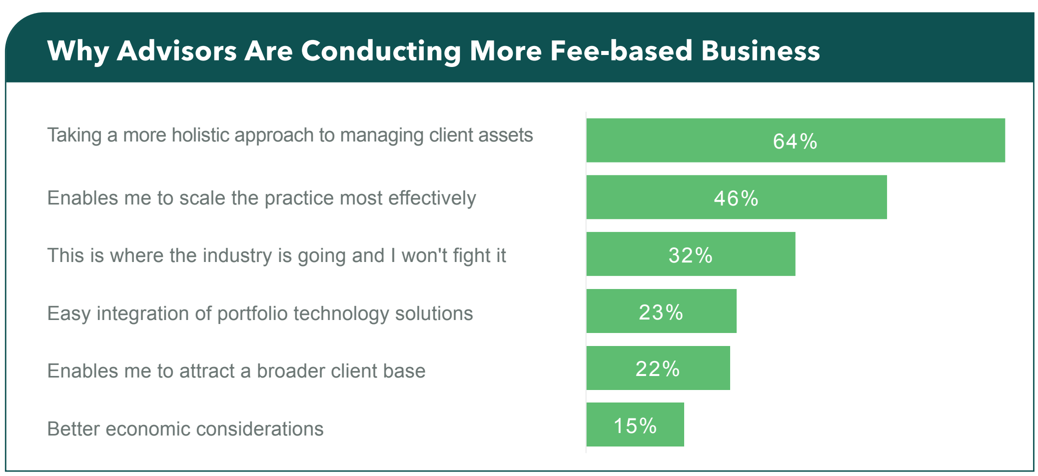

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Consider the decision to buy a major consumer item: a boat, for example. A purchase like this could require liquidating a chunk of the client's savings—money that could have been set aside for retirement—or signing up for an installment plan that reduces the amount of 401(k) contribution the client can make each paycheck. But what if the client puts off purchasing the boat for, say, 20 years? Do they expect to enjoy it frequently at present, or perhaps more in the future—when they may have greater accumulated resources and more time for recreation?

WHERE YOU'LL LIVE WHEN YOU DON'T HAVE TO WORK

Let's look at another decision many investment advisory clients will eventually make: where to live when they retire. In reality, it's a complex matter that begins as much with how well it satisfies their lifestyle preferences as with monetary concerns. Making a decision based solely on the latter could actually result in greater financial pain rather than less.

Consider one very important matter: how easy or difficult will it be to visit family? How about access to, not to mention the cost and availability of medical care, assisted living, and nursing facilities?

Finally, what if the decision to purchase a retirement home is informed partly by the desire to leave it as a legacy to one's heirs? If this is the overriding concern, a longer distance from family and less availability of health care may be prices worth paying.

Any of these tradeoffs can affect the amount of income the client has to enjoy in retirement. That being the case, the advisor—and a well-crafted investment policy statement—can provide vital help to the client in determining what the cost would be of prioritizing, say, proximity to family over a lower tax burden or low housing costs over access to high-quality health care. Each of these is a piece of the larger puzzle, an application of the art of the possible to the client's search to establish a lifestyle in retirement that's as close to ideal as it can be.

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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, these tradeoffs can be a long-term source of anxiety and vulnerability. A successful investment advisor today grasps the opportunity to turn anxiety into a feeling of confidence by helping clients to analyze their choices and decide between them.

One way to understand this opportunity is to look at three highly successful consumer products: the digital camera, the plasma TV, and the K-Cup. The digital camera was once one of the hottest high-tech gadgets, but lost its mass audience after smartphones incorporated a camera feature. The plasma TV was once a high-end technological innovation that commanded a high price and produced a high profit margin. Today, more plasma TVs than ever are sold, but the price per screen has plummeted; the product became commoditized.

The K-Cup is altogether different. Consumers will pay a premium for the convenience it provides, because they value that convenience so highly. Likewise, clients will value the investment advisor who can help them create a rational plan for their financial lifespan because the advisor relieves them of much of the anxiety that weighs down their decisions.

In the second article in our series, we'll look at how the investment advisor can help clients overcome their anxieties and create a plan and a process for achieving a feeling of well-being.