

CHAPTER 9: Designing, Implementing, & Managing an Investment Portfolio: The Role of the Investment Advisor

▲ FROM THEORY TO PRACTICE

Given the investment principles surveyed in the first eight chapters, we assert:

- There is no universally accepted theory of asset price behavior or of individual decision making under conditions of uncertainty. As a result, there is no consensus opinion regarding how to design, implement and monitor an investment portfolio. Investing remains an uncertain proposition. Savvy investors therefore realize that dogmatism is dangerous to their wealth. The prudent investor remains skeptical.
- Every course of action is risky. In the second half of the 20th century, the focus of investing shifted from risk control based on individual asset characteristics ('safe,' 'speculative,' 'blue-chip,' etc.) to risk control based on dynamic interaction of securities within a portfolio. The term 'Modern Portfolio Theory' describes the new-found awareness of the distinction between security risk (unsystematic risk) and portfolio risk (systematic risk). The focus on return also shifts away from predictions estimating portfolio values at a specific point in time and moves towards the concept of a probability distribution of outcomes. Risk and return are inextricably linked. The prudent investor realizes there is no free lunch.
- The landscape of risk is complex. Investment success is vulnerable not only to negative

returns, but also to a host of other risks, including inflation, longevity risk, default risk, shortfall risk, standard-of-living risk (consumption variability), contingent outlay risk (i.e., unanticipated expenses and emergencies), unanticipated changes in the set of investment opportunities, shifts in economic regime, etc. The prudent investor remains cautious.

- Investor preferences may change over time with changes in wealth as well as with changes in health, family circumstances, consumption needs and preferences, etc. The prudent investor remains flexible.

How should investors assemble portfolios suitable to their needs, goals and circumstances? How should they apply the insights of financial economics to the task of selecting, monitoring, and maintaining a diversified array of financial assets? What is the role of the financial advisor in facilitating these tasks?

This chapter addresses these topics.

▲ PRUDENCE REVISITED

At this time, it is worth revisiting the concept of prudence. We defined prudence as using care, skill and caution in a decision making process designed to enhance the likelihood of a successful investment outcome. The two words of immediate interest are 'investment outcome.' We know, from previous discussion, that prudence cannot be an outcome, because

a bad decision making processes can produce a good – i.e., lucky – outcome. If a friend advises you to invest your whole wealth in lotto tickets, hitting the jackpot does not retroactively make the advice prudent. Likewise, a good decision making process cannot guarantee a good outcome. Investing is an activity with many moving parts (‘variables’) any of which could derail a well-designed plan. These observations lead us to conclude that prudence is not an outcome but, rather, a process designed to improve the odds of investment success. One cannot always be right; one can, however, always be prudent.

This insight, however, brings us squarely to considering the unique characteristics of an investment outcome. What is investing? To many investors, this question seems to be asking, “what assets should the portfolio own?” Previous chapters present several expansions on this topic. They note that investing is a process that:

- Moves dollars back and forth through time;
- Increases the amount of happiness (“utility”) extracted from a finite amount of resources;
- Makes asset management elections to increase the probability of successfully meeting economic goals;
- Initially forfeits something of value for the expectation of receiving more than initially forfeited, sometime in the future – e.g., in the words of financial economists, investing attempts to improve the ‘budget constraint.’
- Involves a prudent exchange of risks.

This list suggests that investing is something more

...investing involves a prudent exchange of risks.

...do you want to own a portfolio that offers the prospect of delivering a bad return in bad economic times?

than a decision about what to buy. Rather, it is a series of elections that are forward looking because they both anticipate and promote the achievement of a satisfactory ‘investment outcome.’

Investment outcomes are inherently uncertain. This is the primary reason why investing involves a prudent exchange of risks. In an uncertain world, staying put or changing course are options that continuously recur. This observation, however, correctly emphasizes risk. Investing is about bad times more than about good times. Investing is about how you

react to risk not in theoretical terms, but in terms of your concrete actions. If you can’t or won’t react well to the investment setbacks that will inevitably come, your portfolio design and asset management strategy won’t work for you. Your current portfolio might have many attractive features, contain many promising investments, and may reflect many hours of planning and effort. Nevertheless, if the portfolio is not prudent, you should scrap it.¹ It won’t work. It is too risky because you did not make a prudent exchange of risks at the time you set it up.

▲ RISK REVISITED

A New Perspective on Risk

Investing is about what you will do when times go bad.

Let’s consider the following question: do you want to own a portfolio that offers the prospect of delivering a bad return in bad economic times? Your answer to

¹ Parenthetically, it also explains why the ancient temple at Delphi prominently inscribed the phrase “Know Yourself” as a warning to seekers of the oracle’s wisdom. The other inscription: “Nothing in Excess,” we will take as a sign that the gods wish investors to form well-diversified portfolios. We will not make the argument that investment advisors are modern oracles.

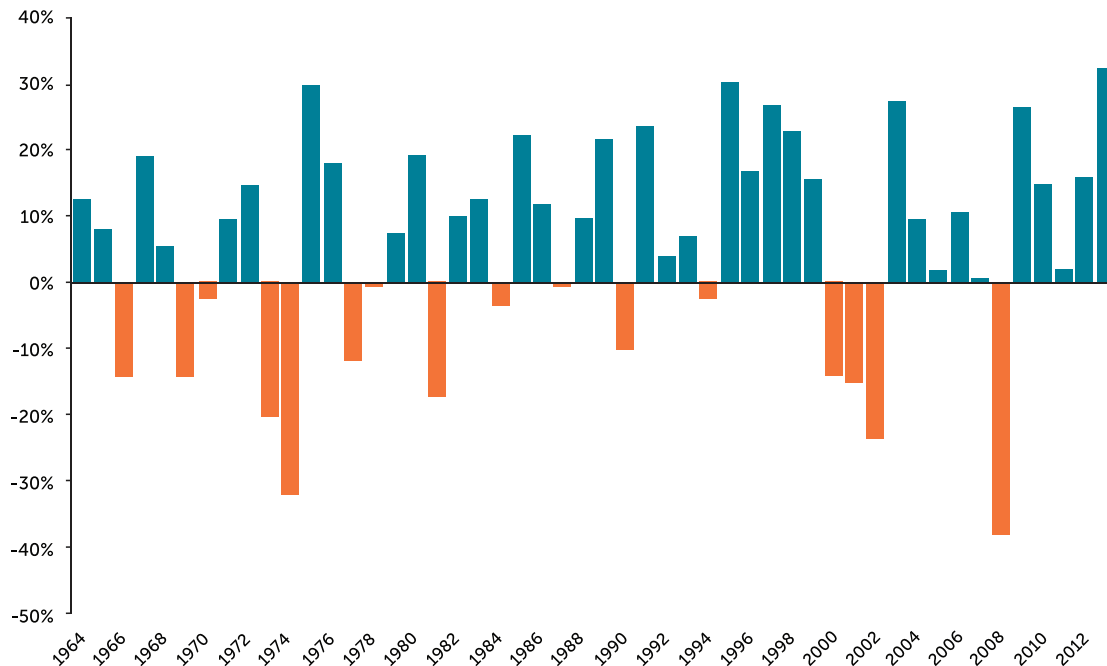


FIGURE 9-1

this question will provide much useful information.

In most years the stock market outperforms low risk assets. In the U.S., at least, investors expect good news. For example, **FIGURE 9-1** is a chart depicting the relative over and under performance of the S&P 500 U.S. Stock Index against 30-day U.S. Treasuries.

The blue bars indicate the magnitude of the excess return of stocks [(return of stocks) – (return of T-Bills)]; the red bars indicate the magnitude of stock underperformance. Stocks don't win each and every year, but over time, stock investors have earned excellent returns. Economists call the extra stock reward the "Equity Risk Premium." It is the extra reward investors receive for taking the risk of investing in stocks, rather than the risk-free return of, say, a bank certificate of

deposit or a US Treasury Bill that matures only 13 weeks after it is issued. How big is the premium? During the fifty-year period from 1964, stocks beat T-Bills by 4.61% per year.

What is the source of this extra long-term reward? Does it really matter that stocks go up and down if the investor earns a higher long-term return by owning them? In fact, from a long-term perspective,

Stocks are risky because they deliver poor returns at exactly the worst time. When you want your financial asset portfolio to provide a feeling of security, it sinks like a stone.

are not stocks the truly safe investment because they have proven they deliver greater returns than those produced by bonds?

Look closely at Figure 9-1. Stocks performed poorly compared to safe T-Bills during years of general economic distress (the OPEC Oil embargo in

1973 – 1974, the Volcker Recession in 1982, the Bush Recession in 1991, the Tech-Stock Meltdown in 2000

...you should not have been in the stock market to begin with.

The portfolio with the greatest promise is also the portfolio that provides the greatest potential for disappointment.

– 2002, and the Global Financial Crisis in 2008). Stocks are risky because they deliver poor returns at exactly the worst time. When you want your financial asset portfolio to provide a feeling of security, it sinks like a stone.

What is going on here? Stock brokers never suggest you should buy stocks because they are likely to perform poorly when the economy turns ugly. A bad return in bad times equals RISK. But risk is the source of the Equity Risk Premium.

Without risk there can be no expectation of returns over and above the risk-free rate. Put another way, return is the reward investors expect to receive for taking greater risk.

Here is the non-technical explanation: You cannot get the big ‘ups’ without the big ‘downs.’ If you own stocks, you need the big ‘downs;’ and, if you are a long-horizon investor, you want the big ‘downs.’

Here is the technical explanation: The increase in downside volatility causes investors to demand a corresponding increase in compensation for holding risky stocks. They demand an increase in the expected risk premium. The higher expected risk premium is implemented in the stock market by a reduction in current stock prices. Lower current prices translate into higher expected future

returns when volatility eventually moderates and the economy recovers.

If you say, “I want to sell my stocks because the losses terrify me,” you are effectually saying, “I want to sell my stocks because I do not want the prospect of high future returns.” If you find you must sell your total stock portfolio at a single moment in time, you should not have been in the stock market to begin with. However, if you can accept the risk of periods with bad returns, you have substantially increased your chance of a favorable investment outcome. When you buy risky assets, you are asking your investment to deliver a bad return at a bad time; and, this is exactly what you want to happen. Without risk there would be no reason to expect long-term compensation – the “extra” premium for holding stocks.

What about retired investors? Do not low or negative annual stock returns translate directly into lower future retirement income? This is a question with more moving parts. For now, however, many retired investors are in an ideal position to welcome stock risk,

because they have long-term time horizons and they require yearly liquidation of relatively small portions from their nest egg. We take up the issue of designing, monitoring and managing a retirement income portfolio later in this chapter.

Risk – An Historical Approach

Chapter 5 provides a detailed look at the historical performance of portfolios, rebalanced quarterly, with allocations ranging from 100% short-term U.S. T-Bills to 100% domestic and foreign stocks. The risk/return characteristics of each portfolio reflect the performance

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of no-cost investment indices over the period 1973 through 2013. The data suggest that successful investors recognize and negotiate an uncomfortable paradox: although tilting the portfolio towards stocks appeals to the desire to accumulate significant wealth quickly, such a portfolio manifests negative returns at a frequency and magnitude greater than a portfolio tilted towards bonds. The portfolio with the greatest promise is also the portfolio that provides the greatest potential for disappointment. Chapter 5 observes that “as one moves deeper into equity risk exposure, the shocks to wealth may seem staggering ... the investor should test his probable responses to the magnitude and frequency of the downside shocks to wealth that will inevitably occur.”

History provides a good first pass at quantifying investment risk because it shows how various asset allocations behaved in response to the challenges and opportunities of the past. But history gives far less information on how a portfolio might behave if the future is any different than that past. Additionally, the historical return data in Chapter 5 provide insight into portfolios tasked with accumulation of wealth under the absence of the very sorts of cash flows that concretely matter to investors – such as taking retirement income from a portfolio. Valuable as they are, the insights gained from a review of history pertain only to a one-dimensional investment goal that abstracts away from the many real world issues that investors confront. Prudent investment planning nevertheless begins with understanding history.

The next step requires a credible risk modeling system. At Schultz Collins, we facilitate portfolio design and asset management using an interactive computer-assisted approach. Because the risk modeling software does all the math, our iterated interactive process allows investors to discover their utility-of-wealth/risk-aversion function without first undertaking a

course of advanced studies in financial economics.

▲ AN INTERACTIVE APPROACH TO RISK MODELING

Ideally, prior to making decisions, investors would like to know the range of probable outcomes – both favorable and unfavorable – so they can make intelligent reward-to-risk assessments. An interactive, computer assisted approach to risk modeling offers an opportunity to test a broad range of retirement asset management strategies prior to their implementation. Before charging ahead with an asset allocation and spending plan, the investor can evaluate both its feasibility and its desirability. This section outlines how risk modeling enables investors to consider a wide range of variables, and see how they interact over time. Assuming that the risk model is credible², the investor can more easily understand the probable consequences of asset management decisions on future consumption, gifting and bequest opportunities.

▲ PLANNING FOR RETIREMENT INCOME: HOW MUCH CAN I SAFELY SPEND?

Investors concerned about generating retirement income sufficient to support a target or threshold standard of living are subject to a number of risks:

1. Inflation/purchasing power risk,
2. Fluctuating investment returns, and
3. Longevity risk.

Although longevity is generally prized, it represents a risk to economic security if assets cannot provide lifetime income. A retirement portfolio succeeds if it supports lifetime income and bequest objectives. It fails if it runs out of money, cannot provide a threshold level of income in each period, or cannot provide sufficient gifts or bequests.

² Patrick J. Collins, Ph.D., CLU, CFA, Huy Lam, CFA, and Josh Stampfli, MS EESOR, “How Risky is Your Retirement Income Risk Model?” [Financial Services Review](#), (Summer, 2015). The article is available on the Schultz Collins website.

The standard-of-living decision refers to the income required to support a desired lifestyle. This is the most important decision faced by the retired investor – it is impossible to take fifteen pounds from a ten pound sack. The standard-of-living decision, in many cases, involves targeting a minimum or threshold cash flow requirement to fund critical needs, as well as identifying cash needs for aspirational objectives. However, it is difficult to determine if targeted consumption during retirement is feasible given current wealth. Current consumption may be a wholly inadequate guide to future spending if it is not sustainable.

Beyond the fundamental standard-of-living decision, success or failure is primarily a function of three factors:

1. Age and Health – variables over which we lack control, but which are flexible to the extent that an investor can often accelerate or postpone retirement;
2. Asset Allocation – a variable subject to the investor’s objectives, preferences, and constraints; and,
3. Spending Policy – the decision to take fixed or variable withdrawals from the portfolio.

By using the three levers judiciously, the investor can hone in on the standard of living decision. To a great extent, the retirement income planning task boils down to making sure that:

- You accumulate sufficient resources for retirement;
- Your spending is in sync with available financial resources given the present and future standard of living targets; and,
- Resources (financial assets) are allocated so

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that there is a reasonable expectation of achieving required returns at a suitable level of risk.

If, however, an investor myopically pursues a safety-of-principal strategy in each period, the portfolio may be unable to sustain a lifetime threshold standard of living. A “safe” portfolio may not be a prudent portfolio. A “no-growth”

portfolio incurs considerable risk unless initial wealth is great. It is not the absolute level of wealth that is the critical factor; rather, it is the ratio of wealth to consumption.

Preferably, one hopes not only to sustain a threshold standard of living but also to provide opportunities for personal consumption improvement if investments perform well. However, seeking returns above the risk-free rate generates downside risks that can undermine lifetime income. This is the risk/reward tradeoff faced by most investors planning for retirement. Taking out too much from the portfolio today runs the risk of outliving your nest egg; taking out too little runs the risk of missing an opportunity for a higher standard of living.

Planning is difficult because the interactions of age (e.g., postponing or accelerating the date of retirement), health, inflation, periodic spending adjustments, and asset allocation can be terrifically complex.

▲ CALCULATING THE RETIREMENT REWARD-TO-RISK TRADEOFF: A BRIEF HISTORY

Conventional forms of retirement risk assessment often involve entering estimates of average inflation, average investment returns and average

life expectancy into a spreadsheet. The spreadsheet's calculation formulae determine whether, on average, a retirement plan is feasible. However, this calculation method generates accurate results only in the unlikely case that all inputs converge to their estimated average and that there are no significant period-by-period deviations from the average with respect to any of the input variables. But investors know that the future will be neither average nor predictable. Retirement income calculators that employ averages (many of which are available for free on the internet) can present a highly misleading picture of retirement feasibility.

A better method is to back test your retirement plan by determining if it would have succeeded in actual historical periods. For example, starting off your retirement plan at the beginning of the great recession in 1973-1974 provides an interesting stress test. Running the plan through the actual inflation and return paths for each 20 or 30 year period since 1973 provides a ready table of the number of periods in which the plan achieved success. It is clear, however, that back testing is appropriate only if you believe that historical conditions are sufficiently similar to current conditions so that they constitute a credible guide to future risks. But each time period presents the investor with unique economic circumstances for which there may be no condition precedent. New sorts of things keep happening!

In order to overcome the limitations of historical back testing, financial economists fit statistical models to the empirical series of investment returns. The normal – bell-curve – distribution is most common. For example, an economist may fit the bell curve distribution model to the historical results of the S&P 500 Stock Index. From 1973 through 2014, the average annual return of the S&P 500 is 10.35% and the standard deviation from this average is 15.45%. The bell-curve risk model enables the economist to estimate the likelihood that future returns will deviate significantly either above or below the historical 10.35% mean. In this case, because two standard deviations constitute

95% of the area under a normal distribution's bell curve, there is a 95% probability that an investment in the S&P 500 Index will earn a yearly return between $10.35\% \pm 2(15.45\%)$ – a range of -20.55% to +41.25%.

Fitting a distribution to the historical return series provides a quantum leap in the ability to model risk. No longer is risk assessment trapped by the limiting bounds of historical realizations. Probability distributions allow us to ponder the likelihood of stringing together sequences of below (or above) average returns, even though such sequences have never (yet) happened. Multi-period sequences provide interesting insights into potential long-term risks and rewards.

▲ BEYOND THE BELL CURVE

Although many financial advisors use the normal distribution as a proxy risk model because it is both parsimonious and easy to communicate, economists have long recognized that it does a poor job capturing many important characteristics of financial asset returns. Unlike the bell curve, financial returns are not symmetrical and, worse yet, extreme events happen at an historical rate far higher than predicted by a bell-curve model. Studies of the time series of stock returns often note that volatility exhibits various degrees of persistence. That is to say, high volatility months tend to be followed by high volatility months, and low volatility months tend to be followed by low volatility months. When volatility manifests itself in downside returns, the bad returns have a tendency to keep on coming. Market participants become nervous, commentators ask investment gurus to predict the market bottom, heightened volatility mandates a higher discount rate for stock price valuation, and so forth. Stock prices exhibit serial correlation (bad returns in the next month are positively correlated to bad returns in the last month), and, if too many investors head for door at once, downside risk turns into a market crisis.

To recap, as prudent decision makers, we are

eager to have an adequate picture of risk prior to committing money to uncertain investment ventures. Historical returns provide an accurate measure of realized risk, but are only a useful guide to the future if you believe that future economies will be exactly like past economies. The attempt to parameterize risk by assuming that the possible distribution of future returns fits into a normal bell-curve shape is a good way to break out of the “groundhog day” risk-evaluation syndrome wherein the past incessantly repeats. However, the bell curve fails to capture important stock price behaviors. For example, the bell curve risk model failed to capture the market crash of 1987. On a single day in October 1987, the market lost over 20% of its value. Under a bell curve risk model, such an event was unlikely to occur at any time in the next 5 billion years. In part, this frequently-used risk model fails in that it assumes constant levels of volatility, does not offer reasonable downside risk frequency prediction, or other elements important for credible risk assessment and control.

▲ FROM THE STATIC TO THE DYNAMIC: COMPUTER ASSISTED PORTFOLIO DESIGN

As we move from the simple symmetry of the bell curve to the more complicated statistical characteristics of investment returns, the computer becomes an invaluable aid for risk modeling. Advances in portfolio risk/reward modeling parallel those in the fields of automotive design and aeronautical engineering. Before the 1980s, engineers would build a full-scale model of a proposed new airplane for testing in a wind tunnel. This was the only way to tell whether a design was feasible. Today, however, they build a mathematical model that exists only within a computer’s memory. The mathematical plane – a computer-assisted design (CAD) – can be tested for stability, handling, aerodynamics and more. The CAD process provides much greater design flexibility because

engineers can test specified changes within seconds. In brief, the designers can see how good the mathematical plane looks prior to building a real one.

Computer assisted design is also indispensable for portfolio design and monitoring. It can be used for:

- Creating credible portfolio risk/reward models; and,
- Test driving the models prior to portfolio implementation or modification.

The process is as follows:

1. Select an appropriate model for the time series of investment returns. This is primarily a technical statistical decision beyond the scope of this discussion.
2. Select the sorts of securities to be employed. This is primarily the strategic asset allocation decision.
3. Select the portfolio management strategy. This is primarily a decision to manage the portfolio according to personal risk tolerance preferences and retirement consumption targets.
4. Input the ages of the investors and their schedule of expected or desired cash flows into and out of the portfolio – annual contributions prior to retirement, annual distributions to fund retirement, bequest objectives, and so forth.
5. Given the asset allocation, test the feasibility (will the portfolio run out of money?) and desirability (is the portfolio too risky?) of the scheduled cash flows against thousands of future investment scenarios.
6. If the portfolio is infeasible or undesirable, go to Step 2 and make appropriate revisions to the inputs.

Step 5 is the key element of the interactive CAD process. It is possible only in virtue of the computer’s advanced simulation algorithms, which allow investors to test candidate portfolios under thousands of future economic histories.

Portfolio Monitoring

Portfolio management does not end with the implementation of a portfolio strategy. Because things keep changing, it is an iterative process. Decisions about investment policy (asset allocation, investment management, periodic spending, etc.) require active portfolio monitoring and ongoing assessment of current strategies. Prudent portfolio management requires monitoring the ongoing sufficiency of the portfolio with respect to the future liabilities it must fund. Prudent planning provides a framework to evaluate information without falling prey to fear or greed.

One important benefit of the CAD process is that investors can revisit their plans from time to time, so as to assess the likelihood of success or failure during the remaining planning horizon, given changes in inflation, wealth, and other circumstances. Asset allocation and cash flows can be adjusted “on the fly” to keep a portfolio on course despite economic “weather.” Static asset allocation thus gives way to dynamic asset management.

The most important levers investors can use to adjust their portfolio management:

1. Asset allocation decisions (percent of exposure to risky assets);
2. Spending policy (how much income can the portfolio safely distribute, and what mid-course corrections will keep it on track); and,
3. Age (accelerating or postponing retirement income).

At any time during the life of the portfolio, the CAD process can tell investors whether they are better served by accelerating or postponing income, by revising the asset allocation, by adjusting the income target, or by some combination of such steps. These levers can help control the success or failure of a retirement plan as it unfolds through time.

In the CAD planning process, investors face three

critical investment decisions:

1. Determine the preferable amount of risk given current portfolio wealth, spending objectives, circumstances, and so forth. This is the calibration of the asset allocation to personal risk tolerance: the ability and willingness to take risk.
2. At reasonable intervals, determine the preferable amount of risk given the inevitable changes that have occurred in portfolio value, spending objectives, etc. This is the stay-the-course or make-a-change decision that best reflects each investor’s reward-to-risk preferences, given what has happened since the portfolio was first implemented (or last modified).
3. Determine if the preferable amount of investment risk is sufficient to generate the return required to achieve future economic objectives, given the portfolio’s current value. This is the decision that calibrates the investor’s continued willingness and ability to assume risk to the return required for keeping the portfolio on track relative to the economic demands placed against it.

Like test driving a car before you commit to purchasing it, prudent planning demands that you determine the probable impact of asset allocation and investment management decisions prior to implementing them. The result is a more fully-informed decision making process and an increased chance for a successful investment outcome. The CAD planning process can help.

▲ INVESTMENT CHALLENGES AND THE ROLE OF THE FINANCIAL ADVISOR

Needless to say, the challenges faced by retired investors seeking periodic income differ greatly from those who are accumulating funds for various

economic objectives. In terms of our previous discussion, retired investors seek to bring a sufficient amount of funds into the present so they can pay for required expenses and maintain an adequate standard of living. Investors in the accumulation stage seek to send money into the future with the expectation that there will be a sufficient amount of funds to meet their financial objectives.

Investors have limited resources. Furthermore, there is an opportunity cost to using scarce resources either to secure the services of a financial advisor or to undertake a personal search for relevant information. The alternative to a time consuming process of research either to choose an advisor or do it oneself is to roll the dice with a canned financial product or service of some sort.

The academic evidence regarding the ability of professional financial planners and investment advisors to enhance portfolio return is mixed.³ It would seem unlikely however that an investor could do better on his own. It is difficult to objectively and dispassionately monitor and manage personal or family funds. Bad decisions are uninformed decisions. In the absence of the right sort and amount of information about any investment decision, it must be founded to some extent either upon hope or fear. A good decision – however well or ill it turns out – manifests the care, skill, and caution that are the hallmarks of prudence.⁴ And those hallmarks are more likely to be found in the ranks of financial professionals – who spend their whole working lives gathering, analyzing and weighing information that bears on investment decisions – than among the investors who are their clients.

Choosing the right financial advisor is unfortunately almost as difficult as any other investment decision!

**Bad decisions
are uninformed
decisions.**

The following sections explore the topic of identifying a financial advisor who can provide the information needed to make informed investment decisions.

▲ TYPES OF FINANCIAL ADVISORS

There are many kinds of financial advisors, with widely different levels of technical expertise and professional reputation, including:

- Technical experts such as accountants or trust attorneys;
- Financial consultants, stockbrokers or investment advisors;
- Generalists who advise on personal budgeting, estate planning, insurance and investment issues – financial planners, wealth managers, and the like;
- Counselors working to help clients in crisis situations (bankruptcy, divorce, credit counseling, etc.);
- Specialists such as mortgage brokers, insurance brokers, bankers, enrolled agents, etc.
- Financial or life coaches, who stress motivational techniques such as positive reinforcement and self-control in the pursuit of financial goals.

If you include stock brokers, realtors and insurance agents, the Bureau of Labor Statistics data suggest that there are over one million “financial advisors” in the U.S., excluding attorneys and CPAs. How can you tell which sort of advisor is right for you?

Credentials are one way. Some credentials are well known and can be obtained only through long hours of study: e.g., CPA for accountants, CLU for life insurance agents, CFP® for financial planners. But there are well over 100 professional designations and

³ Return is a random variable.

⁴ It may be helpful to recall that doctors are not held responsible for the outcomes of medical procedures; rather, they are held responsible for the prudence of their diagnostic techniques and treatment plans. Health outcomes are also random variables.

credentials in use today. Many of them, according to the Wall Street Journal, "... can be earned with minimal or no study and a few hundred dollars." [WSJ Online October 16, 2010: "Is Your Adviser Pumping Up His Credentials?"]

There are a lot of phony "experts" looking to get between you and your money. For example, how would you like to consult with a W.M.S. – Wealth Management Specialist? According to the Wall Street Journal, a W.M.S. designation is the end product of a self-study course with no continuing education requirements. How about a C.S.A. – Certified Senior Advisor? This designation, according to CNN Money research, "... merely indicates that the 'expert' studied how to communicate with (and market to) seniors." Is it better to have the C.R.F.A. degree? According to CNN Money, "Earning the 'Certified Retirement Financial Adviser' credential does involve financial training, but it's a self-study or four-day course and only requires passing a 100-question multiple-choice exam." It seems as if many of these designations can be earned during a lunch break!

Evidence suggests that much of the financial products and services industry can be fairly characterized as a self-serving marketing machine.⁵ Many financial advisors seek a professional designation only to enhance their marketing image. The number of on-line, phony-baloney degree factories has mushroomed. New "institutions" offering cutting-edge designations seem to crop up weekly. These designations are generally not worth the paper they are printed on.

Some independent academic studies have found that working with a financial advisor has only negligible impact on subsequent investment performance. If a large portion of advisors are merely cogs in a "marketing machine," then there should be little expectation that they have the skills necessary to add value to an investment portfolio. When the "advice"

industry is primarily a "marketing" industry, the public can expect conflicts of interest to abound.

Many of the professional designations in the financial business mean little or nothing. What does this tell us about that business? Is the whole industry riddled with flim-flam, as so many of its designations seem to be? How can investors tell whether a financial advisor is skilled? Just as important: how can investors tell if a financial advisor has their best interests in mind?

▲ SELECTING A FINANCIAL ADVISOR

How should you choose a financial advisor? There are hundreds of advice articles on this question. Usually they take the form of "The six things you should know before signing up an advisor," or, "The ten questions to ask an advisor." The best advice available is the Securities and Exchange Commission's [SEC] paper, "[Investment Advisor Transparency and the SEC](#)." This paper is written for a general audience and is available on the Schultz Collins website.

Many financial advisors are trustworthy, have good intentions, are ethical and honest, and have a great bedside manner. However, prudent investing must encompass a standard of competence, as well as a standard of conduct. Great harm can be done by a convivial but unskilled advisor.

So, how can you find a good advisor? On a preliminary basis, we define a good advisor as one who limits the potential for a conflict of interest. Skilled practitioners are most likely to be found in what is known as the "fee-only" segment of the advice profession. These are the advisors whose compensation does not include sales commissions. However, consumers face a big problem trying to identify fee-only practitioners. For example, the College for Financial Planning identifies "fee-based" Certified Financial Planners [CFPs] as

⁵ See, for example, Olen, Helaine, *Pound Foolish: Exposing the Dark Side of the Personal Finance Industry*, 2013.

those earning between 50 and 90 percent of income from fees.

A useful first step is to determine that an advisor's income does not come from sales commissions or production bonuses. Preferably, you should also confirm that the company that employs the advisor receives no compensation from product or service vendors, but this is much more difficult to ascertain. Some of this information is available for firms operating as registered investment advisors in SEC-mandated disclosure documents. We discuss registered investment advisors in greater detail below. Additionally, the cautious investor looks for credible designations and credentials. Two credentials to look for – in order of academic rigor – are Chartered Financial Analyst [CFA] and Certified Financial Planner [CFP®].

▲ THE IMPORTANCE OF A FIDUCIARY STANDARD: REGISTERED INVESTMENT ADVISORS

Registered Investment Advisors are required to act as fiduciaries. This section explores the following topics:

- What does it mean when an investment advisor claims to act as a “fiduciary?”
- Is the firm that states that it acts with “the highest fiduciary standards” better than the firm that states it acts as a “fiduciary within the scope of the engagement?” [Are there “lowest” fiduciary standards?]
- Can a firm claiming that it acts as a fiduciary require execution of an Investment Advisory Agreement that contracts out of fiduciary duties?

Certain firms act in the capacity of a Registered Investment Advisor. Registered Investment Advisors [RIAs] that meet a threshold of assets under management are regulated by the SEC under the Investment

Advisors Act of 1940 (smaller RIAs are regulated by state securities regulators). Generally, the 1940 Act provides that the RIA must act as a fiduciary which, according to the SEC, means that the Advisor must seek to avoid conflicts of interest with clients, and disclose to them such conflicts of interest as may then remain.

Unfortunately, it is a short – but unwarranted – leap of logic to assume that any firm offering financial advice as a Registered Investment Advisor will, in fact, provide conflict-free services, at a level of care skill and caution demanded from a fiduciary. In fact, it is almost impossible for some RIA's to eliminate every conceivable conflict of interest, while a few advisory firms don't try very hard to do so. This is sometimes surprising to investors who assume that designations such as ‘registered investment advisor’ or ‘independent financial planner’ are synonymous with a strict adherence to fiduciary principles.

For example, a portion of the national Trust & Estate bar periodically decries the propensity by some investment advisors to use advisory agreements to avoid requirements otherwise imposed upon them by fiduciary standards. “Opportunistic behaviors” in the fiduciary accounts of banks, brokerage firms, and other institutions are often disclosed in investment advisory agreements drafted by their legal departments. If, as a condition of receiving investment advice, such an agreement is reviewed and signed by trustees, some legal commentators suggest that the parties have agreed not to apply certain provisions of the default standards of prudent asset management embodied in state prudent investor statutes or other relevant law. Trustees asked to sign such agreements should be fully cognizant of the consequences of substituting contractual provisions, defined by a document drafted by corporate lawyers, for the default rules of their state prudent investor statutes.

Sometimes it requires a high degree of financial sophistication even to realize that an agreement

gives an investment firm a hunting license to make money at the investor's expense. Consider the simple provision that an investment firm has the discretion to determine the trade venue for presentation of security buy/sell orders, and that the firm will assure that all orders obtain, at least, the nationally posted best-bid-and-offer [NBBO] price. This seems to be a reasonable provision because the investment firm has trading expertise. Furthermore, it appears to be a valuable consumer protection lest security transactions occur at unfavorable prices. In reality, however, the provision gives the investment firm license to ignore trade venues which offer higher probabilities for price improvement – bid and offer prices better than posted NBBO. Such a provision enables the firm to participate more readily in payment-for-order-flow arrangements or other types of 'soft dollar' compensation programs, to internalize orders while collecting the full bid/ask spread on both sides of the transaction by matching orders within their customer book, or to act as a potentially adverse counterparty to the investor in a principal trade (rather than as an agent for the investor by trading in a public market or alternative liquidity venue).

Disclosure of conflicts of interest rather than avoidance of conflicts of interest is a commonly used technique to water down – or, some would say, to gut – reasonable standards of fiduciary practice. For investors, this puts a premium on the ability to read and fully comprehend the implications of the investment advisory agreement. In a legal evolutionary dance, the stricter disclosure requirements of recent statutes increase the volume of disclosure materials that investors must evaluate, and prompt marketing departments to find ever more creative ways to disclose conflicts of interest disclosures as if they were beneficial to the client. Interestingly, it is often

the Department of Labor's (DOL) oversight activity for retirement plans that puts a halt to some of the more egregious practices. But the DOL has jurisdiction only over certain tax-qualified trusts.⁶ The operating model for private investors seems to be *caveat investor*.

A common business model for RIA firms is the 'hybrid practice model.' This term refers to firms that are dually registered as both an investment advisory firm regulated under the 1940 Act and as a registered representative of a broker-dealer under the Securities and Exchange Act of 1934. Representatives of dually registered firms sell Investment Advisory Services as fiduciaries, and sell securities as registered representatives of a stock brokerage firm. The 1940 Act demands a fiduciary standard of care – unless the advisory firm contracts out of it through client execution of an investment advisory agreement indicating client acceptance of certain disclosed practices. The 1934 Act demands a lesser "suitability" standard of care.

Needless to say, the terminology can be very confusing. An investor must distinguish among services offered by an independent RIA, an Independent Broker-Dealer, a Corporate RIA, a Registered Representative, a Registered Investment Advisor, and an Independent Investment Counsel. Some of these designations imply a fiduciary standard of care, others a lesser standard of care. The same individual may switch hats in the middle of an engagement in order to provide 'full service' to the investor. For example, asset allocation modeling might be done under the auspices of a Corporate RIA structure (to earn an advisory fee) while portfolio implementation might occur under standards applicable to registered representatives (to earn sales commissions). Registered representatives are typically affiliated with broker/dealers that are regulated by FINRA (the Financial Industry Regulatory

⁶ The Department of Labor recently promulgated final regulations governing conflict of interest rules for advisors rendering advice to retirement plans and IRA. These regulations, due to become effective April 10, 2017, should mitigate the adverse consequences from poor quality and conflicted advice given to qualified plan participants and IRA owners. [Definition of the Term "Fiduciary," Conflict of Interest Rule-Retirement Investment Advice Federal Register, April 8, 2016.](#) A good discussion of general fiduciary duties is found in Jennings, [Marianne, M., Investment Professions and Fiduciary Duties, CFA Institute Research Foundation \(2014\).](#)

Authority, a self-regulatory organization controlled and funded by the firms it regulates). While brokers must provide their services in a fair and equitable manner, they have never been required to act in the best interests of the client, nor are they required to disclose conflicts of interest. A brief history of these matters can be found in the essay entitled “[The Fiduciary Flap: Should Advisers Be Required to Put Client Interests First?](#)” from the *Investment Quarterly* 2010 Q1 Issue.⁷

The term Independent Investment Counsel also derives from the 1940 Act. It signifies a Registered Investment Advisor with no formal contractual obligations or informal associations with Broker/Dealers, Banks, Custodians, or other elements of the financial services industry. The SEC defines investment counsel as, “an individual, institution, organization, or department of an institution or organization which undertakes for a fee to advise or to supervise the investment of funds by, and on occasion to manage the investment accounts of, clients.” The 1940 Act defines “investment counsel” as a subset of the “investment advisers” to whom the Act applies. By extension, an Independent Investment Counsel firm does not seek to use RIA services as a springboard to create security sales opportunities. This is a critical distinction for investors because, in some areas of the country, the RIA designation is fast becoming a code term for security salesperson.

There is nothing illegal happening here. All parties are fulfilling their duties as defined by the regulatory authorities. However, portfolios may hemorrhage money in ways invisible to an unsophisticated investor. Not all financial advisers are fiduciaries. More disturbing, many RIAs offer investment advisory agreements that enable their evasion of a wide range of fiduciary standards of practice through disclosures of potential conflicts of interest. Although full disclosure is good, it increases the burden on investors to evaluate the provisions of the investment

advisory agreement lest they agree to cede important economic protections.

▲ A NOTE ABOUT SCHULTZ COLLINS

Schultz Collins, Inc. is an independent firm providing investment counsel to individuals and institutions. Our business is helping clients through the many obstacles they face as investors. All our work is based on the premise that our clients are best served, not by attempts to predict the future direction of markets or prices, but by the practical application of the body of scientific knowledge discovered through research in financial economics. Our focus, therefore, is on staying current with the research, communicating its findings to clients, and using it to improve the operation and performance of their portfolios. This book is intended to provide a theoretical context and grounding for the methods and language we use to construct sound investment policy, and to constitute a defensible rationale for asset allocation and portfolio management decisions.

The freedom to apply academic research in our clients’ behalf comes only with complete independence. We believe that working in the best interest of our clients precludes any other interest. In particular, we avoid conflicts of interest by shunning relationships with any firms which would oblige or otherwise motivate us to do business with them on behalf of our clients, other than by virtue of their financial soundness and the quality of their products or services.

Our firm is, therefore, not affiliated with any vendor of investment products or services, nor do we offer advice with the expectation of receiving commissions, finders’ fees or other similar forms of remuneration. Rather, we are compensated by clients with fees calculated as a percentage of assets under our supervision, or at an hourly rate. Our success is tied

⁷ This is available on the Schultz Collins website.

to the financial success of our clients. We do not sell investment products. We provide investment counsel.

Schultz Collins, Inc. is an investment advisor registered with and regulated by the Securities and Exchange Commission, under the Investment Advisors Act of 1940. The Act states that an investment advisor may be designated as “investment counsel” only if a substantial part of its business consists of rendering investment supervisory services.⁸ The Act defines investment supervisory services as “providing continuing investment advice based on the individual needs of each client.”⁹

Schultz Collins, Inc. acts as investment counsel. Recognizing that each investor faces a unique set of objectives and circumstances, we provide unbiased and relevant information regarding the structure of investment problems and opportunities, the tradeoffs inherent in investment alternatives, and the range of possible future outcomes. We do not maintain proprietary portfolios into which our clients must fit. Rather, we design and supervise each portfolio in a manner specific to the objectives and economic circumstances of each client. We provide information to help our clients:

- Design a portfolio specific to their objectives and economic circumstances;
- Improve their chances of realizing a successful outcome; and,
- Understand and quantify both the likelihood and magnitude of possible unsuccessful outcomes.

Our primary objective is to help clients make informed investment decisions. We are committed to providing investors with the information and knowledge that make such decisions possible. We

employ the quantitative and statistical methodology that generally characterizes the science of decision analysis. In the words of Robert Clemen of the Fuqua School of Business at Duke University:

Instead of providing solutions, decision analysis is perhaps best thought of as simply an information source, providing insight about the situation, uncertainty, objectives, and trade-offs, and ... yielding a recommended course of action.¹⁰

▲ INVESTMENT POLICY AND THE PRUDENT INVESTOR RULE

Schultz Collins, Inc. helps investors define their investment policy in a written Investment Policy Statement. Although an Investment Policy Statement can take many forms, we believe that all investors, not just trustees and fiduciaries, should demand and receive investment advice that conforms definitively to the Prudent Investor Rule.¹¹ We therefore acknowledge the principles of prudence, and assume the requisite duties:

- Decisions concerning individual assets must be evaluated in the portfolio context. Our firm helps investors develop coherent, practical strategies for combining disparate assets into a viable whole;
- Risk and return are directly related. We act on our duty to analyze and quantify risk, and help our clients make deliberate judgments concerning the level of risk and return most appropriate for their accounts;
- Sound diversification is fundamental to risk management. We assist in minimizing uncom-

⁸ 15 U.S.C. § 80b-8(c).

⁹ 15 U.S.C. § 80(b)-2(a)(13).

¹⁰ Clemen, Robert, *Making Hard Decisions: An Introduction to Decision Analysis*, (Duxbury Press, 1996), p. 4.

¹¹ *Restatement of the Law, Third, of Trusts* - Prudent Investor Rule, Ch. 7, p. 7 *Uniform Prudent Investor Act* National Conference of Commissioners on Uniform State Laws Chicago October, 1994. Adopted by the State of California July 5, 1995.

pensated, unwarranted or unintended risk;

- The need for current income must be balanced with protection of purchasing power. We provide clients with the means to achieve real returns on their investments, after considering taxes and inflation;
- A prudently managed portfolio avoids unjustified expenses. Our firm is adamant in its drive to eliminate unwarranted fees and transaction costs.

With our depth of experience and unbiased perspective, we provide clients with practical, economical and reliable solutions to the broad array of issues encountered by investors. We do not provide legal, accounting or tax advice.

Our goal is to lead our clients to a position of understanding. Decisions can then be taken, not on the basis of hunches, or blind trust in another's expertise, but in the context of a rational, comprehensible, legally defensible and academically supported framework.

▲ INVESTMENT POLICY REVISITED

We conclude with observations regarding investment policy.

Investment Strategy vs. Investment Policy

The do-it-yourself investor may incorrectly conflate the day-to-day generation of investment returns with the asset management decision process. Investors sometimes substitute the return generating process for investment policy. By seeking to maximize period-to-period investment returns, the investor may replace prudence with mere 'intention.' The investor intends to select good stocks that exhibit the potential for above average returns. The prudent investor distinguishes between investment strategy and investment policy.

Defining Investment Policy

We define investment policy as:

1. Determining an achievable wealth accumulation/distribution objective for a pool of capital, and
2. Designing and implementing a credible and reasonable program for achieving dollar denominated goals.

Please note that we do not define policy in strategic terms (fundamental and/or technical stock picking schemes, market timing, catching new investment fads, following trading rules as seen on the latest business-network TV show, etc.) designed to maximize period to period returns. Rather, the prudent investor recognizes that policy is the foundation underlying the portfolio design process.

The Need for Investment Policy

Without academically sound and administratively reasonable asset management guidelines, success can only be defined in terms of future results – a wholly random variable. Unstated investment policy becomes merely the act of seeking the best returns. This works fine as long as returns are good. But what constitutes good return? As Yogi Berra summarized the problem: "If you don't know where you're going, you might wind up someplace else."

The emergence of rigorous professional standards for securities valuation and promulgation of new standards based on the scientific findings of financial economists create difficult challenges. At a minimum, prudent management requires a written investment policy statement to ensure that the portfolio design is rational and defensible, and to ensure that the investments are performing adequately when evaluated by objective criteria. The prudent investor recognizes that policy is the foundation underlying the portfolio monitoring and supervision process.

When Things Go Bad

Investors seek returns in excess of the risk-free rate in the expectation that they will realize rewards commensurate with investment risk. Investment portfolios, however, operate under conditions of uncertainty; and, expected results may give way to realized losses. Sound investment policy provides a protocol that will not shield the investor from market losses, but aims to reduce the probability of catastrophic results from which the portfolio is unlikely to recover. An investment strategy that ‘should’ work ‘on average,’ may be wholly inappropriate for a specific investor. Investing requires decisions when things are not going according to plan: stay the course? maintain discipline? avoid market timing? trust the market? change the allocation? reduce spending? Investors must be able to tell when they’re in trouble, and what they can do about it. The prudent investor recognizes that policy is the foundation underlying the intelligent assessment of asset management elections.

Making Advice Work for Investors

The great recession of 2008 – 2009 was a watershed moment for the financial industry. Investors in under-diversified portfolios experienced substantial economic setbacks. Given the NASDAQ tech-stock meltdown in 2001 and the global recession of 2008-2009, an all “blue chip” stock portfolio like the S&P 500 had an approximately zero percent rate of return over the period January 2000 through December 2011. This is a twelve year period in which the investor in

U.S. stocks failed to receive any compensation for risk. Fortunately, the market prediction industry that supported a host of investment gurus also suffered a well-deserved credibility setback.

These harsh realities had some salutary effects on the financial advice profession. Financial decision making began to be evaluated on new and more reasonable metrics. The siren song of “work with me and I’ll make you rich,” gave way, in some cases, to “work with me and I’ll help you discover appropriate strategies to facilitate attainment of financial objectives.” Planning moved from an exclusive focus on the left-hand side of the balance sheet (assets only) to a more integrated asset/liability type of asset allocation and portfolio management approach.¹²

The evaluation metrics shift from how much money you made to what was the value of the planning solutions that you adopted and implemented. It is cold comfort to find that you beat the S&P 500 when it was down 57% peak-to-trough. Intelligent planning enhances the likelihood for financial success, if for no other reason, than it allows for an in-depth discovery and evaluation of planning options. The question of how to plan takes precedence over the question of what to buy.

The Schultz Collins website (Portfolio Management: Theory & Practice – Schultz Collins/Schultz Collins) provides a more complete discussion of the financial advice marketplace¹³ as well as information about Schultz Collins, Inc.

¹² For a detailed analysis see: Patrick J. Collins “[How to Deal with Changing Realities in Asset Allocation: Fiduciary Liability in Turbulent Economic Times](#),” ACTEC-ALI course materials (November 8, 2012), pp. 83-165. This is available on the Schultz Collins website.

¹³ Patrick J. Collins “[What Investor’s and Trustees Should Know about Investment Advice](#),” (August 2016). This is available on the Schultz Collins website.