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Introducing the 'Debt Policy Statement'

by Shawn Brayman

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Executive Summary

- Although investment challenges like those experienced in 2008 and early 2009 can result in consumers losing substantial amounts of their investment capital for a time, many consumers lost their homes in the same period as a result of questionable lending practices or a failure by consumers to understand and plan their borrowing decisions.

- This paper proposes the introduction of a "Debt Policy Statement," modeled off the same principles as an Investment Policy Statement, as a framework for:
  - »» Educating consumers about their "debt portfolio" and the need to manage it to minimize interest costs and maximize the benefits to the family
  - »» Illustrating the risks associated with fluctuations in interest rates, real estate values, and other aspects of the debt portfolio
  - »» Ensuring there is a proper relationship between a client's risk tolerance and the structure of his or her debt portfolio
  - »» Developing a framework of "debt classes" similar to "asset classes" to help consumers understand the relative costs and risks associated with different types of debt instrument
  - »» Recognizing clients' future financial goals to ensure short-term advice does not create future limitations that may impede their ability to attain their goals

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Portfolio Success Rates: Where to Draw the Line

by Philip L. Cooley, Ph.D. ; Carl M. Hubbard, Ph.D. and Daniel T. Walz, Ph.D.

Philip L. Cooley has been the Prassel Distinguished Professor of Business Administration at Trinity University since 1985. He is the author of several books and more than 50 journal articles on financial topics. Carl M. Hubbard is a professor of business administration at Trinity University. He has previously authored and coauthored articles on retirement planning in many journals including the Journal of Financial Planning. Daniel T. Walz is a professor of finance at Trinity University. For Spring 2011, he is a visiting professor of finance at the University of Hong Kong.

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Executive Summary

- Portfolio success rate analysis provides the information needed to plan withdrawals from a retirement portfolio. Because financial markets and other matters of life change unexpectedly, those plans are likely to change.
- This updated analysis reports portfolio success rates net of monthly withdrawals through a range of payout periods. The data we rely on are total returns to large-company common stocks and high-grade corporate bonds as well as Consumer Price Index values and inflation rates from January 1926 through December 2009.
- We conclude that if 75 percent success is where to draw the line on portfolio success rates, a client can plan to withdraw a fixed amount of 7 percent of the initial value of portfolios composed of at least 50 percent large-company common stocks.
- The sample data suggest that clients who plan to make annual inflation adjustments to withdrawals should plan lower initial withdrawal rates in the 4 percent to 5 percent range, again from portfolios of 50 percent or more large-company common stocks, in order to accommodate future increases in withdrawals.
- Changes in withdrawal rates or amounts can be made in response to unexpected changes in financial market conditions using the basic tables we provide.
- For full text go to www.fpajournal.org

Adding a Third Dimension to Bond Analysis

by Joe Taylor

Joe Taylor is the founder and president of Oak Street Advisors in Myrtle Beach, South Carolina. He is a fee-only adviser and member of NAPFA *Reprinted with permission by the Financial Planning Association,* Journal of Financial Planning *July 2011.*

Executive Summary

- This paper seeks to illuminate how bond returns vary as a bond moves through time.
- It also shows how to develop a price curve from the data points implied in the yield curve.
- The author analyzes the effect of coupon rates on bond returns in varying interest rate environments.
- The purpose is to provide information to make better fixed-income investment decisions:
  -Visualize and model expected price behavior of bonds under varying interest rate scenarios.
  -Aid in selecting securities with coupons and maturities to maximize returns in changing interest rate environments.
- The author graphically represents this information for client teaching purposes and better understanding for planners of all experience levels.
- A spreadsheet workbook is available online for advisers to download and adapt to their own practices; Please click here.

For full text go to www.fpajournal.org

Data Security in a Tech-Crazed World

by Tom Nawrocki

Tom Nawrocki, a former editor at Worth magazine, is now the editor in chief of Triton Financial Newsletters, which provides communications for elite wealth managers around the country. He can be reached at Tom.Nawrocki@TritonNews.com. *Reprinted with permission by the Financial Planning Association,* Journal of Financial Planning *July 2011.*

The same electronic tools that have brought so much ease to the lives of financial advisers have resulted in a whole new set of concerns as well. Just how secure are the client files stored on my office server, or out in a cloud somewhere? What sort of compliance regulations affect my data storage plans? And perhaps, most importantly, how do I convince my clients that their confidential information will never be breached?

An entire security industry has developed with the express purpose of answering these kinds of

questions. Many of the solutions go far beyond the kind of security breaches advisory firms have been experiencing, but that may be what clients need to hear in the end. "Clients are really concerned, because this is something that's been in the news all the time," says Ash Bhatnagar, CFP®, president of RIA Independence Company in Titusville, New Jersey, which helps advisers develop independent businesses. "To do the most you can becomes imperative as a matter of client servicing."

For some advisers, especially those with larger practices, the safest and most cost-effective move has been to move everything out of their offices and into so-called cloud computing. "Advisers don't really need any technology in their offices besides their Internet connection and their PC," says Bhatnagar. "That's my goal."

How Cloud Computing Works

With cloud computing, the user's computer contains no files or even software; everything is stored and accessed remotely. While it makes people nervous to lose that kind of control over their most vital files, in many ways cloud computing is a safer alternative to local storage. The vendors have invested heavily in security infrastructure and can develop purer systems that make it harder for hackers to break into. "SalesForce, as an example, has seven different server firms throughout the world, using industry-leading technology," explains Jay Rivard, SalesForce practice director at Harvest Solutions, a CRM consulting firm in Waltham, Massachusetts, that concentrates on financial advisers. "The data resides on like machines, so unlike on-premise apps, where they might have different types of servers and operating systems, in the hosted world it's all the same."

Although it makes some advisers nervous to send confidential data to an unknown location, the files are encrypted before they're uploaded to the cloud, and the storage firm has no ability to unlock them. The standard procedure is for each vendor to back up all its files regularly—every hour or two hours—then validate whether the backup successfully happened for all the data by looking for changes on the encrypted data. And the providers must follow compliance requirements at least as strict as any adviser, usually more so, because they have to account for regulations from many different states as well as the federal rules. Peter Herzog, senior software and systems specialist at ActiFi in Plymouth, Minnesota, which provides software and solutions for financial advisers, thinks this makes security tougher and the ability for advisers to validate it greater.

"A lot of these providers, since they have multiple financial advisory offices on their system, have to go through multiple types of compliance audits—so they're continually being audited and tested," Herzog says. "There's a definite perception that you can lose control of your data, but you can request from a vendor a report from their last compliance. If they can't provide that, they better have a reason why."

Or you can run a simple test to make sure that everything is not only backed up but readily available if you need it. "You definitely need to have a test process in place," says Bhatnagar. "What I do is say, 'I lost a file 10 days ago, and I need to recover it.' And call the help desk; that's what you're paying for. And see what they do. You'd be surprised—some people can't actually recover it! Then you know it's time to move on."

Many of the larger Internet players have moved into the cloud storage space, including Amazon, Microsoft, and Google. With an incredible amount of bandwidth at their disposal, large web-based firms are a natural for this sort of thing. While there might seem to be greater security concerns—Google's Gmail was hacked into this past April, and there have been rampant stories about people being surprised at a perceived lack of privacy with Google Docs—it's important to remember that these are huge companies with varying levels of service available. The version you pay for would have a complete, validated level of security, quite unlike the free apps out there. There are also smaller, boutique IT shops that offer storage solutions for small businesses; Herzog singles out Network Alliance and IVDesk as cloud providers that have done reliable work for financial advisers.

There are drawbacks to storing everything offsite though. If for whatever reason you need to recall all your data from your cloud site, it can be very cumbersome, involving sending the provider a hard drive, having all your information downloaded to it, then having it shipped back to you.

Do-It-Yourself Storage and Encryption

Storing data files in your office still makes a lot of sense for a smaller, one-person shop. "Hard-drive storage is cheap nowadays," Herzog says. "You can buy multi-terabyte hard drives for just a few hundred bucks or less."

Bhatnagar agrees, saying that not only do the economics work particularly well for smaller firms but the security can be tighter as well. He found a server from ioSafe that was particularly impressive: "It's fire-proof and flood-proof, and it was a $320 solution—and no cloud's ever going to beat that for the amount of space that you get," he says. "I think that's a great solution for a one- or two-person shop." Still, he also recommends contracting with a third party for backup, just in case.

Storing your own files also leaves security up to the discretion of the individual adviser, which usually means encryption. Encryption is in the process of moving from a 128-bit standard up to 256 bits, although in the early days of encryption 40 bits were considered sufficient. The bits refer to the different possible key values generated randomly to encrypt the data. Because they use a binary code, the number of bits allows a total possible range of values of two raised to that number's power; in other words, 40-bit encryption used two to the 40th power possible

outcomes.

That may seem like a lot, but today's high-speed computers are able to shuffle through that many values in fairly short order, leading to the rise of 128-bit encryption and now 256-bit encryption. FINRA, for one example, now requires all communications sent to it be encrypted at a 256-bit level. Is that overkill? Herzog thinks not: "Computers today are so fast that 256-bit encryption is very practical in the vast majority of applications," he says, "and I would tell advisers to use it if they have the option."

What to Encrypt

The first question any adviser must answer is, "How much do I want to encrypt?" The client files themselves need to be encrypted, which in some jurisdictions is a necessity. Massachusetts, for example, requires that any clients' personal information be encrypted when it's sent across the Internet or stored on portable devices such as laptops or Cds.

Beyond that lies the option of hardware encryption, which even makes it difficult for people to gain access to the machines themselves. There's little doubt that hardware encryption has been increasing, and it certainly does add an extra level of protection. Bhatnagar also finds that hardware encryption can be more stable and less prone to bugs than encrypting files. But it can also be very costly, because each piece of equipment will require its own encryption.

It's possible to encrypt your software as well—the applications on which your client files run. This would prevent any hackers or burglars from running your programs at all, whether remotely or within your office. But Herzog argues strongly against it. "A lot of people have a tendency to encrypt their whole setup, and I think that's a big mistake," he says. "What they should be doing is separating their data from their software. Microsoft Word and Excel and PowerPoint—there's no need to encrypt all that information. You can always reload the software and recover all your files."

There are even encrypted flash drives for moving data from one place to another. In a sense, this is the most necessary environment for security, because it's probably more likely that you'd mislay a flash drive than get your server hacked into. IronKey, for one, makes a USB drive with 256-bit hardware encryption, capable of storing up to 32 gigabytes of memory. They'll cost $75 to $150; if you need less storage space, Corsair makes an 8-gigabyte version that sells for only $50.

CRM Integration as Security

Another aspect that has enhanced data security is the growth of CRM (customer relationship management) systems. By encapsulating so much of your data and processes under one umbrella, a CRM solution can incorporate security factors while greatly reducing the potential for some kind of breach or error. "Integration just for efficiency's sake is widely popular, but from a security perspective, to remove any sort of human error when you have to duplicate data and enter it twice into the system—absolutely that reduces risk," says Herzog.

"The ability to store all that sensitive data, especially integrating back-office tools … in one spot and be able to report off of it is huge," says Rivard. "These are essentially shrink-wrapped apps, so it's much easier to deploy them, and it's a much higher level of security than you can get on your own."

The key is that everything is held within a single system, making it unnecessary to move files around or access them through a variety of applications. "For sensitive documents," Rivard points out, "you can control access to them without having to distribute them with third-party products."

Not all CRM systems are alike— different ones have different security capabilities. "The top-level types of CRM have very high levels of security within the applications themselves," Rivard says. "Which flavors of that you get depends on the additions … the more expensive the additions, the higher level of security you can get."

You need not just take a vendor's word for it that you've got all the security you need. Herzog points out that there are concrete ways to validate the level of security you're getting. "When you purchase a CRM or other document management system, look for solutions that have auditing capabilities in it, so that whenever anyone changes a field in it, or any value on a client record, that's noted," says Herzog. "It records who did it and what the previous value was and what the new value is. There's a lot of data in CRMs, and to protect that you need to have some auditing around that, too." You should also be aware that such security measures as encryption and firewalls vary from CRM to CRM. Make sure the system you have incorporates all the features you need.

Moving to a CRM system and creating a paperless office means other safeguards should be in place, particularly when it comes to destroying now-unneeded hard copies. "Many times you'll have an original signature on a contract, and you want that scanned in to become paperless," says Michelle Jacko, CEO of Core Compliance Legal Services in San Diego and managing partner of the Jacko Law Group. "Before you shred that original document, make sure that the integrity of the information is sound, and that it's legible. An advisory contract requires an original signature; if you decide you're going to shred that document, the regulations specifically state that it needs to be as close to an original format as possible."

If you have a scanned advisory contract that does not contain the actual client signature, and wonder whether you need to have the client re-sign, Jacko says yes. "If you don't have proof of that, it's as if it were never agreed upon."

Compliance with Privacy Issues

There are compliance reasons to keep your clients apprised of your security infrastructure as well. The Gramm-Leach-Bliley Act of 1999 (with its final rule in 2009) specifically requires financial institutions to provide their clients annual privacy notices. The rules also require that clients be notified of any information-sharing practices and be given the chance to opt out of them. (There are model privacy forms available online at www.sec.gov.)

These compliance requirements have clearly played a role in fueling the growth of the data-security industry. But enhanced levels of security do not seem to address hackers or thieves attempting to breach the files of individual advisers. Despite reports of leaks involving everything from 75 million PlayStation users to Best Buy's e-mail lists, financial advisers have been spared thus far. "Hackers aren't really looking for small advisers," says Bhatnagar. "They're trying to hack into J.P. Morgan."

If breaches are virtually non-existent, why do advisers need to put so much money and effort into preventing them? For one thing, compliance demands it; for another, clients expect it. And there's also the fact that a security breach is one thing your clientele would likely find unforgivable. "A breach is probably worse than losing 50 percent of their assets," says Bhatnagar. "You can explain the 50 percent, but you can't explain the breach."

Advisers seem more concerned about what might be called accidental breaches of the type the New York Yankees suffered in April. An employee accidentally e-mailed a spreadsheet containing the names, addresses, e-mail addresses, and much more information about more than 20,000 of their season-ticket holders. Advisers live in fear that one of their employees will inadvertently reveal confidential information.

Fortunately, there are readily available fail-safes to keep such a thing from happening. "You can set up your e-mail software to look for keywords that [you] may be afraid of and stop those e-mails from going out," Bhatnagar says. "Anything that says 'your account number' on it would get stopped." You don't need to go get a special application to set up such a safeguard; it's included on Microsoft's Outlook, the world's most popular e-mail program. Just look under the Tools menu for "Rules and Alerts." You can set it up for individual PCs or for your entire server.

"Breaches result more from people not really paying attention to their own security policies, or not having a policy at all," says Herzog. "That's more the problem that I [see] than actual security breaches." Not being aware of the security issues led executives at the now-defunct broker-dealer GunnAllen to be charged with taking more than 16,000 client records from the firm as it was winding its business down. As Michelle Jacko puts it, the most common violation of security she sees is when advisers forget that confidential client records belong to the client, not to the firm.

"You need to be cognizant at all times that you've been entrusted with this confidential consumer information," she says. She often sees offices at night where account numbers are left out in the open for the cleaning people to discover, while compliance requires that all the information be locked away at night. Similarly, on your way to becoming a paperless office, there are regulations covering the disposal of old files—they must be shredded rather than simply thrown away. Any scrap of paper with confidential information should be treated as if it had the potential for a security breach.

In the end, looking backward at the breaches that have occurred is not enough to keep yourself and your data safe. It's imperative to look forward as well.

"Many security researchers are saying that we're losing the battle, that hackers are still ahead of current security technology," says Peter Herzog. Whatever hackers are doing today to infiltrate computer systems, you can bet they'll have a new strategy tomorrow. Ultimately, data security is about making sure you're ready for whatever comes next.

Sidebar:

Password Safety

There's one very simple area of security in which there's been a lot of good, defensive research lately: passwords. Hackers have several ways to infiltrate your passwords. There's a dictionary attack, in which the hacker flies through a list of tens of thousands of words until he hits on the right one. Then there is what's called a "brute-force" hack, where a computer shuffles through random characters until it lights upon the proper password.

The dictionary method is the reason people are now dissuaded from using common words as their passwords, and we're usually forced to include numbers or other symbols in them. According to Thomas Baekdal, founder of the Baekdal online magazine, a remote computer can hack a simple password like "orange" in as little as three minutes. But the rise of brute-force hacking has meant that even random formulations of letters can be figured out in short order.

What's the solution? Peter Herzog of ActiFi suggests that rather than passwords, use "pass-phrases." Even a common phrase like "this is fun" can be a much more effective password than a six-letter jumble. "It's ten times more secure to use a pass-phrase of three random words than 'J4FS:2,'" Herzog says. "With six characters, it's just a matter of time before they guess it." Baekdal reckons that while a truly random collection of six letters might take a hacking program a month to breach, "thisisfun" would take 2,537 years.

If that's not enough, there are other ways to deter hackers. Herzog recommends putting a time delay on any wrong password guesses, such that, for example, after 10 wrong guesses at a password, no one can try to enter new information for the next hour. Because hackers operate by use of high-speed password attempts, forcing them into an hour's time-out would quickly make the effort cease to be worthwhile.

Breaking Through: The State of the Risk Tolerance Conversation

by Lisa Holton

Lisa Holton heads The Company, an Evanston, Illinois-based writing, editing and research consulting firm founded in1998. Reprinted with permission by the Financial Planning Association, Journal of Financial Planning *April 2011.*

Neal Van Zutphen turned to the power of the pyramid—his own, actually. Rich Colarossi went back to school. And Todd Terhorst and his partners redoubled their efforts at the art of client conversation. The post-2008 era in financial planning has inspired more self-reflection and practice review than any in recent memory. Client fear, reticence, and in some cases, outright rage, have reset advisory relationships for many professionals, even those who are now seeing across-the-board recovery in those same client portfolios today.

Like the advisers mentioned above, many financial planning professionals have used this three-year period of economic uncertainty to reevaluate the way they discuss, measure, and act on the risk tolerance of individual clients. In this process, many have started—again—at the beginning; that is, by reviewing all the terminology related to risk as well as the basic definition of risk tolerance. The ISO 22222 Personal Financial Planning Standard defines risk tolerance as "the extent to which a consumer is willing to risk experiencing a less favorable financial outcome in the pursuit of a more favorable financial outcome."

Some planners have taken note of how news media and other outside stimuli might be drowning out their own customized advice, and are building an approach around that. Others have begun to reevaluate the way they've used diagnostic and educational materials to budge clients out of reluctance or inertia to make decisions best for their circumstances.

And some financial professionals would argue that risk tolerance isn't the problem planners really need to attack at all. "I think we have to make a distinction between someone's risk tolerance—their willingness to invest with the chance that their investment might go down but go up more—and risk perception, which in everyday terms is, 'How dangerous do you think the markets are right now?'" Says Michael Kitces, CFP®, CLU, ChFC, RHU, REBC, director of research for Pinnacle Financial Group and publisher of *The Kitces Report*, a popular blog addressing investment and practice issues for planners.

"I don't really think planners and clients have a risk tolerance problem," adds Kitces. "It's a risk perception problem. Your risk tolerance means nothing if you think we're in for another major market crash a year from now."

There is a great amount of debate on what the lexicography of risk means for every planner and client. But there is consensus on one point: an increase in risk tolerance can't happen without a deeper and ongoing discussion about the client's perception of risk and how it affects his or her ability to accept an adviser's recommendations.

"Over the years, it has become apparent that the overwhelming majority of people who seek our help have no tolerance for risk. But they actually have no clue what risk tolerance is until it whacks them in the face," says A. Raymond Benton, CFP®, a partner in Lincoln Financial Advisors in Denver, Colorado. "It really can't be shaped other than through repeated experience. So building a long-term relationship based on trust is the only lasting solution toward building and increasing risk tolerance among clients."

Benton adds one more cautionary point: "Any attempt to 'match' risk tolerance to expected portfolio volatility is a formula for producing maximum pain and is thus a formula for failure."

Overcoming New Client Conservatism

In January, the Investment Company Institute (ICI) reported that Americans remain committed to saving for retirement, but they "appear to have become more conservative" in terms of savings, asset allocation, and choice of retirement age.[1] The survey, conducted last November and December, found that 37 percent of respondents had shifted investments toward more conservative choices, away from stocks toward bond and money market assets—even as the Dow Jones Industrial Average neared 12,000, up 70 percent from 2008's market lows. At the same time, 17 percent reported that they had delayed retirement.

The ICI reported similar findings last September that mutual fund shareholders' risk tolerance had not rebounded since the financial crisis in 2008.[2] The organization reported that 30 percent of those surveyed were willing to take substantial or above-average risk for financial gain in May 2010, the same figure reported in May 2009—and down from 37 percent before the crisis in May 2008.

"The decline in risk tolerance between May 2008 and May 2010 was widespread across working-age mutual fund investors," said Sarah Holden, ICI senior director of retirement and investor research, in the study. "Older investors continued to report a much lower

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tolerance for risk when compared with younger Investors."

Such statistics demonstrate that this more conservative mind-set, lingering a few years after the market bottom, represents an enormous challenge for advisers who worked so hard to keep clients from selling and running. Now they wonder how to get them back to a mid-point where they will consider taking on risk appropriate to their age, retirement goals, and asset levels.

Measuring and Documenting Risk Tolerance

If there is a common approach to risk tolerance, it's that most professionals will start a client relationship with some questionnaire aimed at measuring it. Such questionnaires might come from associations, research firms, or other official sources; others might be developed by planners themselves. Beyond that, there really is no standard.

According to Sydney, Australia-based FinaMetrica, a research firm focusing on psychometrics related to financial decision making, advisers typically use a questionnaire of 5 to 20 questions for clients; however, most advisers who use them don't know what they're really measuring. Geoff Davey, FinaMetrica co-founder, says most of these questionnaires "deal with financial matters that have little to do with risk tolerance," which by his definition is the amount of risk an individual prefers to take. And while age and economic conditions may affect risk tolerance on a mass level, "a lot of people think of risk tolerance as a negative, a pain threshold, but risk in and of itself is not a bad thing … nothing ventured, nothing gained," Davey explains. "But where people strike a balance is different. Most of the time, planners are dealing with a too-much-risk scenario to achieve the goals for the client based on the client's risk tolerance."

Why does this happen? Davey explains that risk tolerance is a psychological trait that comes in four flavors— physical, social, ethical, and financial. Though financial risk tolerance may have absolutely no correlation with the other categories, Davey notes that some questionnaires will blend categories in hopes of uncovering some deep insight about the way clients view risk. Instead, such an approach can guide a planner's efforts in dangerously inaccurate ways.

"I don't really think planners and clients have a risk tolerance problem. It's a risk perception problem. Your risk tolerance means nothing if you think we're in for another major market crash a year from now."

—Michael Kitces, CFP®, CLU, ChFC, RHU, REBC

Davey credits Douglas Rice, D.B.A., CFP®, of Golden Gate University with some of the most reliable research on the conceptual flaws in industry standard questionnaires. Among 131 industry-standard questionnaires tested, for those with the most conservative answers, "the percentage of assets allocated to equities ranged from 0 to 70 percent. When answered in the most aggressive way, the percentage of assets allocated to bonds, or bonds and cash, ranged from 0 to 50 percent. This is perhaps the most telling finding of the entire study."

Most of these questionnaires don't really measure how a client is likely to respond to a purely financial proposition. "One of my favorite sayings is that our industry is bedeviled by the superficially plausible. Some surveys date back 30 years," Davey says, adding that American planners tend to be behind those in other countries for developing more sophisticated diagnostics not only for risk tolerance but risk capacity (how much risk clients can afford to take) and required risk (how much risk clients need to take).

Can Education Change the Risk Tolerance Conversation?

No matter how planning professionals choose to measure the initial risk tolerance of their clients, they understand that the aftermath of the 2008 crash has made it tougher to restore and increase risk tolerance for clients hesitant to take on more justifiable risk in their portfolios. More aggressive education methods might be a way to do that, but they're not a panacea.

"Education does not increase risk tolerance, but it can help advisers guide their clients toward realistic expectations and better appreciation of the risk in markets during various cycles," Davey says. "Risk is usually underestimated in bull markets and overestimated in bear markets."

Planners interviewed for this article were in agreement that they are talking more to their clients and trying to respond to queries and concerns by sharing reports and research to help clients better understand the investments and strategies being recommended to them. And some are coming up with inventions of their own to get a broader picture of what clients really want out of the planning process and how far they're willing to expand their risk tolerance.

Feelings First

When Neal Van Zutphen, CFP®, of Mesa, Arizona-based Delta Ventures Financial Counsel, noticed such a violent shift in client mind-set after the 2008 crash, he decided to take time out to do some research on risk tolerance with a humanistic touch. The result was a three-dimensional visual aid called the Happiness Risk/Reward Pyramid that planners can use with their clients to address unmet personal and financial needs, life goals, and potential obstacles toward meeting these goals. Van Zutphen detailed in a

contribution for the Journal[3] how he drew on Elisabeth Kubler-Ross's five stages of grief and Abraham Maslow's hierarchy of needs theory to address how clients handled loss on an intimate basis while giving them a chance to examine what they really wanted out of life.

"Several years ago, I began a research project on the psychology of money. In the past, when we had conversations on risk tolerance and how we should manage their portfolios—risk management— the clients would get a glazed look on their face. Everyone knows about the eggs-in-one-basket sort of thing, and frankly, it was more sales-y than educational," says Van Zutphen. But, particularly after 2008, Van Zutphen and his colleagues were facing the added pressure of communicating with clients who were hearing negativity from all corners. "You'd hear them talking about [CNBC commentator Jim] Cramer saying the world is going to hell in a handbasket, and our clients were getting so wrapped up because bad news sells really well," he explains.

So Van Zutphen decided to create his pyramid and hit the real enemy head-on—fear. Discussion of bad events, both financially and personally, became the subject of extensive conversations. "When bad things happen, people go through stages of grief," he explains, and going through those feelings helps diffuse the guilt and anger associated with them so clients can accept the event and start making adjustments to catch up.

"Over the years, it has become apparent that the overwhelming majority of people who seek our help have no tolerance for risk. But they actually have no clue what risk tolerance is until it whacks them in the face."

—A. Raymond Benton, CFP®

"Risk tolerance is contextual," Van Zutphen explains. "For clients, it's all predicated on their current situation and how they view the future. If someone gets a new job with a $50,000 raise, you bet their risk tolerance goes up, even if they are in fact a moderate risk taker. If there's bad news they feel involves them, it's the same effect."

Back to School

Rich Colarossi, CFP®, of Colarossi & Williams in Islandia, New York, has "never believed in risk tolerance questionnaires. They're silly. It's a snapshot of a client's risk tolerance, and not a particularly good one."

Yet the post-2008 environment called for a different sort of action. "We had people who got through 9/11 and were able to handle volatility. But once 2008 hit, they couldn't. Something major had changed," says Colarossi. There was a loss of perspective that seemed worthy of additional focus. So in the months following the crash, Colarossi enrolled in the New York University School for Continuing and Professional Studies to study behavioral finance and economics.

"I felt I needed a better way to understand what the client really is thinking. In all my years of practice, I always had one or two clients who were hard to move and convince," Colarossi says. "But you saw more of that after 2008. It would go something like this. Say the client invested $100,000, their portfolio hit $150,000 at the top, and then after the downturn went to $130,000 … and then they couldn't move. Overall, they still had a gain, but I had to learn how to effectively get people out of a loss mentality when they were invested long term."

Colarossi believes planners need to have deeper conversations now on the difference between risk and uncertainty. "We need to get people better aligned with their goals and time horizons. That's a healthier way to handle clients."

"Education does not increase risk tolerance, but it can help advisers guide their clients toward realistic expectations and better appreciation of the risk in markets during various cycles."

—Geoff Davey

"Three years ago, I would have been more reliant on quantitative analysis," he continues. "Now I don't even bother. I take a closer look at how they've reacted to loss in the past … [and] focus on what loss really means to them."

As to the current mind-set of clients, "Even though it's calming down now, there is a greater fear of loss. There's no question about it. The pain of loss is a killer," says Colarossi. To an extent, Colarossi also blames the media for ramping up the negativity. So he spends more time talking to clients. "It's an investment of time, but isn't that what the client wants? Isn't that what they're paying me for?"

Joseph Matthews, CFA, CFP®, resident director of wealth management for Merrill Lynch in Westport, Connecticut, helped develop the course Colarossi took as an adjunct professor for NYU in 2008, and teaches it today. The topics featured in the class include heuristics (the theory that people often make decisions based on generally accepted rules rather than rational analyses), framing (the different ways an

individual reacts depending on how ideas are first presented), and anomalies (how efficient market theory's unexpected and unlikely events continue to occur—and why they do). He focuses heavily on the work of two economists and collaborators in the field of behavioral economics: Nobel laureate Daniel Kahneman of Princeton and Richard H. Thaler of the University of Chicago's Booth School of Business. According to Matthews, 2008 was the year "that modern portfolio theory went out the window. Fear became the overriding factor that took precedence in many [planner-client relationships] and a lot of people were looking for answers." In the past three years, his students have included planners, but he's also taught portfolio and hedgefund managers, equity traders, fixed-income analysts, brokers, and wealth management advisers.

"I would say that individuals come into the program with a notion of believing that behavior has in some way, shape, or form an impact on capital markets," says Matthews. "They come out believing that behavior can often be the most important factor affecting markets."

Matthews notes that his students and fellow professionals have really gone back to school on the subject of risk and explaining it to clients. The most effective tools, he believes, still rest on empirical data, such as the simple presentation of an investment class's history during turbulent times. And the historical performance data from 2008–2009 will undoubtedly add significant weight to that approach.

"To be able to say to a client, 'Your $2 million portfolio could be worth X if this set of factors happens again,' is at the very least a way for clients to see the possibilities and judge if that's where they really want to be. It's right in front of them," says Matthews. "Exposing clients to historical down cycles for various asset classes can only help. Then they're not dealing with the conceptual. They're dealing with history."

Putting Risk in Client Terms

Todd Terhorst, CFP®, CLU, ChFC, AAMS, CRPC, president and managing partner of Diversified Wealth Management in the Twin Cities, Minnesota, says the process of measuring risk tolerance at his firm hasn't changed dramatically, "but enough where we had to rethink how we talked to clients about risk and how we describe risk." Part of the process his firm has changed is taking the time to ask clients how they describe risk in their own words, says Terhorst, "because clients don't always describe and think of investment risk in the way we do."

The conversation starts with a risk tolerance questionnaire, but risk is now an extensive part of client discussion, which rarely happened at any length pre- 2008, Terhorst says. Regular attention to the subject of risk has its benefits: "When I meet a new client and ask them how risky their current portfolio is, I'll get 10 different answers in one conversation. But after two to three years with us, I find we sound more alike because there's more information being exchanged and more understanding. That's what's supposed to happen."

Not that risk tolerance doesn't vary over the life of the relationship, says Terhorst, but both client and planner need to see whether a client's actual risk tolerance reflects the investments they're in, and if not, whether the client's risk tolerance needs to be tweaked in some way so realistic goals can be reached. To get there, the opening question can be very basic: "On a scale of 1–10, with 1 being your money being buried in the back yard and 10 being 100 percent exposed to equities, where does your comfort with risk stand?" Terhorst explains. "I wouldn't have used that simplistic a starting point in years past, but today, even if it seems a little silly, whatever you can do to make sure you're on the same page with a client is worthwhile."

"When I meet a new client and ask them how risky their current portfolio is, I'll get 10 different answers in one conversation. But after two to three years with us, I find we sound more alike because there's more information being exchanged and more understanding."

— Todd Terhorst, CFP®, CLU, ChFC, AAMS, CRPC

Terhorst also asks new clients a question about their behavior at the end not only of 2008 but of 2001 as well. "If a client tells me they lost 10 percent and went to cash by the end of those years, that's telling me a lot. That's an actual point of pain; that's behavior. And planners need to hear that so they have something to work from in making future recommendations."

The actual charts-and-graphs side of the discussion has changed too. "I used to talk in terms of returns, which we still do, expectation of returns. But one of the things that we used to gloss over because we felt the client would start to nap was measuring beta," says Terhorst. "For instance, comparing their stock portfolio to the performance of the S&P 500. A beta of 1.0 would mean both investments had the same amount of volatility. So, in 2008, if your portfolio went down 20 percent, you lost as much as the S&P, which makes people a little more comfortable in the risk discussion. They could see the bigger picture." Beta, says Terhorst, can be used not only as a way to gauge overall risk and performance but as a thermostat to adjust risk levels in portfolios over time.

How often should risk be discussed?
"As often as you discuss the portfolio," says Terhorst.

Where Compliance Comes In

The financial professionals interviewed for this article agree that the biggest impact heightened compliance rules around risk have had involves how advisers document and handle transactions and recommendations they make in response to client risk assessment. Compliance issues don't actually govern the length, detail, or emotional punch going into the new risk conversation.

"Certainly, some firms are asking for more detailed records and documentation that might change the process an adviser takes with the client," Terhorst says. "Being that I am an OSJ and Series 24 licensed principal for my firm, I see firsthand how the compliance issue is handled from both sides. If the rep is changing the way they discuss risk with their clients only because of compliance, it is likely they weren't doing their job properly prior to any heightened requirements being put in place."

Endnotes

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Safe Savings Rates: A New Approach to Retirement Planning over the Life Cycle

by Wade D. Pfau, Ph.D.

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Executive Summary

- Focusing on a "safe withdrawal rate" and then deriving a "wealth accumulation target" to achieve by the retirement date may not be the best way to approach retirement planning. Such a formulation isolates the working (accumulation) and retirement (decumulation) phases.

- When considered together, the lowest sustainable withdrawal rates (which give us our idea of the safe withdrawal rate) tend to follow prolonged bull markets, while the highest sustainable withdrawal rates tend to follow prolonged bear markets.

- The focus of retirement planning should be on the savings rate rather than the withdrawal rate. The "safe savings rate" may be based on historical simulations as the savings rate that proves sufficient to support the desired retirement expenditures from a life-cycle perspective, including both the accumulation and decumulation phases. Safe savings rates derived in this manner are less volatile than withdrawal rates and imply a lower ex-post cost to being overly conservative.

- Unlike the 4 percent rule for a safe withdrawal rate, there is not a universal "safe savings rate," but guidelines can be created. Starting to save early and consistently for retirement at a reasonable savings rate will provide the best chance to meet retirement expenditure goals. Actual withdrawal rates and wealth accumulations at retirement may be treated as almost an afterthought in this framework. But the savings plan should be adhered to regardless of whether it seems one is accumulating either more or less wealth than is needed based on traditional criteria.

For full text go to www.fpajournal.org

Guilt, Ego, and Monthly Paychecks: Threats to Wealth Building

by Rick Adkins, CFP®, ChFC, CLU

Rick Adkins, CFP®, ChFC, CLU, is president and CEO of The Arkansas Financial Group Inc. in Little Rock, Arkansas. He served as the 2003 chair of the Board of Governors of Certified Financial Planner Board of Standards. You can write to Rick at RickA@ARfinancial.com. *Reprinted with permission by the Financial Planning Association,* Journal of Financial Planning *July 2011.*

Over the years, I've observed clients who started out with very little, controlled their spending, saved regularly, and now have portfolios in excess of $5 million. I've watched other clients with similar incomes start with little and still have little today. I've observed clients receive large sums of money through inheritance, sale of a business, divorce, or the death of a relative. Some now have substantially less than others—and not because of market losses.

I must confess my curiosity about the implications of divergent money behavior with respect to human nature and our relationship with money. I've found myself wishing I could give certain clients a pill that would cure their self-destructive tendencies with money, but, alas, none exists.

While my personal observations are anecdotal, research conducted by Hoekstra, Hankins, and Skiba on 35,000 winners of the Florida Fantasy 5 lottery game found that 5.5 percent were bankrupt within five years. Further, big winners were just as likely to file for bankruptcy as small-time winners. The bad behavior transcended the amount of money. How could this be? Why do some folks handle money well, no matter how much or how little, while others don't? This plight isn't unique to lottery winners—think of the actors, professional athletes, and other entertainers who have gone from great wealth to destitution.

Here are my thoughts on three sources of challenge for humans in building and keeping wealth: guilt, ego, and a "monthly paycheck" mentality. This is one of those times I would love to have dialogue with other planners who have thoughts on this subject, because as a profession we can have the best investment processes in the world and yet fail clients who need help beyond determining where they should be on the efficient frontier!

Guilt

With apologies to all great mothers highly adept at wielding guilt to manage the behavior of their offspring, the "money guilt" I've observed seems to be either situationally cultural or event-driven. Here are a few of the possible drivers that can derail wealth building:

Misguided Religious Teaching. Some of our clients come from families that were very poor and coped with their poverty by holding onto the thought that "While we may suffer now (because we aren't rich like the Johnsons), we'll be just fine when we die and go to heaven. They might not be so happy then because rich folks will have a harder time making it to heaven than a camel going through the eye of a needle." Were you to buy into this thinking, how could you cope with making more money in a year than your parents did in their lifetime? The idea of accumulating wealth can leave you certain that you're headed straight to hell like the rich man in the story of Lazarus! The resulting behavior can be totally bizarre, unpredictable, and self-destructive.

Blood Money. One of our tougher challenges can be serving a surviving spouse who receives a large insurance payout or legal settlement because of the death of a spouse. Some have great difficulty hanging onto the wealth because it is a constant reminder that the money exists only because the spouse no longer does. They can also become greater prey to relatives who feel the spouse doesn't deserve such good fortune as a result of the death of their relative.

While I'm not suggesting that financial planners should all become great therapists, I do wish I had a better way to help clients so burdened by guilt that they are challenged to ever accumulate adequate wealth to achieve reasonable long-term goals. How do we help them?

Ego

You would think that the first decade of this century would have been a wakeup call regarding risk and loss. Yet our relative affluence during the 1980s and 1990s gave many of us the false illusion that we control our environment and destiny. I well remember clients who would blow off sound financial principles like having an adequate emergency fund or owning appropriate insurance by saying, "I can just borrow the money if I need it" or "She'll be okay; she'll get Social Security if I die."

While this sense of control has been shaken by recent tornadoes and flooding, it's still persistent. Weather is just one aspect of life we don't control; office closings, stock market crashes, job elimination, divorce, health surprises, or death of a loved one tend to diminish our sense of control.

The high income/modest wealth syndrome can become a huge trap in thinking. You see this most routinely with professional athletes. They earn huge incomes for a relatively short time. The pressure of conspicuous consumption is massive. They live as if the income will last forever, but the career lifespan of an NFL running back or MLB pitcher is usually short. As a result, what Texans refer to as "big hat, no cattle" can affect professional athletes, entertainers, and even doctors. My real concern is what is going to happen to physicians' salaries over the next 10 years. I've watched "sector rotation" happen with specialty incomes over the past 30 years. My fear isn't that rotation will continue but that the entire pie will be diminished. The illusion of control from high incomes may be a great hurdle for many of our clients. How do we help them?

Monthly Paycheck Thinking

For Americans above the poverty level, “Give us this day our monthly paycheck” might be an appropriate prayer today. While the original Daily Bread prayer was appropriate in Palestine 2,000 years ago (and still is today for many around the world and even in our own country), our culture and relative affluence no longer leave us wondering about the source of tomorrow’s food. Yet therein, on multiple levels, is the problem.

In my experience counseling clients in financial matters, I have observed that the perspective for humans within an affluent environment has evolved our point of reference for financial decisions. We have become “monthly cash-flow centric.” As a result, we are usually “wealth challenged,” and have trouble emotionally coping with large sums of money. I suspect there are three culprits of illusion that contribute to this problem:

Illusion of Time. With each passing year I become humbled by my changing perception of the passage of time. The song “100 Years” popular a couple years ago illustrates human time perspective from age 15 to 99, beginning each stage with, “I’m ____ years for a moment.” My, how the passing of those moments seems to accelerate with age!

As a result it’s difficult to capture the interest of a 26-year-old with retirement planning; yet, it’s at that point $100,000 invested at 6 percent would grow to become $970,351 by normal retirement age. Waiting 10 years to invest lowers the end value to $541,839; 10 more years it’s $302,560. And $100,000 invested at 56 will end up at only $168,948.

Because most of us don’t have large sums lying around when we’re 26, we lose much of the benefit of compound interest. Raising families is expensive and, as a result, most retirement savings capacity blossoms in the 10 years leading up to retirement. Most of us don’t have a “return” problem, we have a savings rate problem caused by a consumption problem.

Illusion of the Retirement Plan Solution. Some clients come to us presuming that if they just fully fund their retirement plan each year, they’ll magically have enough to retire. My colleague Dr. Broadwater counsels young physicians with the perspective that while they might soon have high incomes, they’ll probably never be wealthy unless they find ways to limit the expansion of their lifestyle and save for future consumption. Just using modest earnings and inflation assumptions, a physician might earn $23,710,251 over a career. After taxes, that converts to $12,625,708. After-tax income in the last year of employment would be $564,947. If nothing is being saved, the portfolio required to support that standard of living would be $14,123,685. If all the client has saved for retirement is $30,000 per year into the clinic’s retirement plan, that might have grown to $3,818,044. There’s an obvious gap. If consumption is constrained so that half of the income is being saved, not spent, only $7 million of capital is needed to fund retirement (that would imply that there’s about as much outside the retirement plan as has been saved inside the retirement plan).

Ilusion That Capital Is the Same as Income. Back before perpetuities became illegal to establish, families like the Kennedys and Rockefellers funded legal structures that ensured the wealth of their heirs for all time. They accomplished this by giving their heirs no access to the principal, only the income generated by the principal. Foundations operate on the same theory today; the withdrawal rate is commensurate with the income generated by the foundation. Spending down principal is either limited or isn’t an option. The beneficiaries never confuse “the tree” (corpus) with “the fruit” (income).

Lottery winners usually have the option of taking a lifetime income or a smaller lump sum. Most take the latter; they would all be better off taking the former. Yet, because corpus is not mentally differentiated from income, they are doomed to eventually have neither.

This issue makes thoughtful estate planning so critical. How much corpus should you leave your children and at what ages? How much access to corpus should they have and for what reasons? How much protection of the corpus should you impose? These aren’t easy questions to answer, but the typical answer of one-third at 25, one-third at 35, and one-third at 45 is a formula for disaster if the heirs don’t understand the importance of living on income, not spending principal.

Whether you call yourself a financial adviser, a financial planner, or a wealth manager, your challenge is presenting facts and risks as accurately as possible so that clients can make rational, smart decisions. I’m convinced that because of our human nature, the deck is stacked against clients to succeed by actually doing what can easily be rationalized. Retirement planning gets more challenging each year, but I believe this profession holds the keys to help clients manage wealth and build decision frameworks that will help them achieve their goals.