

Click on the article title to read it.

1 Retirement Planning
Mortality Assumptions: Are Planners Getting It Right?
by Cheryl Krueger, CFP®, FSA, Special Report, *Journal of Financial Planning*, December 2011

3 Ideas for Preserving the Financial Security of New Retirees
by Mathew Greenwald, Ph.D. Special Report, *Journal of Financial Planning*, December 2011

5 Investment Planning
Hedge Funds: Alpha, Beta, and Replication Strategies(Executive Summary)
by Robert Dubil, Ph.D., *Journal of Financial Planning*, October 2011

Improving Risk-Adjusted Returns Using Market-Valuation-Based Tactical Asset Allocation Strategie(Executive Summary)
By Kenneth R. Solow, CFP®, CLU, ChFC; Michael E. Kitces, CFP®, CLU, ChFC, RHU, REBC; and Sauro Locatelli, *Journal of Financial Planning*, December 2011

6 Professional Issues
Evidence-Based Financial Planning: To Learn . . . Like a CFP
By Elissa Buie, CFP®, and Dave Yeske, D.B.A., CFP®, *Journal of Financial Planning*, November 2011

Recognize What Drives Your Business Success
By Ross Levin, CFP®, *Journal of Financial Planning*, December 2011



Published by the Financial Planning Association/United States. The Financial Planning Association® (FPA®) is the leadership and advocacy organization in the United States connecting those who provide, support and benefit from professional financial planning. Financial Planning Connections is published as a forum for the free exchange of ideas, facts and information relevant to the financial planning profession. The opinions and positions in the editorial copy are those of the authors and do not necessarily reflect those of the Financial Planning Association® (US). Material published in Connections which has been provided by FPA (US) is property of the Financial Planning Association (US). Article reprints are available for purchase upon request by calling +1.303.759.4900 X 7169. Copyright 2007 by the Financial Planning Association, United States of America: all rights reserved. For more information about FPA, visit www.FPAnet.org

Retirement Planning

Mortality Assumptions: Are Planners Getting It Right?

by Cheryl Krueger, CFP®, FSA
Reprinted with permission by the Financial Planning Association, Journal of Financial Planning, December 2011

In its annual retirement income planning study, FPA asked financial planners what age they typically plan to for their male and female clients. The average ages weren't too surprising: 91.7 for male clients and 94.0 for female clients. Are planners getting it right?

It's important for financial planners to know where their mortality assumption comes from, whether it is appropriate for each client, and what the risks are for getting the planning age incorrect. This article provides background for planners who assume that planning to life expectancy is sufficient for retirement planning purposes.

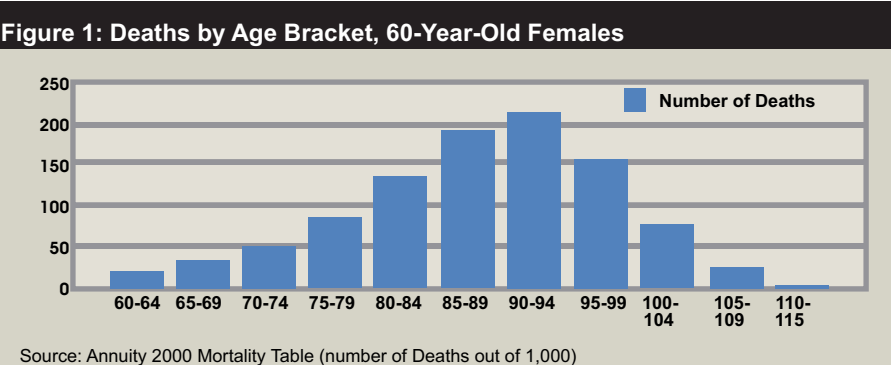
First, a clarification on terminology. I use the term "planning age" to identify the age at death assumed in the financial projections for the client. I distinguish "planning age" from the technical term "life expectancy." Life expectancy is the average expected remaining life span of an individual stated as a number of years; for example, the life expectancy for a group of individuals now age 65 may be 20 years.

Life expectancy is simply a point estimate based on probabilities; people actually die at lower and higher ages. Figure 1 shows how many of a group of 1,000 60-year-old females are expected to die within each five-year grouping.

Although the life expectancy age for this group is 87.4, more than 20 percent are expected to die between the ages of 90 and 94, and more than 26 percent are expected to die at age 95 or later. As you can see, life expectancy provides guidance for selecting a planning age, but it is unlikely to be an appropriate planning age.

Table 1: Life Expectancy Ages in US

Current Age	Males		Females	
	Social Security	Annuity 2000	Social Security	Annuity 2000
60	80.3	84.6	83.2	87.4
65	81.5	85.4	84.2	88.0
70	83.1	86.6	85.4	88.8
75	85.1	88.2	87.0	89.9
80	87.4	90.2	88.9	91.3



Finding the Right Mortality Table

Evaluating planners' assumptions begins with discussing the "right" mortality table to use to determine planning ages. There are many mortality tables with many different uses. The best known are the U.S. general population mortality tables published by the Social Security Administration.

A simple-to-use life expectancy calculator is found on the Social Security website (www.ssa.gov). Enter your birthday and gender, and you'll find your projected life expectancy age. Easy! But when it comes to financial planning, it's important to remember that these tables reflect the total U.S. population, meaning all levels of income and health are included in the data. Your clients likely have mortality profiles more similar to pension recipients or annuitants, who are typically healthier than the general population. And remember, this is a life expectancy, meaning that approximately half of the general population will live longer than the calculated age. One mortality table most commonly used as a basis for healthier, more affluent (middle- to upper-class) populations who have not been underwritten is the Annuity 2000 table. Table 1 shows life expectancy ages from the Annuity 2000 table compared with the Social Security table.

Both tables are gender specific, and both include all levels of health and tobacco use. However, the annuity table represents a group of people who look more like the employed population, and who have selected themselves as having a higher likely life expectancy through their choice of an annuity. Because of this difference, tables such as Annuity 2000 appear to be more appropriate bases of planning ages than the broadly based Social Security table. Because clients tend to underestimate their own life expectancies, planners should be prepared to discuss with clients higher expected life spans.

We know that many factors significantly affect mortality, including tobacco use, gender, certain health issues, family history, and socioeconomic status. Separating clients into groups based on gender and tobacco use can give planners a sense for overall mortality. Knowing more details about the client's health may justify adjusting the planning age up or down. For simplicity, we'll assume we are working with a more typical financial planning client group—middle to upper class, non tobacco users, with no known health issues.

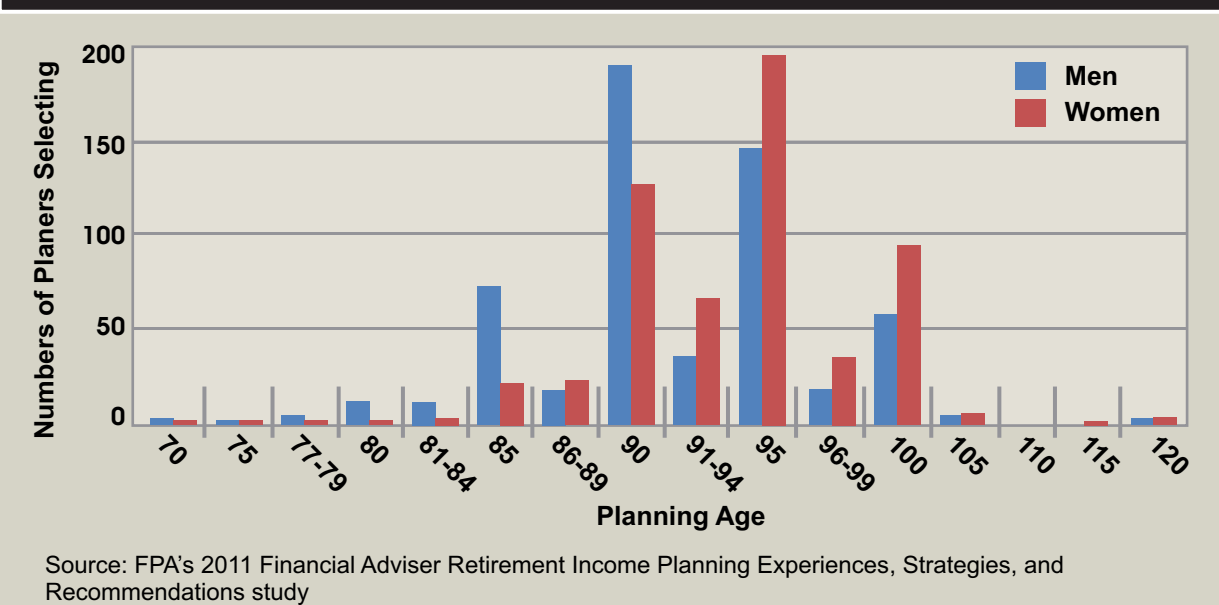
Projecting Life Span

The next issue to address is how far to project life spans, knowing that clients are equally likely to live beyond the life expectancy age as to die prior to that age. As a planner, you may assume a longer potential life span, thereby planning for a higher chance that the client won't outlive his or her assets, or a shorter potential life span to ensure that any risk of premature death is covered via insurance or other risk management techniques.

In a "base" retirement scenario, the planning age is typically longer than the life expectancy, as reflected in the average assumed planning ages in FPA's study. How much longer should it be? Life expectancy age increases as current age increases. You can see in Table 1 that a female age 60 is expected to live to age 87.4. That same female, after she turns 80, is expected to live to 91.3. But by the time the client reaches age 80, she's probably beyond her most effective option for extending her assets—saving more by deferring retirement—so a longer planning horizon is suggested. Although there is no right answer, planning to the 30th or 20th percentile might be considered a reasonable assumption.

FPA's study shows a considerable difference in opinion in the choice of planning ages. Figure 2 shows

Figure 1: Deaths by Age Bracket, 60-Year-Old Females



the number of survey respondents selecting various planning ages for their clients.

At age 65, the 30th percentile planning age from the Annuity 2000 table is 90 for males and 93 for females; the 20th percentile ages are 93 for males and 95 for females. The most common assumptions chosen in the FPA study are consistent with these ranges. Without more understanding of the planner's rationale, it is difficult to support selection of a planning age less than life expectancy plus a margin as a standard planning assumption.

Where retirees' income relies heavily on invested assets (401(k) plans, deferred annuities, IRAs, and investment accounts), outliving assets is a significant risk. Where retirement income is paid based on the survival of the income beneficiary (Social Security, defined-benefit pensions, and income annuities), inflation and the reduced income of the survivor after the first death may be the more pronounced risks to consider.

Using a planning age longer than life expectancy will tend to favor annuitization products, whereas a planning age shorter than life expectancy may suggest life insurance to offer protection for survivors.

Implications of the Planning Age

Are planners getting it right? The average ages reported in the FPA study indicate that, overall, yes. Planners understand that an age greater than life expectancy provides additional certainty and security

for retirement planning for their clients. Planners know that women live longer than men and reflect that difference in their choice of assumptions.

However, it is important to consider the implication of the planning age. The choice of a single planning age is similar to choosing a single investment return. It represents a single, unlikely future outcome. As you disclose the uncertainty surrounding all assumptions in your plan, it is important to discuss with clients how the planning age is selected and how variations from the planning age will affect their ultimate financial outcome.

Endnote

1. FPA's 2011 Financial Adviser Retirement Income Planning Experiences, Strategies, and Recommendations study.

FPA CONFERENCE SERIES
EXPERIENCE
2012

X

September 29-
October 2
San Antonio, Texas

SAVE THE DATE
September 29-October 2, 2012
Hope you join us in San Antonio!
FPAAnnualConference.org

GATHER & NETWORK
with 3000 financial planners representing over 20 different countries

CHOOSE
from five educational tracks and over 60 educational sessions providing cutting-edge content

MEET
with your International Community to share best practices on topics of interest

SAVE MONEY
Members of sister organizations attend at the member rate



3 Ideas for Preserving the Financial Security of New Retirees

by Mathew Greenwald, Ph.D.

Reprinted with permission by the Financial Planning Association, Journal of Financial Planning, December 2011

There can be no doubt that the huge generation starting to enter retirement faces unprecedented financial challenges. A confluence of factors will make it hard for many to maintain their desired lifestyles, or even lifestyles they consider acceptable, throughout their retirements. Chronic under-saving for retirement by members of this generation and their higher life expectancy at age 65 are not the only factors. We can add a much lower likelihood of having guaranteed lifetime income provided by traditional pension plans, high lifestyle needs, and a strong likelihood of higher health-care costs. Some experts warn of: (1) a “new normal” equity market with lower than traditional returns, (2) a likelihood of higher taxes in the face of our country’s debt problem, (3) cutbacks in entitlement programs, (4) the possibility of high inflation as the U.S. budget deficit becomes a bigger problem, and (5) a depressed housing market. Even if none of these threats materialize, it is still clear that the next generation to retire will face genuine financial constraints. The most difficult but addressable risk is of clients getting into real financial difficulty after the first decade of retirement.

Under current circumstances, financial advisers will have to adapt new strategies to help preserve the financial security of retirees. The key question is whether something more is required, and what exactly it is. I have three suggestions.

More Use of Life Annuities

After World War II, the basic idea for financial security in retirement had been the “three-legged stool” of basically one-third of income from the government in the form of Social Security, one-third from employers in the form of traditional pensions, and one-third from personal savings. One of the good things about that approach was that two-thirds of the challenge of retirement income was covered by guaranteed lifetime income payments. Individuals were largely protected against longevity risk.

Now, corporations have substantially cut back on pension plans. Social Security benefits are increasingly reduced by the rapidly growing Medicare Part B and Part D premiums deducted from these benefits. A substantial amount of longevity risk has been passed back to individuals.

Life annuities (also known as immediate annuities and payout annuities) guarantee income for life and have several benefits. They provide much more money and therefore protection to the people who live longer than average—the best deal possible for them. But they also provide higher cash flow than other fixed investments from day one. This higher cash flow permits a higher allocation to equities, and that is likely to be beneficial over the long run. Further, it is

easier to make decisions about how much to save and how much to spend if you have guaranteed lifetime income to plan around. One of the main concerns people approaching retirement have is the possibility of outliving their money. Life annuities protect against this risk. It is time to recognize that more longevity risk has been placed on individuals, and use life annuities to help shield them from this risk.

“The most difficult but addressable risk is of clients getting into real financial difficulty after the first decade of retirement.”

Better Measures of Client Tolerance to Longevity Risk and Long-Term Care Risk

Measuring risk tolerance is beneficial. Asking the questions often focuses clients on the risk and educates them. Getting the answers helps advisers understand how to position a solution and guides them to the best solutions. Advisers typically measure investment risk tolerance, but do not measure or discuss tolerance to two other risks that can financially devastate their clients: the risk of needing to pay for long-term care, and longevity risk—the possibility of outliving resources.

Studies my company has done have shown that different people have different levels of tolerance for these risks. Some people, for example, have high tolerance for the risk of being unable to finance long-term care for a variety of reasons—they believe their children or spouse will care for them, they do not feel a need for care at home or high-quality nursing care, they expect to use their home equity to pay for any needed care, or they do not worry about spousal impoverishment for a variety of reasons. Others have low tolerance for that risk and feel it is crucial to be able to afford long-term care at home, value high-quality care, do not want to burden family, and do not want to draw down assets a surviving spouse will need. They cannot tolerate high exposure to the risk

“Most of the plans I have seen are simple projections that do not discuss what happens if something goes wrong.”

of not being able to afford good long-term care.

It is similar for longevity risk. Some believe they can depend on their children; others feel that being a burden on their children is almost a fate worse than death.

Overall, it is important for advisers to discuss longevity risk and the risk of needing long-term care with their clients. You will learn something and so will your clients. These discussions will lead to better strategies targeted to those who have low tolerance for the risk, and more client acceptance of your recommendations.



A Road Map for Retirement

During the accumulation period, clients tend to shield themselves from risk with insurance products such as life insurance and disability insurance. Many clients can adjust to setbacks by putting off retirement and working longer. Advisers really can focus on just one finance related risk—investment risk.

After they retire, clients are less likely to use insurance, the number of risks they face goes up, and their ability to protect themselves goes down. In terms of finance-related risks, retirees remain exposed to investment risk, but they are also exposed to:

- **Withdrawal risk:** the possibility of taking out too much money from their assets
- **Sequence of return risk:** the possibility of a market downturn early in their retirement that could lead them to have to sell assets “low” to produce the income they need, and make it hard for them to recover
- **Longevity risk:** the possibility of living a long time, which can put a strain on resources. Further, while one can often put off retirement at age 65, it is hard for someone who gets into trouble at age 85 to find a job to rebuild assets.

My firm has done a good deal of research on written retirement plans prepared by financial advisers and financial firms. Most of the plans I have seen are simple projections that do not discuss what happens if something goes wrong, and they do not give guidance in advance on the level of assets clients should maintain.

With the increased risks retirees face, it is important for financial advisers to develop a road map for clients at the start of retirement. The road map would identify the specific asset levels clients should aim to have at each specific year of their lives—the road they must follow. Clients would be told in advance what would be required if their assets fall below that level in terms of reduced spending, possible sale of their home and downsizing, and new and more conservative investment strategies. With this approach, clients will be in a better position to monitor their financial situations and avoid overspending. They will have a specific target to shoot for and will know in advance the consequences of missing the target.

Different times call for different strategies. This is a time not only to be concerned for clients who are starting to retire but to adopt new approaches to help protect them against the risk of ending their lives in deprivation.

Investment Planning

Hedge Funds: Alpha, Beta, and Replication Strategies

by Robert Dubil, Ph.D.,

Reprinted with permission by the Financial Planning Association, Journal of Financial Planning, Oct 2011

Executive Summary

- Hedge funds are no longer only for the rich. Their tactics have invaded publicly traded ETFs. With strategy indices tracking hedge fund performance, broker-dealers have started offering retail investors “index” funds aimed at replicating hedge fund returns.
- If hedge fund performance can be replicated through index-like vehicles, then are we getting alpha or beta from them? Early evidence suggests that the 2-percent-plus- 20-percent fees are not always for managerial acumen, but perhaps for liquidity and access.
- This paper provides a classification of hedge fund strategies based on the logic of the relative value arbitrage pursued.
- The paper reviews the current state of the knowledge on the subject of hedge fund performance replication and the currently available vehicles to U.S. retail investors.

For full text go to www.fpajournal.org



Improving Risk-Adjusted Returns Using Market-Valuation-Based Tactical Asset Allocation Strategies

by Kenneth R. Solow, CFP®, CLU, ChFC; Michael E. Kitces, CFP®, CLU, ChFC, RHU, REBC; and Sauro Locatelli.

Reprinted with permission by the Financial Planning Association, Journal of Financial Planning, December 2011

Executive Summary

- Studies examining the value of active management strategies tend to analyze performance within asset classes against narrowly defined benchmarks; there is little research analyzing tactical asset allocation strategies that change allocations among asset classes, rather than within them.
- The distribution of expected returns and volatility are statistically significantly different at valuation extremes than they are from the general distribution of returns. As a result, the efficient frontier itself can shift because of varying capital market assumptions across different valuation environments, which in turn implies that asset allocations should change as market valuations change.
- A basic market-valuation-based tactical asset allocation strategy that underweights equities (relative to bonds) in overvalued environments, and overweights equities in favorably valued environments, can lead to higher returns and improved risk-adjusted returns.
- The results for improvements in return and risk-adjusted returns hold up on an ex ante analysis and a historical analysis.
- The improved results—comparable to the value of re-balancing—are sustained even when accounting for reasonable tax assumptions, in large part because of the relatively low turnover necessary to achieve improvements through basic tactical asset allocation strategies.

For full text go to www.fpajournal.org

Professional Issues

Evidence-Based Financial Planning: To Learn . . . Like a CFP

by Elissa Buie, CFP®, and Dave Yeske, D.B.A., CFP®,

Reprinted with permission by the Financial Planning Association, Journal of Financial Planning, November 2011

Executive Summary

- The financial planning profession's body of knowledge consists of a mix of consensus-based best practices and research-based findings founded upon formal standards of evidence. Even a cursory examination of that body of writing and codified practice, however, reveals that the former vastly dominates the latter.
- The scientific method provides a framework for validating the profession's best practices, so that practitioners can have confidence that their "best" practices are based on the "best" evidence.
- If financial planning is to leave its adolescent stage of development and achieve its full potential as a learned profession, three requirements must be met:
 - It will require a commitment by all practitioners to stay abreast of new research, without regard to whether it qualifies for CE credit
 - It will require practitioners to possess or acquire the ability to read and critically evaluate that research and a commitment by financial planning educational programs to impart those skills to students
 - It will require a commitment on the part of practitioners to partner with academics in identifying the profession's most important questions and designing research initiatives to answer them

For full text go to www.fpajournal.org



Special FPA International Membership Offering – Only \$49US/year (Regular \$59)



FPA

Global Gathering Place

“FPA membership has opened world of financial planning to me. Hailing from a country where financial planning is still in infancy stage, my FPA membership has broadened my horizons, helped me network across the globe and put me ahead of curve.”

—Gaurav Mashruwala, Mumbai, India



Get involved.
Stay involved.
It's your community.

FPA is delighted to announce a new membership offering for its international professionals at the special price of only \$49US/year for sister organization members. This consists of all of FPA's varied benefits, delivered in an electronic format. As the premier membership organization for financial planning professionals, the Financial Planning Association® (FPA®) is the community that fosters financial planning and advances the financial planning profession.

FPA's membership is as diverse as it is dynamic, with representation in all five continents and over 30 countries. FPA is the place to learn from and connect with your global colleagues. As a member of this varied and vibrant community, you work every day to help people make wise financial decisions so they can achieve their life goals and dreams.

To meet those goals, you need real-world savvy, support and solutions from an organization that understands the issues, responds to the challenges and provides the expertise to make you a better and more successful financial planning professional.

Here you will find exclusive access to cutting-edge education, tools and technology, extraordinary networking opportunities, unparalleled programs, resources and services to help build your business and advance your career and a sense of community you simply won't find anywhere else.

Your journey with FPA begins here

Click on benefits below to learn more.

Increase Your Knowledge

Electronic Publications, including access to:
Journal of Financial Planning
Practice Management Solutions Magazine
Research Spotlight
 FPA Press
 Virtual Learning Center
 Research Center

Expand Your Network

FPA Annual Conference and Exposition
 Follow, Join and Connect
 Online Communities, including a community specifically for international participants

Manage Your Career

Market Yourself More Effectively
 Future of Planning Web site
 Cross-border Planning

Showcase Your Affiliation

Demonstrate your
 Pride in Membership



International Membership = Excellent Value

Join FPA at the reduced rate of \$49US.
 Visit www.JoinFPA.org and enter promotion code: **INT2011** to take advantage of this offer.

“Being a member of such an international association has helped me in see things from a different prospective. The networking opportunities you have in this community are quite remarkable. Finally, the most important aspect is the solid friendship with other members that I have developed over the years.”

—Maurizio Capra, Brescia, Italy



Evidence-Based Financial Planning: To Learn . . . Like a CFP

by Elissa Buie, CFP®, and Dave Yeske, D.B.A., CFP®

Reprinted with permission by the Financial Planning Association, Journal of Financial Planning, November 2011

"CFP® practitioners have an urgent need to develop basic financial planning theory. Without underlying buttressing theory, how can we practice as a profession?" This is not a new observation. In fact, Dick Wagner made that opening declaration more than 20 years ago in his seminal essay "To Think ... Like a CFP" (1990). Nearly a decade later, Warschauer (2002) could still observe that "as one approaches the content of financial planning (CFP Board's 101 topics) from a view of higher cognitive level, it becomes clear that we have poor theory to guide the practice of financial planning." The contemporaneous assessment of Black Jr. et al. (2002) was no better: "The PFP field has evolved largely devoid of a theoretical foundation" and "we know of no respected profession without academic underpinnings and recognized academic standing." More recently, Wagner(2007), while revisiting the theme of financial planning becoming a "learned profession," suggested that "for the most part, we have not closely examined our presuppositions, often settling for bland aphorisms rather than critically examining our assumptions."

If we do, in fact, aspire to the status of learned profession, then financial planning has surely reached the point in its development where the way forward urgently requires us to move decisively from observation to corrective action. Specifically, we propose that the time has come to commit ourselves as a profession to a more scientifically grounded and evidence-based approach to expanding our body of knowledge and assessing and adopting best practices.

Science as the Foundation for Best Practice

The Science Council in the United Kingdom offers this concise definition of the scientific enterprise: "Science is the pursuit of knowledge and understanding of the natural and social world following a systematic methodology based on evidence."

More formally, scientific research can proceed deductively or inductively, and almost always relies on a combination of both. The deductive approach begins with the statement of a broad principle that seems self-evidently true, and then proceeds to "deduce" the implications of that principle through logical reasoning. Data are then gathered to test the verity of those logical conclusions. Put another way, deductive science proceeds from the general to the particular. Here's an example of deductive reasoning (adapted from Gorham 2009):

1. All penguins are birds
2. All birds are animals

3. So, all penguins are animals

Inductive reasoning, conversely, proceeds from the particular to the general. We observe some phenomenon recurring in our environment and begin to wonder what it means. Through repeated observations, we form a belief, expressed as a hypothesis, as to the underlying cause. Finally, we gather data and formally test our hypothesis. Here's an example of inductive reasoning:

1. Hundreds of species of penguins have been observed so far, and all are swimmers
2. So, all species of penguins are swimmers

Financial planning best practices also arise from both deductive and inductive reasoning. Some have developed from "self-evident" propositions and their natural implications, and others have arisen from a slow accumulation of observations that ultimately seem to form a pattern. That our best practices arise in ways that mirror the deductive/ inductive methods of science shouldn't be a surprise; humans have evolved to think that way. As Albert Einstein put it, "The whole of science is nothing more than a refinement of everyday thinking." Of course, that word "refinement" is critical. Our trouble as a profession is that most of our best practices stop at the formation of a belief (the case study presented below, for example, involves a best practice that existed for decades before eventually being empirically tested). And we're quite comfortable stopping there because our personal experience and the experience of colleagues will often seem to confirm and reinforce those beliefs (a common phenomenon psychologists call "confirmation bias"). However, such informal "evidence" is properly termed anecdotal and cannot be the foundation of a truly learned profession's best practices. Instead, we must take the next step: we must form our beliefs into hypotheses, then gather appropriate data and formally test those hypotheses. Only then can we say with confidence that our "best" practices are founded upon the "best" evidence.

Before proceeding to outline the steps necessary for this progress, it's important to point out that we are not suggesting the profession embrace "scientism," the blind worship of anything or only things thought to be "scientific." True science must be practiced with proper humility and a deep awareness of its limits. Karl Popper (2002), a philosopher of science, offered many observations about the limits of science, including the following:

- Insofar as a scientific statement speaks about reality, it must be falsifiable; and insofar as it is not falsifiable, it does not speak about reality
- Good tests kill flawed theories; we remain alive to guess again
- Our knowledge can only be finite, while our ignorance must necessarily be infinite



The first statement is an expression of what came to be known as the “falsificationist” school of thought. Specifically, it suggests that only those statements that can, at least in principle, be proven false qualify as scientific propositions. Understood from this perspective, science is quite modest in its scope, because the number of propositions subject to falsification is finite and those not so limited are infinite. And the fact that a belief or proposition isn’t potentially falsifiable doesn’t make it wrong or foolish or anything else; it simply places it outside the scope of scientific inquiry. For example, one might have a theory that one’s daily prayer or meditation contributes to world peace. This proposition may or may not be true, but because it doesn’t give rise to testable (potentially falsifiable) hypotheses, we would have to say that this theory exists outside the realm of science.

“That our best practices arise in ways that mirror the deductive/inductive methods of science shouldn’t be a surprise.”

Interior or Exterior: It’s All Science

We often hear the phrase “the art and science of financial planning,” with hundreds of references to be found throughout the financial planning literature. Almost invariably, the phrase is used to suggest that financial planning combines the science found in the exterior realm (for example, finance, economics), with the art of the interior realm (for example, feelings, interpersonal communication). In our view, the problem with this characterization is that it ignores the fact that there is science in the interior realm as much as the exterior realm. The “human” dimension has been the subject of a significant amount of formal scientific inquiry and rightfully belongs in the category of science as much as the “exterior” dimension does. Here’s a partial list of the sciences of the interior and the exterior:

Interior Sciences

- Psychology
- Sociology
- Neuroscience
- Neuroeconomics
- Behavioral finance
- Communication

Exterior Sciences

- Finance

- Economics
- Investment theory
- Complexity theory
- Risk management

If one agrees that both realms are essential to the practice of financial planning, then acknowledging and mastering the science of both realms is also essential. This is not to say there isn’t art in what we do! In the artful application of the science, financial planning transcends mere financial advice. In our role as strategists we weave all of the profession’s tools and techniques into integrated strategies for achieving client goals. Strategy is fundamentally a creative act in which we render the components of financial planning into something greater than the sum of their parts (Yeske 2010). Ultimately, the artful application of science as it relates to financial planning is a substantial topic unto itself, deserving of the kind of fuller discussion that will have to await a future paper.

Case Study: CFP Board Practice Standard 200-1

Certified Financial Planner Board of Standards, in addition to setting standards for the profession through education and examination, also maintains a set of practice standards developed by a volunteer workgroup and adopted in 1995. The practitioner dominated workgroup developed and codified a comprehensive list of best practices based on personal judgment and experience, without explicit reference to formal research or standards of evidence. Here is Standard 200-1 and several excerpts from the accompanying explanatory material:

The financial planning practitioner and the client shall mutually define the client’s personal and financial goals, needs, and priorities that are relevant to the scope of the engagement before any recommendation is made and/or implemented.

In order to arrive at such a definition, the practitioner will need to explore the client’s values, attitudes, expectations, and time horizons as they affect the client’s goals, needs, and priorities.

The role of the practitioner is to facilitate the goal-setting process in order to clarify, with the client, goals and objectives.

The public is served when the relationship is based upon mutually defined goals, needs, and priorities. This Practice Standard reinforces the practice of putting the client’s interests first, which is intended to increase the likelihood of achieving the client’s goals and objectives.



This standard can clearly be seen to have arisen through deductive and inductive reasoning. Its propositions seem self-evident and are just as clearly the result of many observations over many years by the practitioners who wrote the standard. Long after this standard was promulgated, Anderson and Sharpe (2008) decided to empirically test a number of its implications. Here's what they found, among many other things:

- Clients place a high value on a “systematic process for uncovering goals and values”
- A systematic discovery process is associated with higher levels of client trust and relationship commitment

These were not trivial findings, because prior research had also shown that higher levels of trust and commitment were associated with high acquiescence, a low propensity to leave, a high degree of cooperation, and functional conflict (the ability to manage conflict constructively; Morgan and Hunt 1994). Higher levels of commitment and trust have also been associated with greater client openness in disclosing personal and financial information, greater cooperation in implementing planning recommendations, and a greater propensity to make referrals (Anderson and Sharpe 2008).

In addition to studying the clients of financial planners, Anderson and Sharpe studied the beliefs and practices of financial planners themselves. What they found was instructive and perhaps a little alarming. Here are two of the statements planners were asked to evaluate, along with the results:

- “I use a systematic process for helping my clients clarify their values and priorities” (59 percent agreed)
- “I use a goal-setting process to help my clients establish meaningful personal financial goals and objectives” (59 percent agreed)

So, more than 4 out of 10 practitioners surveyed were not engaging in a systematic discovery/goal-setting process with their clients. The question we are left with is: will these numbers change now that this long-standing best practice is empirically supported? This, in turn, raises the more fundamental question of how new knowledge is transmitted to practitioners and how they evaluate it. One of the reasons professionals are routinely subjected to continuing education (CE) requirements is the need to maintain competence in the face of new knowledge and emerging best practices. But two questions arise: (1) Can any practicing professional really stay abreast of new developments by accumulating a mere 15 hours of continuing education a year (CE requirement for CFP® professionals), and (2) Should qualification for CE be the most relevant benchmark for where we put our attention as professionals? New discoveries in the financial planning profession rarely qualify for CE until

long after they've become settled practice.

Where Do We Go from Here?

This leads us to three indispensable requirements if financial planning is ever to emerge as a learned profession:

1. It will require a commitment by all practitioners to stay abreast of new research regardless of the assignment of CE credit
2. It will require practitioners to possess the ability to read and critically evaluate that research
3. It will require a commitment on the part of the profession to partner with academics in identifying and designing that research

The first point is one of self-image and will arise from a new kind of dialogue within the profession, one focused on the emergence of new knowledge and the validation of the old. The status of learned profession, however, requires more than the adoption of a new self image; there are pre-requisites. And first among these is the requisite knowledge to engage effectively with research-based literature.

Competency in reading and critically evaluating research is nowhere to be found among CFP Board's education and certification requirements. These requirements are derived from CFP Board's periodic job-analysis studies, in which practitioners are asked to rank the importance of various topics and activities. The resulting list forms the minimum foundation that must be taught in university degree and certificate programs in order to qualify graduates to sit for the CFP® Certification Examination. Many or most of these programs are taught at the undergraduate level, at which there is rarely a focus on the critical evaluation of original research—a skill more generally acquired through graduate study. However, as attainment of the CFP mark promises entry into a profession, a higher standard is surely appropriate. At a minimum, we believe that any practicing financial planner should have the training to be able to read a piece of research literature and answer the following eight questions:

1. What is the problem or question?
2. How was the problem/question conceptualized?
3. What are the key findings from prior research?
4. What methodology was used to test the question?
5. What were the results of the testing?
6. Were the results compelling?
7. What are the practical applications of the results?
8. Will this change the way we practice, and if so,



how?

How might financial planners gain the skills to be better consumers of research? Although an exhaustive list of “next steps” for planner training would need to be explored in another paper, some initial ideas might involve:

- Conference sessions aimed at teaching planners how to read and interpret research-based articles
- A webinar series devoted to the topic
- Articles in the *Journal of Financial Planning* or elsewhere
- A reading list of books that educate practitioners on how to evaluate research
- University courses on evaluating research aimed at practitioners

With respect to the third requirement, we note that a deep connection between academia and practitioners is an element of every established profession. The financial planning profession would benefit from such deep academic practitioner connections no less than any other. After all, financial planning practitioners, through their daily work with clients, come to know the critical questions that need to be answered, and academics know how to address these questions through formal research. This is an essential partnership.

Finally, we must work to ensure that there are widely recognized outlets for the output of what will hopefully be a rapidly expanding body of research. At the moment, there are many dozens of publications aimed at a financial planner audience, but only two or three that even attempt to publish rigorous, peer-reviewed research. Much remains to be done to enhance the quality of the research being published and to heighten the awareness within the practitioner community of where leading-edge findings are to be found.

After more than 40 years of growth and development, the financial planning profession is poised to take its place among the ranks of other learned professions. Among other things, this will require each member of the planning community, whether practitioner, academic, publisher, consultant, or association executive, to accept his or her shared responsibility for building the profession on a rigorous, evidence-based foundation.

Acknowledgments: The authors gratefully acknowledge the invaluable feedback they received from the following colleagues (in chronological order of response): Dick Wagner, Jennifer Maier, Stuart Grierson, Mike Ryan, Brian n Boscaljon, Mark Prendergast, Harold Evensky, and Ed Jacobson.

References

- Anderson, Carol, and Deanna L. Sharpe. 2008. “The Efficacy of Life Planning Communication Tasks in Developing Successful Planner-Client Relationships.” *Journal of Financial Planning* (June): 66–77.
- Anthes, William L., and Shelley A. Lee. 2001. “Experts Examine Emerging Concept of ‘Life Planning.’” *Journal of Financial Planning* (June).
- Black Jr., Kenneth, Conrad S. Ciccotello, and Harold D. Skipper Jr. 2002. “Issues in Comprehensive Financial Planning.” *Financial Services Review* 11: 1–9.
- Gorham, Geoffrey. 2009. *Philosophy of Science*. Oxford, U.K.: One world Publications.
- Morgan, R. M., and S. D. Hunt. 1994. “The Commitment Trust Theory of Relationship Marketing.” *Journal of Marketing* 58, 3.
- Popper, Karl. 2002. *Conjectures and Refutations: The Growth of Scientific Knowledge*. 2nd ed. London, U.K.: Routledge.
- Wagner, Richard B. 1990. “To Think ... Like a CFP.” *Journal of Financial Planning* (January).
- Wagner, Richard B. 2007. “Financial Planning as a Learned Profession.” *Financial Advisor Magazine* (October).
- Warschauer, Thomas. 2002. “The Role of Universities in the Development of the Personal Financial Planning Profession.” *Financial Services Review* 11: 201–216.
- Yeske, David B. 2010. “Finding the Planning in Financial Planning.” *Journal of Financial Planning* (September): 40.

Recognize What Drives Your Business Success



by Ross Levin, CFP®,
Reprinted with permission by the Financial Planning Association, *Journal of Financial Planning*, December 2011

When my partner Wil and I got out of our car in the Wendy’s parking lot, Wil had opened his car door and a huge guy jumped out of his car next to ours. He was wearing a tattered shirt and had a wild-eyed look and untamed hair. This behemoth was gesturing wildly and yelling at Wil for an alleged door nick. When Wil asked him to show him where, the guy pointed at a spot on his littered-with-dents car. Wil calmed the guy down, and we walked somewhat shaken into Wendy’s to plan our future. This was our moment of truth. We had been partners for a couple of years, our business was really struggling, and we were not sure that we could continue.

As we sucked down our giant sodas, we began to write on a napkin the things we needed to do to



succeed in business. One of them was to stop going to Wendy's during the middle of the day to complain about our business. But some other things we tried to figure out were who we wanted to serve, what service we were going to offer, and what things would look like if we were successful. We decided that we no longer wanted to accept commissions, even though our fee revenues were relatively paltry. And we discussed which clients were the best fit for this new model. By the end of the meeting, we felt like we'd created marching orders for ourselves that would hopefully pay off down the road. What we didn't know was that we were using a form of Bayes's rule to do so.

Anyone who has ever done a Monte Carlo simulation has used Bayes's system, where we "modify our opinions with objective information."¹ As I read Sharon Bertsch McGrayne's book, I realized that while we recognize how we make decisions under uncertainty in investments and wealth management, we also do so in how we build our businesses. Bayes's system is about conditional probabilities. What are the outcomes most likely to occur given a wide variety of inputs and how they impact each other? When we think about our businesses, we are constantly making decisions that will have a long-term impact and will affect our futures, but I wonder if we should be making these decisions using a formal, probability model. Here are some things to think about.

New Business

There are many ways to try to get clients. Some people are experts at giving seminars, some people work wonderfully with centers of influence, and some people generate referrals. And there are various types of clients with whom we work best. Some practices have many executives, others work well with people in transition, and still others have built practices through specializing in working with doctors. Each of us brings a certain set of characteristics that will play better with a certain type of individual. Some people love to get deep into details and work well with others of that profile, and others are relationship people who enjoy forming intense relationships.

When you think about it, isn't this in some ways a Monte Carlo simulation? Method for attracting clients is a variable, profession or income of clients with whom we work is another, as is our preferred client personality types. So as you build a practice, where is your greatest probability of success going to occur?

I think this is important to consider because we often spend too much time working in areas in which we think there may be high potential payoff, even if there is little likelihood of success. When I was 30, I had a difficult time working with people with a lot of money. I

"Only by focusing on the high probability events were we able to be around long enough to experience the low-probability, yet rewarding, events that helped fuel our growth."

was emotionally unprepared and uncomfortable in certain situations. When I got in front of people with means, I would fret about the appointment before and after. When they chose to work with someone else, I attributed it to my inability to close the deal or to express myself well, rather than to their good judgment.

As I look back over our business now, there are certain truths I am more willing to face. My greatest successes continue to occur in areas in which I have the highest probability of succeeding. The new clients I attract at 52 are different from those I attracted at 32. The way we got out of our Wendy's rut was that we honestly looked at ourselves and our practice and determined with whom we had the greatest chance of succeeding.

This meant we took our existing client base and looked at who had showed comfort in giving us referrals. Our old approach was to go to our biggest clients and try to get referrals from them, even if their profiles were not likely to give them. We may have had clients who loved us but didn't refer to us. On the other hand, certain clients loved to give referrals. By really engaging those clients and asking them to help us grow our business, we began to meet better prospects.

We also looked at which type of client resulted in the most success. At that point in our careers, it was with young doctors. We began to build an expertise in working with doctors and determined that by finding physician groups, we would stand our best chance of success.

After we were working with a couple of doctors in a group, we would meet with the group's practice manager to go through our clients' benefit programs and buy-ins and discuss other issues. These practice managers often served multiple practices, so we began to expand this part of our business.

As we slowly developed this approach, a funny thing was also happening: we were getting older. This meant that we had been in the community longer, had developed more contacts, had more people closer to our age beginning to have money, and had more clients and therefore more referrals. Eventually, as with anytime one deals with uncertainty, unexpected events occurred. As our business grew, we got referred to a couple of large clients who also happened to be referrers. But only by focusing on the high-probability events were we able to be around long enough to experience the low-probability, yet rewarding, events that helped fuel our growth.

Staffing

I think staffing is also an area in which you can use Bayes's theorem to try to increase your odds of success. We now have 37 people in the company, but that has taken us years to build and grow. What we know, though, is that certain characteristics or skills have increased our odds of hiring success.



For example, we have had the most success with accountants when hiring experienced professionals. We have had the least success when hiring people from large wire house and banking environments. As we feed in future probabilities, we need to focus on those areas in which we have been successful. Although it is certainly possible we can find a good hire from a wire house or bank, it appears this may be a low probability event for our firm (I am talking exclusively about our firm). We have had success hiring from some of the outstanding college programs. But again, one of the things we have had to seriously consider is the likelihood of whether someone who has gone through an out-of-state college program will stay in Minnesota. As I have mentioned before, some of our best hires from these programs moved back to their home states even though they were enjoying their careers here.

Existing Clients

One of the things all firms need to confront is the demographics of their client base. Again, if you break down your client base by age, you may be able to create probability of expected future revenue streams. Clients are often initially accumulators, but eventually they begin to spend their portfolios. We look at this in terms of business risk, because we want our clients to be able to comfortably live off their assets, yet realize that over time those clients will not grow. Therefore, we need diversification among client lifestyle stages.

In McGrayne's book, she says philosopher David Hume believed that "because we can seldom be certain that a particular cause will have a particular effect, we must be content with finding only probable causes and probable effects."² As you begin to look at your business, focus on the things you can do that give you the greatest chances of success. Although it is often painfully obvious, it can be surprisingly difficult to do.

Endnotes

1. McGrayne, Sharon Bertsch. 2011. *The Theory That Would Not Die: How Bayes' Rule Cracked the Enigma Code, Hunted Down Russian Submarines, and Emerged Triumphant from Two Centuries of Controversy*. New Haven, CT: Yale University Press.
2. Ibid.