

# SENIOR CONSULTANT

The Voice of the Investment Management Consultant

## The Prudent Process: Client Profiling

Thomas M. Roginski

We have previously discussed the proposition that the market is an information processing mechanism, that there are certain “opinion leaders” and certain influential individuals who, on any given day, can make an individual stock or the entire market move. Think about the anticipation before a Federal Reserve meeting or what happens when an All-Star analyst changes her/his opinion on a stock. The circumstances surrounding these events, which sometimes seem to be random occurrences, demand that a logical process be in place to guide the actions which follow. The process, not the individual decision, is what you want to defend if you have to. The Prudent Process, as illustrated in Figure 1 and embellished by 30-years experience, represents a variation of the “top down” procedure taught as part of the Chartered Financial Analyst (CFA) program.

There are multiple decision points in the process and multiple reliance on forecasts and experts. All of these decisions must be made by you, the advisor, to influence your choice of a stock, money manager or fund group. You may reasonably ask, as a “prudent person” might, “Does this process work? Has it worked in the past and what is the probability that it will continue to work in the future?” A compliance officer caveat would say, “Past performance is no indication of future returns.” But past performance can be statistically verified (back-tested). Back-testing is an acceptable practice, but a live test is perhaps the best verification of the process. The Prudent Process has proven an ability to add value in live tests conducted as far back as 1974, up to the live test being conducted today. In each instance the value added to a portfolio by the process would have a statistical probability of one chance in 10,000 of occurring by chance alone.

The Prudent Process is a proven procedure for dealing with the various risks associated with the advisory function. As we move through an explanation of the Process, it will become apparent that we are dealing with each of the risks inherent in an asset allocation decision; and finally, we will deal with the risk of dealing with an individual client. Our approach is a mixture of practitioner art, modern portfolio theory and

the psychology one develops after studying thousands of clients.

### The Definition of Risk

*Market risk* is the risk associated with market volatility that affects the value of particular securities. Political developments, market cycles, changing investor sentiments and/or reaction to previous excessive rises/declines can all contribute to market volatility. The relationship of a particular stock to the market is measured by its “beta,” a statistical measure that shows how fast a stock goes up when the market is going up and how fast it is going down when the market is going down. Professional portfolio managers minimize market risk by diversifying a portfolio into a number of stocks and other assets such as bonds and cash equivalents, if appropriate. There have been many statistical studies that indicate that this “asset allocation” procedure is the key factor in determining long-term return.

*Inflation risk* is the danger that inflation will reduce the purchasing power of investments over time. Short-term investments and cash equivalents generally do not provide a return greater than the inflation rate. In most cases, the need for return is secondary to

the need for liquidity or other factors.

*Liquidity risk* is the risk that you will want to sell an asset but find yourself unable to do so. This can occur because the asset is not actively traded, the investment’s structure does not allow early withdrawal or the market is volatile. The investment policy statement that is jointly developed by the advisor and the client will consider the need for liquidity and provide for portions of the client’s portfolio to allow for it.

*Interest rate risk* is the risk that changes in interest rates will cause the value of certain investments to decrease. When interest rates rise, the market value of fixed income securities, such as bonds, declines. Investors can then be locked into the lower rates as the market rates continue to rise. To avoid this risk, advisors will generally “ladder” or select maturities in various time horizons.

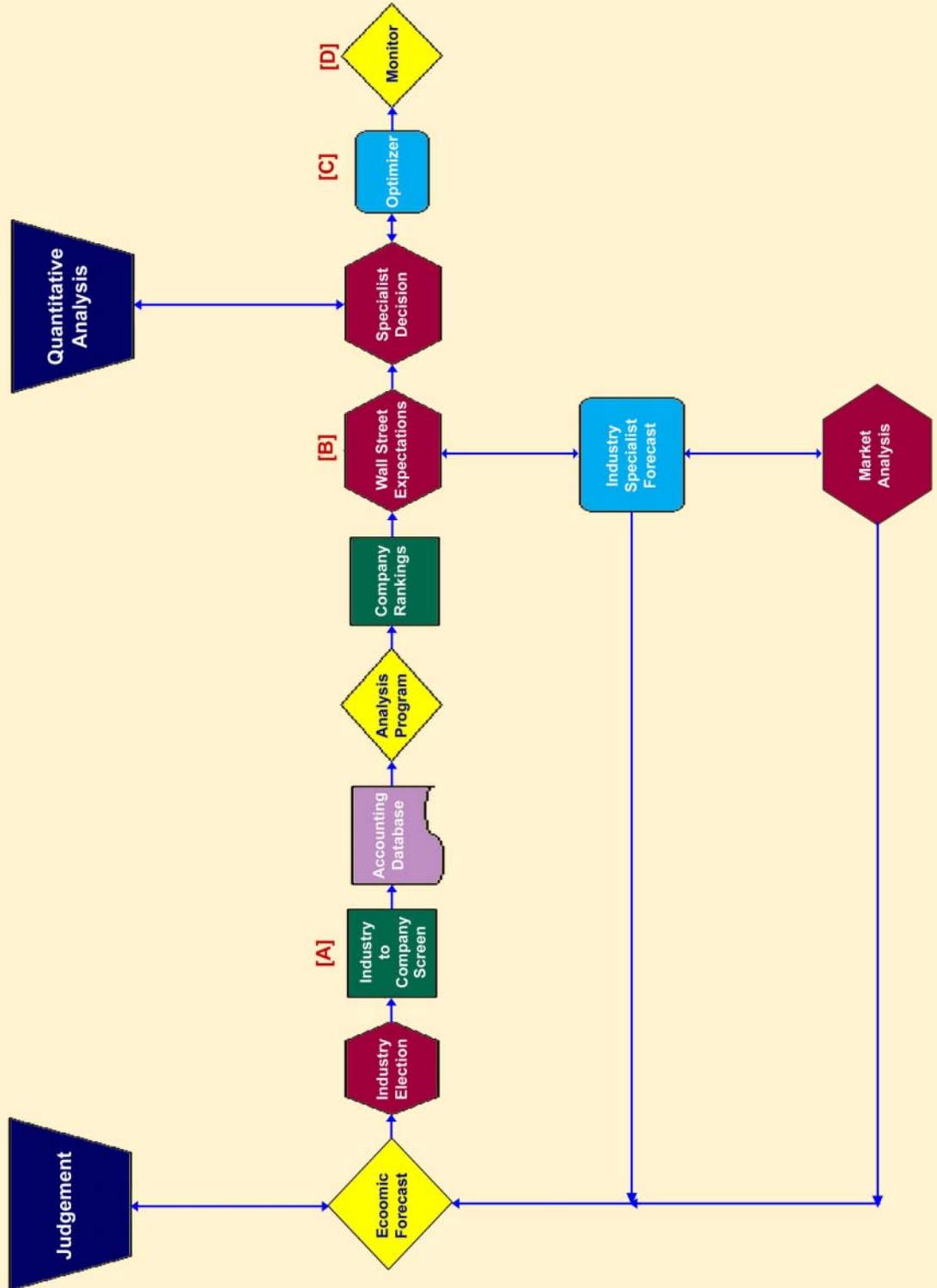
*Default risk* is the risk that a corporation will default on its payments of interest and capital on its

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Figure 1.  
Portfolio Construction Technology  
Prudent Process





debt. To minimize this risk, advisors can restrict fixed income purchases to investment grade bonds (rated BBB or higher). Structuring a portfolio is a cooperative effort between the advisor and the client that takes each of the client's unique needs into consideration.

*Company-specific risk* is the risk that a company's value will decrease due to financial difficulties. Internal factors such as inefficient production and poor management, or external factors such as problems within the industry, economy or trade, can all contribute to a company's specific risk factor. Advisors hedge against this risk by spreading investments across an assortment of stocks selected by their modeling procedures.

### Handling Risk Considerations within the Prudent Process

As Figure 1 shows, the Prudent Process begins with a forecast of the overall economy. By doing this we address the issue of inflation, interest rates, corporate profits and potential stock market actions based on these forecasts. The forecast is then further refined into an outlook for sectors and industries. An advisor might stop at this point and simply select a collection of sector or index funds and choose managers who specialize in group rotation, or he might go deeper into the process and determine the specific industries that would benefit from the proposed outlook.

These are the first steps in minimizing risks and making the asset allocation decision. Defining what companies make up an industry is one of the most challenging aspects of the Prudent Process. Each firm has its own definition/criteria for the various market sectors which impact the composition of these sectors. A sector such as Technology, for example, enjoys a wide and more challenging definition. We generally use the U.S. Standard Industry Classification (SIC) code of the greatest revenue-producing segment of a company's business to determine its industry. (Since SIC codes are part of the data required by the government reporting agencies, it is relatively easy to access this information.) 10K's and 10Q's, as published by the Security Exchange Commission's electronic reporting system

(known as EDGAR), is the data source that reporting agencies use to determine classifications. Standard and Poors, Dow Jones, Investors Business Daily, wirehouse research departments and database vendors all have their own opinions as to who to put in what sector. Remember that the Prudent Process is the focus. If someone says that the Technology area will have the greatest percentage of change in income of 70 industry sectors studied, make sure you have them define what they mean by Technology. We define this definition phase of the Prudent Process as the "Industry to Company Screen" (labeled [A] in Figure 1).

Once the companies that comprise a specific a sector is established, analysis of

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individual company's specific and default risk can begin. There are numerous formulas to determine a company's "value or risk." Ratio analysis is part of the selection process, and MBA and CFA programs teach combinations of ratios that are meant to determine if one company is better than another. One significant ratio, called the "Free Cash Flow" formula, has had success. Another is the "Equity Reinvestment Rate," and combinatory ratios such as the Graham and Dodd valuation formula have also been helpful. Whatever formula or set of formulas is used to establish a company's value or risk for securities selection, these formula(s) is/are part of the advisor's/firm's value-added proposition. Companies can be compared in a machine-enabled model that rank various fundamentals, but fundamentals are only a part of the security analysis proposition.

Analysts' opinions – good, bad or indifferent, changing positively or negatively – also contribute to the value equation. Referring to

[B] of Figure 1, you can see we use a stock's market movement and place a value on the technical or market opinion of the stock. Being a stock analyst and being a business analyst are two different occupations. The best stock in a poorly performing industry may not help you achieve the types of returns you seek; however, having the best company in a "favored" group where that stock has just doubled, should certainly give pause to consider what the future prospects might be.

### Your Client's Risk Tolerance and the Prudent Process

Determining inflation, liquidity, interest rate, market and company-specific risks can all be done fairly mechanistically. Science has a logical process for that. We have now to approach the art of being an advisor, and that art manifests itself in how the advisor deals with the client.

In an informal study of the procedures and processes used by the best and the brightest of Prudential/Wachovia advisors, it was discovered that these advisors excelled because they knew their clients. They had spent hours learning what their clients' needs and wants were, and they were willing to relinquish a client and move on if that client did not follow their advice. Most also developed either formal or informal client policy statements, which documented the client's risk tolerance and return expectations. Each client's portfolio was treated as a unique entity, as the securities that were appropriate for one client might not be justifiable in another. Consider the difference between a retirement portfolio, a college funding portfolio and a short-term gain capital appreciation portfolio.

The determination of a "prudent" risk coefficient was the most challenging aspect of the client interview and discussion. In incorporating the results of this study into a risk profiling system (named "Pegasus"), client education on riskiness of certain asset classes became notable. Rational Investor theory – historic return caveats that you see in the majority of advisory client account opening statements – become part of that education. Traditional Ibbotson-type historical data was introduced as a lead into an eventual discussion of portfolio optimization.

After educating the client about the risk involved in selecting certain securities and the “opportunity cost” of selecting various security groups and industries, the Pegasus system rated the client’s personal risk tolerance. Using right-brain/left-brain profiling techniques, the client was determined to be either a risk taker or a risk avoider. The advisor is also profiled as to his/her predisposition to being a risk taker or a risk avoider, and those profiles were judged within the context of timeframe, e.g., a profile done in the year 2000 and the same profile done in late 2001 which included the influence of the dot-com bubble, newspaper and cocktail conversations.

Finally the client’s “*loss aversion*” was profiled. Clients who had agreed, at least on an intellectual basis, to the rational investor theory of “more risk offers more potential gain,” were asked a series of questions such as: “You, the client, are offered the following proposition: Bet on the flip of a coin. Heads, you win \$15,000; tails, you lose \$10,000.” Capital asset pricing theory would rate this as a good bet. Our study showed that loss-averse clients never took the bet, and it is still amazing how many clients who are willing to sign up for the riskiest portfolios are unwilling to take the rational investor bet.

The real-life experience of the senior consultants as a whole verified this client aversion to loss. At every wealth level, there exists a notion of “this much and no more.” When the dot-com bubble burst, the “no more” was often exceeded and the advisor fired, regardless of what the five-year plan said.

The optimization procedure in the Prudent Process would have considered the loss aversion factor of the client and perhaps made an error on the conservative side. [C] on Figure 1 shows an optimizer which is indifferent to implementation vehicles – outside managers funds and individual securities – as all are combined to achieve the client’s goals.

From a firm’s standpoint, the ability to monitor advisor activity and the assurance of prudent actions in the construction of client portfolios are the cornerstones to fulfilling fiduciary responsibility. Within the Prudent Process, the monitor function ([D] in Figure 1), each client portfolio is modeled at the order-entry level. When an order is entered, the effect of the order on the portfolio’s risk profile is determined *before* the order becomes a trade. Orders that would throw the portfolio out of tolerance are sidetracked and reviewed by a human being, while all appropriate orders are electronically handled. This procedure, which

we call “Gateway,” is the electronic compliance officer in our Prudent Process.

It is believed that the compliance function is one of the primary factors slowing the growth of our industry. If an organization could demonstrate that a Prudent Process was in place, that an electronic guardian monitored compliance within the process and that the Process could be learned and taught to financial professionals, then that organization – be it bank or broker, CPA or CFP – could be in the advisory business. ■

### About the Author

Tom Roginski is director of Research and Systems at Transition Management and Research (TMR), a company he helped to form in 1985. Tom brings to us a unique combination of systems and Wall Street skills. He has been an institutional portfolio strategist at Merrill Lynch, an economist at E.F.Hutton, a financial advisor to the Saudi Arabian Royal Family, a systems advisor to the Getty family and director of research and systems at The Marshall Plan (an institutional, quantitative, money management firm he formed with Greta Marshall who was a former director of the CALPERS pension portfolios).

In June of 1992, Tom worked with Prudential Securities as manager of financial advisor-directed services and headed three departments within Prudential Securities: Portfolio Management, Quantum and Portfolio Advisory Services. In that context he had compliance and revenue responsibility for 862 discretionary money managers. Modeling the behavior of the best money managers at Prudential, Tom began his work that led to PEGASUS (a retail client risk profiling system) and GATEWAY (a suitability testing, order entry and compliance system).

Tom has been a senior member of the New York and Boston Societies of Security Analysts, the National Association of Business Economists, the Market Technicians Association and the Quantitative Analyst Society. He has taught at Baylor University and is currently teaching in the continuing education program of the Boston Analysts Society. His views on investing have been published in the *Financial Analyst Journal* and the *Market Technicians Journal*. His thoughts on technology, have been published by the *Senior Consultant* Newsletter, where he serves as the technology editor. These two systems lay the foundation of the prudent process that TMR markets today. Tom may be contacted via e-mail (TMR@assetmanager.com) or via phone at 978-456-8512.

### Notes

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