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SENIOR CONSULTANT

The Voice of the Investment Management Consultant

Part I: Are You An Advisor Or Reporter?

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Many advisors think that once a client's goals have been identified, a recommended plan accepted, an optimal asset allocation adopted and the investments to fulfill the allocation selected; their continuous value added service is on-going reporting of the client's performance. In fact, the industry spends countless millions on the creation of performance reports.

I must admit, I was an instigator to this industry direction. Nearly 20 years ago, the idea of actually calculating and reporting portfolio returns to the client on a regular basis was a "radical" idea for the investment industry. (More than once in selling this service to various firm's management, I heard something along the lines of, "Report the client's performance to them … are you NUTS?") In the mid-late 80s though, the idea gained momentum as firms started creating and promoting various types of fee-based accounts, all of which required some sort of justification for continuing to pay the advisor once the investment policy was set and the investments selected. After all, we agreed and committed in writing in the client's investment policy that investments would be evaluated over a 3- to 5-year market cycle. We needed a role for the investment consultant to play, while we awaited the completion of that market cycle. Monitoring the performance along the way became the plausible solution for justifying our compensation, and a performance report became a key competitive edge for our advancement.

MONITORING THE PERFORMANCE ALONG THE WAY BECAME THE PLAUSIBLE SOLUTION FOR JUSTIFYING OUR COMPENSATION, AND A PERFORMANCE REPORT BECAME A KEY COMPETITIVE EDGE FOR OUR ADVANCEMENT

The first performance reports were just tables of numbers. Keep in mind this was the mid-80s, and the idea of creating graphs unique to each client was a technological barrier that was, at first, impractical. I have one long- term friend that acknowledged that he actually drew pie charts manually, using an inverted ashtray and protractor. Technology advanced and by investing in graphing software, our dot matrix printers were able to take those tables of numbers and whack out dots on the paper that formed primitive graphs, plotting each client's relative performance to their "benchmark." Those of us who made that technological investment proudly showed a sample of our "sophisticated" graphic reports to prospective clients, knowing few of our competitors had such an "attractive graphic performance report."

Our competition eventually caught up, and we needed to do something to keep the competitive edge we once held. It was still in the late 80's, and laser printers were starting to replace the old dot matrix printers with crisp sharpness and speed … up to four pages per minute! The firm for which I worked loved the investment consulting business and saw it as the future of the industry, so when I, as manager of the Investment Consulting Department, proposed to the management committee that we spend thousands to invest in racks of color plotters, they supported the decision.

Some of you who are younger may not know what a plotter is. They held about 200 sheets of paper and had a carousel that held eight small felt tip pens that would draw color lines and even curves, as both the paper and pen moved about. That enabled us, for the first time in the industry, to produce color performance graphics for the masses. In theory, we could use up to eight colors (one for each pen), but because frequently used colors would go dry before we plotted 200 charts, we filled the carousel with duplicate black, green and red pens (the most frequently used colors). Then we programmed the plotter to use each duplicate pen for different areas of the charts. Doing so enabled us to let the plotter to run for eight hours straight to produce 200 color charts with the pens only rarely going dry before completion (that is 2.4 minutes per page). We had racks of these plotters running for days on end, 24 hours a day, with shift workers coming in every eight hours to replenish paper and pens, and sorting the output by client. It took several years before our competition was willing to bite the color performance report bullet, and by then they had the luxury of color lasers.

Since technology finally caught up to meet industry needs, the next wave of advancements came in the form of the sophistication of the analysis. It was no

longer enough to draw line charts showing the growth of $100 versus the client's benchmark, a risk versus return scatter plot and an allocation pie chart to stocks, bonds and cash. So, the industry "advanced" in two directions. We added all sorts of new statistics to the analysis, running regressions showing alpha, beta and R^2. Then, to create another hurdle for our competition, we added slices to the pie charts. By taking the stock slice and cutting it into small cap and large cap, we created a hurdle for all of our competitors that were not capturing that data for their accounts. As they caught up with our pie slices, we added even more – breaking large cap and small cap into value and growth. For many years, the value of a performance report was measured by the number of statistics shown and how many slices were carved into the allocation pie.

In recent years these hurdles have all been overcome by most competitors, and the competitive battlefield for "better" performance reports has now switched to combining accounts showing aggregate performance and attribution analysis (how much of a manager's value added came from security selection, sector allocation and asset allocation.)

Reflecting on the last 20 years of this progression, it is easy to see how and why various industry players kept one-upping one another. It is less easy to see though, that the client benefit was strangely absent in all of this "advancement." Each time a firm created one of these advancements, the justification was focused on our own self-importance … that we could do something our competition could not. But, if you think about the client, if you can step out of the industry for a moment and step into the shoes of your client, which of any of these advancements can you even imagine your client requesting or materially valuing? For years, most of these advancements were nothing more than "packaging."

Now don't get me wrong, I understand that packaging is a strong motivator in buying decisions … particularly when it comes to products on the grocer's shelves. But the performance report package "box" needs to have something inside of it and that, of course, is the financial advisor. Can you imagine a client in the mid-80s considering which of two financial advisors they will decide upon to entrust their life savings? After hearing about the advisors' investment philosophies, their disciplined approaches, the depth to which they probe to understand their client's tolerance for risk and expectation for reward, the client decided on "Advisor A" because there is a page in a report with a primitive graphic, instead of a table of numbers? How about in the late 80s because of a sharper line chart? Or, the early 90s because of a color scatter plot? Or, the mid 90s because of four more pie slices? Or the late 90s because of a regression analysis showing alpha, R^2 and beta … OH, MY!? What about now … because of attribution analysis? Think about these features and your current clients. How many of your clients would leave you for any of these reasons?

There is an old saying: "Price only becomes an issue in the absence of value" (source unknown). Perhaps it should more accurately stated as "Price only becomes an issue in the absence of either value or effective packaging."

IT IS LESS EASY TO SEE THOUGH, THAT THE CLIENT BENEFIT WAS STRANGELY ABSENT IN ALL OF THIS "ADVANCEMENT"

This "value issue" has been a struggle for years. Years ago, advisors stayed away from managed money because managing the money was *their job* and why would the client keep paying the advisor, if they hired someone else to manage the money? The performance report solved this problem, not because the money manager couldn't also create a performance report (if the value was the report itself, the financial advisor was completely useless because managers already reported performance), but because a performance report generated by the money manager was "not objective." So it really never was the report itself that was the value, it was the objectivity of the financial advisor. Yet, where has our industry ended up?

The real value was our objectivity and not the report, so … where did the industry invest its resources? Over the last 20 years, has the industry at-large invested in becoming more objective or in packaging reports?

Elliott Spitzer knows the answer to this question. While clearly there are some firms that recognized their value was objectivity and did their best to avoid the "pay to play" programs where advisors could objectively select the best mutual funds for their clients (from a list of funds willing to pay the sponsoring firm 25-35 basis points), there are many in the industry who threw away their objective value and relied on packaging.

There are programs where advisors can "objectively" select from the best money managers for the client (from a list of those that were willing to reduce their fees to participate in the sponsoring firm's wrap program). There are programs that make it easy for financial advisors to select from the best firms in the industry (that are willing to pay marketing fees to become a "preferred vendor").

More subtly, most firms have "approved lists" of investment vehicles/funds/managers. Having run an Investment Consulting Department for a major firm, I can tell you that such approved lists (at least at the firm where I was employed) were created to protect the client, the financial advisor and the firm from careless evaluation by financial advisors that were not completely qualified to conduct adequate research and not from the perspective of how much an investment vendor would line the firm's pockets under the table.

However, having been active in IMCA for years, I can also attest to the frustration of many top financial advisors in the industry, who run into constant barriers in attempting to use the best money manager for the their unique client's needs because the firm doesn't have the manager on its approved list. Granted, in many circumstances the firm has good reason for banning their financial advisors from recommending the manager. They normally do not publish such "do not use" lists. The presumption and requirement is that if the manager is not approved, they are hence unapproved. This is the logical equivalent of saying that life is the absence of death. Often, there is no sound or compelling reason other than the firm hasn't had the time to evaluate every money manager that their financial advisors request to use with clients.

So, to be completely explicit, such approved lists may not really be all of the best investments available because, in fact, they are not.

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What they really are is all of the best investments the firm has had the time to generically evaluate for broad use by their financial advisors, excluding the ones that the firm thinks should be generically avoided (probably a good thing) and all of those alternatives that are suitable only for unique client needs (excluding these is a bad thing, if our value is customization and personalized service) and those that they haven't researched and therefore do not know whether or not they are unsuitable (or alive or dead, but because they are not on the list, they are dead).

Elliot Spitzer has many more things to explore and some pretty obvious targets of abuse for the firms that have marketed objectivity, but he fails to adequately disclose that their meaning of objective was only to the point of those willing to pay for shelf space (more packaging?)

With so many big targets on Elliot Spitzer's radar, he might never even get around to the other firms that restrict their financial advisor's ability to be objective on behalf of their clients, particularly if the barrier to that objectivity lacks explicit financial motivation for the benefit of the firm. Some firms are clearly attempting to capitalize on their advisor's freedom in objectively serving their clients. There is no doubt that clients put a value on objectivity. There is also no doubt that many of the advisors who put a high value on their objectivity will end up moving to firms that enable them to freely do what is best for their clients. But for all the scandal and lack of disclosure, for all the lists of "who is in" and the lack of the list of "who is out," for all the money changing hands to play the game or money saved by avoiding doing the work of expanding the approved list, in my mind, these are all nothing more than symptoms of a greater disease that needs to be treated.

Relieving symptoms is not the same as treating the disease, and here is where we start to uncover evasions of the reality. The industry unfortunately does not yet need to worry about Elliot Spitzer's demands of integrity.

- Consider "custom portfolios" for each client who are, for all essential purposes, the same (and actually evaluated by firms to make sure there isn't too much "dispersion" among accounts which, of course, equals "custom").
- "Custom investment policies" based on the client's "unique risk tolerance" and "personal reward objective," resulting in "personalized monitoring benchmarks" (that happen to be identical across large groups of clients).
- "Personalized selection from thousands of firms, of the money manager who is just right for your unique investment policy" (that just happens to be the same 20 or so managers at any one time across most firms and their clients).
- "A custom optimized asset allocation designed to comply with your unique tolerance for risk" (for example, defined as your downside risk tolerance at the 95th percentile of 12.23% which argues for a balanced portfolio with a 60% allocation to stocks and, by the way, also has a 98th percentile downside of 25%, which is more than the 24% downside of an all stock portfolio at the 95th percentile).

Are these statements of what we do as advisors merely more packaging material that our clients would prefer to throw away? In the next two parts of this series, we will examine these statements by putting ourselves in the shoes of a client and learning how we can improve our services to not only include attractive packaging but actually deliver value your clients have been asking for but may have been falling on deaf ears. Objectively delivering custom advice to clients … this is the future of financial advising. ■

About the Author

Prior to founding Financeware in 1999, David B. Loeper, CIMA, CIMC, was Managing Director of Strategic Planning for the retail brokerage division of Wheat First Union. During his 10 years there, he served as Director of Investment Consulting and Managing Director – Technology and Strategic Planning, in addition to creating and managing the Profit Formula program (a semi-independent representative business). David's past experience also includes serving on the Investment Advisory Committee of the approximate $30 billion Virginia Retirement System.

In addition to his practical business experience, Mr. Loeper has been active in several industry associations. A member of Investment Management Consultants Association (IMCA) for over a decade, David has also served on IMCA's Advisory Council for several years, most recently being named as Chairman.

David was granted the Certified Investment Management Analyst designation in 1990 by completing a program offered through Wharton Business School, in conjunction with IMCA. Prior to the merger of the Institute for Certified Investment Management Consultants (ICIMC) with IMCA, David was an active member of ICIMC and had served on the Asset Consulting Roundtable. He has been a featured speaker at numerous industry events and often contributes to industry publications as well as appearing on CNBC, Bloomberg TV and Yahoo Financevision.

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