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SENIOR CONSULTANT
The Voice of the Investment Management Consultant

Part II: Are You An Advisor Or Reporter?

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Last month in Part I (*Senior Consultant,* July 2004, http://www.SrConsultant.com/ Articles/2004-07-Loeper-Advisor-Reporter1.pdf), we looked at the evolution of performance reporting over the last 20 years as part of our on-going "value added" service. We examined how the motivation behind producing performance reports for our clients was driven by the need to justify our continuing compensation, once investment policy was set and investments were selected. We then highlighted the importance of objectivity so that performance reporting would be of value and how Elliot Spitzer is driving more disclosure to avoid objectivity being compromised. We also examined how many of the enhancements to performance reports were really nothing more than packaging, which was critical to replace the value lost to the compromises being made to the underlying value of objectivity. Finally, we examined how the client's needs were strangely absent from consideration of such enhancements and ended with some common descriptions of the industry's services and postulated whether such descriptions truly represented the value of our services or if they were merely just more "packaging." Let's start at the end – a sample performance report – and work our way backward to what we do for clients and examine *why* they should, or perhaps should not, *value* this element of our services.

> **LET'S START AT THE END ... AND WORK OUR WAY BACKWARD TO WHAT WE DO FOR CLIENTS AND EXAMINE *WHY* THEY SHOULD, OR PERHAPS SHOULD NOT, *VALUE* THIS ELEMENT OF OUR SERVICES**

Assume for a moment that the report shown in Figure 1 is the first page of many that have all of the latest bells and whistles of the best performance reports the industry has to offer. Imagine that this is a summary of all of the investor's accounts. There are loads of statistics that follow – scatterplots demonstrating risk and return, attribution analysis showing how much of the alpha could be explained by security selection, sector weights and asset allocation decisions. It is obvious there are lots of pie slices and that the report is in color. Finally, assume the client's "custom benchmark" represents the optimal asset allocation for the client's risk tolerance based upon deep probes of their psyche. I find it interesting that when I show this page at training conferences, most advisors say this client is doing pretty well. To me this demonstrates how well we have trained advisors to search for good news to deliver in their quarterly reviews with clients. If there are enough numbers on a page, surely some of them can tell a positive story, or at least be spun that way. For example, I suspect that an advisor delivering this report might say to the client something along the lines of, "While we were slightly behind your custom benchmark last quarter, we are ahead of your custom benchmark year-to-date, only slightly behind your custom benchmark for the last three years, ahead of your custom benchmark for the last five years which was a very difficult time period, and since inception only behind your custom benchmark by 58 basis points. Of course, this strategy was designed to avoid risk in declining markets and not to outperform in strong markets which is why the strategy lagged in the time period that was dominated by strong markets, like early on in the go-go market before the correction, which affected your since inception return, but despite this we outperformed in the more recent bounce over the last year." Now, let us ignore the fact that over the last six and one-half years the strategy hasn't produced any value added and lagged the client's custom benchmark. We will ignore the fact that early on in the elationship with this client, when the market was running hard and fast, there was no good news for the advisor to deliver; and the advisor was probably forced to explain why this boring, conservative strategy wasn't producing 90% returns like the Wunder Net-Net Dot Bomb fund. We will also ignore for the moment that during the prolonged bear market, the extent of the "good news" the advisor had to deliver was, "Good news! We only lost 23% of your money while your custom benchmark was down 27% over the last year." If you go back and reread this paragraph, you may observe that performance reporting is a lose-lose for the advisor and a self-inflicted wound of the industry because unless you are not diversified and

are speculating, your performance in strong markets will lag some popular go-go risky strategies or indices, and your career-saving "good news" in declining markets is that you lost less of the client's money. Nice! In reading this so far, you may be irritated by the constant reuse of the bolded "your custom benchmark" rather than replacing it with the pronoun "it" as one would do in normal speech. There is rationale as to why I wrote it this way. There is a lot of significance in assigning ownership of your benchmark to the CLIENT. If we are going to measure everything against this benchmark, if it truly represents the appropriate measure of the "client's customized investment policy" based upon the "client's unique tolerance for risk" and "personal reward objective," if it is the basis for how "the right investment managers from among the thousands available" are selected for this client and serves as their direction to manage the client's "custom portfolio," the client should really personally connect to this benchmark, don't you think? Rewind to the beginning of your relationship with each of your clients. When you asked the client for their reward objective, did they respond, "I measure my success versus a blend of passive indices comprised of 37% allocated to large cap core stocks, 18% small cap core, 4.5% to large cap value, large cap growth, mid cap value and mid cap growth, 2% to small cap value and growth, 13% large cap foreign and 10% intermediate fixed income?" Or, did they perhaps say something along the lines of "I want to make a lot of money" or "If I had enough money to retire comfortably, that would be good"? Last week we talked about being objective in the selection of investments for the client. Some of you are in a position to do that. But, are you being truly objective when it comes to selecting the client's benchmark? Isn't the objective selection of the benchmark even more important than the objective selection of investments since it supposedly is the basis for investment selection? How many times have YOU TOLD the client what their benchmark should be? How many of your clients share the same "custom benchmark?" How many clients across your firm have identical "custom benchmarks?" The INSTANT you select the client's benchmark for them, it becomes YOUR benchmark and NOT THE CLIENT'S!

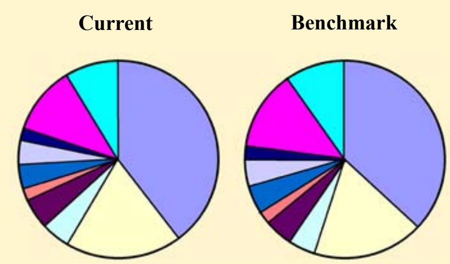
Table 1.
Sample Performance Report

	Last Quarter	YTD	Since Inception
Current Value	$5,050,000	$5,050,000	$5,050,000
Starting Value	$5,000,000	$4,800,000	$2,000,000
Net Contributions/(Withdrawals)	$0	$0	$1,500,000
$ Gain/(Loss)	$50,000	$250,000	$1,550,000
Total Return in %	1.00%	5.21%	44.29%
Custom Benchmark[1]	1.25%	4.88%	49.52%

Trailing Annualized Returns	Your Portfolio	Custom Benchmark[1]	Difference
1 Year	31.65%	29.92%	+1.73%
3 Years	1.07%	1.17%	-0.10%
5 Years	3.20%	2.99%	+0.21%
Inception (6.5 Years)	5.80%	6.38%	-0.58%

[1]Custom Benchmark Allocation

	Current	Benchmark	Difference
Large Cap Core	39.44%	37.00%	2.44%
Mid Cap Core	0.00%	0.00%	0.00%
Small Cap Core	19.19%	18.00%	1.19%
Large Cap Value	4.80%	4.50%	0.30%
Mid Cap Value	4.80%	4.50%	0.30%
Small Cap Value	2.13%	2.00%	0.10%
Large Cap Growth	3.92%	4.50%	-0.58%
Mid Cap Growth	3.92%	4.50%	-0.58%
Small Cap Growth	1.74%	2.00%	-0.20%
Large Foreign	11.34%	13.00%	-1.00%
Long-Term Fixed	0.00%	0.00%	0.00%
Intermediate-Term Fixed	8.72%	10.00%	-1.28%
Short-Term Fixed	0.00%	0.00%	0.00%
Cash and Equivalent	0.00%	0.00%	0.00%



"But Dave, my clients don't know what benchmark to use because I design it based on their unique risk tolerance." The client doesn't know what their benchmark should be? So much for it being "THEIR custom benchmark!"

"Dave, stop it. They connect to it because the benchmark I select is the optimal allocation for their unique and personal tolerance for risk." Really? So the client is really tied to that risk tolerance you labored over identifying with the client, huh? What you are saying (if this is what you are thinking) is that the "custom benchmark" is one step of faith removed from client ownership since it requires them to accept YOUR BENCHMARK as a proxy for a THEIR CUSTOM tolerance for risk you have identified with them. If this is your premise, I hope you are good at identifying the client's risk tolerance. So that risk tolerance is really what the client connected to huh? When you ask a client about their tolerance for risk, what kind of response do you get? If they really own and understand it to the point of accepting YOUR BENCHMARK as a proxy for it, then shouldn't it be something that is easy to identify?

When you ask them about their risk tolerance, since it is the basis of everything else going forward (particularly their benchmark), shouldn't they say something like, "My risk tolerance? Oh, I can tolerate a standard deviation of 15.22% measured over a 5-7 year market cycle."

"Dave, there you go again. Clients don't understand standard deviation, that's why I use downside risk." Yeah, I went down that road starting back in 1986. Of course, back then it was rare to have more than a 5-year track record, which meant that it appeared as though equity portfolios had downside risk of 15%. Wow, what a huge mistake that was because when the '87 Crash came along with its 22% decline, all of my clients' downside risk was violated.

"Right. That's why we measure downside risk statistically at the 95th percentile, which shows that an equity portfolio has around 24% in one-year downside risk and a 60/40 balanced portfolio has about 12.5% downside." Gotcha.

By the way, when you have this downside risk discussion with your client, do you share with them that the downside risk of the 60/40 balanced portfolio at the 98th percentile is 25%. Do they really connect and own that "customized risk tolerance?" You must have some very sophisticated nerdy clients if they really personalize the concept of going with the balanced portfolio because there is a 5% chance of being down 12.5% and 2% chance of being down 25% and the subtlety of discerning this from the 95th percentile of the diversified equity portfolio being down less than 24%. Are you being objective in your evaluation of the selection of the "client's custom tolerance for risk" or has the packaging of our advice product convinced you that maybe the client has connected with it more than they really have? Perhaps my experience is weird, but even when a client has carefully deliberated over their tolerance for downside risk; I have never yet met a client that articulated the percentile probability of where that downside falls. They may accept my "packaging" of the concept of the 95th percentile, but they do so only from A LACK OF DISCLOSURE (Elliot Spitzer?) of what the 96th, 97th and 98th percentile downside is. So far, we have this "personalized custom benchmark" selected by the advisor as a proxy for a risk tolerance that the client did not understand, or at least lacked adequate disclosure to make a truly informed decision. The final problem about that "customized personal benchmark" designed around the client's "unique tolerance for risk" is that no client wants to take more risk than is necessary to accomplish their goals (hmmm, goals ... maybe that should be their benchmark?) Isn't this what you hear from clients when attempting to identify their risk tolerance? They may not know how to articulate it well because they perceive the question you are asking as irrational. "How much money do I want to lose? NONE! Why is he asking me this?" they think to themselves. When you push them to define it, they PRESUME there is some purpose for identifying their risk tolerance other than positioning them in a portfolio to experience it (silly clients). They may even push back with a poorly phrased statement like, "I want to take as little risk as possible" which you might understand better if they articulated what they were trying to say as, "I don't want to take any more investment risk than is necessary to permit me to live the one life I have in the best way possible." This is not usually the same as what they can "tolerate". Coming back to the "objective" performance report that analyzes to two decimal places the performance of the client's account relative to this "personalized benchmark", shouldn't anyone that is concerned over delivering a service of value to the client also OBJECTIVELY consider how far removed "their custom benchmark" is from anything the client really can relate to? One should also consider how arrogant we are in assigning the ownership of that benchmark to the client. Think about the "client's custom benchmark": It is developed through identifying a risk tolerance the client doesn't understand, by subjecting them to the risk they can bear regardless of whether it is necessary. It results in a personalized allocation strategy that subjects them to their maximum bearable risk ... and then some (beyond the 95th percentile which is rarely disclosed other than saying there is no guarantee). It is used as a basis to select managers that may outperform (but also subject the client to the risk underperforming, disclosed as past performance doesn't indicate future results ... but we picked the managers on that basis anyway?), from a list of thousands of managers that always seem to result in the selection of mostly the same 20 managers. It is the basis to create custom portfolios that are for all practical purposes the same (and evaluated to make sure they are by monitoring dispersion). Yeah, the client really "connects" to this and puts a high value upon it. We have packaged our services to sound as though they are highly personalized for the client by generously tossing the term "custom" amongst the lingo describing our services. This is a highly effective marketing ploy because implicit with the word "custom" is better fitting, made just for me, and based on what I value. Now clearly a custom suit may have a better fit, which results in the person looking better when they wear it ... cleaner ... like the suit was made for them instead of it merely wrapping them, because it was made for them BASED ON THEIR PERSONAL MEASUREMENTS. But, if we can step back from our own importance as the "expert" and think about the "measurements" we take for our "custom fitted investment programs," we can begin to observe that all of that customization we tout isn't really based on the client's measurements OF WHAT THEY VALUE, but instead on HOW WE VALUE AND SELL our services. There are probably many of you that are very irritated by my explicit disclosure that of all of this customization and personal selection we tout is not really all that customized or personalized in any MEANINGFUL way for the client.

THINK ABOUT THE "CLIENT'S CUSTOM BENCHMARK": IT IS DEVELOPED THROUGH IDENTIFYING A RISK TOLERANCE THE CLIENT DOESN'T UNDERSTAND, BY SUBJECTING THEM TO THE RISK THEY CAN BEAR REGARDLESS OF WHETHER IT IS NECESSARY

Think about what was written here. See if you can be objective in evaluating your services and the customization you sell, and then think about the concentration of all of those custom portfolios across a handful of managers and funds. Are you objectively evaluating your customization? I know you have a handful of accounts that put restrictions on purchasing military stocks or specific securities the client owns (e.g., employer stock) but are those restrictions objectively evaluated to meet a goal the client has, or are they merely an easy way for us to prove that we provide customization? Were such restrictions evaluated from a perspective of the price to the client's goals? Is the client so irritated by military actions they prefer to subject themselves to investment risk that could be diversified away instead of owning a small piece of a company that makes breakfast cereal for soldiers? If the client is heavily concentrated in his employer's stock, say, Acme Corporation, would the extra 2%-3% a manager might own in their portfolio materially increase their risk? Talk about the tail wagging the dog! If you want to help the client, teach them the price of the risk they are taking by having 50% of their net worth and income tied to one company instead of worrying about avoiding having this position increase to 51.5% from 50% of their total net-worth! Some of you may be able to step back and look at your book and observe the duplicate "custom" portfolios. Some of you may recall how hard it was to determine the client's risk tolerance and how they waffle about in their tolerance for risk as markets advance and decline. Some of you may look at the number of your performance reviews where the client is behind their benchmark since inception. Others will evade this.

The first step in treating this disease is identifying what causes it. Those of you who can objectively observe whether or not your custom services are really all that customized may recognize the gap between your clients' reality and the personalized customization generally touted. If you can recognize this gap, you may also recognize that even if the portfolios and benchmarks were materially customized, the likelihood of the client personally valuing that customization is extremely low because they cannot "connect" to it. If this describes you, it is likely then you would probably like to learn how the customization you have been selling could truly be delivered in a way the client really owns and personally values. The final part of this series will discuss how you can accomplish this objective. Objectively examining the services we provide. 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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Notes

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