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Do Something!

If MPT and the stock market are hurting your business, here are some things you can do about it.

By J. Michael Martin

Many, or per-haps most, of us financial advisors make our living by billing clients a percentage of “Assets Under Management.” We supervise their portfolios, but we also provide a host of valuable noninvestment financial planning services for which we charge … well, nothing! That’s the “AUM Business Model.” As several observers have noted lately, our businesses enjoyed a free ride on the long bull market in stocks and bonds. But now that stocks have actually lost money for the last ten years, clients are beginning to question the AUM value proposition. Surveys say 70% are looking for a new advisor.

How’s the AUM model working for your clients? For your business? If your answer is, “Not so well,” then it seems you have three possible responses:
1) Empathize with your clients and hope the market gets back to “normal” before they quit.
2) Chuck the AUM model and start getting paid for the planning work you’re really good at.
3) Provide a more effective investment service.

The Good Old Days
Good personal financial advisors are well trained and experienced in goal setting, cash-flow modeling, estate planning and a spectrum of needed and even appreciated professional services for which the public has never learned to write a check. Paying a 1% retainer in return for double-digit portfolio returns seemed perfectly reasonable to folks, so we built our modern advisory profession on AUM fees. We religiously honed our planning and client communications skills, and most of us took care of the investments with some version of modern portfolio theory (MPT), style-box diversification and rebalancing.

If you established your business in the ’80s or ’90s, this was a perfect business model. I mean, Perfect! You provided much-needed services and your fees were paid automatically from client brokerage accounts, so you had zero collection problems. The value of stocks and bonds chugged steadily higher most of the time, validating your investment acumen. When markets were regrouping, as they did in ’87, ’90, ’98 and the great swoon of 2000-’02, your main job was to reassure your clients that markets are efficient, America is great and it is foolish to mess with the strategic asset allocation you have prudently designed for them. And sure enough, every market decline was temporary, your calm professional assurances proved prescient, and client loyalty soared along with referrals. What’s not to love?

Reality Sets In
Enter the Great Credit Crunch of 2008. “Not to worry,” right? “Declines happen … keep the faith … all will be well.” OK, this decline is a bit deeper than the others, and it’s been going on for quite a while. As a matter of fact, oh my gosh, the S&P 500 has lost 40% in the last ten years! Clients are getting a little testy, your revenues are actually down and referrals have dried up.

Are you starting to feel a little uneasy about the “stay the course” assurances that worked for so long? Should you be? Is the buy-and-hold, strategic-allocation-with-regular-rebalancing style of managing investments (the one service that you actually got paid to provide) really good for all seasons? Or is MPT and its efficient market hypothesis overly simplistic and maybe even dangerous to your increasingly restless clients and to your business?

I’ve noticed with interest that a high percentage of articles and conference presentations intended to help advisors through this troubling period are focused on being empathetic and having more frequent contact with our clients. “It’s all about the relationship,” they tell us. Focus on the relationship, on showing that you care!

Well, excuuuuse me! If your 64-year-old executive client has lost 30% of his life’s savings under your supervision, and his head is on the corporate downsizing chopping block at work, is another birthday card going to cheer him up, make him happy with your advice? Does he want to pay you to say, “Just work three years longer, Bob,” or “We need to help you plan a no-

frills retirement, Diane?" Is there some reason that you believe they are not among the 70% of clients that the surveys show are ready to switch advisors?

Of course, it's really important to care. We all value our relationships with our clients; that's one of the great things about the advisory profession. But our clients hired us to do a job. In our AUM business model, the only thing they actually pay us for is managing their investments so they can reach their goals. How are we doing with that? I mean, objectively, how are we really doing?

MPT Teaches That We Are Helpless

Whether it is original MPT or a myopic interpretation of it, business schools and professional certification programs have promulgated the notion that an investor is pretty much at the mercy of the markets. All known information is in the prices, the theory goes. The best thing to do, they teach, is to diversify across all the so-called asset classes (to allegedly dampen volatility) and be happy with the resulting returns. As a result, most advisors have based retirement projections on about a 7% average expected return; we figured about a 10% return on equities, so the 60% of the assets in stocks contributes 6% to the portfolio return. We'll get another 2% from the remaining 40% of the portfolio that's invested in bonds and cash at 5%, minus our fee, and everyone is happy.

For a generation this was working, right? So whatever you do, don't go messing with this successful formula. You can't "beat the market"; we know if anyone does, it's an unsustainable anomaly or statistical aberration.

Most advisors have been cowed by the MPT mantra. They really believe that no amount of thinking can give an investor an advantage over "the market." They really believe they are helpless to improve their clients' investment experience. And now, while formerly mild-mannered clients are getting testy and the advisors themselves are losing sleep, advisors keep choosing the first of the three responses mentioned at the beginning of this column: 1) Empathize with your clients and hope the market gets back to "normal" before they all quit. Advisors do this because they have been trained that they are not smart enough to do anything else.

Do Nothing—And Bet Your Business

If you just keep hoping things will get better, you are really choosing to do nothing. Do you really think that you have no other choice? Here's a different and rather sobering way to think about "stay the course" investment advice during these turbulent times: Suppose this advice is wrong. How much more disappointment can your clients take? Will they hang in there with you through another poor year? Two?

Just suppose that the world really has changed with the demise of the great credit cycle that gave us the 20-year free ride. Suppose that government programs and policies don't fix things, or they make things worse—think stagflation. Suppose we really are in a secular bear market with five or more years to go. Is your two- or three-year outlook for the global economy and securities markets so optimistic, so clear, that you are willing to bet your business on an early return to a bull market?

Or Do Something

Don't like that bet? Then maybe you would rather do something to help your clients and to decouple your business from the S&P 500. Like what? Well, you could stop providing investment advice altogether and redesign your practice around your excellent financial planning work and get paid for that. A number of successful firms use this model. Some charge a flat retainer, some charge hourly and some charge project fees. Sound good? Why not touch base with the Garrett Planning Network (www.garrettplanningnetwork.com) and get some ideas?

Or you could at least start to evolve your portfolios by removing some of your indexish, style-box-constrained long equity funds in favor of some go-anywhere managers who have the freedom to build large cash positions or maybe even go short. Buy a copy of Ken Solow's new book, Buy and Hold is Dead (Again). Add a managed futures fund and subscribe to Lou Stanasolovich's Risk Controlled Investing (www.legend-financial.com) newsletter. Changes at the fringe may be just a baby step, and could be too little too late, but it's way better than doing nothing!

Or, if you believe that solid investment returns are integral to helping your clients achieve their goals, you could either:
a) develop your own creative investment team, unconstrained by MPT's proposition that we are all hostage to mediocrity; or
b) partner with a professional investment group that already has a record of investment success and a strategy for prospering in the "new normal."

Over the long term, building an investment team in-house offers the potential advantage of boosting the profitability of your firm if you attract enough new business to leverage this fixed expense. In the short term, hiring creative people with the appropriate investment experience is a not-inconsiderable outlay. And it takes a while to build credibility.

The second approach, partnering, could take several forms. One, perhaps the first to explore if you feel your client loyalty is already waning, could be to acquire or merge with another firm that has done a standout job of protecting client wealth for the past ten years. Add your financial planning and relationship skills to their investment strengths and the whole could be greater than the sum of the parts. Of course this is a little radical for those of us who cherish our independence. Still, it may be wiser than betting the whole ranch on a sustained stock market resurgence.

But I think the approach to better investment results that will have the broadest appeal among RIAs is to remain independent and to partner with another firm for the investment management part of their service.

One forward-thinking advisor in the Midwest called me this past winter to request exactly that. In less than two months we worked out all the practical arrangements. Now, we manage their clients' portfolios exactly as we do our own clients'; we provide on their own letterhead all the same electronic and print communications that we use in our practice; we have a regular conference call with them; and we give them access to all the daily and quarterly reporting that we have developed. They continue to control the entire client relationship; we have no direct contact with their clients.

This firm had decided that the world is changing and that MPT is not a viable formula for investment success in the evolving environment. We have a long history of success as active managers; now we have become that firm's investment management department. You can imagine how much work this takes off the advisors' desks and how much anxiety it lifts from their shoulders, how much more interesting their client conversations are now that they are doing something about returns. Now, they tell us, they have time for marketing and they have the extra advantage of offering prospective clients our investment performance record, which gives them a certain amount of cachet and uniqueness. From our point of view, the new revenues have provided resources to build depth of bench in our research and trading departments. You gotta love win-wins!

Just Do It

If your revenues are tied to AUM and the erratic markets are creating anxiety for you and your clients, you could just stay the course, keep offering assurances and hope things work out. But if they don't, it might get very quiet around your office. Or, you can get off your duff, take charge and try something new. Business coach Richard Gee (www.richgee.com) says the No. 1 business problem is slow death. "People will just act like nothing is wrong and 'stay the course' while their clients and profits drain away. Figure out what's wrong," he says, "make a list of possible solutions, pick one and, as Nike encourages us, 'Just do it!' "

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