Ruminations on Being a Financial Professional

This is primarily for my fellow financial advisors and those entering the industry and is intended to encourage us all toward higher standards. There is (in my humble opinion) a difference between simply working as a financial advisor and being a professional. In my experience the professionals in our industry are rare. What makes a financial professional different from other advisors?

One simple way to think about it would be to consider to whom you would send your mother or your spouse for financial advice if you were unable to advise them. I believe most of us would find it difficult to think of more than one or two people in whom we would have confidence. Following is my view of the differences between a true professional – a professional that I could confidently tell my spouse to go see with the death benefit from my life insurance – and the average advisor.

Competence. The first thing I would look for in an advisor is competence. A true professional, though extremely knowledgeable in his field, constantly strives to learn more. Conversely, many (most?) advisors in our industry have not read a book in their field in the past year (excluding books on how to sell or market more effectively), struggle to meet their continuing education requirements, and are not members of any professional associations.

Credentials are an essential part of competence. Unfortunately, it is difficult, understandably, for clients to know whether an advisor's credential is "good" (one that is respected in the industry and means something) or if it is one a salesperson may get by paying a fee for a weekend seminar.

Close to 650,000 financial advisors practice in the United States. Obviously, all would say they give personal financial advice, yet less than 6% are Certified Financial Planners. Most of those CFP designees specialize in advising people on their investments, yet only 2.3% of CFP designees report being CFA charterholders.

In addition to earning professional designations, advisors seeking to be true professionals can increase their level of competence by joining organizations such as the Financial Planning Association and attending their meetings. I would also encourage reading trade publications with deeper content than the publications aimed at mere sales people. A list of valuable trade publications and organizations is included at the end of this document.

Comparing financial professionals to medical professionals may illuminate the differences in competence among professionals:

- Most advisors would be analogous to a LPN or maybe an RN – they can be helpful to folks with very simple needs.
- A CFP designee would be analogous to a doctor who is a general practitioner – he or she is ideally positioned to recognize problems and solve minor issues while making referrals to appropriate specialists for more complicated situations.
- An advisor with designation such as the CFA would be analogous to a surgeon or other specialist.

While all these practitioners have their places, you certainly don't want your nurse or GP performing your brain surgery! The following designations are both meaningful and in widespread use:

Specialty Area	Best Designations	Other Quality Designations
Personal Financial Planning	CFP	CPWA, ChFC, MBA, PFS
Insurance	n/a	CLU or CPCU
Tax	EA, CPA*	n/a
Estate Planning	JD*	AEP
Investments	CFA	CIMA

*With a specialty in the respective field.

Product. The typical advisor in our industry is still focused on selling products or transactions. The professional sells wisdom, a subtle but crucial difference.

Frequently, companies (and individuals) aren't clear about what business they are in, and it leads them into trouble. A classic example of this is the railroad industry about a century ago. They *thought* they were in the railroad business, when in fact they were in the *transportation* business. Failing to realize this caused them to be decimated by the emerging trucking industry – which *did* realize they were in the transportation business. Most companies in financial services act as though their business is selling financial products – mutual funds, stocks, bonds, annuities, insurance policies, etc. I believe this improper focus leads to problems.

Someone shipping gifts to loved ones at Christmas buys the delivery of the gift *not* the vehicle that transported it. The clerk behind the counter did not explain about the trucks and planes that would deliver it, nor did he or she extoll the experience and track record of the drivers and delivery people. Instead, the customer chose the desired delivery timeframe, and the company simply delivered the package. If the desire was unrealistic, the clerk wouldn't guarantee that delivery date. If the customer wanted better outcomes (within limits), he or she had to pay more.

If we aren't in the financial products business, what business *are* we in? I believe we *should* be in the business of dispensing wisdom to help people maximize their happiness (not their portfolios – though the two are certainly related). While it is generally necessary to *use* financial products, it should not be the focus of the relationship. Note that the business is the provision of wisdom *not* information. Information is freely available on the internet, in the newspaper, etc. Those facts are emphatically *not* wisdom (and in many cases they are more like anti-wisdom).

Knowledge is important, but generally it isn't what you don't know that will get you into trouble, it is what you don't *know* you don't know, and what you *do* know that isn't so.

During the late nineties, people tended to forget they didn't know where the market would go next. It seemed obvious – up! Students of history, however, were familiar with past bull markets and similar feelings among the populace. This was perhaps exemplified best (and infamously) by Irving Fisher, Professor of Economics at Yale University, in 1929 when he said: "Stocks have reached what looks like a permanently high plateau." In hindsight he looks foolish, yet that was mainstream opinion, not only in 1929 but even just a few years ago in tech stocks and more recently in housing.

A vital component of wisdom is to know what we don't know. We don't know where the market will go in the short run. While it would be comforting to our clients to pretend we can call market direction, it would be dangerous. Anyone can design a plan that works if their predictions are correct; the challenge is to design a plan that works even in cases where the forecast is wrong. We need to know what we don't know.

Leonard Read, who founded the Foundation for Economic Education in 1946, had a great illustration. Imagine this page is all knowledge, and the dot below on the left is the amount of knowledge one person has. The dot on the right is the knowledge of a more experienced, more educated individual. Obviously, relative to all possible knowledge both individuals are fairly ignorant. There is a lot of the

page that isn't within the dot. More important is the difference in the circumference of each dot. The person on the left with less knowledge has less contact with the knowledge he doesn't know. The more educated person has a larger circumference. He or she has much more contact with what isn't known. Paradoxically, the more a person learns the more ignorant they feel as they come in contact with more and more they *don't* know.

Thus, it has been my experience that the wisest, most knowledgeable people are those who frequently sound the most uncertain about what will happen next, while those with the least knowledge and experience are the most certain and dogmatic.

Perhaps this explains why, as one wag said, all the people who know how to run the country are driving cabs and cutting hair. The more ignorant a person is on a particular topic, the more likely they are to think they know plenty about it. (In other words, "A little knowledge is a dangerous thing." The original quote is from *An Essay on Criticism* written by Alexander Pope in the 18th century: "A little learning is a dangerous thing; drink deep, or taste not the Pierian spring: there shallow draughts intoxicate the brain, and drinking largely sobers us again.")

Knowledge per se obviously isn't bad, but the person who wields it undoubtedly believes he has more knowledge than he really does. Overconfidence is one of the most pernicious and systematic errors we make as human beings. It is easy for us to think we know the answer to a problem (and that it is not that complicated) when we know only a little about the subject.

Process. Quality advisors realize their value is in their process. For example, the investment process should look something like the following:

1) Identify the client's specific goals, resources, and constraints.

2) Develop the capital market's assumptions (which asset classes should be used, the expected return and risk of each class, and the correlations of each class not only to the other classes but also to other risk exposures the client may have).

3) Run a Monte Carlo simulation or similar analysis combining the previous two steps to determine the optimal solution. (If there isn't one, start over on step one and help the client adjust his expectations).

4) Implement the allocation using the most efficient and effective vehicles.

5) Monitor the situation for any changes to the assumptions in steps one and two and, if any, repeat the process.

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Unprofessional advisors all too frequently start by explaining which product is the solution without going through a process to gain adequate knowledge of the client's goals and current situation.

The Objective. The objective of the typical advisor is to find clients who need what he or she has. The broader objective of the professional is to help the client achieve financial success and remain financially successful in an uncertain world. (Financial success is simply having more than needed.)

The professional advisor reviews the client's situation with the goal of developing a strategy that both maximizes the probability of success in reaching the goals *and* minimizes the shortfall in cases where they won't be met. Difficulties arise as a result of tension between these two objectives.

If I focus only on maximizing the probability of my client's success, I probably would not, for example, recommend my client purchase any type of insurance at all. In such a case, the client could apply the premium savings to reaching his retirement goals. Depending on the case, that would likely increase the probability of an adequate retirement. But, should my client's house burn down or should he die at age 45, that family would *really* be in trouble. It would not comfort them to know they would have been slightly better off because of the premium savings had they not suffered those calamities.

So, I *do* want to encourage my clients to purchase insurance and otherwise address those small (in probability, not in magnitude) risks – but not in all cases.

For example, insurance generally excludes coverage for acts of war. A client could obtain custom coverage from Lloyd's of London or another company for that, but it would be very expensive and thus detract from reaching goals in scenarios where there weren't losses from acts of war. Similarly, there is a very small chance that the stock market will be down over a 50-year period. That particular risk may be avoided by not putting any money in stocks, but the opportunity cost would be so high that even though that one possible (though extremely unlikely) future was "fixed," the results in all the other futures would be suboptimal.

The goal is to maximize the sum of happiness across all potential futures, keeping in mind the declining marginal utility of wealth. In other words, the first dollars are more valuable (have higher "utility") than the last dollars. Going from a retirement income of $30,000 to $40,000 increases happiness much more than going from $130,000 to $140,000 because the next dollar to someone making $30,000 is more valuable than the next dollar is to someone making $130,000.

In other words, quantify the happiness in one possible future and multiply it by the probability of that future. Then, do that for every possible future. The plan that has the highest sum of happiness across all futures is the optimal plan. This is simply an expected return calculation using happiness instead of dollars. The best plan has the highest expected return in terms of happiness.

An example may help explain that more concretely. Suppose an individual has no fire insurance, and the odds of the home burning down in a given year are 1 in 1,000 (I made up the odds). 99.9% of the time, the house doesn't burn down this year and the few hundred dollars of savings from the premium can now be spent on something else. There is probably not a large increase in happiness in those 99.9% of cases. Call it 1 unit of happiness. In the 0.1% of cases where the house *does* burn down and there is no insurance, there is a loss of say 1,000 units of happiness. So, in this case the sum of happiness is 0.999*1 + 0.001*-1000 = -0.001 units of happiness. Thus purchasing the insurance increases happiness by an average of 0.001 units.

Obviously in reality it is hard to quantify happiness, but the principle holds and provides a very useful framework for thinking about financial planning and tradeoffs that must be made. The primary objective is *not* to maximize portfolio value, but to attempt to maximize happiness given imperfect knowledge and an uncertain world.

Collaboration. Professionals works with other professionals to help their clients. Too many advisors see relationships as adversarial and only work with other professionals if something is in it for them (referral fees, quid pro quo, etc.). The true professional "knows what he doesn't know," as mentioned earlier, and gets advice and help in those areas from experts. A typical financial planning and investment management practice will likely need relationships with at least one quality professional in the following fields:

- CPA and/or tax preparer
- Estate planning attorney
- Mortgage broker and/or banker
- Property and casualty agent
- Life/Health/Disability/LTC agent (these may be different people)

Risk focus. The world is risky. This simply means more things can happen than will happen. The professional focuses on what could go wrong, tries to mitigate risks appropriately, and explains them thoroughly. The non-professional focuses on the upside and downplays risks. The professional stresses the fluidity and uncertainty inherent in many decisions; the non-professional strives to have the client believe the advisor knows exactly what will happen and how the future will unfold.

Experience. If the product is wisdom, it is hard to sell it without experience. Experience isn't merely a function of time, however. Many people who have been financial advisors for 20 years don't have 20 years of experience; rather they have had one year of experience 20 times. As much as possible, professionals strive to learn new things and work in new areas. Charlie "Tremendous" Jones said, "You will be the same person in 5 years that you are today except for 2 things: the people you meet and the books you read." We can learn from other people's experience and from history. The reading list at the end of this paper may help.

Ethics. Immanuel Kant's categorical imperative is a good guideline for our actions. One formulation of his imperative stresses that people should always be treated as ends in themselves, never simply as a means to an end. (The advisor helps them reach their financial goals rather than the client helping the advisor reach production goals.) Thus, a professional does not manipulate people through fear or greed to make decisions – even ones that are "good for them." Such behavior does not treat people as ends but rather as means. Additionally, whether an advisor is legally a fiduciary or not, the professional always acts as a fiduciary would.

In spite of the sensational press stories about some advisors – I believe that most advisors *are* ethical and *do* have integrity. However, those with problems seem to fall into one of the following three categories:

1) They are consciously trying to swindle people. Fortunately (notwithstanding prominent recent examples) this type of person is rare, and there is a criminal justice system designed to accommodate them.

2) They just want to make their clients happy. This is the largest problem I see. The advisor isn't "evil;" he or she just doesn't want to deliver bad news and make clients unhappy. The advisor attempts to smooth things over, put a positive spin on the situation, or cover things up – just until things get better. Since most advisors are optimists by nature, this is understandable. But quality advisors contact clients quickly with bad news; a true financial professional is proactive, not reactive, in communication with clients.

3) They live above their means. Some advisors get into trouble (particularly in poor markets) because they are straining to keep up appearances. Truly successful people, advisors or not, live well within their means and see their wealth merely as a tool to better their families and communities.

One last aside on the topic of integrity – as we have seen in the news over the past few years, many firms are conflicted in their relationships with their clients and sometimes don't have their best interests at heart. While many quality advisors work at those firms and try to do what is right, increasingly they are leaving for smaller companies or starting their own firms. True professionals only work where they are permitted to act with integrity in dealings with clients.

Full disclosure. The professional fully discloses potential or actual conflicts of interest, method and amount of compensation, and all material facts about their recommendations.

It is also important to note *how* the advisor is compensated. While no compensation method is perfect, awareness of the potential conflicts of interest that exist is crucial. Obviously, a good advisor should be adequately compensated. On the other hand, the specific products used should generally be relatively inexpensive. Too many advisors continue to use products that have high fees in spite of research indicating this leads to poor performance. In addition, many advisors do not pay adequate attention to (or are ignorant of) tax implications and transaction costs of their decisions. While these costs are not obvious, that does not make them any less real to the client. Products where the commission earned by the advisor is not visible to the client are particularly prone to improper or excessive use.

Conclusion. The financial advisor I would recommend to my family has these attributes. My hope is an increasing percentage of practitioners in the financial services industry will as well.

Appendix 1

Recommended Reading for Investment Advisors

I am frequently asked for a recommended reading list, so I looked through my library and created the list below. It is by no means comprehensive, yet in some respects it is undoubtedly redundant. Some books are out of print and attempting to read it all would be daunting; so think of it as a menu of options you may want to try. To keep it to a somewhat reasonable length, I restricted myself to only one title per author and excluded textbooks. Also, due to my predilections it is tilted toward the areas of behavioral finance, efficient markets, and historical perspective.

- *All About Asset Allocation* – Richard A. Ferri
- *Asset Allocation* – Robert D. Arnott & Frank J. Fabozzi
- *Asset Allocation* – Roger C. Gibson
- *Asset Management: A Systematic Approach to Factor Investing* – Andrew Ang
- *Behavioral Investing* – James Montier
- *Beyond Greed and Fear* – Hersh Shefrin
- *Book of Investing Wisdom, The* – Peter Krass
- *Capital Ideas* – Peter L. Bernstein
- *Common Sense of Money and Investments, The* – Merryle S. Rukeyser
- *Devil Take the Hindmost: A History of Financial Speculation* – Edward Chancellor
- *Efficient Asset Management* – Richard O. Michaud
- *Efficiently Inefficient* – Lasse Heje Pedersen
- *Extraordinary Popular Delusions and the Madness of Crowds* – Charles MacKay
- *Fooled by Randomness* – Nassim N. Taleb
- *Fortune's Formula* – William Poundstone
- *Happiness* – Richard Layard
- *History of the Theory of Investments, A* – Mark Rubinstein
- *Intelligent Investor, The* – Benjamin Graham
- *Investment Management* – Robert L. Hagin
- *Investor's Manifesto, The* – William J. Bernstein
- *Management of Investment Decisions, The* – Donald Trone, et al.
- *Manias, Panics, and Crashes: A History of Financial Crises* – Charles Kindleberger
- *Millionaire Next Door, The* – Thomas J. Stanley & William D. Danko
- *More Than You Know* – Michael J. Mauboussin
- *Myth of the Rational Market, The* – Justin Fox
- *New Wealth Management, The* – Harold R. Evensky, et al.
- *Only Guide to a Winning Investment Strategy You'll Ever Need, The* – Larry E. Swedroe
- *Only Yesterday* – Frederick L. Allen
- *Plungers and the Peacocks, The* – Dana L. Thomas
- *Portable Financial Analyst, The* – Mark P. Kritzman

- *Portfolio Selection* – Harry M. Markowitz
- *Psychology of Investing, The* – John R. Nofsinger
- *Random Walk Down Wall Street, A* – Burton G. Malkiel
- *Reminiscences of a Stock Operator* – Edwin Lefèvre
- *Signal and the Noise, The* – Nate Silver
- *Stocks for the Long Run* – Jeremy J. Siegel
- *Thinking, Fast and Slow* – Daniel Kahneman
- *Where Are the Customers' Yachts?* – Fred Schwed
- *Winning the Loser's Game* – Charles D. Ellis
- *Wisdom of Crowds, The* – James Surowiecki
- *Your Money and Your Brain* – Jason Zweig

Appendix 2

Trade Publications & Organizations

I am frequently asked by financial advisors what trade publications I read and what organizations are worthwhile. Below is a list of my current subscriptions that I would consider most valuable:

- *Wall Street Journal* – subscription required
- *Investment News* – free for financial advisors
- *Financial Planning* – free for financial advisors
- *Investments & Wealth Monitor* – free with membership in IWI
- *Journal of Financial Planning* – free with membership in the FPA
- *Journal of Investment Consulting* – free with membership in IWI
- *Financial Analysts Journal* – free with membership in the CFA Institute
- *CFA Digest* – subscription required

If you are trying to narrow it down, I would recommend *Financial Planning* magazine for technical information and *Investment News* for industry information. I would also join the Financial Planning Association (FPA) which comes with a subscription to the *Journal of Financial Planning*. I also subscribe to a number of other publications (or pick them up on the newsstand), but I don't find them all that valuable.

Joining the following organizations is highly recommended:

- Financial Planning Association (FPA) – for all financial professionals with private clients.
- CFA Institute – primarily for Chartered Financial Analysts (CFA).
- Investments and Wealth Institute (IWI, formerly Investment Management Consultants Association or IMCA) – primarily for Certified Investment Management Analysts (CIMA), and Certified Private Wealth Advisors (CPWA).
- National Association of Personal Financial Advisors (NAPFA) – for all fee-only advisors.

Appendix 3

Advice to a Neophyte

Many experienced Financial Advisors (aka Stock Brokers, Registered Reps, Financial Consultants, etc.) have learned, generally the hard way, what mistakes to avoid. Unfortunately, newer advisors seem to make the same mistakes all over again (and many experienced folks never learn), harming their clients in the process. Many high-quality, experienced advisors tend not to do a great deal of mentoring (though there are exceptions) because the turnover among new advisors is so high it isn't a good investment of time. Given that dynamic, I thought I would try to set down some advice to a new advisor to try to spare them, and their clients, some of that learning curve.

Conceptually, I am addressing a young niece or nephew who has recently been hired as a financial advisor and who, while intelligent, is a liberal arts graduate with no investment background beyond studying for, and passing, the Series 7 (stockbroker's) exam. So without further ado, and in no particular order, here is my advice and the things I think you need to know for your new career:

- Stocks beat bonds (because they are riskier), but less consistently than you think.
- Value stocks outperform growth stocks (because people like growth stories and overvalue the companies, particularly in the small cap space), but again, less consistently than you would like.
- Simple beats complicated.
- It almost certainly isn't different this time.
- Study market history. In particular, read contemporaneous accounts of different periods. As Mark Twain is reputed to have said, "History doesn't repeat itself, but it rhymes." As Santayana did say, "Those who cannot remember the past are condemned to repeat it." And finally, another quote from Mark Twain, "The man who does not read good books has no advantage over the man who can't read them."
- Arguably the most valuable function you serve is keeping people on track and not being sucked into the euphoria or panics that periodically seize the market.
- Psychological mistakes are more detrimental than cognitive mistakes. This applies to your clients *and* you. Study behavioral finance.
- If you get higher compensation to sell a particular product, it isn't because it is a better product. There is a very strong inverse correlation between what is best for clients and what pays the advisor the most.
- You will tend to be swayed toward products where the costs (including your compensation) are less visible to the client. If you would be uncomfortable disclosing your compensation, avoid the product.
- You have undoubtedly heard and read disclosures that "Past performance is no guarantee of future results." I would go further: Alpha is ephemeral and past performance is not only not a guarantee of future results, it isn't even a good indicator of them though it certainly makes investors feel better about what are inherently uncertain decisions.
- You can do a *lot* worse than simply putting 60% of a portfolio into a total stock market index fund and 40% into a total bond market index fund. You should have a high level of confidence that what you are suggesting is superior to that simple strategy before implementing it.
- Never buy an investment that requires someone else to lose for your client to win. Stocks and bonds have a tailwind (on average they make money), while derivatives are a zero sum game that requires someone else to lose money for you to make money. That is unlikely to happen consistently.

- Performance may come and go, but costs are forever.
- One of the worst things that can happen to you or a client is an early investment that wins big. You will become overconfident of your abilities and proceed to lose much more in the future through imprudent decisions than you initially made on the winner.
- The purpose of fixed income in a portfolio is for ballast. It is not there to increase returns, it is there to reduce risk, hence you should keep the fixed income portion of a portfolio relatively short term, high quality, and currency hedged (if using international fixed income).
- In reality, there are only two asset classes: stocks and bonds. Or as I prefer to think of it, risky assets and safe assets. Non-investment grade bonds are in the risky category. Cash is just a bond with a really, really, really short duration. The investment decision with the biggest impact is the decision of how to allocate the portfolio between those two buckets.
- In a bad market the value of risky assets will decline by approximately half. This is to be expected. When it happens it does not mean that the world is coming to an end.
- Your projections, regardless of the quality of the software used to generate them, have high precision (the numbers have decimal points), but low accuracy (you have no idea what the numbers actually are).
- The projections of market prognosticators have neither precision nor accuracy.
- It isn't what you don't know that will hurt you. It's what you don't know you don't know and what you do know that isn't so. Become a Certified Financial Planner as soon as possible. Join the Financial Planning Association and attend the meetings.
- Don't buy individual stocks and bonds. You won't get adequate diversification, you will tend to end up concentrated in certain sectors and in U.S. large growth stocks, and you and your client will make emotional decisions based on how you feel about the company.
- A good company or sector or country isn't necessarily a good investment and a poor one isn't necessarily a bad one. In fact the reverse is generally true.
- Don't confuse price and value. A low-price stock is not a better investment than a high-price stock just as cutting a cake into more slices doesn't mean there is more cake.
- Don't buy insurance or guarantees on investments. High fees and poor performance are the rule rather than the exception. You can't get something for nothing and you can't get market returns without market risk.
- Don't be afraid to reject clients who are irrational, not in your target market, are high maintenance, or that you simple dislike. This is hard to do early in your career, but worth it.
- When marketing, remember deep penetration of a small market beats shallow penetration of a large market.
- Anyone can design a financial plan or portfolio that does well if the assumptions are correct. The trick is to design one that works pretty well even if you are completely wrong.
- Your job is not to maximize portfolio size; it is to maximize client happiness. While these two things are certainly related, they aren't the same thing.
- Successful people have long time horizons, unsuccessful people have short ones. (In finance terms, the successful folks have lower discount rates than the unsuccessful.) Look for clients and associates who are in the long-term-thinking category.
- Get a mentor who has been in the business a long time but who is bad at sales and started very slowly. He or she is more likely to know what they are doing than the personable sales guy who was an overnight success.
- Sell wisdom rather than products, transactions, or information. Information is cheap, wisdom is dear.

- Good clients are wealthy people who delegate.
- Current market valuations frequently change expected returns. They much less frequently change the proper investment strategy.
- Financial success is having more than you need.
- One of the best fixed income investments is paying down debt.
- Don't trust your peers or your firm. If you can't or won't do your own due diligence on a product, don't sell it. If you can't explain a product to an engineer, don't sell it.
- 4% is the sustainable withdrawal rate over a 30 year period for a portfolio that is predominately, but not exclusively, stocks.
- IRA and Roth type investments beat insurance products hands down.
- Base your business on fees rather than commissions as much as possible.
- Read books (not magazines and newspapers) on investing (not sales).
- Markets are probably efficient. To the extent they aren't, you won't be the one that beats them.
- Diversification is the only free lunch – but it works better when markets are going up than when they are going down.
- If everything in the portfolio is going up, you aren't diversified.
- Focus on total return, not yield.
- Beware excess kurtosis and negative skewness – particularly in combination.
- As Warren Buffett said, "Be fearful when others are greedy, and be greedy when others are fearful."
- Don't change investment strategy when scared or euphoric. Wanting to change your strategy is an early warning sign you are about to do something stupid.
- Over-communicate with clients – particularly in times of market stress.
- Setting appropriate expectations is one of your most important functions.
- Just because "everyone" is doing it doesn't make it right. This applies to investment fads.
- Taxes and inflation matter a great deal but because they aren't reflected in performance reports they are inappropriately ignored.
- Taxes should not drive investment decisions though they may influence them at the margin.
- Make sure you are getting experience for the time you are putting in. Few people have 20 years of experience. Many people have the same year of experience 20 times.
- Most mistakes are attributable to ignorance, myopia, and hubris. Principally hubris.
- Wanting or needing x% return doesn't cause it to be available in the market.
- Returns are random and randomness is more random than you think. Control risk and accept the returns that show up when they show up.
- The difference between wise and foolish investors is that the first focuses on risk while the second focuses on return.
- No one has any idea what the market is going to do in the short run and only a vague idea in the long run. When J.P. Morgan was asked what the market was going to do that day, he replied, "It will fluctuate." If your business model depends on your ability to forecast, you are doomed.
- Risk doesn't equal return. You can't earn excess returns without taking risk, but it is possible to take risks that have no reasonable expectation of excess return.
- Leverage works in both directions.
- Your clients cannot eat relative performance.

- Aside from tax management, the wisdom of a trade has nothing to do with the cost basis.
- Don't mistake a bull market for investment skill.
- As Keynes is reputed to have said, "The market can remain irrational longer than you can remain solvent."
- People don't have money problems, money has people problems.
- Clients have no idea if you are competent. Thus they will extrapolate from things they can judge into areas where they can't. For this reason (among others) it is important to do all the other little things right like returning calls, being punctual, having a respectable office, having communications be without grammar and spelling errors, etc.
- The investor's return is the company's cost of capital. If you expect a high return, you should ask why a company has to pay that much for capital.

Appendix 4

Ideal Clients

A full-service, fee-only, wealth management firm can only effectively handle 100 clients per financial advisor (approximately, with a sizable standard deviation and positive skewness). A more transactional model can manage a greater number, but since many of the smaller accounts will be neglected (to some extent at least) it is unclear that the actual revenue generated will be greater than having a deeper relationship with fewer clients. Because the number of clients that can be served is limited, it is important that the advisor ensure he or she is working with the right people.

It is far easier to get the right people from the beginning than to try to upgrade the client base later. Firing clients who were with the advisor from the early days is at best awkward even if they are no longer a good fit. On the other hand, it is better to "pull the Band-Aid" quickly than to let a poor fit continue. Most advisors have at least a few clients who shouldn't be clients. To make sure we maintain the discipline to keep only the right relationships, we have a policy of (politely) firing one client every year. Input on which client that should be comes from all of the associates of the firm.

A policy of proactively removing one client per year has a few positive effects:

1) There is always someone who really isn't a good fit.
2) It keeps the advisor from accepting clients initially that are just going to be let go in the future.
3) It reduces the stress on the firm's associates during the year.

Let me explain that last point. If a client is difficult or simply seems to require more work than their fees may justify, realizing that they may be the one to be let go can reduce the stress level of the associate who is dealing with them, even if they are never the client actually selected for removal.

When accepting a client initially or determining who should be asked to find another advisor, there are four things we look for (in order of importance from most to least):

1) **Personality fit.** If a client verbally abuses an associate or if we feel dread when seeing their name on the caller ID, that client does not qualify to work with us. Life is too short.
2) **Willingness to delegate.** While our clients are intelligent (see the next point), if they do not wish to delegate portfolio management to us, obviously it won't be a good fit. For example, a retiree who watches financial news all day and wants to constantly discuss with us what the talking heads are saying will not be a good fit. We are more than happy to explain what we are doing and why and obviously there has to be agreement on the appropriate risk level of the portfolio, but we are not "co-managers" of the portfolio with the client.
3) **Cognitive abilities.** While obviously people are paying us for our knowledge and wisdom (which are two different things), we want clients who are intelligent enough to recognize our value and who (at least at a high level) understand how we manage portfolios. We have doctors, lawyers, CPAs, etc. and those are all very good clients for us. We work less well with unsophisticated people. In fact, we work well with professional people that other advisors typically struggle with; engineers, for example, are notoriously unpopular clients but we enjoy them. Their thoroughness and analytical approach matches our approach.
4) **Substantial assets.** Our ideal clients have at least $1mm invested with us, but you will notice that this is the last thing on the list. While a prospective client obviously has to have "enough" assets to be managed, once they are at that threshold, the other factors are more important.

Appendix 5

The Advisor's Alpha

In my view a high-quality advisor adds value in the following ways:

1) Constructing an appropriate portfolio (I conservatively estimate the value add to be 100 bps annually from this)
    a) Proper asset allocation, factor tilts, diversification, etc.
    b) Low-cost implementation
    c) Intelligent rebalancing
2) Tax savings (I conservatively estimate the value add to be 100 bps annually from this *if they have funds in multiple tax buckets are in a high bracket, etc.* but much lower otherwise)
    a) Proper asset location strategy
    b) Proper accumulation strategy (maximizing tax-advantaged vehicles)
    c) Proper decumulation strategy (spending order)
    d) Strategic use of conversions, step-up in basis, loss-harvesting, munis, etc.
    e) Optimal transfers for children's education, other funds to descendants and charities, etc.
3) Behavior modification (the value add is mostly unquantifiable, but perhaps as high as the gap from the Dalbar studies, I would estimate 100-300 bps annually, but as noted above it is lumpy)
    a) Maintaining an appropriate strategic allocation at market extremes
    b) Appropriate levels of saving (pre-retirement) and spending (post-retirement)
4) Other financial planning (the value added is either peace of mind or only shows up in a tiny fraction of cases, for example premature death *with* insurance, so the average bps added to performance isn't high)
    a) Risk management including appropriate insurance and asset protection
    b) Liability management (optimal debt)
    c) Estate and end-of-life planning (not primarily tax-related)

So for a client with pretty good behavior (though not perfect), who is in a lower tax bracket or has no investments outside of deferred accounts, the value added might be just 200 bps (100 each from 1 & 3 above) annually. For clients with more emotional behavior, who is in a high marginal bracket, and has savings in various types of tax buckets (IRA, Roth, taxable, etc.) the value added is probably around 500 bps (100 from #1, 100 from #2, and 300 from #3). Thus, advisory fees are typically covered 2-5x.

Notes:

The analysis in this report has been prepared by David E. Hultstrom, MBA, CFP©, CFA©.

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