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The Value of Advice

Good advice holds the keys to success, for clients and advisors, although many people will not see that they are the keys.

With each key the value compounds, however, the differences between good advice and poor advice can be nuanced and difficult to perceive …

The first key is having a financial plan. Sounds so utterly obvious that I shouldn't have to mention it, but you'd be surprised how many people, both industry participants and investors, don't bother with planning. Many financial salespeople just work in one segment, like life insurance, with little idea of an overall plan.

But many investors don't bother with a plan either. In a complex world where you wouldn't build a house without detailed blueprints, most of the population has no plan. It's no wonder that so many people have no savings. As Yogi Berra said, 'If you don't know where you're going, you might not make it'.

A financial plan encompasses things like expected return and downside volatility, saving/withdrawal rate, tax optimization, children's and grandchildren's education, estate planning, and yes, life insurance.

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Chris provides financial planning, investment planning and full implementation services to about 100 families.

We are pleased to welcome new clients. New clients should have $1 million or more of investable assets.

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It only takes a few questions to determine which segments are relevant to a particular client situation. Often it only takes the back of an envelope to work out the action required, but even the simple questions can uncover life-changing opportunities and dangers. And for people with more complex lives, planning brings additional professional advice to bear on serious and difficult issues. A plan can change your life.

A slightly higher level of planning is to discuss and maybe help the client dream of where he wants to go and how to get there. Talk life ambitions and plan to achieve them. The planning process focuses your thoughts and helps you see where you could go. Put the pieces in place, then make it happen. This is entering the realm of the true advisor.

Next is a sound portfolio of investments. A portfolio should be custom-tailored not only to the client's unique personal financial strategy, but also to the current realities of the global financial markets (more on this shortly).

Far more important, the plan and investment strategy should evolve and adapt to your changing circumstances. They should not be cast in stone, but the plan does provide a mental road for you to stay on as the pressures and panics of the world conspire to push you off your course over the years.

A properly done and properly managed plan over time gives you confidence and peace of mind in knowing where you are going and the path to get there. What is the value of reaching your goals?

These are the basics. Very few advisors provide even basics. But my goal is to provide much more.

The One That Missed You

Investing is one of the few things where the best advice is often seen in retrospect as what didn't happen. This is very different from having your tooth filled, your house built, or your car fixed – where the success or failure can be perceived fairly promptly.

With investing, the positive outcome is getting to where you want to go, many years - decades - down the road. Not only that, the future is much less predictable than an appendectomy. On the journey, often what's important is what doesn't happen. Let me explain.

I recall reading at the age of about 12 a Readers Digest story of a narrowly-avoided airplane crash. A jetliner on takeoff had its rear elevators jam in the nose-up position, locking the aircraft in a steep climb that would soon force a fatal stall. The captain thought madly for a solution. In a stroke of genius he backed off the throttles on the two lower engines, leaving the upper engine in the tail at full thrust, thereby bringing the nose down and allowing a partially-controlled but safe landing. The pilots, standing near the aircraft afterwards, were chewed out by a disembarking passenger because she would now miss an appointment. The lady had no idea what had just happened. To which the captain replied, 'I'm sorry you're late, ma'am, but right now I'm glad we're all alive'.

It is sometimes difficult to appreciate what didn't happen. Back to the portfolio.

The financial world is a dangerous place and not everyone is your friend. The true advisor must decide what instruments or innovations are appropriate and which are not. Some, like hedging US investments against a strong Canadian dollar, might be good ideas. Others, like geared ETFs that multiply an index return, are a bad idea. Many advisors don't have the experience, training, or IQ to know the difference.

An important aspect of good advice is what you haven't had in your portfolio.

- no Index-linked Notes – which claimed to provide a GIC-like guarantee with an equity market return, but became 10-year dead money in 2009
- no Asset-Backed Commercial Paper to freeze and take 7 years to get back
- no real estate limited partnerships to blow up, no tax shelters with their CRA audits and disallowed deductions
- no tech stocks to blow up in 2000
- no gold stocks to fall by half in 2012
- no Guaranteed Minimum Withdrawal Programs whose 4% fees preclude any hope of a return
- no pre-packaged, consultant-designed, over-diversified portfolios, masquerading as intelligent investing, with little hope of a decent return.

Each of these things required serious analysis to evaluate the merits and risks. Each one has collected billions of dollars from people who thought they looked like good ideas. Many of them have already destroyed billions of dollars of money in either lost income or actual capital losses. And not one has had a nickel of my own money or my clients' money.

What is the value of missing these painful little bombs?

Capturing an Opportunity

The other side of avoiding dangers is capturing an opportunity. An elementary – but surprisingly uncommon – example is ensuring a client with a long time horizon is able to capture the much higher expected return from equities vs. bonds.

Many advisors give their clients a risk assessment questionnaire cooked up by some academic consultant: 'Do you want risk?' 'No'; 'Do you want a high return?' 'Yes'. Well, duhhh. Clients are slotted into some risk/return box without really understanding the decision they are making. It's like a computer dating service and blind date rolled into one – you check off some boxes for crafty questions, and you are blindly assigned a match - in this case an investment portfolio - without having any idea what or why.

Employer benefit retirement plans are among the worst offenders – people in their 30's, with 50 year horizons, may have 40% of their portfolios needlessly wasting away in bonds. Their questionnaire answers slotted them into the 'moderate' risk category because 'high risk' sounded dangerous. The consultants decided that 'moderate' is 40% fixed income.

The unfortunate result is far less long term growth than the client would have chosen if she had understood the risk/return tradeoff more clearly.

My approach is very different. Clients know that I focus on the actual amount that a portfolio could decline – the downside risk – not on the abstract and irrelevant statistical concept of standard deviation. Standard deviation utterly fails to communicate the thing that the investor is interested in, which is 'how much could my portfolio decline?'

Inseparable from risk is the expected return. Critically, when the client sees that downside fluctuations are temporary interruptions of a long term uptrend, and when it is explained to her that the cost of avoiding volatility could mean a permanent reduction in her long term return, she can easily see the wisdom in accepting the volatility as the price for better long term returns.

I cannot exaggerate the importance of this downside risk vs. return discussion; it is the single most important thing in investment planning. Thorough, honest, and knowledgeable advice on risk and return is very rare, but critical to understanding. Having the discussion with every client, and reviewing it every meeting, is probably the single most important key in my clients and my own long term success. Yet the industry norm is a questionnaire and standard deviation.

What is the value of a captured opportunity?

Beyond Portfolio Construction

Beyond portfolio construction is how it is managed over time. Here we transition into deeper water: the wise investor recognizes that the portfolio needs to adapt over time to a changing economic world, yet it is equally critical that neither the client nor the advisor overreact to surprises and shocks. Deeper waters indeed, for it is here that success or failure is determined.

The first example is portfolio rebalancing. Many advisors - and firms - follow the academically popular principle of automatically rebalancing portfolios back to a standard asset mix. They do this each quarter by selling a portion of what has gone up, using the proceeds to buy what has gone down, thereby keeping the asset mix unchanged. The idea is that changing market conditions do not push the asset mix far off course.

Sounds good in theory, but the problem was, from 2000 to about 2007 this meant each quarter selling some of the Canadian value stocks, which were doing very well, and buying growth and global stocks, which were not. Portfolios that auto-rebalanced through these years suffered serious underperformance.

This overly-rigid application of the rebalancing principle can be a serious drag on performance because the winner – the Canadian value manager – didn't get a chance to run. Similarly, in 2007 and 2008, it meant selling bonds, which were doing well in the gathering storm of the financial crisis, and buying stocks, as they were sliding towards the unseen cliff. The auto rebalancers, instead of 'buying low', were throwing good money after bad.

As Jim Otar and other analysts have pointed out[1], frequent rebalancing compounds the negative impact of a multi-year down market. Conversely, it curtails the positive power of compounding in a multi-year upmarket. Your advisor, on the other hand, prefers a judgement approach – in this case, the experience-based principle of 'let your winners run'.

Similarly our rebalancing into the US in 2012 was based on an assessment that economic growth was getting under way in the US.

1 Jim Otar, High Expectations and False Dreams, 2001; Advisor's Edge Report, October 2014, p15.

Is this market timing? No, these adjustments are not large bets based on a forecast that the US 'is poised to outperform'. This rebalancing is much more a recognition of changing value, an incremental tilting of the asset mix to 'be where good value is' and 'avoid places where value is not'. They are moves towards opportunity and away from danger, not risky wholesale bets.

The 'Emotional Counterweight'

There is yet another key to good advice. This is where the real value is, although it too is sometimes difficult to see.

The reason most people fail to achieve their investing goals is because they - mistakenly - see investing as a series of transactions. Most of the industry, especially the lawyers and regulators, hold this erroneous view. Most of the industry thinks good investing is buying a 'suitable' investment security with a low transaction commission. They think a low fee is the key to success. They think the advisor's job is to provide 'suitable' recommendations such as a 'medium risk' security for a 'medium risk' client to decide to buy. They see the relationship in terms of principal/agent, like buying real estate: caveat emptor and all that. Even worse, they think an ongoing advisor fee is for service, like answering the phone and sending statements.

Unfortunately, nothing could be further from the truth.

Investing is more like a voyage across an ocean. It is a journey. And not just any journey. It is a one-way trip through hostile territory that none of us have been on before. The more experienced professionals among us may have seen similar territory before, but nobody has ever experienced tomorrow. The neophyte has no hope.

Successful investing is not about buying this or selling that. Yes, fees do add up over time, and a too-high fee does steepen the slope. But people don't fail to reach their goals because of a fee; they fail because they lose half their capital in an ill-advised big mistake from which they can not recover.

From this point of view, successful investing is entirely about how you make the trip. It is much more about behavior: how we respond to the twists and turns over the years.

I have referred many times in these pages to the well-documented fact that most investors underperform even the investments they hold, and by a significant margin. The famous Dalbar study found that 219 growth funds averaged 12.5% per year over 5 years while the average investor in those funds actually lost 2.2% per year[2].

Most people don't just get a low return – they destroy their capital in six-figure chunks by buying something after it has gone up, and selling in panic after a temporary decline. In other words, most people don't earn the 5-year return because they aren't in the boat for the 5 years. Never mind 10 or 20! Or to stick with the aircraft analogy, when the ride gets rough, they jump out of the plane!

Good advice helps the client stand against the natural temptation to do something that seems like a good idea, but will be a 'Big Mistake'. Good advice can be very difficult to deliver, because it involves telling the client what he wants to do is wrong; only the very wise want to hear that.

2 Dalbar, 1994. More recently, John Bogle of Vanguard found that typical investors underperformed their funds by 2.7% per year by switching too much.

From the client's perspective, the value of the advice can be tricky to recognize because 'the big mistake' didn't happen. A mistake you could have made, but didn't, easily disappears from memory. Or may not even be perceived at all. The lady in the airplane story had no idea.

And every client is different. Some clients easily saw the folly of the internet stocks in 1999, so there was little discussion required to avoid them. For other clients the internet stocks were irresistible: the meetings to talk them out of investing in them were - to put it mildly - difficult.

Whether it is wanting to move to a manager whose astronomical returns are unsustainable, going to cash as the Fiscal Cliff approached, buying solar panels, real estate LPs, or most recently, moving to cash in 2009, each of these and countless other examples over my career seemed like good ideas to many people at the time, but led to (in many cases) significant if not total and permanent destruction of the invested capital.

What is the value of avoiding even one - never mind all – of these traps?

I will tell you the value. The answer is easily quantified: at the point of maximum pessimism in the financial crisis the markets were down more than 50%. A person who sold in 2009 to sit in cash therefore triggered a loss of roughly 50%. If they remained frozen in cash – industry data confirms a great many people have – they have not recovered. The value of advice to not sell in 2009 saved investors from a 50% loss: roughly 50 years of 1% fees.

Any advisor that had the courage to tell clients not to 'sell and sit in cash until things settled down' is a heroine that has earned her fees for a lifetime.

The reality is that it is a rare person who doesn't have some episode, some time in their investment life, where they either have an idea of their own, or an idea presented to them, that seems a perfectly reasonable idea - whose fatal flaw is hidden from their view. It is the most difficult, and the most rewarding, part of my job to enable them to avoid the disasters that befall so many of their friends.

Today the newest investment fad is web-based 'advice' delivered of course at a low fee (although not as low as you might think). Called 'robo advisors', they will get you onto the airplane with just a few clicks, and at a low price. Customers might initially feel good about saving money.

Unfortunately, at the critical point in the journey, these 'robo-advisors' will fail to deliver the key advice. At the first serious turbulence, or worse, a bird strike that knocks out both engines, the passengers will line up to jump out of the aircraft. Without parachutes. The robo-crew might send an email that says 'I wouldn't do that if I were you'. But the robo-crew won't block the door with all their might.

No, the key advice cannot be delivered in an email, a chat room, or on some website. The key advice can only be delivered face to face, in the crisis, at the exact point of the decision, and with strength to match the conviction behind the looming error.

This is what I call acting as an 'emotional counterweight'. This is the advice that saves your financial life. This is where the value is.

Not Performance

Does the absence of these bombs, or the wise course corrections, or avoiding the big mistakes, lead to top performance? No. Not necessarily, anyway. Clients know that I never pretend to produce top performance. But a big mistake pretty much precludes good performance.

My value proposition definitely does not include top performance. Performance should be reasonable, yes, but pursuit of high performance always leads to trouble. Often catastrophe. Funny how it works, as I've said many times, but the pursuit of top performance skates you close to greed, and the investment gods are very unkind to greed.

My value proposition definitely does include what Nick Murray calls 'real world' performance. Real world performance is the return you actually experience, after sailing through the storms and panics of the years, compared to so many of your friends and neighbors, who just don't make it.

Career Goal

In addition to real world performance, another personal career goal, and the thing that makes my career so deeply satisfying, is to be able to provide each client the advice - just once - to avoid a Big Mistake.

I call this 'The airline pilot analogy'. Most of the time my job looks easy: the plane can fly itself and you think you don't need me to sit up there being paid to watch the instruments. But - it's the flight with the rough ride, where the landing was an awful thump – maybe in the Hudson River, or maybe you missed your meeting - that is the one flight where the captain used every ounce of skill he possessed to bring it through in one piece. That flight alone earned his lifetime salary. Everything else is free.

Thank you for listening. It is a pleasure to be here.

Postscript on Performance (see following page)

Postscript on Performance

I don't promise high returns, but…

Your advisor is one of the few advisors that have a long term track record verified by an independent consulting firm. A $2 million pension fund has followed my recommendations exclusively for over 15 years now. The portfolio is very similar to many client portfolios, as well as my own (except I have no bonds), so while no two portfolios are exactly alike, the results are quite representative of my thinking over the past 15 years.

Compound Annual returns
December 2014 (%/Yr)

	1 Year	2 Year	3 Year	5 Year	10 Year	Inception (16 Years)
Pension Fund	10.2%	16.1%	13.8%	9.5%	6.2%	6.6%
Balanced Fund Index *	8.5%	10.1%	9.2%	7.1%	4.8%	n/a

* Morningstar Global Balanced Index

It should be patently obvious, but is perceived only by few, that you have to be invested for the 10 years to realize the 10-year return. When the average holding period for an investment fund is now only 2 years, holding an investment for 10 years is extremely rare. The benefit is commensurately great: the difference between the Pension Fund's 6.2% and the typical investor's underperformance (i.e. 2.7%)[3] is more than 3% per year. For 10 years.

What is the value of good advice? Good advice is worth multiples of the fee.

3 The Vanguard Study noted on page 5 found that typical investors underperformed their funds by 2.7% by trading too much

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