Navigating the Perfect Financial Storm

By Shawn Brayman
President, PlanPlus Inc.
A Behavioural Finance Game

• Everyone in the room is going to pick a number between 0 and 100
• We will take the average of what everyone says x two-thirds
• Whoever is closest to the answer wins a bottle of Nova Scotia wine
• Write your number on a piece of paper and hand it in now!
Shawn Brayman

- PlanPlus Founder with 20+ years experience in financial planning sector
- Support financial advisors in 10 countries and 4 languages
- International speaker on financial planning
- Winner of the Financial Frontiers Award 2007 for leading research in Financial Planning, Canadian Investment Awards “Advisor Education Award”.

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Navigating the Perfect Financial Storm

The Storms
• The markets
• The regulators
• The clients

Charting a Course
• Research on investment management
• A course ahead
The Market Storm
<table>
<thead>
<tr>
<th>Period</th>
<th>Downturn</th>
<th>1 Yr</th>
<th>2 Yr</th>
<th>3 Yr</th>
</tr>
</thead>
<tbody>
<tr>
<td>March 2000 to October 2002</td>
<td>-49%</td>
<td>34%</td>
<td>44%</td>
<td>54%</td>
</tr>
<tr>
<td>July 1998 to August 1998</td>
<td>-19%</td>
<td>38%</td>
<td>59%</td>
<td>18%</td>
</tr>
<tr>
<td>July 1990 to October 1990</td>
<td>-20%</td>
<td>29%</td>
<td>36%</td>
<td>56%</td>
</tr>
<tr>
<td>August 1987 to December 1987</td>
<td>-34%</td>
<td>21%</td>
<td>57%</td>
<td>46%</td>
</tr>
<tr>
<td>November 1980 to August 1982</td>
<td>-27%</td>
<td>58%</td>
<td>62%</td>
<td>83%</td>
</tr>
<tr>
<td>September 1976 to March 1978</td>
<td>-19%</td>
<td>13%</td>
<td>25%</td>
<td>49%</td>
</tr>
<tr>
<td>January 1973 to October 1974</td>
<td>-48%</td>
<td>38%</td>
<td>67%</td>
<td>55%</td>
</tr>
</tbody>
</table>
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S&P TSX for Canadian Equity Markets

Loss for Bear: 20%

- Months Down Cycle: 62 (13.2%)
- Months Recovering: 117 (25.0%)
- Months Up Cycle: 289 (61.8%)

Based on month-end data from December 31st, 1969 to Nov 30th, 2008

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Find the Market “Bubble”

Source: RAFI® Efficient Indexing for an Inefficient Market
Where is the “Fundamental” Bubble

Do you believe that Financial Services represent 24% to 30% of our economy?
The Quiet Coup

- From 1973 to 1985, the financial sector never earned more than 16 percent of domestic corporate profits.
- In 1986, that figure reached 19 percent.
- In the 1990s, it oscillated between 21 percent and 30 percent, higher than it had ever been in the postwar period.
- This decade, it reached 41 percent.
- From 1948 to 1982, average compensation in the financial sector ranged between 99 percent and 108 percent of the average for all domestic private industries.
So is this different?

• Was there a “Tech Bubble”?
• Was there a “Real Estate Bubble”?

**We are the bubble!**

This is the beginning of a natural swing by an out of control sector to come back to a rational level in our economic reality.
Banks: Market Cap

- Market Value as of January 20th 2009, $Bn
- Market Value as of Q2 2007, $Bn

J.P. Morgan

While J.P. Morgan considers this information to be reliable, we cannot guarantee its accuracy or completeness.
Deflated but not burst!

• Income from lending remains massive
• Some income based on transactions
• Some income based on AUM management fees
• When markets recover AUM fees and activities will increase.
• Business as usual?

NO!
The Regulator Storm
The Need for Clarity

USA
• “A heightened level of transparency among financial institutions is required”
• “perverse short-term incentives for industry players”
• The compensation structure of financial institutions must change to alter these short-term incentives.

UK
• RDR/CAR – Consumer Agreed Remuneration
• Client must be aware of and agree to any hidden trailers, fees.
• Fees must be clear for admin, fund management, advisor sales

Source: Customer Agreed Remuneration – ABI summary of research
The Need to Place Client First

1. Retail Distribution Review in UK
2. Fiduciary for CFP® in US (July 2008)

The responsibility of a bank, fund company or public FI is to its shareholders – yours is to the client.
A Profession in Transition

Basic Advice  Modular Advice  Financial Planning

Basic Advice  Modular Advice  Financial Planning
The Client Storm
The Client Experience

• A client with a balanced portfolio (10% cash, 30% fixed, 20% Canadian, 20% US and 20% International Equity) realized a 2.47% return from 1999 to 2008.

• Compound MER was about 2.3%

• An equity only portfolio with 1/3 in each of Canadian, US and International had a 0% return 2.69% average MER.

• And few funds achieved index level returns.
Research on Investment Management

- Risk Profile
- Initial Portfolio
- Tactical Allocation
- Rebalance
- Withdrawal Strategies

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Risk Tolerance Questionnaires

*Insights from Psychology and Psychometrics on Measuring Risk Tolerance*

- Most industry questionnaires are portfolio pickers not risk tolerance tests
- As good as “Client is moderate +/- 50%”
- Too few questions
- Many “bad questions”
- Not enough good questions

Findings from Behavioural Finance

• The average in large groups is 22.59 and ranges from 17 to 25 depending on age, time of day etc.

• See “spikes” at:
  - 66
  - 50
  - 33 (First order rational 50% x 2/3)
  - 22 (Second order rational 33% x 2/3)
  - 0 to 3 (Totally rational)

• This distribution is reflected in market behaviour.

Source: Dr. Thorsten Hens, IFPUK 2008 Conference
Our Results Today

Survey Results
What Determines Portfolio Performance?

1. Markowitz – Nobel Prize for MPT.
4. Fama (1965) – nominated for Nobel Prize that you cannot pick stocks or mutual funds (Efficient Market Hypothesis).
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Markets are down so...

- Markets are more positively correlated in down markets
- Need to introduce more alternative investments with lower correlations
- So what? The free lunch is getting harder to find!
- Part of our obsession to feel we add value.
Efficient Frontier to Construct “Optimized” Portfolios

- William Sharpe algorithm
- Locate asset class mix that gives best return for a desired level of risk
Estimation Error

- Different timeframes, different capital market assumptions – what to use?
- Because different choices give different results does this invalidate any single choice?

![25 Year Rolling Portfolio Returns Chart]

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Estimation Error

“The 1/N asset allocation rule typically has a higher out-of-sample Sharpe Ratio, a higher certainty-equivalent value, and a lower turnover than optimal asset allocation policies”

<table>
<thead>
<tr>
<th>Table 1</th>
<th>Very Conservative</th>
<th>Conservative</th>
<th>Moderate</th>
<th>Aggressive</th>
<th>Very Aggressive</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fixed 1</td>
<td>45.0%</td>
<td>35.0%</td>
<td>25.0%</td>
<td>15.0%</td>
<td>5.0%</td>
</tr>
<tr>
<td>Fixed 2</td>
<td>45.0%</td>
<td>35.0%</td>
<td>25.0%</td>
<td>15.0%</td>
<td>5.0%</td>
</tr>
<tr>
<td>Equity 1</td>
<td>2.5%</td>
<td>7.5%</td>
<td>12.5%</td>
<td>17.5%</td>
<td>22.5%</td>
</tr>
<tr>
<td>Equity 2</td>
<td>2.5%</td>
<td>7.5%</td>
<td>12.5%</td>
<td>17.5%</td>
<td>22.5%</td>
</tr>
<tr>
<td>Equity 3</td>
<td>2.5%</td>
<td>7.5%</td>
<td>12.5%</td>
<td>17.5%</td>
<td>22.5%</td>
</tr>
<tr>
<td>Equity 4</td>
<td>2.5%</td>
<td>7.5%</td>
<td>12.5%</td>
<td>17.5%</td>
<td>22.5%</td>
</tr>
</tbody>
</table>

1/N versus Efficient Frontier

Efficient frontier does worse:
• Shorter the series of data,
• Lower the volatility of the individual assets or asset classes,
• The greater the number of asset classes

How much worse does it do?
• If volatility was 20% with 4 asset classes it required 50 years of data for EF to do as well as a 1/N strategy.
• Increase the number of assets from 4 to 100 it would require the estimation window in excess of 1,000 years.
Throw Away Allocation?

- Efficient Frontier is not Asset Allocation
- Believe your own disclaimers, “History is not a guarantee of future performance”
Implementation

- Risk Profile
- Initial Portfolio
- Rebalance
- Tactical Allocation
- Withdrawal Strategies
Active vs. Passive

• Can managers outperform?
• If a few can, can we pick them?
• Study on value added of 1,302 Active Management funds vs. Chance from 1962 to 1995 – 2/3rds under perform
The Cost of Having an Idea

• Terry O’Donnel (student of Daniel Kahneman), studied 100s of thousands of transactions – buy and sell within 48 hours

• Compared the stock they sold to the one the bought for next 12 month performance

• Investor lost an average of 3.5% and paid a 0.5% commission!

• Women were better investors than men – they had fewer ideas.

• Institutional investors picked up the 4% individuals lost
Were Managers Better 5 or 10 years ago?

- **Survivorship bias** in available data
- Poor funds are merged, go bust or drop from the picture
- Data is not easily available to consumers or advisors in Canada that does not include this bias.

Source: Data from Morningstar Dec 2008
S&P/TSX Indices vs. Active Funds Scorecard – Q4 2008

Active managers outperforming index

Source: Standard & Poor's Indices Versus Active Funds Scorecard for Q4 2008
Bear Markets?

• Q3-08 Russell Active Manager report said 65% large cap Canadian Equity managers outperformed for Q3
• S&P/TSX down 18.2%, median active managers down 17.2%
• S&P says…
  ➢ “The notion that active managers outperform in a down market is a myth”
  ➢ During bear market 2000 to 2002 only 38.9% of active managers outperformed the TSX Capped Composite Index
  ➢ Q1 only 8.2% outperformed and 15% in Q2-2008

Advisor.Ca October 29, 2008
Advisor News – August 2008
Rebalance
How Often Should I Rebalance?

- Winner of Financial Frontier Research Award in 2007
- Optimal Rebalancing Strategies for Stock & Bond Portfolios
- Looked exhaustively at data from 1926 to 2005
- Compared:
  - % variance in an asset class (1/2%, 1%, 2% up to 10% in an asset class)
  - 1 month, 3 month, 6 month, 1 Year, 2 Year up to 10 years

2.5 Years optimal
Manager Performance Isn’t Persistent

- How do top quartile managers over 3 years (rolling) performed in subsequent 3 years – data from December 1985 to 2005
- US Equities – 50% below median, 42% above and 8% dropped from database
- Non-US Equities – 45% below median, 47% above and 8% dropped from database

Source: Alliance Bernstein - Australia
Research on Manager Past Performance

- Reviewed 100 studies over 40 years from US, UK and Australia
- Focused on studies with proper methodology
- Many studies that found manager persistence failed to account for survivorship bias.
- Good past performance seems to be, at best, a weak and unreliable predictor of future good performance over the medium to long term.
- About half the studies found no correlation at all between good past and good future performance.
- Where persistence was found, this was more frequently in the shorter-term, (one to two years) than in the longer term and of small magnitude. The cost of swapping would outweigh trying to follow.

Source: Australia Securities and Investments Commission and Funds Management Research Centre – June 2003
Withdrawal Strategies

- Risk Profile
- Initial Portfolio
- Implementation
- Tactical Allocation
- Rebalance
- Review
- Withdrawal Strategies

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The Client Reality

• Fidelity Magellan Fund had 12.5% compound return over 25 years (#1) and the average investor received 2.5%

• Dalbar study 1984 to 2003
  ➢ S&P 500 Index 12.2%
  ➢ Average investor 3#

• Dalbar study 1987 to 2005 (published 2007)
  ➢ Buy and invest starting with $10,000 became $94,555
  ➢ Average investor $10,000 became $21,422
Investors are often tempted to buy high and sell low...
Sustainable Withdrawal Rates

- Cooley 1998 concluded 4% withdrawal had 100% success for any 30 year period from 1926 to 1995
- Michael Kitces, using 60/40 portfolios concluded 4.5% in overvalued markets, 5% in fairly valued and 5.5% in undervalued.
- Guyton & Klinger 2007 concluded if included behavioural flexibility, with 40 year periods, adds between 0.5% to 1.0% per annum to withdrawal rates (ie 5.0% to 6.5% overall)
Our Course from Here

- In an April 27 message to members, FPA and its Financial Planning Coalition partners, CFP Board and NAPFA, outlined a proposal to establish federal oversight of the financial planning profession.
- Become a profession in fact, not just name.
How Planning Affects Confidence in Financial Future

How confident are you in your financial future?

<table>
<thead>
<tr>
<th>Category</th>
<th>Not at all</th>
<th>Somewhat</th>
<th>Fairly</th>
<th>Very</th>
<th>Extremely</th>
</tr>
</thead>
<tbody>
<tr>
<td>Comprehensive Planning</td>
<td>4%</td>
<td>17%</td>
<td>30%</td>
<td>33%</td>
<td>16%</td>
</tr>
<tr>
<td>Advice Supported</td>
<td>9%</td>
<td>25%</td>
<td>36%</td>
<td>21%</td>
<td>9%</td>
</tr>
<tr>
<td>Self Directed</td>
<td>10%</td>
<td>27%</td>
<td>37%</td>
<td>19%</td>
<td>6%</td>
</tr>
</tbody>
</table>

Note: Numbers have been rounded and may not total exactly 100 percent.

Source: Value of Financial Planning Study, FPA & Ameriprise

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Since the market has changed over the past year, what actions, if any, have you taken?

<table>
<thead>
<tr>
<th>Action</th>
<th>Self Directed</th>
<th>Advice Supported</th>
<th>Comprehensive Planning Participant</th>
</tr>
</thead>
<tbody>
<tr>
<td>I stayed the course, continuing to save at the same rate as I did prior to the recent market downturn.</td>
<td>50%</td>
<td>38%</td>
<td>41%</td>
</tr>
<tr>
<td>I have rebalanced my portfolio.</td>
<td>11%</td>
<td>16%</td>
<td>31%</td>
</tr>
<tr>
<td>I added more money into existing accounts.</td>
<td>19%</td>
<td>19%</td>
<td>19%</td>
</tr>
<tr>
<td>I have taken advantage of the low interest rates.</td>
<td>22%</td>
<td>22%</td>
<td>22%</td>
</tr>
<tr>
<td>I have moved into more of a cash position.</td>
<td>20%</td>
<td>14%</td>
<td>14%</td>
</tr>
<tr>
<td>I have taken advantage of the down market by investing in low-priced stocks.</td>
<td>18%</td>
<td>15%</td>
<td>15%</td>
</tr>
<tr>
<td>I added more money into new accounts.</td>
<td>10%</td>
<td>15%</td>
<td>15%</td>
</tr>
<tr>
<td>I have taken advantage of the down market by investing in real estate.</td>
<td>5%</td>
<td>10%</td>
<td>10%</td>
</tr>
<tr>
<td>I have taken more money out of accounts than I have added in.</td>
<td>9%</td>
<td>7%</td>
<td>7%</td>
</tr>
<tr>
<td>None</td>
<td>5%</td>
<td>11%</td>
<td>24%</td>
</tr>
</tbody>
</table>

Source: Value of Financial Planning Study, FPA & Ameriprise
Fees as a Function of Management

If you make the majority of your income from managing money and you do not present this to your client, are you meeting your fiduciary responsibility?
Managing Money Options

• Outsource and hold the manager accountable for the fees.
• Take a passive allocation approach using ETFs and minimize costs for the client.
• If you continue to actively pick funds or switch sectors and charge the client – hold yourself accountable!
Business Options

• The industry moved from transactional to an AUM fee approach.
• If you are an advisor/planner and your value is not managing money – switch to fees for time.
• A great opportunity to approach clients to provide value – not by picking products or sectors but by reducing their costs.
• If they pay 1.5 to 2.0% fees on $500,000 = $10,000. That is a lot of serious planning advice.
References

• RAFI® Efficient Indexing for an Inefficient Market, NAPFA 2008
• Customer Agreed Remuneration – ABI summary of research
• Dr. Thorsten Hens, Behavioural Finance, Netherlands
• DeMiguel, Victor, Lorenzo Garlappi & Raman Uppal May 31, 2005, “How Inefficient is the 1/N Asset-Allocation Strategy”
• Standard & Poor's Indices Versus Active Funds Scorecard for Q4 2008
• “Review on Research of Manager Past Performance”, Australia Securities and Investments Commission and Funds Management Research Centre – June 2003
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Questions...