Future Performance: Issues Facing Advisors in 2014

Everyone involved in the financial industry no doubt holds some version of the following disclaimer not far from their every waking thought: *Past performance is not indicative of future results*. So when the *Advisor* asked a few industry thought leaders, "What do you see as a major issue for financial advisors in 2014?", that disclaimer must have sprung to mind

As advisors who take all prognostication with a grain of salt, you're invited to consider the following "educated guesses" about what issues you're likely to face in the coming year. I invite you to join this dialogue by addressing the topics *you* see as major issues—either by submitting articles of your own or by sending me a note suggesting views on specific topics.

I look forward to your own responses and to a happy and prosperous new year.

—Chris Hale

And now for our own disclaimer: The following are the opinions of those whose names accompany them and do not necessarily represent the views of NAPFA, its employees, its members, or the *Advisor.*

Bob Veres

I could mention the portfolio management challenges if/when we finally experience rising bond rates, or the high probability that the SEC will issue a compromise (watered-down) definition of "fiduciary," but those would be too obvious. Plus, I think another issue is sneaking toward the fore: effective messaging and communicating with clients.

There are two components to this. First, what do you say to clients and the press about standards of care in the profession these days? NAPFA has consistently defined the highest fiduciary standard, but the message in recent years has been watered down by NAPFA's loyalty to its coalition partners who (the FPA) have a lot of members who don't always live up to the suitability standard, or (the CFP Board) who are behaving erratically, alternately trying to out-standard NAPFA and then coddling brokerage firm reps who have been misrepresenting their compensation model for years.

Second, and perhaps more importantly: messaging about the markets, helping clients sail through the next pocket of turbulence—the inevitable pullback on equities (it has to happen sometime), the taper and whatever that does to the bond markets, and (I can't be sure of this) future catastrophes ticking like bombs in the brokerage world's latest round of derivative bets. Managing their portfolios will be easy compared to helping clients maintain a long-term perspective and avoid impulsive, self-destructive behavior. With 2008 still visible in the rear-view mirror, I think clients will be more prone to panic at the next swoop of the roller coaster, and NAPFA members will have to step up the frequency and effectiveness of their communications—even if that's not really what they signed on for.

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Michael Kitces

2013 marked a seminal year in practice management: for the first time, the number of non-owner employee advisors in financial planning firms exceeded the number of owner advisors, according to the 2013 InvestmentNews/Moss Adams Adviser Compensation & Staffing Study. This intersection of the rise of the employee advisor, the declining headcount of advisors in total, and the dearth of new planners entering the profession (relative to the number leaving and the rising demand for employee advisors) means that 2014 may be the year we begin to really notice how hard it is to find young new talent, whether to hire as a "larger" firm or to be your successor as a "smaller" practice. While groups like NAPFA Genesis are working hard to fill the void, there is still much work to be done to refill the pipeline of the next generation of financial planners!

On the other hand, a growing number of established firms are reaching the crossroads of potential succession planning and realizing that, with some leverage of emerging technology, they can run remarkably efficient and profitable "lifestyle" practices for many years to come, to the point where it may be more profitable to simply keep running the practice comfortably for many more years, rather than go through a succession/selling process. Thus, while 2014 may mark the year we really begin to notice the "squeeze" of the young talent shortage, I suspect 2014 will also be the year we begin to really see established advisors step away from succession planning and focus instead on how to run a more efficient, more convenient, "lifestyle" practice where the only focus is not succession planning when they retire but "exit" planning to manage the potential of death or disability.

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Mike Byrnes

Technology. The rate of change is going to start to explode in front of our eyes. Every industry will be impacted. From an advisor perspective, more and more day-to-day tasks will be done by computers, putting added importance on the guidance and the relationship aspects of working with clients.

Communications. Clients will want better access to their financial plans and investments. They will begin to demand real-time updates. Advisors who can leverage mass communications on generic topics and personalize one-on-one details specific to each client will do much better. Things like dynamic websites, video conferencing, and social networks will allow for better client connections.

Pricing. Fees have typically not driven most client decisions, but greater awareness and transparency will start to put more focus on the topic. To gain a competitive advantage, more advisors will begin to come up with new ways to charge for their services, lowering the costs to the end clients. It will not be widespread at first, but downward pressure will start to show its head.

Differentiation. Many firms are good at competing against the commission-based businesses, but they are not so great at explaining why they are better than other advisory practices with similar fee models. Those that will be the most successful will be the ones that can stand out against all types of advisors.

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Joseph Patire and David Summers

For the first time in many years, fixed-income total returns across most investment grade sectors have been negative. While it is entirely possible the Fed will remain accommodative for longer than some think they will (or should), we believe the natural tendency is for interest rates to drift higher in coming years. Even a range-bound to a slightly higher yield environment could spell another disappointing year of fixed-income returns as compared to what investors have perhaps wrongly become accustomed to, presenting a challenge to advisors as they grapple with managing clients' return expectations.

Possibly compounding this, it is well known that bond mutual fund and ETF inflows had been extraordinary in the years following the Great Recession. Some of this has reversed in 2013, and perhaps some of these inflows will remain invested for quite some time, reflecting an aging and more risk-averse population. However, it is likely that an increasing number of investors could become disillusioned with back-to-back years of low (or negative) fixed-income returns and, without the benefit of an advisor, begin to pull money out of these funds and ETFs at a much more rapid pace. This could be very challenging for some fund managers as they attempt to raise capital to meet redemptions, especially in less liquid spaces such as municipal bonds.

This is important because advisors who own these funds as part of an overall asset allocation can be negatively impacted not only by rising interest rates, but also by the actions of other shareholders—as fund managers sell bonds to raise cash into a potentially inhospitable market. One way to sidestep these possible risks is to own a portfolio of individual bonds. While the prices of these securities would certainly move with interest rates, investors could ride through volatile periods and hold the securities to their maturity dates.

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By doing so, advisors could attain their clients' expected returns even in the face of rising rates, and not be negatively impacted by the actions of other investors, as may be the case with a fund or ETF.

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Dan Kern

Advisor Partners recently completed a research study that examined the topic of mutual fund survivorship. We were surprised to discover how many funds fail to stand the test of time, which has implications for financial advisors. Of mutual funds in operation in 1995, less than 40 percent still existed in 2013. The remaining funds were either closed or merged into other funds.

Survivorship matters, as fund closures and fund mergers are rarely positive events for investors. When a fund is closed or merged out of existence, there are very real costs imposed on the fund's investors.

We reviewed historical data to identify patterns among funds that survive, observing certain factors that may be leading indicators.

Size. Larger funds are more likely to stay in business—a simple matter of economics. Funds with less than $100 million of assets have a higher likelihood of being liquidated or merged away.

Performance. Bottom quartile three- and five-year performance combined with sub-optimal asset levels is at least a yellow light that indicates that the fund is at risk.

Star ratings. The star system is in many respects a stronger proxy measure for survivorship than it is for identifying future top performing funds! Four- and five-star funds may not be outperformers, but are likely to be survivors.

In most cases, there is no reason to stick around if a fund is being closed. The fund will incur transaction costs during

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the liquidation process and in many cases will be managed by distracted portfolio managers who are serving as caretakers under the supervision of a team of lawyers. In the event of a fund merger, the decision-making process is different. The key decision involves evaluating whether the merged fund fits your portfolio and is of a quality that you are looking for.

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Dave Wright

Over the past 18 months, the Fed has been very successful in its goals of stimulating the stock market and the housing market, the latter being an important factor in overall economic growth. Despite the Fed's massive and repeated initiatives over the past five years, however, the overall economy has still not achieved a self-sustaining growth path, and it appears that each new Fed initiative has less impact than the prior ones.

As 2013 draws to a close, the recovery cycles in both the economy and the stock market appear very extended, and we expect that 2014 will be a very difficult year for both—and potentially a surprisingly good year in the bond markets.

A weaker economy (and, possibly, a new recession) and a third big cyclical bear market in stocks will present both a challenge and an opportunity for financial advisers. During 2014, your clients will need your objective advice more than ever—and in the area of portfolio management, they will want you to focus more heavily on risk-mitigation than ever before. Fortunately, the mutual fund industry has been coming out with many funds that specifically address the risk-mitigation goal, using a variety of strategies.

It will also be important to help clients understand the revolution in investment theory that is underway—both Robert Shiller and Eugene Fama recently won Nobel Prizes, but as many observers are pointing out, they cannot both be correct! One specific area of challenge will be to help clients overcome decades of bull-market propaganda that has exaggerated the appropriate role of equities in a conservative portfolio.

So keep in touch with your study groups, and read material from thought leaders such as Professor Shiller of Yale, James Montier and Jeremy Grantham of GMO, Mohammed El Erian of PIMCO, Rob Arnott and his team at Research Affiliates, David Rosenberg of Gluskin Sheff, and Lacy Hunt of Hoisington Investment Management.

Best to all our friends at NAPFA for an enjoyable holiday season and a great year ahead!

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Martin A. Stever

In 2014, advisors will be giving their clients more advice than ever about avoiding online flim-flams. The rules for the JOBS act have just been published by the SEC. These rules opened real estate and start-up financing to crowdsourcing. This new avenue for fundraising will lead to more broken hearts and bleeding wallets than it will to successful launches of firms that could not previously find capital.

Kickstarter.com is great, because the buyer gets a product. The result is tangible. The risk is small. Investors who have used Kickstarter to "invest" $75 to help someone, receive a product, and enjoy a happy result in a short time will likely draw upon this experience when faced with potential crowdsourced investments. The Kickstarter experience, however, does not correspond to a crowdsourced start-up or real-estate investment. With Kickstarter, it is easy to understand the result. For example, did the buyer get the promised product in the promised timeframe? If not, a refund is usually available. With a crowdsourced investment, does a negative result mean that things just did not work out, or does it indicate the offering was a scam? There will not be refunds in either case.

When many people put only a few bucks at risk into a new investment, there is no one person with a large enough investment to act as referee or sheriff. With crowdsourced real-estate investing, we have already seen this occur. Investors get so excited about "helping" or "buying local" that they fail to consider whether or not they are making a fair, sound, or wise investment. These new offerings will pull at the imagination, but they will not provide broad representation, and they typically have lousy terms. Most crowd-sourced investing opportunities we have reviewed to date come from inexperienced managers who can write a great web page and take advantage of social media, but who have little real-world experience in practicalities such as sales, HR, compliance, reporting, accounting, and tax. In other words, there are reasons they have not been able to source capital.

Next year, advisors will spend their time advising clients to not confuse buying (a la Kickstarter) with investing.

Martin A. Stever is president of real-estate investing firm Pacific West Land (pacificwestland.com).

Timothy F. McCarthy

When compared to overseas investors, Americans are notoriously underweight [on] international investing. Although the U.S. is a great place to invest, our stock market is now considered by most to be full-priced. However, many of the overseas markets remain unduly underpriced.

Furthermore, many U.S. investors inadvertently overweight the developed countries and virtually ignore the most interesting and safest segment of emerging markets. There is little recognition of the importance of segmenting emerging markets into two categories: those countries that have already emerged and are now in a high growth state, and the more "frontier" or still emerging countries. It is this first category, the "growth countries," where Americans often don't realize the dramatic improvement of these some 20 countries over the past decade—they have more established economic and regulatory infrastructure and often stronger metrics than many of the developed countries: positive trade balances, lower debt to GDP, stronger currencies, and a more favorable demographic.

The particular opportunities lie in the fact that investors have already bid up the American firms that have strong international exposure, yet they have missed all the great companies that simply have the wrong headquarters addresses. And many of the global indices used by index funds and ETFs miss the value.

Even the MSCI All-Country World index weights emerging markets-based companies only about 10 percent of the index, yet more than a third of the revenues worldwide come from emerging markets.

The majority of global growth continues to come from these growth countries, yet their stock prices do not yet reflect this growth.

2014 is the perfect year to convince the most reticent of investors to finally allocate a portion of their core long-term investing portfolio to international opportunities.

Timothy F. McCarthy is a former CEO of Nikko Asset Management and former president of Charles Schwab and the Fidelity Investment Advisor Group.

Richard Sincere

I believe that traditional asset allocation (i.e., 60-40) will continue to be under pressure. If certain asset classes continue to under-perform this year and next (i.e., fixed income and emerging markets), clients will wonder why they weren't under-weighted in these categories. This theme is a reminder of 2007 and 2008. At some point, clients of advisors are going to want their advisors to shift from traditional asset allocation to identifying managers that can outperform in all types of markets while protecting them from the downside.

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Steve Atkinson

In 2014, financial advisors face four years of strong stock market returns, and that means that helping clients keep their emotions in check will be extra challenging. I recently watched a financial services commercial on "Getting Back In," featuring a series of baby boomer couples telling their advisors they were ready to invest in the stock market again. Advisors will need to help their clients stay focused on their long-term objectives, and not get distracted by media noise and what happens on a daily basis with the stock market. With interest rates creeping higher and bringing bonds down as stock markets continue to thrive, investors are confused and may want to change their allocation and invest substantially more in stocks without giving too much thought to their true tolerance for risk. In the end, advisors should do what good advisors always have done: have those important conversations with their clients to keep them from making mistakes, and make sure they are diversified into all major asset classes and thousands of companies across dozens of countries with high-quality, short-term bonds used to control the inevitable ups and downs of the portfolio as a whole.

Diversification neither assures a profit nor guarantees against loss in a declining market. Bonds are subject to market and interest rate risk. Bond values will decline as interest rates rise and issuer's creditworthiness declines, and they are subject to availability and changes in price.

Steve Atkinson, CFS, is an executive vice president in charge of the Advisor Relations Group for Loring Ward.

Stephen Wershing

If your clients weren't happy in 2013, you were doing something wrong.

When the equity markets are up as much as they have been this year, it can cover up a lot of other shortcomings. It is not likely to be so good in 2014. The kinds of services you offer, and how well you do them, will be much more important to retain clients and attract referrals. Beyond investment returns, what makes you indispensable? The most successful advisory firms have an answer to that that has nothing to do with how the markets are doing. "Because of our excellent management, you lost less than the market did" is not exactly the kind of endorsement that thrills clients.

This is a great time to be thinking about organizing a client advisory board. Having a facilitated conversation with your best clients will help you discover or clarify what they most want from you and what they most appreciate about how you do it, what they believe could be improved, and what kind of service you could add to your practice that would create the most value. Take action on that feedback to refine and improve your service, and you will be able to keep them loyal regardless of the markets. Even better, you will give them a reason to talk about you to their friends when the markets go down.

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Michael Winchell

As a former chief risk officer at a large investment bank, my starting point regarding asset selection is usually, "What can go wrong, and how big a problem would it be?" Acknowledging that I am biased by my own career choices, I believe financial advisors need to think more like risk officers than portfolio managers or traders. We think risk management is a three-part process. Part one is to define the risk. Part two is to communicate the risk. Part three is to suggest alternatives or mitigation strategies.

Asset allocation decisions typically balance the two goals of growth and safety, given a wide range of possible outcomes. For the most part, high-grade fixed income has consistently delivered both total return and safety for three decades, and was the go-to asset class to balance an allocation to stocks.

Consequently, the decision to focus on interest rate risk today creates new, additional demands on financial advisers. Products such as target-date funds, Treasury inflation-protected securities (TIPS), real-estate investment trusts (REITs), and a wide array of bond funds (high yield, emerging market, mortgage-backed) are each exposed to increases in interest rates. Determining the risk these assets might now pose to the client's objectives—and whether to continue using these assets in a diversified portfolio—requires time and analytical horsepower.

Part one of the risk management process is deciding whether these assets have too much interest rate risk or offer too low of a return. Part two demands taking the time to have an honest discussion with each client. In a fiduciary relationship, a dialogue about what can go wrong is often uncomfortable, but always necessary. Many advisors don't get to part two, because they don't know what to say regarding the alternatives.

We believe good alternatives to a fixed income allocation should include low correlation with equities, liquidity and transparency, and as much income as possible. This is what high-quality fixed income offered for 30 years, and what investors should desire in an alternative allocation.

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