Advising the Affluent Client: Investment Planning

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Greene Consulting Associates was founded in 1979 and provides consulting and training services solely to the financial services marketplace. Located in Atlanta, Georgia, Greene Consulting has worked with the top providers of investment management and wealth management in both the United States and abroad. Focused on helping firms generate incremental revenue growth through more effective sales and relationship management strategies, Greene Consulting offers customized training programs in Financial Services Sales, a Sales Management program, Presentation Training that integrates proprietary products, and a comprehensive suite of online learning courses related to investments and wealth management.

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Introduction

One of the more important financial issues to affluent clients is their portfolio. Consider this: When was the last time you heard someone discussing their insurance needs with a friend at a weekend cocktail party? However, it's quite probable that you have overheard a casual conversation about how well a certain mutual fund has performed or someone pondering how high shares of Google might go.

Additionally, individuals are bombarded with information about the markets, from a quick blurb in the local newspaper to thirty minutes of Squawk Box on CNBC or even a Suze Orman infomercial. This unprecedented focus on the financial markets has certainly resulted in a more educated client, however. For most of these individuals, the more they learn, the more confused they become as they struggle to address key questions such as:

- Is my portfolio appropriately structured?
- Am I on track to reach my goals?
- What changes should I make?
- What are the best mutual funds for me?
- How do I know when it is time to sell?
- Can I reduce my portfolio risk?

Objectives

Now more than ever, affluent clients are looking for advisors who are able to help them focus on these key issues to effectively structure and manage their portfolio, simplifying what is all too often a complex process. This course will equip you with:

- A practical understanding of key investment planning concepts
- Effective strategies for capitalizing on investment planning opportunities

Two Key Questions

The key to capitalizing on opportunities to help prospects and clients address their investment needs lies in addressing two very practical questions:

- How can I effectively uncover the client's needs?
- How do I convert those needs into a sales opportunity?

The first question is resolved by properly ***profiling*** the client or prospect; the second is resolved by engendering a sense of ***urgency***.

Although the methods for answering these questions are simple in theory, the fact is that ***very few Advisors are truly effective in profiling and creating a sense of urgency***. Therefore, before we begin exploring the types of investment needs you will encounter, the next few pages will focus exclusively on giving you practical, real world strategies and tactics that will better enable you to execute these tasks. Utilizing these strategies and tactics will significantly enhance your effectiveness in engaging clients in investment planning conversations and resolving their needs.

Keys to Effective Profiling

The ***profiling process*** is the method by which you will identify potential needs and establish the framework for applying your expertise in formulating potential solutions. Despite its importance, all too often the profiling process degenerates into a long and arduous series of interviews that bring no tangible, recognized value to the client. The result is a client who is frustrated by the process and who ultimately never acts on the opportunity.

Overview	To increase your effectiveness in the profiling process, follow these four simple rules. **Click each rule to learn more.**
1. **Understand the Emotional Issues**	As the old adage goes, "People buy on emotion and justify with facts." Take great care in the profiling process to understand both the Facts AND the Emotions involved. A clinical survey of the facts will often lead to identified needs; however, the facts alone will rarely be sufficient for building a relationship.
2. **Remember that Details are Important**	One of the most common mistakes Advisors make in the profiling process is failing to get the details. Everyone asks the basic questions, such as: "What are your goals?" and "How is your portfolio currently structured?" This information is important; however, such high-level information will rarely identify any significant opportunities, as shown in the following example: **Advisor:** "What are your investment objectives?" **Client:** "Well, my wife and I would like to retire in fifteen years and also pay for our children's college expenses, which begin in about eight years. If we can accomplish these goals, we will be happy." **Advisor:** "How is your current portfolio structured?" **Client:** "Currently, we have about $1.5 million in investable assets. About 60% is in equities, 35% in fixed income, and 5% in cash." **Advisor:** "What securities/funds do you own in these accounts?" **Client:** "Nothing too unusual. Mainly, they consist of funds, with the exception of a few individual stocks and about $300,000 in municipal bonds." Based on the information provided in the case study, what opportunities do you see? ▪ Inappropriate asset allocation? ▪ Lack of diversification? ▪ Tax-inefficient investment approach? ▪ Lack of a disciplined process? **Click here for additional feedback.** Based on the information that has been provided at this point, no real opportunity is apparent:

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	▪ The structure of the portfolio is arguably appropriate, given their goals. ▪ The fact that they primarily own mutual funds and municipal bonds is hard to argue with. The failure to identify opportunities stems from the failure of the Advisor to gain sufficient specificity. For example, the Advisor DID ask, "What securities/funds do you own?" The client, however, did not fully answer the question, simply replying "some funds, a few individual stocks and some municipal bonds." To fully understand the client's situation and diagnose potential needs, the advisor **MUST** understand which ***specific*** securities the client owns, how much of each, and the date on which the assets were purchased. Only by getting this level of detailed information will the advisor be able to analyze the portfolio, thereby determining its exact asset allocation, sector diversification, unrealized gains/losses, and tax situation. Thus, advisors must be careful to interpret the answers to their questions to ensure they get the full amount of information required to provide sound advice. Failing to get this level of specific detail will result in lost opportunities.
3. **Be Focused**	Remember that first impressions have lasting impact. From the moment you begin to engage the client, you are being judged. Being well prepared with targeted questions, focused on key issues, will immediately demonstrate your expertise and help you build credibility and trust. This doesn't mean you have to be overly prepared with hundreds of questions to cover any potential issue. Focus first on those issues that will quickly give you the best understanding of the prospect's situation. The following pages will provide specific insights on how to conduct more focused profiling.
4. **Ask Yourself, "Who Wants the Next Meeting More?"**	Don't fall prey to the notion that it will take three or four meetings to develop an understanding of your prospect/client's needs. This approach is analogous to a doctor telling you it will take three or four normal physicals before he can tell you if you are healthy or not. The most successful Advisors are constantly seeking to understand more about their clients/prospects in fewer meetings. They accomplish this not by rushing through the process, but by being well prepared with specific and targeted questions -- ones that provide them with the key information they need to begin applying their insights and expertise to add value. One way to measure your success in having effective meetings that expeditiously move you forward in resolving client needs is to ask yourself at the end of each meeting, "Who needs the next meeting more?" If the answer is YOU, because you need yet another meeting to gather information, then it's time to regroup, define the information you need and craft the *specific* questions

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	you will ask in your next meeting. If, on the other hand, the answer is the CLIENT or PROSPECT, then you have successfully reached the point where you have the information you need and you have positioned your client/prospect to anticipate the value you will add in the next meeting.

Identifying Investment Planning Needs: *The GAP Profiling Process*

The GAP Profiling Process is an excellent means of maintaining focus in profiling. This is a process of organizing your profiling questions so that they focus on three key areas:

GOALS - Defining what the individual is seeking to accomplish
ADVISORS - Providing valuable insight into the individual's current investment relationships
PORTFOLIO STRUCTURE - Defining how their portfolio is currently structured

Focusing your questions on these three areas will provide you with the information required to conduct an analysis of someone's current situation and diagnose potential investment planning needs.

To enhance your ability to effectively diagnose the common investment planning needs of high net worth clients, we have developed 15 key GAP profiling questions you should ask to uncover common investment planning needs. Review these questions and develop a working list of those questions that you will commit to consistently use with your prospects/clients as a means of obtaining a complete understanding of their investment planning needs.

Click the icon to view and print the profiling questions.

15 Key Profiling Questions to Uncover Common Investment Planning Needs	
Goals	• What are you seeking to accomplish through your portfolio? • What liquidity needs do you anticipate over the next five years? • What income, if any, do you need to generate with this portfolio? • What is your tolerance for risk/volatility? • What is the time horizon for reaching each of your specific goals? • What benchmarks do you use to measure your progress toward your goals and objectives? • What are your most significant current concerns about your financial situation?
Advisors	• With what firms do you currently have investment accounts? • Who do you rely on for investment advice? • What do you value in your current investment relationships? • What specific changes would you make to this relationship?
Portfolio Structure	• What is the total value of your investment portfolio(s)? • How is your portfolio currently structured (equities / fixed income / cash / alternative investments)? • What specific securities do you currently own? • When did you purchase these securities? (Knowing the date of purchase for each security will enable you to calculate current profit/losses and tax basis)

If the profiling process was as simple as listing a series of effective questions, everyone would already be doing it well. The key to success is personally integrating these questions into your own approach. No one else can do that for you. So, take a few minutes to type in the most important questions you feel you should consistently ask your clients/prospects to uncover investment planning needs.

Click here to open the form where you will type and print your questions.

15 Key Profiling Questions to Uncover Common Investment Planning Needs	
Goals	1. 2. 3. 4. 5.
Advisors	6. 7. 8. 9. 10.
Portfolio Structure	11. 12. 13. 14. 15.

Capitalizing on Opportunities

Once a client's need is uncovered through profiling, that need must then be turned into a sales opportunity. All too often advisors attempt to accomplish this by diagnosing a need and immediately telling the prospect how to solve it. In other words, they make the mistake of trying to sell the facts on the assumption that the mere offering of their diagnosis and solution will be sufficient to motivate the client to action. This seldom works because ***individuals typically buy what they want, not necessarily what they need.***

Click the icon to view an example.

Purchasing a Car

If the decision of which car to purchase was influenced solely by facts, we would all simply input our specifications into a worksheet and - voila - the most appropriate make and model for you would appear. But we all know the process is much different. In fact, many decide what car they want based upon issues such as appeal of the style, how they feel sitting behind the wheel, or how they feel the car reflects their own personality or sense of status. Then, after deciding what they want, they mentally justify their decision with facts such as "it's a good value" or "it scored well in Consumer Reports."

To get the client or prospect to ***want*** the solution, the advisor must first engender an emotional response that leads people to be unwilling to accept their current situation. This is because ***people typically buy on emotion, and justify with facts.***

Don't misunderstand this. We're not suggesting that advisors should manipulate emotions. However, we ARE saying that advisors will not bridge the gap between a need and a want until the client or prospect experiences the need on an emotional level. Individuals will not truly want a solution with any degree of urgency until they become concerned and discomforted by the presence of their need.

The best path to engendering this emotional response is by asking another type of question, which we call ***doubt-raising questions***. Such questions help clients recognize their needs AND foster a sense of urgency within the client to address the need.

Click the icon to view an example.

Creating a Sense of Urgency

Good doubt-raising questions create a sense of urgency that can never be achieved by simply telling a client of a need. To illustrate, consider the following scenario:

You are walking down the street and see that a piano is about to fall on a bystander. If you tell the person, "You need to move," the person is not going to be very motivated to do so because he or she has no idea WHY there is a need to move. However, if instead you say, "How are you going to avoid being crushed by that piano dangling over your head?" you probably should step to the side because the person will be quite motivated to move!

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As you begin mastering the skill of asking doubt-raising questions, evaluate your questions relative to the simple criteria listed below.

Click the criteria to learn more.

How…?
Questions that begin with the word "How" are, by their nature, process-oriented. They make the client think through the process of resolving the situation you propose. (Note: This does not mean that every doubt-raising question must begin with "How", but this is a good general rule of thumb, especially as you begin building expertise in asking these types of questions.) For example: "How have you made the determination that you would prefer to pay more taxes at death than reduce them through lifetime gifts?" "How have you made the determination that this is the best strategy for saving for college expenses?"
Focus on Consequences
A good doubt-raising question causes a client or prospect to confront the consequences of continuing with the current strategy (or lack thereof). For example: "How does your current plan provide for the support of you and your family if you should become incapacitated?" "How have you determined that appointing your sister rather than one of your brothers as your executor will not strain family ties?"
Non-Confrontational
Be careful to avoid embarrassing or confronting your clients when asking a question. One way to do this is by asking your question in a manner that presumes they have good reasons for the decisions they have made. When they don't have a good reason, they will generally have no problem responding with, "Well, I really hadn't thought about that" and they will not feel demeaned by having you point out their failings to them. For example, don't ask: "Why did you buy taxable bonds when you could clearly have increased your after-tax income by purchasing municipals?" Instead, ask the question in this manner: "How have you structured your bond portfolio to optimize your after-tax return?" The first question is confrontational. While the second question may surface the fact that the client or the client's current advisor did NOT take after-tax return into consideration, it is clearly non-confrontational and more likely to solicit an inquiry as to what you might suggest.
Focus on the Advisor
If a prospect is currently working with another advisor, frame the question to focus on the advisor instead of on the individual. For example, "How has your advisor structured your portfolio to meet your objectives?" This will avoid the risk of embarrassing the prospect, while

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fostering doubt in the prospect's mind regarding the performance of the other advisor. It will also position the client to be curious as to how your approach might be different.

Know How You Would Answer

There is an old adage that an attorney should never ask a question of someone on the witness stand without first knowing the answer. This is also true for financial advisors. Whenever you ask a doubt-raising question, be prepared for the client to ask how **you** would answer the question you just asked. For example, if you ask "How has your advisor structured your portfolio to meet your objectives," be prepared to explain how **you** would go about structuring the portfolio. In short, be prepared to present your solutions once the client is ready to hear it.

Applying any type of rigid formula to the sales process is misguided. However, using the above rules as reference tools can ensure that you master the art of asking effective doubt-raising questions.

The Marshalls- A Typical Affluent Family

The purpose of this course is to examine key investment principles from a practical perspective, avoiding the typical dry textbook analysis. Understanding this perspective, consider the situation of the Marshall family, a typical affluent client.

The Marshalls

Stan and Robin Marshall are in their early 40s with two children. Stan is employed at a Fortune 1000 company and participates in the company's 401(k) plan. His retirement account value totals $138,000, which is spread among numerous mutual funds and his company's stock. He and Robin have each also accumulated savings and other investments as follows:

	Basis	Current Value
Brokerage Account		
Money Market Fund	$ 23,235	$ 25,598
Applied Materials	$ 24,100	$ 17,890
Oracle	$ 32,423	$ 33,887
Sun Microsystems	$ 11,923	$ 9,546
GE	$ 42,498	$ 44,650
Home Depot	$ 20,000	$ 32,890
Coca Cola	$ 18,769	$ 19,247
Transwitch	$ 31,054	$ 4,224
Diversified SMA Program (growth allocation)	$ 25,000	$ 56,629
Mutual Fund Account		
Fidelity ContraFund	$ 10,000	$ 17,294
Fidelity Magellan	$ 25,000	$ 32,483
T. Rowe Price Bond Fund	$ 15,000	$ 18,082
Ameritrade Online Brokerage Account		
Janus Growth Fund	$ 12,500	$ 14,549
Microsoft	$ 7,428	$ 9,709
Google	$ 10,829	$ 8,102
Totals	**$309,759**	**$344,780**

In reality, this is very typical of the type of client you will likely encounter. They have assets and are investing them as is shown by the accounts listed. Each individual investment can be considered legitimate in its own right and, therefore, might be hard to disagree with as an individual purchase. But the critical questions to be answered are:

- "Will this combination of investments lead to achieving the client's objectives?"
- "Is there an effective overall plan and process guiding the construction and management of this portfolio?"

On the pages that follow, we will refer to the Marshall's situation to illustrate how the issues addressed in the course can be applied in a practical manner to engage your clients in a more effective investment planning conversation.

Focusing on Common Investment Planning Needs

As the case of the Marshall family clearly illustrates, the range of potential investment planning needs you will encounter are countless. However, research shows that a relatively limited set of problems encompass the majority of the common investment planning issues you will encounter. Therefore, we will limit our focus to the most common investment planning mistakes affluent clients typically make. This approach will enable you to focus your attention on those issues with the greatest potential for offering investment advice - issues that you will see day-in and day-out.

6 Common Investment Needs

The following are the six (6) most common investment planning needs you will encounter when working with affluent clients:

1. Lack of clear investment objectives
2. Improperly structured portfolio
3. Lack of a disciplined investment process
4. Inappropriate diversification
5. Failing to maximize after-tax returns
6. Failure to effectively analyze performance

Issue #1: Lack of Clear Investment Objectives

One of the most common problems you will encounter when examining an individual's portfolio is a lack of clearly defined investment objectives. In fact, most individuals will spend more time this year planning for their next vacation than they will spend developing a plan for how their portfolio will be managed. Intuitively, individuals know they should develop such a plan and review it regularly, but most fail to act. Most often, they simply have a general idea of why they are investing (such as for retirement or their children's education) but fail to map out a clear plan that includes:

- Quantified return objectives
- Specific time horizon for achieving each key objective
- Clear risk tolerance
- Well-defined guidelines for portfolio asset allocation
- Parameters for rebalancing the portfolio

Unfortunately, studies indicate that over 75% of all high net worth investors have either an outdated investment plan or, worse, no written plan at all. Most often you encounter individuals with 2 to 4 investment "relationships", none of which are coordinated with the others, resulting in a disjointed portfolio with no clear objectives or purpose. The result is the equivalent of a ship without a rudder to steer it or a chart to map its course.

Recognizing the importance of having a well-defined plan and clear investment objectives, the pages that follow provide a framework for establishing an effective investment plan for clients.

Step One: Understand the Client's Objectives

Whether it is providing for college education expenses for their children, saving for a vacation home, or saving for their retirement, the foundation of a good investment plan and asset allocation strategy is specific quantification of the required dollars needed to meet the client's specific objectives and a time horizon for when the assets need to be available. Without this specific information, neither you nor the client can establish a truly rational investment plan.

Your role in helping quantify the investment objective is to determine the specific amount required to fund the client's objectives and to identify the number of years available to reach them. Following are two simple questions you should consistently ask your clients to begin this dialogue.

- **Objective/s -** What are your **specific** goals for these assets (retirement savings, college education, *etc*…)?

- **Time Horizon -** When will you need to spend the money to meet these obligations?

Important Note

These two basic questions are intuitive to many advisors and, therefore, tend to be posed to clients in a manner not too dissimilar from a doctor going through a litany of questions at the beginning of your annual check-up –"Have you experienced any headaches? Shortness of breath? Dizziness?

Take care not to be clinical in the way you ask these basic but enormously important questions. And more importantly, listen to your client respond to these questions. Make sure you have a true understanding of both the financial goals and the emotions associated with them.

By working with the client to understand the specific liabilities the portfolio is designed to address, you as the advisor can begin the process of structuring a portfolio with the highest probability of achieving these objectives.

Contrast this approach with one used by many advisors in the marketplace which begins by seeking to understand the individual's "risk tolerance." While understanding the client's risk tolerance is critically important, starting the conversation around "how much of this money are you comfortable losing" is not a very compelling dialogue. By first understanding the objectives of the money, you will gain insights that will help you structure the portfolio while also learning more about what is really important to your client, both financially and emotionally.

Step Two: Identify Available Assets

The second step of the process is defining what assets the client has to offset these future liabilities. Once again, consistently asking simple questions are all an advisor needs to get this important information.

- **Current Assets**
  - What specific assets do you have to meet these goals?

- **Portfolio Structure**
  - How are these assets managed currently?
  - What specific securities do you own in each account?

- **Additions to the Portfolio**
  - On average, how much will you add your portfolio/s each year?

While these questions are enormously straightforward, the key to success lies in execution. Most often, advisors ask these (or similar) questions yet fail to get the detailed level of information they need. Consider the dialogue in the following example.

Click the icon to view an example.

Advisor: "What specific assets do you have to meet these goals?"

Client: "I have about $150,000 set aside currently."

Advisor: "Great. How are these assets managed currently?"

Client: "Over the years I have really managed my accounts myself."

Advisor: "Well, you have done a commendable job, but with the assets you have amassed, I feel we can add a great deal of value in working with you to structure a more effective portfolio focused on your specific needs. How much do you anticipate you will add to this portfolio each year?"

Client: "I don't know. It will probably vary from year to year but I would guess about $25,000 a year."

This common exchange may seem effective at first blush, but consider the following questions:
- Are you absolutely sure the client has no other assets other than the $150,000 he discussed?
- How many current investment relationships does he have?
- Who does he rely on for investment advice?
- What specific securities does he own?

Most often, clients will not give you all of the information you are seeking to obtain from any one question. Take care to ensure that you get the specific information and detail you need before moving on in the conversation.

Click the icon to view an example of the required information.

Specific Holdings

- “What specific securities do you own?”

Cost Basis

- “What is your cost basis?”, or
- “When did you purchase these securities?”

Current Advisor

- “Who do you rely on for investment advice?”
- “What do you value in this relationship?”
- “How do you feel they could serve your needs more effectively?”

Step Three: Define the Client's Risk Profile

The final step of the process is defining the client's risk profile. Most affluent individuals define risk as the amount of money that can be lost in an investment. However, that simplistic definition for risk is far too narrow and can lead to significant miscalculations in an investment plan.

Let's examine the major types of risk, providing the framework for effectively addressing risk management in a more meaningful way.

Click each type of risk to learn more.

Inflation Risk

Because the price of goods and services in the economy continue to rise, there is a constant erosion of purchasing power for each investor's assets. If a person fails to achieve a rate of return on capital that exceeds inflation, then the person is, in fact, losing purchasing power and lowering his or her net worth. Inflation risk is defined as the exposure to loss in purchasing power because of inflation.

Market Risk

This is the most commonly used definition of investment risk. Most would classify this risk as the volatility in principal value of an investment over a certain period of time. Market risk also covers the potential risk of losing value in an investment because of depreciation in price.

Outcome Risk

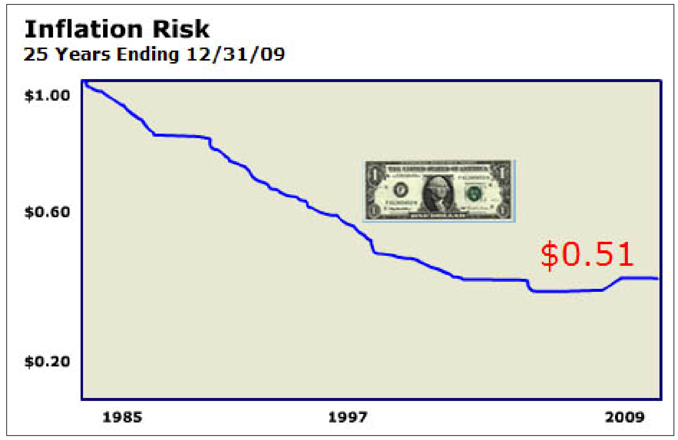
This is the most often overlooked risk, yet should be the most important when developing an investment plan. Outcome risk is defined as the risk of not achieving the desired quantitative outcome of the plan and thereby falling short of meeting a need or reaching an objective.

Most investors understand inflation and the diminishing effect it has on investment returns. Likewise, most investors understand market risk or volatility and its effect on security price. To avoid market risk, investors often choose investments they believe to be "safer and more stable," such as money market securities and short-term bonds. But these "conservative" instruments historically have not produced the return needed to meet typical investment goals, like saving for retirement. Therefore, the investor, by seeking to avoid volatility or shorter-term market risk, is taking on another type of risk that often is not realized until time passes. This risk, "outcome risk," is the risk that the results of investing will be inadequate to meet long-term goals. An effective question that will help you gauge your client's risk tolerance while also helping you understand the type of risk most important to manage for that client is:

> What is more important to you, limiting (or eliminating) potential ups and downs in your portfolio over any given year or the risk of not reaching your defined objectives (retire by the age of 65, etc.)?

We will examine each of these three types of risk in greater detail on the pages that follow.

Communicating the Impact of Inflation Risk



To fully comprehend inflation risk, it is necessary to understand what inflation is and how it affects the purchasing power of money. Inflation is the rate at which the price of goods and services increases, thereby reducing the buying power of money.

In an inflationary environment, investing is like walking up an escalator that's going down. Climbing (or investing) increases the amount of money one can have, while inflation constantly reduces the value or the purchasing power of that money.

Investors often fail to recognize the risk associated with inflation. Two paths that make them victims of inflation are:

- **Do nothing** - This effectively allows inflation to nibble away at the purchasing power of their money. While they might not experience "losses" in the dollar value of their investments, they will have reduction in the purchasing power of their money. (Keep in mind what your grandfather said to you regarding what a movie and bag of popcorn used to cost in his day.)

- **Invest too conservatively** - Again, while conservative investing can be appropriate, one needs to make sure to understand the implications. If returns on investment are not substantial, inflation and capital gains taxes can consume much, if not all, of their purchasing power.

The graphic illustrates the magnitude of inflation risk.

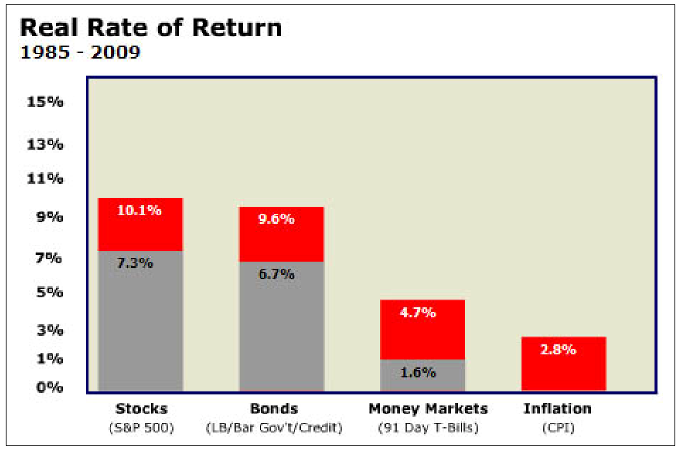
For the last 25 years ending in December 2009, the purchasing power of one dollar has declined to just fifty-one cents. Therefore, the total return of an investment only tells part of the story; it must be measured relative to the inflation that occurred during that period of time, if the true performance is to be observed.

Inflation Risk and Real Rates of Return

Adjusting return for the impact of inflation is known as deriving the **real rate of return**. This is calculated as follows:

Real Return = Total Return - Inflation

In other words, real return takes into account the deflated growth of an investment.



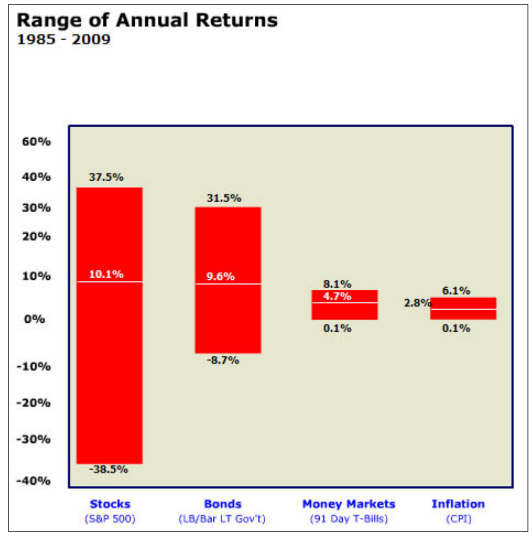
The graphic shows the annualized **"nominal"** (before adjustment for inflation) rate of return for stocks, bonds, money market securities, and inflation for the last 25 years. It shows that stocks grew at a compound rate of 10.1%, bonds grew at a rate of 9.6%, and money market securities at 4.7%. But the **"real"** picture, after adjusting for inflation, is quite different.

When the eroding effect of inflation is taken into account, the real return for each asset class was reduced to 7.3%, 6.7% and 1.6% respectively. These did not reduce exactly by 2.8% due to the effect of compounding.

Communicating the Impact of Market Risk

Almost every investor will understand Market Risk and will define it as the "chance that I will lose money." We will refer to this "volatility" risk as market risk for the purposes of this course. While inflation can deflate the value of the dollar substantially, market risk, or the fluctuating rates of return, will also affect investment returns.

As shown in the chart below, Market Risk can be observed by considering the fluctuating annual rates of return for stocks, bonds, and money market securities that occurred during the past 25 years. The chart shows the maximum and minimum returns that were realized in any single calendar year, as well as the average annual return for the entire 25 years. Clearly, the potential risk associated with any given year is substantial. But the Market Risk is not the same for all asset classes.



Click each bar graph title for an explanation of the returns of each Asset Class.

Stocks (S&P 500)

The maximum one-year return produced by stocks, as measured by S&P 500 during the 25-year period, was 37.5%, occurring in 1995. The worst one-year rate of return for the same period was in 2008 when stocks lost 38.5% of their value. The annualized rate of return for the same period was 10.1%.

Bonds (LB/Bar LT Govt.)

*Bonds, for the same 25-year period of time, had a maximum one-year total rate of return of 31.5%, occurring in 1985. The worst one-year total rate of return for bonds was –8.7%, occurring in 1999. The annualized rate of return for the 25-year period of time for bonds was 9.6%.

*Because of the dissolution of Lehman Brothers in 2008, the bonds measurement is a combination of both the Lehman Brothers Long-term Government/Credit Bond Index and the Barclays US Long Government/Credit Index.

Money Market (91-Day T-Bills)

Money market instruments, as measured by 91-day T-Bills, produced a maximum rate of return for any one-year period during this 25-year period of 8.1%. This occurred in 1989. The minimum rate of return was 0.1%, occurring in 2009. The annualized rate of return was 4.7%.

Inflation (CPI)

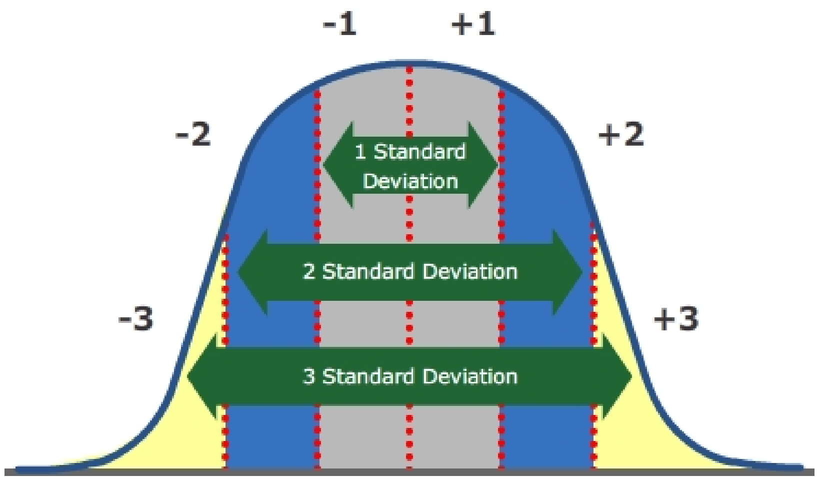
Inflation over the same period had a range from 0.1% in 2008 to a maximum of 6.1% in 1990 with an annualized inflation rate of 2.8% for this 25-year period.

Quantifying Market Risk

In quantifying Market Risk, we begin to make a transition from the basics that nearly everyone understands to the more intricate aspects of asset allocation theory and its application in today's environment. The common way to measure market risk is through an examination of the dispersion of returns over a given time period. This can be measured in ***standard deviations***, which is a statistical measure for quantifying the dispersion of returns around the mean (average). The greater the standard deviation, the more volatile the asset is and the greater its risk.

To understand standard deviation and its application in the measurement of market risk, look at the following chart. It represents what is referred to as a normal distribution of events. When a series of events follow a normal distribution, we can begin to predict the future events within a given probability.

Click each of the arrows to learn more.



Gray
Approximately 68% of all events will fall within (+/-) one standard deviation from the Mean.

Blue and Gray Sections Combined
Approximately 95% of all events will fall within (+/-) two standard deviations from the Mean.

Yellow, Blue, and Gray Sections and Combined
Approximately 99% of all events will fall within (+/-) three standard deviations from the Mean.

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Outcome Risk

The third type of risk, Outcome Risk, is the risk that is most often overlooked by investors, but it is probably the most important risk for investors to consider.

Outcome Risk is the risk that the final outcome of the investment plan will fail to meet an obligation or to achieve a desired result over a specified time. If the expected return of a portfolio is below the desired outcome, then the shortfall is a measure of the outcome risk. For example, if the expected return of an investment for a child's education fails to provide enough money when it is needed, then the portfolio has significant outcome risk.

Investors normally tend to focus on short-term risk or market risk and often overlook Outcome Risk. However, Outcome Risk must always be kept in mind because it is the driver for taking risk in the first place. Rationally speaking, individuals are risk-averse and, therefore, would choose not to take on market risk unless that risk was less desirable than the risk of not reaching their goals. Understanding the importance of helping clients more concretely define their tolerance for risk in each of these three key areas, let's look at how sophisticated risk modeling can help you define and manage a client's investment plan more effectively.

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The Typical Investor Situation

Most often clients come to you with an array of current investments, seeking your guidance on how to build a more effective or efficient alternative. While this may sound simplistic, it can be very complicated in actual practice due to some of the limitations of traditional asset allocation modeling. Consider the following issues:

Click each issue to learn more.

Issue #1

For traditional asset allocation models to give correct results requires that all the inputs are correct, meaning the expected returns, correlations and standard deviations are right for each asset class. If any one input is invalid, then the entire model falls apart.

Here is a recent example:

Suppose you were developing an investment plan in December 1999 designed to meet the long-term retirement needs for a client. When projecting the future returns required to develop a traditional asset allocation model, you would logically use the historical results of the previous few years. Using these return patterns would result in overstated expected returns and understated volatility (in light of what we know today regarding the post-1999 market). While you intuitively knew the market could not continue to provide the amazing returns of 1998-99 forever, you had to use the averages for your calculations. The skewing of the data would lead to improper planning and asset allocation, evidence of the fact that simplistic, traditional asset allocation modeling alone will not provide an effective answer for clients.

Issue #2

Traditional modeling analyzes a client's situation based on a given average rate of return over a given time period – such as the client's life expectancy. The problem is that while the average return will most likely be accurate over the long term, the actual timing of the returns year to year can have a significant impact on achieving goals. This is illustrated in the following example:

Suppose two investors each place $100,000 with an investment manager, to be invested for 3 years. Both have a goal of achieving an average annual return of at least 10%. Also, they are both conservative investors and cannot tolerate any year having a loss of more than 10%. The following are the results they achieve:

	Annual Returns		
	1st Year	2nd Year	3rd Year
Investor 1	9.1%	(6.4%)	27.3%
Investor 2	(20%)	25%	30%

If we simply look at averages, both investors achieved their goal of an average annual return of at least 10%. In fact, both portfolios would have approximately the same value at the end of three years.

But clearly, Investor 2 did not achieve his goal of avoiding annual losses greater than 10%. In real life, given Investor 2's risk tolerance, it is likely that the investment manager would never have had the opportunity to manage the money in the second and third year. Clearly, just looking at the averages is not enough.

Both of these examples illustrate that modeling solely on the basis of averages provides an incomplete solution. Yet that is exactly what many traditional asset allocation models do.

Clearly, more sophisticated investment planning requires a more dynamic approach than can be achieved in such static models. Such an approach is provided by ***Monte Carlo Sensitivity Analysis***. Monte Carlo Sensitivity Analysis enables advisors to run literally thousands of scenarios to define the probability of any particular strategy falling short of the desired result based on the anomalies outlined above.

Monte Carlo Sensitivity Analysis

While a plan may appear perfectly solid when looking at the averages, many things can go wrong in the real world that might cause the plan to fail. For example, investment returns might be lower than expected, or the timing of an investment may be wrong, or death may occur sooner (or later) than planned. To have confidence in a plan, it is important to test it against various possibilities to establish an acceptable level of confidence that unexpected events will not result in the failure of the plan.

Monte Carlo Sensitivity Analysis makes this possible. Grounded in gaming theory, where expected outcomes are modeled multiple times to establish probabilities of a single occurrence, ***Monte Carlo Sensitivity Analysis is a powerful tool available in many portfolio optimization software packages. Monte Carlo Analysis allows you to perform risk/probability simulations over multiple scenarios to determine a "success rate" for a given plan***. Monte Carlo Sensitivity Analysis also makes use of some of the same primary inputs as Mean Variance Optimization: expected returns, standard deviation of returns and correlations. However, it uses them in a more sophisticated manner.

Click the icon to view the overview of how the analysis works.

First, the software randomly generates numbers for uncertain variables such as interest rates, investment volatility, and life expectancy. By running hundreds, sometimes thousands of scenarios using randomized data points for annual return that fit within the historical range of expectations, Monte Carlo Sensitivity Analysis allows you to test the estimated success of the current plan data under different scenarios.

This allows you to answer such questions as: “What is the potential likelihood that I will outlive my portfolio?” or “Can I count on having enough money to fund my education needs?”

This testing will provide you with a more realistic perspective on the viability of a plan achieving the desired goals in a dynamic environment where market returns cannot be predicted, either year to year or over intermediate periods of time.

Communicating Benefits of Monte Carlo Sensitivity Analysis

While Monte Carlo Sensitivity Analysis is a powerful planning tool with many benefits, its complexity can make it overwhelming to communicate to a client. Instead of attempting to detail the framework and details of Monte Carlo, it might be easier to communicate solely the benefits of this approach versus traditional MVO models.

Click each benefit to learn more.

Realism

Most plans simply look at the averages and presume that the plan will achieve results similar to the averages found in past history. But in the real world, performance over the short-term is often very different than the average long-term performance.

By modeling a plan under more realistic market-like circumstances where returns and other factors can vary significantly from year to year, Monte Carlo Sensitivity Analysis produces a more realistic picture of what can be expected.

Flexibility

Monte Carlo Sensitivity Analysis makes it possible to identify and quickly model alternative solutions to a plan and to test the probability of success for each alternative.

Predictability

While no statistical modeling can be 100% accurate, Monte Carlo simulations do provide an added layer of accuracy to a plan's potential viability.

Comprehensiveness

You can more accurately account for the variability of cash flows that are intrinsic to real life situations and also account for various tax implications throughout each plan year.

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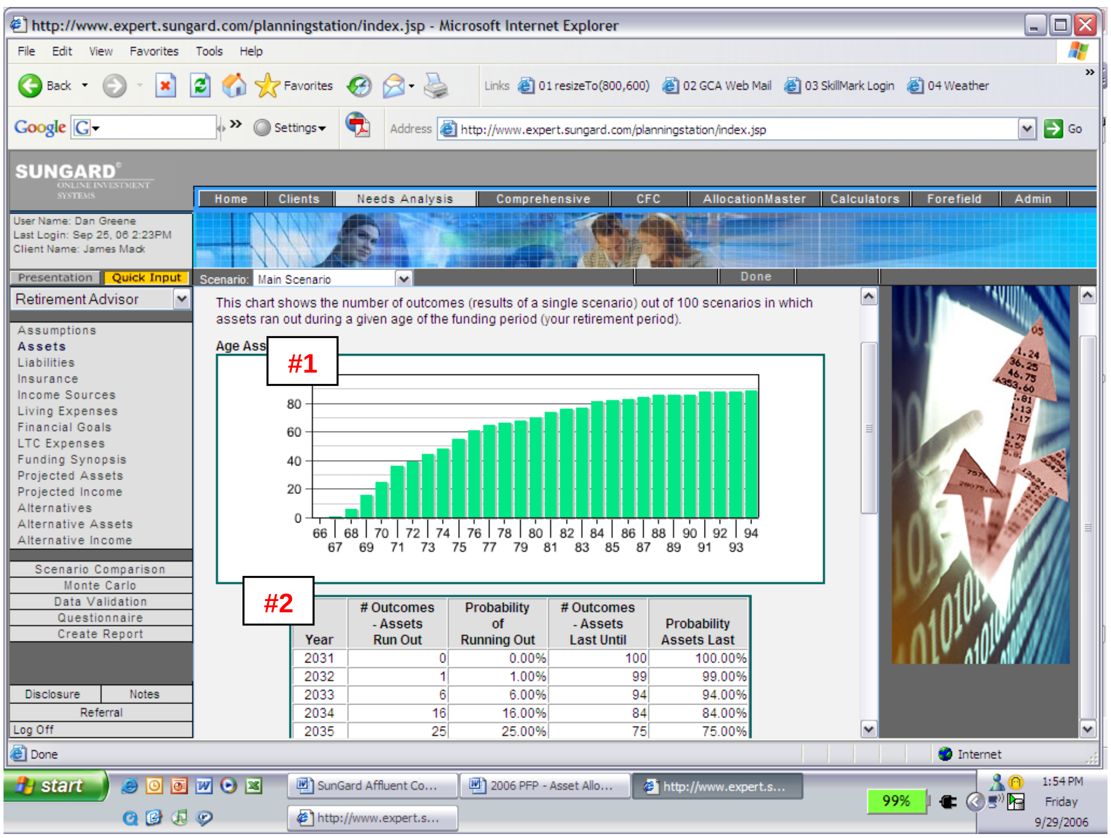
PlanningStation:
Conducting Monte Carlo Analysis for Clients

Obviously, conducting Monte Carlo analysis cannot be done by hand - it requires sophisticated asset allocation tools to generate the analysis. PlanningStation enables advisors to perform Monte Carlo simulations relative to defined goals, such as retirement, and generate high impact reports that can be used to help clients establish a clear and reasoned asset allocation strategy.

The screenshot below illustrates how PlanningStation can be used to perform Monte Carlo analysis and generate a user-friendly report. Click on the numbers in the graphic to get a more in-depth description of the information provided and how it can be used to facilitate a discussion in a client meeting.



#1

The graphic displays the probability of the client running out of money in each year of their retirement based upon their current financial situation. For example, based on the data provided in this case, this family has a 0% chance that they will run out of money at the age of 66 and a 40% chance they will run out of money by age 72. If this were a real life client, your conversation with them could go something like this:

> *"Based on your future retirement income needs, current assets, savings rates and retirement age, I have run a sophisticated analysis that tells us the probability of you potentially outliving your assets. This analysis takes into account hundreds of different potential scenarios in the markets, giving us more scientific insights into your*

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current retirement plan. Using this analysis, we can determine if the current approach is right for you and, if not, make changes to some of the underlying factors to increase your odds of achieving your goals."

#2

Additionally, the same data is displayed in a table format below the graph, providing another way to communicate probability of outcomes based on the assumptions provided.

Creating Urgency: Lack of Investment Objectives

Recognizing the importance of having a clear plan and the overwhelming number of individuals who lack one, Advisors should be well prepared to uncover this potential need and create a sense of urgency to act. Following are effective questions that will help you accomplish this important objective:

Doubt-Raising Questions

- How has your current Advisor worked with you to establish clearly defined investment objectives?
- How has your current Advisor worked with you to understand the probabilities of your current plan enabling you to reach your goals?
- How does your current Advisor help you measure your progress toward your stated goals?
- How does your current Advisor determine when it's time to rebalance your portfolio?

Issue #2: Improper Portfolio Structure

A second mistake that many individuals make in their portfolio is structuring their portfolio in a manner that is inconsistent with their objectives. For example, how often do you encounter a situation similar to the one on the right?

Although John's objectives are very clear, his portfolio is not properly structured relative to his objectives - it is far too conservatively invested. Likewise, you have also encountered individuals who take far too much risk in their portfolios given their objectives. In either case, this mistake can have horrible consequences. While a basic concept, it is worth exploring why individuals consistently make mistakes in structuring their portfolio, maintaining an asset allocation that is either too conservative or too aggressive. These are two of the most common reasons for this phenomenon.

Mr. Brown

John Brown, age 42, has a portfolio currently valued at just over $150,000. John has stated that he is setting aside this money for his future retirement some 20+ years from now when he feels he will need the portfolio to be worth about $750,000. He feels he can add little to this portfolio over the next 20 years; therefore, this portfolio must generate significant growth to reach his objectives. Currently, John's portfolio has the following allocation:

Large Cap Equities	25%
Short-Term Fixed Income	60%
Cash Equivalents	15%

Reason 1: Emotional Decision-Making Process

One of the most powerful factors that often undermines effective investment decisions is emotion. To understand the impact of emotions on investment decision-making, a group of researchers at the University of Chicago conducted a very interesting study to test what has become known as Prospect Theory. Prospect Theory suggests that people respond differently to equivalent situations, depending on whether it is presented in the context of a loss or a gain. Put more simply, individuals are much more distressed at the prospect of losing $1.00 than they are excited by the prospect of gaining $1.00.

Click the icon to view more about the study.

Researchers asked two groups of individuals a question.

The first group was asked the following question:

In addition to what you own, you have been given $1,000. You now have to choose one of the following options:

A. A sure gain of $500
B. A 50% chance of gaining $1,000 and a 50% chance of losing $500.

The second group was asked this question:

In addition to what you own, you have been given $1,000. You now must choose one of the following options

A. A sure loss of $500
B. A 50% chance of losing $1,000 and a 50% chance of losing nothing

How do you think each group responded? **Click here to view the results.**

The first group was given the option of a sure gain with no risk, or the option of a potentially higher return by taking on extra risk. A total of 84% were not willing to take on the extra risk to get the higher gain and selected option A, "A sure gain of $500."

The second group was given the option of a sure loss with no risk, or the option of potentially avoiding the loss by taking on additional risk. Because their aversion to the sure loss was so great, 69% selected choice B and were willing to take on greater risk in the hopes of avoiding a loss (even though they might lose twice as much).

Clearly, people are more motivated to avoid losses than they are to seek gains. That is why investors are generally assumed to be "risk-averse." However, this high propensity to risk aversion can lead to irrational choices. Many individuals will construct portfolios that are far too conservative relative to their defined goals. Their fear of short-term losses will cause them to overlook the long-term risk of failing to reach their investment objectives.

Reason 2: Failing to Rebalance
A second issue that often drives an inappropriately structured portfolio is failing to rebalance the portfolio to ensure the portfolio remains in line with their investment objectives. Most often, individuals adopt a “buy and hold” strategy, feeling that it is the most conservative approach to investing. However, a real life example illustrates the potential impact of this “strategy” on a portfolio.

Click the icon to view a case study.

Linda Smith

In 2004, Linda Smith worked with an Advisor to establish investment objectives for her portfolio, valued at $150,000 at the time. The Investment Policy established the following parameters for her portfolio:

	Target	Min. Exposure	Max.Exposure
Equity	50%	40%	60%
Fixed Income	35%	25%	15%
International Equity	10%	5%	15%
Cash	5%	2%	10%

Based on the returns of Linda’s portfolio for the next 5 years (1/1/05 - 12/31/09), the portfolio would have dramatically changed. At the end of 2009, Linda's portfolio was valued at $173,152 with the following structure:

	Actual Allocation	%+/- from Target
Equity	38%	-12%
Fixed Income	49%	+14%
International Equity	5%	0%
Cash	8%	-2%

As this situation clearly illustrates, failing to proactively manage the portfolio will lead to a portfolio structure that no longer falls within the established guidelines. Worse still, simple math dictates that those asset classes with the best performance will, over time, make up the greatest percentage of the portfolio. This means that failing to manage the portfolio structure will invariably result in an aggressively structured portfolio concentrated in the asset classes with the best recent performance, which are often poised to revert to the mean and pull performance down in the future.

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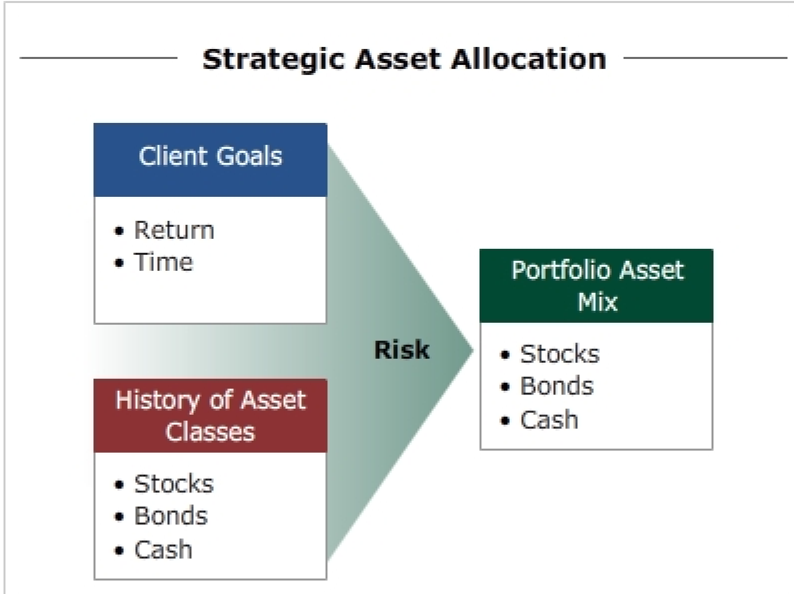
The Importance of Asset Allocation

Asset allocation is the process for structuring a portfolio and managing it relative to the client's objectives. There are two general approaches to asset allocation: Strategic Asset Allocation and Tactical Asset Allocation

Strategic Asset Allocation applies a long-term perspective to define how a portfolio should be diversified across asset classes. In this process, portfolios are not traded frequently, but are simply rebalanced periodically to maintain the desired asset allocation that is most likely to reach the longer-term objectives of the client. The chart below helps describe the process of strategic asset allocation.

Click each box to learn more.



Client Goals
The strategic asset allocation process focuses on the client's goals and long-term perspective, as well as the rebalancing of the portfolio. Before generating a mix of assets within a portfolio, there must be an understanding of the goals and expectations of the client.

Being aware of such goals as the amount of risk willing to be taken, the amount of return desired and the time frame with which these goals can be reached, is essential in the strategic asset allocation process

History of Asset Classes
The historical returns, volatility and future return expectations are the second primary inputs into a strategic asset allocation approach. The historical returns and volatility inputs are factual and cannot be debated.

However, the averages used here can be significantly different depending on the time period chosen to determine these data inputs. Be careful to utilize rational expectations and discuss the impact of a lower return environment.

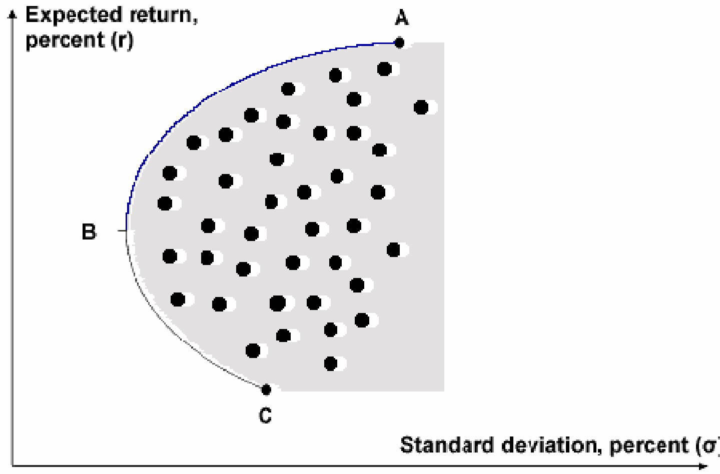
Portfolio Asset Mix
Taking into consideration the client's goals and the historical risk, return, and correlation of various asset classes, the strategic allocation process potential selects an asset allocation that is designed to meet the long-term objectives of the client.

.

Getting Paid for Risk: *The Efficient Frontier*

Every investor is characterized by an asset allocation structure whether it has been proactively defined or not. Most often, the affluent clients' portfolio asset allocation is the result of a series of unrelated purchases, resulting in a poorly structured portfolio. For example, one year an individual gets a bonus which he invests in a Large Cap Equity Mutual Fund. Later, he receives an inheritance from his grandfather made up of shares in three blue-chip companies. The following year, amidst a market decline, he decides to invest his annual bonus in a bond fund, and so on. This is most certainly a case of a not-too-strategic approach to asset allocation. However, what most affluent clients do not understand is the real impact of this type of approach. Enter the Efficient Frontier.

The Efficient Frontier defines the historically highest returns an investor could generate at any given level of risk over a specified time frame. This concept is depicted in the graphic on the right.



Clearly, any rational investor would seek to maximize the returns provided from any given level of risk. This would be found along the curved line depicted by AB. Any asset allocation falling on this line from A to B, known as the Efficient Frontier, would be the most efficient combination of assets possible for any given level of risk. Investors would prefer to avoid profiles that fall inside the curve, as those combinations represent a lesser return for any given level of risk. They would also avoid those profiles falling on the line depicted by BC, since these are the most inefficient profiles available for a given level of risk.

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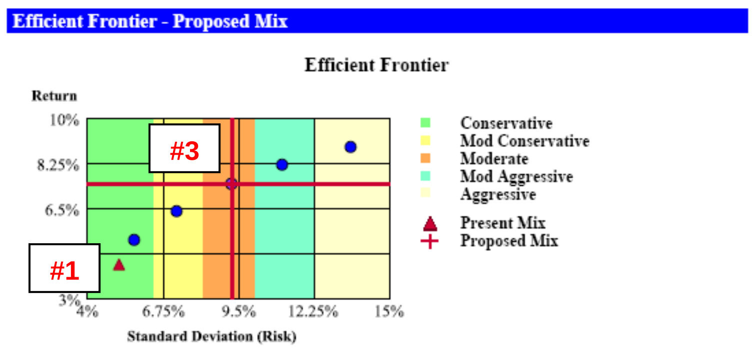
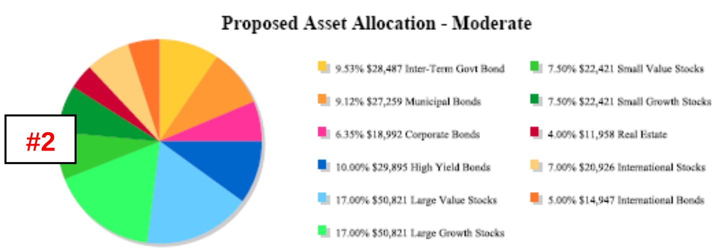
PlanningStation:
Using the Efficient Frontier to Develop an Effective Asset Allocation Strategy

Using the Efficient Frontier can be a powerful way to demonstrate the importance of establishing and maintaining an effective portfolio structure. Certainly, all clients want a portfolio that generates the most return at any given level of risk; however, few if any have the tools and expertise to conduct this level of analysis on their own. Advisors can use PlanningStation to assess a client's current portfolio structure to determine if it is, in fact, efficiently structured and to prescribe potential changes to the portfolio. A sample of the detailed level of analysis that can be performed with PlanningStation is outlined below:





Total 100% $298,949

#4

	▲ Present	+ Proposed
Before-Tax Gross Return	5.65%	8.87%
After-Tax Net Return	4.35%	7.46%
Standard Deviation (Risk)	5.11%	9.19%
Sharpe Ratio	0.26	0.49
After-Tax Yield	1.59%	2.74%

#1

Current Portfolio Profile Relative to the Efficient Frontier. The risk / return profile of the current portfolio structure is shown relative to the Efficient Frontier.

#2

Proposed Portfolio Asset Allocation. The Proposed Asset Allocation structure is illustrated in detail in a Pie Chart, enabling you to effectively communicate how the portfolio could be structured to make it more efficient.

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#3

Proposed Portfolio Profile Relative to the Efficient Frontier. The risk / return profile of the proposed asset allocation is also shown along the Efficient Frontier.

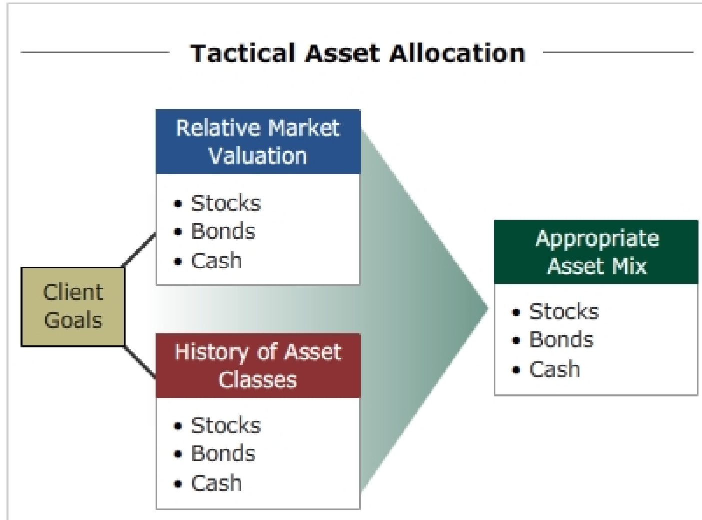
#4

Comparison of Current Portfolio to Proposed Portfolio Structure. Finally, the report compares the client's Current Portfolio relative to the proposed portfolio structure, further highlighting the benefits of repositioning the portfolio to make it more efficient.

Tactical Asset Allocation

Tactical asset allocation has a more short-term focus, seeking to capitalize on short-term market conditions and anticipated market moves. This results in active shifting of the investments within a portfolio.

As the chart below shows, the combination of relative market valuations and the historical performance of asset classes are the primary considerations in determining the appropriate asset mix for a portfolio. Using a tactical method, the client's goals and objectives are given less attention than the current market conditions and short-term market projections.



Creating Urgency: Improper Portfolio Structure / Asset Allocation

Recognizing the risks associated with an improperly structured portfolio, following are effective doubt-raising questions that will help you capitalize on opportunities to address this issue for clients and prospects:

Doubt-Raising Questions

- How does your current Advisor manage your portfolio to ensure it remains focused on your objectives?
- How has your Advisor worked with you to establish clear guidelines for rebalancing your portfolio?
- How often does your Advisor rebalance your portfolio to ensure it remains focused on your objectives?
- How often do you review your objectives to ensure they remain appropriate as your situation changes?

Issue #3: Lack of a Disciplined Investment Process

Another problem common to many investors is the lack of a disciplined process for buying and selling securities. The importance of a "disciplined investment process" is often touted in the marketplace, yet few investors fully understand what this concept really means. Simply put, a disciplined process of investing ensures that decisions are not made on the basis of emotions. This is important because, as evidenced previously, when investors make emotional decisions, the consequences are less than optimal.

Click the icon to view a real-life example.

A True Story

In late 1999, Jack Ross, seeking to capitalize on the Internet stock gold rush, decided to purchase a little known company that seemed poised to become a leader in the hottest new market on the Internet – the Business-to-Business auction market. This company, Ventro Corporation, (VNTR) had developed a niche in the chemicals industry as the premier B2B exchange site and its stock had soared from its IPO price in the low teens to $62. Days after Jack's purchase, VNTR soared to $85 and continued its torrid run, up over 15 points four days in a row until finally reaching a high of $240 in February 2000 - only months after Jack's purchase. Then, in early March, VNTR started to pull back, retreating 5 points, then 10 points, and then another 10. All the while, Jack thought, "Hold on, it is just regrouping before making another big move."

Jack was right. VNTR did make a big move – only the move continued to be in the wrong direction. Finally the stock reached $62, the price where Jack had originally bought it. At this point, he considered buying more, rationalizing that it was a "bargain" at this price. He continued to hold on until he finally sold it when the stock hit $40 – a 35% loss.

How did Jack let this happen? How did Jack let a gain of nearly 400% turn into a 35% loss? It's simple. He bought on emotion, simply trying to ride the Internet wave. Then, he sold on emotion, capitulating at

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the end and finally taking his loss.

This story is real and it is repeated by investors every day. The only method for avoiding this trap is to have a clear and disciplined approach to buying and selling securities. Simply asking well-phrased doubt-raising questions will enable you to identify clients/prospects that have had similar experiences and open up the opportunity for you to position your solution of a more disciplined approach.

Performance*		
	1 year	**2 years**
Stocks Sold	0.54	2.89
Stocks Purchased	-2.68	-0.68
Difference	-3.22	-3.57

***Monthly performance relative to the S&P 500**

Tangible evidence of the impact of undisciplined decision-making is found in a study conducted by the University of California-Davis. The study tracked over 900,000 trades which were made by individuals on an unsolicited basis through a discount broker. It found that, on average, those stocks individuals sold went up relative to the market (outperformed the market) after they were sold. Likewise, the stocks individuals bought went down relative to the market (underperformed the market) after they were purchased. In summary, individuals tended to act on their emotions, buying on greed when a security was performing well and selling on fear when a stock declined.

Discipline ensures that emotions do not unduly impact the process for buying and selling securities. By employing discipline, individuals can be more confident in their investment decisions, relying on factual information to support their decisions when short-term fluctuations may adversely affect their portfolio. This is not to say that simply having a discipline will ensure positive results. It will, however, serve to increase the effectiveness of investment decisions over time, while also minimizing short-term emotional stress.

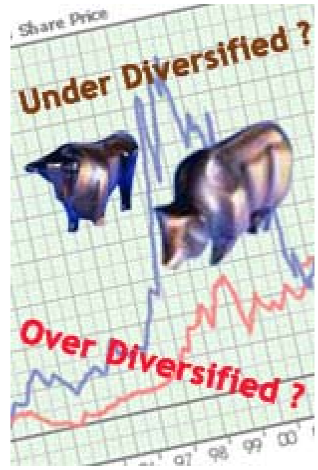
Creating Urgency: *Lack of a Disciplined Investment Process*

Clearly, an emotional approach to investing can have a significantly adverse effect on investment results. Additionally, it is an issue that is very common as evidenced by the studies cited. Following are effective questions that can be used to engage clients in a more meaningful dialogue and potentially uncover opportunities to help them understand the importance of employing a disciplined approach to investing.

Doubt-Raising Questions

- What process has your current advisor used to ensure your portfolio is structured appropriately?
- What process does your current advisor use to identify attractive investments for your portfolio?
- How does your advisor determine when it is time to sell?

Issue #4: Inappropriate Diversification



Though portfolio diversification is critical and most investors know that their portfolios should be diversified, most have no real concept of what constitutes appropriate diversification. The result is a portfolio that is often either **under-diversified** or **over-diversified.**

Under-Diversified Portfolio

Under-diversified portfolios are those that have high concentrations in relatively few individual stocks, sectors of the market, investment styles, and/or asset classes. The result is a portfolio with a risk profile that is much higher than warranted. Under-diversified portfolios are often the result of individuals being attracted to "hot sectors of the market." It is also common to see large concentrations in one individual stock.

Over-Diversified Portfolio

When considering portfolio diversification, many investors fail to realize that you can have too much of a good thing. In investing, there comes a point at which owning more securities in a portfolio results in higher cost of ownership (fees), which serves only to dilute the potential return of the portfolio. Such is often the case with investors who own multiple mutual funds, each with a similar investment objective.

Maintaining a portfolio that is appropriately diversified requires a sound, systematic discipline and proactive ongoing oversight. Investors who fail to carefully manage their portfolio to ensure it is appropriately diversified have a definitive need for help.

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Correlation: The Basis for Diversification

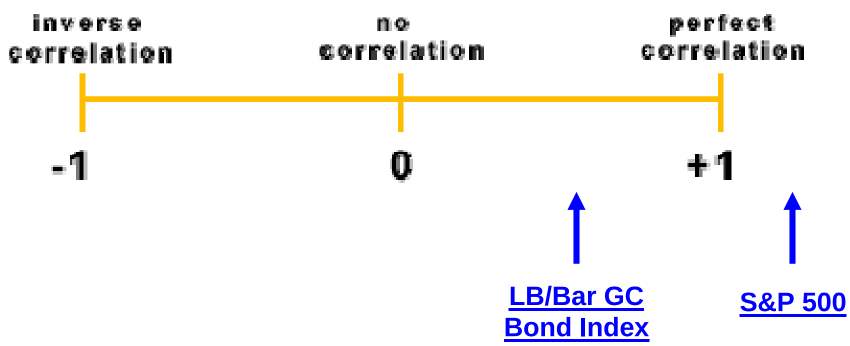
By definition, diversification is predicated on owning a basket of securities that will perform in somewhat dissimilar ways in any given market cycle, thereby mitigating market risk. Although obvious in concept, the question is how does one identify investments that in combination will produce a diversified portfolio?

The statistical measure that defines the degree to which any two investments will perform similarly is called correlation. Correlation is defined as the degree to which two asset classes or investments will have similar returns (or act the same) under a specific set of market or economic conditions. Stated differently, it is a measure of how the returns of two investments "co-relate" to each other. Investments producing similar results over a given timeframe have a high correlation while investments that produce dissimilar results have a low correlation.

To have a deeper understanding of how two investments or asset classes relate to each other, it is important to understand the principle of **correlation**.

Click the underlined indices for an explanation of how they correlate to the Dow Jones Industrial Average.

Correlation with DJIA



LB/Bar GC Conversely, the DJIA and LB/Bar GC (Lehman Brothers/Barclays Government/Corporate bond index), have historically had a lower correlation because stocks and bonds have historically reacted differently to economic conditions.

S&P 500 The returns achieved by the Standard & Poor's 500 (S&P 500) and the Dow Jones Industrial Average (DJIA) have historically had a high correlation to each other. That is, when the Dow has increased 1 percent, in general, the S&P 500 has historically increased at a similar rate.

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Creating Urgency: *Inappropriate Diversification*

Although the concept of diversification is broadly understood by most affluent investors, this knowledge often fails to manifest itself in their portfolios. Whether due to an illogical emotional attachment to a particular stock or an irrational aversion to risk that drives someone to invest in a portfolio of 100% bonds despite the fact it produces a higher risk profile than that of a diversified portfolio, advisors will encounter poorly diversified portfolios everyday. Following are effective questions that will help you capitalize on this opportunity to help clients construct a well diversified portfolio.

Doubt Raising Questions

- How has your Advisor managed your portfolio to ensure it is appropriately diversified?
- How did you reach the decision to construct your portfolio with its current holdings?
- How would an unforeseen change in market conditions impact your portfolio?
- What alternatives have you explored for managing this type of risk?
- How did you reach the decision to retain a large concentration in a single stock?
- What alternatives have you considered for diversifying your concentrated positions in a tax-efficient manner?

Issue #5: Failure to Maximize After-Tax Returns

Another issue that few investors fully consider in managing their portfolio is the impact of taxes on portfolio returns. Everyone understands that taxes can, and do, have a significant impact on the return of a portfolio, yet many fail to proactively manage its impact. The result is a portfolio that is tax-inefficient.

Overview	To fully comprehend the potential impact of taxes on portfolio returns, you must first understand how returns are taxed. **Click on each term to view more information.**
Taxation of Capital Gains	Capital gains taxes are based upon two key factors: • Holding period for the investment • Individual's marginal federal tax rate Gains on investments held for less than a year are considered short-term capital gains while gains on investments held for longer than one year are considered long-term capital gains. In 2009 and 2010, long-term capital gains are generally taxed at 15% (or 0% for those whose regular marginal rate is 10% or 15%), while short-term gains are taxed at ordinary income tax rates.
Taxation of Income	Income from investments (such as dividend payments from stocks or income from fixed income securities) is taxed at the individual's marginal rate, which, in 2009 and 2010, could be as high as 35%.
Taxation of Qualified Dividends	Prior to 2003, ordinary dividends were taxed as ordinary income (i.e., taxed at the same rates as those applied to wages, salaries, tips, etc.); but beginning in 2003, certain ordinary dividends are deemed to be "qualified dividends," which are taxed at a lower tax rate (equal to the long-term capital gain rate, which will be discussed later). This rate for 2009 and 2010 is: • 15% - if the regular tax rate that would apply is 25% or higher • 0% - if the regular tax rate that would apply is less than 25% To qualify for this special tax rate as a qualified dividend, the following conditions must be met: • The dividends must have been paid by a U.S. corporation or a qualified foreign corporation. • The dividends are not : o Capital gain distributions o Dividends paid on deposits paid by banks and savings and loans (these amounts are reported as interest) o Dividends from tax-exempt organizations or a farmer's cooperative o Dividends paid by a corporation on employer securities

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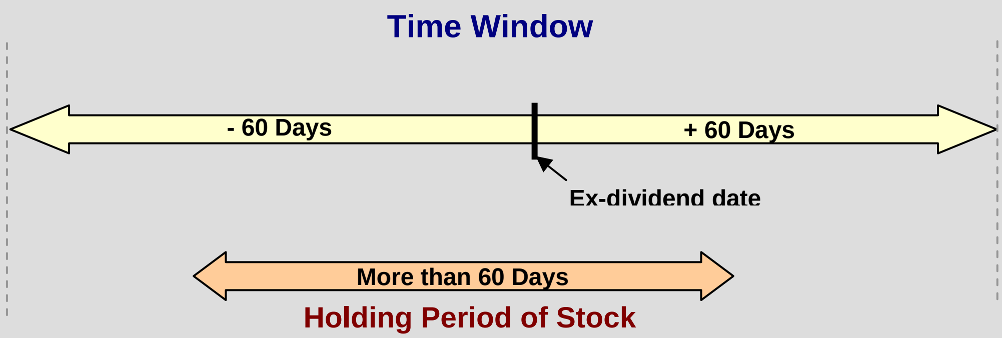
	that are held through an employee stock ownership plan (ESOP) maintained by that organization The taxpayer must meet the holding period described **here**.

Holding Period
As the preceding conditions show, most domestic stock dividends are potentially qualified. But before they can be designated as such, the taxpayer must meet the holding period requirement. To determine if a taxpayer meets the holding period requirement, look within the window of time 60 days before and 60 days after the ex-dividend date. If the stock was held for more than 60 days within that 121-day window, then it meets the holding period to qualify for the lower taxation.*



Note, however, that when dealing with dividends on preferred stock, you must have held the stock for more than 90 days during the 181-day period that begins 90 days before the ex-dividend date **if the dividends are attributable to periods totaling more than 366 days.*

In order to minimize the impact of taxes on portfolio performance, investors can employ tax-efficient investment strategies, including:

- Offsetting capital gains with losses in the portfolio
- Managing portfolio turnover to minimize taxable events in the portfolio
- Investing in tax-advantaged securities such as municipal bonds (where appropriate)

Employing strategies such as these can help reduce the adverse effect that taxes have on a portfolio's performance. However, it is important that these strategies be employed in an appropriate manner, recognizing the fact that managing the impact of taxes is AN issue in the investment decision-making process, not THE issue.

Creating Urgency: *Tax-Inefficient Investing*

The following are effective doubt-raising questions that you can use to uncover potential opportunities to manage an individual's portfolio in a more tax-efficient manner.

Doubt Raising Questions

- How does your current advisor minimize the negative impact of taxes on your portfolio?
- How does your advisor evaluate the impact of taxes when determining when to sell a security?
- How does your advisor work with you to ensure you do not generate an unexpected tax liability in your portfolio in any given year?

Issue # 6: Failure to Effectively Analyze Performance

A common problem many investors face is the inability to access clear and accurate performance information on their portfolios. Many investors, when stuck for an answer, will tell you how great their performance has been, citing their purchase of the latest hot stock or an impeccably timed sale just before a security's decline. However, very few can do more than speak in generalities about their performance, while fewer still actually review performance on a regular basis.

The reason that investors have historically failed to track and analyze the performance of their portfolios has been the lack of tools available to help them measure performance. Tracking the results of individual securities or a few mutual funds is not extremely difficult; however, investors with multiple holdings in multiple accounts spread across four or five different firms face a daunting task.

For those that do track performance, very few are effective in their analysis. For example, consider how clients typically respond when asked about their performance. When the markets are good, they will often make relative performance comparisons: "Why was my fund up only 40% this year when the market was up 42%?" However, the same client will shift to absolute performance comparisons when the markets are bad - "Why is my portfolio down 8% this year" - with no regard for the fact that the market was down 15%. The following pages provide some insight into how to translate this mindset into potential advisory opportunities with your clients.

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Analyzing Performance: Three Important Perspectives

Measuring the performance of a portfolio is a seemingly simple process - just calculate the rate of growth / decline in value of the portfolio over any given period of time. However, it is not the process of calculating returns that is the issue - it is how the results are interpreted.

As an advisor, your ability to help your clients understand how to effectively assess the performance of their portfolio can be invaluable to helping them reach their goals. There are three perspectives clients should employ when evaluating the performance of their portfolio:

- **Absolute Returns Analysis**
- **Relative Returns Analysis**
- **Risk-Adjusted Returns Analysis**

The pages that follow provide greater detail in understanding the relevance of each of these three perspectives.

Performance Analytics: *Absolute Returns Analysis*

The first and most basic level of performance analytics is assessing absolute portfolio returns. The relevance of absolute returns is best summed up in the following interchange between an 82-year-old retiree and his advisor.

The advisor, aware of the fact that the older gentleman would be concerned with the decline in his portfolio stated, “I know you are concerned that your portfolio has decreased in value by 10% since last year, but the market was down over 18% during this period, so we actually did very well.” To which the gentleman replied, “You may be right son, but I still have less to spend at the grocery store.”

This interchange defines the relevance of the absolute returns perspective; however, assessing absolute returns in a vacuum is ineffective in truly understanding the value an advisor is adding in the portfolio management process.

In 2009, a large-cap equity mutual fund posted a return of 15.5%. How would you rate this return?

Click a choice below to rate this return.

GOOD POOR

Good

Incorrect. While a return of 15.5% is obviously much higher than the average return for the stock market over the last 50 years, in 2009 the S&P added 26.5% to its value from year-end 2008. Therefore, the absolute return is well below the appropriate benchmark, meaning that the fund actually underperformed. However, this is not the case in every year. In 2007, for example, the S&P returned 3.5%. Had this fund returned 15.5% in 2007, it would have overperformed.

Poor

You are correct. While a return of 15.5% is obviously much higher than the average return for the stock market over the last 50 years, in 2009 the S&P added 26.5% to its value from year-end 2008. Therefore, the absolute return is well below the appropriate benchmark, meaning that the fund actually underperformed. However, this is not the case in every year. In 2007, for example, the S&P returned 3.5%. Had this fund returned 15.5% in 2007, it would have overperformed.

Performance Analytics: *Relative Returns Analysis*

Most individuals are aware of the fact that portfolio performance should be measured relative to an index; however, very few compare their results to an appropriate benchmark. For example, how often have you encountered an individual distressed by the fact that their portfolio of 60% Large Cap Stocks and 40% Fixed Income was underperforming the S&P 500 by a significant margin? Such a comparison is clearly inappropriate due to the fact that a 60/40 blended portfolio will almost always underperform the all-equity S&P 500 in a rising market. By failing to make legitimate comparisons, investors lack an accurate yardstick for measuring the effectiveness of their current advisors' investment advice.

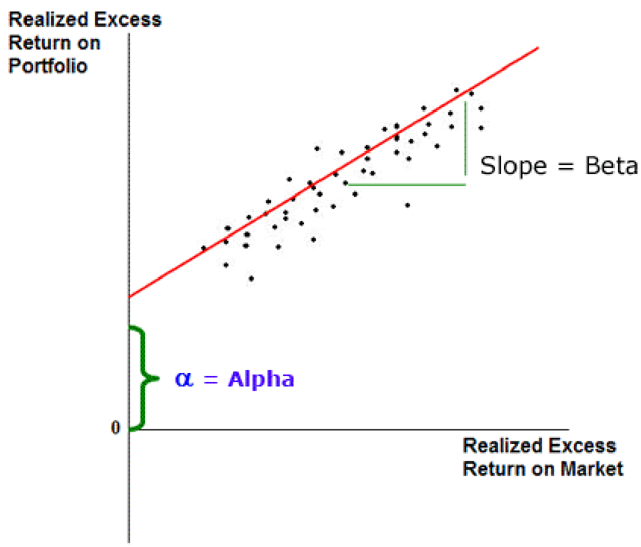
Overview

Two valuable measures of how a portfolio/manager is performing relative to the benchmark are alpha and beta. Although somewhat esoteric in their derivations, these statistics are commonly included in marketing literature; therefore, it is imperative that advisors are able to communicate the value of these metrics. Click on each of the links below to learn more about alpha and beta.

Alpha

Alpha identifies the difference in expected return of a portfolio, based on the beta of the portfolio, versus the actual returns that were achieved. The higher your alpha, the better your portfolio has done in achieving "excess returns. It is generally considered to be a measure of the "value added" by the portfolio manager. The higher the alpha, the higher the "value added" by the portfolio manager, while a negative alpha indicates that the portfolio manager's efforts were counterproductive, resulting in diminished returns.

Click the alpha link in the graphic below.



Beta

Beta is a measure of risk, quantifying a portfolio's sensitivity to movements in a benchmark, such as the S&P 500. A beta greater than 1.0 means that the security or portfolio is more volatile than the benchmark, while a beta less than 1.0 means the asset or portfolio is less volatile than the benchmark. To understand more about how beta is derived, **click the links in the graphic below.**

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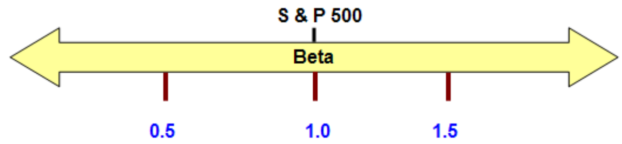

0.5
Beta coefficients below 1.0 indicate that the stock or portfolio is less risky than the market as a whole. Thus, the risk premium is less than that of the market. When the market rises, the stock (portfolio) will not be expected to rise as much; when the market declines, the stock (portfolio) will be expected to decline to a lesser degree.

Example: If the risk premium (the rate above the risk-free rate) for the market is 8%, a stock with a beta of 0.5 would have a risk premium of 0.5 x 8% = 4%.

1.0
A stock with a beta coefficient of 1.0 has the same coefficient as the market as a whole, thus it is expected to behave perfectly in sync with the market. Thus, its risk premium is equal to that of the market.

1.5
Beta coefficients above 1.0 indicate that the stock or portfolio is more risky than the market as a whole. Thus, its risk premium is greater than that of the market. When the market rises, the stock (portfolio) will be expected to rise even more; when the market declines, the stock (portfolio) will be expected to decline even further.

Example: If the risk premium (the rate above the risk-free rate) for the market is 8%, a stock with a beta of 1.5 would have a risk premium of 1.5 x 8% = 12%.

Performance Analytics: *Risk-Adjusted Returns Analysis*

The final level of analysis investors should conduct to evaluate the effectiveness of their approach is examining risk-adjusted returns. For the purposes of this course, we will only examine the most common measures of risk-adjusted returns, equipping you with an effective approach to communicating how the following measures of risk-adjusted return are derived.

Click each measure to learn more.

Sharpe Ratio

The Sharpe Ratio, developed by Bill Sharpe, the father of the Capital Asset Pricing Model (CAPM), which is widely used today in portfolio analytics, is a measure that defines the degree to which an investor is rewarded for taking risk in a portfolio. More specifically, the Sharpe Ratio is calculated as follows:

Sharpe Ratio = (Portfolio Return - Risk-free Rate of Return) / Portfolio Standard Deviation

Treynor Ratio

The Treynor Ratio is identical to the Sharpe Ratio except that the Treynor Ratio uses the portfolio beta as the measure of the portfolio's risk profile. As with the Sharpe Ratio, the higher the Treynor Ratio for a given portfolio, the more an investor is rewarded for the risk they take in the portfolio.

As a result, it is important that you are well prepared to discuss both what these measures are and how they can be used to help identify attractive investment opportunities.

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Creating Urgency: *Failure to Effectively Analyze Performance*

Ultimately, the only reason individuals assume risk and invest is to generate returns. However, very few investors conduct the comprehensive level of analysis that is required to identify attractive investment opportunities. Recognizing this fact, following are effective questions that can help advisors capitalize on opportunities to help clients in this area.

Doubt-Raising Questions

- How do you measure the performance of your portfolio?
- How do you measure the effectiveness of your current advisor's investment decisions?
- How do you select appropriate benchmarks to measure your portfolio's performance?
- How often do you measure your portfolio's performance against its benchmarks?
- How do you evaluate the value your current advisor is adding relative to the risk you are taking in the portfolio?

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Action Plan: Capitalizing on Opportunities

To increase your production, you must address three key steps:

Step One: Hone Your Investment Planning Advisory Skills

First, you must hone your skills, enhancing your approach to capitalizing on investment planning opportunities. Up to this point, this course has been focused solely on this important issue.

- Master GAP Profiling
- Develop effective doubt-raising questions you will ask to create opportunities

To access a printable Reference Guide to the key Issues and doubt-raising questions covered in this course, click here.

Common Investment Planning Needs
• Lack of clear investment objectives • Improperly structured portfolio • Lack of a disciplined investment process • Inappropriate diversification • Failing to maximize after-tax returns • Failure to effectively analyze performance

Lack of clear investment objectives
• How has your Advisor worked with you to establish clearly defined investment objectives? • How does your Advisor help you measure your progress toward your stated goals? • How does your current Advisor determine when it's time to rebalance your portfolio?

Improperly structured portfolio
• How does your current Advisor manage your portfolio to ensure it remains focused on your objectives? • How has your Advisor worked with you to establish clear guidelines for rebalancing your portfolio? • How often does your Advisor rebalance your portfolio to ensure it remains focused on your objectives? • How often do you review your objectives to ensure they remain appropriate as your situation changes?

Lack of a disciplined investment process
• What process does your Advisor use to identify attractive investments for your portfolio? • How does your Advisor determine when it is appropriate to sell a security? • What "rules of the road" have you and your Advisor agreed to with respect to the day-to-day management of your portfolio?

Inappropriate diversification

- How has your Advisor managed your portfolio to ensure it is appropriately diversified?
- How did you reach the decision to construct your portfolio with its current holdings?
- How do you evaluate the total cost of managing your portfolio in this manner?
- How does this annual cost of management compare to other alternatives that have the same risk/reward profile?
- How would an unforeseen change in market conditions impact your portfolio?
- What alternatives have you explored for managing this type of risk?
- How did you reach the decision to retain a large concentration in a single stock?
- What alternatives have you considered for diversifying your concentrated positions in a tax efficient manner?

Failure to maximize after-tax returns

- How has your Advisor managed your portfolio to maximize your after-tax returns?
- How does your Advisor measure and report to you the tax efficiency of your portfolio?
- What was the impact of the mutual funds in your portfolio on its tax efficiency?

Failure to effectively analyze performance

- How do you measure the performance of your portfolio?
- How do you measure the effectiveness of your Advisor's investment decisions?
- How do you select appropriate benchmarks to measure your portfolio's performance?
- What are the benchmarks you use to accurately measure your portfolio's performance?
- How often do you measure your portfolio's performance against its benchmarks?

Step Two: Set Productivity Goals

Simply honing your skills will not on its own have an immediate impact on your production. You must also develop a practical, time-efficient strategy for proactively uncovering opportunities to employ your skills by contacting clients and prospects. It is important that you set productivity goals to both give you something to work toward and something to measure your performance against.

Go through the exercise below, entering your own estimates in numbers 1-3, to set your own productivity goals.

1. How many prospects/clients will you call on every week? ______
2. What percentage of these calls do you feel will result in new business? ______
3. How much revenue do you anticipate generating from each closed opportunity? ______
4. This is your estimated quarterly revenue: ______

Step Three: Contact Key Clients and Prospects

Begin making calls on clients and prospects. In doing this, it will be important that you develop your own approach to how you will engage your clients and prospects to uncover investment planning opportunities. To facilitate this process, **click here to review a sample script for contacting clients to engage in this process.**

Sample Script

YOU: I was reviewing your situation and wanted to spend a few minutes discussing some key issues related to your portfolio. Do you have 5-10 minutes right now to discuss them?

CLIENT: Sure, but just a few minutes. I am about to go into a meeting.

YOU: I understand. I promise not to take too much time. In looking at your total portfolio, I noticed that you have a relationship with _____________. In order for me to effectively manage your money and remain focused on your specific goals, it is important that I am working in concert with _____________. Can you give me an overview of your relationship with ____________?

CLIENT: Sure, I put about $500,000 with ___________ just over four years ago. ___________ has done a pretty good job in light of how difficult this market has been.
YOU: I am glad to hear that. *How has __________ worked with you to set clearly defined investment objectives for your portfolio?*

CLIENT: Well, we really never spent much time on that topic. We really just talked about what ____________ thought about the market and how ___________ felt the investment firm had been able to capitalize on opportunities in the equity market.

YOU: I would like to learn more about _________'s approach. There are some really sound managers in the market today that can be used to add value relative to the indices; however, the most important issue is not necessarily beating a benchmark, but helping you reach your objectives. *How does ___________ manage your portfolio to ensure it remains focused on your objectives?*

CLIENT: Well, as I said, our conversations really focus more on what ___________ is seeing in the market and what the firm is buying and selling. We don't spend much time talking about my objectives.

YOU: This is an important issue to discuss further. What specific securities has ___________ placed in your portfolio?

CLIENT: Well, _________ focuses primarily on large-cap companies like Home Depot, Microsoft and Citibank. ___________ trades a great deal, so it's hard to keep up with the specific stocks I own from month to month.

YOU: It sounds like there is some similarity in approaches as we focus on large-cap stocks as well. What process does __________ use to identify attractive stocks and how does __________ determine when to sell?

CLIENT: Good question. I don't really know the specifics. But that is _______'s job as the professional.

YOU: You're right. That's what you are paying ________ for. However, it is important that you fully understand how ___________ makes decisions. If __________ is not highly disciplined in managing your portfolio, you are the one that will pay a big price. With the turnover that you alluded to, how does ____________ manage your portfolio to maximize your after-tax returns?

CLIENT: Another good question. I have never really thought about it much.

YOU: I suggest we sit down over lunch and spend about 30 minutes discussing these issues in greater depth to ensure your portfolio is being managed in the most effective manner possible.

CLIENT: Fine with me. I just want you to know that ___________ has done a fairly good job for me, so I don't want to get into a conversation designed to disparage __________'s approach.

YOU: I fully understand your position. My commitment to you is to be objective and only do what is in your best interest. If we find you are being well served, this will only give you greater confidence in __________'s approach. Likewise, if we find ways to improve your situation, I will work with you to help you take advantage of these opportunities. I look forward to our meeting.

Conclusion

This concludes this course in the Advising the Affluent Series. Most investors buy and sell securities on emotions. They tend to follow the pack, buying after most of the opportunity for gain is gone and selling after most of the decline has occurred. Such behavior is a recipe for poor performance, if not disaster.

You can offer a better approach. Using the knowledge you have gained from this course, you can offer a rational methodology that places emphasis on:

- Proper allocation instead of picking hot stocks.
- Diversification of risk.
- Portfolios that are built around client needs, risk tolerances, and time horizons.
- Testing portfolios to minimize outcome risk.
- Ongoing monitoring and reallocation.

The end result for the client is peace of mind – greater confidence in the expected results and lower anxiety throughout the process.

Apply yourself to not only master the techniques of proper asset allocation, but to also master your ability to communicate the techniques and their advantages to clients. By helping them to become more knowledgeable themselves, they will have higher confidence in the role you play and place greater value in the services you provide.

Commit yourself to applying the principles in this course and you will see both an increase in your production and client satisfaction with the value you add.