From Plan to Portfolio

February 21, 2017

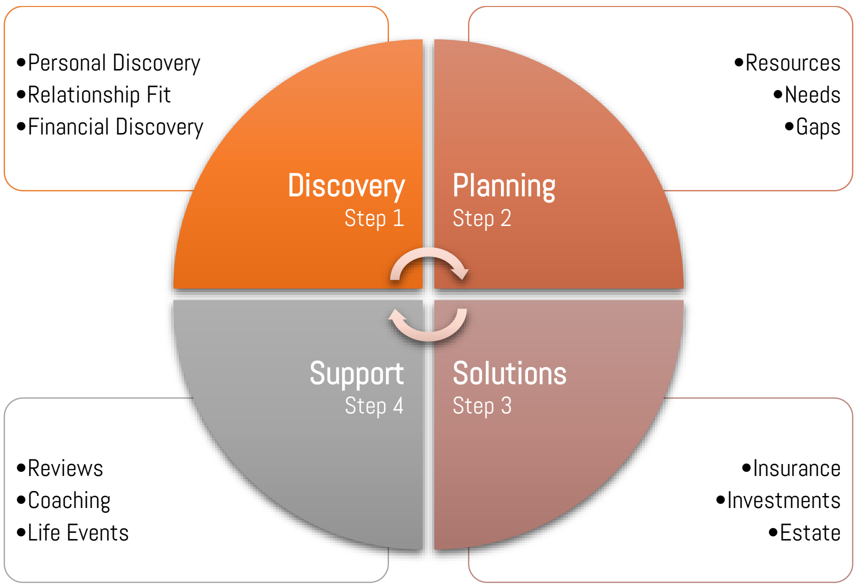
Advisors integrating planning into their practices face new challenges. Of critical importance is the advisor's ability to translate client needs into financial solutions and to communicate how those solutions meet their goals. Needs-based planning builds confidence in the advisor and helps clients avoid costly emotional decisions which can sabotage long-term results.

The planning framework

Many advisors depend on a customer suitability assessment which typically includes questions such as customer age, investment acumen, salary, and current level of wealth to gauge the customer's general level of risk tolerance. The answers to these questions are then used to produce an appropriate risk-based asset allocation portfolio using mean-variance optimization. In this manner, large firms can sell a standardized set of risk based conservative, moderate, and aggressive portfolios to customers in a regulatory compliant and efficient manner.

Contrast this with the needs-based planning approach, in which an advisor works with clients to identify their specific goals and individualized needs. The advisor then proposes and implements solutions that fit the unique circumstances of each client. The focus is placed on building confidence around achieving specific outcomes, rather than using standardized solutions from a common questionnaire.

FIGURE 1: *THE NEEDS-BASED PLANNING APPROACH FRAMEWORK*



For practical reasons, the idea of suitability and risk tolerance doesn't need to be abandoned, but rather than driving asset allocation, the client's situation, attitudes and experiences can be used to inform the advisor about the client's values, motivations and expectations. This valuable information can be used throughout the ongoing relationship to provide relevant context, perspective and coaching. While presented here as an overview, the planning framework is an inherently iterative process that depends on an open and honest dialog as client situations evolve over time.

Step 1: Discovery

The planning approach should begin with a personal discovery dialogue with a focus on soft skills and attention paid to the client's values and motivations. In this phase, the objective should be to determine if a productive advisor-client relationship is possible. Aspects to explore include communication style, personality fit, shared values and other less-tangible relationship qualities. Although difficult to quantify, authentic conversations with a potential client can make it exceedingly obvious if there is alignment.

The discussion should include topics such as how the advisor works with clients, the client's personal experience with money, the expectations of both parties and ultimately what the working relationship looks like. Good planning is personal, comprehensive and needs-based. The discovery process should identify client values, dreams, goals, fears and perceptions about risk.

If the client appears to be a good fit, the advisor should asses if the firm's capabilities align well with the client's needs and desires. Should this be the case, the final discovery step is to get a complete financial picture so that the advisor and client have a comprehensive understanding of resources available and what is already in place. This includes financial assets and liabilities, ongoing budgets, insurance, wills, trusts and other relationships including spouses, dependents, trustees and beneficiaries.

Step 2: Planning

Once the advisor-client relationship has been formally established and the client's current financial situation has been fully inventoried, it's time to move into the planning process. The most critical step in this process is to comprehensively identify needs within five distinct financial areas:

CATASTROPHIC RISKS

Clients face real risks and itemizing and addressing them specifically is important to help ease fears and to build confidence that they are addressed. In particular, clients need to insure against the large financial risks associated with unpredictable catastrophic life events. While insurance and investing are distinct areas of expertise, no financial plan is complete without a thoughtful plan for high-impact risks such as death of a spouse, long-term disability and liability exposure.

KNOWN LIQUIDITY

This category of need includes known future expenses beyond normal household operating expenses which are expected in the next 3-5 years. Job transitions, new vehicles or planned vacations can be among these expenses.

REGULAR INCOME

For clients still in the workforce, this need is usually met with household earnings from employment. For those in retirement, the regular income need is calculated as the shortfall of combined monthly income from social security and pension payments versus monthly expenses. Clients with greater wealth or limited incomes may also rely on their portfolios for distributions or to supplement income. Any ongoing distributions for the next 3-5 years should be considered.

LONG-TERM CAPITAL GROWTH

All assets not committed to short-term liquidity or income generation should be dedicated to investments focused on growth and long-horizon wealth accumulation.

ESTATE & LEGACY

For those clients who have successfully covered the first four needs, the focus shifts to financial stewardship and how a lifetime of accumulated wealth can be best utilized in the future. These needs can include the financial well-being of children and grandchildren or contributing toward a cherished cause.

Step 3: Solutions

Now that all the client's needs have been captured in the planning process, the advisor can seek the optimal solution to meet the specific needs in each category. Prior to looking at specific solutions, there are a few overriding principals which should be considered:

1. Don't use a single solution to meet multiple distinct needs. This results in sub-optimal capital allocation and performance. Whole life insurance (combining insurance and investment) and risk-based asset allocation portfolios (combining liquidity, income and long-term needs) are examples of this.

2. When in doubt, allocate more capital to long-term investments. If liquidity needs strike unexpectedly, emergency capital can be taken from long-term investments to fund the short-term. In contrast, if a client consistently over-allocates to short-term liquidity, it is not possible to make up for bypassed appreciation and compounding over time.

3. Where appropriate, seek solutions from specialists in their area of expertise rather than generalists. Many of these financial areas are complex and mistakes can result in negative results. Identifying and coordinating activities with carefully selected experts is a valuable service in and of itself.

CATASTROPHIC RISK SOLUTIONS

The vast majority of catastrophic event solutions should take the form of insurance policies. It is critically important to address these large financial risks with insurance rather than personal assets or investments. Failing to do so can result in significant capital misallocations. Depending on the client's specific situation, term life, disability, long-term care and umbrella policies may make sense. Even for more mundane forms of insurance such as home and auto, there may be gaps that can be filled with policies like flood insurance which can protect a client's assets.

KNOWN LIQUIDITY SOLUTIONS

The sole function of a known liquidity solution is to deliver a guaranteed stable value. This is typically delivered with a federally-insured demand deposit account for amounts under $250,000 or a cash equivalent investment with immediate liquidity and low volatility for larger amounts.

For more complex situations, specific liabilities can be funded with investments like treasury or investment grade bonds. In certain situations, accessing credit to fund unexpected or short-term liquidity may also be utilized to avoid untimely liquidation of assets and unnecessary tax burdens.

The key point is to inventory specific items and assign values to determine concrete liquidity needs. From a behavioral perspective, the idea is to provide a very high level of confidence that the client's short-term liquidity needs are completely covered.

Only investments with no or miniscule price volatility should be employed to meet known liquidity needs.

REGULAR INCOME SOLUTIONS

To meet regular income needs, an investment portfolio which generates reliable income on a regular basis should be the desired solution. It is critical that the portfolio's principal outpace inflation over time, so as not to lose its ability to generate a sufficient and growing income over time. Often a sustainable distribution range, such as 4%, is set to inform portfolio construction and to set reasonable client expectations. With many investors living longer lifespans, incomes need to last much longer.

The portfolio should be constructed such that it produces a yield that can support a sustainable distribution rate. This ensures the principal can then be left untouched to target growth which outpaces inflation. With interest rates hovering around historic lows, advisors have had to look beyond traditional fixed income portfolios to deliver the necessary yield. Currently, high-yielding investments such as dividend-paying equities, real estate investment trusts and master limited partnerships are well suited for this need.

From a behavioral perspective, it is important for advisors to help clients separate a dividend income portfolio into two parts: the income stream and the principal value. For perspective, dividend research shows that 80%-90% of dividend paying companies keep dividends constant or increase them each year[i], which translates into a high level of confidence for the dividend stream. Meanwhile, the impact of stock volatility shrinks dramatically over longer time horizons. Conceptually separating the portfolio's income from its price variability can help to reduce client concerns about both short-term market volatility and the long-term risk of running out of money.

Only investments which can generate the required income reliably should be included in this portfolio.

LONG-TERM CAPITAL GROWTH SOLUTIONS

Solutions in this arena should be tuned entirely for maximum capital appreciation over the long-term. The most important factor should be expected returns, as the rate of return and compounding over time will dominate all other considerations. For this reason, the growth portfolio should be invested in equities. With a little research, high-quality active management can be identified to potentially add significant value, providing as much as 4-6% in excess returns over time[ii].

Based on our research and others, selecting equity strategies that meet the following criteria have the greatest chance to outperform over the long-run:

- Pursue a narrowly-defined strategy with consistency and conviction
- Manage less than $1 billion in a single strategy
- Do not closely track an index (r-squared below 0.70)

Constructing an equity portfolio of 3-5 truly active managers who pursue different strategies enhances the client's ability to stay invested over time by allowing different strategies to perform in different market environments.

Investments which have low expected return or place volatility reduction before capital appreciation have no place in this portfolio.

ESTATE & LEGACY SOLUTIONS
Unlike the four areas above, which are focused on protecting and growing wealth during the client's life, the estate and legacy area is really focused on intelligent divestiture of the client's wealth in accordance with the client's wishes.

Advisors should compile and maintain inventories of financial assets, where they are held, account numbers, how they are titled and beneficiaries. This not only provides a complete financial picture, but can be an invaluable resource when unexpected life events occur.

Since no two clients will be alike in this area, custom tailored solutions will be the norm. Estate planners and tax expertise can be effectively leveraged to create trusts, foundations and charitable structures, which help clients make a personal and meaningful impact with their lifetime of hard work.

Step 4: Ongoing Support

Setting the right groundwork for a financial relationship can be an important contributor to investment success. We advocate taking a holistic approach to planning with adequate attention to the discovery phase, a needs-based approach to portfolio construction and the use of specialized expertise.

Just as important is maintaining and reviewing the plan. Advisors should have a well-defined process whereby each major area of the plan is updated and reviewed on a regularly scheduled basis. This provides valuable process discipline that most people lack on their own and provides touchpoints for the ongoing relationship. In addition, advisors can provide coaching to help clients stay on track by providing educational support and perspective. By referencing back to the process, goals and agreements, advisors can help clients stick to their plan.

Each of these aspects build the advisor's credibility and confidence in the eyes of the client and the advisor has a greater chance of helping clients to minimize or even eliminate behavioral mistakes.

The planning framework works particularly well in this regard because it is designed to directly meet specific client needs with specific solutions. One of the biggest advantages of this approach is in the ongoing client dialogue. Below are some examples of what dialogue looks like in this framework:

> **Client:** Am I going to run out of money in retirement? Will I be able to maintain my standard of living?
>
> **Advisor:** To meet those needs, we've built an income portfolio which is designed to fill the income gap between your social security payments and what you spend on a monthly basis. The rest of your retirement savings are invested in a growth portfolio so that you won't run out of money in retirement.

Client: When is the next big market crash going to happen? Shouldn't we be going to cash now?

Advisor: The future is uncertain, and we don't try to predict it. We've allocated cash to meet your short-term needs, but the rest will stay invested in growth assets for the long-term. Market pullbacks are painful in the short-term, but we won't compound the loss by attempting to time the market. The stock market has averaged 10% per year while absorbing large pullbacks from the Great Depression, world wars, price bubble collapses and geo-political turmoil.

Client: Why did you pick Mutual Fund XYZ? It did terrible last year. When are you going to sell it?

Advisor: For your growth portfolio, we have picked several complementary investment strategies which are designed to work well during different market conditions. Not all strategies will perform well over the short-term, but we would expect the portfolio to do well over the long-run. As long as the fund continues to meet our criteria, we will not sell it based on short-term underperformance.

One of the most valuable things an advisor can do is to help clients build and stick to a plan. It is essential for the advisor to help clients understand how the nature of risk and return change over different time horizons and different situations. By allocating the right capital to each financial category based on the client's unique circumstances, the probability of long-term success is greatly improved, both mathematically and behaviorally.

About Athena

AthenaInvest's innovative investment research process, *Behavioral Portfolio Management*, uses measurable and persistent behavioral factors to build innovative investment solutions focusing on active equity management for long-term capital growth. With a focus on behavioral factors, AthenaInvest has pioneered a unique and systematic way to view asset allocation, investment selection, and tactical management.

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[i] http://faculty.chicagobooth.edu/Richard.Thaler/research/pdf/ChangesDividends.pdf
[ii] https://www.advisorperspectives.com/articles/2016/01/26/why-most-equity-mutual-funds-underperform-and-how-to-identify-those-that-outperform