Fair or Foul: Weatherproofing a Practice Against Market Downturns

by Paul Palazzo

Some years ago, a reporter was questioning a successful college coach on his team's run of bad basketball. "You know," the coach said, "I have a tougher job than you do. My success depends on a bunch of 18-to-21-year-old kids."

Volatility rules. Way up one day. Way down the next. You're confident in the long run, but in the short term, look out. You can't control the swings in performance. Nor predict them, or even, really, explain them. All you can do is manage them.

Financial planners are coaches, of course, and similarities can be drawn between the pressured college basketball coach and the planner who manages assets for a percentage. Each is expected to deliver. And each relies to some extent on the unreliable; the coach has his kids and the asset manager has the market.

For financial planners with assets under management, then, the question is this: How do you get through a bad run? The percentage game, after all, cuts both ways. And, when the losses pile up, the people you work for aren't happy.

"I've always had a problem with charging a percentage of assets under management," says Deena Katz, CFP, executive vice president of business development for the Evensky Group in Coral Gables, Florida. "I have no problem with people getting paid that way, but the problem is that clients then tend to focus on performance."

Katz says the Evensky Group, under its emerging business model, will move toward charging flat fees for services. Asset management and other services will be included under the basic retainer, with "concierge" services costing extra.

Barbara Steinmetz, CFP, EA, manages assets for a percentage, but for her it's only part of the job. "I think people doing strictly assets under management may have a problem" in a protracted downturn, says Steinmetz, head of Steinmetz Financial Planning in Burlingame, California. "I decided that no matter what you do or what you make, you always have to pay taxes. So I went that route," Steinmetz says. "I think diversity is going to be just as important to practices as it is to portfolios."

To be sure, interviews for this story uncovered no sense of doom about a market downturn. Like Steinmetz, some planners who manage assets for a percentage said diversification would see them through. Others regard client education as the key—make the job less about winning and more about, well, coaching. Still others have faith that in rough times investors will want more, not less, help with their investments. The bottom line: prepare, and then adjust.

"Eat hamburger instead of steak," says Elliot Lipson, CFP, ChFC, CLU, with a quick and ready answer when asked what he would do in the event of a downturn. Lipson, president of Horizons Financial Advisors Inc. in Atlanta, Georgia, has been a planner for about 20 years and has five employees, three full time. "My situation is such that I can live with fluctuations," he says. "If the market stayed down for three or four years, I'm not sure I'd be saying the same thing. But a year or two, I can weather that."

Lipson says it would be a bigger problem for younger planners. "It's the same story as for any small business. You'll fail if you're not adequately capitalized and can't handle a downturn. Until you get started and established, cash flow is a problem."

Budgeting for Problems

"Any financial planner who is a halfway prudent business person is not going to let expenses get ahead of income," says Merle Born, CFP, of Merle Born and Associates in Nashville, Tennessee.

Still, some people think potential problems could be lurking out there.

"I'm surprised at the number of practices that don't really do any kind of downside case when they look at budgets," says Dennis Stearns, CFP, CFC, president and founding partner of Stearns Financial Services Group in Greensboro, North Carolina, and a strong proponent and teacher of scenario learning, a method for planning for different futures.

"Most people tend to underestimate the downturn and overestimate upturn," says Katz. "You need to look at what is realistic and what isn't. We take a pretty drastic, dramatic look at the possibilities."

Budgeting techniques, like assumptions about the market and business in general, vary from planner to planner. No one spoke of taking market gains for granted. Downside estimates varied, however. One planner said he assumes that gross revenue from asset management will be flat. Another said he assumes he'll end the year the same as he began it unless he adds new business.

Multiple budgets and scenarios are not uncommon. "I do a worst-case scenario that total assets will fall by 15 percent," says Sam Hull, CFP, sole practitioner with Northstar Financial Planning Inc., in Bedford, New Hampshire. "I'm a Yankee with gray hair. I know what a bear market looks like."

Katz does three budget scenarios each year: (1) the market stays the same, (2) the market falls by 25 percent and (3) the market rises by 10 percent. She begins the year operating under the first scenario, and adjusts from there. "If the market takes a great downturn, we adjust the budget," she says. "We earmark things we can do without. When times are good, there are more things we can do."

As a further precaution, projections in business growth also get adjusted. Under normal circumstances, the assumption is that business will grow by a "modest" 1.5 percent a month. But according to Katz, under scenario two, the 25-percent drop in the market, "we take the growth out, so we really have a cushion."

Stearns Financial also uses different budgeting levels. According to Steve Giacobbe, a partner in the firm, the budgets run from an optimistic 8 percent growth in assets to a 20 percent reduction, year over year. Running scenarios out over a couple of years, the worst case is a drop of 12 to 15 percent.

Like Katz, the Stearns people add in projections for client growth (or loss) as well. "We make sure we don't raise salaries unreasonably," says Stearns, whose firm manages assets for a percentage and also does comprehensive financial planning. "We'll make it up in bonuses. If your bonus is 5 grand, that's fine; if it's 150 grand, so much the better. My viewpoint is, the worst that can happen is we forgo bonuses for a while. We won't have to lay people off or do any serious business pruning."

Out of the Equation

Steinmetz doesn't even worry about asset growth, at least with regard to her budgeting. "I totally disregard it. The other portions of my business totally support my expenses," she says.

Naturally, the effect of a market downturn on assets may vary from planner to planner, depending on his or her investing style and the goals of the clients. A planner with a high ratio of conservative investors, such as retirees, may be on more stable ground than one who works primarily with 30-somethings who wish to trade bio-tech stocks.

"If I were a 100 percent equity manager, a 40 percent downturn in the market would be a calamity," says Greg Friedman, CFP, head of Friedman & Associates in San Rafael, California. "With our suggested diversity, the worst I can imagine is 20 percent—more likely, a 5 to 10 percent drop. The stock market might drop 40 percent, but we'll have people broadly diversified."

In the second half of the last century, large-company stocks lost ten percent or more in a calendar year four times, according to Ibbotson. The worst drop during that time was 26.5 percent, in 1974. The second worst, 14.7 percent, occurred the year before. Small-company stocks fell more than 10 percent six times, including 30.9 percent in 1973 and 25.1 percent in 1969.

Make of that what you will.

"Forecasting is a very difficult science, especially when it concerns the future," Stearns says with a laugh. "I told one story in Phoenix [at the Financial Planning Association's Retreat 2000] about how, in 1981, they pulled in the top gold experts in the world. These were people from the International Monetary Fund—the best of the best. Well, they came back in 1987, and the scenario that they had given a one percent probability was one that came true. The conclusion of the scenario experts was that when you assign probabilities, you're almost setting yourself up for defeat."

Budgeting for a cash-flow shortage is, of course, only one part of sound business practice. Another is what you do with the money that you bring in. What gets reinvested, and what gets taken out?

Peter Vessenes of Vestment Consulting in Denver, Colorado, who serves as a business advisor to financial advisors, advises his clients not to consider themselves profitable until they've put aside money—targeted profits—for cash reserves, business growth and business diversification. "I change the perspective of what breakeven is," he says. "They think breakeven is the point where revenue equals fixed expenses, variable expenses, depreciation and taxes. My contention is that that's wrong. It's the point where revenue meets fixed expenses, variable expenses, depreciation, taxes, plus targeted profits.

Vessenes goes on to say, "We believe cash reserves should equal four to six percent of breakeven revenue. Growth and diversity [targets] depend on what phase your business is in. The younger the business, the higher it is. Assuming you've been in practice for a while, we generally find that growth and diversity money amounts to four to eight percent."

Katz mentions another expense item that planners don't always consider as one. "Several years ago, I sat in on a conference with Mark Tibergien," she says. "Mark says, 'Okay, what's everybody's salary?' We're all looking at each other and saying, salary is what you have left over. But you should be building in a reasonable salary. What would you pay someone to do what you do? That needs to be included in the budget. Then, what's left over is profit." Katz continues, "Most planners don't have a good handle on their profit margin. Unless you really take this seriously, what you wind up doing is what we've probably done for years. You make the money, pay your bills, and take what is left."

Tibergien is a partner in Moss Adams, a large Seattle, Washington accounting firm whose services include working with planners on practice management. He says Vessenes's guidelines represented "a great way to think about it. In most cases, there's probably not enough diversion of cash for retained earnings or other safety. Whenever you're doing budgeting, you need to know what your breakeven is." Tibergien suggests having cash reserves to sustain a three-to-six-month market downturn of 20 percent.

Inexact Science

Several planners were asked about Vessenes's guidelines, and none said they used benchmarks that specific.

"I wish I could be that disciplined," Hull says. He shares the concern for sound practice management, but isn't that formal in his approach.

Friedman says, "Every time I've looked at formulas and applied them to my situation, they don't work very well. Number one, I live in the Bay Area, which is a very expensive place to live. Two, it's an expensive area to do business."

Still, "You have to have a contingency plan," Friedman continues. "In the business plan I set up every year, I've definitely built in what-if, what-if. We have some cash reserves. If for a period of time revenue is less than hoped, it doesn't pose a challenge to the business because of the style in which we manage.

According to Friedman, "There are two forms of reserves. One is variable compensation. Obviously, if revenue at the firm is down because of the market, we'll forgo bonuses. Second is building up a nest egg. It's not huge, but we have money set aside. I do financial planning for a living. I have to practice what I preach and save for a rainy day. If the market doesn't go up next year, it's not going to be like I can't pay people."

Friedman has three employees and he says that 85 to 90 percent of his revenue comes from asset-based management fees. He always starts his budgeting process with a review and analysis of several previous years. Nine-tenths of budgeting success, he says, lies in knowing what you've done. Like others, he says that for budgeting purposes, he treats the growth of assets as a bonus. "For the health of the business, I measure three things," he says. "One, new clients; two, new assets' and three, client retention. My feeling is those are the three things I can have some control over."

Jeff McMahan has been a CFP licensee since 1986. He operates McMahan Capital Management, LLC, in Indianapolis, Indiana, which brings in the "vast majority" of its revenue through asset management. McMahan says of the Vessenes guidelines, "It's probably something I should do. I think the concept is right. I don't know what number I would give it. I'm certainly mindful that some kind of reserve and growth are important."

McMahan prefers to put money into growth, including software and training conferences, and use credit lines as a cash reserve. "That's a personal decision," he says. "It's the same with clients. If people want to be fully invested, I have no problem with them using a home equity line of credit as part of their emergency funds. For people who are real conservative, having cash on the sidelines is probably better."

McMahan was practicing in the Bay Area until a couple of years ago, when he, his wife and children moved to the Midwest for lifestyle reasons. "I don't have a large office here, about 1,000 square feet," he says. "I have a fairly lean staff [three, including himself]. I want to make sure my comfort level is high, so that if I want to expand I can afford it."

The move to Indiana has created unusual challenges for McMahan; he still has clients out West and commutes there four times a year. "Travel has gone way up," he says. "All we have is the relationship with the client."

If the market tanks, McMahan says he'd probably absorb the losses out of profit rather than reducing the amount that he plows back into the business for growth. "In a downturn, that's when you expand. Sometimes it sounds counterintuitive. Bigger companies gain market share when there's a problem."

More Business, or Less?

In a steep market downturn, a fall in asset value and commensurate reduction in income is just one concern. Another is whether clients will change course, deciding to invest more conservatively or even invest on their own.

"Certainly, if there's a prolonged downturn and you're charging .75 or 1 percent, there's an inclination to ask, 'What are you doing for me?' Sam Hull says.

Dennis Stearns points out that predicting what consumers will do is tricky under any circumstances. "There was a series of studies done on consumer behavior in the 20th century," he says. "Both consumers and experts got it wrong almost every time."

McMahan, for one, thinks business could improve in a downturn, though he isn't eager to find out. "I want to stay sharp and realize that any day, clients can leave you," he says. But, he added, "With the market going up the way it has been, there might be a tendency for people to say, 'What do I need you for? I can throw darts at The Wall Street Journal and pick winners.' When the accounts start going down, people might start thinking that maybe they need some help. When do you see a therapist? When you're in pain. Now, if you're selling performance, then I do think those folks are at tremendous risk."

Giacobbe agrees that a "nasty market" could produce new accounts. "That type of environment might trigger people to do more planning," he says. "One of the trends we're seeing, even with the volatility this year, is that lot of people who have been do-it-yourselfers are starting to feel a little out of touch, feeling an overload."

Paul Seibert, CFP, of Asset Management Associates, LLC, on Cape Cod, Massachusetts, says he doesn't expect clients to panic in a bad market. "I really think the average investor is more sophisticated in that respect than we give them credit for," says Seibert, a sole practitioner who manages assets but charges almost exclusively on an hourly basis. "I think most are knowledgeable enough to know that the portfolio is set up to withstand that.

Seibert continues, "With my clients, a lot of their holdings are in qualified plans. I think they view them differently. Nonqualified holdings belong more to them, if you will, and they tend to be more sensitive to them. With the qualified plans, they have a better understanding of what it's there for. They'll look at a statement once a quarter, and they won't tend to react to what's happening on the 6:30 news."

Glenn Kautt, CFP, EA, president of The Monitor Group in Fairfax, Virginia, agrees. "Normally, we don't have clients who wish to pull money out when broad markets are declining." The Monitor Group manages assets on a percentage basis. "They understand that it does not mean that ultimately they will lose any money. Even with a sudden and dramatic downturn a few years ago, less than one percent of clients asked us to take them out of the market."

But it's never too early to prepare them, he and others say. "It's incumbent on planners to educate, educate, educate," Kautt says. "In rising or falling markets, we're going to have asset classes go up and down. If we have a prolonged downturn or flatness, I believe most good investment managers would look for better performers within asset classes."

Says Seibert: "One of the things I have tried very hard to do, even if clients (invest) on their own, is prepare them for what might happen. It's hard to do, given what has happened over the last ten years or so. No matter what they say, it might be a jolt to their system. I try to prepare people for the fact that it might happen. If the portfolio is properly designed and the time horizon is correct, clients should not be concerned about that."

Planners, Traders, Educators

Like many other planners, Barbara Steinmetz uses quarterly newsletters to help keep in touch with her clients and educate them. "There's always something in it about the markets," she says. "Also, we do a cover letter with our quarterly statements. The message is reiterated over and over and over. We want them to know that by keeping it in perspective, we can still get there."

In fact, Steinmetz wonders whether quarterly statements might undermine the goal. "We keep talking about the long term, but we send out quarterly statements," she says. "I would almost consider not sending them out quarterly."

Hull also spoke of "longer terms and broader visions." He works on a retainer basis, fixing the fee for a year. The foundation for the fee is a percentage of assets, though it's adjusted depending on the level of services required. "I think it's a fatal error to cast yourself as strictly a money manager," he says, adding that he doesn't take on clients "whom I don't do a plan for."

Vessenes thinks asset managers will actually have the advantage in a downturn over people who charge fees to do a plan, provided the asset managers are really engaged in planning. "For someone doing a plan for a fee, when there is a severe downturn, people are more concerned with the ability of the plan to work," he says. "They think of the plan as growth."

But, he adds, "There's a difference between a planner and a trader. Someone whose focus is growth, like a wirehouse person, is going to be hit hard in a severe downturn. But a good planner sits down with clients, tells them that growth goes up, growth goes down, growth is a long-term process. He asks what the strategies are for distribution in retirement. What are the strategies for legacy and transfer? A good planner is far less affected than someone who is involved just in growth."

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