Staying the Course

by Ed McCarthy, CFP

At first glance, the past 20 months or so would appear to have been an extraordinarily difficult time for financial advisors. The U.S. equity markets peaked in the spring of 2000 and the subsequent bear market decimated many investors' portfolios. It wasn't just the high-flying Internet and dot-com stocks suffering, either: Through the 18 months ending in September 2001, the S&P 500 index showed a negative total return of roughly 29 percent.

Bear markets have a direct financial impact on advisors whose incomes are based on the assets under management (AUM) model. For example, if an advisory firm manages $50 million dollars at an average charge of 80 basis points, those assets will generate $400,000 of annualized fees. If the market lops $10 million off those accounts, management fees fall to $320,000. Of course, an advisory firm's costs do not drop in tandem with income; in fact, it's likely that most of its expenses will continue to increase. This is the downside of a predominately fixed-cost business: income reductions often flow straight through to the bottom line.

The September 11 terrorist attacks and the subsequent trading halt exacerbated the general bear market malaise. News reports featured interviews with Americans who had begun to question the wisdom of planning and investing for the future. "Why worry about the future?" was a commonly expressed theme. "We could all be dead tomorrow." This newfound pessimism was evidenced by increased sales among East Coast luxury-auto dealers. Despite the recession's growing impact, many dealers reported brisk post-9/11 sales as consumers acted on their impulses and bought their dream vehicle.

This combination of a bear market and a significant mood swing among consumers could have—and perhaps, should have—seriously affected numerous financial advisory practices, especially smaller firms. As we spoke and corresponded with advisors around the country from a variety of practices, we found a general admission that business had slowed. But without exception, our sources reported that their clients' portfolios and their practices were holding up quite well. While most of these advisors had modified investment portfolios during the past year, none had deserted the equities markets completely in favor of cash or fixed income alternatives. Despite news reports to the contrary, none of their clients had adopted a "live for today" attitude because of the terrorist attacks. In fact, many reported that business is good as they continue to see a steady stream of new clients whose self-directed portfolios have shrunk in value. Without exception, these advisors expressed an optimistic outlook for their clients' investments and their own businesses.

Cushioning the Blow

Not too long ago, the concept of diversification seemed to have fallen from favor. The fashionable investment strategy stressed growth and New Economy stocks, relegating stodgy value stocks and fixed income investments to the widows-and-orphans' portfolios. Fast-forward to fall 2001; once again, diversification has proved its value. While stock-only portfolios were off sharply from their highs, a boring 60/40 portfolio, composed of the S&P 500 and intermediate Treasury bonds, dropped only 13 percent from April 2000 to October 2001. Scott Kays, CFP, president of Kays Financial Advisory Group in Atlanta, Georgia, used bonds effectively in his clients' portfolios. "When the tech bubble was at its peak, bonds were a tremendous value," Kays says. "So we took our portfolios up to the maximum bond allocation for the client's risk tolerance. As the market dropped, we gradually moved money back to stocks."

Value stocks also proved to be a haven for many clients. Bernard Kiely, president of Kiely Capital Management Inc. in Morristown, New Jersey, manages roughly $25 million in client assets. He looks for reasonably priced investment values and adjusts asset allocations away from overpriced sectors. "When growth was going bananas, we were selling growth and buying value," he says. "So when growth fell apart, our portfolios had 50 percent growth and 50 percent value."

J. Banks Link, a principal with Covenant Partners LLC in Brentwood, Tennessee, also has benefited from value stocks. According to Link, for much of the past two years he had been shifting clients away from growth to value. The strategy paid off. "Because of that shift, the assets we manage for clients really haven't fallen off that much," he says. "In fact, we love sending out our quarterly statements right now because they validate everything we've been saying to clients over this two-year period."

Obviously, there’s no guarantee that both value and growth stocks and fixed income investments won’t perform poorly simultaneously. As a result, advisors must prepare clients for potential losses across the board. Jeff Feldman, Ph.D., CFP, owner of Rochester Financial Services in Pittsford, New York, also shifted his clients toward value funds and fixed-income. As he made the changes, however, he stressed the markets’ unpredictability. "I tell my clients that we’ll never have a time in the stock market where there is a clear path to take," he says. "We have to play it both ways. Right now, there are at least two opposing schools of thought. One school says things look dire and you should not be in stock funds. The other school says we’ve already suffered quite a bit and stocks are cheap now. As advisors, we have to weigh both sides and determine the right path for a client."

Despite the unclear outlook for the markets, advisors aren’t positioning their clients’ portfolios for an ongoing bear market. To the contrary, many are beginning to view growth stocks and funds more favorably again. "We tend to think of long-term conditions as being what they are at present because that occupies our thoughts," says Richard Krentz, CFP, owner of RDK Financial Group in Valley Cottage, New York. "We project those conditions into the future."

Krentz manages approximately $30 million in client assets and he believes it’s the wrong time to position for a continuation of the bear market. "I’ve gone as high as 60/40 value/growth," he says. "But I’ve told my clients that I’m thinking that in 2002, we may move back to 50/50."

Another important factor in reducing the declining markets’ impact was helping clients prepare for below-average returns. This theme of educating clients about portfolio volatility was common to all the advisors interviewed for this article. Tom Grzymala, CFP, president of Alexandria Financial Associates Ltd. in Alexandria, Virginia, took advantage of the good years to remind his clients about risk. "By far, most clients understand what’s going on in the markets because we educated them continuously," he says. "When things were going good, we told them these were the rip-roaring days and the nineties couldn’t last forever."

Ron Pearson, CFP, owner of Beach Financial Advisory Service in Virginia Beach, Virginia, uses clients’ periodic performance reports as an educational tool. "As clients’ portfolios have gone down in value, I’ve been able to show them that they are doing much better than the S&P or the other benchmarks I use with them," he says. "When they get their monthly statements, it tends to alarm them. But when I put it into context, they feel much better about how they are doing."

The Bottom Line

Preserving clients’ wealth through down markets is a vital service, but simply treading water doesn’t provide asset-based growth for an advisor’s practice. Sources for this article reported that fees from existing accounts had dropped from 10 to 30 percent, depending on the portfolios’ asset mix. The revenue shortfalls didn’t force any advisors to close up shop, though, as most of them had planned for potential setbacks. "If I’m telling clients that tough times can come to their lives, I have to plan for my business that we will go through periods where revenues drop," says Scott Kays. "Several years ago, when things were going really well, we started saving cash so we would have it if needed. Fortunately, we have not been forced to dip into the cash yet."

J. Banks Link took a similar conservative approach to cash management by putting 15 percent of his firm’s fee income into reserves. "We don’t base our lifestyles or our business on that reserve," he says. "So as the market fluctuates we don’t necessarily feel the impact. We haven’t had to cut back one bit."

Instead of waiting for the markets to rebound, several advisors have stepped up their marketing efforts to bring in new clients. Phil Cook, CFP, owner of advisory firm Cook and Associates in Torrance, California, recognized that his projected income would be lower and has since been concentrating on acquiring new clients. Tom Grzymala and his associates decided to focus on increasing referrals. "We are really working harder at getting referrals from our current clients," he says. "Last year, for example, we sent out 48 letters introducing ourselves to prospective clients. So far this year we’ve sent out 82 letters."

While assets in existing accounts have fallen, several advisors noted that steady growth in total assets, fueled by new clients, has offset the revenue decreases. Bernard Kiely reports that new money has been coming into his firm at the same rate as the market was taking it away, so he hasn’t experienced a decrease in income. Ron Pearson recently raised his account minimum from $100,000 to $500,000 to stem the flow of new clients. According to Richard Krentz, business has been "too good," as he has recently acquired new clients who had suffered significant losses because of inadequate diversification.

Live for Today?

Despite the news reports that the September 11 attacks led to a widespread sense of fatalism, my sources did not see any evidence of that behavior. As Phil Cook points out, proximity to Manhattan may play a role in such a mood swing. "I haven't noticed a 'live for today' mentality developing among clients," he says. "But I'm on the West Coast and for many of us, while the attacks were horrific, I don't think we've taken it to heart in the same way as people in New York and on the East Coast."

It's also possible that the reported shift to a short-term mentality will prove to be a short-term phenomenon itself. As Jeff Feldman notes, life moves on despite the grief and shock the attacks evoked. "When the attacks happened, in my mind and for many clients, I would guess, we asked how we could be concerned about finances when thousands of people had lost their lives. But a few weeks later, if you're retired, you realized that you still have to live in retirement for the next 20 or 30 years. We've been through all kinds of crises and there is always the numbness following the act. But after a while you have to get back to living your life."

Looking Ahead

The difficulties that advisors experienced in 2000 and 2001 have illustrated several points. First, the assets-under-management (AUM) business model has held up through a bear market. After canvassing wealth managers across the country, we could not find any advisors who planned to move away from that billing method. Of course, sources tend to be self-selecting: advisors who blew out their clients' portfolios and plan to change careers aren't likely to share their experiences. Despite lower revenues, however, advisors are sticking with the AUM model.

Second, diversification still works. Clients with diversified portfolios have lost less money than their growth stock-only peers. Likewise, advisors whose clients diversified across asset classes experienced more modest revenue decreases.

Finally, it seems this bear market has confirmed the value that advisors bring to their relationships with clients. The market apparently agrees, as professional, prudent advisors continue attracting new clients and assets. Those who stayed the course and refused to panic appear to be in excellent shape for the markets' eventual recovery.

Ed McCarthy, CFP, works as a freelance writer, focusing on finance and technology.

Surviving the Bear

We asked the advisors interviewed for this article to share some of their tips for surviving future bear markets. Here are a few of their insights:

- Constantly communicate with clients and urge them to communicate with you.
- Don't base your long-term financial success on one long-term assumption.
- Asset allocation is the key.
- As investment managers, we owe it to our clients to avoid becoming part of the herd.