

Back to the future

As the global financial crisis unfolds and financial planners question their assumptions about investment, the good news is that some things never change. Simon Hoyle reports

As 2009 grinds on, it feels as if the world we knew has changed forever. We're in the teeth of an unprecedented economic malaise. The only thing plunging faster than asset values seems to be consumer confidence.

Retirees are wondering if their life savings are going to last as long as they thought (and as long as they need to), and those still saving for retirement are eyeing the future with a growing sense of unease, adjusting their expectations of lifestyle in retirement or knuckling down to work for a few years longer.

The relationships between planners and clients have been tested by the extent and the severity of the global crisis and its impact on investment markets. But amid the gloom and pessimism, wrecked dreams and shattered plans, it's the job of the financial planner to guide clients out.

An analysis of this financial crisis shouldn't be limited to investment markets and clients, however. The impact on the financial planning community itself cannot be underestimated.

Damian Crowley, head of adviser distribution at Perceptual, says many financial planners are "severely rattled" by events.

"They are shell-shocked and fatigued," Crowley says. "Those are not too strong words to describe this. Eighty-seven per cent of advisers back in May '07 felt that times were good, or very good, and none felt that times were bad. By December 2008, 50 per cent believed that times were bad, which is an amazing downturn.

"Unfortunately, advisers haven't got a lot of answers."

And that's not surprising - the events we're

living through are unprecedented, and past experience is not necessarily of any comfort at the present time. Crowley says that in adviser focus groups held by the company, the shock is palpable.

Crowley says that one adviser told the focus group: "I look at my qualification on the wall and for me at the moment it's the equivalent of someone finishing a science degree, walking past a tree and seeing an apple float off into space. Everything I have been taught has gone out the window."

(See accompanying box for more of the Perceptual focus group feedback comments.)

However, the good news is that even though some things feel like they've changed forever, other things simply haven't changed at all. One of the most valuable things a planner can do for clients in the months and year ahead is refocus on two tried-and-tested investment principles: diversification, and the related concepts of risk and reward.

The theme for investing in 2009 could be described as back to the future.

Simon O'Grady, head of Tyndall's global premia division, says investors and their advisers largely lost track of investment fundamentals during an extended bull run. Most asset classes produced positive returns, and there was no penalty for a lack of diversification.

As a consequence, too many investors lost sight of risk, and the absolutely critical importance of making sure they were adequately rewarded for the risks they were (sometimes unwittingly) exposed to.

Far from being the case that diversification (at an asset allocation level) is no longer an investor's ally, O'Grady says it's critical that there be a sharp

refocusing on the benefits of both risk and diversification, and that planners employ both effectively.

In a recent investment update, O'Grady says recent events in global investment markets have "emphasised the importance of investors focusing on risk premia as the basic building blocks of an investment portfolio".

"Asset classes are aggregates of several risk premia, and recent market turbulence has highlighted that the mainstream asset classes of equities, credit and property are all linked to the same risk factor: corporate earnings.

"This will come as a surprise to many investors who erroneously viewed credit and property investments as diversifiers of equity risk.

"When an investor focuses on risk premia as the portfolio building block it can deliver a number of benefits."

O'Grady says these include:

- + Making investors more risk aware, with a greater tendency to ask: "Where is this risk coming from?";
- + Making investors look far more closely at risk premia, and to question whether the return they are getting is appropriate for the risk they're taking;
- + Providing a framework in which to evaluate the performance of all investments, and to identify valuable risk premia that may be available in non-traditional asset classes.

As a general rule, asset allocation is determined by two things: an investor's financial goals and their current financial resources; and their ability to tolerate financial risk.

It's a financial planner's job to use his or her

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nous to help the client achieve a financial goal using the financial resources available to them.

That requires setting an appropriate long-term asset allocation, using debt where appropriate, using the correct investment structures, an element of education to explain how everything is expected to work, and last, but not least, a clear, unwavering focus on the goal and the appropriate timeframe for achieving it.

Asset allocation is partly driven by the goal, therefore, and partly dictated by the investor's tolerance for risk. Tolerance is defined in two parts: the investor's ability to physically withstand a financial loss - that is, if the money disappeared tomorrow, the impact it would actually have on their plans and lifestyle; and their psychological ability to withstand a loss - if the value of a portfolio plummets, whether it gives them sleepless nights or other stress-related symptoms.

If setting an asset allocation to achieve a financial goal (and putting in place the right structures to do it efficiently) is the science of financial planning, then accommodating the psychological needs of the client is the art.

Planners need to continue to take these elements into account when defining and implementing investment strategies, but Tim Farrelly, principal of investment consulting firm farrelly's, says the course of action also depends on what situation clients are currently in.

"There's a large group of planners who have clients who are reasonably fully invested," Farrelly says.

"They face a different set of issues than the advisers who have clients who are reasonably cashed up. They are obviously very different issues.

"My sense is that there are quite a few advisers who have cashed-up clients. They are making a whole lot more noise than they have for a while. But there's far more who have planned it for the long term, whose clients are pretty fully invested, and they are hurting right now."

Farrelly says the main issue facing cashed-up clients and their advisers is how and when to de-

'The approach needs to be more flexible to allow investors to align portfolios'

ploy liquid funds back into investment markets. He says that while there's a possibility that markets will get worse before they get better, when they do get better they may do so very quickly.

The dual risks, then, are committing capital to markets ahead of a decline, and not committing it quickly enough to benefit from a recovery, if and when it happens.

The issues facing clients who have had a long-term strategy in place, and who have stuck to it, are quite different.

"Clients have been beaten up," Farrelly says.

"But I think the real problems are going to start to emerge in three to six months' time.

"It seems like whenever there's a major dip in the markets, everyone assumes it's going to come back quite quickly.

"The market falling to 5000 points or so didn't really burn people too much. That was my sense. But it seems that the next leg, when the market fell by another 30 per cent, that really hurt.

"People getting their [investment] reports through now would be quite shocked by that."

But Farrelly says it's future reporting periods that are going to become "really, really challenging for people".

"Even if the market rebounds to 5000, which is a pretty healthy rebound from where we are, a lot of clients are still down a fair bit. I think at that point the penny will drop that there's been some permanent damage done. That's going to be a real challenge for people: even if things get better between now and [say,] September, they're not going to get better enough to make people happy.

"That creates a massive communication issue.

"On top of that, all evidence is that the economy is sinking like a stone at the moment. Economically, things are going to become more and more dire. The credit crunch doesn't seem to want to go away. And that means more and more firms will go to the wall. Newspapers are going to be full of bad news."

So that's the double whammy facing financial planners, Farrelly says: Just as economic conditions reach a nadir, investors will twig that markets haven't improved enough to restore their pre-global financial crisis (GFC) positions.

"That's the tricky bit," Farrelly says. "What should planners be communicating?"

"If you take a forward-looking estimate of what returns are going to look like over the long term... the outlook is extraordinarily attractive.

"Things do get back to normal."

(Or, as the head of Australian equities at Schroders, Martin Conlon, puts it: "I do not think this will be the first time that we don't have a recovery.")

But a new view is emerging on the issue of asset allocation. Simon Doyle, head of fixed income and multi-asset at Schroders, says the traditional fixed strategic allocation that's occasionally modified, occasionally with a modest tactical tilt, may not serve investors well in future.

Doyle says the approach needs to be more flexible, to allow investors to align their portfolios with the assets that are most likely to produce adequate reward.

He says the traditional approach of having a fairly rigid 60/40 or 70/30 (or whatever) split between "growth" and "defensive" assets may be outmoded. An approach more akin to an "absolute return" fund might be better, so that investors have the flexibility to withdraw from overly risky asset classes (defined as those unlikely to produce sufficient reward).

For example, a Schroders fund managed along exactly these lines currently allows the manager to have an exposure to equities of just 25 per cent, reflecting the manager's view that now might not be

A challenging time for advisers - Comments from Perpetual's financial planner focus groups

Financial planners are questioning what they know

"I look at my qualification on the wall and for me at the moment it's the equivalent of someone finishing a science degree, walking past a tree and seeing an apple float off into space. Everything I have been taught has gone out the window."

Investors are questioning the value of advice...

"A client last week said: 'I've had all these fees raked off my account; I've had all the worry of the tech wreck and 9/11 and now this. But if I had just stuck my money in the bank, I would be in the same place.'"

...and the value of the products they are invested in

"Clients are asking me: 'What are these fund managers doing?' I've been asked it many, many times."

Investors and advisers have been burned by poor-quality credit funds...

"Clients intensely dislike losing capital from the defensive part of their portfolio."

"My view on these hybrid funds that have produced returns of minus 20 to minus 30 per cent is that you will never see an adviser use them again as a defensive part of anybody's portfolio."

...and are looking for a capital secure income option

"I don't think we've got anywhere else to go at the moment - we're looking for answers for retirees in the allocated pension space. We're out there looking."

Investors are wary of international equities, particularly US stocks

"When things are terrible, there's a tendency for people to keep it simple. And the international story is just that little bit more complicated."

"I'm getting more and more all saying: 'Don't give me those CDO things and don't give me America'."

Where is the money going?

Advisers were asked to indicate which two asset classes they are writing most heavily in the current financial climate

Australian equities: **61 per cent**

Cash: **58 per cent**

Fixed interest: **27 per cent**

Diversified: **26 per cent**

International equities: **11 per cent**

Alternatives: **5 per cent**

High yield/credit: **4 per cent**

Listed property trusts (Australia): **2 per cent**

Mortgage trusts: **1 per cent**

Listed property trusts (global): **0 per cent**

Source: Wealth Insights, Research on Adviser Sentiment, December 2008.

the time to pile back in, and gives the manager flexibility to place investors' capital elsewhere until the risk/reward trade-off appears sufficiently palatable.

Doyle says the task for financial planners and investors to focus on in the months and years ahead is relatively straightforward.

He says it is neatly summed up by John Hussman, founder and principal of the US funds management group Hussman Funds, in an article entitled *The Stock Market is Not in 'Uncharted Territory'*.

"Our activity as investors is not to try to identify tops and bottoms, it is to constantly align our exposure to risk in proportion to the return that we can expect from risk, given prevailing evidence," Hussman says.

In other words, asset allocation should be dictated by where the best risk/reward trade-off is likely to be found, not by some ideological or marketing-driven adherence to a specific "growth

asset/defensive asset" split.

Hussman suggests that "investors can get a good understanding of market history by examining a great deal of data, or by living through a lot of market cycles and learning something along the way".

"Only investors who have done neither believe that current conditions are 'uncharted territory,' he says.

"Veterans like Warren Buffett and Jeremy Grantham have a good handle on both historical data, and on the concept that stocks are a claim to a very long-term stream of future cash flows. They recognise that even wiping out a year or two of earnings does no major damage to the intrinsic value of companies with good balance sheets and strong competitive positions.

"Most importantly, these guys never changed their standards of value even when other investors were bubbling and gurgling about a new era of pro-

ductivity where knowledge-based companies would make the business cycle obsolete, and where profit margins would never mean-revert.

"They knew to ignore the reckless optimism then, because they understood that stocks were claims on a very long-term stream of cash flows. They know to ignore the paralysing fear now, because they still understand that stocks are a claim on a very long-term stream of cash flows."

Doyle says it's counter-productive to spend too much time "trying to forecast what is largely unknowable", and that it's better to "redirect our focus to allocating our clients' capital to those assets likely to reward them most over an appropriate investment timeframe".

"First and foremost it suggests we should discard the notion of a fixed strategic asset allocation - typically dominated by equities - in favour of a much more dynamic approach that concentrates investor risk capital in those assets offering

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prospective returns aligned with the goals of the investor,” Doyle says.

“Consistent with this, it means we need to be contrarian in our approach. The time to be worried about risk assets was when [historical measured] volatility and implied market risk premium were low, like 18 months ago.”

Matthew Drennan, director of investments for Zurich, says diversification and a focus on risks and returns will stand investors in good stead in years ahead.

But “the first thing is to do a comprehensive risk profiling exercise with the client”, Drennan says.

“They have advanced a long way in recent years,” he says. “You can get a lot from putting various scenario questions to clients - what their real risk profile is, and what their tolerance for loss is.

“The second part, clearly, is that financial planners need to place some reliance on research house reports on various products to give them at least a fundamental understanding of what the risks and rewards of various products are.

“But I don’t think that’s enough. Once they have gone through the initial screening process, they need then to really understand the product in a detailed fashion. And I think that’s where some financial planners let themselves down, and let their clients down in the recent bull cycle.

“Some clients were being put too heavily into products that really were not adequate diversifiers in terms of their portfolios. I think it’s still very important to get back to basics and say that Investing 101 demands diversification in clients’ investment portfolios.”

Drennan says some fund managers were guilty, too: “You had situations where some fund managers were masquerading leverage as alpha - they would put together a product that produced a small amount of alpha and then by leveraging it four or five times they gave the illusion of creating significant alpha.”

It’s a challenging time to be defining and implementing investment strategies. Perpetual’s Damien Crowley says investors’ trust in the financial plan-

‘This is the question we should have focused on last year’

ning community’s abilities has been shaken. Investors’ natural move to safe havens (such as cash) and a very strong “home bias” in equities are two of the forces that planners need to effectively combat to keep long-term plans on track.

Now, more than at any time in the recent past, is when investors need really good advice, Crowley says. And a foundation stone of that advice is “regular, honest communication”, he says.

“Certainly, the main [business] response I have seen so far is an increase in client communication and contact,” Crowley says.

“It’s been quite hard for newer advisers who’ve bought into the business in the past three or four years. They may have borrowed money as part of a succession planning model, and now their income is down, but they still have to service those income costs.”

Crowley says the industry can be divided into two very broad groups.

First, there’s those planners whose entire value proposition was based on presenting themselves as some kind of investment guru, who possessed rare insights into markets and asset classes.

Those planners are doing it toughest, because by and large clients no longer believe what the planners have to say. They have failed comprehensively to deliver on an investment performance-focused value proposition.

But the second group includes those whose value proposition encompasses much broader issues, including education, strategic planning, and much less of a focus on predicting or promising particular investment outcomes.

“They are travelling quite well,” Crowley says. “It’s the ones who were not as clear about their

value proposition, or who have positioned themselves more as investment gurus, who are suffering a bit more.”

Tim Farrelly says a refocusing on proper diversification and sound strategic asset allocation remain key. Now is the time that planners should be listening to clients’ concerns, but seeking to mitigate against clients’ natural tendency to want to see a low-returning so-called safe haven.

“This is the question that everyone should have focused on last year,” Farrelly says.

“Right now, it’s not much of a problem, if the expected return from equities is, say, 14 per cent [a year] and from cash it’s 5 per cent. There is a huge equity risk premium.

“The risk of underperforming cash is pretty low right now. You’re being handsomely rewarded for taking the risk.

“Even if things go horribly wrong, and you get a return of 1 per cent to 2 per cent out of equities for the next couple of years, that’s more or less what you’re getting out of cash, after tax.

“The chances of dramatically underperforming cash over a longer time frame are pretty low right now.”

Even so, piling all your money into equities would not be a good move.

“I would still want to be really well diversified,” Farrelly says.

“One of the things about diversification is people bag it on the grounds that it has not worked in the past couple of years, because everything has gone down.

“Well, we know that when things are really crook everything goes down.

“But if it hasn’t helped that much over the last few years, it certainly hasn’t hurt. And you’ve got something that has the power to do you a lot of good.” ■

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