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BOTH SIDES OF THE LEDGER

Barra co-founder Andrew Rudd
is helping advisors build
portfolios that balance client
resources against future claims.

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BOTH SIDES OF THE LEDGER

BARRA CO-FOUNDER **ANDREW RUDD** IS HELPING ADVISORS BUILD PORTFOLIOS THAT BALANCE CLIENT RESOURCES AGAINST FUTURE CLAIMS.

BY C. MICHAEL CARTY AND JULIA M. CARTY

AMONG THE LESSONS ADVISORS TOOK AWAY FROM THE 2008 FINANCIAL CRISIS WAS THAT THEY MUST MANAGE BOTH SIDES OF CLIENTS' HOUSEHOLD BALANCE SHEETS MORE CLOSELY, NOTABLY LIABILITIES AND EXPENSES.

It's no secret that clients who survived 2008 and 2009 with the fewest psychological scars often were the ones who had their expenses under control and virtually no liabilities.

The most effective way advisors can help them get to that point is to balance client resources against the future claims against them. But in a profession that has devoted the lion's share of its human capital to the asset management side of the equation, that's not so easy.

Enter Andrew Rudd, the chairman and CEO of Advisor Software Inc. (ASI), the co-creator of a comprehensive, integrated approach to portfolio construction. Rudd is an expert in risk management, performance measurement, asset allocation and modern portfolio theory, having spent most of his career at Barra Inc., a prominent institutional consulting firm he co-founded and later served as chairman and CEO of from 1984 to 1999. Rudd launched ASI because he saw some of the problems facing financial advisors and thought they could benefit from an institutional approach to budgeting and risk. To this end he has filed U.S. patents for software, developed with head of research Nicolo Torre, that analyzes budgets for clients.

Rudd's resulting process may prove challenging to advisors and clients alike. Some advisors try to beat the market as if their clients' appetite for risk matched the volatility of the S&P 500 every day. Although advisors may think of risk as the volatility of returns, their clients think of it in terms of failure: How far can their portfolio values tank in a year such as 2008 and how much time will it take them to recover? They don't look at risk in statistical terms but in terms of failing to reach their goals or tackle their objectives. At best, the second home they wanted to buy might now be out of their reach, the trip around the world little more than a dream. At worst, they won't be able to live any longer the way they do today.

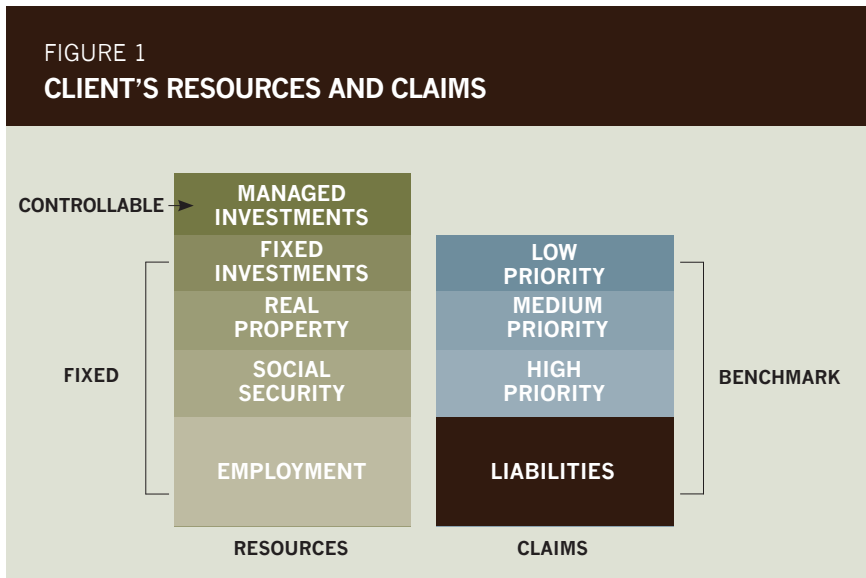
"By matching specific investments with specific objectives," Rudd says, "the resulting portfolio can have less overall risk than an ad hoc, mean variance approach, which frequently requires increasing risk to get a high enough return to achieve all goals."

A HOUSEHOLD BALANCE SHEET

The typical relationship between a personal or household balance sheet is illustrated in Figure 1. The asset side contains financial resources, including employment income, Social Security payments, rent or capital gains from real property, interest from fixed investments and current income and capital gains from managed investments. Each asset class normally has its own unique variability and risks (for example, interest income has lower variability and managed investments higher).

The liability side of the balance sheet contains claims against these financial resources. This list could include mortgage payments, financing charges, retirement living expenses, college education or capital purchases—a list of unavoidable fixed liabilities as well as obligations with lower payment priorities that might be postponed.

The challenge for advisors is to both satisfy claims while growing different sets of assets to meet them, matching specific assets with specific obligations. If a client has a lump sum payment to make in the future, for instance, then he must invest sufficient assets in a zero-coupon U.S. Treasury bond maturing at the same time. Meanwhile, he could invest other resources in more variable assets for more variable claims (plowing money into value stocks for a college education, for instance, or into growth stocks for luxury items). You're looking for the sum



total of all controllable and fixed assets to the total individual liabilities and claims.

Until recently, there were few formal methods for doing that, but Rudd has come up with one.

THE METHOD

ASI's methodology is implemented in several steps, the first of which is to capture the household financial goals and resources, and then represent them as a household balance sheet, a process that balances a client's marketable resources and the claims against them. ASI has built this process into a separate client Web site called "goalgami." (It is available free-of-charge to advisors on www.advisorsoftware.com.) The name is a portmanteau of the words "goals" and "origami." Like the latter, the Japanese art form that fashions a flat sheet of paper into a sculpture, the process allows an advisor to fashion a flat set of disparate goals into a quantifiable form so that he can develop a comprehensive portfolio strategy, one consistent with the client's risk preferences.

One planner who uses the goalgami Web site with clients is Lex Zaharoff, CFA, the founder and president of fee-only wealth management firm LZ Investment Advisors LLC in Weston, Conn., and a 28-year industry veteran. Goalgami helps Zaharoff because he says that clients' goals are usually fuzzy in their initial meetings. That's why this part of the process requires the heavy lifting of the clients—asking them to figure out what their real goals are so that the wealth management component can come later.

"Money is personal," Zaharoff says, "and speaking about goals with a client is difficult unless one focuses on the end goals such as standard of living, providing a college education, taking care of elderly parents or building an estate."

A typical question clients ask Zaharoff is, "Do I have enough to retire now?" The goalgami Web site doesn't answer yes or no, because the complexity of the answer cannot be determined solely by any analytical tool, despite its objectivity. Instead, the tool allows the advisor to ask the client, "What happens if you work for another five years?" The additional step in the analysis provides a more informed conclusion for both the advisor and the client.

Zaharoff first asks the clients to use the goalgami method privately, which encourages them to figure out what their goals are without being intimidated by him or feeling that he is in-

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—LEX ZAHAROFF



NEAL RINGQUIST,
PRESIDENT AND CHIEF
OPERATING OFFICER
OF ADVISOR SOFTWARE;
AND ANDREW RUDD

truding. After that, they can come back in a month and he can review the issues with them.

Advisors don't have the luxury of taking an infinite amount of time to analyze a client's goals. Because the user interface helps the client participate in the process, it leads to a more balanced asset-liability match.

"Essentially, Andrew took classical tools used in institutional work and applied them to personal finance," says Zaharoff. This is especially important because of the difficulty individuals have focusing on their goals, speaking openly about their spending habits and identifying major spending goals. By integrating institutional tools with the advisory function, an advisor can come

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up with a more workable investment solution for the client.

Another adherent, Rick Miller, the founder and managing member of Sensible Financial Planning, in Waltham, Mass., believes goalgami's household balance sheet approach is useful because it simplifies the lifetime financial planning problem. He often laments the state of financial planning and portfolio optimization tools. "They're generally not fully integrated," he says. "Most service providers are focused on either planning or investments. Andrew is making the strongest attempt at integrating both."

CONSTRUCTING THE INITIAL PORTFOLIO

The second step in ASI's portfolio construction approach after displaying the household balance sheet is the wealth management component—which evaluates a client's ability to bear risk by projecting his future cash flows. If there is a surplus of resources to help him meet goals, he will certainly have the capacity to bear risk (i.e., be able to confidently weather a downturn in the market) but depending on his tolerance for risk, he'll be more or less inclined to bear risk. If he's coming up short, on the other hand, he will have a lower capacity to bear risk (i.e., a market downturn will significantly affect his ability to achieve his goals) and he will either need to re-evaluate his goals or adjust his risk tolerance. Once the client and the advisor figure out the risk capacity together, the advisor can come up with an investment strategy, carving out the portfolio most likely to perform within the risk parameters.

This second step analyzes the current portfolio using institutional-caliber diagnostic tools that match the client's current allocation against proposed allocations, reveal style and industry exposures, find the client's proximity to the efficient frontier, anticipate cash flows and perform Monte Carlo simulations. This analysis can also offer insight into a wide range of investment products used to build portfolios such as mutual funds, individual stocks and bonds, ETFs, SMAs and variable annuities.

It can be simplified by the software, but the analysis can also be as extensive as the advisor wishes to make it. He can set up unique investment universes, asset allocation models or a collection of model portfolios. He can also generate multiple investment proposals, rebalancing plans and investment policy statements. Should he run into problems, he can access technical support, online demonstrations and live question-and-answer sessions.

FIGURE 2

HOUSEHOLD BALANCE SHEET FOR COUPLE WITHIN FIVE YEARS OF RETIREMENT



FIGURE 3

COMPARING THE GOALS-BASED ASSET ALLOCATION AGAINST A GENERIC WEB-BASED FINANCIAL PLANNING TOOL AND THE VANGUARD 2015 TARGET DATE FUND

ASSET CLASS	PORTFOLIO ALLOCATIONS		
	ASI GOALS-BASED	GENERIC ASSET ALLOCATION TOOL	VANGUARD 2015 FUND
EQUITIES (LG/MID)	5%	44%	47%
EQUITIES (INT'L)	6%	0%	12%
FIXED INCOME	—	52%	—
FIXED INCOME (TIPS)	87%	—	41%
CASH	2%	4%	0%

ACTUAL CASE STUDY: ANALYSIS AND RESULTS

A husband and wife, New York state residents, are within five years of retirement with comparatively little in the way of savings. They have an IRA worth \$500,000 and own a house, also currently worth approximately \$500,000 with a small mortgage outstanding, but they have decided for emotional reasons to retain the house and not sell it. The husband is still working and earns a base salary of \$95,000 per year, which will cease when he retires at age 65. They have estimated that their necessary expenses before retirement are \$60,000 per year, which will drop to \$48,000 per year after they both finish working. They need to invest their assets and any savings over the next five years to meet their declared level of essential expenses in retirement, since Social Security income will meet only a portion of their retirement needs. (See Figure 2.)

A quick look at their household balance sheet generated by ASI Wealth Manager shows they don't have a great deal of financial flexibility. Their capacity to bear risk is not great, suggesting that an investment of any significant amount of their assets into

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equities will jeopardize their goal of meeting their necessary expenses of \$48,000 per year in retirement. The ASI Wealth Manager suggested allocation is 11% in equities, 87% in bonds (with a large holding of TIPS) and 2% in cash (Figure 3). This solution is based on their declared household goals, so modifying them will potentially change their asset allocation. For example, if they were able to reduce their essential expense level and thereby free up some income for additional saving, then this may enable them to increase their allocation to equities—increasing the expected return on their investment assets though they will also bear additional risk. (See Figure 3.)

Also shown in the figure are the portfolio weights obtained by filling out a client questionnaire and using a generic asset allocation tool on a popular Web site. The results suggest a more aggressive equity allocation of 44% than the goal-based solution of 11%, and a less conservative fixed income position of 52% instead of 87%. The Vanguard Target Retirement 2015 Fund (VTXVX), designed for persons expecting to retire in five years, is a portfolio of preselected index funds automatically rebalanced to become more conservative over time. Currently, its asset allocation is the most aggressive of the three portfolios with exposures of 59% in equities and 41% in fixed income (TIPS).

Other industry sources recommend much higher equity allocations, some over 50%. These allocations force the

household to bear significant risk, which in down markets may require them to sell their house to survive financially.

PORTFOLIO REBALANCING, ONGOING MAINTENANCE

In addition to offering its goal-based solutions, ASI also offers portfolio rebalancing technology that allows advisors to rebalance single or multiple accounts, rebalance accounts tied to a household or to a model portfolio. And a growing number of financial institutions are offering this technology to independent advisors through their internal platforms, including Charles Schwab, LPL Financial and TD Ameritrade. ASI has seen the use of its rebalancing program increase 50% over the first half of 2010 compared with 2009.

David Umstead, the founder and president of Cape Ann Capital, a Manchester, Mass.-based fee only RIA, manages more than 100 funds. He constructs these from 18 carefully selected no-load mutual funds using ASI's rebalancing tool, ensuring that the individual fund weights remain consistent with a client's long-term strategic allocation. Early in his career, Umstead, a Ph.D. with more than 30 years in the business, used quantitative tools to help manage institutional accounts at Putnam Investments and State Street Global Advisors. He recognizes the

need to bring a well-defined discipline to manage high-net-worth clients.

"The more clients understand the process, the more they buy into the program and can commit to an asset allocation target," he says. This simplifies his management task, he says, because he can make changes to a client's strategic allocation whenever the client undergoes life changes affecting risk tolerance or return objective. They are "not the result of temporary tactical changes," he says.

At a time when people are making decisions about whether to stay in the workforce longer, about how to fund education or delay long-sought dreams, the market cataclysms of 2008-2009 remind advisors that each client's economic situation is unique, that his financial objectives are uniquely determined by his assets (marketable resources) and the goals (claims) against them. To construct a portfolio to meet client needs, an advisor must understand the magnitude and variability of the client's resources and claims and start speaking the language the clients are speaking about those risks that have the greatest bearing on their lives and decisions. Rudd and Torre's balance sheet approach, if nothing else, reminds advisors that risk is something seen in a different light by clients and advisors. That makes it valuable for both. **FA**

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