

INSIDE INFORMATION

The newsletter for serious financial advisors. (www.bobveres.com)

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EARLY WARNING

● Notable upcoming conferences: the NexGen Conference, July 20-22 at St. John's University in St. Cloud, MN (70 miles from Minneapolis/St. Paul), and the FPA Reunion at the same site, July 18-21. Register at: <http://www.fpanet.org/nexgen/> and at <http://www.fpanet.org/reunion/>.

Also: the PridePlanners conference in Washington, D.C., at the L'Enfant Plaza Hotel, September 27-29. Register at: <http://www.prideplanners.com>.

BEYOND GALILEO

NAPFA's annual meeting explored the art and science of creating client portfolios in a new post-MPT era of investing.

The NAPFA National conference in Chicago was really four conferences held in the same time and space. First, the organization is pioneering something called NAPFA University, which (eventually) will be the subject of an article in this newsletter. For now, let's just say that every NAPFA meeting now includes an organized curriculum in each technical area of the profession, with increasingly advanced-level courses in development.

Second, each conference also features Basic Training, helping newer advisors get up to speed on creating and running a planning practice.

In addition, this particular meeting was organized around two interlocking themes: 1) helping advisors become better communicators--in speeches, in their client presentations on complex topics, even in their e-mail messages; and 2) an unusually detailed look at the evolving science of creating and tending client portfolios. The actual theme might be fairly summarized as: why traditional modern portfolio theory is becoming increasingly quaint and outmoded.

We'll focus on the communication theme in the next article. Theme Two began with a bang: the opening keynote presentation by Woody Brock, of Strategic Economic Decisions, Inc. Brock started with a more general issue: he told the audience that their biggest challenge going forward will be figuring out how to resolve a growing information overload problem--for themselves and their clients.

“Where do we turn for accurate guidance?” he asked aloud. “How can we tell what DOESN'T matter?” Brock envisions a day (I think he

You can't register at the NAPFA regionals yet, but for more information, go to <http://www.napfa.org/conferences/UpcomingConferences.asp/>.

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was actually talking about tomorrow or, at most, sometime next week) when we are drowning in millions of factoids, with more coming at us every day. Keeping up with it becomes a dangerous drag on our time, especially since, in reality, very little of it really matters.

The solution to (often irrelevant) information overload, Brock told us, is “a good theory,” which does several things. First, it gives you a context with which to decide whether this or that fact makes sense. Second, he said, it “gives you better forecasts, and helps you be less wrong than others in a complex world of structural change.” Less wrong? “Being ‘right’ has no meaning in this kind of world,” Brock told the audience, explaining that in times of radical global change and adjustment (think: the rise of China and India, and also of terrorism and global oil shortages), there is no possible way to accurately predict exactly how the future is going to play out.

So what does a good theory look like? Brock’s best example was understanding how inflation moves—which is important to financial planners for two reasons: inflation erodes the real value of assets, and it influences the Federal Reserve Board, whose policies impact the U.S. economy. Brock’s theory of inflation breaks it into two very different components: inflation on Main Street (think: the rising cost of toothpaste) vs. inflation on Wall Street (think: stock market bubbles). If you draw the distinction, you quickly discover that Main Street inflation is running on the order of 1.9% a year, which is unlikely to

drive the Fed into a panic.

To follow (and anticipate) movements in Main Street inflation, Brock told the audience, you would look primarily at unit labor costs (which, he showed graphically, are in a prolonged downtrend) and a psychological component he described as the general public’s “inflation expectations” (also going down).

Dig a bit deeper and you find that unit labor costs are highly dependent on productivity, which is tracked by a variety of economists, in and out of government, with some precision. Brock pulled them all together by pointing out that wage growth exploded in the 1970s precisely because productivity declined—and inflation soared as a result. Indeed, the fact that it was soaring created a psychological bias toward planning that it would continue soaring, which meant that workers demanded higher paychecks each year just to stay current.

From 1981 through 2005, the whole trend reversed itself. During that period, productivity exploded, increasing at a rate of 4% a year. At the same time, the rise of China and India (Brock refers to them as “Chindia”) put more workers on the global market, hollowing out the bargaining power of the individual laborer. The theory leads to a prediction of more of the same until something changes the underlying drivers.

A good theory can also help to Wall Street Inflation, which we might translate into: how securities prices are moving, since most of the dramatic movements in stock prices come not from underlying corporate performance, but from

the willingness (or not) of investors to bid up the prices. One important driver, Brock said, is the availability of credit. Another is the explosion of optimism about returns—analogue to the expectation of inflation. “In 1980, the average person expected zero returns from stocks,” he said. “That had been their experience for the past 10 years. The result was a P/E of 7.8. In 2000, people expected 13% a year; that had been their experience.” Result: a rising P/E.

This led Brock into Theme Two: a discussion of the efficient market hypothesis, which he compared to Galileo’s theories—revolutionary in their time, but kind of quaint in a world of quantum mechanics and string theory. Specifically, Brock took issue with the underlying assumption of a stationery environment. “The [efficient markets] theory assumes that things can change, but the way they change doesn’t change,” he told the group. “Therefore, it assumes we can extrapolate from history. Every investor is assumed to be making rational decisions, and every piece of information is factored into the price of assets.” In the best line of the conference, he added: “Markowitz was absolutely right on a planet that we don’t live in.”

So what IS right? Brock said that advisors have to embrace the reality that the way things change changes, and then try to sniff out the major structural changes that are taking place around us.

One example is oil. Brock offered an interesting slide showing two supply and demand curves, one in the past, the other today. The more recent curve is steeper, which means, for a variety of reasons,

that oil prices are going to be more volatile on the upside AND the downside going forward, and also that small events could send prices much higher than anybody seems to be expecting--an effect that has been noticed by anybody who has visited a gas pump lately. "Oil prices have risen 300% without any visible drop in demand," Brock said. "This is characteristic of a vertical demand curve." The same thing, he said, is happening to certain other commodities like, for instance, copper--where, like oil, many of the largest reserves are located in places inhospitable to capitalism.

Advisors should also begin to believe that they can exploit market misbehavior--those times when mass psychology (specifically high or low return expectations) results in a joint mistake--when, as Brock put it, "most people are both wrong and highly-leveraged." And, he said, advisors can begin to exploit logical errors of inference about how



*"I'm much too busy for a financial plan.
Couldn't you just give me a few half-baked suggestions?"*

the markets work. His analogy was a farmer in Vermont who knows to plant certain crops in the Summer and others in the Winter, and not the other way around. The implication: that it is possible to know the investing season and climate and to adjust your portfolio accordingly, rather than planting the same crop every season (buy and hold based on historical returns) and watching it die with some regularity during the adverse seasons.

How do you know what season we're in now, and when the next season will arrive? Brock failed to provide a definitive answer, but he is coming out with an online service that promises to explore these issues in detail (www.minimax.com). As the seasons pass, we'll have a chance to see if his theories are good enough to identify climate changes in time to

plant the optimal investments.

Correlationless Investing

Rick Ferri, of Portfolio Solutions, LLC in Troy, MI, addressed another modern portfolio theory issue: the fact that correlation coefficients are constantly moving around, making the efficient frontier a moving target. In many ways, Ferri is an MPT traditionalist; his firm manages some \$300 million of advisor assets using index funds and ETFs in scientifically balanced portfolios. But he confessed that he's troubled by the way most advisors determine their asset mix. "The problem with mean-variance optimization models," he said, "is that you input one correlation number, even though the correlation

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Inside formation

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Trendspotter

Not one but two major announcements came out of the CFP Board this month: the naming of a new CEO, and a decision to relocate from Denver to Washington, D.C.

The DC move may be the more interesting of the two, because the avowed purpose is to “solidify the organization’s plan to have a more influential voice in public policy debates,” presumably by making it possible for Board executives to walk to Capitol Hill rather than send e-mail messages. Public policy in the Board context would seem to involve regulatory issues, but the press release hinted at a broader scope, talking about the public’s “ever-broadening array of financial planning challenges and options.”

The new CEO, meanwhile, is Kevin Keller, chief operating officer of the Bethesda, MD (Washington, DC-area) based Association for Financial Professionals--whose 15,000 members are CFOs or corporate treasurers. In that role, Keller works for AFP CEO James Kaitz--who happens to be a volunteer member of the CFP Board of Governors, one of its two non-CFPs. The AFP sponsors and administers the Certified Treasury Professional designation, but unlike the CFP Board, it is also a membership organization which publishes its own magazine and runs an annual conference larger than anything in the financial planning space.

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between any two asset classes is constantly shifting.”

To illustrate, Ferri showed a slide that graphed the correlation coefficient between the S&P 500 and 5-year Treasury notes. The long-term average correlation is 0.10, but the actual number, measured on rolling 10-year periods, ranged from near .50 on the plus side to somewhere around -.25.

“So now you have a simulation model,” said Ferri, “and you want to optimize the portfolio going out ten years. What correlation do you put in? If you put in the range of returns, and run an optimization using the range of correlations, you get a whole range of possible portfolios. Which one is right? Which one is optimal? You really don’t know how much benefit you’re going to get from asset class diversification.”

His solution: leave out the correlations altogether. “In our portfolios, we assume that everything is positively correlated all the time,” says Ferri. Instead of using historical returns, he uses a complex system which basically looks at the historical volatility of each asset class, and then calculates an expected risk premium--a possible future return figure which he believes is much more stable and predictable than correlations. Indeed, one of his slides showed that the most consistent figure related to each asset has been their volatility relative to each other. “Large cap stocks are always more volatile, over any 10-year period of time, than Treasury Bonds, and so forth, all the way down,” says Ferri.

Armed with expected returns

(the relative risk premiums of each asset class) and historical volatility, Ferri can calculate a portfolio’s expected return and risk by taking the weighted average expected returns and volatilities of the asset classes. The result will be an underestimate if there is some benefit to correlation; if the asset class correlation coefficients turn out to be anything lower than 100. “If you wind up with the benefits of lower correlations, and lower volatility, then that’s a bonus,” says Ferri. “But in the meantime, you’re overestimating the amount of risk, so that the actual portfolio will usually be less volatile than what you’ve illustrated.” Call it one more way to control client expectations. And, maybe, an efficient frontier that you can hit more easily.

MPT on Steroids

Instead of ignoring correlations, Bryce James prefers to watch them in real time. In what may have been the most intriguing presentation at the conference, the president of Seattle, WA-based Smart Portfolios gave a tour of all the many financial and mathematical innovations that have come along since the original Markowitz paper in the early 1950s: Capital Asset Pricing Theory (1964) and Inter-Temporal CAPM (1973), Arbitrage Pricing Theory (1976) and Macro Arbitrage Pricing Theory with lagged variables (1987), Value-at-Risk (1994), Extreme Value Theory (2002) and James’ own innovation, Dynamic Portfolio Optimization (2005). Of course, the members of the audience were sinking lower in

their chairs as each new model was identified and discussed, since the profession is still pretty much using 1950s investment models.

And not even the full version of that. Later in the presentation, James pointed out that Markowitz himself had hoped to use correlations between individual assets (rather than whole indices, as most of us do today), and forward-looking earnings forecasts (rather than historical numbers) to anticipate what the correlations might be in the future. The data and computational limitations of his era forced him to accept simplifications.

Today, James is under no such constraints. With a data feed, he can assess the day-by-day movements of individual security prices and correlations. Since the correlations tend to go up during market downturns, he will watch for times when they seem to be tightening, and add assets which are less correlated (bonds? cash?), trying to keep the overall diversification stable. That, in turn, helps the portfolio sidestep bear markets, since money is moving into things that aren't moving down in lockstep with the market. It's like MPT on steroids.

James also challenged the traditional bell curve of returns and, indeed, standard deviations as a proxy for the actual distribution of returns. His graphs of different asset returns bore a superficial resemblance to the traditional bell curve until you looked at the tails, where the actual distributions extended out to places that practically don't exist on the bell curve. Focusing on the movements of the Dow, James showed a chart which calculated the probability,

based on the mean return and standard deviation of the Dow, that the market would lose 7.18% of its value in one day on October 27, 1997 (one in fifty billion), or the August 27, 1998 drop of 4.1% (a mere one in 20 million, or one in 100,000 years of daily trading). The chart showed one-day drops of 7.1% (September 17, 2001), 5.7% (April 12, 2000), 6.4% (August 31, 1998) and 4.4% (September 20, 2001). In July 2002, there were three steep falls in seven trading days, an event which traditional mean-variance mathematics predict to happen, at most, once in the entire 14 billion year duration of the universe.

Rather than model an asset's return with a bell curve that doesn't accommodate these anomalous events, James prefers to let the computer draw a curve that fits the actual return profile of each asset. This allows him to graph changes in real time--creating something that he compared with a "Doppler Radar" forecast of the weather, with heavy emphasis on the negative end of the tails. The goal is to identify and then forecast trends in different stocks or mutual funds, telling him when they appear to be reverting back to the mean after extreme behavior--or moving into zones of extreme behavior on the upside or the downside.

Mean Reversion made Visible

But is there really any such thing as mean reversion? The last day of the conference featured DePaul University behavioral finance professor Werner DeBondt, who outlined three competing

theories of stock prices:

1) *The random walk model*, articulated by Gene Fama at the University of Chicago, suggests that at any point in time, a stock's price is exactly equal to its value, and you can estimate the value using a discounted cash flow model.

2) *Herd psychology*, articulated by John Maynard Keynes, posits that there could be times of complete disconnection between prices and values (think: most of the late 1990s). Keynes coined the term "animal spirits," which economists use today to describe economic forces that are causing effects their models don't predict.

DeBondt offered some evidence that this model is the most accurate. "Suppose you knew beforehand the earnings of all publicly-traded companies," he proposed. "What you'd find is that this information wouldn't help you very much in getting above-average returns."

3) *The reversion to the right price*, articulated by Ben Graham. This model assumes that there is a long-term connection between prices and values, but in the short run, the human factor can drive a gap between the two.

Most of the rest of DeBondt's presentation offered evidence that the first theory is at best incomplete. "From a time series perspective, there's astonishing evidence of seasonality, mean reversion, intermediate-term momentum and other anomalies," he said. To this, he added herd behavior, which DeBondt postulated was itself a very powerful driving force in stock market behavior. He defined it as:

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a change in a person's behavior as a result of real or imagined social pressure--when people feel more or less inclined to do something because others are doing it.

As a simple example of herd behavior, DeBondt suggested that we look at pictures of men at a baseball game in the 1940s, and notice that all of them are wearing a hat. Look at a picture today, and there are very few hats, especially with the wide brims. "Have the objective reasons for wearing hats changed over the last 50 years?" he asked the audience.

If you apply herd behavior to the dynamics of a market bubble, you end up with four phases:

1) An economic or fundamental shock justifies a market movement.

2) Rising investor confidence, extrapolation bias, use of leverage and speculation drive the market higher for reasons other than economic fundamentals.

3) Herding behavior sets in, driven by positive feedback trading (the market is going up! I have to get in before it's too late!), with many newcomers flocking into the market.

4) The herd becomes aware that prices are too high, and there is a rush for the exits.

What does this look like in the real world? DeBondt offered the results of some research initiatives that are so simple even a journalist could do them. He took the seven countries that make up the G-7--Canada, France, Japan, the UK, the U.S., Germany and Italy--and, starting in 1969, ranked all of them against each other according to their stock markets' most recent three-year

performance. Then he assumed that he had invested, over the subsequent two years, in the economy with the highest prior returns, and (separately) in the economy with the lowest returns. He calculated the data for rolling monthly periods, giving him 388 different time periods, and found that, on average, the highest-performing countries' markets underperformed the average returns of all the markets by 6% a year, while the underperforming countries' markets outperformed the average by 5% a year. In all, the difference was an astonishing 11% a year.

DeBondt also performed the study with smaller countries, and combinations of two "winners" and "losers," and found the same effect. He tried to correlate these movements with the underlying economic changes in each country (Recessions? Currency movements? Trade policy improvements?), and found no such correlation. The only reasonable explanation was mean reversion over time, a kind of herding behavior captured in time-lapse photography.

Initial Conditions

DeBondt was followed by James and fellow panelist Ken Solow, of Pinnacle Advisory Group in Columbia, MD--and Solow offered more evidence of mean reversion. Early in his presentation, he showed a graph, from Crestmont Research, which divided 87 different rolling 20-year return periods on the S&P 500 into deciles; the worst-performing (returns ranging from 1.2% to 4.5% a year, averaging 3.2%) on top, the 10% of those 87

that performed next-worst (4.5% to 5.2% a year, 4.90% average) all the way up to the top decile (11.9% to 15% annual returns; 13.4% average). The slide also showed the average beginning and ending P/E ratio of the index for each of those 20-year periods.

The pattern illustrated what Brock called Wall Street inflation--and deflation--in stunningly clear terms. The worst 10% of all 20-year periods started with an average P/E of 19 and ended with a P/E of 9--deflation at its worst. The next-lowest-performing decile started with an 18 P/E and also ended at 9. The three best-performing deciles all started with P/Es of between 10 and 12, and ended at between 20 and 29. The audience could hardly fail to note that the market today is trading at a higher multiple than the average starting point for those worst deciles.

There are actually two points to the slide. One is that the buy-and-hold investment portfolio won't necessarily return what the market has averaged over the past 50 years--and, indeed, may not deliver more than 3.2% a year over a 20-year investment horizon. Solow noted that the middle decile only delivered an average return of 6.7% a year, which appears to mean that most of the time, investors are getting below-average returns, punctuated by sudden vertical updrafts that certainly cannot be counted on in advance.

The second point is that initial conditions matter when you look at expected returns. As Solow pointed out, and this slide makes clear, when you're investing at a time when investors aren't clamoring for stocks,

Communications 5001

Giving speeches? Teaching clients about their investment options? Here's an advanced curriculum in how to deliver important information effectively.

your chances of outperforming the historical averages are better than when you're (to use DeBondt's phrase) following the herd into a late-stage bull market and buying at more than 20 times earnings.

In addition to simple P/E valuations, Pinnacle looks at 30 different economic indicators, trying to anticipate the overall impact on the stock market. Solow admitted that this isn't scientific; interpreting how energy prices, the loan default rates, the shape of the yield curve and the movements in the trade-weighted dollar will affect stocks is much more art than science.

At the end of the conference, where DeBondt was followed by Bryce James and Ken Solow, the advisors who were still in the room were shaking their heads, either dazed or exhilarated. One advisor described the experience as "liberating," because the sessions, taken together, plausibly removed the constraints of historical returns and buy-and-hold investing and let him think again about how to add value to client portfolios.

This is likely to be a subject of considerable debate over the next couple of years, and I expect that people who have relied on Markowitz and MPT and MVO and 1950s technology will mount their own counterrevolution in an effort to rebut all this newfangled thinking. Advisors who attended NAPFA National will have a strong leg up on whichever side of the debate they choose to side with. They were, after all, exposed to as much good, out-of-the-box investment thinking as any conference is likely to offer for some time to come. ■

Arguably the biggest challenge in today's planning profession is effective communication: to the community about the value of your services; to clients in order to change their behavior in beneficial ways; to *everybody* about what the numbers mean after you've completed a financial plan. This was Theme One at the NAPFA National Conference in Chicago, which introduced the audience to some experts and speakers you probably haven't heard from before.

Such as? Let's start with Sam Savage, a professor of Management Science and Engineering at Stanford University, and Andy Parker, head of the quantitative strategies group at Bessemer Trust in New York. Savage started out telling us what we already know in an interesting new way: he said that linear projections that assume the same annual return each year will dramatically understate the chance of failure. "If a drunk is walking in the middle of a busy highway, weaving and staggering around, his average position is on the white line," Savage told the group. "On average, he is alive, but his actual chance of survival is nearly zero."

Then Savage demonstrated a "probability management" program from a company called Frontline Systems, which lets you build interactive simulations about just

about anything—including, of course, retirement projections. He showed that advisors who run Monte Carlo simulations using one set of data and assumptions are almost as naive as those who project retirement sufficiency with spreadsheets—because they are relying on a stable set of assumptions in an era which (as Rick Ferri pointed out in the earlier article) gives us ever-changing ones.

Savage believes that advisors need a "stochastic library" of different possible inputs for mean returns and volatility (alternatives to the log normal distribution around a stable expected return) and different possible correlations between assets and asset classes. Instead of running one simulation, the advisor plays with a lot of different possibilities, and begins to communicate these alternative futures to clients.

Savage was the theorist; Parker came up next to show us how to make the connection with clients. To start with, he showed a slide of 60 disastrous events and scandals, all negative fat tail events, since 1900. The list was impressive: two world wars, a couple of presidential assassinations, major scandals, economic collapse and market meltdowns, all happening with surprising regularity during a period when the Dow climbed from double digits to over 12,500. "At

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