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Where is your real value add to clients?

The Rand weakens dramatically. The oil price rises steadily. Trump threatens nuclear war with Rocket Man. America suffers its worst mass murder of modern times. For the umpteenth time another hurricane causes mayhem, signalling that climate change may not be a hoax perpetrated by the Chinese. Not to mention ISIS, terror attacks, the rise of the right wing in Germany, or the Guptas. Our world today seems to be lurching from one potential catastrophic crisis to another.

What do your clients make of all this? Nervous? Despondent? Desperate? Do they want to change their investments as a result of any of these events? What are the types of conversations you are having with them? What actions are you taking? Have you been lured into speculating on the future of the Rand? Never mind the future of the Guptas, or Zuma. Perhaps the two are linked? Or is it more complex than that?

Whilst speculating about the future makes for interesting conversation, that's where it ends. After all, we don't know. Nobody can predict the future. Yet you are in the business of preparing your clients for their future. So how can you add value to them if you can't predict anything for them? A number of industry experts suggest that you can add profound value to your clients by helping them to manage their behaviour.

Meir Statman, author of the book, *What Investors Really Want*, says "93.6% of the financial planning process is the behavioural management of clients". I'm not sure how he gets to this exact percentage, but he obviously thinks it's important! In a similar vein, Don Phillips of Morningstar, reflecting on 25 years in the industry, suggested that financial planners and asset managers are not in the "money management" business, but rather the "behaviour modification" business.

Vanguard's research found that a financial adviser can add about 3% "alpha" to a client's portfolio, and at least half of that value add is due to "behavioural coaching". Envestnet also puts the advisor-value add, which they refer to as "Capital Sigma" at around 3%. While they

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acknowledge the critical importance of getting to know your client and your relationship with the client, they find it difficult to quantify the value add of this aspect of financial planning.

Nick Murray, in his book *Behavioural Investment Counseling* on the other hand argues that the value is very clear. He cites the Dalbar study which repeatedly shows over periods up to 30 years of annual studies that investors pay an "investor behaviour penalty" of, on average, between 5% to 7% per annum depending on the time period being measured. This penalty is due to investors making mistakes like chasing performance in funds, buying high and selling low, or making investment decisions based on news in the markets, or in response to events in the world, rather than sticking to a well planned investment strategy. Switching in and out of funds also incurs costs, which hamper investment returns.

They demonstrate this penalty by comparing the returns of funds and market indices, versus the actual returns that mutual fund investors achieve. For example, in 2014, the average equity mutual fund investor in the US underperformed the S&P 500 by 8.19% an even higher margin than the long-term average. The broader market return was more than double the average equity mutual fund investor's return. (13.69% vs 5.50%)

Murray argues that as a financial planner, the value of being able to help manage the behaviour of a client is equal to the "investor behaviour penalty" minus your fees. So if you charge on average 1% pa, then the value you can add to a client's portfolio is on average 6%-1% = 5%. This suggests that the value of being a behavioural coach lies anywhere in the range of 1.5% (Vanguard) to 5% (Murray) of "alpha" to a client's portfolio. It also highlights that if clients were simply able to rely on their financial adviser to stop them behaving badly, the implications for their investment portfolios would be profound. And more importantly, the implications for the outcomes of their financial plan would in all likelihood be material to the lifestyle they can lead in later life.

Murray actually goes one step further to propose that investment performance is irrelevant. "That is, it has no significant bearing on the long-term, real-life return of real people". He argues that the "dominant determinant" of this is their "own behaviour". As a result of this perspective, as an adviser you can, "almost at will, become an extraordinarily effective manager of the behaviour of your clients with respect to their investment decisions. This will unfailingly lead to superior long-term, real-life returns for your clients." Now one can debate whether you can simply do this "at will', but certainly if you can find a way to effectively manage the behaviour of your clients, you will have a profound influence over their "real-life returns".

According to Murray the alternative is that "you may – with almost limitless amounts of very hard work and constant anxiety – become a relatively good manager of investment portfolios themselves". But, no matter how much time and energy you put into this activity, "you will only intermittently – and quite unpredictably – 'outperform' the markets. And, at the end of the day, all your hard work will be destroyed by the irrational behaviour of your clients – speculative euphoria at market tops, and panicky capitulation at market bottoms to name only two".

This provides a challenging dilemma for financial planners: become a good manager of investment portfolios, or an excellent behavioural coach. Murray argues that you have to make a choice between these two pursuits, as you can't achieve excellence in both. Just one, or the other.

So as you have conversations with clients about the latest catastrophe, or about the demise of the Rand, or the sideways movement of the markets, consider where you will be adding the greatest value to their lives? Will it be in speculating about the future and finding a "better" investment? Or will be it in encouraging and supporting "better" behaviour?

The outcome for you and your clients will be significant. If your clients know that you are there to help them achieve real-life returns through good savings and spending habits and not getting caught up in emotional responses to events in the world and the markets, or in their investments, then the quality of your relationships will surely be enhanced. You will be able to focus on what's important, your client's life, rather than trying to explain why one fund in which your client is invested is underperforming this month, or why you didn't invest in another fund when it happens to be the top-performing fund this year. That's a loser's game, both for you and your clients.

Deciding where you actually add value to your clients, and pursuing that avenue to the best of your ability, could equate to a 5% greater return per year, compounded for a long time. This is a real-life return to your client, and yes, quite a handy return to your business if you charge asset based fees. Not to mention your quality of life and that of your clients.

If you need a "nudge" to help you decide where your value is, you may be inspired by the award of the 2017 Nobel Prize for Economics to Richard Thaler, co-author of the book *Nudge: Improving decisions about Health, Wealth and Happiness*, for his work in the field of Behavioural Economics. His research showed how traits such as lack of self-control and fear of loss encourage decisions that may not have the best long-term outcome for an investor. And yes, these are the sorts of traits that are triggered by the potential and real catastrophes that have impacted markets, and investors, for hundreds of years.

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