

# INSIDE INFORMATION

The newsletter for serious financial advisors. ([www.bobveres.com](http://www.bobveres.com))

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## STRUCTURED GUESSING

*If investing is as much art as science, how do you strengthen the science end of it?*

Tom Coyne first caught my attention when he wrote an op-ed contribution to the Financial Times of London which drew an interesting distinction between trying to navigate through efficient markets and through adaptive ones. Most of us, I think, agree that the investment markets--and, indeed the economies they reflect--are not perfect models of efficiency, but most of us stop there and simply compensate by using tools designed for efficient markets somewhat more cautiously.

Coyne argued that economies and financial markets are best viewed, in his words, "*as complex adaptive systems, filled with positive feedback loops and non-linear effects caused by the interaction of competing strategies (for example, value, momentum, and passive approaches), and underlying investor decisions that are made by people with imperfect information and limited cognitive capacities, who are often pressed for time, affected by emotions and subject to the influence of others.*"

He continued, in the Financial Times piece, by suggesting that investors and advisors abandon a rigid belief in buy and hold, and pay more attention to asset class valuations and how the evolving economic situation could change them. Along the way, we need to shift our collective attention from external performance metrics to achieving the long-term portfolio return that each investor requires to meet his/her goals. "*When your objective is to outperform your peers or an external benchmark,*" he wrote, "*it is too tempting to*

*vice).*

The clue? Walter is asking for modification of the 1934 and 1940 acts, governing BDs and Advisors, and then recommends a uniform standard of conduct which would fudge the fiduciary standard by basing it on the scope of the engagement and type of client. And enforcement would be rule-based: Walter recommends business practice rules. (You can find the full text of the speech here: <http://www.sec.gov/news/speech/2009/spch050509ebw.htm>).

## EARLY WARNING

●When is a fiduciary not a fiduciary? SEC Commissioner Elisse Walter, who used to work with Mary Schapiro at FINRA, has called for all advisors to follow a fiduciary standard, which may have been a way to blur the lines between the FINRA position (harmonize regulation and put everybody under FINRA's SRO structure) and the fiduciary RIA position (require real fiduciary standards for anybody offering investment ad-

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## Structured Guessing

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*stay too long in overvalued asset classes, as too many investors have painfully learned."*

This, it seems to me to, could be a pretty good outline of the next leap in our awareness of how to invest, kind of like the profession's phase transition from the investment pyramid to correlation coefficients that took place back in the late 1980s. And, as it happens, Coyne is quietly leading this thought leadership charge, publishing a monthly newsletter called Index Investor (<http://www.indexinvestor.com>), which monitors asset class valuations according to what MIT economist Allen Lo has called "The Adaptive Markets Hypothesis."

Coyne's background includes working, as a young man, as an international banker with Chase Manhattan, followed by employment at the International Monetary Fund trying to help unravel the enormous (and unpaybackable) loans that U.S. money center banks had made to developing nations in Latin America. He moved back into the banking industry in 1983 and worked on creating, for distressed bank portfolios, the kind of investments that he thought he would never see again: debt/equity swaps and securitized loans. He worked as an investment banker in London until 1994, when he turned his hand to serving as the global CEO of the Corporate Growth and Turnaround Center of Excellence, a consulting consortium that consisted of 300 business school professors organized by the Harvard Business School. After CapGemini

purchased the firm, he worked as a financial services consultant and CEO of an environmental technology company before joining Index Investor.

In followup messages, Coyne suggested to me that we (professional investors) need to finally concede that market disequilibrium is the *natural* state of affairs, not the exception. Asset allocation is still the most important investment decision, but the optimal allocation is always changing because of conditions on the ground—the ever-evolving economy and the over- or under-shooting of markets by investors who are participating either in a buying or selling frenzy.

For those who (like me) were nervous that the New Paradigm in investing would be highly mathematical and too complex to understand or implement, Coyne offers a reassuringly straightforward way to address all the things we've been trying to figure out. I found him to be equally-accessible, and the Index Investor web site and newsletter service are even more so. They cost just \$195 a year, which buys you a LOT of monthly commentary on different possible future investment scenarios, plus model portfolios denominated in eight different currencies, each stress-tested against thousands of different hypothetical return regimes.

You also get monthly comparative valuations of stocks, various bonds, commercial property, commodities and timber—all discussed as index valuations, although Coyne seems to have no

strong objection to your chasing a bit of alpha or using an active manager to buy any of this exposure.

Looking back through past issues, I found a rather strongly-worded analysis published in May 2007, which begins with the following:

*Long-time readers of The Index Investor and Retired Investor know that we have a soft spot for quantitative analysis, as we believe it helps prevent our decisions from being overly influenced by emotion and the cognitive limitations that are hard-wired into all human beings. That being said, we also believe that eons ago we were also endowed with an "inner voice" or instinct (perhaps "Spider Sense" is a more appropriate modern term) that warned us when we were in danger, however unaware we might be of its specific source. Our modern preoccupation with quantitative analysis (not to mention political correctness) too often causes us to ignore these instinctive warnings, sometimes with disastrous consequences.*

*With that in mind, this article will try to summarize why our inner voice is growing louder with its warning that big (and negative) changes are not too far away in the world economy, even as global growth continues to be strong, equity indexes around the world hit new highs, and credit risk margins are at or near record lows.*

Despite his experience in various niches of the global financial system, Coyne says that his fundamental view of the markets came when his wife's father

suggested that he talk to members of the Santa Fe Institute. “That was where I was introduced to the whole complex adaptive systems theory, at a time when I was doing consulting and turnaround work,” he says. “It was natural, in that context, to ask, wait a minute: How do bubbles form? Complex adaptive systems theory did provide, in my mind, some basis for thinking in a more structured manner about, okay, how do you actually recognize that asset classes are not always efficiently priced, and markets and economies can be in disequilibrium? I had my business school degree, my undergrad in international economics, my masters in finance, so I was saying, okay, where do you take the classical valuation approaches and adapt them to a disequilibrium situation? And then you could take a step back and say, okay, I can also see how investor behavior and momentum and other factors can work their way into this.”

One key insight from all this research is that different asset classes will inevitably be under- or over-valued at different times, for all the reasons that we all know and love. But Coyne doesn’t think that simply comparing today’s valuations with historical norms will be as effective as this might imply. “Valuation analysis may actually not be very helpful in the short term,” he admits. “But if there is a tendency or attraction toward equilibrium, then they should be helpful in the long-term.”

Coyne thinks that individual investors and advisors have an advantage over institutional or fund investment professionals because you don’t have to set the default goal as beating your peers. Instead, you can adapt the goal specifically to the client’s circumstances. “If you’re facing an external metric, whether it’s a peer metric or an index benchmark metric, you have to be as cognizant of not investing in something that goes down as in investing in something that goes up,” he says. “Type 1 and Type 2 errors are equally important to you. At the margin, that can force you to stay into something you consciously know is overvalued for too long. Knowing lots of people who are professional investment managers and advisors,” Coyne adds, “I appreciate that most of them are good ethical and smart people who want to do the best for their clients. But the clients often hold them to a set of performance standards that forces them into very challenging decision situations.”

The alternative? “Once my metric changes to: am I on target

for this long-term liability-driven rate of return that I need,” says Coyne, “once you have an asset allocation and rebalancing policy in place, which looks like it has an acceptable probability of getting you to that goal, then it is no longer a 50/50 balance between the kind of mistakes you can make. It becomes much more important to avoid overvaluations and big downside losses than it is stretching for that extra bit of return. And similarly,” he says, “once you’ve gotten out or hedged something that you think was really overvalued, you no longer feel the same kind of pressure to absolutely get in at the bottom. By virtue of the fact that something has declined so much, history says that the expected rate of return from that low starting point is going to be higher than the average you probably used when formulating your long-term portfolio target. History is on your side. You don’t have to be perfect in your timing getting back in.”

That, of course, brings up the May 2007 article calling attention to a possible future meltdown, and a certain amount of nagging in subsequent newsletters about the issue. “Normally you can pretty much talk about diversification and rebalancing as good ways to minimize downside risk,” says Coyne, “but by May of 2007, we had reached the point where it was clear to us that those things are not always sufficient. When you see these widespread overvaluations, and Charlie Prince saying, we are just going to keep dancing--I had memories of Joe Kennedy saying

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**Editorial offices:**

1804 Garnet Avenue  
Suite 510  
San Diego, CA 92109.  
E-Mail: bob@bobveres.com

## Structured Guessing

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that he decided to get out of the market in 1929 when the shoe shine boy started giving him better stock tips than the professionals. I don't claim that we called it completely accurately," he adds, "but we did make reference to the fact that housing prices are dropping, and said that we don't see any evidence of that in the market, and that cannot last. Our reading was that there are signs that this system had become really poised at a point where a lot of things could break loose. We did say, when it does go, the structure of the derivative markets could cause it to really go hard and fast in a downward way."

This raises the issue of forecasting, which I think in our profession has gotten a bad name because whenever we hear the term, we think immediately of the guy in a business suit we saw on the cable financial channels, telling us with absolutely absurd levels of confidence what's going to happen in the next week or two. Coyne prefers to start with two or three likely future scenarios, based on the evidence that he's looking at, and then spending most of his time talking about the evidence that is NOT consistent with these scenarios. "The goal is to force us to avoid the traditional trap of looking at information that confirms your pre-existing views," he says. "Then you can look at the implications for your portfolios should any of the scenarios come to pass."

Over time, as one scenario starts to develop, he goes back to the drawing board to devise two



*"I've included only the indictments, regulatory censures and arbitration awards that I felt I really deserved."*

new scenarios out of the one that we're in now, again considering their implications for asset allocation. "Everybody is flooded with information every day," Coyne adds. "But when you think in terms of scenarios, it helps you think about, what is a high-value piece of information that is much more likely to be seen under one scenario than another? It helps you organize the flood in a more structured manner."

So what are the most important economic issues that investors should be paying attention to today? Coyne starts with the fact that households throughout what he calls the Anglosphere--Canada, the UK, Australia, New Zealand, the U.S.--are very highly-leveraged. "On top of that," he says, "they've received a huge uncertainty shock."

This becomes significant because these households, especially in the U.S., had been spending the world into prosperity. "I think everybody recognizes that we can't have these huge current account imbalances and huge financial flows," says Coyne. "That system can't continue, but are we going to be able to make structural changes?" He points out that China, in particular, seems to be in denial on the need for more balanced current account surpluses with the U.S., most recently when its political leaders said that the high savings rate is the result of Confucian values, and therefore there will be no effort to stimulate demand in its domestic economy.

Meanwhile, the banking system is going through a frightening insolvency crisis, and

the middle class voting populace in the U.S. is volatile and angry. “You introduce a mortgage relief program, which would stabilize a lot of things,” says Coyne, “and the voters say, wait a minute! My tax dollars are going to bail out people who were irresponsible? That puts a constraint on the solutions and the speed that things can be resolved.”

Add to that uncertainty over whether Iran will normalize its relationships with the other countries in the Middle East--or not. Coyne talks about a Conflict Scenario, where the U.S. goes through a swirl of populism, where trade barriers are erected and retaliated against, where there is another oil shock as a result of increased tensions or war in the Middle East, where the rich and poor in the Anglosphere become active antagonists. “Throughout history, when things really hit the fan,” says Coyne, “one way out of it is broader cooperation and collaborative solutions, and another way out, unfortunately, is deeper and wider and more extended conflicts.”

The Index Investor’s relative valuation information is presented with some caution; rather than saying an asset is overvalued, it is fixed on a scale that includes possible, likely and probable overvaluation and undervaluation. One might put U.S. Treasuries in the “probably overvalued” slot, but what else? Coyne evaluates the stock markets based on current dividend yields plus the underlying economy’s long-term growth rate, and then he layers on the long-term required return based on the current uncertainty levels in the

markets--and admits that this last factor is quite subjective, which is one reason why you won’t find Coyne making bold asset class calls. But when you look at the global opportunity set, he points out that U.S. dividend yields have not risen as high as other markets in the Anglosphere, and the U.S. stock market has recovered a bit faster than its overseas cohorts. “U.S. stocks aren’t severely overvalued,” he says, “but they are not notably undervalued either.” Currently, he sees more attractive valuations in Australia and the UK, but his enthusiasm for stocks in general is not high.

On the bond side, Coyne notes that the AAA spread over the 10-year Treasury is at historic levels, and the BBB spread over AAA is also in historic territory. “On the other hand, those spreads may also represent a very fair price, given the balances of possible economic outcomes,” Coyne warns, “so we aren’t jumping up and down about that.” Foreign currency bonds have gotten cheaper during the rush to the dollar over the last year, and Coyne thinks that commercial property everywhere except Japan is offering attractive valuations right now. Finally, Coyne is bullish on timber.

As we grope around for The New Paradigm in investing, Coyne offers some perspective on how to conduct the search. “The fundamental problem,” he says, “is how do you make good decisions in the face of uncertainty? Most finance theory assumes that everybody knows the range of possible outcomes, and the probability associated with them.

But in the real world, none of us know the possible outcomes, much less the probabilities associated with them.”

Add to that the fact that every individual (and set of investment performance goals) is unique, and you have a situation which, Coyne argues, is too complex for traditional mean-variance optimization (hereafter referred to as MVO) to address with any confidence. “From a computational point of view, the problem you face is that there are just too many variables, too many inputs are needed that you don’t have,” he says. “You can’t explore all the possibilities, and on top of that, the data quality stinks. There are huge errors relative to the expectations that we use, the standard deviations and correlations have a lot of noise in them, and all of them change depending on the regime we’re in.”

So, Coyne says, the advanced investor, the practitioner of The New Paradigm, has to recognize that asset allocation is always going to be as much art as science. “So then you ask yourself: how can we strengthen the science side?” he says. “That’s how we got into using multiple regimes, and why we avoid using linear programming like MVO to find an ‘optimal’ solution. Instead, you look for asset allocation solutions that appear to be robust in the sense that they have an acceptable probability of achieving the real long-term target rate of return over a wide range of scenarios, and then you watch the scenarios. You constantly have to be on the lookout for dangerous

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## Structured Guessing

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overvaluations and have a willingness to take some additional steps beyond diversification and rebalancing to hedge that risk, whether it is moving into cash or buying put options or other risk management steps.”

Finally, Coyne says that in the real world, randomness affects outcomes. The mathematical certitude of MVO portfolios doesn't mirror the real world, where uncertainties abound, and clients ought to be allowed to know that. Reading his newsletter is refreshing; it looks at complex topics without flinching, it talks about uncertainty without apology, and it struggles visibly with the kind of issues (changing valuations, changing investment regimes, the need to pay attention and the possibility that even then you'll get it wrong) that many advisors have swept under the carpet over the years.

“We're trying to help advisors make better decisions,” Coyne says, “because at the end of the day, the hopes and dreams of investors are riding on the quality of advice they're getting from their money managers and financial advisors.”

There may not be a New Paradigm here in this conversation, or a Next Thing, but there is certainly a sense of responsibility that, like it or not, has fallen on all our shoulders as the markets continue to surprise advisors and their increasingly skittish clients. I suspect that in the future, a lot more advisors will be thinking like this, and Coyne himself, and his newsletter, is an interesting bridge to that future. ■

## Investing

# Good News in Bad Times

*Two conference presentations offer an antidote to all the gloom and doom in the financial media.*

**W**hen the markets are going gangbusters, the most valuable information tends to be cautionary, reminding us that bull markets typically end badly and that euphoric investors may be heading blindly for the edge of a cliff. When markets have been in the dumper, the opposite message offers useful perspective: we need to remember that bull markets inevitably follow bears, and caution in the face of bargain stock prices is never the optimal strategy.

Two keynote sessions at the Northern California Regional Conference in San Francisco dared us to move against the herd, and did a nice job of backing up the recommendation.

The first presenter was Roger Gibson, author of the classic: *Asset Allocation, Balancing Financial Risk*, who kind of disappeared from the speaking circuit for a while. Gibson has been thinking and rethinking the role of asset allocation during these market meltdowns, and has come to some interesting conclusions. I'll give you one of the punchlines immediately; despite his “stay the course” message, Gibson hasn't lost clients in the market storm. In fact, he confessed that he had a far bigger problem retaining clients during the later years of the Tech Stock Bubble in the late 1990s. From a business

perspective, reigning in greed can be far more difficult than counteracting fear.

But Gibson believes that your advice during these panic periods matters more than it ever does during sunny investment climates. “I have never seen an environment where the stakes are bigger with regard to investment decisions,” he told the audience. “We all got whacked. It's natural that clients recoil from these markets, and as a result, people are going to get very different investment experiences going forward.”

That would be nothing new. Gibson's third slide compared the return experience of the average stock investor from 1984 through 2000 with the actual return of the average stock fund. Even though we know there are disparities between what the markets deliver and what investors experience, the magnitude of the difference is eye-catching. As Gibson put it, individual investors typically pick up financial magazines or watch the cable financial stations and sell out of their funds in favor of yesterday's winners. They sell during bear markets and buy during bulls, and as a result, during a very favorable investment climate, when the average fund was delivering 14% annual returns, the timing of cash flows into and out of funds

shows that, on average, investors came out of the 16-year period with annualized returns of just 5.3%.

“Reasonable people doing reasonable things turned the greatest stock market boom in history into a money market rate of return,” Gibson told the audience. “And they did it while managing to keep all of the equity risk.”

This, of course, represents the real benchmark of professional investment advice: if you, the advisor, can manage to keep clients from moving with the investment herd, you can help them experience the generally positive returns of the investment marketplace. Today, that means keeping them invested when the herd has been stampeding out of equities.

This is why Gibson believes that asset allocation isn't a dead science. While acknowledging that there may be other significant (and possibly undiscovered or not-widely-known) pieces to the investment puzzle, he pointed out that asset allocation makes a simple promise and consistently delivers on it: that a diversified portfolio will deliver better total returns with less volatility than the individual components of the portfolio will. He noted that this is not a skill-dependent activity, nor does the client have to pay extra for this boost in performance.

From there, Gibson walked the audience through a lot of things you already know: the superiority of stock returns over bond returns comes with a significant and not-always-understood volatility risk, which raises the possibility of long periods of underperformance.

Gibson acknowledged that clients got more volatility last Fall than they had been told to expect; in the last four months of the year, the S&P 500 moved 5% or more on 21% of the trading days; the leading commodities indices did the same. International stocks moved 5% or more on 33% of the trading days, and REITs on 54%--basically every other day, on average. Meanwhile, stocks delivered the all-time lowest 10-year return in market history during the period ending last December, and unless the S&P 500 is up 20% or more this year, the 10 years ending at the end of next December will break that unhappy record.

Later, Gibson pointed to the one rolling 20-year time period since 1926 when long-term government bonds have outperformed both stocks and corporate bonds: the two decades ending last December 31. “That basically spans my career,” he said with a rueful laugh.

But he also pointed out that bonds, historically, deliver returns that are perilously close to inflation averages, and showed a chart which highlights the magnitude of the inflation risk. For a client with a 30-year time horizon--basically anybody retiring today--a 3% inflation rate will take the purchasing power of \$1,000 down to \$412--a purchasing power loss of 59%. Based on the flood of money being printed by the U.S. Treasury in response to the liquidity crisis, few of us believe that 3% is the most likely inflation number going forward. A 4% rate will diminish purchasing power 54% over 20 years and 69% over 30. If inflation

manages to reach 5% a year--a not totally farfetched scenario--then the purchasing power losses will run to 62% over 20 years and 77% over 30. At 6% a year, the comparable numbers are 69% and 83%--and bond returns are clearly not sufficient to cover that risk.

The first point is that most of the time, although not recently, a healthy allocation to stocks, without selling or diminishing stock allocations at the bottom, will be the safest way to navigate through the risks faced by retirees.

The second point is that those periods after the markets get pounded, and investors are least likely to favor stocks, are the times when fully-invested clients get their best returns. Gibson showed a chart that divided all past markets into four categories: times when the P/E ratio, normalized over the past ten years, was below 12; when it fell between 12 and 16, between 16 to 20, and above 20. Then he looked at average returns going forward for investors who started out in an environment when stocks were cheap (under 12), relatively cheap (12-16), average (16-20) and expensive (over 20), and found what you would expect: the under-12 P/E environments, the times when investors were shying away from the markets and lamenting the fate of their portfolios, delivered an average of 14.88% annualized returns over the next 10 years, and the lowest 25% percentile returns for those lucky investors were still over 14%.

As the starting P/E went up, the future returns went down, to 12.91% a year, on average, then

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## Good News in Bad Times

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to 8.5%, then to 4.68% for those unlucky enough to invest in stocks with a P/E above 20--in other words, those times when investors were enthusiastically piling into the markets and celebrating their luck.

Gibson seemed confident that investors with diversified portfolios that include stocks will experience strong returns over the next ten years, but that doesn't mean the roller coaster will move up immediately. He is currently showing clients another chart showing the possibility that things will get worse before they get better. He looked at the bottom decile P/E (8.86) and calculated where the market would have to go if we touch that unhappy point. The answer, from where the market is now, would be a 40% drop--and Gibson is warning clients that if they want to experience those anomalously high returns over the next ten years, the trip could include another free-fall experience.

The remainder of the talk focused on the behavioral aspect of markets. Gibson scoffed at the idea that the markets are totally efficient and every investor is rational; he said that it's obvious to anybody in the business that markets tend to overshoot on the upside and the downside. His own clients are sometimes questioning whether the downturn will ever end, and whether this may be the end of the free enterprise system. Furthermore, the magnitude of recent losses can influence a person's willingness to risk further losses.

To counteract these tendencies to sell low and fail to

harvest the market's recovery, Gibson is focusing his clients on the businesses that they own in his portfolios, many of them Fortune 500 firms with global operations. "I'm asking them, do you believe these companies will be around in five years?" he told the audience. "If you do, then they may get whacked around, but if you can hold on, they'll eventually recover." Bigger picture, barring total global economic collapse, most of the companies in a broadly-diversified portfolio will survive and recover.

If clients don't believe that free enterprise will survive, Gibson said, then their portfolio should consist of a cabin in the woods, canned food, Krugerrands in the floorboards, guns and bullets. And chances are, their investment experience, long-term, will end up below whatever returns the markets deliver.

The other NorCal keynote presentation offering glimmers of hope came from David Kelly, the chief economist at J.P. Morgan. Kelly acknowledged that the world is experiencing a crisis of unprecedented scope and magnitude, and he confessed that he has little faith that the actions taken by the central governments of the developed nations (the U.S. included) are going to be very effective. Nevertheless, he was upbeat about the prospects for a recovery as early as this year.

First, some statistics. Kelly made Gibson's point about volatility a bit differently when he said that over the last 50 years, the average daily market movement for the S&P 500 has been .81% in

either direction. In the final quarter of 2008, that figure rose to 3.7%--an unprecedented number, what Kelly described as "a 100-year flood of volatility." We are not out of it yet; in the first five months of the year, the average price movement came to 1.6% a day.

This, plus the free-fall, scared investors right out of the marketplace. Kelly noted that last year \$234 billion flowed out of equity mutual funds. This didn't merely break the previous record; it was TEN TIMES the previous record. "In the last six months, how many of you have had clients calling you to buy stocks on margin?" Kelly asked the audience, to general laughter. Then, turning serious, he said "we will never know how much of the market downturn was caused by the credit crunch and how much of it was due to panic."

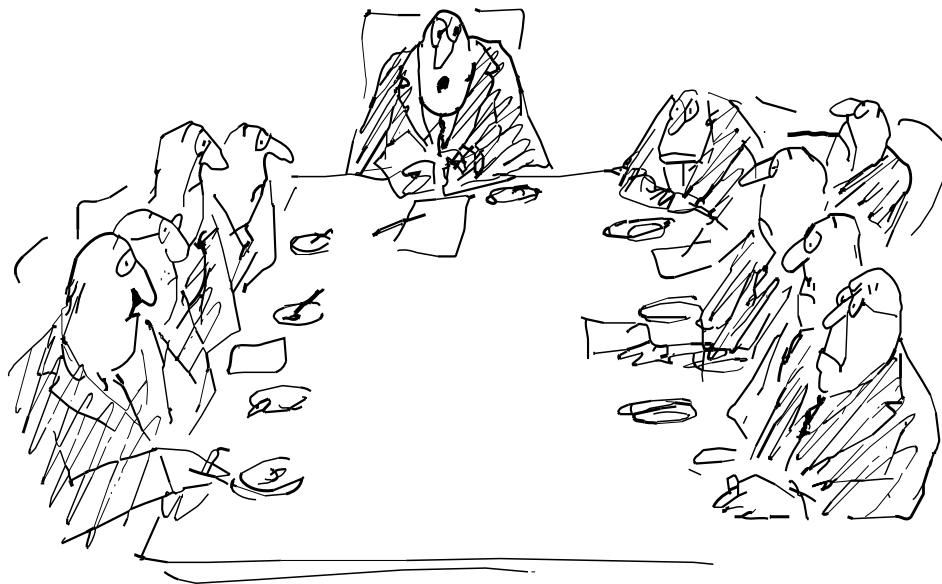
From there, Kelly offered a quick tour of the current deep recession. He noted that until the 4th quarter of last year, the economy was in a very mild recession, and then the bottom fell out: a 6.3% drop in GDP in the final quarter, plus a 6.1% drop in the first quarter of this year. This, he said, is comparable to the 1982 and 1975 recessions, but not nearly the same magnitude as what the U.S. experienced in the 1930s.

Interestingly, in this year's first quarter, consumer spending rose slightly, and the export/trade numbers were flat. Much of the steep 2009 downturn was the result of a huge drop in inventories, which Kelly takes as a positive sign. "When inventories get whittled away," he said, "eventually you bring supply and demand back

in balance, and this seems to be happening at a faster than normal pace.”

Meanwhile, there is evidence that the housing bubble is finally in the last stages of its long and painful burst. “We have seen a 25% drop in housing prices across the American economy,” Kelly told the audience. “Combine that with low interest rates, and housing today is more affordable than any time since the Nixon Administration.” In addition, new housing starts have fallen to 500,000, well below the 2.3 million people who are entering the homebuying marketplace every year, which could precipitate a run on housing at some point in the future. Kelly pointed out that auto sales fell to 5 million cars at a time when an average of 30 million vehicles are being scrapped each year. “These things all have to bounce, simply based on supply and demand,” he told the group.

Looking at jobs, Kelly explained that unemployment tends to rise even after a recovery is underway; it is a classic lagging indicator. “On average, unemployment peaks five months after the recession is over,” he said, predicting that the the U.S. rate will hit 10% before the year is out. From there, the unemployment figure tends to fall about one percentage point a year during the recovery; Kelly predicted it will fall to 8.5% by the end of 2010, to 6.5% or so by the end of 2012, and bottom out around 5% within 5 years. This, too, could be regarded as a positive sign; if you add historical gains in productivity (around 2% a year if you’re somewhat optimistic), then adding those jobs will mean,



*“The good news is that our angry policyholders are locked in an ugly legal battle with our rogue agents.”*

by itself, an extra boost in GDP growth. “Lowering unemployment could fuel five or six good growth years after the end of 2009,” Kelly told the group.

Some in the audience found Kelly’s inflation forecast to be a bit optimistic; he said that until the unemployment rate has been lowered to an equilibrium point, wage inflation won’t be an issue, and declared that the Fed probably won’t have to start fighting inflation until the middle of the next decade. We’ll see.

Interestingly, Kelly is not afraid of the budget deficits that the U.S. government will be running in the next few years; the deficit will run around 11% of GDP in 2009 and 2010, compared with 30% in 1943

during World War II and 109% in 1944. Kelly is more worried about the possibility that consumers will become thriftier, stifling growth, and he anticipates more oil shocks in the future.

Overall, Kelly said that using reasonable economic assumptions, he can envision the possibility that stocks will double over the next five years. He pointed out that the investment climate tends to have very short winters and long summers, and that the time to buy is always before you feel good about buying. I think most members of the audience were less persuaded by this than by the reassurance that Krueger rants in the floorboards might not be the right investment strategy after all. ■

# Ambassador to Fiduciary

*Brian Stimpfl talks about his new role  
in the advisory world.*

**W**hen it comes to supporting the fiduciary independent advisor business model, the planning profession has no better friend than TD Ameritrade. Tom Bradley, TD Ameritrade Institutional's CEO, is still the only person in his position to come out publicly and say that the Merrill Lynch Rule was a bunch of crap and that advisors ought to be regulated according to no-nonsense fiduciary standards.

Since then, the company has made a quieter but more substantive commitment to the fiduciary cause; Bradley has assigned Brian Stimpfl, one of his top senior executives, to become an advocate-at-large for independent RIAs and financial planners. Stimpfl's portfolio includes participating in the regulatory process and the war planning on the side of the FPA, NAPFA, CFP Board and the Investment Advisors Association, advocating for the fiduciary business model in Congress and with regulators, and also talking with advisors around the country about ways that TD Ameritrade can help them address their key business challenges.

"Tom came to me and said, I really want someone who knows the business deeply," says Stimpfl;

"not only our business and what we offer as an organization, but also of advisors and what THEY need from us. On the macro level," he adds, "that means participating in the debate on fiduciary versus suitability, and the nonsense that consumers are too stupid to understand the difference between brokers and advisors, so let's dumb down the regulations and treat them both the same. It also involves practice management, how advisors can be more efficient, what their challenges are today, so we can point our efforts at the things that can make the most difference and the biggest impact for their firms."

So what's he seeing now? At my request, the conversation started on the macro level, and Stimpfl said that Bradley's comments are sometimes misinterpreted as being anti-broker. "From my standpoint, and from TD Ameritrade's, we feel that the brokerage business, despite its recent problems, is a viable business model," he says. "If you, the customer, know you are purchasing a product from a sales person, we don't have any problem with that. But," he adds, "there is a very big difference between that and actually purchasing investment advice. Watering down regulations

to treat everybody like a broker would be the worst possible thing we could do for the investing public."

Stimpfl thinks that the recent SEC actions are completely understandable if you recognize that Commissioner Mary Schapiro comes from the brokerage mindset at FINRA. "Nobody should be surprised, judging from her past tendencies and public statements," he says. "What scares me is what came from Tim Ryan at SIFMA, that the harmonization she talks about is going to involve a removal of the "legalese terms" of fiduciary and suitability, and that he expects her to put some fair standard of practice in as a substitute."

Of course, the pace of regulatory change has been more deliberate than expected; compared to the efforts to regulate the banks that are too big to fail, Stimpfl describes RIA/brokerage regulatory reform as "contemplative," which seems to be synonymous with "slow." His chief worry, when he sees FINRA endorsing the fiduciary concept, is that different people mean very different things when they use the word, and a weaker meaning might be adopted. "When I see the IAA, the Consumer Federation of America, NASAA and the Coalition all support the fiduciary standard, it sounds encouraging," he says. "But if I were Barney Frank or Chris Dodd, there are so many people talking about this that no one voice is heard. There is a danger in having so many people speak variations of the same thing, versus having everyone stand

together.”

Moving from the macro to the individual, Stimpfl acknowledges the biggest practice management issues today still revolve around the market declines. But in two recent surveys, the company found that some 90% of RIA advisors have the same number of clients that they did before the meltdown—or more. “That was great news,” says Stimpfl. “And 93% of advisors said their clients are not taking money out of their advised accounts. So those stories back in January of folks running for the mattress and stashing money in their closets, as far as our advisors was concerned, was overblown.”

Stimpfl is talking with advisors to figure out how best to deploy the 35 TD Ameritrade employees who work directly with advisory firms on technology, practice management and investment solutions. “The number one issue that we’re hearing from advisors is: how do I grow my business?” he says. “That was an eye-opener, given the current market conditions. Advisors weren’t focusing on cutting costs; they want to make up the revenue shortfall with more clients.”

TD Ameritrade’s first response was to set up workshops on how to segment clients and focus on a niche market. The second was a strategic partnership with a firm called Infinata, which is basically a database of above-middle-market prospects for financial planning services. “They’re using a web crawling technology to go out and collect publicly available information on executives, on

people who work for charities and serve on boards,” Stimpfl explains, “and it amasses this information in such a way that an advisor can search through the information using any number of search criteria and narrow down a set of prospects that they might want to contact to win that person’s business.”

The third response was to create the AdvisorLink database of companies interested in merging or being acquired, which includes a strategic partnership with ECHELON Partners, an M&A service provider that can work out the documents and arrange financing.

What else are advisors expressing concern about? Stimpfl says that after growth and marketing, after regulatory reform, the third most-often-mentioned issue is operational efficiencies. He says this may be the area where a consultant or strategic partner can make the biggest impact. “I have visited hundreds of advisory firms over the past seven years,” Stimpfl says, “and you would not believe the difference between what one advisor might do with his CRM application, highly-automated and highly-personalized to the practice, and another successful firm, where they are still using sticky tabs passed around the office. Going forward, we’re trying to point out ways that either we, through our technology, can help them, or how a third-party outsource provider might be able to assist them. The trend is toward outsourcing all the non-core functions,” he adds, and mentions portfolio accounting, data input, client portals and

even routine office functions as outsource candidates.

More recently, Stimpfl has worked out a strategic partnership with ActiFi to offer something called RoadMap, a software program that identifies business challenges, puts the relevant metrics on the advisor’s computer dashboard and lets the advisor track specific tasks and objectives, top-line and bottom-line revenues, costs and progress in each area.

As the regulatory reform process goes forward, you’re going to be hearing more from Stimpfl—and, probably, words of public support from Bradley as well. As Stimpfl sees it, his two most valuable activities are lending the weight and prestige of his firm on the right side of the regulatory debate, and listening to advisors tell him about their practice challenges. “Like everybody, we could come up with a lot of things we could do for advisors; the question is whether they’re the RIGHT things, or whether they address the most pressing issues,” he says. “And then following up. We introduced a program. Did advisors become more profitable as a result? Are they getting more clients? How effective are we being at helping them be more effective?”

At a time when the institutional back offices are becoming increasingly commoditized, you can expect advisors to pay more attention to who stands on their side, both in Washington and in their day-to-day activities. Let’s hope Stimpfl is the first of many in this new and interesting role. ■

## P/C Process

*If you'd like to offer better service around home and auto insurance, here's a great way to get started.*

**H**olly Gillian Kindel, of Mosaic Financial Partners in San Francisco, started off her presentation at the FPA Retreat by asking the audience how many of them were really turned on by addressing a client's property/casualty insurance issues.

A few hands went up, but none with any visible enthusiasm.

Then she asked how many avoided the whole P/C issue altogether, as if suffering from a mental allergic reaction. This time, there was visibly more enthusiasm as hands went up--including my own--around the room.

The fact that P/C coverage is boring and complex may explain why it also happens to be an area of great inefficiency in the U.S. marketplace. Kindel quoted statistics showing that more than half of U.S. homes are underinsured by an average of 22%. Only 42% of homeowners have created an inventory of their home's contents.

So how do you overcome your mental allergies, and develop enough knowledge in this area to work with clients on the one side and agents on the other? Kindel acquired her own expertise by, first, creating a methodology for

testing local brokers. Her allied professional review process began when she gave several brokers a "test client" to work on. The brokers were given a real client situation and also the recommendations that Mosaic thought reasonable.

When the evaluations came back, she and her staff would evaluate on several fronts. Did the agent agree with their recommendation, and fulfill their requests? Did the broker attempt to give different advice to the client without first discussing it with them? Several brokers, she said, did no analysis of current coverage and just proposed a new solution.

The best agents provided an analysis of existing coverage and suggested possible improvements to Kindel, helping her better understand the issues and making her more knowledgeable for the real thing, and also showing a level of professional cooperation that Mosaic requires in its allied service providers. "You don't ever want to reduce these people to order-taker status," she told the audience. "You want them to provide their expertise, and get the benefit of their professional understanding of the client situation and the possibilities."

Today, when clients come in

the door, Kindel will, as part of the planning process, collect all the home and auto and umbrella policies, do an in-house analysis, make tentative recommendations, and have clients complete a detailed questionnaire about their house and the contents inside it. She'll then send the materials to one of the winning brokers for a second opinion. The package also includes the driver's license and social security numbers, so the broker can check on the client through the Comprehensive Loss Underwriting Exchange, and see how many claims the client has made in the past.

For homeowner's insurance, Kindel recommends HO-03 coverage, which means the policy has to name all the perils that it won't cover, vs. the less expensive HO-02 policy, which simply names the perils it WILL cover. She also calculates how much coverage will be needed to rebuild the house, typically by multiplying the typical per square foot building costs in the house's location by the number of square feet in the home. This can get complicated, however, when you find yourself applying higher rates to custom or unique features of the house.

She may also recommend extended dwelling endorsements (designed to cover future rises in general costs to rebuild) and building code endorsements (designed to cover costs associated with rebuilding in order to bring the property up to code). Also, if the garage is detached,

or if the fence doesn't connect to the home, then clients should be aware that these structures will not be covered under Coverage A of the policy. These separate structures, plus a swimming pool or other amenities, would have to be covered via a policy endorsement.

That's called Coverage B. Coverage C applies to personal property owned by the insured while it is anywhere in the world, or personal property owned by guests or residence employees while occupying the residence premises.

If you want clients to have full coverage, Kindel said, make sure unique property is scheduled separately. That means having clients perform a full inventory of all their significant personal property within the home--a process which may require outside help. (Kindel recommended that advisors consider working with somebody from the National Organization of Professional Organizers; you can find them here: <http://www.napo.net/>).

Then there's Coverage D, which pays for loss of use of the home if it's damaged or burned to the ground. Normally, the amount is based on a percentage of the dwelling coverage--20% to 50%, and most policies limit coverage to 12 months.

Finally, Kindel talked about excess liability coverage, which provides an extra layer of protection of the home and auto, and also protects clients against catastrophic lawsuits or

judgments. The policy normally protects the insured, family members and any person using a covered vehicle or watercraft with the client's permission. (Some things are specifically NOT covered: intentional acts, molestation, misconduct or abuse, criminal acts, acts of war and any nuclear hazards the client may have lying around the front yard.)

Kindel invited the audience to consider risk tolerance issues. If the client is in an auto collision and accidentally kills a high-income person with many dependents, or the person in the other car suffers severe brain damage requiring full-time care, or even causes a transport vehicle carrying 100 computers to overturn, the exposure could be considerably higher than the limits on a typical auto policy. Swimming pools, teenage children or the fact that a client is a celebrity can all raise risks.

Kindel finished the talk with a discussion of auto insurance: Part A liability coverage (which follows the car pays when the client or some other driver with permission is sued); Part B (pays medical payments if the client is injured); Part C uninsured motorist coverage (pays if the client is hit by somebody without insurance coverage); Part D (collision coverage that pays for damage to the client's car); Part E (lists duties after the accident or loss) and Part F (a general provisions section). Kindel seemed to prefer the single auto

limit (which allows the overall limit to be allocated between bodily injury and property damage) over the split auto limit (where there is a limit for paying an injured person, a different limit for all persons who might be injured, and a third limit for property damage per occurrence). For collision coverage, Kindel would raise the deductible to over \$1,000 to lower premiums and minimize small claims that could result in coverage being cancelled.

It seems to me that the most valuable part of this presentation is the process it offers--a relatively straightforward, non-intimidating step-by-step process that would allow even the most P/C-ignorant advisor to start learning the ropes at the same time you're identifying the best service providers in the community.

I have to confess that even after getting the benefit of this well-packaged tutorial, which probably took Kindel countless sessions with P/C agents to acquire piecemeal, I still feel the allergy in my brain.

But based on the statistics, this is an area of great inefficiency in the marketplace, which tend to be areas where you can add significant value. There is no doubt that this is an area where the advisor/agent collaboration can provide real value, at a time when many planners are looking for ways to expand their client relationships and their service menu.■

## Sci-Fi CRM

*Instead of just working on the road with a mere computer, connect with your client database with a smartphone.*

At the 2009 T-3 Conference, both Dave Drucker and Joel Bruckenstein predicted that within five to seven years, maybe sooner, advisory firms will increasingly rely on smart phone technology and handheld devices as they work with clients. The conference offered an interesting presentation that had a science fiction feel to it; we watched a speaker pull out information from various databases in his office and configure them on his iPhone, Google Phone and various other smartphone devices. Imagine being able to pull up a client's net worth, portfolio, tax or other relevant information while the two of you are having lunch, or, in the exhibit hall of a conference, schedule tasks for your employees as you encounter new ideas or new information.

These pleasant fantasies appeared to be dashed when, late in the session, somebody stood up and asked the killer question: is anybody in the planning space offering these capabilities? At the time, the answer was no.

Now we have a different answer.

"Basically, we're introducing a way for people to get 80% of the capabilities of the Junxure CRM program on any phone that has a browser," says Ken Golding, Junxure's chief technology officer. Junxure Mobile, as it's called, is one

of the enhancements in Version 7.0, which also introduces (yawn) direct integration between the program and Outlook to allow mailmerge and archiving of client messages linked to client files. The new version offers a required minimum distribution alert system and the ability to set up tasks that make sure this chore doesn't slip through the cracks, and an unlimited number of (yawn) action templates for office management. Version 7 also offers a new interface with QuickBooks so users can (stretch, yawn) track their business metrics on a dashboard; users now have the ability to customize the client information that shows up on your screen when clients call in asking for an update or advice, and if you happen to be an early adopter user of Microsoft's SharePoint program, you might get excited about the new integration capabilities.

But you really start living in the sci-fi world when you open up your phone, enter the Web and log into Junxure, which, according to the demo I received, takes you immediately to your alerts--tasks that have been assigned to you, or things that you want to remember to do.

While you're there, you can assign tasks to your office staff, or you can go ahead and search for clients using the same tool you use when logged onto Junxure at

the office. "You can view all their history, edit any history, you can create a new action for that contact--or, if you've talked with somebody who might be a prospect, who wants to get your newsletter, you could add a new contact," Golding explains. "You can see everyone in a certain classification of client, or get a list of all your clients, or all your employees, or all your ex-employees, or anything that you might search for in Junxure in your office."

You can also do these things by computer if you happen to be sitting in a hotel room somewhere--which, Golding says, addresses the persistent complaint that advisors can't use Junxure on any computer on the road, the way you can with Redtail. (Of course, they could do it if they have remote-desktop software or a mirror program that ties into their office computer.) The Junxure Mobile service becomes especially powerful if you also use ClientView, a standalone program that Junxure offers which creates individualized client web sites, with performance and other reports and key documents.

"Then you can go in and review all the reports that have been set up for that client, and check the documents while you're on the road, maybe face-to-face with the client over lunch," says Golding. "After lunch, you might want to schedule a task or make sure something gets done for that particular client."

Are there security issues here? "None of this information stays in our data center when you call it up," says Golding. "And it's all encrypted going through."

If Junxure Mobile only offers

## GOOD RELEASE, BAD RELEASE

80% of what the program will do when you sit down behind your computer in the office, what is the 20% that it can't do? "You can't run a lot of the reports that are on the back end," says Golding. "And if I'm on the desktop version, I can add new templates. So I can say, maybe a client service phone call or an account transfer sequence needs to be created for the office. We don't allow you to do that on the web site. You can only use what has already been set up. I can use any of the templates that I want, but I can't set them up from the Web; I have to set them up from my office. Same thing with the lists. If you want to add classifications or keywords to the drop-down lists, you can't do that from the web. When you're on the road, you can only use the ones that have already been developed."

Golding was too polite to say that he doesn't expect old people like the person interviewing him to get really excited about tapping into the home office database with a Google Phone or iPhone--yet. But he does think that younger advisors who are more accustomed to browsing the web at lunch or on the road will quickly pick up the habit of organizing their business life on the fly. "Some people I've talked to are pretty excited; they can't wait to start using it," says Golding.

And, as usually happens, when the doddering old Baby Boomers finally manage to notice this extra productivity, and attend three or four more conferences where mobile technology is gradually demystified, they'll crawl suspiciously out of the stone age and start fulfilling the Drucker/Bruckenstein prediction. ■

The first time I saw the SEC's most recent proposed rule--Custody of Funds or Securities of Clients by Investment Advisers, Release No. IA-2876; <http://www.sec.gov/rules/proposed.shtml>) I found myself nodding approvingly at all but two or three sentences of it. It starts off plausibly enough, saying that RIAs who have custody of client funds or securities should undergo a surprise examination by a CPA each year, unless client accounts are maintained by an independent custodian. The idea is to prevent client funds from being lost or misappropriated. In addition, the advisor should make sure the custodian provides independent account statements directly to clients at least quarterly.

So far, so good. As long as the custodian is actually holding the assets, and reporting directly to clients on their status, you would think that the SEC's concern would plausibly shift to how safely the custodian is holding those assets.

Several times, the SEC references unfortunate situations where advisors held custody. In one case the advisor was a general partner of client assets; in another he was manager of hedge fund assets. The release points to the Stanford case, where the assets seem to have been held in various Caribbean banks. And, of course, the Madoff case is mentioned in passing. Absolutely, I say: when those people are holding client securities in their hands, let's give them a little more regulatory attention.

But wait... On page 10 of the release, the regulators seem to go off the ranch, and wonder whether these provisions should also apply to advisors who have client assets untouchably in the hands of a custodian, but who are paid asset management fees out of client accounts. This despite the fact that (as a footnote points out) these independent advisors are instructed to answer "no" to the Form ADV question on whether they have custody or not, and that this instruction would not change under the proposed rule.

Later, on page 21, in sort of the beginning of the wrapup of the release, the SEC says "We are proposing this addition to the rule because we believe maintaining client assets with the adviser or a related person instead of with an independent custodian can present higher risks to advisory clients. On page 27, the SEC wonders whether it might not be simpler to require every advisor to maintain client assets with an independent custodian, rather than subject everybody to this surprise inspection scheme. Finally, on pages 40 and 41, the SEC suddenly

*Continued on page 16*

## Parting Thoughts

*Continued from page 15*

includes, in its calculus of the size of the investment burden it might be imposing, all 7,126 advisory firms who “have custody due to withdrawal of fees only with respect to the discretionary accounts that they manage.”

Given that none of the referenced enforcement actions involve advisors who have their custodians take AUM fees out of client accounts--fully-disclosed and subject to the review of the custodian--it seems plausible to wonder why the SEC is even considering including these people alongside the Stanfords, Madoffs and self-custodying hedge funds of the world. No, the release doesn't directly propose to lump you in with those people, but in the wondering and requesting further comment, it opens the door to an initiative that would almost certainly double or triple the compliance costs of every independent fiduciary RIA firm.

More importantly, the release once again shows that the SEC leadership is not just having trouble figuring out which service providers are brokers and asset-gatherers and which are fiduciary advisors; it seems also to be having trouble telling the difference between those who work under a very risky (to the customer) business structure and those who operate under an extremely safe one.

The obvious, easiest and safest solution to the Stanford/Madoff problem is to do what the SEC wonders about on page 27: require everybody to put client assets in the hands of an independent custodian, directly and without ever touching the money. It's interesting to note, from the text, that the SEC seems to think this would resolve the problem. But if it does, then why would this surprise inspection proposal even think about including those who already fall under this solution?

It's pretty clear, if you look at who self-custodies and who doesn't, that the only constituency who would argue against independent custody are the large investment banks who currently custody their own

client assets. And so once again, we have a vivid example of the SEC going deeply out of its way to find a complex solution to a simple problem, bending over backwards simply to avoid inconveniencing the same large wirehouse firms that recently brought the world's financial system to the edge of ruin.

I think we should look at how this release unfolds as a first test of how serious the SEC is in addressing the real, manifest problems in the marketplace, which were mentioned in the release and which all of us know and deplore. Or, alternatively, it may show us that the real agenda is not addressing fraud, but using the fraud it failed to uncover as an excuse to make the competitors of brokerage firms less viable in the marketplace.

SEC chairperson Mary Schapiro has a long and public history of defending the brokerage business model, and opposing fiduciary standards, and generally providing comfort to the wirehouses. She has not yet build a stellar record on consumer protection. I would suggest that advisors download this release and send a response to the SEC (the first page of the release tells you how) recommending that the SEC simply require independent custody of all client assets, that the independent custodian be required to send statements independently to clients, and that all deducted fees be disclosed to the client. That, all by itself, would slam the door on the kinds of fraud referenced in the release, and it would not raise costs for the SEC or the advisor community.

Then let's see if Ms. Schapiro takes this very simple, very reasonable, very consumer-protection-focused advice on its merits, and makes the most of this opportunity to show the world that she is absolutely not what senior executives in the brokerage business have told me she is: a lapdog in their control, who will contort the investor protection system for their convenience, at their bidding. I can hardly wait to admit that my suspicions are unfounded, and those executives are totally wrong. ■