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Sobering Advice

Post-crash, advisors are easing clients toward lower expectations

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BY RICHARD STOLZ

It is the standard caveat of the investment business: Past performance is no guarantee of future results. But are CPAs actually advising their clients accordingly?

Specifically, can history dating back to 1925 provide a reliable guide to the sort of returns that clients can bank their retirements on in the years and decades ahead? Or are ongoing shifts in the global economy and the United States' role in that economy fundamental enough to alter an 85-year pattern?

Some say yes. Some say no. Others remain agnostic. But at least the questions are being asked, and investment strategies are becoming more sophisticated - as are efforts to help clients understand the range of potential outcomes.

Thirty-year veteran Peggy Ruhlin, a CPA/PFS at Budros, Ruhlin & Roe, in Columbus, Ohio, has not been too rattled by recent events, including the 2008 crash. "We believe that any assumptions you make for long-term planning have to be rooted in fact - in other words, history," she said. Specifically, the widely used Ibbotson historic standard stock market returns dating back to 1925. Any effort to modify those numbers for long-term assumptions about the future, she said, amounts to speculation. "You have to decide, what's your track record" on other predictions, Ruhlin added.

Her firm currently is assuming average long-term returns on U.S. stock portfolios of 8.5 percent - a number that, interestingly, is higher than the 7.1 percent Ibbotson geometric capital market assumption (as of October). However, Ruhlin said that any advisor who simply plugged such assumptions into planning models and client conversations without the additional dimension of probability factors using Monte Carlo analyses would be making a grave mistake.

In addition, Ruhlin emphasized the importance of using a sufficiently long historical period as the basis for long-term investment assumptions. "People have told me to start measuring returns in 1970, because that's when [analysts] started tracking returns of foreign equities. But people who did not use returns between 1925 and 1940 probably got killed by what happened in 2008."

REDUCING EXPECTATIONS

But many advisors whose clients were indeed injured, even if not fatally, in the 2008 market crash have responded very differently from Ruhlin. One response has been to drop expectations of future long-run returns from those suggested by the pattern dating back to 1925 (both on the stock and bond side).

"We have dialed back our expectations," said Jeff Call, a CPA/PFS and shareholder-in-charge of Bennett Thrasher's wealth management unit in Atlanta. For example, the firm's "guidance" on long-term stock market expectations today is in the 6-7 percent range, "even though that might be optimistic," and sharply lower than what he considers the "historic" average in the 8-10 percent range.

He is also operating on the assumption of a long period of lower bond yields, in the range of today's levels. "If you have a diversified portfolio, the bond portion is definitely going to pull the return down," he said.

What's behind these lower expectations?

For Call, it's the expectation that the Federal Reserve's current strategy to keep rates low will endure.

On the equity side, as it pertains to U.S. stocks, the outlook for some advisors reflects a sense that the U.S. economy is not likely to be as vibrant as it was for most of the 20th century. "It was only a relatively brief period of our history," pointed out Theodore Sarenski, CPA/PFS, of Blue Ocean Strategic Capital in Syracuse, N.Y., "that the U.S. was dominating the world - only since World War II." He suggested that the momentum has shifted to Brazil and China.

Part of the basis for his somewhat pessimistic outlook is the enormous size of U.S. public and private debt. "We have had some good years [recently], but it was on borrowed money. We have to pay that back."

Brazil and China, he said, "are now where we were in the early 1900s." And yet he still uses an 8 percent long-term return assumption on stocks, though that represents a two-point drop from the 10 percent benchmark he had used not so long ago. His benchmark return assumption on taxable bonds has dropped to 4 percent from 6 percent.

THE ASSUMPTION GAP

Some advisors are attempting to bridge the gap between lower and more historically based investment return benchmarks by creating a two-stage model, Sarenski said. "The idea is keep the assumption at the lower end of the range for the next 10 years, and raise it after that." That approach might apply to retirement planning strategies for relatively young clients. He said that he considers that idea "somewhat reasonable."

But advisors must be careful what they do with these assumptions - including applying consistent methodology in creating them. "We talk a lot about stock returns and lowering assumptions about their future performance," noted Brett D'Arcy, CFA, the San Diego-based chief investment officer for cbiz. "But nobody's talking about raising bond assumptions, even though they have over-performed" during this rocky period.

And no matter what advisors may think themselves, they must factor in their clients' own sentiments, said Sarenski - especially when clients are more conservative than the advisor. "If a client is conservative, we'll lower the expectation," and adjust the investment strategy accordingly, he said.

But rather than look at these long-term assumptions as predictions per se, some investment strategists use them in choosing and arranging the building blocks for each portfolio. One such person is Jaco Jordaan, CFA, the senior portfolio manager for H.D. Vest Advisory Services. "Our assumptions," he said, "are intended to capture the relationships between risk and return of various asset classes."

Aggressive, moderate and conservative gradations for return expectations of different asset classes, he said, "are captured via Monte Carlo simulation that accounts for returns which may fall below our assumed average returns based on our risk assumptions."

RESPONDING TO RISK

No matter how carefully return assumptions are developed and integrated into portfolio design, advisors aren't all content to use them as the primary basis for steering clients' investment dollars on a relatively static asset allocation basis. For example, after the experience of 2008, Rob Hoxton of Hoxton Financial Advisors in Sheperdstown, W. Va., became much more of a "tactical" asset allocator, and much more attuned to "recognizing and responding to increasing risks."

"We went from being pure strategic asset allocators, to using that as the overlay, but using technical analysis to determine when risk was increasing," Hoxton said. "The only way to address systematic risk is to no longer have a buy-and-hold strategy." Hoxton's "research vendors" keep him focused on various indicators that serve as "a proxy for the mood of the market."

But even advisors who, like Ruhlin, are reluctant to employ a more active investment style are not frozen in time. Rather, they are simply looking at historic investment returns of a broader category of assets, and diversifying portfolios accordingly.

A basic example in Ruhlin's case is foreign stocks. "Twenty years ago, we had almost nothing allocated to foreign equities. But as the future became clearer," she recalled, "you knew you couldn't have zero percent." Today, some of her clients have as much of one third of their entire portfolio invested in foreign stocks. More typical for a client with 55 percent of the portfolio in stocks would be having 20 percent in foreign stocks and 35 percent in domestic, she said. Her long-term assumption benchmark for foreign developed country stocks is 8.5 percent, and 10.5 percent for emerging markets.

Most advisors have also been adding a host of "alternative" asset classes to client portfolios, such as commodities (including precious metals), high-yield bonds and real estate investment trusts. The purpose behind expanding asset classes is not necessarily only to increase long-term returns. "Most of our clients are already fairly wealthy," noted Call. "They don't want to take a lot of risk. For some of them, a 4-6 percent return may be all they need. We're trying to build diversified portfolios that are going to try to achieve that return objective without a lot of volatility - volatility is their biggest fear."

CLIENT UNDERSTANDING

Indeed, managing clients' expectations and allowing them to sleep at night seems to be advisors' top goal today, and conservative investment return assumptions are critical to their success. What is also essential, advisors say, is to understand what numbers are truly meaningful to clients.




"Measuring performance against an index that everybody has heard of, like the S&P 500, isn't what most people want to hear about," said Hoxton. "They want to know, 'Am I going to meet my objectives or not?'" And don't even begin to talk about standard deviations, he said. "Humans don't measure risk in terms of standard deviations, but are the results below my minimum acceptable return."

Even Monte Carlo simulations can create issues for clients. "It's hard to explain to most people what they mean. If we say, 'There's an 85 percent chance that this plan will work,' they say, 'I want 95 percent.' It's hard to explain that 85 percent is really good," said Sarenski.

Besides, noted Jordaan: "Monte Carlo and other probability systems all have the same flaw: They can't predict the future."

The issue is not whether these tools can be helpful to advisors - they can - but when to use them with clients. Hoxton is a fan of using basic rules of thumb, such as, "You should be saving 10 percent of your income" - especially with younger clients. Of course, the older and wealthier the client, the less useful such truisms become.

Lamented Hoxton: "There were never any easy answers. It just seems like [that] in retrospect." What is also necessary when investment return assumptions are being lowered, he said, is having "frank discussions" with many clients to persuade them to "live on way less than they thought they could."

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