VOLUME 27, NUMBER 1 JANUARY 2017

inside information

*Edited/Published exclusively for leading financial professionals - www.bobveres.com*



# Inefficient Market Theory

**Synopsis:** ***Active fund managers are quietly talking about the best investing environment of their careers. Credit the fund flows into ETFs and passive investments.***

**Takeaways:** ***Passive flows are lifting or lowering the prices of companies that aren't exposed to the underlying investment dynamic. Many industries are being disrupted. Larger pools of assets are chasing larger stocks, and ETFs are trading based on fund flows rather than fundamentals.***

Mutual fund flows have been trending strongly away from active managers toward passively-managed mutual funds and ETFs, and the trend is accelerating. So why does active manager Chris Davis, CEO and Chairman of Davis Selected Advisors, describe today's investment climate as "a dream environment?"

"Everything that is happening that is bad for our business will be good for our investors and our investment results in the long run," he says. "For a firm made up of investors in our own funds, we'll make a lot more money from ten percent better results than ten percent more assets under management. For us, this period of asset flows into passive funds is wonderful, and let it go further."

*Categories by passion*

As Morningstar's Don Phillips has pointed out for decades, there are two broad categories of active fund managers in the investment marketplace. In Category One, which includes most funds, many of the larger firms are far better at marketing than managing;

### EARLY WARNING

• We've opened up registration for the Insider's Forum conference at the Omni Nashville, TN, September 6-8, 2017, featuring a keynote session with Bob Veres and Angie Herbers, unplugged, unscripted and asking each other the toughest questions they can come up with.

Also: Tom Giachetti on the new regulatory regime under the Trump Administration and a new SEC Commissioner, Sudden Money Institute's Susan Bradley and Cheryl Holland in a presentation on how to create new workflows and procedures with your staff. The conference, once again, will feature a track geared for operations professionals.

Plus a keynote presentation by Roy Ballentine, who runs one of the most effective planning firms in the profession, offering a discussion of the most important lessons he's learned in the business.

Registration is $875; Inside Information subscribers get a $150 discount with coupon code 2017INSIDER. (*www.insidersforum.com*) they come out with new trendy funds, and their more traditional offerings will generally hug the indices, meanwhile charging five to ten times as much as an ETF that mirrors the same index.

Category Two is made up of fund families run by people who have a passion for investing. These firms tend not to put much time and energy into marketing; instead, they devote a correspondingly greater percentage of their resources into research and security selection. Their funds tend not to correlate closely with the indices, probably because they score very high on the active share measurements.

This latter group of managers, in recent years, has lately been finding more and better investment opportunities than ever before in their careers, as many of the investment decisions in the marketplace—driven by passively-managed funds and ETFs—have become largely automated. The phenomenon is somewhat complex. But after a series of interviews, it's becoming clear that—for a variety of reasons—the unprecedented shift of fund flows into passive and away from active have put a wind at the back of many of the more thoughtful portfolio managers in the mutual fund space.

*Inexplicable correlations*

So what factors are favoring active fund managers in the passive-dominated marketplace? David Giroux, Vice President of T. Rowe Price Group and co-chair of the company's asset allocation committee, points first to an otherwise-inexplicable rise in correlated movements of the stock prices of companies whose fundamentals don't seem to be correlated at all.

***Index fund flows are driving stock prices up and down indiscrimately when certain stocks are not exposed to the underlying factors. the result is growing market inefficiency.***

"As an investor," Giroux explains, "you want to have situations where fundamentals move away from the underlying stock price, either positively or negatively. That's where the alpha opportunities can be found." An example of this opportunity came when interest rates went up, which caused momentum investors to buy ETFs that invest in the financial sector.

"That inflow dragged higher the stock prices of a lot of companies that were not really exposed to that factor," Giroux says. "If you're the owner of some of those names, that provides you with an opportunity to reduce your exposure. Even though the fundamentals hadn't changed, the money moving into the ETFs that owned those companies caused their prices to rise."

Another example? "Remember back in the fourth quarter of 2015, when people were selling out of ETFs that invested in high-yield bonds because they were worried about their energy exposure?" Giroux continues. "It turns out that energy exposure was only 20% of the index. When all those investors moved out of the ETFs, they weren't just selling energy exposure," he says; "they were also selling a lot of consumer bonds, telecom bonds, things that were getting no negative impact from lower energy prices. So the ETFs were having to sell those securities, and they were trading lower on the markets.

"As a portfolio manager who runs a multi-asset-class strategy, we were getting day-in, day-out opportunities to buy $10 million non-energy high-yield bonds two to three points below where they traded the day before," adds Giroux, "just because supply and demand had been misplaced."

*Business Disruption*

Giroux and Rob Sharps, T. Rowe Price's Group Chief Investment Officer, point to another area where active managers can find greater opportunity in a market where the fund flows are passively-dominant. "I've been in this business for 18 years now," says Giroux, "and I've never seen a time when more business models are coming under secular challenges. There has been so much disruption, like Amazon displacing traditional retail, or Internet companies challenging traditional service providers."

Adds Sharps: "The companies that are affected, like IBM, Wal Mart and others, are big constituents of the benchmarks, and the changes that are challenging their businesses are happening more rapidly."

How is this related to passive fund inflows? "If you're doing your research and taking a long-term view, you can have a meaningful underweight to the companies that are being disrupted," Giroux explains. "At the same time, we can overweight the companies that we believe will benefit from those secular changes. The passive strategies can't make those increasingly important distinctions."

"The ability to assess these changes, the impact of a shift to electronic payments, cloud computing, digital and social media away from print and broadcast media, will be crucially important to the long-term investor," adds Sharps. "These things are happening very quickly. In this environment, more than ever before, there are entire industries on the cusp of being upended. Think of the implications of autonomous driving or artificial intelligence. An index manager won't be evaluating that. They won't be asking what Airbnb means for the Hiltons, Marriotts, Expedias and Pricelines, or what autonomous cars means to the auto industry. If you're a fundamental investor with a long time horizon, you have much better odds of being on the right side of these trends, and maybe also avoiding some of the carnage that results."

***Business models are being disrupted by the Internet and tech faster than ever before. But who's making those decisions in a passive fund?***

*Selective inefficiencies*

Beyond that, the indexing phenomenon could be driving the markets toward systemic inefficiency more quickly than the fund flows might indicate. People who are not worried about how prices are being set will cite research showing that the investment markets would be relatively efficient up until the day that passively-managed funds account for 90% of the total assets.

Davis concedes that, in this indexing-dominated environment, there is still a great deal of market efficiency around short-term data processing and momentum investing. But he's seeing dramatically less active management participation in his firm's particular sweet spot—investment decisions designed to outperform over a 3-, 5- or 10-year period.

Why? Because many managers are avoiding the potential consequences of long-term investing in a world where everything is compared to short-term index results.

"I was speaking with a very well-regarded hedge fund manager recently," Davis says, "and I said to him: *if I gave you a stock that was 100% guaranteed to outperform over the next three years, but two of those three years it was going to underperform, and I couldn't tell you which two. Would you buy it now to be guaranteed the outperformance?*

"He said: *I wouldn't go near it*," Davis reports. "He said: *I can no longer afford to be under for a year. My world has changed*."

*Big flows, less competition*

David Marcus, founder and manager of Evermore Global Advisors, says he's having the time

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of his life as a portfolio manager. "Right now, more than I've ever seen in my career, all the big passive funds and ETFs are bidding against each other for a relatively small number of fish in the pond," he says. "They're all chasing the big fat whales and giant groupers, because they have to manage the huge flows they have to put to work."

hungrier and more aggressive in how they do business, and not everybody is going to make it. You aren't drawing those important distinctions if you're managing an ETF. In that world, it's all about managing to the fund flows."

In addition, he says, echoing Davis, even those investors who might be attracted to the companies that the smaller managers are looking at are not really competing for them in the same way. "A lot of the funds that CAN invest in these restructuring companies that we look for are only interested long after they've finished the restructuring process," Marcus explains.

***The passive funds and ETFs have gotten so big they're fishing for fat whales and giant groupers. Smaller managers can chase more and smaller fish.***

Meanwhile," he says, "I'm able to chase the smaller fish—at a time when there are more of them and fewer people fishing for them."

The more money that is concentrated in larger pools of assets, the more money has to be shoveled out the door to keep those larger pools invested. The result: less competition for the best ideas of opportunistic managers who invest in special situations.

Marcus also agrees with Sharps and Giroux that the business realities are changing very quickly across the economic landscape, and the active manager who is paying attention has an advantage over passive funds who don't make distinctions. But he's looking at a different type of shift.

"It's no secret that the whole business world, and especially in Europe, is restructuring," Marcus explains. "Companies need to be more efficient than they were in the past, they need to be

For example? "There's a company in Belgium that everybody calls CFE, which is in the dredging business but also has traditionally also been in construction," says Marcus. "As it happens, dredging is one of the greatest businesses that you could be in, because almost every port in the world is too shallow for the new ships that are being built today."

Dredging companies, he says, trade at 7-8 times cash flow in the markets. However, most investors look at the lowest-common-denominator business in a firm, which in this case means that CFE was valued on its construction operations. "Construction, if you're really good, might trade at 5 times cash flow," says Marcus. "Which explains why CFE was trading at less than five times cash flow."

The firm has been selling off its construction businesses, and Evermore was able to buy the company at 45 euros—five times cash flow—early in the process. Three years later, the stripped down company was selling at 100. "That's when the ETF gets interested," says Marcus, "because now it's a pure play, instead of being a conglomerate that doesn't fit comfortably in whatever theme they're trying to build."

Another example? "A couple of years ago, Siemens decided to spin off Osram, which owns Sylvania, which is in the lighting and light bulb business," says Marcus. "If you owned 100 shares of Siemens, you got two or three shares of Osram. They threw it away like it was a piece of dirt."

Marcus did some homework on this piece of dirt, liked what he saw and bought up shares being sold by the Siemens shareholders, who didn't know what to do with them.

"It was a company that came out at five times cash flow, and started doing things they couldn't do when they were cowering inside the giant," he says. "They downsized, they closed plants that were inefficient, and because the company had never traded before as a standalone business, the indexes weren't interested in it."

Eventually, Osram was trading in the mid-40s, at which point the indexes knew where it fit in their portfolios. "I might have been the one to sell it to the index funds," says Marcus.

*Short perspective*

The most active of the active managers are those who run long-short funds, among them Caldwell & Orkin in Atlanta. The perspective of managers who take short positions is interesting because, on the one hand, they're seeing a lot of what appear to be terrific fundamental opportunities in overvalued stocks, and yet many of those stocks have continued to rise as this long extended bull market floats all boats. This raises the possibility that a dam is about to burst in the equity markets.

"The government interventions have been so aggressive that downturns have been quickly met with accommodation," says Patrick Fleming, who co-manages the Caldwell & Orkin Market Opportunity Fund. "If you're passive, you haven't experienced a significant downturn since 2009," he adds. He references not only the Fed's bloated balance sheet, but overseas, where the Bank of Japan now owns 62% of all Japanese ETF assets and the Swiss National Bank owning $61.8 billion worth of U.S. stocks.

Add that to huge investor inflows into passive portfolios, and you get what company CEO Michael Orkin refers to as "the socialization of stock picking." "When the government or individuals put money into the index," says Orkin, "it goes to the individual stocks with no allocation of resources depending on the risk/reward characteristics of the individual stocks."

In that environment, he says, exposure becomes more important than analysis."

***When the world's governments and investors put billions into index funds, the result is the socialization of stock picking.***

Fleming says that when the firm has been correct in its short position calls, they've learned to quickly harvest those profits. "The very next day, after the vote has been placed on the fundamentals, you're back to having a passive dominance, especially if the stock is owned by the ETFs," he says. "You'll see it start to recover the original price, even if the fundamentals haven't changed."

Think about what that means about today's valuations. The clear implication is that there are many companies, hiding out in the indices, whose fundamentals don't justify their current valuations. If the world's governments ever were to become less accommodative, if investor inflows ever became more discriminating, then the markets might abruptly reflect underlying reality. That would be a field day for investors who take short positions. At the same time, passive investors could wake up to a whale of a correction.

Add to that another factor. "Many corporations have been accessing the bond markets for share repurchases, which has been another tailwind behind their stock performance," says David Bockel, Caldwell & Orkin's chief compliance officer and portfolio manager. "As interest rates go up, it could impair that a little bit. It will be interesting to see what kind of impact that could have on the markets as well."

*ETF vs. non-ETF bond markets*

What about the bond market? Have inefficiencies and opportunities cropped up there as well? Carl Kaufman, Vice President and Managing Director of Fixed Income at Osterweis Capital Management in San Francisco, says that in the high-yield space that he invests in, bonds can be placed in two very different categories.

"There are two monster high-yield ETFs (HYG and JNK) and a few smaller ones," he says. "The larger benchmark issues that the ETFs invest in will be bought and sold frequently, are very liquid, but they also tend to be priced more richly."

This, he says, is a high-friction environment. "The ETFs are always bidding on up days and on down days they're always selling," Kaufman explains, "so the friction can be 1/2 to a point plus their fees, which are about 40 basis points. So typically, the high-yield ETFs have lagged the benchmark by about 1.5 points or so, which is friction plus fees."

In contrast, active fund managers like Kaufman tend to trade in the second tier of bonds, where the spreads are tighter. "I can almost guarantee that I'm going to do pretty well just by buying non-ETF bonds," he says.

As an example, Kaufman talks about bonds issued by the R.R. Donnelly company. "Their bonds used to trade at 5% yields for five year paper," he says. "Not cheap, not rich. It was fine."

Those bonds were large enough issues to be eligible for ETF investing. But then the company split into three parts, and two of the resultant companies retired some of the debt by floating issues of $350 million and $400 million respectively.

"Those offerings were too small for the big guys to care," says Kaufman. "They couldn't get it done at the former pricing; they ended up selling 7- and 8-year paper, one at 8.25% and the other at 8.75%. So when we invested," he says, "we got pricing that was probably 200 to 300 basis points higher yield than we would have if those had been billion-dollar issues."

Kaufman says that another factor in the bond market is dealer liquidity. "After all the regulatory changes, if a 500 bond lot comes up for sale, the dealers don't want that on their books," he says. "So they show it to the street and the street puts a bid on it."

So? "Instead of the dealer pricing those bonds, I get to price them," says Kaufman. "Sometimes I buy them a little below the bid, depending on the market conditions, sometimes I just buy them a tiny bit above the bid, as opposed to buying them on the offer."

***Wide price swings used to come from naive retail investors. Now the whole market looks like that retail impact.***

Incremental differences in price, he says, can mean a short-term yield of 4% as opposed to what would have been 2% or 3% if the dealer had purchased the bonds for its own inventory and then looked for buyers. "With short-term paper, you don't need a lot of price movement to get a big difference in yield," says Kaufman.

At the even smaller end, Venk Reddy, founder of Zeo Capital in San Francisco, isn't afraid to trade with the big ETFs. "We see a lot more pricing getting pushed around by fund flows than by underlying fundamentals," he says—once again citing the recipe for inefficiency that T. Rowe Price is eyeing. Reddy's particular specialty is higher-quality, shorter duration high-yield bonds, with an eye to smaller trade sizes.

In that market, Reddy says, the ETFs are captive to the fund flows; they may be selling a particular bond today and buying it back tomorrow—at whatever the market will bear. "You often have the situation," he says, "where an index fund, especially ETFs, will be lifting offers in bonds one day and then hitting bids in the same bonds the next day, and paying for the round trip transaction [the difference between the bid and offer]. Our advantage," he adds, "is knowing what to avoid."

Reddy cites an example of a small 350-bond lot that went on the market almost a point and a half below where it had traded just three days before. In another case, bonds that were trading at 2.5% were suddenly, days later, trading at a 1% yield.

"Historically, these weird price swings would have come from naive retail investors," he says. "But when you combine brokerage firms not willing to use balance sheets with prices getting pushed around by ETFs, now the entire market looks like what used to be only the subset that had this retail price impact."

The obvious strategy in this increasingly inefficient market is to be patient and know what the securities are actually worth. "Our counterparties sometimes get frustrated," says Reddy, "because we say: *I don't care where it's trading; here's where we want it*. And we wait for it to come to where we think it is an appropriate purchase. If it never gets there, we don't buy, and that's okay."

*Better investors*

Finally, and perhaps most simply, the fund managers who exhibit a passion for investing are enjoying fewer but better investors.

"We have a saying here: *You can't do what everybody else does and expect a different result,*" says Davis. "But for years, at every client meeting, we would always get the same questions: *Why are you overweighted financials? Why are you underweighted consumer staples? We're used to managers that slightly overweight or slightly underweight. But you don't look anything like the index.*

"Now we find that the clients who have stuck with active management are actually encouraged that we don't look anything like the index," Davis adds. "We're in a world where people accept that if they're going to be interested in active, you'd better not look like the index. All of those restrictions—*are you value? Are you growth? Are you small cap? Are you large cap?*—are becoming discredited. For an investment culture like ours," he says, "where we look at industries without regard to market cap or geography, this is a wonderful environment to invest."

Marcus says he's enjoying his relationship with the RIA community more than he ever did before, and he believes there's a bifurcation going on in the RIA community, where advisors who aren't interested in investing have gravitated toward the passive funds, while those who do more research are finding him.

"This is a business of intermediaries," he says, "and we're down to a core of long-term investors who have an alignment of interest with us, who know exactly what we're doing on behalf of their clients, and why. They're more knowledgeable, they participate and pay attention at the conference calls, and they aren't jumping in and out of the fund the way people used to do," he adds. "They're the kind of investors you want, who, when we hit the inevitable rough patch, will say: I know this strategy is going to have some lumps from time to time, but I'm comfortable with it. If it's news to them that special situations and catalyst-driven investments have lumps," says Marcus, "then our team did a bad job of communicating what we do."

*Risk is deviation?*

Let's be clear: the trend of greater fund flows into passively-managed instruments is going to continue, in part because so many investors and institutional managers have been taught by the academics that passive is and always will be superior, in part because the definition of risk has changed. Until the tide goes out and exposes all the boats that have risen as the waters have gone up, until active fund managers can establish track records that prove that judgment beats exposure, people will continue to flock into ETFs and their passively-managed counterparts.

In this environment, "risk" has been redefined not as the chances of a loss but as the possibility of deviation.

"We had a long-time client who manages the portfolio of an insurance company, who is personally invested in our funds," says Davis. He said to me: *I'm a believer. I believe judgment, alignment and experience are all strengths. But*, he said, *for my job, I cannot recommend an active manager after a period of underperformance. If I stick with you, there's an 80% chance I'll be glad I did, but a 20% chance I'll lose my job—and I can't take that risk on behalf of my family.*

"For a lot of pension advisors, consultants and even individuals," Davis adds, "we've moved into an incentive system that pushes them away from a focus on the absolute outcome toward a focus on deviation from the benchmark. Safety," he says, "equals mediocrity in this new environment."

That makes it harder for funds like his to attract new investors, but the wind in his marketing face is more than compensated by the wind at his investing back.

"I really like the world that we're going into as an investor," Davis says. "My partners and I, we feel like we are at a perfect spot in our careers for this to happen, because we're right in a sweet spot as far as managing our portfolios, and we think this trend is going to continue until people suddenly realize, hey, maybe those managers who outperformed are not an anomaly."■

Practice Management

# A Tool for All Seasons

**Synopsis:** ***How engagement standards documents can be used not only with clients, but also with your firm and individual client situations.***

**Takeaways:** ***Figure out what drives you crazy about client relationships and establish on the front-end the client's expectations of your services. Then apply the same approach to the staff at your firm. Look for people who can connect with the goals of the firm.***

Carolyn McClanahan, of Life Planning Partners in Jacksonville, FL, has her clients read and sign an engagement standards document before they sign on as clients.

Why? "Everybody comes to a relationship with different expectations," she says. "It's not intentional, but people will make assumptions about what you'll do, and what you're going to expect them to do, which may be completely inaccurate."

For example?

"Let's say you're an advisor who is really bad about returning phone calls," McClanahan proposes. "The client might expect you to return calls immediately, and she made that assumption without any communication on the subject at all. People may assume that just because you asked for some piece of information, they can take their time about getting back to you with it."

I've included a copy of McClanahan's client engagement standards document in this article, which was initially created in 2007 at the recommendation of life/business coach Tracy Beckes, and has been updated several times since. "Tracy said that I should think about: what things about clients drive you crazy, and put that in there," says McClanahan. "And: what things do you absolutely love? I started from there, and tried to figure out how I could preemptively get rid of the things that drive me crazy, like people who don't get back to me when I really need something, or who don't agree with our passive investment philosophy and think we can time or beat the market. If we can't agree on those things," she adds, "then we don't need to work together."

***The engagement standards document has resulted in a higher rate of clients signing on for services.***

McClanahan says that the engagement standards document has resulted in a higher rate of clients signing on for her services. "It sets a tone, and people tell me they love the clarity," she says. "They'll say: Wow! I like this! This is fabulous!"

The standards document has also helped her address some of the client issues that come up in any business relationship. "One of the things we say in our engagement standards is that we return phone calls within a day and emails within two, and we stick to that," McClanahan says. At the end of the document, there are commitments that the client will make: among them, the client agrees to provide requested data and documents in a timely fashion.

"I say to them: *if we've reached out to you, and we haven't heard from you within a reasonable period of time, especially if we've sent you two or three emails and a phone call, we worry that you might be dead*," says McClanahan with a laugh. "I say: all we need back from you is a one-word email that says: '*busy*.'

"We also tell them that a financial planning relationship will have a tiered level of urgency," McClanahan continues. "If it's something I really need, I'm going to say: I really need this. And we expect it back very quickly. This is especially true with tax things.

"If it's something, nice for us to get done but you don't have the time to get it done right now, then I'll remind them," McClanahan adds. "We have an every-two-week reminder for stuff that needs to get done but is not urgent. Then I have an every-three-month reminder for stuff that we really kind of should

## Client Engagement Standards

Our purpose is to provide the best financial life planning possible and to build excellent long term relationships with our clients. We believe that the secret to any successful relationship is to have clear expectations from the beginning. We ask that you read the tenets by which we operate, what you can expect from us, and what we expect from you, as our client.

### Our Tenets:

I. Financial Life Planning is an ongoing process involving: goal-setting, cash flow planning, risk management, investment management, asset protection, healthcare planning, tax planning, and estate planning.

II. Good communication is critical for a mutually beneficial relationship.

III. We employ a systematic approach to achieve thoroughness and efficiency in providing comprehensive financial life planning services.

IV. A terrific plan requires a time commitment from you as well as from us.

V. We believe in a disciplined investment approach based on long term tactical asset allocation. We do not try to time the market.

VI. We enjoy working with great people who appreciate the true value of our services.

VII. Everyone should have the opportunity to live a great life. Our goal is to help people achieve this.

VIII. Our fees are based on the complexity of your needs. The flat retainer fee covers all continuing planning services, including investment management. We receive no compensation from any entity other than you.

### What We Deliver:

I. We look at all aspects of your life to create an ongoing financial life plan that fits your goals, values, and resources, as well as maximizes your opportunities.

II. We assist you all along the way with the “heavy lifting” process of implementing your plan. Then we monitor your plan regularly to make certain that all parts stay relevant and updated.

III. We keep all your information confidential, safe and secure. Our client portal and office systems employ advanced security features and protocols to protect your data. We share information only as needed with attorneys, accountants, and other professionals with whom you may be working, in order to effect services, quote coverage, or review accounting, insurance, and/or legal service options.

IV. We strive to return all phone calls within one working day and emails within two working days. We will inform you of any short term deviations from this policy.

V. We have regular meetings to keep you up to date with your plan. We review each of the following at least once a year:

A. Insurance and risk management
B. Investments and your investment policy
C. Estate planning and asset protection
D. Goal planning and projections, tax planning and cash flow planning

In addition, we address any issues of concern to you throughout the year.

VI. We are highly flexible in both the timing of when we are available and methods of communication to make meeting participation convenient for you.

get done, but nobody is going to die if it doesn’t get done.”

At the last tier, there is a once-a-year reminder where clients said they would do something, but there’s no confirmation that it has been done.

Are the standards effective at promoting a more cooperative working relationship? “People understand that we’re serious,” says McClanahan. “I had a client come in who is good friends with another client who was taking some time getting back to us. And she said, *you know, Rich thinks you’re going to fire him*.”

When clients can’t live up to the standards, they CAN be fired. “We had this one guy come in the office, who was super nice on the surface but he was treating us like we were his girl Fridays,” McClanahan recounts. “When things came up that he considered to be urgent, he would be calling me at 6:00 in the morning. But when we needed something, we wouldn’t hear from him.”

McClanahan was able to pull out the engagement standards and point to the clause that the client was violating. “It says, if we’re ever feeling like we’re not respecting each other and enjoying each others’ company, then we need to discuss it,” she says. “I finally had to say: *I don’t think we’re right for you*, and it was there in black and white.”

McClanahan cautions that anybody creating their own engagement standards document should start with a clean sheet of paper, even though hers are right there on the page and have been working well in her firm. “These have to reflect who you are, and address the issues that you, personally, want to address," she says. "You can't write in there, *I will return your emails and phone calls within a certain period of time* if you're not going to stick to that. You don't want it to be aspirational. You want it to be who you really are."

*Corporate standards*

The client engagement standards worked so well that McClanahan decided to apply the same tool to other relationships. Whenever she volunteers, including her work at NAPFA, she will insist that engagement standards are drawn up to define her role and the expectations.

Certain client situations have also called for her to draw up an engagement standard document that will move the process along. "We had clients who have a child in his 40s that they are still supporting," says McClanahan, "so we drew up a family agreement on how they were going to get him off the dole."

In another situation, a client who is seriously ill worked out an agreement. "He has a wife and children from his previous marriage," McClanahan explains. "We know there are going to be some issues around them thinking the wife is not doing a good enough job. So we created these engagement standards around what is going to happen with this guy's care plan as he gets sicker."

Finally, McClanahan has created a corporate engagement standards document which her staff sign and initials—also reproduced here. "We came up with that as

VIII. We commit to always doing our best on your behalf. We are proud to serve in a fiduciary capacity for you. We love what we do and take pride in doing the best job possible.

IX. We are compensated by client fees only. Our fees are fully disclosed to you and we do not accept any commissions or referral fees.

**What We Expect From You:**
*(Please initial each section to indicate that you understand these statements.)*

______**I am willing to participate in the Financial Life Planning process as described above on a continuing basis.** I understand that each part of the process is interdependent and requires information or participation from me.

______**I am willing to delegate the implementation and monitoring of my plan to Life Planning Partners, Inc.** I understand that if I act without your input or knowledge, this may affect your ability to provide appropriate advice. I am hiring you to help me enjoy life more fully, and part of this process is to let you do what you do best.

______**I agree to be responsive to emails and phone calls within a reasonable period of time.** Many financial planning issues are time sensitive, most especially tax items.

______I **agree to provide requested data and documents in a timely fashion.**

______**I agree to receive documents electronically either via e-mail or the Client Portal.**

______**I understand that Life Planning Partners, Inc. only accepts clients that agree with their investment philosophy.** Diversification is the key to sound investing, and we want to work with clients that appreciate this approach, as opposed to clients who want to follow the "herd" mentality of the latest "hot" investment.

______**I understand that Life Planning Partners, Inc. will only provide advice on investments selected through their research.** We pay for and utilize a large number of investment research sources. It is not time or cost-effective for us to investigate investments that do not fit our investment philosophy.

______**I appreciate that Life Planning Partners, Inc. keeps flexible hours for clients as well as for staff.** Deviations from the normal schedule are communicated via company newsletter, email response, and/or through voicemail outgoing message.

______**I appreciate that Life Planning Partners, Inc. dress code is casual on days there are no client meetings and on weekends.** Clients are welcome to "drop by" the office but we may be in casual attire.

______**I understand that Life Planning Partners, Inc. takes full responsibility for their errors.** You agree to make us aware of errors as soon as they are discovered. We do our best to minimize errors and correct all errors to the best of our ability to make you whole.

______**I agree that our relationship needs to be reevaluated if we ever stop enjoying or respecting one another.** We are committed to living our lives from a place of joy and kindness, and hope to have long-lasting, healthy relationships with all of our clients.

______**I understand that fees are due on a quarterly basis and are deducted from my account or paid directly by me.** Life Planning Partners, Inc. sets client fees at the end of every even year (2014, 2016, etc.).

My initials above indicate that I understand these statements and have had any questions answered to my satisfaction.

## Life Planning Partners, Inc.
## Corporate Engagement Standards

Our purpose is to provide the best financial life planning service available. A great work environment is important to achieve this goal. Engagement standards provide clear directives on how we operate as a company and how our employees are expected to interact with each other. Open and direct communication fosters a great work environment and helps us create great lives for our employees as well as our clients.

What we expect from each other:

______ PLEASANT WORK ENVIRONMENT - We like to have fun at work and strive to maintain a pleasant working environment. We enjoy laughing, jokes, and anything else that brightens the day. Constant curmudgeon type personalities will not fit in here.

______ PASSION FOR EXCELLENCE - We have a passion for excellence in all that we do to continue to make this a great company. All employees are expected to do a great job.

_____ COMMUNICATION - We have an open door policy with honest, direct, and clear communication. If something bothers or offends an employee, they need to share that information. If there is a criticism of another employee or the way things are done, we listen to each other from a place of learning, empathy, and goodness and work to resolve the situation through compromise. We do not speak behind employees backs, and if it does happen, it is understood this information will be shared with the employee of concern. We have regular meetings to give us time to communicate about any issues.

_____ UNCERTAINTY - All questions are good questions. If you are uncertain ask. “I don’t know” is an acceptable answer between staff members. “I don’t know, but I’ll find out” is an acceptable answer to a client.

_____ LIFETIME LEARNING - Continuing education is valued and expected. We agree to mentor each other in our areas of strength to allow us to learn and grow as a team.

_____ TEAMWORK - We encourage collaboration of ideas and actions. We also share in the work that has to be done. Everyone pitches in when needed, no matter the type of job that needs to be done.

_____ A BALANCED LIFE – Balance is important when creating a great life. Taking care of us first helps us take care of others better. We are encouraged to take time off for fun and family matters. We encourage exercise by budgeting for participation in athletic events. We also like to give back to the community - we allow time off for community service or other charitable work.

_____ RESPECT FOR OTHERS - We are all valuable. Our relationship needs to be reevaluated if we ever stop enjoying or respecting one another. We are committed to living our lives from a place of joy and kindness, and hope to have long-lasting, healthy relationships with each other and all of our clients.

_____ ERRORS – Humans make mistakes. We take full responsibility for any errors made and we learn from them. We agree to make each other aware of errors as soon as they are discovered. We do our best to minimize errors and immediately remedy errors that occur. Our goal is to make the client “whole.”

_____ RELIABILITY - We rely on each other to do what we say and say what we do.

_____ INTEGRITY - We pride ourselves in having high ethical standards. We always do the right thing.

a team,” she says. “When you’re working with other people on a regular basis, then it needs to come from everybody, so you have their buy-in.”

Has this helped her manage her firm? “It helps get everybody on the same page with how we act as a company, and it helps define the culture of the company,” McClanahan says. “It sets forth that we’re going to have fun, and if you’re a constant curmudgeon who is not into having fun, you are not going to fit in. We expect you to be excellent, and we expect you to do continuing education. We pull them out every year and say: *are we following our engagement standards? If not, what can we do to get back to what it says here?*”

This is a tool that the firm can use, procedurally, if somebody is not meeting the company’s expectations. McClanahan tells the story of a new employee who seemed initially enthusiastic when shown the engagement standards document. “*He said, oh, this is great!*” she says. “But it was somebody we felt not totally 100% about at first.”

After three weeks, McClanahan found herself pulling out the engagement standards and having a conversation with the employee. “I said, *mister, you are failing at direct communication*,.” she says. “He was passive-aggressive, and I was able to have an honest conversation with him about the expectations and behaviors that he had signed off on. I said, *here are the ways you are not meeting these standards*. Eventually nothing changed, and we had to let him go.”

Another employee never

managed to follow the "passion for excellence" standard. "Her main goal seemed to be to always get out of here," says McClanahan.

McClanahan believes that the engagement standards concept can be applied to just about any situation where people might have unconfirmed expectations about each other. "The bottom line," she says, "is that whoever you use them with, engagement standards are about helping get everybody on the same page, knowing what to expect, and being clear about what you want and don't want in the relationship. All I can tell you," she adds, "is: they've worked really well for us."■

_____ COMPLAINTS – We are always striving to improve. If an employee has a complaint, they must always suggest solutions that may resolve their complaint.

_____ COMPETENCE - We are expected to be competent to the level of our training.

_____ VERIFICATION - We trust, but verify. We check behind each other to make certain tasks are getting done. We have policies in place to make certain the company's and client's money are being protected.

_____ DELIVERABLES – We are consistent in how we deliver our services to clients. We develop and refine client service procedures to maintain efficiency and quality. It is expected that all employees will follow the same procedures.

_____ HOURS OF OPERATION - Life Planning Partners, Inc. keeps flexible hours for clients as well as for our staff. Deviations from the normal schedule are communicated through voicemail or email messages.

_____ DRESS CODE - Life Planning Partners, Inc. dress code is casual on days we do not have client meetings and on weekends. Clients are welcome to visit the office unannounced, but are informed that we may be in casual attire. When we have client meetings we will dress in proper business attire. We strive to maintain two casual days a week.

_____ COMPENSATION - Compensation is currently tied to revenue and performance. Our goal is to have all employees paid well above market rates.

_____ CELEBRATIONS - We believe that a job well done should be rewarded. As goals are met, we have celebrations of these goals.

I understand and agree with these awesome engagement standards. Any questions have been answered to my satisfaction.

Agreed to and accepted by:

Employee: ______________________________________________

Signature: ______________________________________________Date: ___________

Client Services

# Holistic Planning

**Synopsis:** ***How to provide career asset management and coaching within a financial planning context.***

**Takeaways:** ***Recognize that clients have some of the most important answers in the initial evaluation. Look for opportunities not just to enhance their assets, but their lives as well.***

Frank Corrado, of Blue Blaze Financial Advisors in Red Bank, NJ, started his working life as a CPA at Ernst & Ernst, later becoming a financial manager at JP Morgan before getting his CFP and starting his own financial planning practice. So it might be surprising that much of his work is focused on the softer side of financial planning.

"Starting out as a CPA and a financial guy, and then getting my CFP, I couldn't get more analytical," he admits. "But as I gave financial planning advice, it became clear that certain clients were just not getting to where they wanted to get to, even when they had a nice tidy plan. It seemed that we weren't approaching them from the right perspective."

This insight really hit home when Corrado devoted 45 minutes to explaining a client's tax returns to him. "At the end, he turned to me politely and said, *you know, you could have just told me where to sign*," Corrado says. "In time, I realized that there are three modalities that we deal with our clients on: teaching, advising and coaching. There are times when we need to be able to educate our clients on what they need to know in order to help them make an informed decision, and there are times where we have to advise, based on our knowledge and expertise. And finally, we have to recognize that we haven't got all the answers; in many cases, the client has the answers. It comes down to our ability to understand the full landscape of what you're operating under, and to elicit from the client what he thinks the best strategy is moving forward."

***It became clear that certain clients were just not getting to where they wanted to get to, even when they had a nice tidy plan.***

Today, Corrado is pioneering a more holistic form of the planning service that includes career asset planning and coaching, along with the traditional retirement analysis and investment advice. He says that his client outcomes are greatly improved, and so too is his job satisfaction.

"The whole concept of comprehensive net worth really opens a lot of doors," he says. "It's a combination of human and financial capital, which unlocks the potential that people have, which I believe really needs to be cultivated better in society."

The journey started with 400 hours of coaching training through the International Professional Education and Coaching organization, based in Shrewsbury, NJ. "I never thought of coaching as a stand-alone service," Corrado says. "It seemed like a skillset that was necessary to deal with my financial planning clients. It gave me the tools to identify the real reasons for some of the blockages and issues in client situations."

*Changing careers*

Corrado is a member of the Alliance of Comprehensive Planners, and like most of its members, he does extensive tax planning and tax preparation work for clients. Also, like ACP members, he is compensated a retainer basis. As a career changer, he decided to make a speciality of helping clients change out of a stressful career into something they enjoy more.

A prime example is one of his key employees. John was a client of ours who worked in the foreign exchange business," says Corrado. "He was very good at what he did, but the question was: how long did he have in that role? The movement of the business was toward screens, the market was changing, the compensation was changing, and doing his tax returns, I could see that his compensation was going down."

In the discovery

conversations, this client confessed that he had to endure a three-hour commute each day to Westport, CT. "He was pretty miserable," says Corrado.

The solution? "The first thing we did in the planning process was get his deferred compensation straightened out so he was putting away money for rainy days, and showing him how to access the cash value in his life insurance policies," Corrado explains. "That allowed him, if he wanted, to take some kind of reinvention sabbatical."

As the employment situation became more intense, Corrado referred the client to a professional career counselor. One of the possibilities was to switch careers and become a financial planner, which he embraced—and Corrado hired him into the firm. "He was 49 years old, with four children, including twins going to college," says Corrado. "We helped him sell his house in Connecticut and move to New Jersey, sell his vacation house and boat—so he would be able to live on a salary that is probably ten percent of what he was making before. Now he absolutely loves the fact that he has much more time with his wife and children, and he sees a profession where can work for the next 25 to 30 years, as opposed to watching the clock tick away on his career."

Another career changer client, who also happened to work as a foreign exchange trader, confessed that he had always dreamed of becoming a florist. "After we made sure his balance sheet was squared away," says Corrado, "we counseled him on going to floral school, helped him set up an LLC, worked with him to write a business plan and set up his website, and then planned the cash flow during the early years of the business. Eventually," he says, "we got him to the point where he could follow his passion."

***Not all career asset management is about a spectacular shift in careers. Many of Corrado's clients are negotiating better job arrangements.***

*Negotiating job improvements*

Of course, not all career asset management is about a spectacular shift in careers. Corrado says that many of his clients feel stuck in a job or a job situation when they could be negotiating a better arrangement. "When somebody wants to move to a new job, we help our clients understand the terms and conditions of their current employment," he says, "to make sure that when they negotiate their severance package they're getting the best outcomes with their executive and deferred comp. We look at their benefit packages to make sure that their life insurance and health benefits are extended. If they're forced to sign some kind of release letter, we take a look at it and refer them to employment attorneys to make sure that somebody is looking out for their best interests."

That's on the exit side. On the side of the new company, Corrado will help negotiate the salary arrangement. "Sometimes people will take a big decrease in salary in order to change their lifestyle," he says, "but other times they need to ratchet up their salaries. If the position is high enough," he adds, "then I'll look at SEC documents and 10K filings where they disclose the salaries of the senior executives of the firm, to get them some guidance on what they can negotiate."

Since his practice includes a lot of financial executives as clients, Corrado has become skilled at calculating how much money an exiting employee is leaving on the table in terms of restricted stock that has not vested. "Usually the new firm can be induced to make them whole if they want to hire them," he says. "Then we have to look at the tax implications."

One client, a scientist with a large pharmaceutical firm, had been working on a cancer treatment that utilizes the human immune system. "He had his product go through clinical trials," says Corrado. "But in our early discussions, he confided that his current position wasn't flexible enough for him. He wanted more control over what he was researching. We looked around and identified a small biotech company on the West Coast."

Corrado calculated the client's

*"We've decided that the best way to reign in Wall Street greed and corruption is to staff the regulators with a bunch of Goldman Sachs executives."*

unvested deferred compensation, and then estimated the salary level the client needed to earn at his new job. He toted up the relocation costs and helped negotiate how much of those the new company would pay for.

"We advised him on the deductions for moving expenses and the severance package with the new company," Corrado adds, "as a precaution against the possibility that the new job wouldn't work out."

This was fortunate, because the client left the company after nine months. "He's now with a firm in Boston, and we did all the same things on the way back in," says Corrado. "Throughout these conversations, it is not just a financial conversation," he adds. "We were talking with the spouse, trying to define what it's going to mean moving from a house in the suburbs of New Jersey to renting an apartment in Los Angeles, what it will mean having their children apart for a period of time, and the risk to their relationship. It's a huge decision that has tremendous implications, both financial and non-financial."

*Renegotiation and reenergization*

Not all career asset management advice revolves around changing jobs. One client, a bank employee, came to Corrado to talk about the annual review meeting he was about to have with his boss. "His approach was to rip into it, and jump right into what he wanted," says Corrado. "I was able to be honest with him about what he needed to be careful about. We changed the way he approached the performance review, and got him in the best position to get a promotion or a raise."

Another client, a working mother, was hoping to spend more time at home. "She was totally frightful at the beginning of our conversation, saying there was absolutely no way the company would accept any modification to her existing work schedule," says Corrado. "After a series of conversations with her, we came up with a way to frame why it would be beneficial to the company to make the change. Then we created some accountability for her to stop delaying her efforts to change what was an uncomfortable situation."

Eventually, the company shifted her to 10-hour workdays, with some of that time working at home, and Fridays off with her child.

The best part about these outcomes, says Corrado, is that they're the equivalent of taking money left on the table; creating a better situation for clients than they realize are possible. "Our mantra is to control what you can control," he says. "We don't have a lot of influence over the investment markets. But there are a lot of things that people can control about their lives if they choose to do so, and these things can have a huge impact on their quality of life and their finances."■

Parting Thoughts

# The War Still to Be Won

There isn't any marketing hype machine behind my newly-launched book, *The New Profession*, but I suspect that by now you know it's out there and available. By far most of the value of the book is guidance on how advisors can prepare for the coming years of hyper-rapid evolutionary change, along with some great tips on marketing, practice management, client service and personal productivity. I say at various times that this or that tip is worth ten times the cost of the book, and there are at least 15 of those scattered around in various chapters. (*www.bobveres.com*, click on "order" and choose e-book or print format.)

But there's one potentially-overlooked point which I tried to make, and I'll try to make here as well. I'm afraid that our lobbyists and thought leaders may be missing the big picture when it comes to fighting the good fight on behalf of the profession. We seem to think that the battle is over compensation models, or the fiduciary standard (or imposing it on other business models), or the DOL Rule, or, well, a lot of stuff.

Make no mistake: those are important issues. But they are not the war. And knowing the big picture goal is important. It's possible that we'll continue to lose pretty much every battle we fight with the regulators and Congress. But if we stay focused on the bigger picture outcome that we want to bring about, then it will still be possible to win the much larger conflict.

What war am I talking about? The goal is not to create a fee-only society; there will always be sales agents. The goal is not to force everybody to act as a fiduciary at all times; we know they won't. The goal is to create a real profession, which will be called Financial Planning—a protected domain where we can create and enforce high standards.

My book talks a lot about what "creating a profession" means, but we can list the important outcomes fairly quickly. First: every consumer will know how to find somebody who will act in his or her best interests, and also have the training and experience to provide excellent advice. Today, we live in a world where every financial advisor wears the equivalent of white lab coats, and it is impossible to tell the professionals from those who will carefully listen to your financial situation and then recommend the non-traded REIT they had in their briefcase all along.

It also means better, tighter, more meaningful regulation that is guided by the profession itself. The SEC may still regulate RIAs, but members of the financial planning profession will set their own standards. In The New Profession, I envision a world where most financial planners are compensated by retainers (this is a few years in the future, you understand), where investment advice will be primarily handled via online platforms. Is a financial planner in that environment considered to be an RIA? Quite possibly not. Won't THAT be an interesting world?

Our debates would be richer and more interesting if everybody involved were a true professional, and I suspect that a lot of people who rely on commission revenue today would be attracted to the greener pastures of professionalism. Within our confines, we could protect the fiduciary standard and erect barriers to entry against the incompetent, the conflicted and the greedy opportunists.

This is not utopia; a profession would still require self-policing and a lot of internal debate about what it means to be a financial planner. The profession would hopefully never stop evolving. But I envision a better world once we, collectively, have given birth to a new true profession—for consumers, most importantly, and for the people in the financial planning world almost as importantly.

Keeping our eyes on the big picture—on the big war behind the skirmishes—gives us a better chance of achieving our goals. And it helps us recognize that the losses we endure—and there have been and will be many—aren't the end of the road, but another step toward eventually claiming an important victory. One of the most interesting historical facts I know is that George Washington, who commanded the Revolutionary armies, never won a battle against the British army, and ultimately won the War of Independence.

We can do that too. *The New Profession* is my best effort toward bringing about that historic event.

I wish you all a terrific 2017, and remind you of something I constantly remind myself: that fulfilling this wish is at least partly the result of things we, ourselves, can control. ■