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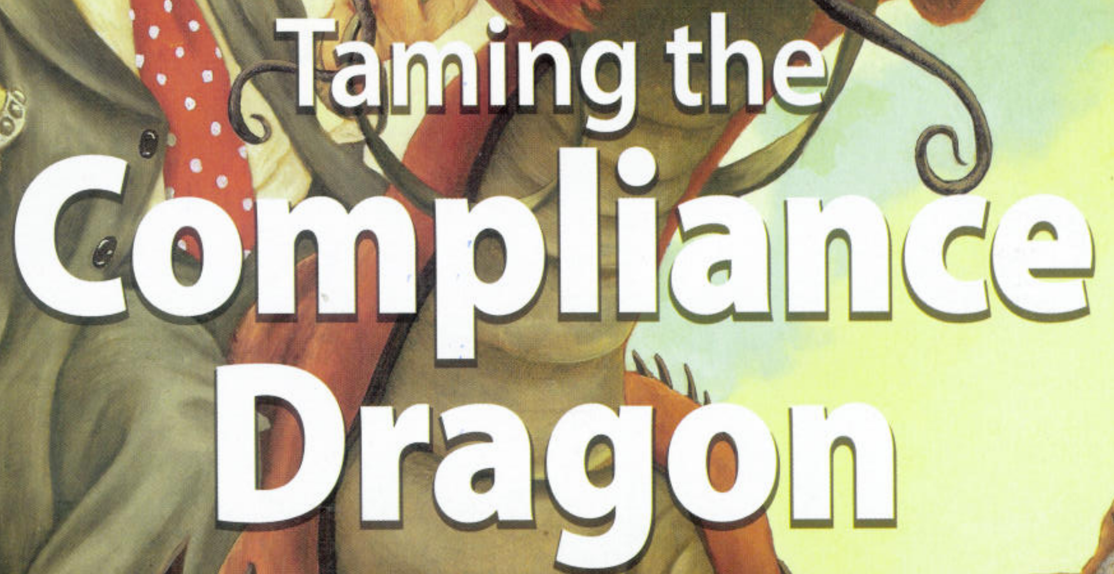
# ADVISOR TODAY

THE OFFICIAL PUBLICATION OF THE NATIONAL ASSOCIATION OF INSURANCE AND FINANCIAL ADVISORS



## Taming the Compliance Dragon

**40** Tips for helping your clients weather the investment storm.

**55** Keeping score will keep you on track

**56** Great ideas for making it to the top

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FINANCIAL PLANNING

# "You May Lose Some Money!"

Prepare your investment clients for the worst of times—and they'll stay with you for life.

Steven Holt Abernathy

While this may surprise you, the wisest thing you can say to a client is: "I'd like to assure you that you may lose money in about three of the next 10 years, regardless of where you invest. My job is making sure those years don't ruin your plans."

As advisors, we tend to adroitly sidestep the topic of losses. Clients don't hire us to lose money; yet, we know that at some point, it will happen. We have cursory conversations about risk tolerance and the ubiquitous cautions about how "past performance is no guarantee of future success," but few advisors prepare clients for losses forcefully and well in advance. Then, when markets turn downward, these same advisors experience problems with clients "acting irrationally." The time to teach clients to act rationally when they are losing money is long before they ever lose money.

## Most common mistakes

On day one of your relationship, hand your client a list of common mistakes the average investor makes, and let him know that you are there to help him avoid those pitfalls that ensnare even the most intelligent, well-intentioned investors. Explain each item to him. Invest the time up front because it's nearly impossible to do so after someone has lost 10 percent of his net worth in the last year and is being bombarded with messages from competitors and the talking heads on TV.

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Here are the seven most common mistakes average investors make involving losses.

- **Selling when stock prices drop.** If the company you own is worth $60 and you own it for $40, it's nonsensical to sell it simply because the market price has dropped to $30. If you own a house worth $600,000 and you bought it for $400,000, why would you sell it simply because the real estate market dropped the price to $300,000? You wouldn't, and you shouldn't sell valuable shares when they drop, either.
- **Buying good companies instead of good investments.** Many companies are great, but their share price already reflects all of that greatness. Using the example of the house above, you can point out that no matter how beautiful a house is, it should be bought at a fair price—or better yet, at a bargain. The same is true of every company.
- **Investing based on potential rewards rather than on the relationship between reward and risk.** Always demand a margin of safety. Buying stock in a company with the potential to go through the roof is a great idea as long as the downside risk if you're wrong isn't severe. Too often, investors set up their own losses by buying high-potential or high-growth companies that have no margin of safety.
- **Monitoring results instead of processes.** No one—including the best on Wall Street—can control returns. We can, however, control risk and the odds of getting outsized returns. Successful investing—by a portfolio manager, financial advisor or individual investor—is about maintaining a successful investment process that is repeatable regardless of short-term results. Average investors pay attention to their one-to-three-year results, whereas the world's best investors have found success by sticking with a process that underperforms for one, three or even four years. Why? Because it works in the long run.
- **Being shy in down markets.** Depressed markets are often irrational and usually cheap. Average investors see falling prices and keep their money under

their mattresses. Smart investors know this is the time to act rationally since risk is at its lowest and rewards are at their highest. Keep cash on hand for these times.

• **Using accounting numbers to value companies.** Average investors use numbers like P/E ratios, EPS and price-to-book to judge the potential risk and reward of owning stock. These numbers, however, are founded on accounting-based reporting from companies. Wall Street's top managers all translate such numbers into actual economic numbers before working with them and usually use different metrics for determining risk and reward. Average investors who buy on accounting numbers set themselves up for losses. During down markets, they use these same irrelevant numbers to divine what's cheap. Smart investors and advisors rely on money managers who recognize—and can explain—why these metrics are useless.

• **Diversifying into correlated investments.** Average investors do diversify but typically into mutual funds with a high correlation to the S&P 500, which makes no sense. There is a role for uncorrelated (alternative) assets in most high-net-worth portfolios, but average investors tend to create the environment for bigger losses by ignoring this. They become dangerously confident because they think they're diversified.

Advisors who paint a rosy picture of their clients' financial future often lose those clients during natural market downturns. Alternatively, those who prepare their clients for losses can find that, during the worst of times, they are winning clients for life. AT

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QUESTION OF ETHICS

# Term or Perm?

## Don't let the prospect of a higher income influence your decision.

Frank C. Bearden, Ph.D., CLU, ChFC

Ethical issues involved in recommending temporary or permanent life insurance to prospects fall into two categories: the suitability of the recommendation and a possible conflict of interest because of the difference in commission compensation for term or permanent insurance. As a financial advisor, you can make a suitable recommendation for temporary or permanent insurance simply by recognizing the key benefits of each type and the needs of your prospect. Both types of coverage have as their primary benefit a death benefit payable when an insured dies.

To rightly apply this primary benefit, you must ask your prospect if he needs coverage for a limited period or for life. In many instances, coverage needed for 20 years or more is considered sufficiently long term as to be lifetime. Short and clearly limited time frames of need are usually best satisfied with term, while lifetime or permanent needs are best satisfied with permanent insurance.

Permanent insurance also provides extensive secondary benefits such as cash accumulation for emergencies and long-term investing through asset allocation. However, the secondary benefits should not supersede the primary benefit of the insurance, which is to provide death-benefit coverage over a limited or long period.

So when you recognize your client's need for a death benefit, the first question to ask him is how long he needs the coverage. His answer will let you know if you should recommend temporary or permanent insurance. If you recommend term, you should consider the length of time that coverage is needed and make

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