Getting back in the game

By Garnet Anderson
Illustrations: Michael Austin

As investors try to pick up the pieces, there is an opportunity for CAs to help clients reevaluate their strategy and investment philosophy

Markets have been like a roller-coaster, with the spills outnumbering the thrills by a punishing margin. Overlay aging demographics and crimped incomes, and it is easy to understand why so many Canadians are anxious. As clients turn to professionals for advice, chartered accountants need to be prepared with context to respond to clients' concerns.

How did we get here? There is little value in rehashing the triggers to the massive decline suffered in the world markets, but suffice to say, there was a host of interrelated causes: persistent trade imbalances; US government home-ownership policy; loose central bankers; under-resourced and impotent regulators; overleveraged and undermanaged banks; lax credit agencies; herd-mentality investors and spend-thrift consumers. The players may change, but history is replete with episodes of this bubble-like behaviour. In every cycle, fear and rational expectations give way to greed, envy and overconfidence as the economy expands. And then some unpredictable event pops the bubble and fear takes root and the rout is on.

At the time of writing, it appears that the Great Depression II has been downgraded to "just" the Great Recession. Bank failures have subsided, equity indices have bounded higher and corporate bond spreads have narrowed from ungodly levels. The market, historically leading the economic recovery by about three months (see table "S&P 500 lead/lag vs. US economy" below), is strongly suggesting that an economic resurgence is on the horizon.

Still, world trade, capacity utilization, government balance sheets and employment levels have suffered significantly. And while it is the popular view that equity indices hit their lows in March 2009, it isn't a guarantee. If that possibility seems outlandish (the MSCI World Equity Price index in local currencies was, after all, 56.3% off its July 13, 2007, high on March 9, 2009; for its part, the S&P/TSX index's peak-to-trough damage amounted to 50.6%), consider the ugly 20-year plight of the Japanese equity market, which is still off its 1989 high by more than 70%.

Where does that leave us? In the hole! The math is basic, but it continues to confound investors. It takes a return of 100% to re-cover from a 50% market drop. In other words, portfolios will take time to recover. Not a problem for a 30-something investor, but a potentially serious issue for someone living off of his or her savings and facing the risk of depleting his or her capital base.

Where do we go from here? The US large cap equity price index table on page 22 looks at recession-induced US bear markets since 1929. The average bear market lasted 19 months and pruned 37% off of the price index. It then took 33 months to reclaim the previous peak — if March 2009 was the bottom and the average were to somehow play out exactly, investors will have to wait until December 2011 for the S&P 500 to reclaim its October 2007 peak of 1,576. In other words, an investor must endure the pain of the decline and then stoically bear a lengthy recovery — an average 46-month period — in order to rebuild wealth.

S&P 500 lead/lag vs. US economy

Index peak	US economic peak	Market lead +/lag - recession (months)	Index trough	US economic trough	Market lead +/lag - recovery (months)	Contraction from peak to trough (months)	Expansion from previous trough to this peak (months)
Sept. 1929	Aug. 1929	(1)	July 1932	March 1933	8	43	21
March 1937	May 1937	2	March 1938	June 1938	2	13	50
May 1946	Nov. 1948	29	June 1949	Oct. 1949	4	11	125
Aug. 1956	Aug. 1957	12	Oct. 1957	April 1958	5	8	94
Nov. 1968	Dec. 1969	12	May 1970	Nov. 1970	5	11	140
Jan. 1973	Nov. 1973	10	Oct. 1974	March 1975	5	16	36
Nov. 1980	July 1981	7	Aug. 1982	Nov. 1982	3	16	76
July 1990	July 1990	(0)	Oct. 1990	March 1991	5	8	92
March 2000	March 2001	11	Oct. 2002	Nov. 2001	(11)	8	120
Oct. 2007	Dec. 2007	2	March 2009?	TBD			
Average recession lead time		**8**	**Average recovery lead time**		**3**	**15**	**84**

Source: NBER; month-end measurement

US large cap equity price index (day-end values)

Peak	Trough	Months	Loss %	Peak reclaimed	Months	Months to new peak	Subsequent gain
Sept. 6, 1929	July 8, 1932	34	-89%	Sept. 17, 1954	266		
March 10, 1937	March 31, 1938	13	-49%	Dec. 10, 1945	92	6	9%
May 29, 1946	June 13, 1949	37	-24%	April 10, 1950	10	76	179%
Aug. 2, 1956	Oct. 22, 1957	15	-21%	Sept. 24, 1958	11	122	118%
Nov. 29, 1968	May 26, 1970	18	-36%	March 6, 1972	21	10	11%
Jan. 11, 1973	Oct. 3, 1974	21	-48%	July 17, 1980	69	4	17%
Nov. 28, 1980	Aug. 12, 1982	20	-27%	Nov. 3, 1982	3	58	140%
July 16, 1990	Oct. 11, 1990	3	-20%	Feb. 13, 1991	4	89	222%
March 24, 2000	Oct. 9, 2002	31	-49%	May 30, 2007	56	4	2%
Oct. 9, 2007	March 9, 2009	17	-57%				
		19	**-37%**				**87%**
				Average time to reclaim former peak	**33**		
				Average time to form next peak		**46**	

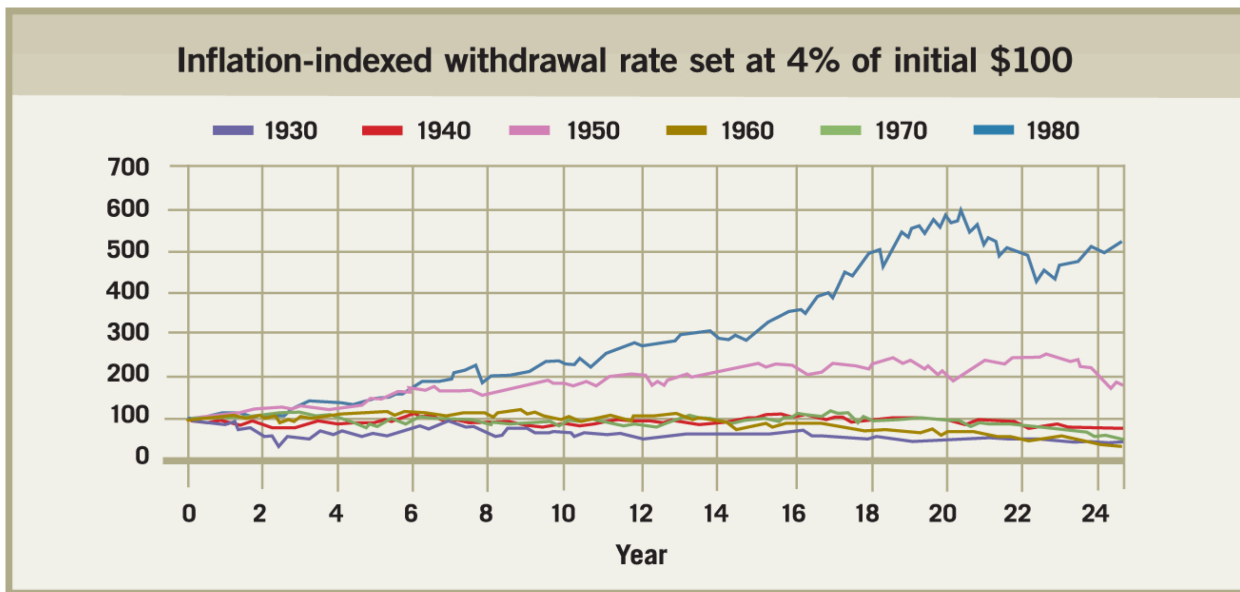
Note: Averages exclude 1929; index is a combination of S&P500 and Dow Jones Industrial Average

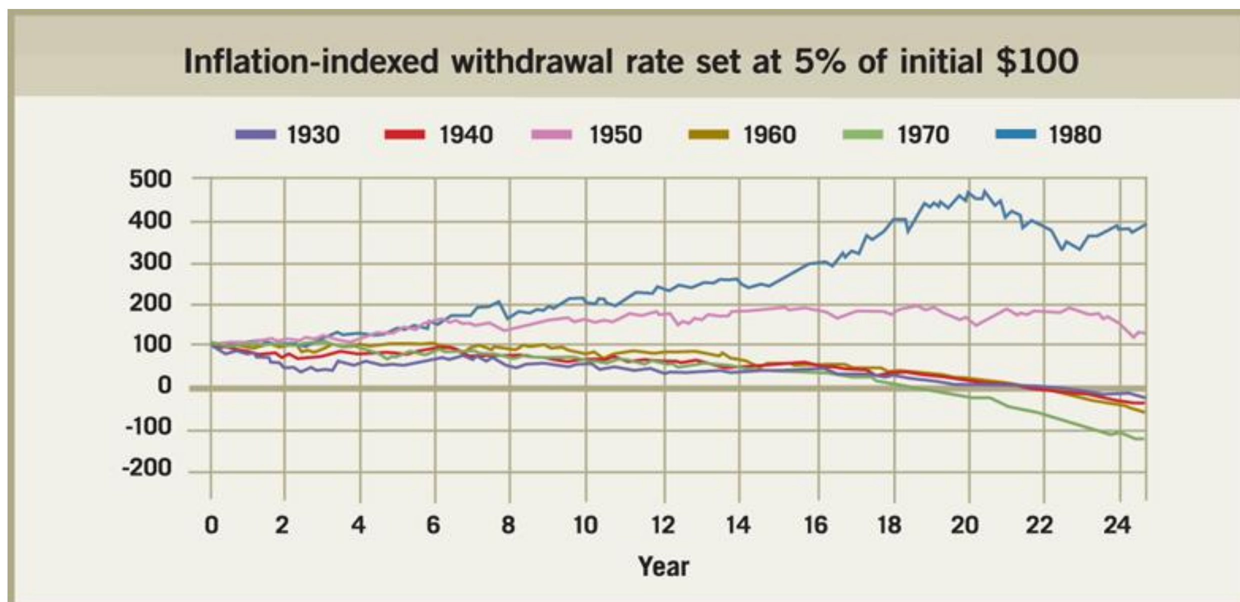
What have we learned? Remember the words of poet and philosopher George Santayana: “Those who cannot remember the past are condemned to repeat it.” So as investors try to pick up the pieces, the following investment fundamentals may help them chart their new and wiser courses.

January 1927 - June 2009
Annualized total returns - US large cap stocks

	1 year	3 years	5 years	10 years	15 years	20 years
Periods	991	967	943	883	823	763
Number of negative periods	266	157	122	37	2	0
Number of periods bonds outperformed stocks	349	284	240	148	87	12
Maximum return	162.9%	43.3%	36.1%	21.4%	19.7%	18.3%
Minimum return	-67.6%	-42.4%	-17.4%	-4.9%	-0.4%	1.9%

Source: Morningstar Ibbotson





1. Portfolio diversification remains critical. Unfortunately, geographic diversification in equities provides only so much protection as correlations increase in times of distress. Go back to first principles and consider an appropriate allocation to cash, fixed income, equities and real estate. Then consider geography, style, currency, sector, method of security selection and vehicle type.

2. Investing is part science and part art. Modern portfolio theory, capital asset pricing model, efficient market hypothesis and stochastic (VAR) modelling are all conceptually brilliant and useful, but not perfect given the unpredictability of the real world. The folks who conceived, built and managed adjustable-rate mortgages, collateralized debt obligations, special-purpose vehicles and credit default swaps are obviously bright, but not bright enough to have covered all angles. Investment professionals need to be well schooled in the limitations and risks of the various theories and investment types. If something is too complex to grasp, then avoidance is probably the best policy.

3. Risk calibration is important. Investors now know what risk really feels like. Interestingly, the last market blow-off was in 2000, and while it was different this time, one would have thought that the lesson about being prudent would still have been relatively fresh during the last bull run. Understanding an investor’s risk tolerance (emotional attitude to risk) and capacity (ability to financially cope with losses) is a cornerstone of an investment strategy that a client can live with through thick and thin. A single emotion-based investment decision can undo years of careful planning and execution.

4. Strategic asset mix remains relevant. Numerous studies have concluded that an investor’s asset mix is of utmost importance. Yet, some pundits now contend that strategic asset allocation, where asset class targets are set and then rebalanced to, did little to protect investors in the meltdown. This would be rash as both individual and institutional investors need the discipline of a strategic plan to control portfolio risk and the emotions that beset us all. While intuitively appealing, alternatives such as market timing and portfolio insurance have such challenges as precision, repeatability, transaction costs and taxes.

5. Tactical changes are expected by many investors. Standing in the corner and getting beaten by a plunging market without taking action is difficult for investors to accept. Predesigned and agreed-upon asset mix ranges should be set to provide the adviser or portfolio manager with the flexibility to buffer the portfolio through changes without providing too much licence to abandon the core strategy. It is a delicate balance; the investor must understand the degree of flexibility permitted and realize that the adviser will never be perfect in implementing these "tweaks."

6. Being Canadian has its benefits. Given our commodity-influenced economy, the Canadian dollar runs higher in good times but retreats when the global economy slows. The result is a built-in portfolio shock absorber for US and international investments. The issue is that many investors will forget this downside support, and grouse about currency losses when the Canadian dollar is rising and want their currency exposures hedged. Given the current exchange rate levels and the difficulty in forecasting currency changes, now is a good time to set a longer-term currency hedging strategy. The focus should be on minimizing investor regret by using a partial hedging strategy.

7. Stocks for the long run. Most individuals, endowments and pensions need to incorporate equities into their portfolios to meet long-term obligations. Given their incremental risk, it makes sense that stocks generate higher returns than cash or bonds. The table "Annualized total returns" on page 24, however, emphasizes that it can take years before an investor can be sure stocks will generate a positive nominal return. It also shows that bonds (intermediate term US government) can outperform stocks over substantial time frames — most investors need both.

8. Due diligence is worth its weight in gold. It takes experience and resources, but searching for better or different investment products is critical to improving the client experience. Flare-ups such as the frauds perpetrated by the hedge fund Portus and Bernard Madoff only serve to heighten the importance of establishing a review process. Initial due diligence has to morph into ongoing monitoring so that weak links can be constantly identified. Investors have to ask themselves whether their managers perform as expected, given that the sell-off was far and wide.

9. Tax loss harvesting. A silver lining in the massive sell-off was the opportunity to tax loss harvest and generate cash flow for some, or create future tax deferred growth room for others. Successful harvesting often requires you to sell, temporarily replace the market exposure and then reintroduce the original security when permitted by the Income Tax Act.

10. Financial planning. Surveys show that clients know their world has changed. For example, Phoenix Life Insurance's July 2009 edition of High-Net-Worth Market Insights indicated 49% of pre-retiree respondents expect they will have to defer their retirement date. The 2009 EBRI Retirement Confidence Survey indicated that 72% of working Americans now expect to work for pay in retirement. While no one wants to reset his or her expected retirement date, spending rate or gifting plans, many need to. Instead of letting clients live in a fear-laden fog, a revised financial plan will give them the context to march ahead and tackle the required adjustments. This is particularly relevant for those in or close to retirement. The chart on page 26 shows that retirement success can partly be attributed to luck. It charts the 25-year outcomes of an inflation-indexed withdrawal rate of 4% overlaid on a simple portfolio (60% S&P 500 total return, 35% intermediate-term US government bond total return and 5% cash return) for someone retiring at the beginning of each decade since 1930. Identical spending and investment strategies lead to varying outcomes: Ms. 1980 Retiree's $100 turned into $552 after 25 years of funding her monthly withdrawals, while Mr. 1960 Retiree had just $40 left.

Timing is only part of it. Clients often don't appreciate how little of their portfolio they can spend annually if they want a high probability that their capital is not depleted. The following version (chart on page 28) simply boosts the initial spending rate to 5% of the $100 of capital with the result being that in four of six exhibit periods, the capital was totally depleted.

COMMUNICATING WITH CLIENTS
By Dan Richards

There has been a broad range of aftereffects from last year's collapse of global stock markets. As a result consumers are rethinking their spending and retirement plans; regulators around the world are reviewing the policies for oversight of financial industry practices; and governments have had to step in to keep financial institutions solvent and to stimulate their economies. Similarly, investment industry professionals and academics are reexamining the fundamentals of how portfolios have been built and the measures in place to control risk.

In discussions with almost 500 investors during roundtable focus groups and one-on-one interviews about the recent market downturn, a number of themes kept recurring regarding what investors want from their financial advisers.

Some of the things investors seek from their financial advisers remain constant. Investors still look for advisers who listen, demonstrate they care, put their clients' needs first and provide advice tailored to each investor's needs along with the ability to recommend solutions from the widest range of offerings.

At the same time, a fundamental shift has occurred in other things that investors look for from their financial advisers. Four new imperatives have emerged.

Demonstrate empathy
Almost no investor has emerged from the market events of last fall unscathed — even with the market's recovery since March, some still feel devastated by the impact on their portfolio and retirement plans. In many cases, the first priority for financial advisers is to establish a bond of empathy and to tap into client feelings — often, clients are unable to listen to their adviser until they first feel listened to.

If an adviser hasn't had an in-depth conversation about how a client feels, one of the better ways to start a meeting is to say, "Many investors have lost sleep because of the market events last fall. Tell me, how have you been affected by the market over the past while?"

Sit back and listen — encouraging clients to elaborate with phrases such as "Tell me more about that."

Sometimes, clients feel better if their adviser talks about how he or she feels. One adviser tells clients, "This has been the most incredibly difficult period in the markets that anyone can remember. I'm truly sorry that I was unable to anticipate the decline and protect you from the downturn — unfortunately, almost no one saw this coming, including some of the smartest and most experienced people in the investment world."

Provide guidance and direction with balanced optimism
The second imperative is to provide guidance going forward. While almost no one is happy with what's happened to their portfolios, as a general rule investors aren't blaming their advisers for this — they see everyone they know in the same boat.

What is causing dissatisfaction among many investors is a sense that their adviser is overly passive and not providing direction on what they should be doing going forward. Today, investors are looking for guidance on how to move forward — and if they don't get it from their existing adviser, they'll look elsewhere. Even given the uncertainty of today's environment, advisers need to sit down and talk to clients about the different scenarios for the period ahead and the implications for their portfolios.

As part of that process, advisers need to update financial plans or develop them where they don't exist. One of today's causes of anxiety for many investors is the sense of being out of control of their financial future — something that a financial plan can help address.

The other thing that most investors look for is an adviser who has an outlook that is on balance positive for the midterm. That doesn't mean an adviser who is a market cheerleader or only focuses on positives — it's important that advisers are seen as providing a balanced perspective — but many investors are tired of the doom and gloom of the last while and are looking for an adviser who can help create a realistic road map that will get them to where they want to go, even if the journey is delayed by a year or two.

Incorporate fresh perspectives
A common complaint among investors is that their portfolios are unchanged since the market meltdown began last fall — a common comment is, "If my portfolio made sense then, given everything that's changed, I don't see how it can be right now."

In cases where investors are in mutual funds or managed money, of course, their portfolios have been actively managed — and it's incumbent on the adviser to help clients understand how their investments have changed.

In other instances, it might make sense to introduce a new element into client portfolios, such as investment-grade corporate bonds. Clearly, any recommendation has to be appropriate and you never want a change for the sake of change — but failing to recommend appropriate changes runs the risk that clients will see their adviser as taking them for granted.

That doesn't mean you can't recommend a stay-the-course strategy — just understand that you have to work harder to support that recommendation, demonstrating all the alternatives that were considered and the options examined before concluding that no change is merited.

Ramp up communication
The events of last fall have heightened demand for the frequency of contact — whatever the level of contact clients wanted a year ago, it's almost certainly higher today. And it's not just demand for quantity that has increased — investors are looking for more substantive commentary on prospects for the market and for their portfolio.

Many advisers can't meet this demand simply by increasing the number of meetings and phone calls. Supplement the traditional personal contact with new communication vehicles —
e-mailing articles, conference calls and group sandwich lunches in a boardroom, to name just three.

Investment managers have been forced to reexamine their practices and adopt new approaches. In a similar vein, to be effective, investment advisers need to rethink their approach to client communication, bearing these four imperatives in mind.

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In summary, individual and institutional investors suffered material setbacks over the past few years. How lasting and vigorous the ensuing rebound is remains to be seen. Regardless, such an episode is a great time to evaluate your investment philosophy, portfolio implementation techniques and value proposition to clients. Major pension plans have already started to incorporate lessons learned into their strategies, and Canadian investors deserve the same thoughtful review and introspection.

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