VOLUME 35, NUMBER 6 JUNE 2024

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

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Exploring the Advice Frontier

Synopsis: ***A new study group has formed around the DataPoints and Klontz Money Scripts assessments. The initial members are pioneering of a better way to provide planning advice.***

Takeaways: ***Instead of simply helping clients define goals, the DataPoints/Klontz assessments make it possible for advisors to help clients achieve the habits of the most successful economic citizens.***

If somebody were to ask me to define the state-of-the-art with life-planning (AKA better understanding of clients before giving advice), I would say that the frontier is applying new tools to the discovery process. It is expanding from asking clients about their goals to... learning about how they think, how they make decisions, what their habits are, and understanding how best to help them achieve what they want.

The newest item to put in your toolkit is something called DataPoints (*https://datapoints.com/*), which offers a number of assessment quizzes. The assessments, and reports that come out of them, were created by Dr. Sarah Fallaw, who built on the work of her famous father: Dr. Thomas Stanley, author of *The Millionaire Next Door*. Where Dr. Stanley uncovered a hidden group of people that advisors could sell or market to, Fallaw went

EARLY WARNING

The Insider's Forum conference (*http://www.insidersforum.com*) (September 16-18, Denver, CO) annually hosts the HIFON operations and practice management preconference, which was created as an adjunct to the operations track for ops professionals and COOs. It is still the only educational track in the profession for the 'other' half of advisory firm staff.

The pre-conference has become one of the most popular parts of the meeting—not just for the operations community, but also for advisor attendees, due to the richness of the three featured presentations.

The conference schedule also includes a session on how advisory firms can find the funding to stay independent amid the Great Consolidation, another on the new best practices for creating engaging client experiences (a surprisingly unexplored topic) and a panel discussion among chief talent officers on development of advisor and operations talent internally.

Plus a keynote panel discussion where chief marketing officers share their best advice on organic growth.

Inside Information subscribers should use the 24INSIDER discount code on the registration page: *www.insidersforum.com*, and note that a second attendee from the same firm (the COO?) receives a significant discount.

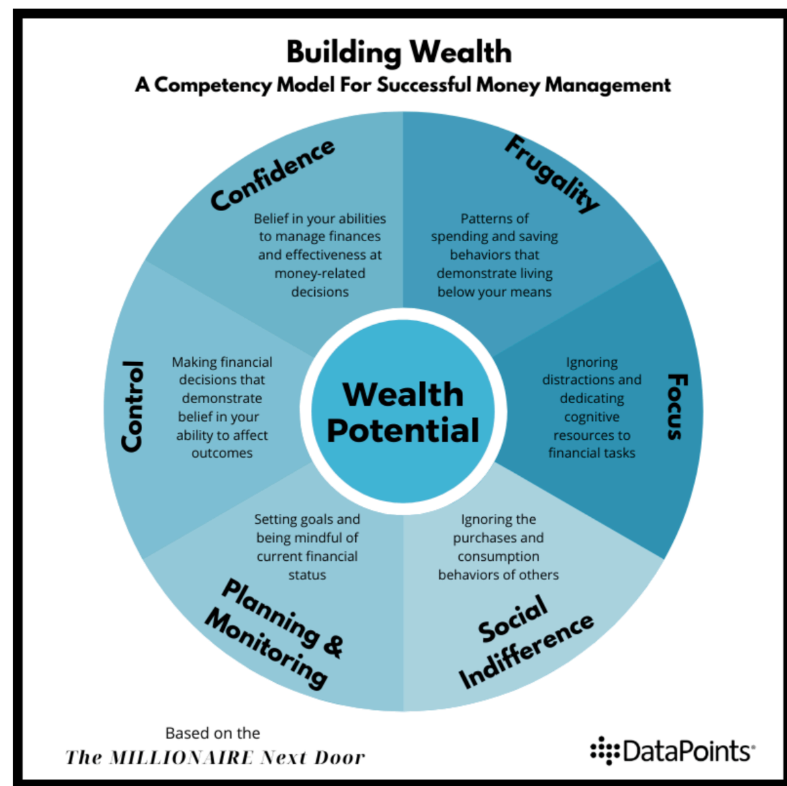
to the logical next step and identified what was different about them—the personality traits and habits that lift seemingly ordinary people in seemingly ordinary occupations to became wealthy.

The assessments address questions that nobody else is asking: how can advisors help more people become like these successful people? How can you determine what kind of advice and coaching each individual needs in order to become fully-functioning, successful economic citizens?

How can you help people not just understand their goals, but also acquire habits that will allow them to thrive economically in a world of unlimited distractions trying to part them from their money—the ubiquitous enemies (advertising, trying to keep up with the Joneses, intimidating financial complexity) to our economic health.

The DataPoints client discovery tools, include an investor risk profile, a money attitudes test (*how do clients feel about budgeting, spending and financial management?*), an assessment of financial perspectives and the Money Scripts assessment that uncovers potentially disruptive beliefs around money acquired during childhood.

At a high level, the assessments determine how high (or low) a client scores on the six factors that seem to be present in people who are best at navigating our messy, distracting economic system:



Social Indifference: can the client ignore the purchases and consumption behaviors of others around them (the key factor identified in *The Millionaire Next Door*);

Focus: can the client ignore the many distractions and dedicate cognitive resources to financial tasks;

Frugality: are clients capable of achieving a pattern of spending and saving that allows them to live below their means;

Confidence: do the clients believe in their ability to manage their finances and be effective in money-related decisions;

Control: do the clients make financial decisions in the belief that they have the ability to affect outcomes; and

Planning and Monitoring: are the clients capable of setting meaningful goals and be mindful of their current and evolving financial status?

I think the reader can see, instantly, that these assessments can lead to a qualitatively more useful level of service than simply helping clients understand their goals.

It is, in my mind, the next dimension of financial (life) planning.

Study group and values

The question that has not been fully answered, yet, is how advisors can make use of these assessments in their client engagements and advice. Fallaw herself doesn't provide advice in this area because, as she has confessed in her presentations, she is not a financial planner. She knows the formula, but she leaves it to the advisory community to apply it.

Recently, a solution of sorts has emerged, a community and group discussion forum called Trove (*https://datapoints.com/coaching/*), founded by Fallaw and Ashley Quamme, a licensed marriage and family therapist/money therapy psychologist, in Evans, GA.

Quamme happens to be married to a financial planner, and began studying behavioral finance so she could make her family

therapy work more meaningful. "In 2019, just prior to Covid, I started implementing more financial therapy practices with my couples, just because I saw a need there. From there, I completed Kansas State's financial therapy graduate program, and got certified as a certified financial therapist, and then became a certified financial behavior specialist through the Financial Psychology Institute."

Quamme now serves as a consultant for financial planning firms who want to offer more productive advice, service, and she also provides individual coaching for difficult client situations. "I call it a fractional financial behavioral officer role," she says. "I'm a thinking partner for firms on how to implement what some people call the human side of advice, or financial psychology, or behavioral finance strategies and tactics. I've found," she adds, that the skillset I possess and the experience that I have in the couples and family therapy realm have been directly transferable to working with and for firms."

In this planning-related work, Quamme might be considered a power user of DataPoints and the Klontz Money Script Inventory (KMSI) tool (also available through a DataPoints subscription); she is now the primary facilitator of Trove's weekly group discussion's among advisors using these advanced life planning tools.

Quamme began studying financial therapy so she could be more effective in couples counseling. The training took on a life of its own.

"The vision with Trove," she told an audience in the introductory webinar, "is not only to get your questions answered about the tools, but also to improve your skillset and to discuss specific client situations, which translates into client growth." Later she told the audience that she will frequently field questions from advisors along the lines of: *"I just came out of a client meeting and I have this information about them, but I don't really know how to apply it."*

So how does Quamme recommend using the information with, for example, a client whose frugality factor is very low?

"The first step is having a clarifying conversation," says she. "You say, *hey, these are the results and what it showed about you. Here are some of the individual questions. I want to understand what's behind your answers*."

The conversation provides nuances that an assessment only hints at. "I'll find that clients will answer that they feel really good about their ability to do their money management," Quamme explains. "But in the conversation, they will say that they feel good about their ability to do money management, but with the bigger financial decisions, they're less confident."

In another client meeting, Quamme noted that, on the assessment, the clients expressed a high degree of money vigilance (they monitor their financial situation closely), but they also value family time and experiences. "The family time and experiences can rub against their high degree of vigilance if they struggle to spend money on family vacations or taking trips for fun," she says. "I've found that highlighting this information to them oftentimes can be enough for clients to start behaving differently when it comes to their money."

Ideally, advisors would use the DataPoints tools in the onboarding process, but of course advisors who are only now adopting them don't have that luxury. How would they use DataPoints with clients they've been working with all along?

Here, Quamme points to the inflection points. "If there's a life transition happening, and it creates tension in a couple that is making

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hard decisions, it can be a great place to use the tools to help them understand why there is tension." She points to the KMSI assessment, which can uncover money beliefs that clients picked up from their childhood experiences. The beliefs, which may not be rational, can operate in the background of their decision-making, like a ghost that haunts their responses to money-related situations.

"I'm thinking of a couple that are now empty nesters, and the wife wants to use the new freedom to travel and have more experiences," says Quamme, "and the husband is saying, *no, we're in our early 50s; we still have another ten years before that happens. I've got to work, work, work.* We applied the KMSI, and found that he has a high degree of money vigilance, and she has a fair amount of avoidance."

In the clarifying conversation, Quamme talked about the very different places that each member of the couple was approaching the decision from. "They were able to see, *okay, this is why we're not able to talk about this in a way that feels good, why this is sparking a lot of tension between us,*" she adds. "These beliefs are working against each other—and before the assessment, they were hidden."

In her own work, Quamme will add a values assessment, using a simple tool created by renown therapist/researcher Brené Brown.

Simple? The 'tool' is a list of 118 different values listed in alphabetical order. The reader who cannot imagine that there could possibly be that many human values should consider looking at the list yourself (*https://brenebrown.com/resources/dare-to-lead-list-of-values/*); you'll find things like adaptability, authenticity, caring, connection, courage, fun, growth, humor, intuition, joy, learning, loyalty, making a difference, personal fulfillment, respect, safety, serenity, teamwork, uniqueness, vision, wholeheartedness and wisdom.

After clients take the assessments, advisors should schedule a clarifying conversation to help both sides understand the responses.

Isn't that… a bit overwhelming?

"I'll actually have them pick out 12 to 15 first," says Quamme, "and then we'll take that list and see where there are overlaps." For example: money and security might be two selected values, but money might mean security to this client. That becomes one value, plus an insight into the client.

"Then, after that, I'll have them prioritize," Quamme adds. "Finally, we funnel it down to a top three to five."

Is this superior to just asking clients what their values are? "I think a lot of people are confused about what a value is," says Quamme. "I had one client tell me that she valued time, family and food. I didn't say it in front of her, but in my head, I'm saying, *well, food is not really a value*."

Discussion topics

The weekly Trove discussions are going to go beyond simply communicating the assessments, to the unexplored nuances of how to help, say, spendthrift clients develop the kind of habits that helped ordinary people become millionaires next door. Quamme says that only a limited number of advisors are willing to get this deeply involved with clients—similar to the almost violent resistance many advisors had, early on, to the idea of asking about client goals and objectives in the onboarding meetings. It's extra work, and who wants extra work when the client relationship is sailing along, profitably, without the coaching element?

"I don't recommend that advisors give these assessments just for the sake of taking them," says Quamme. "As an advisor, you should use these tools only if you're going to use the information to increase the value of your client services."

But in her work with advisory firms, she's found that adding this new dimension to client assessment (and client service) can be valuable. The undiscovered frontier of planning is behavior change, particularly where progress is stalled or clients aren't acting on advice that they solicited in the first place. Knowing what is stalling them is important; even more valuable is knowing how

well, or how little, they conform to the formula for economic/financial success.

Quamme's coaching activities with advisory firms, and advice during the discussions, include what she calls 'meeting structure,' which means defining goals that the advisor wants to achieve in each meeting, whether it be discovery or plan implementation. "What kind of time constraints do you put on it?" she explains. "What will the flow look like? Will you start with small talk, and then talk about the assessment results? How many meetings do you need to capture the data and information that you can start with? How will you pay attention to the nonverbal communications of clients?"

The followup 'clarifying conversations' involve more than active listening—which Quamme believes is a tired and overused phrase. She prefers empathetic responses.

"The goal is to not only communicate that you're listening, but that you also care, that you're compassionate," she says. "You are not just preoccupied with getting through the meeting agenda."

The assessments offer opportunities to provide 'care' in a way that many advisors might not be fully comfortable with, where they might need coaching or group support.

"Sometimes I think people believe that showing care means not being mean," says Quamme. "But sometimes care is having the courage to deliver hard truths or have hard conversations and say that the path you are on is concerning to me."

At this writing, Trove has just completed its fourth group call—and Quamme is adding a dimension to them that goes beyond simply acting as a user group for DataPoints. But the tools are where it starts. "Every other week, we are doing an educational-type conversation, where Sarah will bring in data from the assessments," Quamme explains. "The first was the investor profile, talking about risk, giving some greater context around how advisors can navigate different personality styles or behaviors around market fluctuations."

The Trove conversations will bring together advisors who are exploring the new tools to talk about actual case studies they're working on.

The other conversations will explore cases that the advisors will bring to the group. "You have the assessment results, you met with the clients, and now you don't know where to go from there," says Quamme. "In those, I will chime in with suggestions, but the group members are going to offer their own insights into how they've handled similar situations."

Quamme says that, in this added dimension of financial planning advice, advisors have some advantages over therapists. "Unlike therapists, advisors work with their clients over the long haul," she says. "In mental health, the engagement is much shorter. In my couples counseling, I never get to see clients through life phases and multiple life transitions, or do intergenerational planning. The financial planning engagement offers so much promise for value to people that you really can't find anywhere else."

Trove is supported by membership fees; the cost currently is $125 a month, which Fallaw said in the introductory webinar is intended to be a founding member price. The fee may go up from there, but DataPoints users—the people

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who are exploring this new service dimension and the tools that support it—will get a discount.

DataPoints costs $165 a month for Fallaw's assessments and the KMSI.

And for advisors who want to go deeper, Quamme's coaching service is priced at ten hours per quarter for $1,000 a month or $3,000 per quarter. It is not hard to envision that Trove members will avail themselves of her services, and that her advice will help more advisory firms get more comfortable with helping clients develop the habits of people who consistently achieve economic success.

Inside Information exists to give its readers a heads-up on future trends. This new unexplored dimension in life planning, moving beyond goals to coaching on actual habits and proclivities that lead to achievement go goals, is going to catch on and eventually become as mainstream in the future as goals-based discovery meetings are today.

Before DataPoints and KPSI, the profession lacked the tools to uncover client habits and proclivities, and to understand how they could be modified toward (financially) healthier ones. Now we're in the early stages of understanding how to expand a planning engagement into this area of enhanced client success, and making client engagements and advice more valuable.

Nobody is more interested in creating better client service and advice than Inside Information readers. Think of this as a 'heads up,' a chance to be among the first to get acquainted with something new, different, and potentially better. ■

Optimizing Portfolios at Scale

Synopsis: ***A presentation at T3 showed how advisors can add value to client portfolio management—and save as much in taxes as they charge in fees.***

Takeaways: ***Create direct index portfolios and use software to automate systematic, opportunistic tax-aware rebalancing throughout the year.***

As I reported in the February issue of *Inside Information*, most of the sessions at the recent T3 conference in Las Vegas focused on what was new and different—new features, proposed new features (using AI and creating a gestalt user interface to tie different parts of the tech stack together), and new companies offering entirely new tech vistas, like TestimonialIQ, Nebo Wealth, Syntax, VRGL and the new Astra custodial interface at APEX.

> ***Advisors who rebalance portfolios and harvest tax losses once a year are missing most of the potential value.***

Most of the sessions involved demos and description of features.

One session stood out in all this introducing and demo-ing: Jerry Michael, founder of Smartleaf's portfolio management and direct indexing platform (*https://www.smartleaf.com/*), offered a deep dive into how the profession can start offering personalized, tax-optimized portfolios at scale. The presentation compared how most advisory firms are creating and tax-managing portfolios with how they could be doing it—basically turning the demo idea on its head by offering a CE session on advanced portfolio management without ever once showing the Smartleaf product.

Advisors who use AdvisorEngine, APEX Clearing's portfolio management engine or SEI's trading and rebalancing platform are already using Smartleaf without, perhaps, knowing this, and of course many Orion users have some of the same capabilities. Michael's presentation was an invitation to do a lot more with the tech on behalf of clients.

So what did he recommend? First, Michael said that advisors should rethink the idea that rebalancing and tax-loss harvesting is a once-a-year, end-of-the year activity. His memorable line: *"I think*

once-a-year rebalancing is a lot like once-a-year bathing: it's not often enough."

The presentation offered a graph which shows that opportunistic, systematic rebalancing and tax management (the two are, of course, tied together) throughout the year could reduce client tax burdens by 64% over the more traditional once-a-year approach.

But, Michael said, that's only half the value-add. He also showed that, on average, the systematic rebalancing/tax management process also results in a 60% reduction in tracking error in client portfolios.

The value, Michael said, comes from what he called risk-sensitive gains deferral—defined as not selling overweight positions if the trade would trigger short-term capital gains. "Risk-sensitive gains deferral," he explained, "basically means that you are constantly balancing your desire to have more tax deferral with your desire to give the client the type of portfolio that you think is best for them." It is balancing lower taxes with low tracking error.

This is more complicated than it sounds—and I wish Michael had talked about how to automate these visibly labor-intensive activities earlier in his presentation. He probably lost some (labor-avoidant) audience members when he talked about having a percentage of each asset class in the tax-deferred as well as the taxable accounts. It's more work, but it lets advisors choose to rebalance some positions at the household level out of the tax-deferred accounts (no taxable gains triggered), if there are no loss positions to sell in the taxable portfolio.

Michael addressed the additional work issue directly. "The obvious question is: *why don't we hear about this?*" he told the audience. "The tax-deferred accounts create an extra tax-management level, but most advisors think of it as: *I put my bonds and alts into the IRA because they generate short-term capital gains*. They make it a one-and-done decision," Michael added. "Including the tax-deferred vehicles in your tax-managed rebalancing is an ongoing perpetual task."

The process of demonstrating your tax savings has to be honest and straightforward.

Buttoned-down tax optimization

Advisors who decide to embrace this first recommendation, Michael said, gain a new opportunity to demonstrate their value. He recommended something that looks even more labor-intensive (which, as we'll see later, can also be automated): documenting to clients that you are saving or deferring more in tax obligations than you charge in fees.

Apparently, this can actually be done; that is, if you embrace the idea of continual tax-aware rebalancing, the numbers will work in your favor more often than not. Michael cited one firm that documented its tax savings and deferrals; it found that 68% of client households passed this 'tax value greater than fees' test, and the number went up to 90% when they did the calculation on a dollar-weighted basis.

"The reason those are different is that the average dollar is in a larger account," Michael explained. "Larger accounts generally belong to investors who have higher tax rates, and larger accounts are generally charged lower fees on a percentage basis. So it's easier for the taxes to be greater than the fees."

The reader might question the fairness of this calculation. In a later explanation, outside of the presentation, Michael showed an example from a direct-index portfolio composed of individual stocks—an asset management methodology which he recommended in the presentation. Imagine a client's IBM holding reaches 4% of the account's total value, but the target weight is actually 3%, and the holdings have an unrealized loss. The Smartleaf software will recommend reducing the exposure from 4% to 1%, not just rebalancing, but also harvesting the loss. The software will assume that the harvested loss will be used to offset gains elsewhere in the rebalancing process.

But the realized loss, in the tax value calculation, will only assume the difference between reducing the holding from 3% to 1%, since a normal rebalance would have taken it from 4% to 3%. Only the additional harvesting is calculat-

ed in the tax value shown to a client.

Suppose that 4% IBM holding had unrealized short-term gains. Smartleaf would recommend no rebalance, at least until the gains become long-term—and only the difference between short-term and long-term tax rates would be included in the tax benefit report.

If the 4% IBM holding has unrealized long-term gains, then Smartleaf would recommend holding the position as is, and would count the unrealized gains that were not taken in the tax benefit report.

Michael confirmed that this 'taxes saved or deferred' report is calculated in the Smartleaf system daily and year to date. In the presentation, he told the audience that advisory firm are showing the tax-savings report to great effect in prospecting meetings. But the benefit is not what you might think.

"These advisors define themselves first and foremost as financial planning firms," Michael told the audience. "And of course the value of financial planning is that it is rather hard to document. You can see it after 30 years, but not easily in the initial stages of the client relationship."

Michael said that tax mitigation is, at best, maybe the third most important thing a planning firm does in the eyes of the prospect. "But when they see this report," said Michael, "it tells the prospect that this firm is so buttoned-up on the third-most-important thing that they do that the prospects become comfortable that the firm is also buttoned-up on the things which are more important. The main benefit of documenting that taxes saved or deferred exceed your advisory fees is not proof of value," he continued; "it's proof of competence."

If you ditch the sleeves in custom indexing, you replace a lot of complexity and decision-making with a more workable solution.

Ditching the sleeves

From there, Michael moved the presentation to direct indexing, which he said is almost certainly superior to what most of the profession is doing with their client portfolios in a variety of ways—and, Michael said, "probably more than you realize."

He started with the transition of a prospect's portfolio to the advisor's own models, which incurs the tax drag of selling the prospect's holdings and buying the advisor's recommended assets. Michael cited a study of 8,000 different portfolio accounts, showing that the liquidation process would, on average, result in a tax loss equal to 7.21% of the portfolio—obviously more in some cases, some less, depending on how well the prospect's holdings match the ETFs and mutual funds in the advisory firm's models.

"What if, instead, you took those legacy equities and simply dropped them into a direct index?" Michael asked rhetorically. "The average loss to taxes would have dropped to 0.29%." He didn't explain the difference, but it's not impossible to imagine building a mix of individual stocks around the existing holdings to create a transitional portfolio with low tracking error against the recommended index allocations.

Low? The slide illustrating the difference in tax cost noted that the tracking error will (obviously) be zero if the prospect's portfolio is liquidated and moved into the advisory firm's model. It averages about 1.54% when the assets are moved (on a tax-aware basis) into a direct index allocation.

But many advisors are already implementing direct indexing, are they not? Michael said that the most popular direct indexing methodologies don't capture most of the benefit of the concept. "You typically see advisory firms having SMA accounts, with sleeves or subaccounts that are partitioned," he said. "Every custodian, wirehouse and platform has some sort of SMA arrangement where the money is spread out among several different managers, each with their own responsibility."

His recommendation was to get rid of all that structure and simply manage a portfolio of individual equities supplemented by ETFs.

"The sleeveless approach," Michael told the audience, "is not just better; it's MUCH better."

For starters, it's simpler. "There's none of this, every time a client puts some cash in, you have to figure out how much cash to give to this SMA sub-manager," said Mi-

chael. “Every time there’s a cash out, you don’t have to figure out, how much cash should I ask of each of my SMA managers? If there’s an asset class rebalancing, you don’t have to figure out how much cash goes in or out with each of the SMA managers, or the wash sale avoidance across different SMA managers. All of that goes away when you get rid of the whole subaccount, sleeve infrastructure. And,” he said, “it’s less expensive.”

And, he said, the portfolios experience lower overall portfolio-level drift and dispersion.

Why? Michael said that when you chop up the portfolio into pieces, you cripple your efforts to manage risk and taxes. He imagined the not-uncommon case where a midcap stock experiences a nice gain, so that it no longer fits into the midcap sleeve. It is now a large cap. So the midcap sleeve sells the stock, and the large cap sleeve eventually buys it. The process, repeated many times over the life of the portfolio, generates unnecessary taxable gains, since the midcap stocks that grew into large caps were among the biggest winners.

“If you’re managing the portfolio holistically, the stock will just stay there,” says Michael. “It’s now a part of your large-cap allocation.”

Rebalancing is also less complicated with direct indexing *sans* sleeves. A holistic direct index portfolio would selectively sell a few of the large cap stocks, preferably the ones with little gains or a loss, buy some midcap stocks, and the process is complete.

Michael concluded that, done right (and automated), managing a direct index portfolio should be as easy as managing an ETF portfolio. And he noted that personalized portfolios are easier to create with direct indexing (think ESG value screens and client preferences). (Syntax did an entire presentation on how to automate highly-customized client portfolios at T3.)

The good news is that managing, rebalancing and tax-harvesting customized portfolios can be automated or outsourced.

Automating or delegating

The presentation finally got around to automating all of this— which might have revived the audience members who were imagining that Michael was destroying their lives with complex (daily) portfolio tasks. He said that the standard should be: one staff person in the office should be able to manage the daily opportunistic tax-loss harvesting and rebalancing, and also manage the client reports on the value of customized tax management.

“The end goal here is that for every client, you provide them with whatever level of tax management personalization you think is right for them,” said Michael. “Not the amount that you can afford to do. There should be no compromise due to the operational complexity; just whatever is in the best interests of the client.”

Later, he said that automation is the only way to deliver personalized portfolio management and tax optimization at scale.

The key is to centralize or outsource the rebalancing activities. Michael said that firms should not have their advisors manage the trading and rebalancing activities because, he said (not exactly mincing his words) “most of them suck at it.”

More politely, he said that advisors have far more important things to do: manage the client relationships and give advice that can transform their lives for the better. The more time they spend on that, the better for the firm and clients.

And then Michael added that rebalancing is not, and never will be, a core competitive differentiator.

Smartleaf offers the software that automates risk-sensitive gains deferral and portfolio tax optimization, and also (through Smartleaf Asset Management (*https://www.smartleafam.com/*) an outsourcing option. Michael said that, in his opinion, it makes more sense for advisory firms to outsource than to manage the tasks he outlined in-house.

The good news, Michael said, is that advisory firms are becoming more willing to embrace automation and provide more portfolio personalization and tax-related value. After this presentation, the T3 audience became more aware of how to provide it at scale.■

Rethinking Retirement Risk

Synopsis: ***Monte Carlo assessments of sustainable retirement spending are reliably leading clients away from the experience 'dividends' that are their most important life asset. Isn't there a better way?***

Takeaways: ***All Monte Carlo odds of success indicators above 50% can be recharacterized as the underspending zone. Retirement risk tolerance is different from risk tolerance in the accumulation years, and the odds can be modeled in a way that gets away from pass/fail.***

It's not often that I hear a convincing argument that the planning profession, as a whole, should do a 180-degree shift in a key element of its client communications, and literally never do I see the explanation convincingly rendered in a single graph.

The argument came from Johnny Poulsen, founder of the Income Lab retirement distribution software (*www.incomelaboratory.com*), who set me up nicely by asking me about my early-May vacation trip to Italy. Like any recent tourist, I told him about the beauties of Lake Como on the Swiss border, where you can literally see snow-capped mountains falling straight into the clear waters of a lake that is dotted with scenic villages clinging to the steep edges of the shoreline. Then I talked about driving around the hill towns of Tuscany with my wife (she had some colorful things to say about Italian drivers), visiting 'cities' built entirely from stone on top of fortified hills, Middle Age architecture frozen in time.

He told me about his own visits to Switzerland, where there are lakes that he believes are more beautiful, and a month-long trip through Spain (Granada and Barcelona), Rome and Naples (and Pompeii), and then back up through Denmark. (He also managed to hike up to Machu Picchu on a different trip. I was envious.)

> ***A 100% retirement success rate in Monte Carlo analysis means a 100% chance of short-changing a client's retirement.***

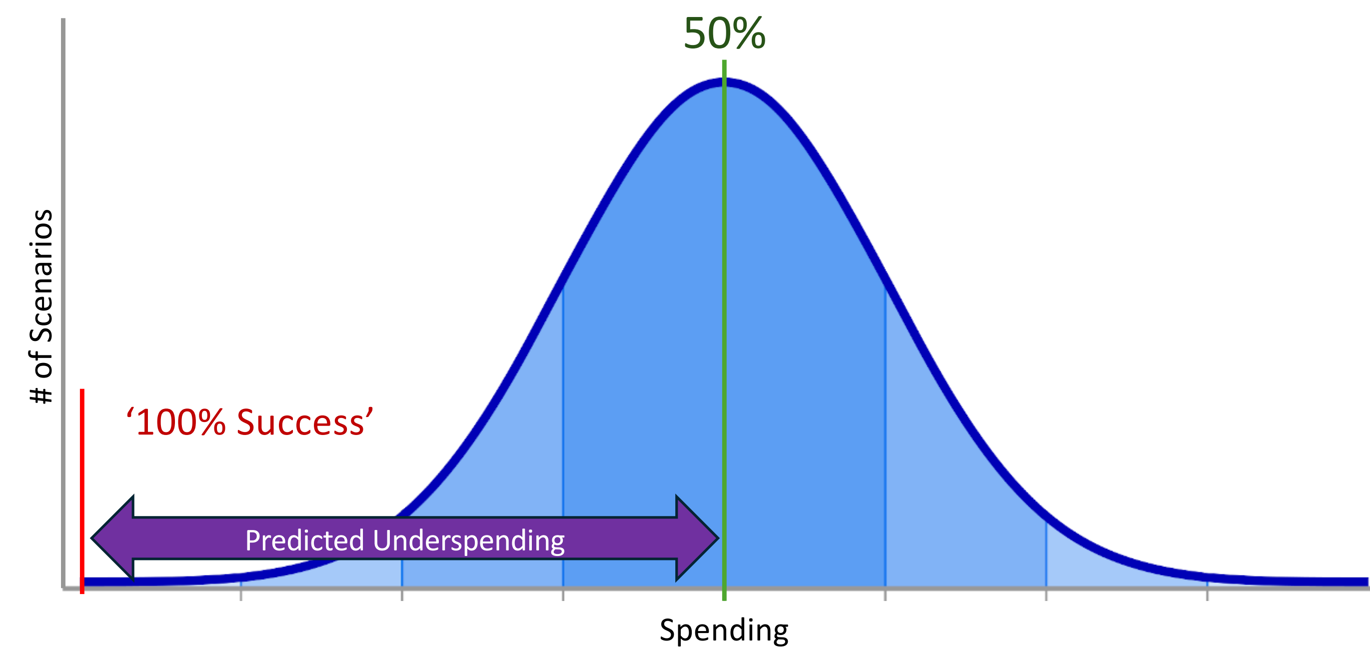
And then Poulsen went in for the kill. "Have you ever read the book, *Die With Zero?*" he asked me.

I had not. "The book starts out describing what our lives are really made of," he said. Your life, and mine, and all of our lives are best measured as the sum of all the experiences we've had, including your trip to Italy," said Poulsen. "And associated with all of our experiences, there are memory 'dividends,' which become even more valuable as you talk about your experiences with others. When you're talking about Lake Como with friends and family," he added, "your experience is going to be enhanced through those conversations."

Of course, we aren't just talking about vacation experiences; there's also experiences with kids, grandkids, spouses, friends—but the point of Poulsen bringing up the book is that it makes the case that experiences are the most valuable commodity in our lives, and that is especially true in retirement, when people have more leisure to pursue more... experiences.

But how (Poulsen asked) does the planning profession counsel clients about planning for those years when they have freedom to pursue experiences? With a Monte Carlo analysis that implicitly steers clients to set spending levels that would register at an 85% (or above) chance of success. For many clients, 100% would be an ideal goal.

"If your goal in retirement is live the best possible life that you can, given the resources you have," says Poulsen, "then it is impossible to accomplish that using probability of success."



The underspending zone

This might be the right time to introduce that graphic I referenced at the top of this article. The familiar image on this page is a log normal distribution, with shadings that indicate one, two, three and (if you look at the very tip of the tails) four standard deviations. The center, the 50% line, indicates the most likely outcome in retirement, as defined by the Monte Carlo calculation. Yet Poulsen points out that this is is forbidden territory in today's advice model.

"No advisor today would tell clients to aim for a 50/50 chance that they will outlive their assets," he says. "Even a 75% probability of success would be uncomfortable to most clients; a one in four chance of running out of money is a completely unacceptable level of risk."

The framing matters. If clients think that they have a one in four chance of living under a bridge in a cardboard box, eating cat food for dinner, then of course they will opt to move their retirement spending all the way to the left side of the graph. But in the real world, the actual trade-off at the 50% or 75% line is that, in a number of statistically-improbable-but-possible future market scenarios, they would have to cut back on spending for experiences a bit.

"Retirees don't fail; they adjust," says Poulsen. "In fact, retirees are the segment of the population that is least likely to file for bankruptcy."

Later, he cites research by David Blanchett which suggests that most clients would be fine with taking a 20% cut in their retirement distributions for a few years. That's very different from living under a bridge.

So what's a better way to frame the retirement advice? Go back to the graph. Poulsen argues that the territory on the left side, with Monte Carlo chances of success greater than the average, should be recharacterized as the *underspending zone*. "That's where people are living below their means," he says. "If their Monte Carlo number is 75, then they are *severely* underspending, and the cost is not spending on some, maybe all of those experiences that are so valuable to people, especially in retirement."

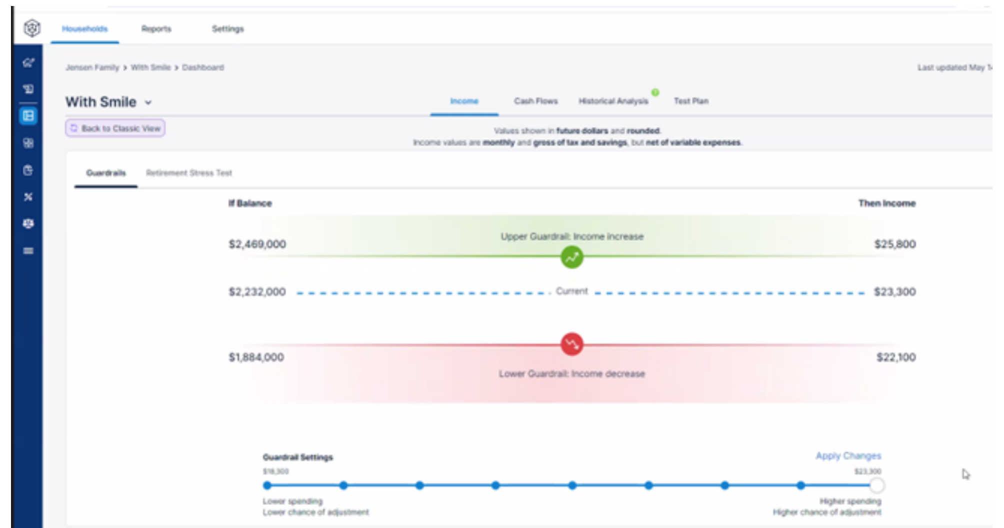
Above 50% puts people in the underspending zone; below 50% (the right side of the distribution) should therefore be redefined as the overspending zone.

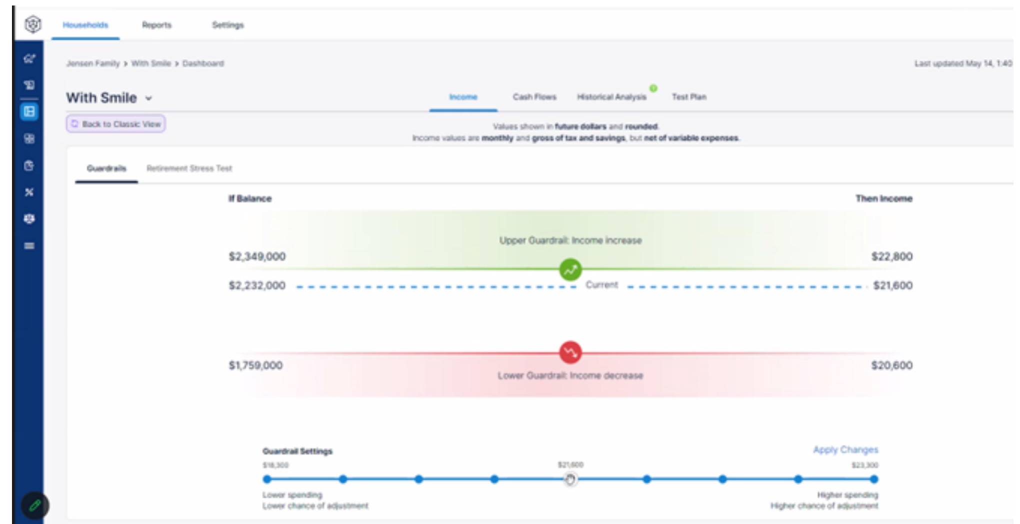
A 100% probability of success, by this standard and actually

in the real world, means spending far far below your means in retirement.

Poulsen is not (definitely not) trying to convince the profession to always recommend that clients aim to score a 50 on the Monte Carlo retirement sufficiency scale. Instead, he argues that, just like clients have a risk tolerance score (or level) during their accumulation phase, so too should there be an evaluation of their tolerance for risk in retirement.

Assessing retirement risk requires a different kind of client conversation than the Monte Carlo outputs are creating. "When we think of retirement income, it shouldn't be a pass/fail," says Poulsen. "That provides advice that reliably leads to underspending, often significant underspending, and people not living the best life they could live. It really should be," he continues, "a conversation about the likelihood that we would have to adjust at some point, and the size of those adjustments."





Retirement risk tolerance

Just like every client scores differently on the risk tolerance assessments, so too will every client 'score' differently on their comfort level with different degrees of spending adjustments in retirement. "Maybe you're the type of client that would say, *I want to spend less today because I can't stomach the uncertainty around those adjustments*," Paulson suggests. "Or maybe you're more like me; you want to go out and explore history and nature, and travel around the world, and build those experiences that are, I would argue, the most valuable commodities in our lives."

At present, there is no such 'score' that would neatly measure retirement risk tolerance. (This writer would argue that no such 'score' neatly measures risk tolerance in accumulation, either, but that's a separate article.)

So how do you go through this assessment with clients?

Income Lab offers one solution, and Poulsen is quick to point out that, now that his firm has opened the door to more nuanced conversations, he expects other competitors to emerge with similar systems. The Income Lab algorithm takes into account several dimensions at once to propose a spending level that is at or near that dreaded 50% on the Monte Carlo graph. The variables include the percentage of risk assets in the client's retirement portfolio, and also on how much of the income

will come out of the portfolio that is exposed to market fluctuations. (Remember, most clients will be receiving inflation-adjusted Social Security checks, and more than a few will be receiving pension income as well.)

The program also offers tax-aware distribution calculations, which are not part of this article, but which factor into the proposed retirement income.

On the previous page, you can see a sample output. There's the proposed retirement spending level, and two guardrails, one at the top and the other at the bottom. If the markets are generous and the portfolio grows to the upper guardrail, then the client will able to adjust spending upward. If the retiree encounters a bear market (which will impact different clients differently, depending on how much of their retirement income is coming out of the portfolio), then the retiree might hit the lower guardrail, and have to adjust spending downward. You can see by how much.

Clients who want to be more conservative (who have a lower retirement risk tolerance) can move the slider, and opt to take less income out of the portfolio to start with. (see lower image, previous page.) The guardrails shift accordingly. (See second image.) There's now a higher chance of getting a retirement 'raise,' due to the conservative spending, and a lower chance of having to tighten the proverbial belt. The amount of belt-tightening also goes down.

"There is no right or wrong here," says Poulsen. "There is an ideal setting for every single retiree, for spending and also for the investment mix, which can dial down the risk asset percentage. Maybe," he adds, "for especially nervous clients, an immediate income annuity could be added to address their longevity risk."

Interestingly, most of the time, when a client hits that lower guardrail, the spending cut is often temporary. Income Lab has a feature which shows how the client would have fared during some of the more dramatic market events (the global financial crisis, the stock market crash and the Great Depression, the dreaded stagflation era that Bill Bengen's research found to deliver the lowest safe distribution rate). Even the worst require only a temporary belt-tightening.

Recalculating retirement distribution

The key point of this conversation, and Poulsen's agenda in drawing me out about my trip to Italy, is that clients in retirement almost certainly value the experiences they can create as much, often more, than anything else. And the typical Monte Carlo framing of retirement spending tends to unnecessarily inhibit their pursuit of those experiences with their financial assets—in some cases (where the Monte Carlo needle points to 90 or above) fairly dramatically and especially harmfully.

Risk tolerance in the accumulation and decumulation phase of life are very different, and should be evaluated with different tools and conversations.

"We're on a mission to build this movement around reframing the retirement income discussion," says Poulsen. "And this movement is far beyond Income Lab. It's a movement to provide better advice for retirees. It's about helping and empowering people to live the life they deserve based on the savings they have, and certainly not scare people out of seeking out those important experiences that define who they are. I don't by any means think the people who created the probability of success had bad intentions," he adds. "But I think we can give much better advice, and have better conversations, with what we know now."

Before you go, I want to share one other insight from my conversation with Poulsen. He and his team have done some research into the percentage distribution levels that would, in hindsight, have been sustainable over a 30-year retirement—basically the Bengen research—but with an interesting twist. You can read about it here: *https://incomelaboratory.com/sequence-of-returns-risk-has-been-greatly-exaggerated/*, but the twist is to factor in the accu-

"On the other hand, we could take a more conservative approach."

mulation experience before retirement for different time periods, and calculate the inflation-adjusted amount of income in dollars instead of percentages.

And that tells us… what? Essentially, that the safe distribution percentages don't take into account the fact that people who experience poor market experiences in retirement, because the market valuations are too high to be sustainable, probably enjoyed an excellent market experience during their accumulation years. They would have larger portfolios to take those smaller (percentage-wise) distributions from.

And the same is true in reverse for retirees who have been able to take out much higher distribution percentages; they might have retired at a time when valuations are low, which suggests that they suffered through an unfortunate market experience during their accumulation years. They're taking higher (on a percentage basis) distributions from smaller retirement portfolios.

The article contrasts people who retired in 1968 (and experienced Bill Bengen's lowest safe-max distribution rate of 4% of the initial portfolio, inflation-adjusted) with the people who retired in 1982, who are considered lucky because, in retrospect, they could have taken 11.6% a year, inflation-adjusted, safely for 30 years.

Some difference, right?

Poulsen's team did a machine learning analysis which assumed that both retirees saved $1,000 a month over 40 years, and the money was invested in a 60/40 portfolio consisting of the S&P 500 and the Ibbotson SBBI Intermediate-Term Government Bond Index. Cutting to the chase, the 'unfortunate' person who retired in 1968 would have accumulated $2 million, while the 1982 retiree, who lived through the stagflation bear market during the accumulation years, would have a retirement portfolio worth $800,000.

In dollar terms, the 4% decumulation would have resulted in $6,600 a month, inflation-adjusted, while the 11.6% decumulation would have generated a safe monthly withdrawal of $7,800.

This is not a trivial difference, but the difference between a safe withdrawal rate of 11.6% and 4% might imply that the 1982 retiree was able to live on three times the income of the 1968 retiree. Poulsen's team has done this calculation going back into the late 1800s, and the conclusion is that the actual income difference for retirees doesn't fluctuate nearly as much as the safe withdrawal rate measured in percentages.

Which I think is interesting. I recommended that the Income Lab team, in light of Bengen's most recent research, make portfolio assumptions different from 60/40, and see whether there are allocation mixes that are more likely to generate higher retirement income across the spectrum of market cycles and time periods.

Stay tuned; those results are coming.■

Parting Thoughts

Our Shared Role in the Profession's Evolution

This issue of Inside Information represents the mission of the publication, and my mission as a writer in the profession. Each article invites our readers to rethink client service, investing and advice in new and better ways.

Better? Over the years, I've been privileged to witness a long, positive evolution, an evolution where financial planners offered increasingly more valuable advice to their clients, and used better tools to supplement it. When I started in the early 1980s, financial planning was all about sales, all the time. The prevailing investment paradigm was the 'investment pyramid.' Retirement projections took the historical rate of return and projected that same return, every year, from the date of the plan out to the date of retirement in order to calculate the terminal value of a portfolio.

Since then, we've seen the advent of life planning (collecting client goals and objectives before giving advice), more sophisticated investment recommendations based on Modern Portfolio Theory, career tracks and specializations for planning staff, fee-only revenue models, and far more sophisticated financial planning tools that are now trending toward deeper and more client-friendly analytics.

As we can see on the pages that came before this end-of-issue rant, that evolutionary journey is continuing, and I expect it to do so pretty much forever.

The way the ecosystem works—has always worked—is that an idea emerges from the great laboratory that is the planning profession. It's massaged until it starts to work for the benefit of clients or the firm—or it doesn't. If it doesn't, we generally don't hear about it. If it does, you hear about it, eventually, on these pages; that is, in fact, our (my) part of the ecosystem. Others adopt it, refine it, and it becomes mainstream, and we look back and wonder at the lack of sophistication of advisors, say, five or ten or 40 years ago.

In my experience, all of these innovations were initially embraced by a small group of advisors who were constantly looking for something better in every aspect of their professional lives. We can call them pioneers, the tip of the spear, the innovators who take a new idea and flesh it out to the point where others can adopt it without going through the extra work of experimentation.

In any given era, there are very few of those early adopters. I believe that I can count them with surprising accuracy as the *Inside Information* subscribers and attendees at the Insider's Forum conference, the small handful of advisors who take time out of their schedule to learn about the innovations, and everything about the innovations, as they are happening, so they can be among the first to adopt them and improve their service to their clients.

The percentage of people who drive the profession forward in its evolutionary journey is, by that count, just under a thousand—out of an overall professional population of (by one estimate) 100,000 or more. Less than one percent.

The financial planning world owes people like you (the professional one-percenters?) an enormous debt of gratitude for all the progress we've made, and are continuing to make, from relatively primitive origins to relative sophistication today. My guess is that nobody has bothered to thank you for this. So I'm taking this moment to express deep gratitude to you for your support of our publication, but more importantly, for your role in creating of all the better advice and service that the profession is delivering to clients today and in the future. ■