VOLUME 17, NUMBER 9 SEPTEMBER 2007

INSIDE INFORMATION

The newsletter for serious financial advisors. (www.bobveres.com)

Special to this issue:

Portfolio Management: *Here's a preview of the NEXT big financial scandal, and how to prepare for it now.* ....**page 7**

Portfolio Management: *Global investment themes from the leading investment conference in Australia.* ....**page 10**

Practice Management: *Brace yourself for the next set of regulatory hassles.* ....**page 13**

DEPARTMENTS

The Insider......................... 4
Parting Thoughts..............15

A BRIDGE TO THE MIDDLE

Suddenly, the planning profession is evolving some new middle market planning initiatives. Here's why, and here's how.

John Hill, CEO of Pinnacle Advisory Group in Columbia, MD, thinks he knows why so many financial planning firms are not aggressively asking for referrals from their clients. "As a firm that is dedicated to profitable growth, we're critically aware of the importance of referrals in our marketing program," he says. "But we've found that many of our affluent clients know people who are less affluent than our minimums. As a result, a number of prospects who were referred by an existing client do not meet our minimum. This is an embarrassing situation for all parties," Hill continues. "Yes, we could possibly refer these people out, and we have. However, it is less than ideal, as the referring client begins to get gun shy with additional referrals."

There are several possible solutions to this problem. One is to have clients more carefully screen people before they give their referral names. But how many people know the net worth or investable assets of their friends, or are willing to ask the question before taking the additional risky step of making a referral?

Another is to take a deep breath and provide services to anybody who comes referred by a client, even if that person is more qualified to receive credit counseling than asset management services. But if your firm has a focused message and target audience, accommodating all referrals can work to your disadvantage when you look for new clients from

Continued on page 2

EARLY WARNING

• The ComplianceMax compliance platform has been a terrific resource during this overly-regulated chapter in the profession's history, and so the company's purchase by National Regulatory Services (and parent company Source Media, owner of Financial Planning magazine) has generated some concern--especially since the combined firm will be called NRS.

But this looks more like a marriage than a takeover; the goal was to buy the ComplianceMax technology platform (including Resources for RIAs), ComplianceMax's audit team (which will conduct more than 2,000 mock audits this year) and enterprise compliance contracts with Morgan Stanley, Lincoln Financial and Mass Mutual. So the Resources platform will not only survive; the plan is to enhance it with model forms, documents and manuals developed by the NRS team. Meanwhile, ComplianceMax founder Lisa Roth will remain with the firm as vice president and managing director.

Portfolio Management

Follow That Theme

The Australian financial planning community is looking for that elusive edge in global investing--in the right places.

If you want to keep a financial audience focused through a challenging program of investment theory, schedule it during something like the subprime meltdown in the U.S. During the annual Portfolio Construction Forum in Sydney, Australia, the global equities were losing 6% of their value, making caution and additional information seem even more important than usual.

In his opening address to the more than 450 upper-echelon asset managers and financial advisors, conference coordinator Graham Rich stressed the importance of three megatrends in today's portfolio construction activities: the strategic and tactical consequences of globalization, and especially the rise of Brazil, Russia, India and China (the so-called BRIC economies); the "retirement of retirement," where more and more people appear to be earning at least part-time income in their Golden Years; and the increasing introduction of new technologies into the global economies.

None of these issues matters, of course, if one subscribes to the purest tenets of modern portfolio theory, which holds that strategic or tactical portfolio adjustments are nothing more than elaborate exercises in futility. The opening keynote speaker, Bryce James, of Smart Portfolios, LLC in Seattle, offered a variety of evidence that the profession's widespread MPT assumptions are either wrong or outmoded.

Most of it is, by now, familiar to readers of this newsletter. James took the audience on a quick tour of increasingly sophisticated investment models, showed the dangers of investing based on past data when correlation coefficients move around in real time, and took issue with the way MPT is used to quantify risk in client portfolios. Based on standard bell curve mathematics, the 7.17% one-day drop in the Dow Jones Industrial Average on October 27, 1997 should happen only once in 50 billion trading days--or once every 136 million years. Three steep drops in July 2002 would be predicted to occur roughly every 4 trillion trading days, which is somewhat longer than the life of the universe. On average, James told the audience, these extreme events tend to occur roughly once a year.

The presentation offered some suggestions for how to improve on the MPT foundation by looking at movements in correlations in real time and extrapolating when stocks or mutual funds seem to be regressing back to the mean from extreme positions. But the major takeaway is that the rest of the sessions may not be a total exercise in futility; that having a little more information than other investors, and understanding how to process it more efficiently, may improve client portfolio returns--especially in uncertain markets.

Global Markets and Forecast-Driven Portfolios

Two followup sessions focused on strategic and tactical portfolio adjustments, both in response to the global market meltdown (the topic du jour) and longer-term expectations. In one, Scott Berg, international equities manager for T. Rowe Price's U.S. operations, noted that, long-term, there is little cause for panic. The developed economies are growing at an average rate of 4.4% a year, while the emerging markets are experiencing a more volatile 7% annual GDP increase. Meanwhile, global earnings per share growth is running at 17.6% a year in the emerging markets, 10% in the European Union and 11.6% for the world at large. Short-term meltdowns, in that context, look like a buying opportunity.

Despite the faster rate of growth--in GDP and EPS--in the emerging markets, the PE ratios of emerging markets equities are still a bit lower than the slower-growing developing nations, suggesting that global investors don't quite believe that the developing economies have stabilized as safe harbors for their capital. Berg pointed out that 2007 PE ratios in Europe (14.3) are lower than the emerging

markets (14.9), but elsewhere stocks are pricier: investors are paying an average PE of 16.0 in North America, 19.4 in Japan, and 15.6 overall in the world.

The second presentation, by Sydney-based analytical strategist Tim Farrelly, was designed to help advisors act on their own forecasts and expectations in real-world portfolios. Farrelly noted that all returns in the equities markets are driven by three factors: the dividend, the growth in earnings per share, and the movements, up or down, of the PE ratios.

Ever the contrarian, Farrelly expects PEs to eventually trend downward, and he was not optimistic that companies can grow their earnings at current rates, noting that in the last decade, the percentage of Australian (and global) GDP that has come from corporate profits has gone up to record levels. The trend seems to have only one way to proceed: back down to more normal (i.e., in line with GDP growth) earnings expansion.

Later, Farrelly offered an interesting and, for some, amusing, demonstration of how forecasts and portfolios can be linked. First, he showed the audience five different portfolios, each weighted differently between Australian and ex-Australia equities, real estate, hedge funds, fixed-interest and cash. He then asked the audience their expectations for future returns on each of these asset classes, and the audience used elaborate handheld polling devices to vote for their expectations. A computer in the back compared the portfolio that each person had chosen with his or her forecasts.

The result? Only 21% of the audience picked what would have been the optimal portfolio given their overall forecasts, while 28% (the highest percentage of the group) picked the portfolio that would have delivered the *least* beneficial performance if their forecasts proved to be correct. It is possible that the advisors in the room--like advisors here in the U.S.--spend more time selecting individual investments than creating strategic allocations based on their forecasts. Or--Farrelly's interpretation--advisors trust traditional allocations more than their own instincts.

Inefficient Selling Strategies

If so, they're not alone in their dysfunctions. Perhaps the most innovative presentation at the conference was delivered by Allesandro Lunghi, London-based director of a company called Consulting Inalytics. Lunghi has performed a detailed study of 500 global fund managers, looking at the subsequent performance of the stocks they sold out of their portfolios, and comparing the returns of those rejected stocks with the returns of the stocks they purchased to replace them.

Ideally, a fund manager should let the winners run while cutting losses by selling stocks whose performance simply didn't meet his or her expectations. But Lunghi found that the opposite was true: 57% of the stocks that managers sold, in aggregate, had outperformed their market averages during the previous 12 months. For some reason, managers seemed to be selling their best performers and holding onto their losers.

Looking further, Lunghi found that the stocks that these managers sold out of their portfolios, on average, outperformed those that they purchased to replace them. The difference was not inconsiderable: three full percentage points over the following 12 months.

Interestingly, these managers WERE selecting outperforming stocks; the average impact of the buys, on average, was a positive 47 basis points a year above the indices. But the effect of the sell decisions reduced returns by an average of 94 basis points a year, more than overcoming the benefits of stock selection.

What's going on here? Lunghi hypothesized that most fund managers do less research on their sell decisions than on their purchases; that they tend to want to lock in small gains rather than take the risk that their more successful stock selections will go from positive to negative. They may also want to raise cash for the next exciting investment idea that crosses their desk.

On the other end, Lunghi thinks that these managers might tend to be reluctant to realize losses in stocks that have lost value, and so will tend to hold onto them, clinging to their original belief, long after it becomes clear that the stock isn't going to justify their faith in it.

In the future, he plans

Continued on page 12

Follow That Theme

Continued from page 11

to look for fund management processes that pair a good buyer (plentiful) with a good seller (much harder to find), which might eliminate the persistent drag on fund performance. The analysis suggests that the markets may not be as efficient as MPT suggests it is--bringing the conference full circle to its original point.

Rising India

The closing keynote address of the first day addressed the conference theme of globalization, when Dr. Anand Sethi, of the Applied Technology Services organization in Mumbai, India, gave a broad overview of the emergence of the Indian subcontinent as a major player in the global economy.

Sethi offered estimates that in the year 1000 AD, India represented 27% of global GDP. In 1700, just before the Industrial Revolution, its output made up 22.6% of the world's--more than all of Europe combined.

"By 2050, India is projected to account for 15% of the world's GDP," Sethi told the audience. He noted that India's universities matriculate a million postgraduate students each year. "Our growth is generated entirely by Indian companies, not foreign companies using India for cheap labor," said Sethi. The goal, he said, is for India to become the knowledge hub of the world, to become rich through its brain power, not by becoming a low-cost manufacturing location.

Is it working? Sethi cited a statistic that 25% of global research and development is now being performed in India--including the design of the iPhone chip and the designs of both the Airbus A380 and the Boeing Dreamliner aircraft.

Retirement in Transition

The second theme relating to retirement was addressed by Elizabeth Segers, managing director of market planning and development at Putnam Investments; David Williams, principal of the David Williams Consultancy; and Andrew Robertson, managing director of Ingevity, a Sydney-based consulting firm. Segers began by noting that, according to research by her firm, 25% of U.S. retirees are not retired at all in the traditional sense; they've gone back to work. And the percentage appears to be growing.

Why? Because they have to. Among the more interesting facts: more than 60% of U.S. persons over age 65 still have mortgage debt on their home--with, on average, 12 more years until it's paid off. In addition, 50% of the retired respondents are helping their aging parents either financially or physically. Meanwhile, 31% of the survey respondents are either paying rent for children over 25 years of age or providing them with a place to live. Thirty three percent are helping with living expenses, and 17% are paying for their adult children's cars. "New evidence suggests that it is taking eight more years to launch children into the world than it did a generation ago," Segers told the audience. Her conclusion: "Retirement in the future will be crowded and elusive."

Williams, meanwhile, offered convincing evidence that clients of financial advisors will probably live much longer than you expect them to. He estimates that a male financial planning client age 50 today can be expected to live to age 92 (rather than age 80, as the actuarial tables say), and a female client can be expected to celebrate her 96th birthday (while the actuarial tables list her life expectancy at 84).

How do you evaluate all this data for clients in the real world? Williams has founded a company that is creating software to take into account a variety of health and longevity factors, give a score for each of them, and then calculate a more precise life expectancy to use in retirement sufficiency calculations. Stay tuned.

Finally, Robertson looked at the financial planning implications of so many people living longer than people have ever lived before. One issue to consider is that the longer-lived persons will require not just more income to draw out of their retirement plans, but also the back-end money to pay additional one-off expenses related to health care.

How will this affect the profession? "Decumulation planning will become a planner's primary service in the not-too-distant future," Robertson told the

group. Advisors will, in effect, assume the role of the actuaries in defined benefit plans, helping clients draw down realistic sums from their portfolios. In addition, he expects a growing number of financial planning clients to buy--and financial advisors to recommend--risk pooling products which will pay income for life.

Despite the complexity of much of the information, the takeaways were not impossibly complicated and (more importantly) were largely actionable. We seem to have moved into an era when the efficient market hypothesis and the mathematical models of modern portfolio theory, are becoming less tenable, but there is no clear successor except the instincts and knowledge of the professional investor. Meanwhile, the goal that we have assumed most investors are saving FOR--retirement--appears to be changing to something very different, which may require different capital inputs and income sufficiency analyses, and a shift in overall goals from financial fulfillment to personal fulfillment. Longevity projections will need to be corrected, and future costs may be far greater than expected--but so too will income in the early years of many so-called 'retirees.'

Exactly what all this means is unclear, and will remain so for some time. In Australia, like here, advisors don't have the luxury of waiting for solutions; they'll have to develop them and let academia catch up when it can. ■

Practice Management

Compliance in Chaos

The regulators are coming up with creative new ways to keep you up at night, and technology solutions are dangerously behind the curve.

If you think your world is full of compliance and regulatory headaches today, just wait. A bunch of new initiatives are brewing which may create significant challenges in the near future.

Let's start with NASD Notice to Members 07-70, put out for comment in June and widely thought to reflect the SEC's thinking on various subjects (which means RIA proposals may follow). The notice talks about tightening up the compliance department's capturing and surveillance of instant messaging communications with clients--which is, itself, a significant challenge that advisors and RIAs may soon be facing. It talks about supervising employees' e-mails that go through outside platforms--like your home account through Yahoo!--and goes on to state that broker-dealer "members should consider requiring pre-approval for the business-related use of any personal electronic communications device." It says that message board messages and E-Faxes should be retained and reviewed, and then, in the footnotes of the discussion about electronic devices, you get something really scary:

"For purposes of this joint guidance, 'electronic communications'... can include such forms of electronic communications as instant messaging and text messaging." In other words, the BD and branch manager, and potentially the RIA firm, will have to figure out how to capture and review text messages sent from a rep's or advisor employee's cell phone.

"How do you regulate telephones?" asks Joel Bruckenstein, co-editor of Virtual Office News and co-proprietor of the annual Technology Tools Conference. "There's no technology to do that right now. People buy their own phones, and they aren't connected to anybody's compliance network."

Bruckenstein sees a bigger picture here, which may require all of us to rethink how we wire our offices. He thinks that the regulators are trying to fit square pegs into round holes, by applying the SEC and NASD regulations relating to document retention to all forms of client communications. "The fundamental question is: what is written communication?" he says. "The answer is: nobody really knows."

For instance, what about a free voice mail service called "Jott?" "With Jott, I can leave myself or anybody a voice mail," says Bruckenstein. "I call Jott and say, remind me to pick up milk on the way home. It will send an e-mail to my computer telling me to remember to pick up the milk.

Continued on page 14

Compliance in Chaos

Continued from page 13

If you're on my address list, I can pick up the phone, dial Jott and say, tell Bob Veres to meet me for lunch tomorrow here. And it will send you an e-mail.

"Is that e-mail a document?" Bruckenstein asks. "I would argue that it's a voice mail, because the way they used to make that distinction is: what did it originate as? But since it's being turned into text and e-mailing, they could take the position that it's a document."

This may be just the beginning of a new compliance quagmire that extends to more traditional documents as well. Bruckenstein points out--with me, and in an important article in this month's issue of Financial Advisor magazine--that the most common paperless office solutions will soon fall short of encroaching regulatory standards. The SEC and NASD both require the advisor to safeguard all stored records, and generally to ensure that they cannot be tampered with. Today, e-mail records are typically backed up on MS Outlook, and documents are scanned onto read-only disks. But are those records tamper-proof? Can anybody authenticate who had access to them--or, indeed, whether those records had been removed and then replaced with the next backup?

"People who think they've avoided all this and have everything in paper have a different set of issues," says Bruckenstein. "If it's in paper, where is your disaster recovery plan? If your office burns down, you're screwed. You've got nothing."

Fortunately, there are a few emerging options, which may not be ready for advisors to use, but may provide a way for advisors to meet future compliance standards as they emerge. One is a service called ProofMark, by ProofSpace Technologies (www.proofspace.com/), which tags all electronic business records with a self-validating cryptographic seal, and detects whenever somebody (an employee?) has tampered with any of them. Most importantly, having a proofmark on the document proves that the contents of the record have not been changed since the proofmark was applied. The system also provides an audit trail for who accessed the document and when.

There are other possibilities, and still others are emerging, and may be online as the NASD collects its comment letters and decides how to proceed on instant messaging, text messaging, voice messages turned into e-mails and the ever-evolving definition of "tamper-proof." The SEC will almost certainly weigh in with its own evolving standards. Look for new standards to intrude on your office procedures by the beginning of next year, and for a full discussion of them at the Technology Tools Conference (January 10-12) in Orlando--including, perhaps, a few solutions among the vendors in the exhibit hall.

At a minimum, says Bruckenstein, advisory offices are going to have to rethink their paperless office systems, moving from what he calls Version 1.0 to 2.0. Most in need of updating will be systems that let you store digital files on a computer's hard drive, with retrieval dependent on the operating system's search capabilities, or (one step more sophisticated) something like Google Desktop. But he thinks that even PaperPort systems, which piggyback off the Windows file structure, will have to be upgraded with some kind of internal audit trail and authentication.

"The bottom line is that we're still figuring a lot of these things out," says Bruckenstein, "and until the SEC and NASD sort out what they want, a definitive solution won't exist." For now, all he can do is outline a plausible solution; between now and early next year, a new document storage and retrieval standard will emerge, and his mission is to figure out how to make the conversion as painless as possible.

Bruckenstein may sound like an alarmist, but read through the NASD's notice, and you realize that the regulators have no idea how you work or what is and is not possible given today's technology platforms. I lost hope that they would be reasonable back when solo practitioners were required to create compliance manauals for themselves; this is more of the same.

The Tech Tools conference may be the best way to get a full picture of what's happening and what can be done as soon as the new rules come out. I'm glad to report that for once, we're on top of it: Inside Information members get a $50 discount off the regular registration fee for the Tech Tools Conference--which will be Jan. 10-12 at the Gaylord Palms Resort and Hotel in Orlando, FL. Our price: $269 if you sign up before October 31; www.virtualofficenews.com/, enter the discount code "conf07nside." ■