WHAT IF WE’RE WRONG?

Advisors and Uncertainty

By Bob Dannhauser, CFA®, FRM, CAIA®
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Editor’s Note: Many financial plans extrapolate historical returns to develop expectations about the future. But what if future results differ from the past? What if the data used in models is wrong? We posed these questions to Bob Dannhauser, head of global private wealth management at the CFA Institute, who responded with the following essay.

Benet's the unique facts, circumstances, preferences, fears, and aspirations of every client lies the hope that an advisor can lend certainty to the future. Our industry has (thankfully) moved beyond the idea that the best product will deliver performance that will sweep aside the concerns of individuals contemplating their futures. Nevertheless, advisors still are called upon to make sense of the future and exercise professional judgment regarding client needs and aspirations. That's an essential part of a fiduciary mindset, and the confidence with which advisors pursue that obligation is key to a successful client relationship. Professional judgment, however well-intentioned and faithful to client interests, unfortunately sometimes will be wrong, especially as planning horizons extend. Just how should we address that fact with clients?

Even with professional training, insights about what makes clients tick, and access to information and analytics that would have been unimaginable just 10 years ago, advisors inevitably get some things wrong. Clients understand that there are no crystal balls, but that doesn't keep them from wishful thinking. So clients are drawn to a practitioner who projects confidence in managing substantial yet unknowable dimensions of the future, be it the performance of securities or markets, economic conditions, or even the client's lifespan. Advisors can't predict the future with the certainty clients would surely appreciate and value, but they can help clients plan for contingencies and mitigate risks.

ADVISOR AS FALLIBLE PROTECTOR

Sometimes this persona of advisor as protector blurs the reality that returns aren't possible without risks, and clients react with disappointment, anger, or insecurity when risks—and drawdowns—are realized. Smart advisors consider their vulnerabilities around the uncertain future and focus on helping clients understand just how the advisor's professional judgment comes into play. An advisor should resist point estimates that may offer the false security of precision. An advisor should resist probabilistic estimates that describe only a binary future state of success or failure. And an advisor should thoroughly discuss and document the advisory process as it relates to both the client's accumulation and decumulation of assets.

Take, for example, capital markets expectations, the heart of many portfolio strategies. Rare is the client who won't ask about the advisor's outlook for the markets. Slightly less rare these days is the advisor who is willing to concede to not really knowing where any particular slice of the market is likely to end up over the short or medium term, as a welcome culture of candor has begun to take hold in the industry. But expectations of market performance and volatility still form the basis of strategic asset allocation decisions. Expected returns, volatility of returns, and correlations of performance with other market sectors set the framework to calibrate portfolio expected risk and return.

But what if we're wrong? If we predict 10-year U.S. equity nominal performance of 6 percent annualized and end the year with actual performance of -4.75 percent, were we wrong? Many clients will suspect that we were, perhaps even after we remind them of the longer-term nature of our original prediction. Perhaps we should take the lead of a prominent asset manager that suggests, “Given the complex risk-reward trade-offs involved, we advise clients to rely on judgment as well as quantitative optimization approaches in setting strategic allocations to all of these asset classes and strategies.”

Put in more client-friendly language, that might translate to, “I read the reports, looked at the data, and held my finger up in the air—and came up with an allocation.” That’s also an interesting meld of the rational expectation hypothesis (i.e., how investors develop expectations of market performance) and behavioral finance theory (i.e., the premise that investors use inputs other
than measurable fundamental factors to predict future performance). According to one study, investors use both fundamental factors and extrapolation (a behavioral element) to develop market forecasts, but the relative contributions vary unpredictably over time (though significant events seem to motivate a change in the mix). This introduces the notion that events that aren’t amenable to probabilistic estimation (so-called Knightian uncertainty or unforeseeable change) are nevertheless relevant to models that purport to predict the future. This is at the heart of an emerging focus of economists on “imperfect knowledge economics.”

Arguing the theory of market expectations might enthral academia, but meanwhile, on the front lines of practice, we have a dilemma. Perhaps we confess that all the data in the world can’t predict what markets will do and that our professional judgment is the thumb on the scale that will determine our strategy. Or perhaps we argue that we’ve gathered better, more, or different data than any one else, which justifies confidence in our outlook. Or we fall back on emphasizing to clients the long-term horizon that can mask poor short-term predictions, with the added convenience that it takes an equally long time to fairly evaluate if our long-term expectations were sound. We remember, however, that the client was unimpressed with the gap between our 6-percent long-term annualized prediction and the year’s actual ~4.75-percent return, so we wonder if we’ll be retained long enough for that long-term evaluation.

DEALING WITH ADVISOR FALLIBILITY

A more tenable course is to acknowledge and incorporate uncertainty of the future, and try to describe confidence intervals around point estimates of market expectations. We might predict a 10-year annualized U.S. equity return of 6 percent, but we also might use—and disclose—a 95-percent level of confidence that the returns will fall between -2 percent and 12 percent. Adding this dimension of confidence conveys important information about a reasonable range of potential input values for allocation models, as well as the relative conviction associated with a point estimate. At least one leading asset manager has begun to do just this. Different methodologies have varying degrees of robustness, but the added dimension of an interval of likely values is welcomed by model architects and provides a framework for advisor conversations with clients. Acknowledging and quantifying uncertainty beyond the variability of historical returns changes the question from whether we are right or wrong to whether we have taken an appropriate view of an uncertain future.

Describing the excitement that lurks in the far reaches of the left side of a probability distribution is useful so long as we have confidence in the ability of the distribution to accurately reflect potential returns, but we also should consider the circumstances that could shift skewness and kurtosis.

We also can acknowledge the unforeseeable rather than make the simplifying assumption that the future holds no significant surprises. Describing the excitement that lurks in the far reaches of the left side of a probability distribution is useful so long as we have confidence in the ability of the distribution to accurately reflect potential returns, but we also should consider the circumstances that could shift skewness and kurtosis (the asymmetry and degree of “tailedness” of a distribution). Part of this exercise is useful in thinking about where points of departure from the modeled world might be, to signal that something significant is happening even if we don’t yet fully understand it, and prompt defensive or corrective action. This presumes, of course, that the unforeseeable evolves rather than shocks, leaving some time to recognize a secular change. This sort of approach is one motivation behind growing interest in evaluating environmental, social, and governance (ESG) factors as part of the investment strategy; you need not have a firm embrace of your front yard’s elm tree to appreciate that environmental changes may have material impacts on supply and demand and thus on portfolio companies’ business models in ways that are difficult to predict.

“Guardrails” can be specified, perhaps as an extension of a rebalancing discipline, that prompt reconsideration of the strategy upon specified volatility or unusual return, not unlike a stop-loss order. It is easy to imagine reasons why guardrails may fail (the significant event happens quickly, the advisor or the client is indecisive about recognizing the significant change) but as a matter of process, these predefined points of reflection are useful and, because they are defined in advance, they reassure clients that a potential roller-coaster experience is equipped with sensors that will either slow the ride or prompt a thorough review of the initial judgment that set the client and advisor on that particular course today.

PROBABILITIES FOR SUCCESSFUL ACCUMULATION

Clients aren’t statisticians (except for the ones who are—not to mention the engineers, who look under the hood and want to figure things out). Advisors are hired to address all the technical details that either bore or confound most clients. But just as a surgeon wouldn’t operate without a patient’s informed consent, advisors need to educate and often compel using the client’s language and context before acting. A common
construct in modern wealth management is to use Monte Carlo simulation to predict the probability of success or failure of a strategy. Let’s stipulate that the quality of implementation of Monte Carlo analyses has been uneven (sometimes assuming normal distributions, and treating each return as independent of the next), which may affect how results are interpreted (for example, Derek Tharp describes the countertuitive conclusion that Monte Carlo simulations may actually overstate tail risks). Even with confidence in the underlying methodology, clients receive an estimated probability of success (or the inverse, of failure) of the strategy to achieve future goals; advisors who can produce solutions with acceptable probabilities of success are viewed by clients as having overcome inherent uncertainties.

For all but the wealthiest, the probability of success is likely to be less than 100 percent. How should clients interpret that? How should clients distinguish between a 5- and a 10-percent probability of failure? Many U.S. clients will have revisited their interpretation of probabilities in the wake of the 2016 presidential elections, in which a prominent pollster assigned Hillary Clinton a 71-percent probability of winning on Election Day. Especially if a goals-based planning process has been used, the APS can identify primary goals, their relative priority, and the funding strategy for each (for example, ongoing cash flow, asset liquidation, etc.). It also can identify a tax-efficiency strategy that relates asset location (in taxable or tax-deferred or otherwise sheltered vehicles) to liquidation preference.

Some advisors will introduce the severity of failure as part of the client conversation to consider whether failing to achieve a goal is indeed devastating. Such failure may be mitigated along the way by varying spending and savings rates, altering an investment strategy to assume more or less risk, or redefining goals. This is helpful in recasting the client’s understanding of the analysis from something that is binary (success or failure) to more prescriptive (excess assets or course correction required).

Monte Carlo simulation demonstrates the variety of paths a client might experience and the importance of sequence of returns along the client’s path forward. But it would be more intuitive to depict client objectives in terms of the nominal wealth required in each year of the projection to fund the liabilities represented by future spending to achieve client objectives, and a confidence interval around a point estimate of projected assets in each year, given the distribution of expected returns on the investment portfolio, savings rates, spending rates, taxes, etc. The client objectives could use a commonly used goals-based planning taxonomy, categorizing the liabilities of future spending by relative necessity, which would make the consequences of failure more apparent. For example, the consequences may be the need to forgo some aspirational spending in favor of spending for living essentials. In this context, client strategy isn’t a lottery of one preferred path forward but rather focuses the client on the range of outcomes given uncertainty, with direct connection to how the advisor and client can recalibrate accordingly.

Moshe Milevsky makes a compelling argument for an even simpler analysis of capital adequacy for individuals. Milevsky calculates an expected portfolio longevity using the current portfolio value, a dollar withdrawal rate, and expected growth net of taxes, fees, and inflation, then compares it to the life expectancy of the client, which is an estimate itself. The beauty of this approach is the intuitive comparison of client life expectancy to portfolio life expectancy, which draws attention to factors the client can control directly (levels of wealth and withdrawal), which is more productive than obsessing about the uncertainties of future returns. And, although the growth parameter is still subject to uncertainty, at least it will reflect the known drags on returns.

Finally, documenting a process can keep advisors and clients alike on track in times of stress, develop alignment in perspective around points of uncertainty, and help clients understand better where they can rely on professional judgment and exert control over their destiny. Investment policy statements (IPS) were first used by institutional asset owners to document investment policy, establish accountabilities among those who governed and serviced the assets, and align investment managers with the asset owner’s purposes and objectives. Private wealth managers have found similar benefit in crafting IPS for their clients. Especially in difficult times for markets, the IPS can remind clients of the rationale for strategies and encourage a longer-term view.

THE DECUMULATION PROCESS

Because an investor’s decumulation phase is subject to risks and uncertainties in many of the same ways as the accumulation phase, advisors should develop a companion to the IPS that focuses on the strategy for achieving objectives by spending assets. Because “decumulation” isn’t a word widely used outside the industry, I suggest calling this document the achievement policy statement (APS).

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The APS also can establish standards for measuring and maintaining ongoing capital adequacy. Comparing planned to actual spending and setting guardrails for reevaluation of spending or investment strategy can be memorialized in the APS. Clients with more modest wealth must be vigilant about spending to avoid derailing their plans. One interesting approach calibrates spending rates to a “virtual annuity” at the start of each year, such that the investor is as well-off at the end of the year as at the beginning in terms of ability to consume at the same inflation-adjusted level. As the client’s portfolio value moves...
around, so does the value of the annuity recalculated at each new year. This technique still relies on setting a planning horizon (presumably life expectancy and a buffer, depending on pension or other annuity income the client may have), but the direct feedback to spending policy as a result of portfolio value change is very useful indeed.

As with the IPS, the APS should be reviewed and updated regularly with clients. Such reviews reinforce the idea that part of the advisor’s value is the process created to manage the client’s financial journey. Such reviews also can clarify how and where the advisor is using professional judgment to make decisions amid uncertainty.

SUMMARY
The vast majority of clients don’t expect perfect foresight from their advisors, but they do value proactive consideration of potential challenges and opportunities by their advisors. Here’s how advisors can shift their practices to focus clients on meaningful and realistic outcomes even as the prospects for living longer grow and planning horizons extend:

- Make your value proposition about your process and ability to guide your client’s journey, and not about your value as a guru. Uncertainty, especially beyond the short term, is what clients fear: You can’t make that go away, but you can offer evidence of your ability to navigate together with the benefit of your professional judgment.
- Incorporate uncertainty explicitly in your practice. Resist the urge for point estimates in favor of confidence intervals, and stress test your assumptions within those intervals. Preview for your clients’ extreme outcomes (both good and bad) so they know you are aware of contingencies. “Extreme” need not mean “terrifying” if you can describe outcomes that are disappointing but not dire, challenging but not terminal.
- Use stress tests of client situations to review your own beliefs and biases, and reconsider your preferred tactics accordingly. Environments change, products evolve, and maybe your long-held aversion to annuities, belief in currency hedging, abhorrence of hedge funds—or whatever pillar of your philosophy you thought was timeless—deserves a fresh look.
- Document the relevant beliefs and policies for both the accumulation and the decumulation of assets. Pairing an investment policy statement with an achievement policy statement lends discipline to thinking about the full range of required decisions before emotions run high in tough times. Done right, you’re providing clients with proof of your process and assurance that they can make it through uncertain circumstances. Done wrong, you’ve added to a dusty pile of documents your client doesn’t read. Take the time to discuss the importance of the IPS and APS documentation process, engage your client in their construction, and review them annually with your client.
- Broaden your expertise. In particular, be sure you’re giving adequate consideration to the relation between human capital and financial capital in your clients’ plans, as well as the related issues that longer active lifespans suggest.

Clients don’t need gurus, and advisors can be wrong—but they need to demonstrate that they are effective managers of uncertainty on their clients’ behalf. Addressing uncertainty head-on can inspire your clients’ confidence in your professional judgment, process, and abilities to add real value beyond smart portfolio strategies.

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ENDNOTES

CONTINUING EDUCATION
To take the CE quiz online, www.investmentsandwealth.org/IWMquiz