What Your Wealth Manager Should be Doing!

Finding advisors with the necessary **expertise, resources** and **systems** to construct, plan and manage portfolios to meet financial needs over time can be a complex exercise.

- Advisors must have the necessary investment discipline and expertise to deliver objective, safe and efficient management of risk and return given your financial and risk objectives.

- Advisors must have the resources to fund the security, market and economic research that underpins safe and objective portfolio management.

- The advisor must have the systems and expertise needed to structure your portfolio to meet your financial needs now and in the future, in a manner which protects your financial needs against significant stock market and economic risk at all times.

- Your advisor must add value?

Working out whether your advisors are delivering can be complex. Unfortunately, significant expertise is needed to determine whether a portfolio is being managed properly and in the client's best interests.

Whatever your advisor, whether they be your insurance, estate planner, financial planner, accountant or portfolio manager, they should really be basing their advise on your total financial position.

But, what your advisor should be doing often depends on what type of arrangement you have with the advisor(s).

If you are using your financial/investment advisor solely as someone who is a source of investment recommendations that you decide for inclusion within your portfolio, then the advisor has little or no leeway to deliver a service.

A relationship that is based on product sales and transactions alone is not one that can be relied upon to manage financial assets and financial needs.

If, however, you depend on your wealth and asset manager to make all decisions relating to the management of assets and financial needs, whether or not this is within the context of an advisory (investors need to be aware of regulation of this relationship) or discretionary relationship, then this section details what your wealth manager should really be doing.

- The section dealing with the **initial meeting** discusses the importance of information gathering and the level of information gathering needed. Risk assessment is part of information gathering and the initial meeting is the start of the education process.

- The **report section** discusses all aspects of your financial position and issues relating to portfolio construction planning and management that need to be communicated to the client. The report provided by your advisor will also tell you how disciplined, structured and resourced your service provider is.

- The **review section** discusses what a manager should be doing at each investment planning and asset management review. Note, if you are relying on your investments to meet your needs, or will be planning on doing so in the next 5 to 10 years, your manager should be managing your assets with regard to the size and timing of your financial needs.

- **Integration:** looks at integration issues which are extremely important where advisors responsible for the client's needs and assets are not working together.

- **Retail standards:** looks at minimum retail standards and discusses why a minimum is an insufficient standard.

The problem for the investor is that many portfolio managers regard asset management and investment/financial planning as separate roles and the integration considered important by TAMRIS does not actually occur.

Without a well structured service process, the necessary asset and liability management disciplines and the focussed allocation of sufficient resources, you cannot deliver.

The document dealing with Total Asset, Life Cycle Wealth Management, held in the Education section of the site provides additional perspective.

Initial Meeting

Your financial advisor needs to start off with a ***full fact find*** to determine your long term financial profile.

A portfolio manager who does not do this personally would need to obtain this information from someone who has, in most cases your financial planner.

If financial planning and asset management are carried out separately, it is important that the work carried out by the two is integrated.

Information collected by the financial planner should be used by the portfolio manage to construct portfolios.

All investment assets

The advisor would need to find the size and disposition of all your investments including your cash deposits and any expected inheritances, bonuses, stock options etc. This would also include the disposition of your defined contribution pension plans and RRSPs and/or RRIFs.

It is important that all portfolio construction, planning and management, where assets are to be used to meet financial needs, take account of the disposition of all your assets.

If you are not handing all your money to one advisor, at least one of your advisors needs to be in control and all your advisors aware of the overall asset allocation decision(s).

All expenditure, income and capital and all earnings and income from all sources

Your advisor needs to find out your current and planned future expenditure as well as your current and expected future earnings.

This should also include details of any defined benefit pension plan, income from trusts or any other source of income other than income from your investments.

A proper analysis of financial needs also includes details on all expected capital expenditure. You may replace your car every 5 years, you may plan to purchase a cottage, go on a big holiday, you may have to pay a large tax bill, wish to purchase an overseas property, buy a business, pay for your children’s weddings, pay down the mortgage, renovate etc.

Financial objectives

Your primary advisor needs to find out your objectives, what you want to spend in retirement, any education expenses, when you intend to retire, your wishes for your estate and details of your wills. They also need to find out your life insurance position, disability, long term care, permanent health insurance and so on.

In fact (where assets are to be used to meet financial needs) no portfolio should ever be constructed without knowledge of the client’s total financial position. A portfolio that has to meet your financial needs over time cannot be successfully structured, planned or managed without this information.

Most retail know your client forms and risk assessment questionnaires will only ask for information regarding your time frame for investment and will not go into the detail needed to properly construct a portfolio let alone manage it.

The reason, is that most systems used do not actually use financial needs to construct portfolios. Most "know your client" forms require the basic minimum information that organisations use to align a model portfolio option to each client..

Risk assessment

As discussed in risk assessment, your advisor needs to educate you about the basics of investment, about their investment discipline, about how they will run your money and how they will go about managing the key investment risks.

They need to assess your attitudes to these risks and explain to you the effects of these attitudes on the ability of your portfolio to meet your needs, risk preferences and financial objectives.

This first risk assessment should be preliminary and should only be used to develop the investment planning and portfolio management report.

After the client has read the report and/or has met to go over this report, the risk assessment needs to be confirmed.

A copy of your risk assessment should be given to you!

Client agreement

All asset and wealth management agreements require a client agreement. Those that have value are backed up by a strong, focussed, professional and ethical organisation and clear standards and expectations of service.

Most importantly of all, the best agreement is one based on the facts, objectives and reasoning of a comprehensive investment planning and asset management report.

Suitability, the cornerstone of good advice

We all live in the same investment universe; we just occupy different positions within it. This investment universe holds all asset classes with varying, risk, return and liquidity characteristics. Each asset class could within reason be included in any individual portfolio.

However, what defines the proportion to be invested in each, is determined by the nature of risk and return at a point in time and the nature of risk and return over time, relative to the financial needs of the investor over time. Effectively any investment is suitable, but suitability can only truly be addressed by assessing the whole; that is the relationship between an investor's total financial assets and total financial needs over time. Depending on an advisor's investment disciplines, suitability will also be determined by valuations, whether they be relative to other securities and asset classes, or absolute.

This section of the site defines the true components of suitability and the prerequisites of suitability.

The five rules

There are five dimensions or component rules that comprise suitability. These are as follows.

1. An investment (its position and allocation within the portfolio) should relate to the size and timing of financial needs over time and the amount of capital available to meet those financial needs (both current and future disposition of capital).

2. An investment should relate to attitudes to risk and investment preferences: risk and performance preferences will impact the position of an asset within a portfolio and the amount of capital allocated.

    - We all live in the same investment universe but our risk preferences (in addition to our financial needs) determine our final position within it.

3. An investment must relate to all existing investments: in order to recommend an asset/security you need to identify the allocation gaps in the portfolio, and then relate these gaps to the security recommended.

4. Fourthly, and dependent on the portfolio and investment discipline being followed, the recommendation made must make sense given the market and economic environment of the time and the risks the investment could be exposed to over time.

5. Suitability can only be fully assessed with client interaction in the decision making process. This also means that education and communication regarding the basics of investment, the risks of investment, the manager's investment style and how portfolios are constructed, planned and managed to meet financial needs over time are key to agreeing suitability of transactions, products and recommendations.

Without communication of where the advisor stands on the first four rules of suitability, it is unlikely that a client is able to make an informed ex ante decision about transactions within an advisory relationship and an informed ex post assessment within a discretionary relationship or about the suitability of portfolio management structures within both advisory and discretionary relationships.

Rule 1 – relationship with financial needs over time

If your advisor does not know the disposition of all your assets and the disposition of all known or likely needs, or the specific assets and specific needs related to the mandate at hand, he or she cannot fulfil rule 1.

Irrespective of the process or discipline used by an advisor, transactions need to pass a suitability test defining the process in which the structure, planning and management of assets meet financial needs as and when they arise while managing the risks and the costs of such a process.

Since every investor has the right to know the limitations of the service they are receiving in this respect, advisors and firms promoting wealth management services have a fiduciary responsibility (quasi or otherwise) to communicate the portfolio construction, planning and management process and its limitations with regard to suitability.

An organisation where the logically inherent limitations of a service are not communicated to a client, is taking a fiduciary or fiduciary type, especially when promises of personalisation, customisation or risk management are made.

Since the structure of the portfolio and how it manages the risks to the ability to meet financial needs over time is key to accommodating risk aversion, the client also needs communication of this discipline and to be able to assess their aversion to this risk.

Rule 2 – Relationship with attitudes to risk and performance preferences

If the amount that is allocated to each primary asset class and security is based on financial needs then each recommended portfolio should be unique.

However, what may be the most efficient asset allocation of transactions for the advising company’s assessment of the investment universe, based on their disciplines, may not be one which the investor feels comfortable with.

Advisors that do not relate the structure, planning and management of assets to meet financial needs to all key risk factors (liability, performance/style and volatility/aggressive/conservative) will not be able to address the suitability of the portfolio to the client’s main risk preferences. As such the management of expectations regarding these key risks cannot be effectively conducted.

This leaves the advising company exposed to suitability risks, irrespective of whether the relationship is advisory or discretionary. It also implies that the company has taken responsibility for the management of this risk themselves, which implies a fiduciary duty towards this component of the process. Indeed this applies to any component of suitability which is not explicitly explained to the client or managed by the advisor.

It is therefore important for organisations where rule 1 is not assessed, and where attitudes to the risks associated with rule 1 are not addressed, that they specifically explain that these risks are not addressed within the construction, planning and management of assets.

This fiduciary or fiduciary type risk is particularly important where investors are depleting capital over time, and where inappropriate portfolio structures and costs will impact on the ability of the proposed transaction solution to meet needs and protect against risks.

Rule 3 – Must relate to all existing investments

All recommendations should take place within an asset allocation framework determined by financial needs, risk preferences, the manager’s investment style and valuation/risk relationships.

The individual security selection should relate to the recommended asset allocation and security selection for a given client return/yield/risk/liability profile.

The suitability of an investment can only be viewed by its position within the portfolio, its affect on asset allocation, valuation and on risk and return over time relative to financial needs. As discussed later the

"Know Your Client" form does not actually provide a structure for the management of assets and needs. It is a transaction profile wholly inappropriate for the proper management of assets and financial needs.

The only time a broker should be recommending a single transaction is where the client is in a transaction relationship. Such a relationship should only exist where the client has knowingly taken full responsibility for the management of their assets.

Rule 4 – Must relate to current risk/return relationships in the market place

Rule 4 is dependent on a firm's or advisor's worldview of market and economic relationships: modern portfolio theory would argue that you do not need to pay attention to issues of valuation since markets are always efficient pricing assets, whereas more fundamental value based investment disciplines would state otherwise. Financial, market and economic events of the last 10 to 15 yeas would suggest that markets are not efficient enough to rely on them for efficient pricing of assets.

If suitability relates to the management of risks likely to affect the ability of assets to meet financial needs over time, then the initial investment decision is important.

The current valuation of an asset is material to the suitability of the asset and the management of expectations.

It is not enough to say that an asset is high risk/high return (in terms of communicating its expected risk/return profile), since it should be clear that valuation is an important factor in assessing risk at a point in time. Most risk statements do not cover the current valuation risk material to understanding the investment decision.

Whether you are in an advisory or discretionary relationship the initial investment decision is material and both discretionary managers should go through the same risk assessment process with regard to this risk and need to disclose the process in which these risks are assessed and managed.

Rules 5 – Suitability and education

If a client has not been educated over the portfolio construction, planning and management process used by the advisor and cannot relate this to the management of their financial objectives, it is unlikely that they can realistically have accepted the recommendation.

If a client has not been educated over the basics of investment or the risks of investment, then the advisor is taking discretion over the suitability of an investment and the resulting transaction recommendation irrespective of the client relationship, whether it be advisory or discretionary.

Education and communication is important in terms of determining where in the universe the client is in relationship to the investment advisor. Communication (reporting) is important in confirming the rationale for all material decisions and for communicating the rationale for the management of the portfolio and the attendant risks of the strategy. Quite how an investor is bound to accept the risks of an investment transaction without clear and formal communication is of enormous concern. Investments should not be considered only as transactions unless the client has specifically requested and self initiated a transaction request and has confirmed responsibility for the suitability components.

Further information on the communication process (reporting, education, risk assessment) can be found on the TAMRIS web site.

Responsibility and suitability in the transaction environment

The only time a transaction can be clearly assessed as a stand alone transaction should be when an experienced and sophisticated investor uses his or her investment advisor to solicit a security or a trade idea. In this sense, the individual investor is assumed to have taken full responsibility for the consequences of the transaction and for all issues of suitability.

Individual investors who do not have the expertise to be initiating transaction decisions, but do, are also taking responsibility for issues of suitability and relieving their investment advisors of their fiduciary/fiduciary type duty.

Investors relying on their investment advisor for advice, and are inexperienced in investment must note that it is important that they do not start initiating transaction decisions. Although, making sure you actually have a proper mandate and agreement as to how the account will be managed is an important prerequisite.

In terms of suitability, once an individual investor starts to initiate their own transaction decisions they may negatively impact the portfolio construction, planning and management framework instituted by their advisor. Individual investors without the necessary expertise are going to be making trades that do not meet the rules of suitability and that will violate the structure of the portfolio. An advisor should not be held responsible for this, although they should be responsible for informing the individual of the risks they are taking.

The current know your client form is more or less appropriate for transactions initiated by the individual investor.

It is important that the mandate for the advice and the framework in which the relationship will be carried out is agreed in advance so that issues of responsibility, suitability, duty of care and fiduciary duty are covered.

Two types of transaction

What is also important to understand is that there are two types of transaction within the wider environs of suitability. There is the transaction between securities designed to reduce risk and or enhance return and there is the transaction initiated by the relationship between financial needs and assets.

An investor can initiate the second type of transaction without violating their mandate or the advisor's fiduciary duty towards them as long as it is the manager that makes the transaction decision. For example, I need to spend C$30,000 in two years time, please provide me with the capital at the time.

It is important to realise that whatever the relationship mandate, advisory or discretionary, where the client is reliant on the advice of the advisor that the advisor will be initiating the recommendation and the reasons for the recommendation. Because of this it is therefore important that suitability lies behind all decisions irrespective of the mandate (advisory or discretionary).

The prerequisites of suitability

An organisation must have the necessary expertise, investment discipline, resources, business and services processes and systems needed to deliver personalised wealth management in order to be able to deliver suitability.

If an advisor is are recommending an asset class or security as part of a wealth management service solution but does not know how to value it, manage it, or incorporate it within a portfolio suitable to client financial needs and risk preferences, then he or she may be acting negligently and risks being in breach of an implicit fiduciary/fiduciary type duty.

Suitability conclusion

Suitability is a framework, not a transaction. It is unlikely that a client could ever fully ratify suitability without knowledge of the rationale for the transaction and structure in which the risks and returns of the investment are managed. In this sense even an advisory relationship is operating with discretion over the framework governing suitability.

It is also unlikely that a client who has not been properly educated about the construction, planning and management process will be able to understand whether something is suitable or not and therefore is unlikely to be able to mitigate unsuitable or inappropriate advice successfully.

Since it is the responsibility of all advisors, whether they be discretionary or advisory, to ensure that all transactions and structures are suitable, even a discretionary relationship should have structures developed by interaction with the client.

In fact we need to assess the true nature of suitability in order to fully understand the responsibility that all advisors are taking and, the duty of care they are responsible for providing. Most clients are vulnerable in the face of the complex world of portfolio personalisation.

Suitability is a cornerstone of all portfolio management. It is where the management of assets meets the management of financial needs and where the approach and discipline of the manager is tailored to the risk and performance preferences of the individual.

KYC

Minimum industry standards

The Canadian industry's minimum standards are defined by the “know your client” form. The other minimum industry standard is that no advice/recommendation need be in writing, although all trades need to be confirmed in writing.

TAMRIS considers this form to be insufficient to determine the suitability of an investment and incapable of properly constructing, planning and managing assets to meet financial needs over time.

Much of this section is taken from the TAMRIS report on Suitability, Minimum Standards and Fiduciary duty in the Canadian Financial Services Industry.

“Know Your Client” form

The standard industry Know Your Client form as exemplified by the Mutual Fund Dealers Know Your Client form stipulates that only the following are needed before advice can be given.

Individuals may also not realise that you do not actually need to sign this form in order to validate its use within the organisation. In fact, you do not even need to receive a copy of it.

- Investment knowledge; extensive, moderate, none.
- Risk tolerance; low, medium, high
- Time Horizon; 1 to 3, 4 to 5, 6 to 9, 10 plus
- Investment Objective; income, growth (short/long term), balanced.

· Individual income

· Household net worth

Does the Know Your Client form collect the information needed to satisfy suitability requirements as stated in section 2 of the TAMRIS Special Report on Suitability, Minimum Standards & Fiduciary Responsibility

No!!!!!!!!!!!!!!

The KYC was only ever intended to assess the suitability of individual transactions and not the suitability of a portfolio or the suitability of a transaction within a portfolio. Indeed, this presumption is supported by securities case law.

Investment knowledge

As discussed in suitability and education (section 2.6 of the TAMRIS Special Report), merely asking a client's investment knowledge is insufficient to communicate the necessary information needed to establish suitability within the wider context.

Merely asking the extent of an individual's investment knowledge is sufficient to assess whether a client who is initiating a transaction request, and who may not rely on their advisor to assess suitability, has the expertise needed to initiate the transaction; although, even here, investment advisors can effect client initiated transactions that are not suitable within the parameters of the KYC.

Risk tolerance

A general statement of risk tolerance is insufficient to assess suitability in the wider context. Indeed many investors make an assessment of their risk aversion based on their perceived need for security; how a portfolio is structured, planned and managed to meet financial needs over time and how that portfolio is designed to manage significant risks is key to the individual's ability to assess their attitudes to risk.

For suitability to be confirmed, investors need education over the basics of investment and of the advisor's investment discipline and risk management process. If the risk assessment process does not educate the client over the risks likely to impact the ability of their portfolio to meet their financial needs over time, then logically, it is unlikely that the recommendations can be proven to be suitable. In this case, there are two conclusions.

- The first is that the KYC can only be used to assess the efficacy of a transaction on a transaction by transaction basis by someone who understands risk and who is initiating the transaction request.

- Secondly, where a KYC is used for clients who are relying on their advisors for their expertise to provide a portfolio solution, the advisor is taking a fiduciary responsibility with regard to the provision of a wealth management solution.

Moreover, if the risk assessment process does not assess all the key risks likely to impact on the ability of the portfolio to meet financial needs as well as the performance risks of an investment style, then the advisor will have failed to properly satisfy their fiduciary duty. Most risk assessments fail to educate the client over risk, fail to properly assess risk and fail to provide the client with a meaningful illustration of the impact of their risk preferences.

Time horizons

Time horizons are rarely singular and are more likely to be multiple and relative. All transactions impact on the risk/return relationship of all assets and on the relationship between all assets and all financial needs. For this reason, service processes that rely on singular time frames cannot manage the suitability of the transaction.

Only the individual that can break down their needs and objectives into multiple time frames and multiple individual allocations per time frame (meaning they will have needed to carry out a complex asset and liability analysis), can initiate transactions on a transaction by transaction basis.

Because of this, the “know your client” form has little or no relationship with the fundamental precepts of suitability and is an inappropriate foundation for delivering wealth management solutions that need to address the total portfolio management problem.

Investment objective

The investment objective approach noted in the “KYC” is at best an antiquated approach to selecting broad portfolio options. It provides no information about the size and timing of financial needs over time and hence no information as to the actual structure of the portfolio needed to meet actual needs.

The objective of the client can only be determined by the relationship between financial needs over time and the size and disposition of assets over time. Broad objectives, while sometimes useful for delivering broad model portfolio options, are totally unsuitable for defining the suitability of individual security transactions. Likewise, broad, fixed, model portfolio options are inefficient in providing personalised solutions.

Unless an advisor has knowledge of the disposition of all assets and all financial needs it is impossible to work out from a broad objective just what asset class and specific security the individual is deficient in. Additionally and, logically, if the advisor does have an idea of disposition of assets and needs over time, without written communication of the rationale for the allocation and the asset class, security selection is actually a discretionary decision; if one assumes that suitability is the framework and the transaction merely an allocation within it.

As with many of the other components of the KYC, the only way the “investment objective” can work on an individual security transaction is for the client to take responsibility for the rationale and reason. Perversely, this implies that the investor has significant ability to structure, plan and manage allocation, which is far from the truth.

Individual income/household net worth

Both important pieces of information, yet the KYC totally ignores the importance of finding out the size and disposition of financial assets (key to working out where the gaps are in the portfolio structure and what to buy and/or sell) and the actual financial outgoings key to determining the relationship between assets and financial needs.

Why do minimum standards exist, what are their objectives?

Within a transaction led industry, minimum standards were designed to provide structure to the process in which transactions were recommended. They were not designed to provide minimum standards for the delivery of transactions within a portfolio construction capable of managing the ability of assets to meet financial needs over time. As such, they do not cover suitability for individuals relying in their advisor for their expertise in crafting wealth management solutions.

Is the objective of a transaction industry to provide total wealth management solutions?

No, it is not!

Is it possible to raise standards within a transaction driven industry so that transactions are suitable to financial needs, reflect total assets and the relationship between assets and financial needs and risk preferences?

No, it is not!

The only way you can do it is to change the objective of a transaction driven industry. This is difficult if regulation is still focussed on managing a transaction led process and, the arbitration and legal system one which assesses the parameters of a transaction driven framework in determining fault.

At the present moment in time minimum standards are important because they keep the status quo in check. It is debatable whether the industry could actually move to a service led business process that would be demanded by raising the minimum standards governing suitability of advice.

While it is in the industry's interest to keep standards at a minimum, if legal precedent were to start looking at wider standards governing suitability, current minimum standards could become a liability.

Conclusion KYC

The "Know Your Client form" is an archaic form appropriate to a transaction driven industry. While it may still be appropriate for basic client initiated trades, it is clearly inappropriate for individuals looking for financial advice.

What makes the "KYC" of greater relevance is the extent to which it is used to determine fault in arbitration and within the legal system. One could conclude that the industry and those charged with policing the industry have little or no understanding of suitability and erroneously consider the KYC to fulfil basic suitability requirements.

By keeping minimum standards, is the industry in breach of its fiduciary duty?

If the service it is providing is below the service it is capable of providing, given its resources and expertise, if the individual investor relies, in good faith, on the industry to manage their assets and needs, and the industry accepts this trust, knowingly, then by keeping standards low it is consciously in breach of its fiduciary duty to the individual investor. Yes.

Reporting

If you want to make sure that your wealth and/or asset manager has a good grip on your affairs and, that your portfolio is indeed structured to meet your financial needs and risk preferences, you will need a comprehensive report.

Comprehensive means that it will need to address everything that has a material impact on the structure, planning and management of the portfolio and justification of the recommendations, strategy and decisions.

A report lets you know that the advisor has discipline and structure,

.....................lets you know what they are doing and why,

....................allows you to check whether the information they have is correct, whether you are in agreement with their basic approach and,

....................if you have any questions, provides you with a framework in which to ask them.

- A comprehensive plan is impossible to provide cost effectively without integrated systems that can manage the complex relationships between the risk and return of assets and the size and timing of your financial needs over time.

- Comprehensive plans are impossible to provide without a structured service process.

- It is also impossible to provide if your portfolio manager does not incorporate investment planning disciplines into portfolio structure.

No report, or a poor report, equals poor communication, can lead to mismanagement of expectations and potential for significant problems down the road.

If TAMRIS was an individual, these are things that it would want to know before it invested with anybody and it would want to make sure that its advisor was in control of all these issues!

It is important to note that an investment planning and asset management report is an **investment report based on an individual's personal financial needs, objectives and risk preferences**.

A comprehensive report significantly reduces the time that needs to be spent on managing your assets and financial needs.

Not only are all issues dealt with in advance, but because of the instituted planning and structure, changes to objectives and needs can be easily and objectively made.

Systems that manage the integration between assets and financial needs do all the work. Even large changes financial needs and/or changes in market and security values can be adjusted for within seconds.

Implementation, taxation and charges

Implementation strategy should be detailed enough to reflect the plans, strategy and responsibilities of the advisor, as should the tax and transaction cost consequences of change.

A summary of all asset and wealth management charges should also be detailed within the report to confirm the basis on which the portfolio will be managed.

The manager should state their attitudes towards taxation, how their strategies will aim to minimise this and when significant taxation arises as a result of recommendations and transactions that these be justified.

For example, there may be some very large allocations to securities with very large accumulated capital gains. The risks of retaining these investments may be more than the taxation costs of realisation.

It should also state how the individual's attitudes towards taxation and registration of investments will affect their investment strategy.

Indeed if the advisor is taking over a portfolio which has never been properly managed, this will be an important section and will occupy much of the advisor's time in terms of managing the transition of the portfolio. Planning this transition will be important and this will need to be communicated to the client.

Investors need to understand that taxation is a fact of life and that managers need to focus primarily on valuation, risk and return when managing investments. Tax considerations, though important, should be secondary issues unless the client wishes to place them at the fore.

An investment with large accumulated gains is more likely to represent a larger part of a portfolio as well as a more highly valued part of a portfolio. Selling an investment which is over valued and buying an under valued investment reduces risk and increases the potential for future gains.

The tax consequences of taking on a new portfolio should always be communicated to the client before change is made and where a portfolio is managed on a discretionary basis, tax due from sales should always be reported to the client. Investors should not have to wait for their accountant to tell them what they owe in capital gains tax.

Portfolio Structure

The report should explain why the advisor has selected the recommended asset allocation.

Why is this important?

The management of a client’s financial needs and assets are brought together within a portfolio structure.

The portfolio structure combines the management of the asset allocation needed to secure financial needs both now and in the future and the management of asset allocation to manage risk and return.

The reason for the recommended portfolio structure between low risk assets and equities **should therefore be provided**, as should any allocation due to the transitional nature of the portfolio.

There are in fact a number of possible components of asset allocation.

- There is the basic structure needed to manage financial needs.
- There is the allocation of the components of the basic structure that would be recommended by the advisor.
- There is the allocation that the advisor would recommend for a more aggressive or a more conservative investor.

Transitional means that the initial recommended allocation may actually be different from the intended recommended allocation.

- Markets may be too high to invest all available funds, there may be an excess allocation in an illiquid asset which cannot be immediately sold etc.
- Future capital may be earmarked to bring the portfolio to its recommended allocation and therefore transaction costs and other realisation risks can be avoided.
- Portfolio planning may envisage a change in allocation as retirement draws near. It could be that savings from income will be sufficient to right the portfolio imbalance, in which case it would not make sense to make immediate costly changes.

Importantly comments regarding portfolio structure should relate to overall asset allocation as well as the allocation of individual portfolios. For example, while the pension portfolio and the personal portfolio may be run as separate portfolios, their asset allocations should be combined to come up with one representative of the client's total financial needs, risk aversions and their interaction with the advisors own investment discipline.

Whether or not your advisor reports this information to you, it should form an integral part of the portfolio construction, portfolio planning and portfolio management process.

Every advisor has to construct a portfolio to meet your needs if that is your objective. Every advisor should have their own preferred allocation and their own preferred allocation for each type of investment objective. Because every investor has a different attitude to risk, it is therefore only logical that an advisor should be able to adjust the recommended allocation to account for risk aversion.

Additional reporting

Modelling

Where modelling has been used to assess the ability of assets to meet financial needs over time, the risk and return assumptions need to be shown and the method in which they were generated need to be explained.

Asset Allocation

It is common practise amongst most retail asset management operations to provide projected portfolio returns.

Where these are used to generate the asset allocation, they need to be included within the reporting structure.

However, it is important that where these are provided that the way they were generated is also explained.

Strategy

Current investment strategy, economic and/or market valuation analysis of all markets, components and sectors to which portfolios are directly exposed should also be provided.

Complex investment planning issues

It is not just current financial needs, but future financial needs that impact on the recommended structure of the portfolio.

Your report needs to deal with how the portfolio and the portfolio's planning will cope with these issues. The following are number of complex issues.

- In retirement, some individuals will be drawing on both personal portfolios and pension investments (RRIFSs) in Canada.
    - How much you take from either will affect the investment strategy and asset allocation of these portfolios.
    - When you draw from your RRIFs and how much you draw will affect the structure of your personal investments.
- Estate planning issues may also affect the strategy and structure of the portfolio.
    - Do you really have an estate planning problem. It may be that your planned expenditure and financial objectives will deplete much of your estate.

  - You may want to be able to transfer capital now to your beneficiaries. How much is it safe for you to give without affecting your future financial security?

- Other areas of discussion could involve the impact of a sale of a business or decisions to continue earning via consultancy following retirement.

  - If you intend to be earning after retiring, this can radically affect the structure of the portfolio that you need both now and in the future.

- You may be concerned about the cost of paying for health care as you age.

  - Do you really need an insurance policy if your assets are capable of covering the costs?

All these issues need to be resolved and decided before a portfolio can be constructed since they all impact on the ability of assets to meet financial needs over time and, the timing, structure and strategy of asset allocation decisions.

In fact, a portfolio needs to be planned well in advance of future needs. A well disciplined portfolio structure will start to take into consideration changing financial needs often as far away as 8 to 10 years, gradually adjusting structure through a client's income and capital inflows or taking advantage of extreme valuations to realise capital for restructuring.

No portfolio should be a hostage to current events.

Many asset managers consider these issues to be financial planning issues. In fact, because asset allocation is significantly affected by the inflows to and outflows from a portfolio as well as their size and timing, they need to be assessed within an asset management context.

Unfortunately this long neglect of these issues has left many without the necessary disciplines, structures and software to manage these complex relationships.

A manager's ability to take these into consideration within the portfolio structure, planning and management will be reflected in their reporting.

Asset allocation vehicles

Whatever the allocation vehicles used, the advisor should be able to justify the reasons for the use of their chosen asset allocation instrument, whether it be a direct equity or an indirect actively managed fund or index investment.

High expense ratios on certain WRAP accounts need to be fully assessed and explained here. If the advisor does not have a rationale as to why their approach is an optimum medium for the investment of your capital they are more likely to be selling products than managing money.

There are indeed some products that can never be justified yet are sold quite actively within the industry.

Managers of direct equities will often state that mutual funds are the poor cousin of asset management. In fact, the most efficient vehicle for the delivery of asset management is a mutual fund structure.

A manager can focus on the investments they want to buy without having to deal with large numbers of individual portfolios which detract from stock selection and management, they can deal more cost effectively and the firm can allocate its best managers to selecting and managing these investments.

Indeed, most firms who have a disciplined stock selection approach will work off a recommended stock list and most portfolios will be directly related to a model portfolio structure.

Where mutual funds become inefficient is where a) the costs are too high due to excessive commissions on purchase and egregious trailer fees, b) where the managers using the mutual fund lack the expertise to use them appropriately and c) where the portfolios constructed are incapable of providing the personalisation needed.

Provided you have the necessary expertise and ability and resources, direct equities can be cheaper, although not necessarily cheaper than no load funds with no trailer fees and, can be effectively used to provide personalisation.

Used properly, collective investments, such as mutual funds and exchange traded funds, can be just as effective and efficient as direct equity investments. Look at Warren Buffet, his expertise is sold via what is effectively a mutual fund.

In the wrong hands, both direct equities and mutual funds can be extremely bad vehicles.

Existing investments

Analysis of existing portfolio

No change should ever be recommended to an existing portfolio without first providing an analysis of the allocation, investments and the risk and return profile of the existing portfolio, as well as its appropriateness to the individual's financial needs and risk preferences.

If the advisor cannot justify a change on fundamentals then why should they be allowed to incur the costs of change on the individual's behalf?

This is important, because it should be extremely difficult to be able to justify the sale of all investments. Indeed, this section is just as important for the explanation of the reasons for retaining certain investments.

Mutual funds are an important case in point. Mutual funds are essentially asset allocation vehicles in that they are either allocating to a market in general, a specific area of a market and/or a particular investment style. Because of this, an advisor who uses mutual funds to allocate investments should be able to retain a good portion of the existing investments.

In fact, the primary reason for buying a mutual fund should be its asset allocation and its style, not its performance. Because of this, an advisor needs to have an asset allocation framework. All that they should use mutual funds (and ETFs) for is to build up the asset allocation. The asset allocation should only be changed as relative risks and relative valuations change, which means the advisor needs investment discipline and asset management expertise.

The main reasons for selling an existing mutual fund are as follows.

- You already have enough larger company/mid cap/smaller company exposure and the fund is merely selling the over weight position.

- You need significant additional yield from your portfolio and the allocation you have does not provide sufficient yield.

    - Note that a marginal yield differential is not sufficiently good an argument since the additional yield could take years to cover the transaction costs.

    - Note that too high a yield is not sufficient argument for a sale for an investor with no yield requirement because both value and contrarian styles, with higher yields, could be appropriate investments.

- You are a conservative investor and your large cap/mid cap/smaller company exposure is invested in higher risk investments and a more conservative allocation is needed and vice versa for an aggressive investor with too many defensive conservative holdings.

- You have too much in one market and funds need to be sold in one and bought in another.

- The fund is basically a mirror of an index fund and you could get the same allocation for a much lower cost through an index investment.

The only instance where a like for like transaction should take place is where there are clear grounds for change based on poor discipline, lack of expertise and resources backing the fund so as to place real concerns over its ability to add value and manage risk.

Why are mutual funds sold inappropriately?

- Because quite often advisors are tied to model portfolios held within a packaged solution.

- Because the advisor does not have a valuation discipline and an asset allocation framework to be able to incorporate existing investments.

- Because the advisor does not have the expertise and resources to research and monitor investments.

- Because in order to get the trailer fee they need to sell your investment and buy another.

- Because most financial advisors either do not know how to manage an existing portfolio (recommending is easy) or they do not have a system capable of managing existing allocations. Most software systems that deliver portfolio management basically deliver recommended portfolios.

While the arguments needed to sell individual equities are slightly different, the advisor still needs to be able to justify his or her strategy in terms allocation, valuation and risk management. Importantly an advisor who is selling mutual funds to buy equities has to justify the validity of their investment strategy and recommendations relative to the allocation and the management of the existing mutual fund holdings. A mutual fund with no trailer fees is unlikely to be more expensive than the average direct equity portfolio. Additionally, while the performance of a mutual fund is accessible, the performance of the average direct equity portfolio is not.

There is no point in selling your mutual funds if all you are going to get is the same type of investments, the same level of diversification and more or less the same performance.

Recommendations

Overall Portfolio

The recommendations section should provide at the very minimum a recommended portfolio with specific allocations to each investment, showing the yield provided and a supporting summary of the recommended asset allocation. This should be provided whatever the management agreement, discretionary or advisory.

If your portfolio is being constructed, planned and managed to meet your financial needs, then the investments have not just been selected because they have a specific risk/return characteristic. They have also been selected because they have a role an objective and a timeframe. This is to meet your financial needs as and when they arise.

This is particularly relevant for low risk investments, where the management of liquidity is paramount.

Low risk portfolio

Therefore the role of each low risk asset class or allocation to a set of securities should be explained; cash, government/provincial fixed interest, corporate fixed interest, preferreds and international bonds as well as specialist higher yield investments.

Additionally an explanation of the each type of investment should be provided in either a supporting appendix or information package. If the portfolio holds preferreds, these need to be explained, likewise corporate bonds and international fixed interest investments. Information on transaction charges and costs should also be provided.

Equity Portfolio

The equity recommendations should be accompanied by a detailed explanation of the overall equity strategy, the risks of the strategy, how the strategy and allocation will be affected by different market environments and, how the allocations to securities, market components and markets may change in response to changes in valuation.

Additionally, an explanation of each security or fund and its rationale for inclusion needs to be provided.

Generic information on the type of investments used should also be provided either in appendices or as part of an information package.

Summary technical information such as the allocation to markets, to market cap, to sectors, Price/Earnings ratios and P/Es relative to the market, price to book and relative to the market, dividend yield and relative to the market, as well as individual security standard deviation (or other statistical risk data) and portfolio relative to the market should also be provided.

What is the point of all this?

If the organization is well disciplined, well organized and its systems and asset management processes well structured, the information should be easily provided.

If they cannot deliver this information, it either means they are not organized but have it, or they do not have it and are not organized or able.

Providing this information means that their actions are accountable and justified. They have to think carefully about their service, the management of your assets, your education and the management of your expectations.

It is up to you the individual investor, as to whether or not you want to read this information. But, you need to be given the opportunity. This is your last chance before you invest.

Detailed reporting protects both the investor and the advisor!

If you have accepted everything and everything has been explained and justified, the advisor cannot be held accountable for any action or recommendation conducted in accordance with the agreed mandate. Likewise, a report protects the client by making sure that the advisor fully justifies and explains what he or she is doing and why and that if they act outside the mandate that they be held accountable. If there has been any misrepresentation of the facts, then the report will also hold the advisor accountable.

Whether you are an advisory or a discretionary manager, wealth management service processes should by now have evolved to the point that all service agreement come equipped with a detailed and comprehensive report.

Risk analysis

A portfolio cannot be constructed without information about risk, about valuation, about the relative valuation/risk of one investment to another, without knowledge of the relationship between the portfolio and the financial needs they are ultimately to provide for.

It seems only natural that these guides to portfolio structure, risk and return that the manager uses, be reported to the individual investor.

The reason is simple.

You cannot build a portfolio without attention to this detail and, if the manager is building a portfolio without this information you need to know, or at least someone does.

Importantly risk and valuation information tells you whether your manager is actually doing what they say they are doing and whether or not there is actually a rationale and a structure.

Finally, you may not be able to understand exactly what it means and, this information should be reserved for an appendix, but it holds the advisor accountable for the decisions they make and the statements they make.

What sort of information should be provided?

- A statistical measure of risk that tells you how volatile each investment has been historically and how risky in terms of price movements, all the securities/investments in the portfolio combined would be.
    - The problem with statistical measures of risk is that they do not tell you how over or under valued an investment is at any one point in time. Statistical measures of risk therefore need to be backed up with fundamental measure of valuation.
    - According to these measures an investment which fell by an average 10% a year would not be risky while an investment which went up by 10% one year, 20% another and 40% another would have a high level of risk attached to it.
- A measure (s) of the valuation of each investment and the portfolio; for example price to earnings, price to book and/or other measures, especially their primary valuation measures. Valuation measures not only give you a guide to relative risk and relative value but they also give you some insight into the manager’s own discipline.
- Thirdly an asset allocation analysis will show you where the portfolio is invested relative to the market or the world market. The asset allocation analysis should also show the average valuation and statistical risk analysis against which the risk and valuation of the portfolio can be compared.

This analysis would let you know how risky your portfolio is relative to the market both in terms of historical price movements, current valuation and asset allocation.

More important than understanding all this information is the fact that this information will hold your advisor accountable for the decisions they are making.

Liquidity and financial security

An assessment of the liquidity and the financial security provided by the portfolio should be provided.

- What would happen if the stock market crashed today, the economy moved into recession and share prices remained below the price you bought them for a number of years?
- Could your portfolio still meet the financial security that had been planned for and for how long?
- Could your portfolio cope with higher inflation?
- Is your portfolio capable of meeting planned income and capital needs from cash and maturing investments or would your manager have to be selling assets to meet these needs. How will your manager deal with these risks?

Is this information onerous to provide?

If you are not organized or well structured, then yes, otherwise, no. This information should be to hand and formatting it for distribution to the client should be a formality.

Allocation Rationale

Low risk allocation rationale

The rationale for the allocation and management of the low risk portfolio in relation to the investor's financial needs and risk preferences needs to be provided in the report; providing of course that there is a direct relationship within the low risk allocation to the size and timing of an individual's financial needs.

Relative to financial needs, what is the reason for the cash allocation and its objective, the reason for the fixed interest allocation, the amount invested in each security and the maturities of the securities, the amount allocated to international bonds, preferreds and corporate bonds.

Additionally any aspect of the low risk allocation, security selection and strategy affected by market and economic conditions, relative valuations and risk and return also needs to be explained.

Allocations that are being or are not being made because of market conditions should be explained as should additional low risk exposure brought about by risk aversion and how this will affect risk and return of the portfolio.

Why?

Because you need to know if they have a handle on your financial security or not.

This should not be an onerous job for a well organised wealth manager. The way financial needs affect the allocation and selection of low risk investments should be capable of being automated and the basic explanation of rationale for the allocation capable of being standardised for all clients. Likewise, the current strategy for all low risk assets should be capable of being put into an appendix to be read, if so wished by the client.

Equity allocation rationale

A statement of the recommended equity allocation should be provided and accompanied by an explanation for the allocation within each market, or market component and the reason for the current allocation, whether it be under weight or over weight.

A basic explanation of the manager's diversification rationale as well as equity investment discipline also needs to be provided. More information on the manager's investment discipline should be provided in either an appendix or a client reference manual.

Supporting information on the portfolio covering strategy and individual security or fund justifications as well as specific risk and valuation data should be provided and are discussed in additional reporting data.

Why?

Every asset and every asset allocation within the portfolio is not there just to manage risk and return, but it also has a role to play in providing either current or future financial needs.

Again, a well organised and discipline wealth manager should not find this information onerous or time consuming to provide.

Investment Planning Fundamentals

Investment planning fundamentals

A good report would explain how a portfolio is structured, planned and managed to meet financial needs over time and how this structure is designed to manage risk and return.

This has nothing to do with investment strategy (under/overvalued), investment discipline (value/growth), allocation to markets or security selection.

The report should explain how the size and timing of your financial needs affects the basic allocation of your portfolio between cash, fixed interest and equities over time and how the risks affecting the ability of assets to meet needs are managed.

It should also explain how the wealth forecasting/asset and liability modelling is carried out and why the modelling can be relied upon and to what extent it can be relied upon. If the wealth forecasting or modelling shows that assets cannot meet financial needs, or the specific stated objectives over time, this needs to be discussed and alternative solutions provided for consideration by the investor.

It is important that an organisation provide supporting explanation of its disciplines to clients so that they can broaden their understanding of the advisors approach. The report is only going to be able to hold a brief explanation.

The report needs to clearly assess the ability of current and expected future assets to meet current and expected future financial needs based on conservative risk/return assumptions over the individual’s lifetime. Actuarial mortality tables should be used in this assessment.

You the investor need to know what impact your risk preferences and your financial demands could have on your investments over time.

It is important to note that investment planning is an investment discipline and not a financial planning discipline. If your financial planning and portfolio management are conducted separately then it is unlikely that you will receive this vital reporting component.

You will only receive this if the portfolio manager has an investment planning discipline, in which case, they will not be able to construct a portfolio without the necessary data from the financial planner.

Note on Modelling

Many advisors and portfolio managers do not relate the size and timing of your financial needs to the structure of the portfolio. because of this, when modelling the ability of your assets to meet financial needs over time, they are not actually assessing the ability of the structure planning and management of the portfolio to meet these needs.

The modelling should take into consideration planned expenditure (income and capital), planned savings from income and, capital injections and personal as well as pension assets.

All many are doing is projecting the return on your investments and deducting income and capital expenditure from the projected value of future capital. Somewhere in the report, there should be an explanation of how they model the ability of your assets to meet your financial needs.

If your advisor has had to significantly change the income and or capital you can take from your portfolio because of short term market and economic risk, they may not be doing a proper job. Likewise, beware the advisor who increases what you can take from your portfolio in line with sharp and short term upward movements in investments.

Integration

Your asset and wealth managers should be working together

Your financial planner should not be selling you investment products which contradict the strategy and structure of your asset manager's portfolio.

Likewise your asset manager should not be making recommendations that affect your financial needs, if they are not responsible for their management.

Your estate planners and accountants should bear in mind the management of needs and assets in making their own decisions.

Someone should be ultimately responsible for the overall decision making process with regard to the management of assets and financial needs over time.

Most investors and very few advisors realise that it is structure that is the most important part of managing wealth and financial assets. Without a structure that integrates the management of all financial needs and all financial assets you cannot effectively manage risk and return, you cannot control costs and you cannot prevent unnecessary and needless transactions that increase costs, increase risks to your financial security and reduces your return.

In fact, you could actually have poor investment performance, yet through a properly managed structure actually out perform (in terms of total return) a portfolios with far better underlying performance.

Please see Total Asset, Life Cycle Wealth Management for further information on the importance of integration of your wealth and asset managers.

Reviews

Your wealth and asset managers should regard your investment reviews as an important time to reassess the suitability of the portfolio, the information on which it is based and any changes to your objectives and financial position.

With the proper systems and a well discipline service structure, this is not as complex or as time consuming as one might think. Updated financial needs are easily inputted into the systems that manage your assets and wealth and the touch of a button completes all the analysis.

The reviews provide the wealth manager with an opportunity to explain what has happened and why and, to illustrate the benefits of their strategy and approach.

Again this is not a complex issue within a well structured and disciplined service process. As far as asset management is concerned, all security selection and asset allocation decisions are interrelated and all client portfolios, irrespective of their differences are related.

Importantly, the review process provides accountability to the individual investor of all decisions made.

Many advisors will provide a quarterly report to the investor which will provide a valuation and a simple performance analysis and/or market commentary. This is not enough if your money is being managed to meet your financial needs over time.

If your money is being managed properly, your wealth and asset manager should also provide you with three important components to your reports.

- An ***annual investment planning review*** where the ability of assets to meet financial needs are reassessed. This will be a much shorter version of the initial investment planning and portfolio management report. It will restate financial needs and objectives and adjust for any changes. It will also rework the financial modelling and should adjust financial objectives for recent annual inflation.

- The second reporting requirement relates to changes to investments within the portfolio due to changing relative valuations or security suitability and changes to asset allocation and securities due to a portfolio's asset liability requirements. Where assets and needs are being managed, transactions will also be generated by changing asset liability relationships and not just market or security valuation and relative valuation.

    - It is not the transactions that need to be reported, but the rationale and reason.

- The third type of report is the ***performance analysis***, which needs to compare the performance of the portfolio to a domestic index, to a comparable active benchmark and to comparable style benchmarks. Performance analysis needs to be after management expenses and transaction charges. Advanced performance analysis should also be able to measure the effectiveness of the asset allocation strategy in meeting financial demands on the portfolio. Good portfolio structure and good management of the relationship between financial needs and assets can actually enhance total return.

Other important factors involve transaction details and total transaction costs including commissions.