

After The Descent, What Colour The Phoenix?

A perspective on the development of integrated wealth management processes in the Canadian Retail Financial Services Industry

Part 2 b – Financial/Economic Crisis Related Issues – Investment Planning Issues

These issues are by implication directly related to market timing issues (*the associated risk management of income and capital security*) given that market falls impact financial security, but they are also tied to distribution and service issues, productivity, competition, regulatory and registration, wealth management brand recognition, advisor roles and relationship issues, technological development, and are integral to the move from transactions/stand alone products to process/complex product and integrated platform financial services distribution. In fact, you could state that investment planning lies at the heart of the future direction of the retail financial services industry because of the associated impact on productivity, margins, value added at the investor level, business and services processes, and services and product distribution in the market place.

Long term business, service and product development needs to include an assessment of the impact of the issues associated with investment planning and the importance of sophisticated integrated wealth management systems in future product and service distribution.

Investment planning is still a discipline in its infancy.

- ✦ Asset management is not yet fully integrated, despite what many may perceive, with liability management (*the relationship between size and timing of financial needs and the asset allocation, maturity profile, credit quality and liquidity of assets amongst other factors*) not fully integrated with asset management/portfolio construction planning and management processes.
- ✦ In Canada financial planning is not a function which requires financial services regulation despite the fact financial planners provide asset allocation and long term cash flow/withdrawal management strategies that are integral to investment planning. In fact, this division is more likely to increase cost and reduce value to the investor who will often have to pay twice.
- ✦ Minimum industry standards with respect to “know your client” are insufficient to support integrated investment planning processes: there is just not enough information to construct a withdrawal plan, a portfolio and a portfolio management strategy.
- ✦ Many (*if not the vast majority*) of the portfolio construction systems do not incorporate liabilities in their asset allocation algorithms: time frames and investment horizons used to select appropriate

portfolios are not sufficient to create the level of integration needed to achieve optimal investment planning solutions¹.

- ✚ Investment planning in the main still plays second fiddle to the transaction and even the portfolio, yet integrated asset and liability management systems are key to delivering higher productivity and value in the retail financial services industry.

Without sophisticated systems (*and the implicit need for integrated business and service processes*) the costs and logistics of delivering integrated services² with investment planning components are prohibitive. In order to be able to understand this, institutions and firms will need to be fully conversant with the differences in process requirements between transaction based processes and integrated total wealth management (*all assets and liabilities*) service processes before either embarking on change or accepting the status quo. They will also need to be aware of regulatory and registration requirement restrictions on the development of their own business segment and the competitiveness of a given business segment³.

But just why is investment planning an issue now?

When investment planning veers significantly from the expected, promised or anticipated outcome (*planned withdrawals, portfolio liquidity, accommodated risk scenarios, appropriate security selection and asset allocation*) we have a problem with the credibility of the process and services being offered. This is precisely what is happening. A gap in credibility also creates opportunities for those looking to close down this gap. Also, as discussed, increased use of technology and innovation in process is key to reducing costs in a very tough trading environment whilst maintaining or enhancing quality of service and services.

What is the point with planning if it cannot cope with risk⁴?

Investment planning is a core component of the wealth management solution (*even though it may not always be considered so*) and is key to determining and providing a stable level of income and/or capital withdrawal to meet financial security.

While there has always been a risk with mainstream investment planning⁵, the events of the last 10 years, exacerbated by recent events, have highlighted a chasm between investment planning processes, methodologies and expertise and their outcomes; while markets moved up as the retail financial services industry has matured, weaknesses in processes and structures have been ignored.

¹ Reasons will be discussed in further perspectives.

² A detailed definition of such is provided in later subject matter specific perspectives.

³ That insurance industry advisors and IIROC/MFDA regulated advisors can effectively provide two different solutions sets for the same problem is an issue given that some solution sets are more constrained than others in being able to deliver optimal solutions.

⁴ Monte Carlo simulations assigned low probabilities to extreme risk events which would only be catered for by low withdrawal rates that would be unrealistic for most investors. The trouble is, unless return assumptions are adjusted to reflect lower valuations, Monte Carlo simulations (post the risk event) will rerun using the lower capital values and hence result in a much lower level of projected financial security.

⁵ Return assumptions may have depended far too much on historic returns and structure (systematic withdrawals from equities in down markets) may have been untowardly exposed to sustained periods of poor equity market performance.

Investors prefer, to lesser or greater degree, certainty of income and capital security and therefore prefer solutions that minimise risk to planned income and capital security given their (investors') own risk and performance preferences. This also means that integrated processes are better able to manage the risks and the deviations from these risks due to investor and advisor risk and performance preference differences. A transaction based industry without a formal structure for integrating asset and liability management risks, conflicts with optimal management of risk and of delivering services, products and platforms that meet investor financial needs and risk preferences.

Following recent events, there should be concern by both advisors and investors as to the volatility of income and capital projections from many of the industry's standard investment planning tools and the significant shifts in projected long term financial security. There should also be concern amongst retail financial services firms in general as to how they can better manage these risks and meet investor and advisor needs in this context.

Advisors (and institutions) should be concerned over the effectiveness and credibility of their investment planning solution software and services, and their own advisor and client concerns over these issues⁶.

- ✦ Advisors using Monte Carlo analysis, or simple linear average historical returns, would see a wide variation between prior projected income and capital withdrawals and current achievable rates of withdrawal. Such variations would require advisors to significantly cut withdrawals from portfolios following significant declines seen.
- ✦ If portfolios are relying on systematic withdrawals of equities, then the deterioration in financial security could worsen further the longer assets remain at or below current values.
- ✦ High costs matter in a down market given their impact on returns and optimal withdrawal rates.
- ✦ Projected returns on investment policy statements dependent on historical average risk/return inputs will also currently be in default of expectations.
- ✦ Many risk assessment processes and portfolio selection have been based on risk/return scenarios that conflict with the last decade's market risk and returns.
- ✦ The above does not include those investors with advisors that have not followed a disciplined process: these individuals could possibly be seeing even worse outcomes and may hold larger allocations to illiquid and inappropriate securities.

As discussed, there are a large number of issues associated with investment planning. While there is the immediate concern as to how institutions and advisors should be alleviating some of the stress in their clients' portfolios it is the longer term changes to business models, systems and processes that are the most important.

⁶ Anyone who has ever modelled the ability of a portfolio to meet financial needs would understand the critical importance of making sure risk/return outcomes do not jeopardize planned withdrawals: this does not mean that market movements do not have an impact, just that the impact of the asset price moves does not significantly alter investment plans; conservative risk/return assumptions, sensible withdrawal rates and structures capable of managing short term risk minimise such consequence.

Does the future of investment planning solutions lie in the development of stand alone complex products?

Probably not for a number of reasons that will be addressed in detail in further perspectives: sophisticated systems that integrate the management of assets and liabilities are able to incorporate a number of wealth hedging strategies whether they be through the use of the basic investments, derivatives or planning solutions that effectively provide all and more than any stand alone product (complex or otherwise could provide). Integrated systems also challenge the distribution and remuneration framework of the current retail operation and as such we may see intermediate innovation whose main objective is to protect the current distribution and remuneration system.

There are, of course, a number of ways of providing solutions that manage the risk of deviating significantly from planning that are low cost and simple to institute: higher allocations to lower risk assets, lower withdrawal rates, use of derivatives/insurance/hedging (*exception to the lower cost benefit*), conservative risk return modelling, more precise modelling of the interaction of total financial needs and total assets that the retail industry may need to pay attention to.

Products on the whole are light on investment planning for a reason and the product of the future is more likely to be the integrated platform than a closed, relatively inflexible, relatively simple (in many aspects) stand alone transaction. But change rarely comes over night and it is also likely that many variations of what we know as products will continue to be launched until integrated platforms take over as the predominant medium for delivering wealth management solutions⁷.

Investment planning issues are more involved and complex than perhaps many believe!

- ✦ How sensitive should risk/return assumptions be to the market and economic cycle?
- ✦ Are equilibrium based forecasting models realistic (Monte Carlo) and still relevant and if so how do we adjust them to be more realistic and capable of managing significant risks?
- ✦ To what extent should asset and liability management be integrated (*this impacts management of income and capital security and asset risk/return management and the extent to which the industry moves away from products and transactions to total wealth management*)?
- ✦ To what extent can traditional and other portfolio strategies be adjusted to accommodate greater integration?
- ✦ To what extent should asset allocation and security selection adjust dynamically to market movements and long term asset liability relationships?
- ✦ How much leeway should there be to interact with client risk preferences as well as advisor performance risk preferences and investment disciplines? This much more critical than many might initially think.

⁷ Stand alone products/securities will continue to be developed and be attractive, but they are more likely to be integrated within and used as components of sophisticated platforms. This also raises competitive distribution issues for product developers, or those who deliver asset management expertise via products, issues explored in later perspectives.

- ✦ How much leeway should systems provide in terms of their ability to adjust strategy and planning for the size and timing of future inflows to and outflows from a portfolio?
- ✦ How open or closed should systems and solutions be? Open systems allow higher levels of personalisation and adjustment and require fewer decision rules while closed systems are either extremely limited in application or very complex to build.
- ✦ How will risks to income and capital security be managed or transferred?

There are of course many other issues that need to be addressed that have been and will continue to be discussed throughout these documents: for instance, restrictions and issues caused by industry regulation and registration of different sectors significantly impact the development of business and service processes and the ability to compete in a developing market place.

This perspective believes that the ability to make investment planning projections that are sensitive to economic and market valuations is important in enhancing the stability of retirement income planning services and in making investment planning projections more stable. It also believes that asset allocation and security selection should be fully integrated with client income and capital (inflows and outflows) profiles, that asset allocation and security selection relative to income and capital profiles should have a dynamic relationship with market movements and financial needs and that investment planning system decision rules should allow for a significant level of flexibility. Complex systems allow for simple outcomes, yet simple systems constrain and limit the outcome, leaving complex issues still to be managed. Organisations are going to have to spend time understanding the very real demands of investment planning issues if they are to develop the services, systems and business and service processes of the future.

The deviation between investment planning expectations and actual outcomes is both a cause for concern and an opportunity to reassess and improve wealth management delivery systems in the retail financial services industry. As to the time frame for the development of more sophisticated systems, we do not know and the industry could take years before it is able to overcome structural, cultural, technological, consumer, regulatory and other barriers to change. It is nevertheless becoming a more critical issue the longer the current market and economic crisis continues and is worthy of consideration.

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