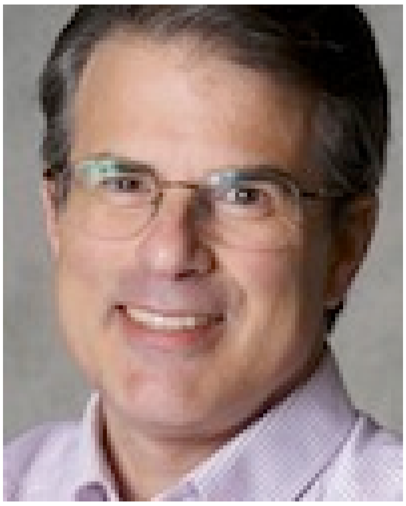
Dealing with the Contradictions of Financial Advice

By Kerry Pechter *Thu, Aug 3, 2017*

'This is not a problem of Truth and Proof,' wrote Francois Gadenne of RIIA in an email and the inconsistencies of advice. "It is a problem of measurement (of outcomes) and fit (to a specific client type).



About two decades ago, when Francois Gadenne left the professional ranks of financial services and became a high-net-worth consumer of retirement planning advice, the founder of the Retirement Income Industry Association noticed that the advice he received was inconsistent and sometimes even contradictory.

Under such circumstances, how could a client become well-informed about income planning, and how could he or she decide what the best strategy might be? And, if there are no bedrock principles or unified theories of retirement income planning, what can an advisor recommend with any degree of confidence?

This problem bothered him 20 years ago, and it still bothers him. A big part of RIIA's mission, especially after it developed the RMA (Retirement Management Analyst) designation for advisors, has been to establish a "body of knowledge" and "best practices" in the field of retirement income planning.

Easier said than done. RIIA's eclectic group of members, including some from the world of public policy and broad solutions for aging populations, and some from the profession of advising high-net-worth, tax-averse clients, could not agree on best practices. Some hated annuities, for instance. Others liked annuities but differed strongly on the timing of annuity purchases.

Gadenne raised this issue during his presentation at RIIA's 2017 Summer Conference in Salem, Mass., three weeks ago. And he included several of the contradictions in the book that he and advisor Patrick Collins published as a study guide for the conference.

Equities and Hamlet

We're all familiar with some of the common contradictions in financial planning. For instance, we're told that the market's past performance is no indication of its future returns. Yet most projections of likely future returns depend on analyses that rely, in one way or another, on price history.

There are even more controversial contradictions. Jeremy Siegel and many others have told us that stocks pay off in the long run. And we often follow that principle. Anyone who accepts the "bucket" method of retirement income planning knows that clients should put small-cap equity funds in the bucket they won't tap for two decades or more—as if small-cap equities were a type of wine that matures to perfection after

20 years.

But Zvi Bodie and others say that this is nonsense, just as it is nonsense that an infinite number of monkeys, etc., could ever produce the text of Hamlet. Stocks are more volatile than bonds, and their volatility only compounds over time. “Time, on average, decreases risk over the population average; but, for any given individual, time increases risk. [This] may temper the inclination to advise a client to hold equities if they have a long planning horizon or to hold bonds if they have a short-term planning horizon,” wrote Gadenne and Collins in the conference handbook.

The concept of “utility”—always a puzzle to this writer—is another source of disagreement among retirement income specialists. By definition, it is the amount of satisfaction that a person gets from something—such as a larger portfolio, a better physique or a child on the Dean’s list.

Investment-focused advisors might think of utility purely in terms of wealth and what a client is willing to give up for it (like safety). An advisor who uses behavioral economics might think of utility in terms of achieving emotional or spiritual goals in addition to financial goals. The question becomes: Should the advisor try to make the client richer, or happier? The implications for the retirement planning process are profound.

Other contradictions are easy to find. There is the index-versus-active management conflict, the disagreement over liquidating tax-deferred assets first or last during retirement, the insurance versus investment products dispute, the leverage-home-equity/ignore-home-equity conflict. There’s the question: Does “bucketing” work as a risk management technique, or is it just “mental accounting”?

The match game

RIIA has a big-tent kind of membership philosophy, and Gadenne doesn’t take sides in these controversies. But he assumes that advisors do, and he’s come to the conclusion that they follow three basic schools of thought. As he and Patrick Collins wrote in the latest issue of ***Investments & Wealth Monitor***, the magazine of the Investment Management Consultants Association (IMCA), most advisors will either be “Curves,” “Triangles,” or “Rectangles.”

By these geometric symbols, respectively, he and Collins refer to advisors who focus primarily on investment management and who rely on Modern Portfolio Theory as a guiding principle; advisors who incorporate behavioral finance into their advice and align investments with their client’s personal goals and aspirations; and advisors who incorporate all of a household’s assets and liabilities into each retirement income plan.

Smart advisors will match the right techniques to the right client, or specialize in certain techniques and certain types of clients, Gadenne believes. “This is not a problem of Truth and Proof,” he wrote in an email. “It is a problem of measurement (of outcomes) and fit (to a specific client type).

“The remedy described in our paper seeks to associate prescriptions with descriptions (of specific clients type to whom it applies), We ask the advisor, “Can you describe the ideal client for this (prescriptive) recommendation?”