CHAPTER 1

The Most Important Concepts in Wealth Management

Years ago, in the span of a couple weeks, we sat down with two prospective clients. Both of them were nearing retirement and wanted to make sure that they were prepared. Both were senior executives at their respective firms, had high incomes, solid benefits, and substantial investment portfolios. And most importantly, both had large holdings of their company's stock.

Both worked for Fortune 500 organizations: the first for a pharmaceutical company, the second for an energy firm. Both of them had financial backgrounds, including master's degrees in business. In other words, they were "numbers" guys. Being a senior executive in finance is an interesting role, inasmuch as it tends to instill a sense of confidence.

It was this confidence, borne of familiarity with their respective companies, that made them resistant to the idea of diversifying their substantially concentrated positions of firm stock. It certainly didn't help matters that the success of these firms was one of the primary reasons that they were both so well off. Comfortable in the idea that their levels of wealth would afford them the luxuries of a leisurely retirement, neither of them was willing to sell any of their company stock.

But, there was a problem: the pharmaceutical company was Abbott Labs and the energy firm was Enron.

After Enron's 2001 bankruptcy, the stories of destitute ex-employees covered the airwaves. We were bombarded by countless tales of heartbreak: Entire investment accounts had vanished, along with the dreams they had previously inspired. It was, in every sense, a national tragedy. It was also a cautionary tale, and in its retelling now, a teachable moment.

Despite reaching out on several occasions, we never heard from Mr. Enron again. Mr. Abbott, having internalized the reality that fate alone spared him a more tragic outcome, ultimately sold 85 percent of his company stock and diversified his portfolio with the proceeds.

Concentrated investments are but a single example of the myriad ways investors lose their financial bearings. Messrs. Abbott and Enron were laser focused on returns as the primary way of measuring success. Indeed, during their respective tenures, Abbott and Enron both outperformed the S&P 500 causing a false sense of security to set in.

Their confidence, nay, *overconfidence* in their firms was almost certainly exacerbated by a natural compulsion to seek out information that confirmed their positive biases. As long as one analyst in the financial or media world had something positive to say about Abbott or Enron, it was reason enough not to sell. They accepted the positive information that supported their biases while rejecting those opinions that ran contrary to what they thought they knew. And as if that wasn't enough, the lauds of peers—jealous that Messrs. Abbott and Enron's stocks were doing so well—cemented their beliefs.

That the stock was "beating the market" was all that mattered in the moment. But with the benefit of hindsight, their belief that they knew *why* was a complete delusion and the social pressure they were under completely inhibited their skepticism.

The sad reality is that this isn't an isolated, one-time incident. We see this happen more than we care to recount.

Even for the most sophisticated investors, there exists an unrelenting psychological urge to know whether we're succeeding or failing *at this very moment*. The easiest way to do this is to measure individual performance against a benchmark such as the S&P 500 or the S&P/TSX Composite Index. What few people realize, however, is that such comparisons are ultimately just distractions from what really matters. Those who judge their portfolio by its performance relative to some narrow benchmark are focusing on an issue that is largely irrelevant to their ultimate financial success. And yet, every prospective client that walks into our office invariably asks how our investment methods stack up against "the market" over some completely arbitrary historical period.

While we'll delve into this more deeply throughout this book, it's worth momentarily pausing for a high-level exploration of why comparisons to benchmarks aren't useful. A simple thought experiment should suffice. Let's imagine a world with two asset classes—stocks and bonds—that behave like we imagine that they should. In other words, over time, stocks have higher returns and higher volatility while bonds have lower returns and lower volatility. Assuming an investor identified some financial goal that they want to accomplish in the future—literally *any* specific goal will do—then the optimal portfolio for tomorrow is dependent on how the portfolio performs today.

It's important to note that this logic does not extend to ambiguous goals such as "I want to have the largest nest egg possible at retirement." We deeply believe that qualitative goals like these are not useful, since they beg for a reliance on relative performance measures. In other words, doing "as good as possible" could manifest as losing 30 percent of your portfolio in a year when the benchmark loses 40 percent. Many financial advisers would view that as a success. We would view this as a tremendous setback.

However, targeting a specific goal, the portfolio which maximizes the odds of hitting that target changes based on past performance. Did the portfolio have an outstanding year, putting you "ahead" of your projected path? Then the strategy that maximizes the odds of hitting your target—for reason we will discuss in Part 1—likely involves reallocating toward a lower-volatility portfolio. Notice that we have completely and intentionally ignored benchmarks in this thought experiment.

For a tactical strategy that invests both globally and in multiple asset classes, comparisons to a narrow benchmark are neither good nor bad—they're simply not useful. Why? Because targeting a specific level of volatility to maximize the odds of hitting a specific future target means that the benchmark is constantly changing. The only benchmark that you should care about is one that indicates whether or not you're on track to accomplish your financial goals.

We strongly suspect that this benchmark isn't your home country's equity market.

The tendency to compare one's progress to some irrelevant benchmark, or even worse, to "chase returns," is magnified during periods when markets are shooting the lights out. During these times, investors become acutely aware of how their portfolio is performing relative to whatever index is attracting the most attention.

It is precisely at moments like this where we spend a lot of time revisiting the core reasons that compelled our clients to hire an adviser in the first place. For almost all of them, the primary driver was a desire to reach one or more financial goals at some point in the future. Many are hoping to support children in university and eventually retire with a comfortable lifestyle. Other clients, who are already in retirement and drawing income from their portfolios, are primarily concerned with maximizing sustainable income and ensuring that their assets don't expire before they do.

These are all noble goals. Unfortunately, given what we will cover in this book, many of these goals will go unrealized. At root, this tsunami of unrealized dreams will stem from a fundamental misunderstanding about the respective roles of risk, return, and time horizon in determining success and failure. As you will learn, wealth planning is an exercise in risk management, and risks are *everywhere*.

Most investors imagine the wealth-building process as a smooth line from now to retirement. According to this narrative, investors must unfailingly set aside exactly what they have committed to save each year, and the markets must keep up their end of the bargain by delivering the long-term average return year-in and year-out without variation. This outcome is what we call a *unicorn*—it's beautiful, and it doesn't exist.

The only thing that we can say for certain is that reality will look nothing like that smooth line. There will be times of ease and times of stress. During times of ease it's easy to "fall asleep at the wheel," so to speak. Just ask Messrs. Abbott and Enron. And during times of stress it's equally easy to abandon robust plans that might still be in your best interest. This is why we try our best to keep our investors focused on just two critical tenets that, when taken together, represent the most important concepts in wealth management:

1. Risk is measured as the probability that you won't meet your financial goal.
2. Investing should have the exclusive objective of minimizing this risk.

We would encourage you to read these two lines again because these two thoughts together are critically important concepts to internalize.

In the world of finance, the term *risk* is as vague and malleable as any idea one might imagine. Don't believe us? Astoundingly, a 2009 article in the *Journal of Portfolio Management* outlined 107 different conceptions of risk that have been proposed in financial literature. Yet, even with 107 different choices, we believe the paper's authors still miss the point. There are many potential measurements of investment risk, many of which we will discuss later, but they fail to address the heart of what should really matter to investors of all types: hitting financial targets.

If you are an average investor with a typically basic understanding of investing, the notion of "hitting financial targets" will probably make perfect sense. However, executing on this philosophy is an entirely different issue. This is because investors' behavioral time horizons are, in practice, just a small fraction of their true financial time horizons.

For example, a 50-year-old investor may have a life expectancy of another 35 years, and wish to leave a legacy amount with a much longer time horizon still. However, data on investor behavior suggests that this investor is unlikely to stick with a strategy for much longer than four or five years. Dalbar's 2014 *Quantitative Analysis of Investor Behavior* report shows that investors in stock and bond mutual funds tend to stick with their strategy for about three years, while diversified investors (*asset allocation*) have historically held on for almost five years.

We expand on this concept in great detail in Chapter 40, but from a modeling and planning perspective, there is little value in setting investor portfolio preferences for a 35-year time horizon if they're likely to change their strategy every five years or less. Rather, the objective should be to recommend a portfolio that the investor is likely to stick with through thick or thin, but also where the investor is likely to come to the least amount of harm if he or she abandons the strategy after experiencing an adverse period.

Applying intelligent strategies that meet both financial and emotional needs is how the best advisers execute on the most important concepts in wealth management.