NAIFA's advisor Today

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FINANCIAL PLANNING

Assess the Downside First

Before making any investment recommendations, help your clients to consider worst-case scenarios.

Many advisors spend an inordinate amount off time searching for investments with upside potential without fully considering the downside risk. But recommending investments based primarily on upside potential creates client expectations that may be unrealistic and largely unattainable in the long run. When performance falls significantly short of expectations, rationalizations for the investment choices fall on deaf ears.

I have a motto: Regardless of the upside, if the downside looks too steep, stay away. An investment must fall under the client's "acceptable risk" category in order for it to be considered. Like most decisions, it's easier said than done. But putting the clients interest first is the best way to build a lasting business practice.

Every now and then, we get calls from clients excited about a "hot stock" they've heard about on TV or the golf course. Sometimes, you may have to overcome a sales pitch from another broker. If you haven't previously schooled your clients about focusing on the downside potential of an issue, you may have a difficult time dissuading them from making imprudent investment choices.

Client relationships may ultimately depend upon your ability to suggest adding alternative investments to the traditional monolithic approach of investing solely in the stock and bond markets. This is especially relevant to high-net-worth (HNW) individuals in that some alternative investments carry minimum net-worth requirements.

What do HNW individuals want from an advisor? They want primarily four things: to grow a nest egg, prudently increase income, find tax relief and discover above-average investment opportunities. Typically, what they need the most is a strategy designed not only to grow their wealth but also to protect the wealth they've already accumulated.

The Need To Assess The Downside

Toward the end of the 2008 market downturn, I met a couple in their late 60s whose portfolio had plunged from upwards of $8 million to about $4 million in less than a year.

Their broker had them completely invested in stocks. What made matters worse is that the client statement from the broker's own firm suggested a more conservative allocation, a recommendation he failed to highlight the couple. Remember that as an advisor, it is your responsibility to monitor and review statements with your client to make sure everyone is on the same page and that the client understands the investment process.

A check into this advisor's history revealed he was a broker with minimal experience. Perhaps this was part of the reason he never discussed tax ramifications to the couple. They had endured 40 percent to 50 percent losses on their portfolio in 2008, and the broker never mentioned that is was necessary for them to sell loss positions to generate realized losses and avoid unnecessary capital-gains taxes.

If the downside looks way to steep, stay away.

While no investment strategy can endure success or prevent a loss, managing this client's investments with strategic tax planning and adding a bond component and noncorrelated investments offers them potentially huge benefits.

Every client portfolio should have an appropriate portion of these noncorrelated investments that have the potential to do well in the down markets, whether part of an absolute return or a risk-adjusted or other hedging strategy.

HNW individuals are as susceptible to suffering potentially large losses as anyone else. Advisors who seek to provide the highest level of client service must be well versed in alternative and noncorrelated investments, maintain an unblemished professional reputation and always assess the downside before making any investment recommendation.

My practice is dedicated to serving HNW individuals and giving them perspective to consider worst-case scenarios before committing to an investment program. Its regimen that has made life easier and hopefully, theirs a lot better.

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