Basic Training Revisited

IMAGINE A WORLD without credit cards. Imagine paying cash for a new car or a home mortgage that's limited to three times your annual income.

This may sound like the economy of an underdeveloped country or a throwback to the U.S. in the 1950s, but all it really means is a world where people buy and live within their means. If you are a standard-issue baby boomer, your parents lived in such a world. Just ask them.

Our current economic problems reflect shifts in the values and attitudes about credit among both consumers and institutions. The problems of those financial companies now in the news stem from their fundamental inability to address their risk management. No economist would encourage consumers to support a level of debt service that exceeds 60% to 70% of income. Why should corporate America be different?

Our regulatory system has been asleep at the wheel, showing misplaced confidence in the financial markets to self-regulate, and now the statements of bankrupt public companies reveal how deeply they were immersed in debt. Similarly, individuals from this generation of golden opportunity have learned not to question the cost of a major purchase. Instead, they are thinking only about how they pay for it. The consumer's thinking, just like corporate America's, has tilted toward cash management and debt service.

As financial advisors, we must inspire and remind our clients that the principles of wealth are built on discipline, saving, risk management and periodic review.

Discipline

We forgot that the credit and capital markets were created to purchase capital assets that hopefully would generate or appreciate in value. A value shift occurred when credit was extended to support a lifestyle, or when the debt-to-income ratio became an acceptable measure for lenders to judge whether something would be repaid. But in the current economic malaise, it's no longer clear what's probable and what's certain.

Basic accounting calls for assets to offset liabilities. In the old world, loans were made to the most creditworthy people, whose assets were expected to appreciate against a defined liability. In the new world, it's often difficult to assess the liability of lending against assets or income subject to sudden change. Financial institutions require discipline to distinguish between the old world and the new realities we face today.

Saving

The United States has one of the lowest savings rates among industrialized nations. Wealth accumulation requires the discipline to forgo something today that may provide immediate gratification in favor of saving for a more secure or financially sound tomorrow. The notion that collective consumption will be supported by future income is fundamentally unsound.

Our role as advisors is to show our clients that there's a parallel between fiscal and physical fitness. The medical community is quick to point out that good physical health allows us to be more resistant to colds, and that a strong immune system will enable us to better cope with illness. The same argument holds true for saving: A strong saving component can help us weather financial storms, both as individuals and as a country.

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Risk Management

The fundamental tool we use with our clients is a risk management questionnaire. It's a tool with a limited shelf life, though. Attitudes and emotions can change very quickly in a volatile market environment. It's our professional responsibility to regularly engage out clients and see if their attitudes toward risk have changed since their accounts were established.

If we are not up to the task of revaluating the risk, we create a risk of our own—that we will lose the client. At the very least, we might mistakenly suggest that account positions remain static when we should be doing what we can to make the clients more comfortable with the risk they have.

Periodic Reviews

These allow you to reinforce the trust and relationships that your practice is built on. Equally important, a periodic review keeps the client engaged, allowing them to measure the progress they're making in achieving their goals.

We are in the trust and relationship business. Unless we live up to the professional commitment to engage our clients and discuss discipline, savings and risk management and regularly review the relationships, we may be shortchanging them.

The trust is tested, of course, with each triple-digit market swing. But the current economic mood also offers an opportunity to uphold our professional responsibilities while getting clients back to the basics.

The process will not only fortify our current relationships but also help new clients as well. Toward this end, we might help them do the following:

Adopt a new consumer attitude. Credit is for emergencies. Everything else should be paid for within 30 days.

Lower their personal monthly expenses. This will lower the drag on their income from earnings and investments. Personal budgeting can quickly expose items that may be discretionary, problematic or disproportionate in relation to income.

Think old money/new money. The money that was already inside our client's 401(k) plans and equity investments was for the long term. In 2009, we can decide where new money goes. If our risk tolerance has changed and we are inclined to be a bit more conservative, then this new money can support more cautious investments.

Use dollar cost averaging for systematic saving. If your client's risk tolerance has not changed and she is participating in a program that enables her to direct savings toward longer-term goals such as retirement, the current economic malaise may prove to be a boon when the economy and markets recover.

Think global. We live in a world of relative bargains. The world economy is unbalanced. Developed economies require higher wages to support a general higher standard of living while developing economies appreciate every opportunity to export.

We have entered the golden age of financial planning. If there was ever a doubt that sound and consistent advice from a professional was necessary, the past few months have laid it to rest. A sleeping giant has awakened: Retirement plans have shifted from employer-paid to self-directed programs. Year-end statements reflect the reality that holding or folding is a serious question, not to be considered without guidance.

We've all heard the adage, "When the going gets tough, the tough get going." This can be said for our financial services industry. As advisors, we are on the front lines with clients who have placed their trust and confidence in us. This is our battle to win, both for our clients and ourselves. FA

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