

DEFINING THE NEW MODEL FOR Client-Advisor Engagement



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INVESTORS TODAY ARE CAUTIOUS AND DOUBTFUL, questioning not only the individuals who advise them but also the financial system as a whole. Yet the challenges of the market environment and the crosscurrents ahead make the right help—including sound ideas, dynamic strategies and effective plan implementation—more important than ever. Therefore, a new and different quality of client-advisor engagement is necessary. To serve investors well in this decade, this approach must reflect a number of key facts.

Broken Trust, Emotional Reactions and the Need for a New Model

THE ECONOMIC AND MARKET EVENTS OF THE LAST FEW YEARS have left investors with doubts about the safety of the financial system itself, along with the credibility of its advisors. Despite financial reforms and newly introduced consumer protections, many investors remain skeptical.

Amplifying the problem of broken trust, many investors realized too late that they did not fully comprehend the risks inherent in their investment strategies. Often the risks were obscured by jargon-filled communication from their advisors.

Human emotion was a contributing cause of investment failure as well. Unfortunately, the more alarming the news, the more likely investors are to be swayed by their fears. The sheer scale of market losses in recent years has often led investors to panic and make portfolio changes at precisely the wrong time.

The fact that trust, communication and emotions are at the heart of these challenges might suggest that hard and fast solutions would be difficult to define. Yet investors and their advisors can directly control their mutual destinies by committing to three rules that can help guide their interactions:

- PARTNERSHIP AND PERSONAL RESPONSIBILITY
- CLEAR COMMUNICATION
- OBJECTIVE-DRIVEN INVESTING

Partnership and Personal Responsibility Are Imperative

EFFECTIVE PARTNERSHIPS REQUIRE MUTUAL ACCOUNTABILITY, with investors and their advisors sharing responsibility for achieving success. Advisors and clients alike will be most successful in this decade through closer involvement and a greater regard for the contributions each can make to the relationship. Simply stated, they must recognize that enhanced engagement can lead to better results over time.

To begin, investors must know what they want to accomplish with their wealth and make sure their advisors do as well. Plans must embody each investor's personal views, concerns, values and principles. Investors must also take responsibility for understanding the strategies their advisors recommend. In fact, although investment and wealth management techniques can be complex, they should be fundamentally understandable and logical. If the ideas and practices an advisor is applying do not make sense *to* the investor, there is a good chance that they do not make sense *for* the investor.

For their part, advisors must acknowledge that successful strategies depend on a thorough understanding of their clients and on direct, reciprocal communication. Advisors should be just as accountable for these qualities as for the ultimate strategies they implement on their clients' behalf.

Additionally, investors will need to adopt sound strategies rather than apply individual tactics that may (or may not) have worked for others. They should do the homework necessary to make informed decisions, relying on hard data as opposed to testimonials, gut reactions or cocktail party conversation. Ultimately, they must listen to their instincts but also undertake the requisite due diligence, keeping in mind that if it sounds too good to be true, it probably is.

Finally, investors entering a relationship with a financial advisor should seek ample transparency. They should know what they hold and why. The same rule applies for advisors—if they do not have a clear view of what their clients are invested in and why, they cannot adequately protect against countless risks.

Full transparency should also play a role in how investors pay for advice. Investors should understand the net value of the advice they receive after all management fees and incremental charges for transactions, mutual fund costs and bond spreads, for instance, are taken into account. This is particularly true when future expenses are liable to rise and returns are expected to be more modest. Because compensation can drive behavior, investors will want to ensure that they are paying for what serves their best interests (satisfaction or portfolio growth) versus their advisor's bottom line (product sales and transactions).

All of this depends on clients being open and direct about communicating with their advisors, and advisors communicating clearly, concisely and consistently in turn. No client should ever think a question is too basic to ask. In fact, an advisor's inability or unwillingness to answer a question should be a clear warning signal. In the end, communication skills and honesty are just as important as technical skill, as is a willingness to partner with a client to arrive at the right solutions.

Clients and Advisors Must Speak the Same Language

JARGON MUST BE ELIMINATED. No matter how often it is used, it never provides clients with the insights they need to make educated decisions. Terms like *standard deviation*, *alpha*, *beta*, *dispersion*, *mean reversion* and *Sharpe ratio* may have their place, but not in client communication.

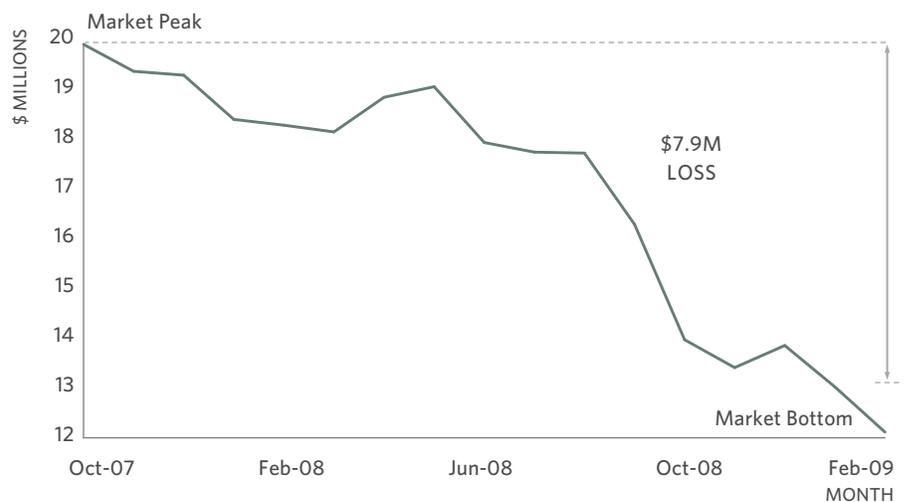
In a study published following the 2008-2009 crisis, 40% of high net worth individuals described themselves as less risk tolerant than they had been the year before.¹ Yet it is hard to say whether the respondents became more conservative or never really understood the risk of their previous strategies. For example, an investor with a \$20 million portfolio in 2007 might have felt comfortable with a 70% equity and 30% fixed income asset allocation described as “moderately aggressive” by his advisor. In reviewing the allocation, the investor probably focused on the 7% average return the advisor projected, rather than on the 10% standard deviation or the nuances of “kurtosis” and “fat-tail risk” that may have also been mentioned.

In reality, the benign-sounding 10% standard deviation meant that the investor could expect returns of between -3% and 17% about two-thirds of the time. The investor probably did not focus on the remaining one-third, but might have if his advisor had used plain language. After all, a 1% chance of something bad happening in any given month means that it is likely to happen about once every eight years. In this case, something bad did happen.

By March 2009, at the bottom of the financial crisis, the \$20 million portfolio would have dwindled to \$12.1 million, as illustrated in Exhibit 1, and the investor would have gained a much clearer understanding of the risks involved in a “moderately aggressive” strategy.

Exhibit 1

Steep Decline in Balanced Portfolio



Decline of \$20 Million 70/30 Portfolio, 10/31/07-2/28/09

Footnote: Asset allocation based on a 70/30 portfolio, diversified across asset classes.

Blended 70/30 portfolio comprises 40% large cap equity (S&P 500), 7% mid cap equity (S&P MidCap 400), 3% small cap equity (S&P 600 SmallCap), 10% developed international equity (MSCI EAFE), 10% emerging markets equity (MSCI EMF) and 30% taxable fixed income (Barclays Capital U.S. Aggregate Bond Index).

Sources: Morningstar and BNY Mellon Wealth Management.

Without clear communication and mutual understanding between advisors and their clients, emotions are apt to overpower rational thinking to disastrous effect—often when reason matters most. This has been made clear in recent years. In part because of extreme volatility and in part because of lost trust, investors’ fears have at times caused far more damage to their portfolios than they might have otherwise. Yet, in these times, markets are going to frighten even the hardest investors. For this reason, investors need an approach that will help them:

- Understand proposed strategies better, to ensure they do not commit to something that will not suit them when times get tough
- Maintain discipline and stick with their strategies in any market environment

On both counts, part of the solution is objective-driven investing.

The Value of Objective-Driven Investing

“WILL I HAVE ENOUGH MONEY TO LIVE ON?” “WILL I HAVE ENOUGH TO ACHIEVE MY GOALS?”

As sophisticated as wealth planning can be, these basic questions are frequently asked of advisors by even their wealthiest clients—and are among the most important to answer. Objective-driven investing is designed to directly address these questions by assigning the right strategies to the right assets, helping to ensure that clients remain confident in their plans. In principle, objective-driven investing is very simple—it matches investment strategies to each client’s ultimate goals, including both lifestyle spending and wealth transfer goals. Why is it becoming an increasingly powerful tool today?

Consider the experience of the investor in the previous example. Rather than accepting the “moderately aggressive” income mix with 10% standard deviation, suppose he had an in-depth discussion with his advisor about the amount of money he would need to live on for the rest of his life. Then suppose he told the advisor he intended to transfer the remainder of his assets to his children or to personal causes. Taking the client’s objectives into account, the advisor might have allocated the dollars for the client’s lifestyle spending needs to a conservative portfolio of investments and invested the wealth transfer assets in riskier securities that could potentially offer a higher return over the long run. During the 2008-2009 market crisis, the highly conservative lifestyle assets would have declined modestly, but not enough to alter the client’s future plans. The wealth transfer assets would have been sizably impacted, but there would have been adequate time for them to recover and grow to meet their longer-term objective.

How would this investor have reacted? Would he have been more likely to remain confident in his separate and distinct strategies, knowing he was safeguarding his lifestyle portfolio? Would he have understood that his wealth transfer portfolio had the potential to recover and perhaps even thrive over the long run, assuming he remained invested? While human behavior is never entirely predictable, an increasing number of investment professionals believe that objective-driven investing greatly increases the odds that investors will understand their strategies, stay the course and avoid lasting damage.

In this example, the outcome of the objective-driven, two-strategy approach might not have been dramatically different from that of a traditional consolidated portfolio strategy. But, assuming the investor understood that his objective-driven approach was designed to protect the assets needed for his long-term security, he would have felt more confident in his plan. Even in the worst of times, he would have been more inclined to stay the course—something that makes a major difference in achieving long-term investment goals.

Although simple in principle, objective-driven investing can be complex in its application. The process typically begins with a discovery phase—straightforward questions, such as, “How much will you need to live comfortably for the rest of your life?” and “How much do you want to be able to leave your family?” But the process of arriving at the right answers is quite extensive. An in-depth understanding of each goal—what the words used to describe each goal really mean to the investor, both personally and quantitatively—is required. Is the lifestyle portion of the investor’s portfolio intended purely to preserve wealth or to generate an ongoing income stream? Or is a combination of the two required? What special expenditures—a vacation home or other expenses—are contemplated? Is early gifting to children, versus at death, preferred? Do the future beneficiaries have assets of their own that should be considered in aligning strategies?

Exhibit 2

Defining Goals and What They Really Mean

Lifestyle	Wealth Preservation Provide principal protection, stability, liquidity and consistent income generation
	Income Generation Provide high levels of current income, modest principal growth and inflation protection
	Wealth Accumulation Provide capital growth/growth of principal
Wealth Transfer	Generational Transfer Provide growth of principal for current and subsequent generations
	Legacy Funding Sustain portfolio assets and income across generations in perpetuity

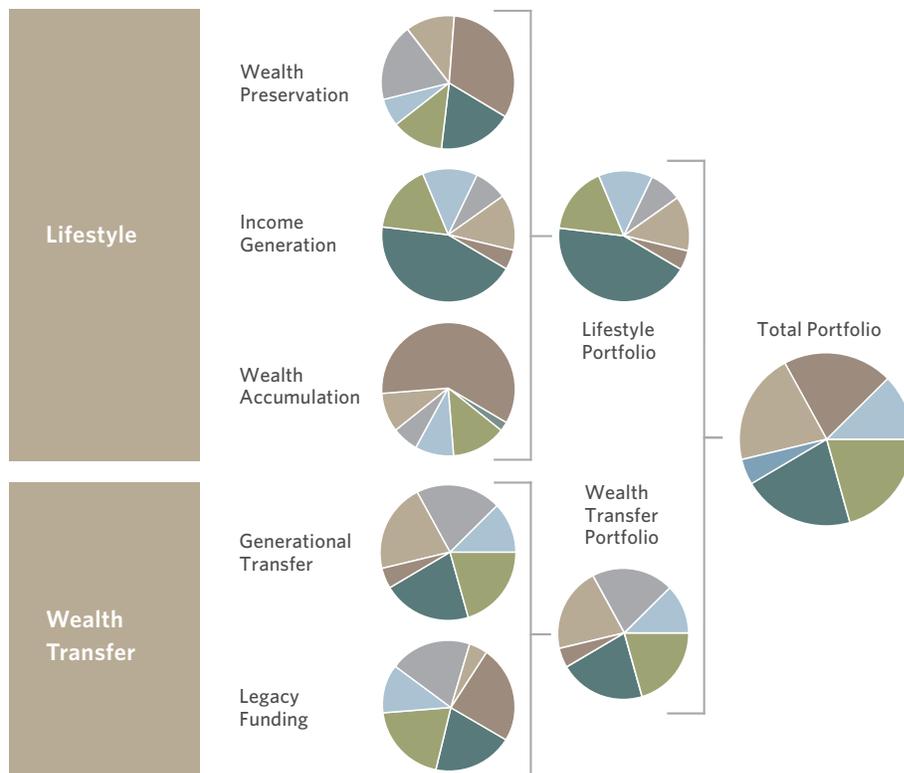
The Value of Objective-Driven Investing (cont.)

Based on this discussion, explicit portfolio goals, such as those reflected in Exhibit 2, can be identified, and work can begin on aligning assets and strategies to meet them. In doing so, the ability to accurately identify and forecast future costs and spending needs, and to address these within a tax-efficient portfolio, becomes critical. Selecting from various portfolio goals and allocations, as reflected in Exhibit 3, the appropriate dual-portfolio strategy can then be developed—a strategy that is as unique to each client as are his or her circumstances and objectives.

While objective-driven investing is a complex process, the end result can be profoundly valuable. By being more explicit about clients' true goals and the way strategies match up against them, advisors can better validate their advice and actions, and clients can remain confident that their strategies are right for them—in any market environment.

Exhibit 3

Objective-Driven Investing



Navigating this Critical Decade with Confidence

PUTTING IT SIMPLY, THE OLD WAY OF WORKING ISN'T WORKING. If your advisor thinks yesterday's approach can succeed in today's climate, you may want to consider the BNY Mellon Wealth Management approach. We would be happy to share more insights with you and answer any questions you may have. By working closely together, we can offer an unobstructed view of where you're heading and a better understanding of how you'll get there.

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