CFA Montréal

INVESTMENT PRINCIPLES

INFORMATION SHEET FOR CFA PROFESSIONALS

EVALUATING YOUR FINANCIAL NEEDS

THE ROLE OF ADVISORS

5A

IMPORTANT NOTICE

The term "financial advisor" is used here in a general and generic way to refer to any duly authorized person who works in the field of financial services, including the following:

- Investment brokers
- Mutual fund brokers
- Scholarship plan dealers
- Exempt market dealers
- Portfolio managers
- Investment fund managers
- Life insurance agents
- Financial planners (F.Pl.)

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THE ROLE OF ADVISORS

Individual investors face many obstacles when confronted with investing. Most lack the knowledge to evaluate their future financial needs and how to achieve them. Furthermore, they are prone to emotional reactions and rash decisions. Even though advisors have a better understanding of the subject matter than most investors, their primary role is not to forecast expected returns in financial markets (securities, indexes, asset classes, or factors) or to make calls on tactical asset allocation. Rather, it is to help investors establish an appropriate financial plan, communicate reasonable expectations, facilitate efficient implementation, and, most important, help maintain greater discipline.

ADVISORS ARE NOT FORECASTERS

We have already made the argument that investing is a zero-sum game before fees and that fewer than 30% of managers and products are likely to outperform a plain vanilla cap-weighted index after fees over longer horizons. Of this ratio of successful managers, some may even have outperformed by chance. The fact that some investors attempt to forecast expected returns and economic variables in order to outperform does not change these facts.

Forecasting is difficult. In fact, there is very little evidence that investors, managers, or advisors can, on average, appropriately forecast expected returns or significant economic transitions. For example, in a survey completed among economic forecasters by the Federal Reserve Bank of Philadelphia in November 2007, only 3% forecast an economic growth rate below 0% in 2008. Furthermore, some individuals were credited with forecasting the financial crisis, but their overall forecasting track record (before and after the financial crisis) is usually far from unblemished. Finally, in an industry where potentially tens of thousands of individuals will publicly express their financial and economic views, a few will always appear to have forecast some specific events. The more important question is: "Can we identify who, among

thousands of forecasters, will forecast the next significant event?" The evidence appears to indicate that it is unlikely for most.

Furthermore, numerous studies indicate that the average performance of individual investors is much lower than the passive return offered by a balanced indexed portfolio. According to the 2015 release of Dalbar's Quantitative Analysis of Investor Behaviour (QAIB), the average investor in fixed income and equities had an annualized performance of 3.51% over a 10-year period while the performance of the S&P 500 was 7.67% and that of the Barclays Aggregate Bond Index was 4.71%. Although everyone agrees with the principle of buying low and selling high, many investors convince themselves to invest in the market after a run-up and to run away after a crash. Having a realistic financial plan, implemented with discipline with the support of a trusted financial advisor, significantly increases the odds of success.

THE COMPONENTS OF SOUND FINANCIAL PLANNING

A good financial planner helps investors understand the relevance of:

- starting an investment plan early;
- setting reasonable objectives;
- maintaining savings discipline;
- building an appropriate portfolio at a reasonable cost;
- making maximum use of tax-efficient opportunities;
- establishing a rebalancing strategy (because forecasting is not the key to success);
- evaluating the role that life insurance and annuities can play in overall retirement planning;
- appropriately reviewing where the investor stands against his objective as time goes on; and
- making appropriate portfolio adjustments as the investor's situation and objectives change.

The advisor should have access to tools (software) and documentation to facilitate these tasks. The advisor must also help the investor understand that the choice of a portfolio allocation is the result of a compromise between:

- the asset allocation that is appropriate for the investor's objectives and time horizon; and
- his own ability to withstand short-term losses both financially or emotionally.

For example, some investors may have the ability to withstand financial losses and yet have emotional difficulties dealing with these losses when they occur. As such, the role of advisors is to educate investors in order to achieve, over time, a more appropriate balance between the rational and emotional acts of making investment decisions. Educating investors is also important because advisors will find that some investors may second-guess their advice as soon as the next market downturn occurs. This behaviour makes it difficult for investors to achieve personal investment goals and financial independence.

Investing is a tremendous challenge for individual investors. Investors who are capable of managing their emotions and have some expertise could do well on their own. But for the majority of investors, an advisor is required. Advisory services are not free but they help many investors avoid costly mistakes. We will attempt to evaluate the cost of poor decision making in document 5c.
This will help support the value of paying for proper advisory services. The role of advisors is to educate investors, coach them through the process of putting in place an investment plan, encourage greater discipline, and communicate rational expectations of what investors should expect. It is a tremendous challenge because many investors believe investing successfully is all about timing the market and finding the next Alphabet.