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What We Learned from the Market Collapse

By Carl Richards and *Financial Planning* staff

September 1, 2009

This month is the one-year anniversary of the fall of Lehman Brothers—and a good point to start reflecting on the lessons of the alarming Fall of 2008. Some of those lessons were universal—real estate prices really can fall nationwide; leverage is both a seductive route to megaprofits and a recipe for disaster—and others affected financial advisors most poignantly.

We all have spent the year learning in the harshest way what extreme environments mean, both economically and emotionally. From September to April, it was tough to be clear-headed, with frozen credit markets and an equity market so volatile that many investors felt paralyzed.

But now, as the markets slowly emerge from crisis and the bad news has finally relented, it's time to assess the impact of the economic turmoil. So *Financial Planning* asked leading minds in the industry to share what they learned during the past year. We start with a provocative essay by noted planner and blogger **Carl Richards**, founder of BehaviorGap, who muses on the nature of risk. In addition, you'll find wise observations and gauntlets thrown down by industry leaders and observers like **Michael Kitces**, **Chip Roame**, **Tom Bradley**, **Roger Ibbotson** and more. Read on, and share with us online: [What did the past year teach you?](#)

Carl Richards, Principal, Clearwater Asset Management
Founder, [Behavior Gap](#)
Salt Lake City, Utah

RISK IS RANDOM

I recently had a conversation with an engineer friend who works on problems associated with storing nuclear waste—pretty important stuff. At the time, I was trying to understand some of the statistical tools that make up the foundation of modern portfolio theory (MPT), including Monte Carlo simulations. Turns out, the engineer told me, he also uses Monte Carlo in his work to simulate the physical systems associated with storing nuclear waste.

I asked him how many years' worth of data he needed to feel confident about his conclusions. He said that nuclear engineers start to feel sort of, kind of comfortable with 200 to 400 years of data. Let's stop here for a second. The foundation of almost everything financial planners do, whether it's portfolio design, comprehensive planning or risk management, depends on data that starts in 1926 with the predecessor of the S&P 500. That is 82 years of data! Some of us have tried to stretch the data farther back into history, but it really isn't there.

Back to my conversation with my engineer friend. I asked him how he would feel about using 82 years of data to make decisions. Not from an ethical or moral perspective, but from a risk perspective. He replied, "I don't know how you sleep at night!" Since that day, I haven't slept all that well.

QUESTIONING THE FAITH

I started questioning everything. You see, I've been a member of the community of believers that took MPT theory as gospel. To me, it was settled doctrine and not up for debate. As [Russ Thornton](#), an advisor from Atlanta, recently pointed out, MPT is a theory accepted as scientific fact and elevated to religious status. I find myself questioning the faith. As I allowed myself the freedom to look at my assumptions objectively, I've been surprised at the degree to which I accepted MPT as the scientific way to invest when it is was really intended to be nothing more than a theoretical model. As an industry, we've treated MPT as a scientific law.

How did it happen? The root of the problem is our very human desire to find a way to make intuitive sense of the complex issues surrounding risk and return. With the uncertainty we deal with in this profession, we want

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a model that will help us accurately explain what is going on in our clients' portfolios, and help us frame, to some degree, what we can expect in the future.

This need to put a framework around risk and return, along with a desire for simplicity, led us to this deep, unquestioning embrace of MPT and planning tools based on similar statistical assumptions.

In fact, [Andrew Lo](#), director of MIT's Laboratory for Financial Engineering, names the desire "to capture 99% of economic behavior in three simple laws" a "deep psychological disorder." He calls MPT "physics envy," and says it has led us to want to fit this complex and uniquely human endeavor into a model that will help us make sense of it.

At the core of MPT is an elegant attempt to capture the uniquely human experience of risk and return in a bell-shaped curve. You know the bell-shaped curve your teacher used to grade you on in high school? It is the same model that works for height, weight and other natural phenomena. For example, if the average height of adult men in the U.S. is about 70 inches, with a standard deviation of 3 inches, then: (1) 68% of all men would be 67-73 inches tall, or within one standard deviation of the average; (2) 95% would be between 64-76 inches tall, or within two standard deviations; (3) 98% would be 61-79 inches, or within three standard deviations; and (4) almost no one would be outside of five standard deviations.

When data is distributed normally, it allows you to make sense of the world. In fact, in the above example, we can be pretty confident that you'll go your entire life and almost never run into a U.S. male that is over 85 inches tall—that is, 7 feet 1 inch—except on the pro basketball court. To run into one elsewhere would be very, very rare. It would be a five standard deviation event.

ANOMALIES ARE NORMAL

But what if you kept running into really tall people? If it happened often enough, you would be faced with a dilemma. Is the model wrong or is there something wrong with reality? (Hint: Chances are, it's not reality that's wrong.)

If you view the world through MPT, you keep running into really, really tall people. Here are some examples: Black Monday: Oct. 19, 1987. Before this particular Black Monday, the Dow's largest one-day decline was about 12%, in 1929. Then, on that one Monday, the Dow fell more than 20%. According to the MPT model, the chance of that happening was 1 in 10 to the 50th power. In other words, a decline that steep should never, ever have happened. But it did. The Asian Financial Crisis: On Oct. 27 1997, the Dow fell more than 7%. Chance of that happening: one in 50 billion. The Russian Crisis of 1998: August 4, the Dow was down 3.5%, three weeks later down 4.4% and then again on August 31, down 6.8%. Viewed through the lens of modern portfolio theory, the odds of that final event was one in 20 million, the odds of all three in a single month: 1 in 500 billion. Tall people everywhere!

But the past is nothing compared with what we have just lived through: In 2008 alone, we lived through four days that simply couldn't happen. Four days with declines so large that they were statistically impossible. After each of these events someone came on CNBC and said something like, "Our model wasn't wrong, reality just didn't conform to it."

Maybe, just maybe something is wrong with the model. Maybe there is nothing standard at all about risk. Maybe there is nothing normal about returns. Maybe risk is not like a little dial we can control on clients' portfolios like we tune in a radio...Or maybe, just maybe, reality is wrong.

Roger Ibbotson, Founder, [Ibbotson Associates](#)

Professor, Practice of Finance, Yale University, New Haven, Conn.

What struck me is that the volatility of markets could rise so much. We had the same sort of volatility in the 1930s, but after World War II, the markets quieted down. The year 2008 was the second worst in history, back to the 1800s even. It was a surprise that we would return to that kind of volatility, but it happened. Now it's damping down.

I wouldn't say the market was broken, but parts were, like credit default swaps and mortgages. The banking sector was breaking. The counterparty risks were broken. The market was trying to assimilate the vast amount of uncertainty in the other instruments.

So personally, yes, the recession affects my income and wealth. But for the most part I look at this as a very interesting time to be in. I didn't live through the Depression. Having this crisis stresses us, but as an economist it's extremely interesting to see these sorts of things happen and to have live examples of what we can actually do about it, and how the economy reacts—and that you could have these kinds of collapses.

It leads us to question the invisible hand of capitalism. We've learned another lesson and we're going to pay for it, plus all kinds of regulation and excess spending. I'm afraid all the regulatory authorities are subject to a lot of political pressure. They have bureaucratic procedures in place, but they're lobbied in various ways. I would rather have simpler regulations, some transparency. If the SEC could just provide some transparency

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and catch fraud, I'd be happy. They haven't done it in the past. Maybe they'll be better now.

For consumer protection, if you make things as transparent as possible for consumers and restrict them from certain activities without qualifying, that would be okay. Think of a new issue, say an equity. Right now, it has to have all these warnings. Once you start having so many warnings, people ignore it. One warning, like on a cigarette box, is hard to ignore.

The more warnings you make, the less likely people are to respond to them. That's the problem. You'd like to have a few, very salient warnings, but not a big bundle. Maybe they'll recognize that, as economists do. Behavioral economists are beginning to study salience, and what kind of information people react to. Unfortunately, agencies and Congress are essentially made up of lawyers, and lawyers think that a page of dense boilerplate is somehow informative.

Lee Baker, Founder, President
[Apex Financial Services](#), Tucker, Ga.

It's my hope that one of the consequences of all of this mess over the past year is that more of America begins to recognize the value of financial planning. If we are going to champion the financial planning process and say there is value in it, then we should charge for it. And I hope that the rest of America sees that.

Financial planning has been mostly just for the wealthy, the top 15% of the country or so. But there is significant value in doing planning for all of us. Sure, for the bottom 15% to 20% there is no viable business model, but for that 60% in the middle, those people need financial planning perhaps more than the people at the two ends of the spectrum. And there are certainly viable models to serve them.

All the folks in the middle access lawyers, doctors, dentists and CPAs, but they don't access financial planners in significant numbers. There are CFP programs all across the country doing a great job of bringing in these students. But who are going to be their clients if we do not do something that says, "let's begin to broaden our reach"?

I hope that folks who don't have millions are realizing that all this [loss of investment value] has done some damage to their retirement plans and that they need financial planning. It's necessary for the industry. Otherwise, without more consumer demand, it will impede our progress toward being seen as the professionals we want to be seen as.

Diahann Lassus, President, [Lassus Wherley](#)
New Providence, N.J.

[NAPFA chair](#), 2009

I don't know if there's so much a change in the industry as a change in how we view the industry. Many of us in the financial planning profession have much less trust in institutions; that's changed the way we view investments and companies. We tend to question things more than possibly in the past. I think it has caused myself and the folks in my company to step back and see what we need to do differently in terms of running our business, and working with our clients based on the underlying issues, including the global economy.

One thing I say to clients a lot is that if it seems too good to be true it is. And the other is that just because you can do something doesn't mean you should. The bottom line is that even the professionals got really spoiled in the market from 2003 until the fall of last year, and probably didn't do a very good job of seeing the signs of the underlying issues within the mortgage industry, with toxic securities and those sorts of things.

The biggest lesson I hope the brokerage industry and those people who produce creative products learned is that there are always unintended consequences. The fact that you can create a product that in the best of all worlds does something really good and can give you certain levels of return doesn't mean you should—because you truly don't understand how all of those things interact. You can't create a computer model that takes all of those things into consideration. We had a lot of unintended consequences that came together at one time.

The bottom line is we've all seen a need for more transparency, more accountability for products that are sold and advice that's given, and for people who run these large companies to focus on something other than short-term profits. If they don't, we all pay the price.

In the last year one of our top priorities [at NAPFA] has certainly been regulatory reform and working with the Financial Planning Coalition to establish regulation of financial planning, so we can raise the fiduciary standard and make sure it is not watered down.

We would like to see other groups and their members who believe in the financial planning profession also participate in that conversation. I testified for the Financial Planning Coalition a couple of weeks ago before the House Committee on Financial Services and that was an amazing experience. The fact that we were there makes a very strong statement.

Charles "Chip" Roame, Managing Principal
[Tiburon Strategic Advisors](#), Tiburon, Calif.

Nothing ever works out the way people predict. I don't know what's going to happen, I'm just positive that it's not going to be a smooth line. People are saying that every broker is going to break away and that every one of them will be independent. Well, there are 90,000 wirehouse brokers and 52 left. And that's the trend we're talking about? Really? Find a real trend.

When you have a crisis like the one we've had over the last year and a half, you have a reversion to simple business models. Index funds will grow. Money markets will grow. Discount brokers will grow. Fundamental, simple things will grow. What won't grow are collateralized mortgage-backed securities, structured debt deals, the IPO market. It's the same every time.

So what have people learned? Geez, they're learning the same damn lesson they learned last time we had a recession—not much. Twelve months from now, they'll be doing all the same crazy-ass shit again. The banks will be selling leveraged funds out the ying-yang again. I don't know when, but they'll grow—and then they'll blow up all over again.

James Roumell, Founder and President
[Roumell Asset Management](#), Chevy Chase, Md.

If you go back to the fourth quarter of 2007, there was a question of whether we should be worried given the volatility, but things stabilized so quickly it was kind of like being on a roller coaster where you go down, but you come right back up. And then 2008 was just another fall and people got really whiplashed.

There were months in 2008 when there was absolute fear and panic about whether people were going to make it and be able to retire. We had instances where we had grown people crying on the phone. Now there has been a tremendous amount of relief. We rarely hear from clients anymore. In fact, we're getting a fair amount of new money and that's kind of the scary thing.

We came out at the end of 2008 with a dedicated fixed-income portfolio, very much focusing on high-yield debt. People were still scared, but we got the brave and mighty, and the money came in. It's done extremely well. Now, many of the people whom I was trying to raise money with in the first quarter want to open up accounts today—after a 30% high-yield run. And that's where things in fact feel like the more things change, the more they stay the same.

I am flabbergasted that we are fielding calls pretty regularly from people wanting to open accounts. They feel it's safe now. I'm surprised how quickly people will put aside risk. We're built a certain way psychologically and I guess it's just fear, greed, fear, greed, fear, greed. Frankly, we're wrestling right now with whether we want to put a moratorium on taking new money.

Larry Swedroe, Principal and Director of Research
[Buckingham Family Services](#), St. Louis, Mo.

The biggest mistake investors make is treating the highly unlikely as impossible (such as having a massive crisis), and the likely almost as if it's certain (such as the probability that stocks will outperform bonds over 20 years). Thus, they end up taking more risk than they should and when the risk shows up, as it did last year, their plan blows up.

This was the third 50% drop for the Dow since 1953. The problem is that most advisors fail to tell their clients it can happen again. They don't show clients the history, walk them through it and make sure they understand the risks—and that they've considered a plan B.

Think about Pascal's wager [in which the consequences of being wrong far outweigh the benefits of being right]. The consequences of going from rich to poor should dominate asset allocation decisions. You don't think you're going to get laid-off or that the price of your house is going to drop significantly, but that's irrelevant. It could happen. If you have \$10 million, turning it into \$20 million doesn't really change your life. But going from \$10 million to \$3 million, or \$3 million to \$1 million, can change it dramatically.

You need to have a plan with the virtual certainty that you'll have big bad bear markets at some point. There's a 90% chance that if I'm 80% in equities, I'll be all right. There's a 5% chance of failure. If that 5% shows up and I can't make it, that's a bad asset allocation. We need to think of the plan B: I'll retire later, or I'll buy the cheaper car. But most advisors don't even discuss plan B's with people. They dismiss it or say don't worry about it. Then the plans blow up.

Michael Kitces, Director of Financial Planning, Pinnacle Advisory Group
Publisher, [Kitces.com](#), Columbia, Md.

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On the practice management side, we've learned that maintaining reasonable profit margins and learning your business as a business is required. Otherwise, in an environment like this you can't survive. Through the past year, good business management skills were necessary: understanding how to maximize efficiency of your staff, and how to set appropriate fees for clients and compensation for staff, with flexibility when you need it.

People certainly absorbed some school of hard-knocks lessons. People who have flexible compensation systems pay advisors a portion of compensation based on incentive goals, so in a bad year they don't have to pay them as much. You get crushed as an owner if you pay people the same dollar amount each year. Significant salary cuts. It might really be the same thing, but with flexible compensation it's part of everyone's expectation that you won't make as much during the bad times, so cuts won't be experienced as negatively.

A lot of people tended to look at profit margins as how much to be taking out of the business, versus a buffer for bad economic times. If a firm's profit margin was 15% of revenues, and revenues go down by 15%, you have to put money into your business to keep it afloat or fire people, etc.

Advisors are also realizing the holes they dug for themselves in terms of fees. Fees have to have some bearing on the amount of work you do for clients. A lot of advisors underpriced their services and counted on a lot of clients not wanting a lot of attention. But during a bear market, you will find yourself working much harder for the same compensation. It's important to be more cognizant in setting up services and pricing, so figure out what the cost of your time is. You also need to make sure it's possible to deliver the amount of services you promise in the amount of time you have.

Some advisors are going out of business and some will work all of 2009 basically for no business. You can't necessarily change a lot of this after the fact, especially after people are going through a crisis. Next time, advisors will make sure they have more flexibility.

Muriel Siebert, Founder,
[Muriel Siebert & Co.](#), New York, NY

I shouldn't say this, but I learned I was right. I testified about derivatives in 1988, in 1998, after Long-Term Capital, and after Enron. I have said and written that, No. 1, we have truly global markets and regulation must be global. People who can't borrow enough money here go to London. If I had my way, the head of the SEC would make the rounds of all the global regulators. Mary [Schapiro] might well be doing it.

How did CDOs get so big and why did we not know who had them? And how many did they have? I've seen estimates of \$30 trillion to \$70 trillion overall, a big range. The numbers are vast and they should be registered. We have to know what we have, what kind they are, who owns them, what percentage do they represent. We have to ask basic questions. I cannot believe—I don't want to believe that in this environment, if we started to contact other countries, that they would not say yeah, we want to be part of this. You can't do it on your own.

The lessons are clear: We know there are new products, we don't know the entire ramification. We're going to have to learn it. You don't want regulations just to have regulations, but we have to see what damage these people could cause and what we can do to stop it, or put our arms around it, so we can regulate it. Are people too leveraged? What are the systemic dangers? What can we do to take those dangers out of the system?

If derivatives had been registered, we would have known what dangers were out there and people could choose whether to do business. You have to know the numbers. There's nothing wrong with that. I'm not saying to regulate, but you look at it first and you analyze it. There's got to be an acknowledgement that these things do come with risks. Real people get hurt and it rubs off on the little guy.

Tom Bradley, President
[TD Ameritrade Institutional](#), Jersey City, N.J.

There are two main things. No. 1, that our business model validates our philosophy to run a clean, conservative, strong business and balance sheet. And No. 2, that you should resist the temptation to go farther out on the risk spectrum to get a little more yield. Or at least if you do that, you had better make sure that you're hedged or well diversified.

When you are in business and competing, it might look like somebody is ahead of you, so you'd better make sure that you understand why and make a decision—if the reason is that they are farther out than you are comfortable with, be careful. Investors learned the risk lesson when the Internet bubble burst and have relearned that lesson.

We stuck to what we're comfortable with and our top priority, which is safety and security of custodied assets. That worked for us.

When you look at how we're all regulated, there needs to be financial reform. We have to work to eliminate politics and make sure, for example, that the SEC has the resources and focus it needs to do the job. On the

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fiduciary versus suitability issue, we believe that we need to maintain a high fiduciary standard for RIAs and anyone purporting to give full-blown advice, especially discretionary advice.

We believe in suitability in certain scenarios. Suitability works for an individual who is simply selling securities and products, for example, selling a stock, bond or mutual fund. Under that scenario, a significant number of full-commission brokers would probably fall under the fiduciary standard, but many others who operate as old-fashioned stockbrokers, such as brokers at TD branches, would fall under suitability.

Ken Dychtwald, President and CEO
[Age Wave](#), San Francisco, Calif.

There's been an existential reckoning. Everyone has been knocked back against the wall. We've all been forced to think about our lives, futures, expectations, hopes and fears. One of the lessons that has been most powerful for me: Life is not nearly as predictable as we thought or wished it could be.

How could things have happened like this? How come Alan Greenspan missed it? How come Jim Cramer told everyone to take their money out of the market? We live in an era where people have some degree of mastery of life and the forces of nature. But like a tsunami that appeared, to some, out of nowhere, this reckoning took many by surprise.

I know this is going to sound hokey, but I also think for those of us born after World War II, this has been the most rugged storm we've had to endure. At the same time, we realized that it's not nearly as hard as what previous generations had to struggle through. For all of our discomfort and unfamiliarity with these situations, what is worse: Not being able to go on vacation, or going off to fight in Normandy?

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