

THE IMPORTANCE OF FINANCIAL PLANNING

"If you don't know where you are going, you might wind up somewhere else"
– Yogi Berra

Someone in the financial planning industry once said that the average person in the UK spends less time planning for their financial future than they spend planning one year's holiday.

While we don't know if this assertion is true, there is a fair amount of evidence from the UK market to suggest that it may be. There are typically a number of reasons why people are reluctant to plan for their financial future, but in our experience the primary reason is that they tend to confuse the *process* of planning with the *end product*, a financial plan.

Let's take a brief look at the distinction.

Viewed in isolation, most financial plans will likely turn out to have parts that become inaccurate over the long term due to the effect of unforeseen events. But while the ultimate long term accuracy of any single financial plan may be limited to some degree, the ongoing *process* of financial planning is vitally important. Why?

Creating a traditional financial plan begins by making a large number of assumptions which typically include, among other things, expectations for the long term rate of inflation, the average return on investments, the potential volatility of investment returns, tax rates, how much you will save over time, the age you intend to retire, how much you will spend in retirement, whether you will incur extra health care costs as retirement progresses, and even when you are expected to die. Anyone who has been through this process knows that it can sometimes be uncomfortable because we must face a number of potentially difficult life issues that we might prefer to leave lurking in the background. Procrastination is also made easier because intuitively we know that no matter how hard we try, over time even the best financial plan may turn out to be wrong in some areas. This is one of the cruel ironies of long term financial planning: we simply do not have all of the information we need when we start out. But this is true in any endeavour, whether we are starting a business, charting a career path, or building a financial plan.

If we can accept the fact that that a well constructed financial plan is really only our current best estimate, we are freed to focus on the critically important *process* of planning instead of endlessly ruminating over the assumptions. It is certainly necessary to chart a course for where we think we want to go, and this requires us to make some assumptions about the future. But we must remember that at best these assumptions are just educated guesses – we need to make them and move on.

A good analogy is to think about a sailboat making a sea crossing. The journey plan amounts to the sea captain's best educated guesses about many variables such as wind speed, weather patterns, the tides, the size and weight of baggage on the ship, etc. But no matter how much time the captain spends on the plan, the actual journey is unlikely to follow the charted course precisely. There are simply too many variables to predict in advance and therefore the key to

the captain navigating a successful crossing is in his or her ability to *make consistent small course corrections* in response to events that occur along the way.

When it comes to financial planning, once you have a good general idea of your personal destination and how you are going to get there, your focus should shift to the specific actions you can take to help get you there. Using shorter time frames when planning specific action steps helps one to get fully involved in ‘the answer’ rather than constantly fretting and delaying about ‘the problem’ (which is mostly comprised of a large number of unknowable macro-economic and other variables that are out of your control).

Successful financial planning and implementation therefore boils down to four key points: (1) don’t dally - set a course quickly, (2) realise that over time your plan may well turn out to be inaccurate in some areas, (3) over time methodically review your progress against the plan, and (4) always be ready to make course corrections in response to changing circumstances.

The Annual Financial Review Process: Keeping on Course

Everyone knows it is important to get an annual service and check-up for your car. A good garage will check everything, change the necessary parts and advise you what is likely to need attention over the coming 12 months. All this helps to ensure trouble free motoring over the long term.

A similar process is required to keep your financial plan current. To put it bluntly: a lot can happen in a year. Markets change, phone numbers change, beneficiaries change, tax laws change, and your life changes. A quick trip to your financial adviser for an annual check-up can go a long way to making sure that your plan stays on track. Some key areas worth reviewing on an annual basis usually include the following:

Is your net worth growing? This is one of the best barometers of your financial health, and systematically reviewing it can help a skilled financial adviser gain insight into whether a longer-term problem may be emerging. Importantly, a decline in net worth isn’t necessarily a bad thing – the key is to understand why it has declined and how this change fits in with your stage of life and your long term financial goals.

How are your ratios? A skilled financial adviser will also know when it may be appropriate to look at certain other target ratios such as your debt-to-income ratio, your savings rate, or the amount of your liquid contingency funds. The targets for these ratios will vary depending upon your stage of life. For example, the target debt-to-income ratio for a young executive aged 35 will likely be different from that of a 65-year old retiree. Again, each personal situation is different – one size does *not* fit all.

Are you spending more than you earn? In our experience, the biggest problem here is that people often have difficulty consolidating and organising their financial data in an easily manageable format. The result is that they simply don’t know ‘where they stand’. A good financial adviser can help you organise and manage this aspect of your financial life.

Are you still adequately insured? Updating your lifetime cash flow forecast for any changes that have occurred can help a skilled financial adviser identify any new requirements. Again, the best insurance strategy will vary depending upon your stage of life.

What has changed in your life during the last year? Big life events can disrupt even the best financial plan. Getting married, having a child, getting divorced, retiring – all can have a material effect on many aspects of your financial life such as inheritance tax planning, investment risk tolerance, insurance planning, etc.

How well are you sleeping at night? The financial crisis of 2007-2008 reminded many investors that perhaps the most common investing mistake is to over-estimate your emotional tolerance for market volatility. The truth is that global financial markets have always been very volatile. The key is to work with your adviser to ensure that the level of volatility built-in to your portfolio remains within your tolerance even in scenarios where the market experiences extreme shocks of the kind that occurred in the recent crisis.

And finally – have your outlook or goals changed? Are you happy? At its core, financial planning is not simply about money and investing. It is actually about finding the best way to finance what you really want out of life, whether that is spending more time with family and friends, changing careers to focus on the type of work that inspires you, travelling, becoming involved in philanthropy, etc. A good financial adviser will use the annual check-up to help make sure that you are working towards what is really important to you.

How Does Investment Strategy Fit Into This Picture?

In previous newsletters, we have highlighted the fact that much of the financial services industry works on a business model that actually encourages people to take precisely the *wrong* approach to managing their financial future. A harsh volume-driven sales culture leads many financial services firms to adopt a position which in essence amounts to “we don’t really know what your life goals are, and frankly we don’t care, because the answer to all of your problems is to buy this hot new investment product (on which I will receive a big sales commission).” The industry marketing machine dutifully produces a never-ending stream of ‘fashionable’ new funds and products that are presented as ‘timely solutions’ for whatever the dominant investor emotional concern of the moment may be. And most ultimately rely on the age old sales lure of offering the investor something for nothing (high returns without high risk). The well documented history of mis-selling scandals in the UK provides a solid testimony to the very deep flaws in the traditional industry business model.

What can you do to avoid this type of pitfall? We would like to close this letter with a reflection on what constitutes good investment advice and how clients can recognise it when it is offered to them.

First, good investment advice is about structuring an investment strategy that is *right for the individual*, not one that reflects what the adviser is trying to sell or what will earn them the biggest commission. *The right investment strategy has to support the long term financial plan, not drive it.* It is also critically important to match each individual’s appetite for risk.

Second, good investment advice is *not* about trying to forecast the market or trying to guess which fund manager will be lucky enough to ‘beat the market’ next year. Study after study repeatedly shows that there are far too many unforeseeable variables in the markets, and that over the long term strategies which aim to out-smart the market with pseudo-scientific models simply do not deliver statistically reliable results after adjusting for the amount of risk they take. In contrast, the best and smartest advisers are not those who seek to divine what will

happen next in the markets – rather they are the ones who help their clients to make smart decisions about their money and help them to secure an appropriate long term capital market rate of return for the level of investment risk that they are willing to take.

Third, good investment advice is about structuring a portfolio around risks where there is a clear identifiable relationship with return. The history of mis-selling scandals in the UK mostly results from people not understanding (or not being told about) the sizeable risks that they were taking in order to chase high returns that they thought were ‘guaranteed’.

Fourth, good investment advice means ensuring that investors clearly understand what they are investing in and that the management of those assets is conducted with full transparency and integrity.

Fifth, good investment advice means being direct and honest with clients about what they can and cannot control. If an investor wants to earn long term equity-related returns to help them achieve their financial goals, there is simply no way for them to avoid being exposed to a market downturn if that occurs. However, a smart long term investor can control and mitigate certain risks by focusing on controllable factors such as the level of fees being paid to fund managers and custodians, taxes being paid by the underlying funds, and the underlying degree of diversification in their portfolio.

Note: With respect to managing costs, we are pleased to confirm that from January 2011 our clients will benefit from a reduction of custodial fees. Transact (our current preferred provider of custodial and administration services) will implement a fee reduction of approximately 8.3% in January 2011, with a further 8.3% reduction to be implemented in January 2012.

And finally, good investment advice means keeping investors disciplined in their chosen asset allocation, *even when the markets are going against them in the short term*. Falling prey to short-term anxiety and dumping assets to ‘run for shelter’ in a difficult market will almost never result in the best long term results.

Fensham Howes in 2011

As 2010 comes to a close, we want to thank you for your ongoing confidence and support. While the current environment has presented challenges for some firms in the financial services industry, we continue to expand and over the last 12 months we’ve grown our business by approximately 30%. Enquiries are also up, due mainly to the referrals we continue to receive from our existing clients, for which we are always grateful. We are continuing to find that an increasing number of investors are responding enthusiastically to a philosophy based on comprehensive financial planning and supported by an investment strategy that utilises hard analysis and transparent information.

We wish you our sincere best for this holiday season and the upcoming year. As always, please do not hesitate to contact us if you have any questions or require any additional information.