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Four Steps Advisors Should Take to Prepare for Any Market Environment

Just as people plan for the end of summer and the onset of winter, financial advisors should help clients to review and construct all-weather portfolios.

By Scott Rawlins

For most people in the United States, summertime is a season to be savored, particularly as the prospect of winter storms seems farther away than at any other time of the year. The month of September becomes a time to start preparing for inclement weather, especially for residents of the East Coast or Midwest.

Just as people plan for the end of summer and the onset of winter, financial advisors should help clients to review and construct all-weather portfolios. Of course, a key distinction is that we know with certainty when summer will end and with reasonable confidence when the weather will change, but we cannot simply look at a calendar to determine when market volatility will arrive and a bull market will end.

With an aging bull market, more and more investment pundits are making a prediction that we are overdue for a market downturn and are urging investors to take action now. Based on a naïve review of market history and the frequency of market downturns, these pundits are correct – we are overdue for a correction of at least 10%. Corrections of that magnitude occur, on average, once every two years, and we have not seen a 10% correction in U.S. large companies since the middle of 2011 – about three years ago.

To lend credence to their market predictions, pundits like to point out all the things that are wrong in the world – geopolitical unrest in the Middle East, disappointing growth and credit concerns in China, a slowdown in the European Union, a bloated Federal Reserve balance sheet which basic economics suggest should spur inflation, a fearful expectation that interest rates will soon begin to rise, and other mixed economic data here and abroad. These are concerning developments, but throughout history there have always been macroeconomic pressures. Some have resulted in down-turns, others have passed with limited impact.

Financial advisors have to be careful to evaluate the difference between a historical probability and near term certainty. History tells us we are overdue for a 10% correction, and probability tells us we likely will experience multiple corrections over the next 30 or 40 years. Furthermore, any of the macroeconomic factors pointed out by those calling for a downturn has the potential to escalate and spur volatility. However, we cannot look at history or any of these factors and know with certainty *when* a correction will occur, only that it *will* occur at some point in the future.

Are markets teetering on the edge of a cliff, needing just a nudge to fall into an abyss? Or can the bull continue to run, sometimes pulling, sometimes pushing along a fledgling recovery? Will interest rates start to rise this year? Early next year? How much will rates rise if and when they start to increase? Can Japan manufacture a recovery? Can Europe put differences aside and work together for the good of the union?

The point is, we don't know, and yet financial advisors are tasked with a responsibility to help clients navigate and invest through an always uncertain environment. Therefore, here are four key actions we believe advisors should take as they prepare to meet with their clients for forward-looking planning.

1. **Behavior Modification** – Clients are likely to think in terms of rate of return in comparison to benchmark performance broadcast on financial news (or worse, the rate of return that neighbor

Joe says he achieved). However, it is important clients understand that a rate of return is not the goal. The goal is to be able to retire and live off the accumulated capital. The goal is to save for and pay for college. The goal is to be able to afford to travel. To refocus clients on what is important, sit down and work through a financial plan, defining the important checkpoints in time which will ultimately determine whether the plan was a success. Once goals are defined, the focus can shift to annual progress towards the goal instead of market performance.

2. **Establish an asset allocation based on the probability of success** – Various financial planning solutions today incorporate tools to predict a range of outcomes based on an investor's asset mix and expected cash flows. These tools can help clients to establish a suitable long term allocation and to focus on probability of success or failure over their time horizon. Importantly, these plans can be revisited annually to track progress and make adjustments in savings or spending rates. It is within this step that advisors should also consider current valuations and whether any near term risks should be hedged (interest rate risk, as an example) in order to start the plan along a reasonable trajectory.
3. **Plan for short term downturns** – Long term investing requires weathering the inevitable short term downturns. Therefore, it is important that a client have a source of liquidity that is adequate to meet their needs over the short to intermediate term. That may be as short as six months, or as long as multiple years' worth of living expenses. Knowing that short term needs are covered can provide peace of mind for clients and also means the investment portfolio can be left alone to recover following a downturn.
4. **Keep a constant eye on taxes** – Every investor has a silent partner in Uncle Sam, ready to take his share of investment returns. Careless investment decisions can result in unnecessary taxes which will reduce the lifetime value of an investment portfolio. The truth is that nearly every investment decision is also a tax decision, especially with changes in the tax code over the last few years. For advisors with tax expertise, taking taxes into consideration should be a natural and seamless part of the financial planning process. For others, navigating the tax code might be a little more complex. If that's the case, advisors should coordinate and attend regular meetings between clients and tax professionals to make sure everyone is on the same page.

Ultimately, clients may not want to know about all of the details behind the factors that are driving markets up or down. In fact, some may not even care that intensely about how their portfolios are performing at any given moment of the year.

What clients do care about is making progress towards meeting their financial goals and objectives. For financial advisors, the four steps outlined above offer a way to help clients put in place a plan to pursue goals without requiring certainty in near term market results.

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