The Four Top Investment Strategy Challenges for Financial Advisors

By Susan B. Weiner, CFA
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One year ago it seemed as if the good times would never end. Today, many investors go to bed wondering what bad news will greet them in the morning. In this volatile environment, *Advisor Perspectives* asked financial advisors to identify their greatest investment strategy challenges.

Biggest Change: The Need to Diversify

Rising correlations of returns across asset classes makes diversification a challenge, said Eve Kaplan of Kaplan Financial Advisors. That's particularly true across traditional asset classes, potentially limiting the risk-reducing benefit of diversification.

Many advisors concur. Kevin Brosious of Wealth Management, Inc. says "You can no longer use just US bonds and US stocks when building a portfolio. Long-short funds should be part of the mix, [along with] US and International REITS, Treasury Inflation Protected Securities (TIPS), private equity, International and Emerging bonds." There's no going back to the simple world of U.S.-only investing. [Ed. Note: See our recent article on this subject.]

Brosious focuses on asset classes that are available as mutual funds or ETFs. Some advisors are taking diversification one step further. Todd Rustman of GR Capital Asset Management said, "I think the core/satellite approach becomes more and more important for getting alpha outside the normal exposures. We are looking at managed futures and switching more and more to ETFs for the core exposure."

Kipley Lytel of Montecito Capital Management is also broadening his clients' diversification. "We are 45% allocated to alternative asset classes, such as private hedge funds, mutual hedge funds, private equity and other private alternatives. We hold 10 asset classes, while the traditional investment advisor typically suggests 2-3, like stocks, bonds and REITS. However, we side with the Harvard and Yale Endowments and fully endorse their institutional approach to weather the current and foreseeable storm." Lytel is motivated partly by a conviction that U.S. asset classes are fairly valued or overpriced based on risk.

Of course, investing in alternative asset classes brings its own challenges. There's not only due diligence, but also the challenge of gaining access to leading managers. Given the capacity constraints on alternative asset managers, there's lots of competition to invest with the best. [Ed. Note: See our article on hedge fund investing for advisors]

Adrian Cronje of Wilmington Trust likes investing in alternative assets. He also recommends investing in asset classes that can deliver real sustainable earnings, like inflation-linked bonds, real estate securities and commodities that offer a hedge against inflation.

Inflation and Interest Rates

Speaking of inflation, "We have a nasty combination of plunging interest rates and rising core inflation expenses. This is enough to give any planner and client a migraine," said Kaplan Financial's Kaplan.

Jason Whitby of Investor Solutions believes that "Too many people are trying to retire too young in a low yielding environment with rising costs." This can't work when low interest rates are sapping returns on cash, fixed income, and annuities, especially not when combined with rising life expectancies and inflation. There's no easy solution.

Jeb Collier of D. L. Blain & Co., LLC, said, "Our biggest challenges are the prospects of being in a secular bear market, rising inflation, and low prospects for bond returns."

Credit Risks Abound

Advisors used to feel they could trust the analysis performed by major rating agencies. No more–at least not when rating complex debt securities. "How valid is an AAA or AA rating on some fixed income securities? The reputation and credibility of credit agencies has been cast to the wind," said Kaplan.

Morris Armstrong of Armstrong Financial Advisors agreed, saying, "Any ratings that are not for plain vanilla instruments may later be deemed inaccurate. From both an advisor and investor's point of view, it is becoming more difficult to truly understand all the risks inherent in many of the debt instruments." He copes by not investing in complex instruments.

Clients and Their Emotions Pose Biggest Challenge

The biggest challenge to investment success currently facing advisors isn't—strictly speaking—an investment strategy issue. Too often, clients panic and want to get out of volatile markets at the worst possible time. Mark McNary of The Gensler Group said, "For our firm, the biggest challenge is preventing our clients from making a rash, emotional decision to alter their long-term strategic allocation."

His comment was echoed by many other advisors. For example, Michael Flower of Financial Principles, LLC, said, "Between all of the bad news that you see on the TV and clients' expectations, it is difficult to stick with asset allocation and a diversified portfolio." According to Burk Rosenthal of Rosenthal Retirement Planning, "A few of [my clients] seem to think the world is coming to an end and therefore they must get out of the market (or at least make a major shift in their asset allocation) at all costs."

Even an advisor who made a successful shift into cash in July 2007, like Ted Feight of Creative Financial Design, said "The biggest problem is doing the right thing at the right time, even if you have a clue when that is…. When you start to buy back in, some clients do not understand this and want to fight your calls, as to when to buy back in."

Ron Rhoades of Joseph Capital Management, LLC, is also working hard to ensure that clients stick to their recommended approach of strategic asset allocation with targeted rebalancing. "Each year we have endeavored to educate our clients, repeatedly, that "the markets don't always go up" and to always "buy low, sell high." For the most part we have been successful. Over 98 percent of our clients have accepted our recommendations this January and February to rebalance their investment portfolio, which often involved selling fixed income investments and buying equities (in our case, low-cost, institutional stock mutual funds)."

Some of the greatest challenges facing advisors are ongoing, like human nature. Others—like alternative assets—are new but may become permanent fixtures. Yet others may shift with the changing tides of markets.

Susan B. Weiner, CFA is a writer-editor specializing in investment and wealth management.