FLIPPIN, BRUCE & PORTER
Investment Counsel

FaceValue℠
Building business through knowledge

Wisdom or Babel

Use the power of language to manage clients and build your business

Investors need your guidance. A Spectrem Group research survey found that only 31% of retirement plan participants felt they had a well-defined strategy for investing their plan money. But in a world of information overload, how do you make yourself heard and understood, and successfully capture and keep your clients' attention?*

**Source: Spectrem Group, "Trends and Insights," May 2007.*

If clients listened only to you…

"What we have here is…failure to communicate."

It's a classic line from the movie "Cool Hand Luke." But the quote could just as easily sum up one of the greatest challenges in managing investment portfolios or running an advisory business: effective communications.

Listening to your clients. Educating them about basic and advanced investment concepts. Establishing realistic expectations. Crafting personalized investment strategies designed to address individual goals, time horizons and risk profiles. And most fundamentally, gaining the respect and trust of clients, so together you can achieve specific objectives. All of these critical tasks require constructive communications between you and your clients.

Is it reasonable to assume then, that a clear, unimpeded channel of communications exists between you and your clients?

Oh, if only your job were that simple.

If you've been a financial advisor for any length of time, you've learned that clients are influenced by a wide range of allegedly dependable "advisors," such as:

- **A brother-in-law who works at an Internet start-up that's seeking private investors.** When you take a look at the company, you discover it has no customers, no market share, and no product. What it does have are lots of ways to spend your client's money.
- **Friends who have invested in high-yield, subordinated debt.** Neither your client nor his friends understand the risks involved, and don't realize that "subordinated" means "last to get paid" in case of default.
- **A television "expert" who claims his proprietary, stochastic-driven, ultimate oscillator algorithms portend an imminent market crash.** Your clients don't understand what the guy is saying. Nevertheless, your frightened clients insist you move all their money to CDs, while on the flip side, greedy clients want to short the market.

Investors today are buffeted by an avalanche of information — some of it confusing, much of it conflicting and a good deal of it clearly inappropriate for your clients and their financial objectives. Clients don't listen just to you and they don't follow your recommendations alone.

Therein lies your challenge, and your solution: By adopting a straightforward approach, setting expectations and establishing an effective communications plan, you can build productive relationships with clients — to educate and inform them, and help them understand how the expertise and services you offer can enable them to achieve critical goals.

Scientific jargon can compromise investment decisions

Friends and relatives who offer financial advice may mean well, but their knowledge often is limited, and their recommendations can be ill-advised. Professional pundits — who use every media outlet to air their prognostications — may know what they are talking about, but are motivated more by commercial considerations than an honest desire to help clients build wealth.

Even experienced, well-trained investment advisors can be guilty of falling back on industry buzzwords. With the competition for clients fierce, financial professionals can be tempted to impress investors with displays of technical expertise. But while expounding on the use of alpha and Sharpe ratios to explain risk-adjusted performance may have its place in conversations with clients, in the long run, an excessive use of jargon only confuses and frustrates many investors.

This scientific approach to communications can serve to betray the incautious or indiscriminate advisor. For when the science doesn't work — the markets don't behave as the client expected or the client's account loses money — the value, trust and integrity of an advisory relationship can be significantly damaged. The prudent advisor understands this and takes care to sense, and work within, the limits of the language of finance.

In the end, misunderstandings and inadequate clarifications serve no one's interests. The more scientific jargon is misused — to suggest intellectual superiority, create intellectual noise or act as a barrier to protect advisors from clients — the more clients eventually distrust their advisors. And when investments don't perform as expected, poorly informed clients are more likely to leave.

But if communications (or the lack thereof) presents a barrier to some, it offers a clear road to success for those advisors willing to invest sufficient time and effort in building productive relationships with their clients. Language is an important factor in how clients make decisions about their long-term strategies, the investments they choose, and the extent to which they trust their advisors.

Always remember, it's about the client, not the investment. Rule 2310, NASD's suitability rule, requires firms to make reasonable efforts to obtain certain information from clients, and to have reasonable grounds for believing that a recommendation is suitable for an investor, based on the investor's financial situation and needs. Just because it's a good investment doesn't mean it's a good investment for the client.

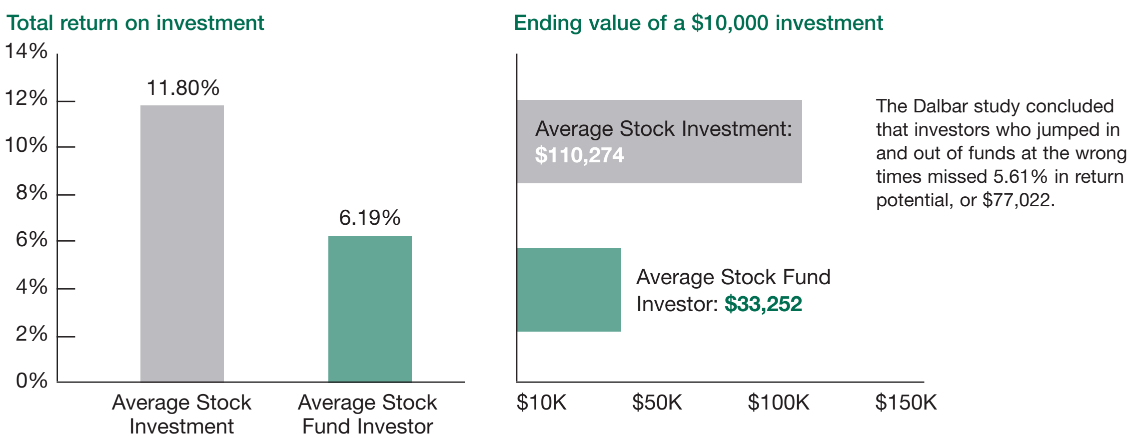
How could investors do so poorly when the market was doing so well?

A study conducted by Dalbar compared the annual returns of the average stock mutual fund to the annual returns achieved by the average investor in those same funds. The results were staggering: While the average stock fund returned 11.80% a year, the average stock fund investor gained just 6.19% annually.

If there were any question about the importance of the role advisors play in helping clients grow wealth, the illustration below should erase all doubts.

Fear and greed can cost investors dearly

Average Stock Investment vs. Average Stock Fund Investor (1987-2006)



This chart is hypothetical in nature and is not representative of an investment in an actual mutual fund. Source: Dalbar, "Quantitative Analysis of Investor Behavior," 2007 www.dalbarinc.com. Dalbar analyzed mutual fund data for the period from January 1987 through December 2006. The average stock fund investor refers to the universe of all mutual fund investors whose actions and financial results are restated to represent a single investor. Dalbar quantitatively measured sales, redemptions and exchanges. The measurement of investment behavior is the net dollar volume of the activities that occur in a single month during the period being analyzed. The average investor return is calculated by measuring the actual gain investors realize as the change in assets, after excluding sales, redemptions and exchanges, which capture realized and unrealized capital gains, dividends, interest, trading costs, sales charges, fees, expenses and other costs. Average stock investment performance is represented by the S&P 500 Index, an unmanaged index of 500 common stocks generally representative of the U.S. stock market. An investor cannot invest directly in an index.

How could this happen? In any number of ways, including:

- inadequate or nonexistent investment strategies
- long-term plans surrendered to short-term perspectives
- attempts to time the market
- listening to bad advice

Bad advice. It could have come from friends or relatives. Or, sadly, it could have come from financial advisors. The Dalbar study included many broker-sold funds; it's reasonable to assume that at least some underperformance was due to unwise recommendations from brokers who selected investments that were easiest to sell, rather than those that were most appropriate for clients.

Much of the value advisors bring to their client relationships is knowing the types of costly errors investors routinely commit, and helping clients avoid such mistakes. Advisors also should understand how emotions such as fear and greed influence investment decisions. But advisors would do well to exploit such emotions, not take emotion out of the investment process. Emotion is critical to "knowing your client" and knowing yourself.

Still, advisors who rely on commissions for part, or all, of their income often must deal with the ineluctable tension between what is best for the client and what will sell. This is when it's particularly important for advisors to appreciate the fact that they are not just salespeople, but financial stewards.

Potential conflicts of interest aside, effective communications is the key to establishing a long-term, productive connection that can benefit both advisor and client. There must be open communications about the parameters of the advisory relationship, the needs and predisposition of the client, the modus operandi of the advisor, and the solutions that are truly appropriate for the client's particular set of circumstances.

Again, consider the illustration and its implications. Think for a moment: Based on your experience, how could you have used your communication skills, or best practices, to change the outcome in this example?

*Research shows that most clients change advisors not because they are unhappy with investment returns, but because they are unhappy with the service they are receiving. Further, while most clients have strong opinions about where they want to invest their money, they are looking for advisors who will help them make smart decisions and not just lead them to buy securities.**

**Source: CEG Worldwide, "Cultivating the Affluent," 2002.*

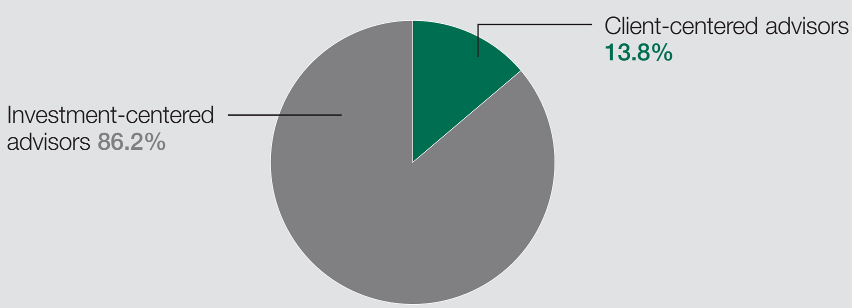
What defines a client-centered advisor?

Based on our experience, it's clear that our industry's business model is evolving: More advisors are providing constructive guidance, rather than just selling product.

In keeping with that trend, many financial professionals would claim to be focused, first and foremost, on their clients' investment needs. But in truth, a study by CEG Worldwide indicates that only 13.8% of advisors are actually client centered, while the remaining 86.2% could be classified as investment centered.

What type of advisor are you? Is responding immediately to client inquiries very important to your practice? One-hundred percent of client-focused advisors said yes, compared to just 66.4% of investment-centered advisors. How about meeting with clients (88.1% vs. 19.8%), or personally contacting prospective clients (84.5% vs. 16.8%)? On the flip side, 57.4% of investment-centered advisors said it was very important to strategize about the stock market, while only 6% of client-centered advisors agreed.

Most advisors are investment centered



Source: CEG Worldwide, "The Best of Times," 2001.

Realistic or false expectations?

"…people trade [in the markets] for both cognitive and emotional reasons. They trade because they think they have information when they have nothing but noise, and they trade because trading can bring the joy of pride. Trading brings pride when decisions turn out well, but it brings regret when decisions do not turn out well. Investors try to avoid the pain of regret by avoiding the realization of losses [and] employing investment advisors as scapegoats..."

— Meir Statman, "Investor Psychology and Market Inefficiencies," Equity Markets and Valuation Methods, The Institute of Chartered Financial Analysts, 1988.

Managing expectations

Of course, benefiting clients is the overarching objective of a financial advisor. And one of the key roles you play as an advisor, perhaps the most important way in which you add value to client relationships, is managing expectations.

Nowhere is this more apparent than with time and market volatility, two critical elements in the investing calculus. Investors need to understand and acknowledge that time passes continually and volatility is unavoidable. When advisors try to gloss over these market realities — through fancy, jargon-filled proposals or performance-chasing scenarios — they can squander the fundamental opportunities that effective management of time horizons and portfolio volatility can offer. In short, volatility and time can be your friends or your enemies, based on how you manage your client relationships.

However, many clients will come to you with expectations that simply are not tenable. How often have you heard an investor state, with complete confidence, "This market is up (down) and it's going to keep going up (down)"? Or, "I want an investment that has no risk, so put me in bonds"? Or even, "I know there's a good reason why those stocks have dropped, but I just want to stick with them until I'm even again"?

Thus, the challenge facing advisors can be daunting. It is hard to reason with investors who are far from always reasonable. As Rongrong Zhou writes in "Individual Investors' Decision-Making: The Ubiquitous Influence of Promotion and Prevention Self-Regulation":

…recent findings in the behavioral finance literature suggest that individuals often fail to evaluate investment opportunities in accordance with normative finance principles. Instead, investors… often are prone to biases such as the representativeness heuristic [the need to judge the probability of an event by finding a "comparable known" event and assuming that the probabilities will be similar] (Camerer 1992, De Bondt and Thaler 1985), overconfidence (Camerer 1992) and disposition effect [investors sell their winning stocks too early and hold losing investments too long] (Shefrin and Statman 1984, Weber and Camerer 1998)...[1]

Clearly, as an advisor, you have your hands full. Clients come to you with emotional biases and misperceptions that can derail your best efforts to create a workable strategy and stick to it through variable market conditions.

Advisors should talk with clients in meaningful exchanges that share knowledge, not overwhelm clients with impressive-sounding, but ultimately counterproductive, gobbledygook.

Investors	Advisors
Representativeness heuristic	**Reality based**
"Past performance is representative of future results."	"Past performance does not guarantee future results."

How can you use communications to constructively adjust investors' mistaken perceptions?

Perhaps the trickiest aspect of managing expectations applies to anticipated portfolio performance. Investors, especially those with relatively little experience in the markets, can have little or no idea about the long-term returns they can reasonably hope to earn.

For example, every advisor knows that since the mid-1920s, stocks have delivered annualized returns of roughly 10%. But ask individual investors about long-term performance, and you'll likely get a wide range of responses, based partly on ignorance and partly on current market conditions. If stocks are flying high, for instance, so will investors' emotions and predictions — irrationally so. If the market is in a downswing, excessively pessimistic forecasts will abound.

Again, advisors must recognize that, for many clients, investing is an emotional experience, often driven more by greed and fear than by reason. Therefore, instead of focusing on past or potential performance, advisors should emphasize the value of specific services they offer clients, such as helping clients figure out how to:

- afford to send their children to college
- afford to buy a vacation home
- stretch their retirement savings
- save hundreds of thousands of dollars in taxes (for themselves and their beneficiaries) by developing an effective estate plan
- donate to their favorite charities while receiving tax benefits

The best way, then, to help clients navigate through an emotion-filled process is to establish realistic, attainable expectations early in a relationship and maintain those expectations over many years.

Emphasizing communications

Relationships built through clear, concise communications can be useful in establishing and exploiting a new way of doing business. If advisors are to successfully move away from a product-based practice, clients must also be converted to focusing on relationships, rather than short-term transactions.

How can this significant shift be achieved? Through timely, focused, quality communications and taking advantage of face-to-face opportunities. For example:

- Call clients at the end of the quarter to see if they have questions about their statement. This is especially effective during downturns, as it will allow you to address concerns and help quell any anxiety.
- If appropriate, invite the client and key family members to lunch to ensure that the client's spouse and children understand the investment process and products being used. Use this time to learn about the family's needs and concerns.
- When clients contact you for advice about a new investment they want to include in their portfolio, invite them instead to develop an Investment Policy Statement that will illuminate a holistic approach to portfolio management.
- During annual reviews, take the opportunity to discuss personal life events and changes, such as a child, new job, marriage, divorce or elder parent's declining health. Many of these changes could require more thorough financial planning or extensive modifications to existing investment strategies — which would allow you to showcase your full range of services and expertise.
- Take the time to follow up your phone or in-person meetings with written communications, thoroughly explaining relevant investment strategies and concepts, such as asset allocation, diversification, modern portfolio theory, etc. This could enable you to better establish your role as a trusted advisor.

Another significant factor to consider is that successful communications don't happen by chance; they have to be *planned*, not piecemeal or haphazardly, but systematically and strategically. By developing a standard communications plan — including parameters for the timing and frequency of phone conversations, written correspondence and in-person meetings — that can then be customized for each client, you ensure you enter each client meeting with an agenda, and approach every client call with an appropriate list of items to discuss.

Most advisors are successful because they are good salespeople. But to really excel, they must become great relationship managers and develop acute listening and communication skills — attributes that may not come naturally to most salespeople.

Tools to counter emotion-driven investing

As a comprehensive study of investor behavior indicates, investors and advisors are truly different animals. While advisors focus on long-range investment plans, investors often base decisions on single-event outcomes — such as a winning stock that soars higher or an ill-advised investment that tanks — a reaction the study's authors liken to a gambler's mentality.[2] Consequently, as you attempt to steer clients away from emotion-driven responses, these key elements of a well-considered plan of action can be constructive:

Stay true to your word. Understand what you can control and what you can't control, and don't make promises you can't fulfill. Also, don't adjust time horizons for short-term expediency.

Recognize a client's personal dynamics. Consider goals that extend to clients' families. Include the client's spouse, and other appropriate family members, in your conversations. Remember that your clients' goals are not necessarily constrained by a single lifespan.

Pick your spots. There are limits to what you can accomplish in a single conversation with a client; don't try to do too much at one sitting.

Understand that timing is as important as content. The timing of client communications has just as much impact as the message you're trying to convey.

Display a professional demeanor. You are not an order-taker, you are an advisor. Look, sound and act like one.

Plan how you communicate with clients. Develop a communications plan for each client that specifies the timing of the contact, the goal of the communication and the action item to be completed.

Document the investment process. Develop an Investment Policy Statement (IPS) for each client. Conduct regular client review meetings and update the IPS as necessary.

Don't hide behind jargon. If you are not communicating effectively, if the client does not understand you, it will be impossible for you to advise effectively — let alone create and foster a trusting and lasting relationship.

Remember, understanding the intensity of human emotions, and incorporating that intensity into the way you approach and nurture client relationships, can be a powerful driver to your success and the success of your clients. The effective use of communications can build relationships and grow your book of business. The more connected you are with clients, the less likely those clients are to leave, and the more likely they are to entrust you with greater assets.

At Flippin, Bruce & Porter, we recognize the value of language as a communications tool for financial advisors. Advisors who offer a vibrant channel of communications, placing a premium on originality of thought and context, will discover they can tackle old problems with new language, and often unearth novel solutions.

With more than two decades of investment advisory experience, the professionals at Flippin, Bruce & Porter understand that through proper communications with clients, increasingly sophisticated investment options are more effectively developed and exploited. We invite you to contact us to learn more about our focused asset management style, and how our approach could help you add value to your advisory relationships.

[1] Rongrong Zhou, "Individual Investors' Decision-Making: The Ubiquitous Influence of Promotion and Prevention Self-Regulation," doctoral dissertation, Columbia University, 2002.

[2] Source: Merrill Lynch Investment Managers/Matthew Greenwald & Associates, 2005.

FLIPPIN, BRUCE & PORTER
Investment Counsel

P.O. Box 6138
Lynchburg, VA 24505-6138
1-800-851-3804 | www.fbpinc.com