WEALTHSHIELD

Your Investment Philosophy

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In the effort to build an institutional quality asset management business, you must start with a set of core values, a philosophy. Philosophy can be defined as the most basic beliefs, concepts, and attitudes. What are your bare-bones beliefs about investing? What do you think drives markets? How do you define risk? What is your attitude toward the market? Do you believe that the market is always right? These are some of the questions that an advisor should ask themselves when attempting to formulate an investment philosophy. I also recommend reading portfolio theory and gaining a thorough understanding of the academic theories that dominate the landscape today.

When you are crafting your investment philosophy it is also important to remember the why. Your overall purpose and mission should be woven through your investment philosophy. The whole reason you have an investment approach in the first place is because of your purpose and mission as a financial advisor.

Having a well-defined investment process and philosophy is important to growing your business over the long term. Once your clients and your professional network can describe your investment process, they can then begin to introduce your services to others. Your investment philosophy is also important in determining whether or not someone is a fit with your organization. If a client believes that markets are inefficient and hedge funds are the best path for achieving attractive compounded annual returns, yet you are a strong believer in efficient markets, you are probably not a good long-term match. If you do not have a clear investment philosophy, then you may find yourself taking on clients that are not good fits—only to realize it much later.

We are extremely rigid in our investment philosophy. That does not mean that we think our process is the only one in the world that works. There are countless ways to manage portfolios that are supported by academic literature and with sound basis. We are rigid in the fact that we know our philosophy is the best for our unique personalities and beliefs, and therefore we do not sway. It is important to be intellectually honest with yourself when determining your philosophy. You need to be able to stick with it during the good times and the bad.

As an example of our rigidity, we interviewed an advisor recruit for a position in our firm. The advisor would manage their own book of business, but would operate under the umbrella of our firm. My partner and I really liked the individual. He was bright, charismatic and knowledgeable, of impeccable character, experienced and credentialed. The only problem was that he ran covered call strategies and individual stock portfolios. We spent weeks trying to justify bringing him into the firm, but could not get passed the difference in investment philosophy. In the end, we decided not to pursue the candidate. Our investment philosophy defines who we are and is a critical component of our value proposition.

It is important that your investment philosophy mesh well with your personality and firm culture. If your passion is bottom-up research, where you focus intently on security selection, then your philosophy should reflect this. On the other hand, if you enjoy the top-down approach of focusing on the macro environment to determine various investment themes, then your philosophy should reflect your asset allocation approach. You need to make sure that your philosophy is in line with your passion and personality, otherwise you will never be happy and most likely abandon your process during the tough times.

Your investment philosophy should have a sound and reasonable basis. In other words, you need to have supporting evidence that it can work. You should definitely read that major academic papers on investment management and portfolio construction. You could simply start with the Nobel Prize winners and have enough evidence to support active, passive, and alternative investing. We primarily focused on the Fama-French factor model and behavioral finance research to support our philosophy. The important point is to make sure that it is defensible.

I know that when our firm was formulating their investment philosophy, we had already invested thousands upon thousands of hours researching and studying markets. Our core philosophy was birthed on the back of great academic research performed years ago. We simply formed an amalgamation of various concepts to mold our beliefs. This is an incredibly important first step.

I also assign reading, strictly organized around some of the greatest papers and views on investing and portfolio construction. After advisors go through the readings, they are then asked to formulate a rough investment philosophy. This exercise allows me to understand what influences them most, and it really helps me understand their views. Then, and only then, can an advisor form a true investment philosophy.

Crafting and perfecting an investment philosophy is a central to a thriving investment business. Therefore, it should be done with the input and cooperation of the team. Often times, in a more traditional team, the senior advisor may dominate this section and influence the direction of the firm's philosophy. Although the senior advisor may actually end up setting the final philosophy, it is important that the rest of the team is heard and that their input is valued.

I accomplish this by interviewing each team member individually to listen to their beliefs, opinions, and thoughts regarding an overall investment approach. I then approach the team as a group with a concise understanding of the common ground shared among the team and the possible points of misalignment.

Teams can collapse under misalignment. If there is philosophical dislocation among team members, the partnership can eventually fold and it will be tough for the business to survive. Lack of alignment will kill a partnership. It does not always show up in the early stages. It may even go undetected. Like cancer, it will soon grow to overtake every other issue. Most disagreements will eventually lead back to the lack of alignment. My firm is a perfect example of how a difference in philosophy can break a team apart.

When we were starting our RIA, there were three advisors looking to leave larger brokerage firms to establish a registered investment advisor. All three of us had a lot in common: we were all credentialed, had supreme ethical records, and a vast amount of experience in investment management. These commonalities were also a large problem. We all had varying methods of managing investments and all believed we had the superior approach. We met for about six months, every week, attempting to hash out a uniform investment philosophy and a common vision. Each time the discussion came up about how we should manage client money, a disagreement would ensue and we would couch the conversation for a later date. We all became perpetual can-kickers.

We ignored the warning signs and ended up starting the firm together. Within a year, one of the partners was gone. Although we parted ways with him in an amicable light, it was an extremely stressful and distracting time period. We were all at fault—we ignored our core differences and penalized the organization with a massive disruption as a result.

I would warn you about going too fast through the investment philosophy process. It will govern everything about how you manage client money, reverberate through all of your content, and define your very identity. It is also the foundation for the processes and procedures that you will use to consistently implement your philosophy for clients.

After we have successfully defined and articulated an advisor's investment philosophy, we construct a simple and concise investment philosophy statement. This is not to be confused with an investment policy statement. The investment philosophy statement is the elevator pitch if you will, that simply explains your approach. This statement is critical because it becomes a core piece of your value proposition. You will see later on in the book how we use this statement repeatedly to influence more introductions. Let's face it, if your client's cannot articulate your approach quickly to their friends and family, you will not get introductions.

Finding your Edge

Great companies, great investors, and great advisors all have a definitive quantifiable edge. The word edge, as applied here, is defined as an observable advantage. This advantage should be able to be exploited to deliver asymmetric returns. We want you to imagine for a second that you operate a casino. A casino is a big business, based on exploiting probabilistic edges in various games. The promise of the win, the jackpot, and the fast riches lives in the players. In the end though, the casino always wins. Over the long run, the small edges pay off to the casino. The casinos offer a chance of victory to the players, but the edge lies with them. Players pay the casinos for that opportunity, resulting in a stable and profitable business. As the owner, you know this fact and that your job is to simply play the game, or better yet, to allow others to play your games. The longer the players play, the better your outcome.

As a financial advisor, you need to realize your business advantage and exploit it as efficiently as possible. In fact, we would argue that your practice, and the systems that make it, should be constructed around your edge. Most advisors attempt to add value through service or relationship management expertise. They think that because they roll out the proverbial red carpet for their top clients, that they have some type of edge over the competition. They think that if you provide efficient, referable service, growth will be the natural by product. Now, we agree that good service and great relationship management skills can go a long way towards orchestrating a successful business. However, our thought is that service is seldom an edge. How does one quantify service as an exploitable advantage? Sure, you can make it repeatable, attractive, and referable. That does not mean that this is an advantage. The truth of the matter is that most advisors progress down this path.

The rise of the robo advisor has demonstrated that relationships, personal touch, and chemistry are not the dominant force in the average advisory relationship—nor will they be in the future. Robo advisors are lowering the costs for clients everywhere. They are allocating assets the same way that most of the expensive wealth managers do, and they are doing it more efficiently. Moreover, they are adding value through tax loss harvesting, financial planning, and asset location strategies. The efficiency and low cost are awesomely appealing. The bigger firms like Charles Schwab and Vanuguard are following the pioneers into the robo advisory model.

The lower cost model of robo advising is shaking the very foundation of the advice business. It is now more important than ever to identify your exploitable edge. The reason is that you cannot simply do what everyone else is doing, because soon you will be priced out of the business. Advisors need to find a way to differentiate their businesses from the robo advisors and other human advisors as well.

If your edge is service or relationship management, focus your entire business on refining this area of your practice. The bottom line is that this is a crowded trade and you will need to expend a tremendous amount of resources and time to effectively build a “wow” service model. Our advice would be to build a virtual team to accomplish everything that does not have to do with relationship management and client service. Outsourced teams are incredibly cost effective and efficient; moreover, they can help add scale to your business. For example, advisors that affiliate with our firm, WealthShield, could outsource everything from asset management, compliance, client onboarding, and back office support while focusing solely on the relationship management aspect of their business. Furthermore, they would have access to the advanced technology tools to help facilitate an efficient operation.

We think there is a tremendous amount of value in the hybrid approach. By hybrid we mean that a financial advisor uses the digital tools necessary to better serve their clients. That is why we built the firm WealthShield. The market would agree with our assessment as well. Hybrid versions of robo advisors are being rolled out at firms across the country. Vanguard would be the most recognized among the hybrid firms and their growth has been astounding. As of the writing of this book, Vanguard had over $20 billion dollars in their hybrid model—almost 10 times that of the pioneer robo firms Wealthfront and Betterment. You should take notice of this trend as customers are voting with their assets. The winner is clearly a personal financial advisor over a digital platform. Still, these numbers are much less than the amount of assets held at the largest wealth management institutions. At the end of 2014, the largest three Wealth Managers held a collective $5 Trillion in assets under management. Nevertheless, there is a tremendous amount of support for the hybrid model.

This means that advisors can focus more on their relationship management and use modern technology to create a unique differentiation strategy. Their edge can be realized in their efficiency and scale. Lets face it, outsourcing the money management is not new. The lower cost technology is the disruptive force that will most likely simply drive more. WealthShield has focused intently on exploiting what we believe to be a long-term edge in asset management. The firms we partner with realize this edge and outsource the tedious, highly involved task of intelligent asset allocation to us. Our edge allows them to communicate a definitive advantage to their clientele, and we only serve as a behind the scenes support service. Not only can they reference the modern “robo” technology and low-cost platform, but they can also reference a potential long-term investment management edge.

WealthShield is different because we use a proprietary asset allocation system instead of impractical financial theory. Our edge is found in identifying the practical shortcomings of theory and exploiting human behavior over the long term. The results are better client relationships, optimal long-term investment results, and faster business growth.

Our advisors can now focus on building better relationships, scalable business practices, and superior asset management methods. They can engage the client in deeper, more meaningful conversations about their financial goals and planning for their financial future. Furthermore, they can become the trusted investment professional in their clients' lives, not simply the middlemen.

Outsourcing key investment management roles is blasphemous in some circles. Besides, a lot of advisors started in the business pedaling blue chip companies. They bought into stock picking, active money management, and the whole Wall Street pitch. The fact is that partnering with a firm like ours allows you to express your unique investment philosophy and leverage our resources and technology platform to deliver them efficiently.

Many advisors are whistling past the graveyard. The only way they are going to survive is by quickly refocusing their business on deepening client relationships through a differentiated investment approach. Advisors must focus on the two areas where they can still realize a competitive advantage: 1) a deep relationship with their clients and 2) an intelligent investment approach.

They no longer have the luxury of wearing too many hats and being subpar at any function of their job. You should not go into business if you do not know your edge. If you cannot quickly and succinctly explain what you do the best, then you should not be in the industry. Edges do not have to be grandiose or massive in scale. Edges can often be small. But even the smallest edge results in outsized success. When determining your ideal investment philosophy statement, it is important to identify your edge and accentuate it. For instance, at our firm, we have built the entire business around differentiating our asset allocation process. We believe that our unique approach is our edge. So our mission statement, internal vision, and business procedures are all focused on communicating and realizing that edge for the ultimate benefit of our clients.

We had to identify what we could be the best at in the industry. Asset allocation was our natural choice. Our expertise, passions, and strengths converged on this discipline. Our understanding of quantitative methods, behavioral finance, technical and fundamental analysis allowed us to create a method that would act as our advantage. Most money management firms, poured money into individual securities research and talent acquisition. Their methods for asset allocation are still extremely outdated and stale. Portfolio theory governs the way most portfolios are constructed and the math is inherently flawed. Despite the shortcomings of theory, herd mentality and blame avoidance allow for its continued use. We discovered this gap and focused intently on creating a better method. We felt that if we were not already the best at asset allocation, we knew this is where we could become the best.

Our core beliefs, overall purpose, and edge are all components to our investment philosophy and approach. We believe that markets are inefficient because of human behavioral flaws. Behavior drives markets and changes in liquidity tend to affect behavior. We seek to protect and grow wealth using an asset allocation strategy that readily adapts to changes in market psychology. This serves as our overall investment philosophy statement as well as business purpose.