PacificCPE

COURSE
40855A

Investment Advice Essentials for Financial Planners

Helping clients make sound investment decisions requires a clear understanding of core investment principles and how to communicate them effectively. This course covers practical investing concepts financial planners use when advising clients, including strategies and considerations relevant to building and managing portfolios. For CPAs and tax professionals who want to speak more confidently about investment topics or integrate investment awareness into their broader client planning conversations, this course delivers focused, applicable guidance.

CREDIT HOURS 2 | FIELD OF STUDY BUSINESS | EXAM QUESTIONS 10

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Assignment

- Study the full course materials included here.
- Complete the review questions after each chapter.
- Answer 10 final exam questions.
- Final exam is scored immediately, 70% or better passes.
- Certificate of completion is available in your account.
- Failed exams can be retaken free of charge.

Course Objectives

- Identify the types of risk that are considered systematic.

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Chapter 1: DISPENSING ADVICE ON INVESTING

Chapter Objective

After completing this chapter, you should be able to:

- Identify the types of risk that are considered systematic.

There are many issues that run through both planners' and clients' minds today concerning investing. The 2020s will not be like any decade we have seen previously. Part of that reasoning is that the world has changed so much that things are not on automatic pilot in the way that we had become accustomed to. There is too much impatience and people use shorter barometers for measurement than before. Further, at the beginning of this decade, with COVID playing a major disruptive role, and other future uncertainties, people are concerned about investment markets changing too rapidly. Unfortunately, people tend to be reactive rather than proactive. This chapter is not going to focus on investment types; there are plenty of great books and super class curriculums covering that. The concepts explained here will include the term investor more so than the client. This chapter will focus on those issues you need to have a handle on to counsel your clients through the investment planning process.

The problem with today's world is everyone acts a little too quickly, and based on social media news and other reports they may have heard, they wish to change their approaches even more rapidly instead of sticking with an appropriate strategy and making modifications where planned and where necessary.

So, if there is so much uncertainty in the world of investing, the question becomes, what do you do when a strategy performs poorly? We have generally had success in this arena for many years, especially during this last major and longest bull market, which unfortunately ended abruptly. "The basic mistake clients make is when it comes time to judge performance, three years is a long time and 10 years is an eternity," says Larry Swedroe, Chief Research Officer, Buckingham Strategic Wealth, St. Louis, MO.

"Don't run away from risk, and diversify as much as possible. There is much added value through passive investing which still would enable higher prices when adding value," says Swedroe. He also quoted Nassim Nicholas Taleb from his book *Fooled by Randomness*: "A strategy should be judged in terms of its quality and prudence before, not after, its outcome is known." That supports the short time frame that clients use today. So how long is enough to determine whether strategy works? Per Buckingham Strategic Wealth: "To have confidence, a strategy must have evidence of premium and persistence over long periods of time and across economic regimes; pervasiveness across sectors,

countries, geographic regions and even asset classes; robustness to various definitions; implementability surviving transaction costs; and intuitive risk- or behavioral-based explanations."

Swedroe says, "The bigger firms are moving assets into a commodity-like setup, thereby pushing down fees . . . if you don't integrate into an asset management platform, you're a dead man walking." He adds, "Advisors must be scale based and have access to products that others don't have. Also be broad based and anticipate total market, US markets, emerging markets for very long periods. Spend money on tech and need to be on top of cybersecurity and compliance." Swedroe thinks the industry will bifurcate like two barbells consisting of major nationals and a few others, and niche shops.

[NOTE]

1. Investment Risk
2. Other Issues That May Impact Investment Decisions
3. Investor Returns
4. Risk-Adjusted Performance Measures
5. Investment Policy Statements
6. Asset Allocation and Portfolio Diversification
7. Practical Approaches
8. Tax Efficiency

We need to have a handle on the level of risk the client is willing to assume. It is paramount to everything else we do for the client. We have covered this during the data gathering and interactive goal and objective setting session of the financial planning process (Chapter 1 of course 40853A). As we have learned from the financial planning process, each client is different. Therefore, there is not a one-size-fits-all mentality or approach. Before any investing is recommended, we have to make sure our clients understand the risk in getting there. Let's take a look at the risk that your clients need to understand before setting up their investment portfolios.

INVESTMENT RISK

This should be the starting point for any client conversation in this area. Investment risk is the uncertainty that an investment's actual, or realized, return will not equal its expected return. In turn, "expected return" is defined as the return that the investor demands or expects to make. It is computed by multiplying each of the investment's possible annual returns by the probability that these returns will occur and then summing up the results. (Note: It can also be computed using the capital asset pricing model and/or dividend discount models as discussed later.)

Investment risk may also be thought of as total risk, which consists of two particular kinds: systematic and unsystematic risk. Another name for total risk is standard deviation (this will be discussed later). Since unsystematic risk can be diversified away, the only kind of risk for which the investor is rewarded with an expected return is systematic (or nondiversifiable) risk.

Systematic risk

Systematic risk is that risk associated with the entire market rather than being unique to an individual company. As a result, all securities tend to move together in a systematic manner in response to these risks. In my classes I use the acronym PRIME, standing for the first letter of each type of risk: purchasing power risk, reinvestment rate risk, interest rate risk, market risk, and exchange rate risk. Systematic risk cannot be eliminated through diversification because it affects the entire market – it may only be effectively managed. Beta is used to measure the amount of systematic risk that the investor has assumed. However, beta, as we will see later, is an accurate measure of systematic risk only if calculated for a diversified portfolio.

In addition, not all "betas are created equal" since the computation of beta may vary slightly from one investment reference service to the next.

Systematic risk consists of five different types of risk, as follows:

1. **Purchasing power risk:** The risk that inflation will erode the real value of the investor's assets. As prices for goods increase, the purchasing power of assets will decrease. The objective, therefore, is to have earnings in excess of inflation, so that the real value of the assets is not eroded. Inflation is the main cause of purchasing power risk. Bonds held to maturity are likely to suffer from purchasing power risk because the maturity value will remain the same.
2. **Reinvestment rate risk:** That part of interest rate risk resulting from uncertainty about the rate at which future interest coupons can be reinvested and earn current rates of return. This also can be thought of as the risk of an income decline due to a drop in interest rates. For example, if a bond promises a return of, say, 8%, assuming that the issuer does not default, will its actual rate of return equal 8%? Callable bonds are most impacted by reinvestment rate risk, although the price of mortgage-backed securities (such as a collateralized mortgage obligation (CMO)) also is influenced by this risk. It is also high on short-term maturity bonds. This is because the shorter the maturity of the bond, the *fewer* the years when the relatively high old interest rate will be earned, and the sooner the funds will have to be reinvested at the new low rate. Reinvestment rate risk also greatly impacts mortgage-backed securities, such as real estate mortgage investment conduits (REMICs). When market interest rates decline, borrowers tend to refinance mortgages, which in turn leads to an early payoff of the principal obligation and the need for reinvestment of terminated funds backing the REMIC. The investor is thus confronted with the need to reinvest their original REMIC investment in a lower interest rate environment.

3. **Interest rate risk:** The risk that changes in interest rates will affect the value of securities. There is a tendency for an inverse relationship to exist between the value of fixed investments and changes in interest rates (i.e., as interest rates increase, the value of bonds declines, and vice versa). Rising interest rates will also generally have a negative effect on stocks. Reasons for this include the increased discount rate (required rate of return) for valuation of cash flows, increased borrowing costs, and increased yields on alternative investments. Bonds are most impacted by interest rate risk. The duration of a bond is a measure of the bond's interest rate sensitivity.

How much interest rate risk a bond has depends on how sensitive its price is to interest rate changes. In turn, this sensitivity depends on two factors:

- The bond's term to maturity
- The bond's coupon rate

These factors are succinctly captured in the concept of bond duration (to be discussed later). However, generally:

- The *longer* the bond's term to maturity, the *greater* its interest rate risk (in other words, there is a direct relationship).
- The *lower* the bond's coupon rate, the *greater* its interest rate risk (an inverse relationship).
- The *lower* the bond's yield to maturity, the *greater* its interest rate risk (an inverse relationship).

The duration of a bond with coupons is always less than its maturity date. (Note: A zero coupon bond's duration is always equal to the bond's maturity date.)

4. **Market risk:** The tendency for stocks to move with the market. When the market is increasing, most stocks will have a tendency to increase in value; conversely, most stocks will tend to fall with declines in the market. Often, a move in the market will be preceded by some change in the economic environment. Fluctuations in market prices of assets are caused by unanticipated world events (e.g., 9/11) and the reaction of investors to actual and anticipated events in the economic, social, and political world. The investor cannot reduce this market risk of loss by increasing the number of companies whose common stocks are in his portfolio because the market prices of equities tend to rise or fall together.
5. **Exchange rate risk:** The variability in returns on securities caused by currency fluctuations. An exchange rate specifies the number of units of a given currency that can be purchased with one unit of another currency (for example, Japanese yen for U.S. dollars). The inherent volatility of exchange rates under the current "floating" system (not tied to the gold standard) prevalent in international trade and investments increases the uncertainty of investor cash flows. For example, a U.S. investor who buys a German stock denominated in euros must

ultimately convert the returns from this stock back to dollars. If the exchange rate has subsequently moved against the investor, losses from these exchange rate movements can partially or totally negate the original return.

As a result, an investor in foreign securities may see a realized profit turn into a recognized loss due to changing currency exchange rates. This is known as exchange rate risk and impacts any investments made in other countries where the return is not denominated in U.S. dollars.

Unsystematic risk

An unsystematic (or nonmarket) risk is one that affects only a single asset or small group of assets. Because such risk is unique to an individual company or industry, unsystematic risk may be diversified away, minimized, and even eliminated by not investing (or investing only marginally) in company stocks that exhibit unsystematic risk.

Four common types of unsystematic risk are business, financial, regulatory (also known as political), and default risk. Each is discussed in more detail below.

1. **Business risk:** Business risk is the economic or operating risk associated with how the company earns its income and of the company's stock if the company uses no debt in its capital structure. More generally, business risk may be thought of as the amount of investment risk inherent in company operations. A corollary risk to business risk in some firms is financial risk.
2. **Financial risk:** Financial risk is the loss possibility due to leverage from the additional risk placed on the common stockholders of a company as a result of its decision to use debt (bonds) as part of its capital structure. If a company issues any bonds, then, in effect, it is partitioning the investors into two groups and concentrating its business risk on only one group: the common stockholders. The additional risk that the stockholders of a leveraged company assume, in excess of the risk assumed if the company used no debt in its capital structure, is the company's financial risk.
3. **Regulatory/political risk:** Regulatory or political risk is the possibility of expropriation and the unanticipated restriction of an investor's cash flows by a foreign government. It is greatest in foreign countries that are unstable politically (or may become so in the future). Since such risk is greatest with international investment, to avoid political risk, investors should not invest in stocks of companies operating in unstable countries.
4. **Default/credit risk:** Default risk is the loss possibility arising from a borrower's failure to pay interest and principal on a timely basis. The borrower can be a government, company, or individual. This is a concern for clients who hold corporate or municipal bonds in their portfolio. Federally government-backed bonds have the lowest risk and the lowest interest rate return among bond issuers while corporate bonds generally have the highest interest rates but

have the highest default rates. Bonds with a lower chance of default are called investment grade while bonds with a higher likelihood of default are generally listed as junk bonds.

Rattiner's Secrets

I have had many clients who would have liked to invest with me or with me assisting them, but they had reiterated that they did not want to assume any risk. I told them, "Not happening!" What I tried to clarify for them is that we can maneuver certain types of risk from the equation. That means they are going to have to accept the systematic risk associated with investing, but depending on the approach and investments, we can probably minimize, diversify, or even eliminate the unsystematic risk.

Standard deviation

Standard deviation is an absolute measure of the variability of the actual investment returns around the average or mean of those returns (otherwise referred to as the "expected return" of the investment). There is a direct relationship between standard deviation and risk. Often, standard deviation is used as a measurement of the risk that is assumed by an investor with respect to any asset (or portfolio), also known as total risk.

Assuming a normal probability distribution, standard deviation may be used to predict the expected return of an investment based on historical performance of the asset or portfolio. For example, the expected return of an investment should occur within a range of one standard deviation from the mean 68% of the time, assuming that the series of historical returns forms a normal probability distribution curve. Dispersions around the standard deviation and the bell-shaped curve are:

- Approximately 68% of outcomes fall within ±1 S.D. of the mean
- Approximately 95% of outcomes fall within ±2 S.D. of the mean
- Approximately 99% of outcomes fall within ±3 S.D. of the mean

Beta (or "beta coefficient" as it is sometimes known) is a relative measure of an asset's or portfolio's systematic risk. Thus, it is best used as a measure of risk for a diversified portfolio or a portfolio that has no unsystematic (or diversifiable) risk. Alternatively, standard deviation is best used as a risk measurement for all assets, including a nondiversified portfolio. (However, remember that an investor is rewarded – in terms of expected return – only for assuming systematic risk since a portfolio should be diversified as a matter of good investment practice.)

Specifically, beta measures the volatility of a particular security's rate of return or price relative to the volatility of the market as a whole. Therefore, since the overall market has a beta of 1.0, a stock or portfolio exhibiting a beta of 1.2 is 20% more risky than the market. Alternatively, a stock or portfolio with a beta of 0.8 is 20% less risky than the market.

Betas can also be negative. For example, the risk characteristics (and expected returns) of gold stocks frequently exhibit negative betas. (This means that their risk is relatively independent of the broader financial markets.) An asset with a negative beta may assist greatly in protecting the investor from a significant decline in the value of their portfolio in a down (or "bear") market.

Finally, the concept of a stock or portfolio's beta forms the basis for the capital asset pricing model (CAPM) from which an investor may determine an appropriate required rate of return before making an investment decision.

Covariance

Covariance is included as a significant component in the standard deviation of a portfolio formula. Specifically, covariance measures the extent to which two variables (the expected returns on investment assets) move together (positively) or opposite to one another (negatively). Thus, covariance may best be described as the relationship between or among stocks that includes not only the individual stock's variability but also its impact on and interaction with other portfolio securities.

Semi-variance

Unlike standard deviation that measures the risk of all expected returns, semi-variance measures only those series of historical returns that are below the mean or average return.

Thus, for a relatively risk-averse investor, semi-variance is a better measure (than standard deviation) of the total risk that is assumed in making any investment.

OTHER ISSUES THAT MAY IMPACT INVESTMENT DECISIONS

Tax risk

Tax risk is the uncertainty associated with a country's tax laws that potentially affect the rate of return that may be generated by an investment. This could become more of a concern based on where the country is now. Thus, it is really a subcomponent of political or regulatory risk.

All investment alternatives should be analyzed on an after-tax basis so that the returns from tax-exempt investments are comparable to taxable investments. The specific computation that compares the yield on a tax-exempt investment to that of a taxable investment is the taxable equivalent yield (TEY) computation (as discussed later).

Investment manager risk

Investment manager risk is the risk that a portfolio's performance will be negatively impacted with a change in investment managers. It is really a subcomponent of market risk, although it can be minimized by simply not investing in a particular mutual fund or other professionally managed asset. The risk is highest with mutual fund families, which do not generally communicate staffing or