Fiduciary Ethos

Living in a Fiduciary World

Volume One: Investment Management

FPA® Financial Planning Association

EDITION

Donald B. Trone

Foreword by
Keith Loveland, J.D.

Sponsored by

Thornburg Investment Management®

Ethos (ē´thos) n.

The distinguishing leadership behaviors, core values, and decision-making process of a person, group, or institution.

Learning Objectives

The objectives for writing this book are to provide financial planners:

1. An introduction to a *fiduciary ethos* that supports the fiduciary standard defined by the Financial Planning Association (FPA) and the Certified Financial Planner Board of Standards (CFP Board)*;
2. The details of a decision-making process that meets the requirements of an investment fiduciary process, and CFP Board's *Financial Planning Practice Standards;*
3. Information on the roles and responsibilities of a fiduciary, and the best practices and skills associated with a procedurally prudent investment process;
4. The leadership behaviors of highly effective financial planners, and how these behaviors are consistent with the FPA's *Code of Ethics* and CFP Board's *Code of Ethics and Professional Responsibility;* and
5. The procedures to assess a financial planning practice against a defined *fiduciary ethos.*

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strategic ethos

I don't know what your destiny will be, but one thing I know: The ones among you who will be really happy are those who have sought and found how to serve.

– Albert Schweitzer

Leadership should not be done purely for personal gain or goal accomplished: it should fulfill a much higher purpose.

– Ken Blanchard
The Heart of a Leader

There has always been difficulty in understanding and practicing real leadership. That's because it is more of an art than a science. There seem to be no set rules for leaders to follow—only guidelines and concepts, perceptions and ideas, abstractions and generalities.

– Donald T. Phillips and Admiral James M. Loy
The Architecture of Leadership

Seventy percent of strategic failures are due to poor execution of leadership. It's rarely for lack of smarts or vision.

– Ram Charan
Execution: The Discipline of Getting Things Done

Acknowledgements

There are a number of leaders who have been instrumental in bringing this book to fruition; most notably:

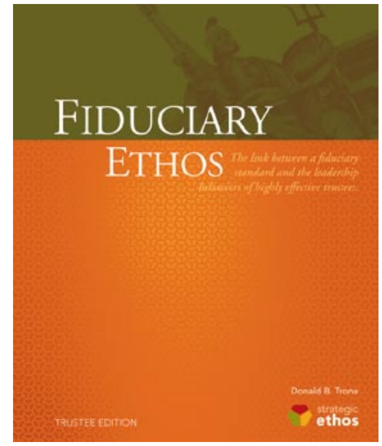
Marv Tuttle
Jean Cantey
Ian McKenzie
Duane Thompson

The FPA Board of Directors
The FPA Fiduciary Task Force
The Certified Financial Planner Board of Standards

The FPA's Standard of Care:

- Put the client's best interests first.
- Act with due care and in utmost good faith.
- Do not mislead clients.
- Provide full and fair disclosure of all material facts.
- Disclose and fairly manage all material conflicts-of-interest.

A Note about the *Fiduciary Ethos* Series



The ***FPA Edition*** is the third book in the *Fiduciary Ethos* "Series"—the other two are the ***Investment Advisor Edition*** and the ***Trustee Edition***.

All three books share the same decision-making dimensions and leadership behaviors. The primary difference with the ***FPA Edition*** is that the order of the Steps and Dimensions are arranged so that they align with the CFP Board's *Financial Planning Practice Standards.*

The advantage to the series is that you can use the ***Trustee Edition*** with clients who are serving in an investment fiduciary capacity—as a personal trustee or as a member of an investment committee of a retirement plan, foundation, or endowment. The procedural prudence you teach your fiduciary clients is parallel to the process outlined in the ***FPA Edition***.

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Foreword

Keith Loveland, J.D.

The FPA has a long history of advocating and advancing higher professional standards for the financial planning industry. In particular, the FPA is committed to serving in a leadership role in promoting fiduciary standards; supporting members and the profession with high-quality books and courses on fiduciary responsibility that are integrated with the FPA's holistic and comprehensive planning approach; and benefiting the public.

While each financial planning discipline warrants its own defined fiduciary standard, certain disciplines, particularly investment planning, have risen to a higher level of demand and relevance because of the current economic crisis. Many investors have lost trust and confidence in the capital markets and the financial services industry. Trust is the cornerstone of the financial planning profession, and the FPA is committed to the restoration of trust through its fiduciary education initiatives.

This book is intended to be the first in a series. It will present a fiduciary standard of care for investment decision-makers. Although the focus will be on investment planning, the ethos decision-making framework introduced in this book will be used to structure similar fiduciary standards for the remaining financial planning disciplines. Based on input from stakeholders, the FPA will identify subject matter experts from the remaining disciplines to produce each new book in the series:

- General Principles of Financial Planning
- Insurance Planning and Risk Management
- Employee Benefits Planning
- Income Tax Planning
- Retirement Planning
- Estate Planning

Background

In 2006, the FPA Fiduciary Task Force was formed and directed to research and review current and future issues regarding the use and status of fiduciary concepts and language in financial services. After extensive deliberations, the FPA Fiduciary Task Force recommended that the FPA adopt the following principles:

- Cultivate the body of knowledge and advance the financial planning profession.
- Establish a pattern of responsibilities, no matter what products or services are being offered.
- Promote consistent behaviors of professional conduct.
- Outline a decision-making process and corresponding leadership behaviors that can be applied throughout the financial planning process.

The FPA answered the call and adopted the principles. At the forefront of the FPA's current efforts is its leadership role in advancing a fiduciary standard of care for the profession. These efforts have included:

- The release of the ***Preliminary Report on Financial Planner Standards of Conduct*** in which there is a renewed call for professionalism, findings as to the current state of the law and practice, and recommendations relating to adoption of CFP Board's ***Professional Standards of Conduct***.
- The promulgation of the ***FPA Standard of Care***, which provided the FPA's interpretation of a fiduciary standard for financial planners.
- The development of ***Best Practices Tools and Templates***, which support the implementation of the ***FPA Standard of Care***.

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- The production of educational webinars offered through the ***FPA's Virtual Learning Center***, which focus on the ***FPA's Best Practices Tools and Templates*** and CFP Board's revised *Standards of Professional Conduct.*
- The formation of the ***Financial Planning Coalition*** in 2008, which brought together the FPA, CFP Board, and NAPFA to unify the voice of the profession and address regulatory issues.
- The approval by the FPA Board of Directors of the ***Fiduciary Education as a "Strategic Priority"*** in December 2009.
- And the most current effort, the publication of ***Fiduciary Ethos-FPA Edition*** and the development of related educational programs.

Other events have propelled the subject of fiduciary responsibility to the forefront of the industry:

- In July 2008, CFP Board's ***Standards of Professional Conduct*** was revised to include a fiduciary standard of care in its Rule 1.4.
- In the fall of 2008, the world entered into the worst economic crisis since the Great Depression. The economic meltdown can largely be blamed on systemic breaches of fiduciary responsibility by many of the world's major financial institutions.
- In June 2009, President Obama announced legislative efforts to reform the financial services industry, including a proposal calling for a change in legislation which would require all investment advisors to be held to a fiduciary standard of care.

The FPA Edition of *Fiduciary Ethos*

The FPA's educational initiative is to provide members and the profession with high-quality books and courses on fiduciary responsibility. ***Fiduciary Ethos*** incorporates—and then builds on—the holistic six-step, sequential financial planning process we all know:

1. Establishing and defining the client-planner relationship
2. Gathering client data, including goals
3. Analyzing and evaluating the client's current financial status
4. Developing and presenting recommendations and/or alternatives
5. Implementing the recommendations
6. Monitoring the recommendations

Fiduciary Ethos provides several important overlays and enhancements to the well-known financial planning process shown above. It does so by adding three important structural elements which correspond perfectly to the standards and codes promulgated by the FPA and CFP® Board of Standards:

1. The Ethos base, or foundation, is a principles-based fiduciary process standard.
2. Added to the Ethos base is a flexible, "universal," decision-making framework that defines a procedurally prudent process.
3. Added to the decision-making framework are the leadership behaviors that are essential to the role of the financial planner.

Fiduciary Ethos stands out because it is the first work to link leadership behaviors to a defined decision-making process. The financial planning process and related disciplines outline the ***competencies*** of the profession. ***Ethos*** builds upon these competencies to also address the ***effectiveness*** of the professional.

Foreword

The Impact of a Financial Planning Ethos

I am an optimist by nature—for me, the uncertainties of future change always hold great promise of improvement to the communities we serve. Adopting and embracing a *fiduciary ethos* will advance and elevate our profession by promoting a more effective decision-making process, and serving as a constant reminder of the critical leadership role we play in the lives of our clients.

Might ***Fiduciary Ethos*** be a catalyst for change? A strong, vibrant professional association should be avant-garde. The FPA is committed to being a leader in the fiduciary movement because it makes good business sense for its members and, more important, because it can dramatically improve the financial outcomes for individuals fortunate enough to be clients of financial planners.

Innovation, any new idea, drives change, and the current fiduciary movement is no exception. I foresee financial planners staking out a higher moral ground in the eyes of the public. Financial planners didn't need, or wait for, an economic crisis to begin advocating for a higher standard of care. ***Fiduciary Ethos*** will provide further validation of financial planning as a true advisory profession, regardless of the compensation or business model used by the financial planner.

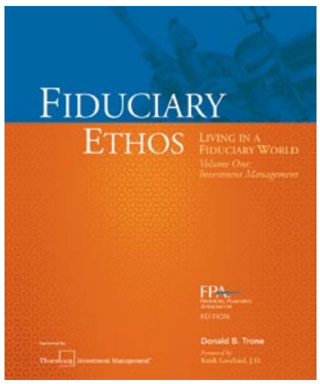
I foresee the financial planning process, the workflow, improve because of the application of a universal decision-making framework that can be applied to the whole planning process, or to the individual disciplines. Communications between staff and with other service professionals will dramatically improve because everyone is using the same framework.

Finally, I foresee financial planning practices (offices) becoming more efficient. The FPA already has taken the initiative to develop powerful and useful ***Best Practices Tools and Templates***, and more will be developed as an *ethos* is prepared for each of the remaining financial planning disciplines. When problems occasionally arise, most of the time it is because a financial planner omitted a critical step, and not because the planner used bad judgment.

The FPA's role in advocating fiduciary standards is well documented and has been of critical importance. However, much more needs to be done to educate the membership, profession, and public on the importance of fiduciary responsibility and the direct impact higher standards of care can have on the fiscal health of our country.

Author's Preface

This book will introduce you to a ***Fiduciary Ethos***; to a standard of excellence defined for financial planners. ***Ethos*** has three important structural elements which correspond to standards and codes promulgated by the FPA and CFP Board of Standards:



1. The ***Ethos*** base, or foundation, is a principles-based, ***fiduciary process standard.***	Both the FPA and CFP Board require financial planners to adhere to a ***fiduciary standard of care.***
2. Added to the ***Ethos*** base is a flexible, "universal," ***decision-making framework*** that defines a procedurally prudent process.	CFP Board's *Financial Planning Practice Standards* define a decision-making framework for financial planners.
3. Added to the decision-making framework are the ***leadership behaviors*** that are essential to the role of the financial planner.	The FPA and CFP Board *Codes of Ethics* define the principles which are intended to guide the behavior of financial planners.

Ethos helps to answer the question:
How do I incorporate these Standards and Code into my financial planning practice?

No matter what type of client you are working with, superior performance will be the result of developing a prudent process or strategy and then adhering to it. Only by following a structured process can you be certain that all critical components of a financial plan are being properly implemented.

Fiduciary Ethos is intended to be global in its application and to serve as the basis for a "global" standard. The decision-making process and leadership behaviors are the same, whether you are:

- Serving as a financial planner, wealth manager, or retirement advisor;
- Managing retail- or institutional-size portfolios;
- Advising individual investors, private trusts, foundations, endowments, or retirement plans;
- Based in the U.S. or in the Ukraine.

Author's Preface

Your role as the financial planner is to maximize the benefit to be gained from the process—that is, to maximize the likelihood of your clients, achieving their goals and objectives. It will be your actions as the manager of the financial planning process that will have the greatest impact on your clients' success.

Furthermore, when serving in a fiduciary capacity, you are required to demonstrate your *procedural prudence*—the details of your decision-making process. This book is intended to take the subject of procedural prudence to the next level—to define a ***fiduciary ethos.***

Added to the procedurally prudent process is another critical, often overlooked, aspect—leadership.

> ***Through the eyes of your clients, you have to be viewed as a leader. If you're not, you're never going to gain their trust and confidence, and you're going to have difficulty keeping your clients through the current crisis. The first response to any crisis should be (often it is not) a leadership response; and a financial crisis is no exception.***

If you accept this presupposition, than the follow-on question is:

> ***What is the leadership theory associated with your unique role as a financial planner?***

This book will attempt to answer that question, and will do so by linking the essential leadership behaviors of a financial planner to the decision-making process. I intend to take an integrated approach to bind together decision-making dimensions and leadership behaviors in order to define a standard of excellence—an *ethos* that is higher than what is required by industry regulations. ***Fiduciary Ethos*** is intended to suggest a new way of thinking about the role of the financial planner and to provide additional footing for the financial planning profession.

Ethos is intended to be a reference guide for knowledgeable financial planners, as opposed to a "how to" manual for persons who are not familiar with basic financial planning and investment management procedures. I will describe a decision-making process that provides clear guidance to practical, readily identifiable, and easily adaptable steps. The process is virtually the same for all types of clients, regardless of asset size. While the process discussed will not guarantee success, it will significantly increase the odds of building and structuring a financial plan that will withstand the test of private and public scrutiny.

Fiduciary Ethos outlines the requisites that make your roles and responsibilities authentic and ultimately practical. It is written for those of you who recognize that your role as a financial planner is a form of public service. The material is meant to be transformational—it is intended to make you think about the details of your decision-making process and the relationships that you have with your clients and your staff. It is meant to give you the framework to define your own ***fiduciary ethos.***

All the best,
Don Trone
Mystic, CT
don@5ethos.com

A profession is an exclusive group of people who possess and apply a systematically acquired body of knowledge derived from extensive research, education, training, and experience. Members of a profession have a special responsibility to fulfill their function competently and objectively for the benefit of society.

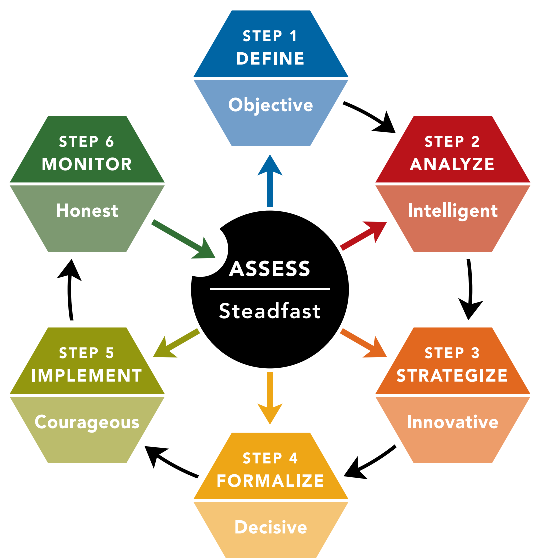
– *Duty with Honour* (Canadian edition)

Fiduciary Ethos Framework

Fiduciary Ethos is based on an interdependent, sequential framework which begins with the traditional six-step financial planning process (Define, Analyze, Strategize, Formalize, Implement, and Monitor). For each Step, we also have identified the leadership behavior that is essential for the execution of that Step (Objective, Intelligent, Innovative, Decisive, Courageous, and Honest). Central to this process is the need to assess performance on an ongoing basis, and to make necessary adjustments.

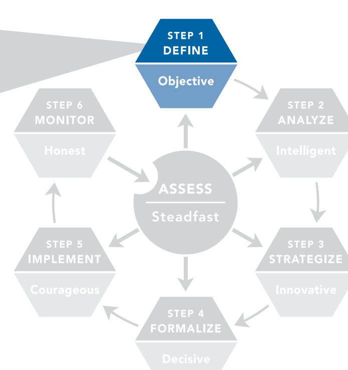
The secret of getting ahead is getting started. The secret of getting started is breaking your complex, overwhelming tasks into small, manageable tasks and then starting on the first one.

– Mark Twain



Each Step is then further defined (refined) by Decision-making Dimensions —there are 17 Dimensions.

Step 1: DEFINE	OBJECTIVE
Decision-making Dimension	Leadership Behavior
1.1: Define roles and responsibilities of decision-makers.	*Competent*

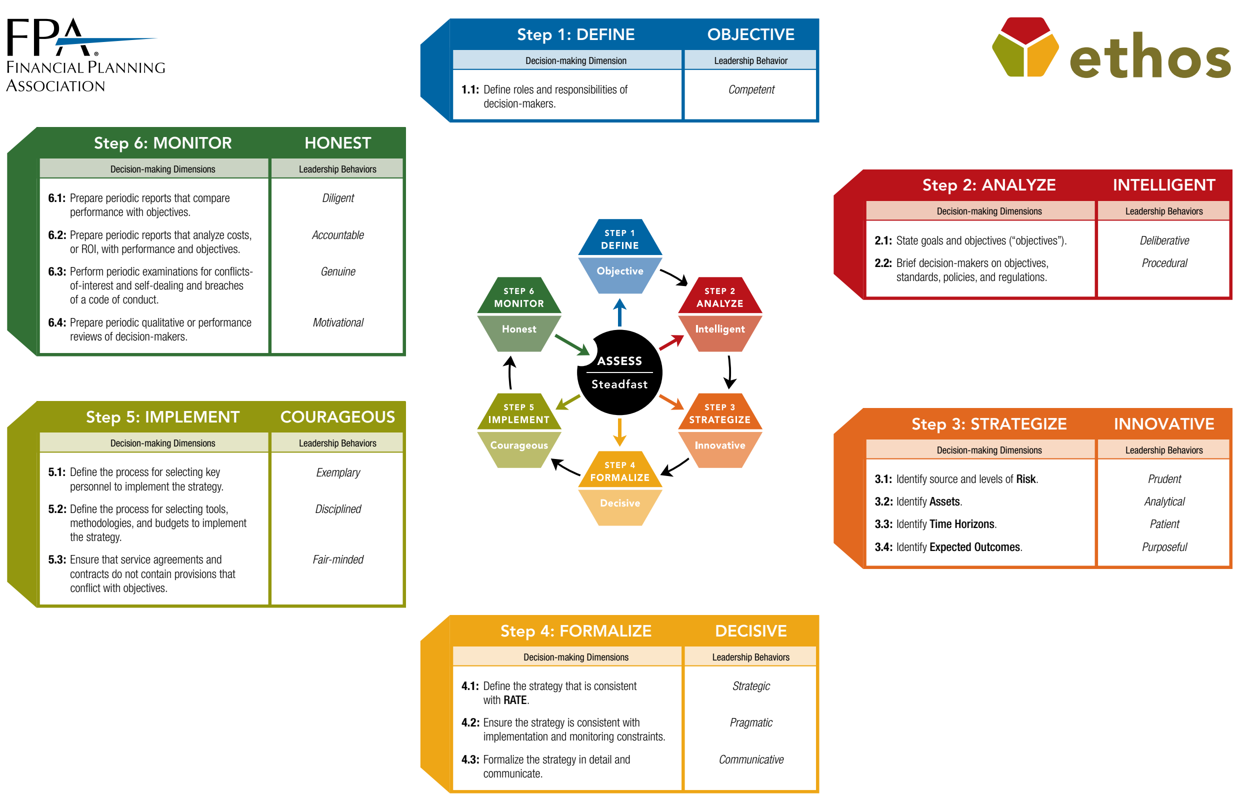


Fiduciary Ethos

In turn, each Decision-making Dimension has a corresponding leadership behavior.

Step 1: DEFINE	OBJECTIVE
Decision-making Dimension	Leadership Behavior
1.1: Define roles and responsibilities of decision-makers.	*Competent*

When the Steps, Decision-making Dimensions, and Leadership Behaviors are woven together, you produce the ***Ethos*** framework:



Fiduciary Ethos

Ethos Decision-making Dimensions and CFP Board's *Financial Planning Practice Standards*

	Ethos Decision-making Dimension(s)	CFP Board's *Financial Planning Practice Standard(s)*
Step 1: DEFINE	**1.1:** Define roles and responsibilities of decision-makers	**100-1:** Defining the scope of the engagement
Step 2: ANALYZE	**2.1:** State goals and objectives ("objectives") **2.2:** Brief decision-makers on objectives, standards, policies, and regulations	**200-1:** Determining a client's personal and financial goals, needs, and priorities **200-2:** Obtaining quantitative information and documents
Step 3: STRATEGIZE ("RATE")	**3.1:** Identify sources and levels of **Risk** **3.2:** Identify **Assets** **3.3:** Identify **Time Horizons** **3.4:** Identify **Expected Outcomes** ("performance")	**300-1:** Analyzing and evaluating the client's information
Step 4: FORMALIZE	**4.1:** Define the strategy that is consistent with **RATE** **4.2:** Ensure the strategy is consistent with implementation and monitoring constraints **4.3:** Formalize the strategy in detail and communicate	**400-1:** Identifying and evaluating financial planning alternative(s) **400-2:** Developing the financial planning recommendation(s) **400-3:** Presenting the financial planning recommendation(s)
Step 5: IMPLEMENT	**5.1:** Define the process for selecting key personnel to implement the strategy **5.2:** Define the process for selecting tools, methodologies, and budgets to implement the strategy **5.3:** Ensure that service agreements and contracts do not contain provisions that conflict with objectives	**500-1:** Agreeing on implementation responsibilities **500-2:** Selecting products and services for implementation
Step 6: MONITOR	**6.1:** Prepare periodic reports that compare performance with objectives **6.2:** Prepare periodic reports that analyze costs, or ROI, with performance and objectives **6.3:** Conduct periodic examinations for conflicts-of-interest and self-dealing and breaches of a code of conduct **6.4:** Prepare periodic qualitative reviews or performance reviews of decision-makers	**600-1:** Defining monitoring responsibilities

Fiduciary Ethos

Ethos Leadership Behaviors and the FPA and CFP Board's *Code of Ethics*

We have identified the following leadership behaviors as essential for an effective financial planner.

Step 1: DEFINE

Objective
Competent

Step 2: ANALYZE

Intelligent
Deliberative
Procedural

Step 3: STRATEGIZE

Innovative
Prudent
Analytical
Patient
Purposeful

Step 4: FORMALIZE

Decisive
Strategic
Pragmatic
Communicative

Step 5: IMPLEMENT

Courageous
Exemplary
Disciplined
Fair-minded

Step 6: MONITOR

Honest
Diligent
Accountable
Genuine
Motivational
Steadfast

Leadership does not come with detailed maps—only a general sense of direction.

– WWW.EEF.ORG

Ethos leadership behaviors have a strong correlation with the FPA and CFP Board's *Code of Ethics.*

FPA and CFP Board Principles	Corresponding Ethos Leadership Behaviors
Integrity	Courageous, Honest
Objectivity	Prudent, Patient, Purposeful, Pragmatic
Competence	Competent, Intelligent, Analytical, Strategic, Communicative
Fairness	Deliberative, Fair-minded, Genuine
Confidentiality	Accountable
Professionalism	Innovative, Decisive, Exemplary, Disciplined, Motivational
Diligence	Procedural, Diligent, Steadfast

Introduction

What Is an "Ethos"?

Ethos is fast-becoming *the* executive power word. Twenty years ago, the power word was "synergy." During the last ten years, executives were told to define their mission and value statements. Moving forward, professionals are going to be asked to define their organizational, or personal, *ethos*.

Simply stated, *ethos* is:

> *The distinguishing leadership behaviors, sentiment, moral nature, guiding beliefs, and decision-making doctrine of a person, group, or institution.*

Benefits of a Defined *Ethos*

There are numerous benefits associated with having a defined *ethos*:

1. Provides the framework for a simple decision-making process, which is a key success factor when operating in a complex and dynamic environment
2. Provides the basis for standards, prudent practices, and procedures which can be independently assessed and drive performance improvement
3. Guides consistent decision-making across all levels, which facilitates delegation to staff, money managers, and other service providers
4. Helps to benchmark current status, prioritize work, and measure progress
5. Helps to uncover procedural and behavioral risks of decision-makers
6. May help to reduce errors and omissions liability insurance premiums—awarding a "good driver discount" to advisors who can demonstrate conformance to a defined standard

The terms "ethos" and "ethics" are derived from the same Greek root word, and even share a similarity in their definitions. Both are based on moral behavior and are "principles-based," as opposed to "rules-based." (Principles-based standards tend to define higher standards of care. In contrast, regulatory compliance requirements would be an example of "rules-based" standards.)

However, *ethos* is used in a much broader context and includes the link between behavior, principles, and discernment (the ability to judge wisely and objectively). In addition to the moral behavior (ethics) of a financial planner, *ethos* also examines the planner's leadership behaviors and decision-making process.

"Ethos" is "ethics" on steroids—the difference between "good" and "great" financial planners can be explained in terms of the planners' defined ethos. The fact that a planner can demonstrate conformance to a code of ethics does not mean the planner has a defined *ethos* and is capable of managing a sound decision-making process, or has the capacity to effectively work with clients.

The differences between "bad" and "good"financial planners—even the differences between "good" and "great"—can be explained in terms of a defined *ethos*: There is a consistency in the leadership behavior, sentiment, moral nature, guiding beliefs, and decision-making process of great financial planners.

Introduction

What Is Required of a Financial Planner Providing Investment Advice?

If you provide clients comprehensive and continuous investment advice, you need to demonstrate that you are following a prudent investment process which is based on:

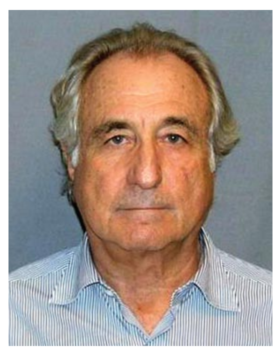
- Industry best practices;
- The best interests of the client; and
- Generally accepted investment theory.

Your effectiveness as a financial planner will be evaluated against a process standard—can you demonstrate the process that you followed to prudently manage your investment decisions? Complaints and/or lawsuits alleging misconduct are likely to increase as investment strategies become more complex and our capital markets become more volatile. However, contrary to popular opinion, liability generally is not determined by investment performance, but by whether a prudent process was followed.

> ***It's not whether you win or lose; it's whether you can demonstrate how you played the game.***

As a practical matter, a comprehensive framework is needed to ensure that your process is fully and effectively addressed on an ongoing basis. Most investment litigation involves the omission of certain practices and/or prudent procedures, as opposed to the commission of certain acts.

This book incorporates a "checklist" process to help ensure that your investment decisions are prudently managed. However, I caution you not to fall into a "checklist mentality"—putting a checkmark in the "box" without fully investigating the appropriateness or completeness of a procedure.



Soap Box

As we have witnessed repeatedly for the last two decades, securities regulations do not fully protect investors. In fact, there is growing evidence that there is an inverse relationship between regulations and instances of abuse and fraud.

Complicated disclosures make it more difficult for the public to make informed investment decisions, and voluminous regulations only make it easier for dishonest advisors to hide within the system.

The fact that Bernie Madoff was "registered" with the SEC no doubt lulled some of his investors into thinking that the SEC had conducted its own due diligence on Bernie and there was no need for the investor to replicate the effort.

A sad state of our industry is that there always will be financial planners who hide behind the letter of the law in order to escape the higher demands of an ethos. One of the objectives of this book is to provide you with a unique approach to client relationships: one that is beneficial in helping you fulfill your role as a financial planner while, at the same time, rebuilding trust with your clients.

Introduction

Investment Decision-making Roles

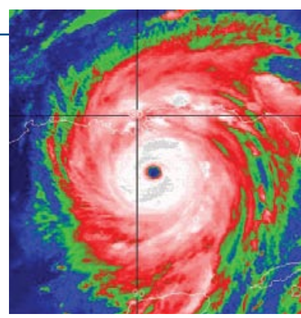
Broker/Agent	Steward	Fiduciary
The decision-maker is ***authorized to act*** on another party's behalf. The advisor's conflicts-of-interests should be fully disclosed.	The decision-maker has ***agreed to act*** on another party's behalf—there is a basis of trust and confidence. The interests of the advisor should be aligned with those of the other party.	The decision-maker has ***accepted legal responsibility to act*** on another party's behalf. The advisor can have no conflicts-of-interest.

Lowest → **Highest**

Requisite Level of Procedural Prudence

Examples of "*Ethos*" in Action

Example #1 – U.S. Coast Guard



I recently completed an assignment as Director of the Institute for Leadership at the U.S. Coast Guard Academy, and one of the questions I attempted to answer was: "Why was the Coast Guard so successful in its response to Katrina?"

I discovered that the short answer was "ethos"—the Coast Guard has a well-defined ethos. No matter where you sample the Coast Guard's inner core, you find a consistency in the leadership behavior, sentiment, moral nature, guiding beliefs, and decision-making doctrine of the organization.

"The Coast Guard faced many of the same challenges as other government agencies in responding swiftly to Hurricane Katrina—and yet it was able to outperform all of them… Its service in the hours after Katrina descended on New Orleans has been the one bright spot to an otherwise dismal early government response."

– ***The Washington Times***
September 8, 2005

Decision-maker's Standard of Care

At the risk of oversimplification, a financial services professional can be categorized either as a broker/agent, steward, or fiduciary. One of the difficulties facing the industry is that often there are no visible lines distinguishing one role from another.

Under most regulatory schemes, it is the ultimate decision of the court or arbitration panel that determines the role you have played and, in turn, the requisite level of procedural prudence that you will have to demonstrate. Your services agreement or contract that defines your role is helpful, but doesn't preclude a court from reviewing the facts and circumstances to determine whether you should be held to a higher standard of care.

In the case of FPA members and CFP® certificants, the determination of fiduciary status has been made for you—*you will be considered a fiduciary when providing financial planning!*

The FPA's *Standard of Care* states:

- Put the client's best interests first.
- Act with due care and in utmost good faith.
- Do not mislead clients.
- Provide full and fair disclosure of all material facts.
- Disclose and fairly manage all material conflicts-of-interest.

CFP Board's *Rules of Conduct* – Rule 1.4 states:

> *A certificant shall at all times place the interest of the client ahead of his or her own. When the certificant provides financial planning or material elements of financial planning, the certificant owes to the client the duty of care of a fiduciary as defined by CFP Board.*

Introduction

These are two additional reasons why you should have a well-defined process that meets the requisites of a fiduciary's procedural prudence, such as the decision-making process covered in this book. By following a structured process, you can be confident that critical components of an investment strategy are being properly implemented and that you are fulfilling your fiduciary responsibilities.

Fiduciary Code of Conduct

A fiduciary is defined as someone acting in a position of trust on behalf of, or for the benefit of, a third party. Determination of fiduciary status is a complicated area that requires expert legal advice. In a general statement, it is determined by "facts and circumstances" and persons likely to be considered fiduciaries include:

- RIAs – including both investment advisors and money managers;
- Registered Reps providing comprehensive and continuous investment advice or financial planning for a fee;
- Trustees and investment committee members of retirement plans, foundations, and endowments; and
- Trustees of a personal trust.

U.S. fiduciary requirements are codified under four Acts—one is federal (ERISA), and three (MPERS, UPIA, and UPMIFA) require adoption on a state-by-state basis. The model state legislation was promulgated by the National Conference of Commissioners on Uniform State Laws (www.nccusl.org), and their Website provides an update on the status of the adoption of the various Acts by each state.

ERISA (Employee Retirement Income Security Act of 1974) – federal legislation impacting qualified retirement plans

MPERS (Uniform Management of Public Employee Retirement Systems Act) – model state legislation defining a higher standard of care for trustees of state, county, and municipal retirement plans

UPIA (Uniform Prudent Investor Act) – model state legislation defining a higher standard of care for trustees of personal trusts

UPMIFA (Uniform Prudent Management of Institutional Funds Act) – model state legislation defining a higher standard of care for trustees of foundations, endowments, and other charitable assets

Fortunately, the four fiduciary Acts define substantially similar fiduciary requirements, which can be summarized as follows. The investment fiduciary is required to:

1. Define the goals and objectives of the portfolio.
2. Diversify portfolio assets with regard to a specific risk/return profile.
3. Prepare a written investment policy, and document the process used to manage investment decisions.
4. Use prudent experts (professional money managers and service providers) to implement the investment policy.
5. Monitor the activities of hired prudent experts.

A fiduciary is a steward cloaked in a legal shawl.

– Don Trone

Introduction

Law of Decreasing Risk

With the recent crisis, investors saw all asset classes tank—there were no "safe harbors." This has led some industry observers to conclude that modern investment theory is dead—diversification failed to protect investors.

I disagree. There were asset classes that did not retreat as far as equities; and investors who were prudently diversified fared much better than those who were not.

Furthermore, those investors who were applying additional prudent investment procedures (additional to diversification)—such as having a due diligence process for selecting their money managers, and procedures for monitoring the managers they hired—fared considerably better than those investors who had merely diversified their portfolios.

This observation—the performance differential between the returns earned by investors that were procedurally prudent versus those who were not—set me on the path of exploring the concept of the *Law of Decreasing Risk*.

The management industry has the ***Law of Compounding Risk*** (developed by Robert Porter Lynch), which states that complexity increases by double the number of new elements introduced in a business model. For example: The complexity of (1) launching a new product, (2) with a new partner, and (3) in a new location increases the complexity (and therefore the likelihood of failure) by a factor of six. For those of you who are math majors, the formula is:

(N)(N-1) = compounded risk

If the ***Law of Compounding Risk*** is true, then shouldn't the opposite also hold true: that complexity (risk) should decrease as we introduce prudent procedures to a decision-making process? That the risk of an investor not meeting their goals and objectives proportionally decreases by the number of additional prudent investment practices being employed? For example, the investors who prudently (1) diversify their portfolios, (2) employ a due diligence process in selecting their managers, and (3) monitor the performance of their portfolios substantially reduce their investment risk (of not meeting their goals and objectives). The formula would look something like:

(N-1)/N = decreased risk

I strongly suspect that the "math" behind the ***Law of Decreasing Risk*** will not withstand empirical testing. However, I do believe it provides a conceptual framework for arguing the value of being procedurally prudent. (Keep in mind that the law already requires the fiduciary to be procedurally prudent.)

Law of Compounding Risk*	Law of Decreasing Risk*
Complexity (risk) increases by double the number of new elements introduced in a business model. ***Example:*** The complexity of (1) launching a new product, (2) with a new partner, (3) in a new location increases the risk of failure by a factor of six. [Formula: (N)(N-1) = compounded risk] *Source: Robert Porter Lynch, ***Business Alliance, the Hidden Competitive Weapon***	The risk of investors not meeting their goals and objectives decreases proportionally by the number of additional prudent investment practices employed. ***Example:*** Investors who prudently (1) diversify their portfolios, (2) employ a due diligence process in selecting their managers, and (3) monitor the performance of their portfolios reduce their investment risk by two-thirds. [Formula: (N-1)/N = decreased risk] *Source: Don Trone

Introduction

Ethos Leadership Theory

Take a moment and think about the great decision-makers in the financial planning industry. *What behaviors and traits do they have in common?* They are viewed as leaders in the eyes of their clients and staff, their peers in the industry, and their community.

Great financial planners also tend to be great leaders, and it is because of their leadership behaviors that clients place their trust and confidence in planners. One can rise to a position of leadership by the role or position he or she assumes, or by influencing the decisions of others.

Leadership, as defined within the context of ***Fiduciary Ethos***, is about projecting ethical and objective advice, and convincing all parties involved with the investment process to follow and to do what is right. Great ***Ethos*** financial planners must possess the character and values, innate traits, and acquired skills of a leader—traits and skills that can't be legislated, tested, measured, or audited by regulators.

If you accept the premise that great financial planners also must be great leaders, than what leadership theory adequately defines the unique role of the financial planner?

If you were to examine the five most prominent leadership theories found in business literature today, no one theory adequately defines the leadership role of the financial planner. However, we could easily describe ***Ethos*** leadership theory as a melding of the five leading theories:

Servant Leadership: What are the needs of my client?

Situational Leadership: What are the capacity and willingness of my clients to be involved in the financial planning process?

Transactional Leadership: What rules and regulations impact my conduct as a financial planner?

Transformational Leadership: What are the best practices of other financial planners?

Emotional Intelligence: What is my ability to monitor the feelings and emotions of my clients, and to use this information to guide my thinking and actions?

The ***Ethos*** leadership style will appeal to the financial planner who possesses the following behaviors:

- A sincere commitment and courage to develop a consensual formulation of client goals and objectives;
- The discipline to develop long-term strategies, and the patience and courage to evaluate events calmly against the backdrop of uncertainty;
- An understanding of personal and organizational strengths and weaknesses to determine when delegation and outsourcing is appropriate; and
- The ability to get the right things done, otherwise known as effective management (the link to *Organizational Ethos*, the next book in the ***Ethos*** series).

Ethos leadership is the actualization of our victory over our own petty self-interests.

– Don Trone

Introduction

Management versus Leadership*

When defining *Ethos* leadership, the terms "management" and "leadership" are not always interchangeable. Great *Ethos* financial planners need to be great managers, but the opposite is not always true—great managers are not always great *Ethos* planners. *Ethos* planners not only inspire people to get things done; they know how to get things done. As agents of change, they have the skill sets to organize, coordinate, direct, and administer a decision-making process.

Ethos management includes:

- Allocating resources (human, financial, material, intellectual, or intangible) in an optimum combination;
- Implementing strategies in a timely manner;
- Producing monitoring reports on a regular basis, and suggesting appropriate adjustments; and
- Documenting decisions as they are made.

Taken collectively, management is about the mechanics of leadership, and is a significant component in the "how" part of leadership—"how" to get things done. *Fiduciary Ethos* incorporates these same key elements that are essential to any effective decision-making process.

To successfully apply the *Ethos* process, you must:

- Maintain a macro/portfolio view, and avoid the lure of hot investment trends and products;
- Have a keen eye for identifying and prioritizing strategic issues—focus first on determining the right things to do, then prioritize what needs to be accomplished;
- Have a systematic approach for crafting and choosing between alternative solutions;
- Provide clear direction to staff, money managers, and service providers; and
- Be disciplined and follow through.

**The author acknowledges the influence of Don Phillips and Admiral James Loy, and their book* The Architecture of Leadership *in the development of this section.*

Management versus Leadership

The manager administers; the leader innovates.
The manager is a copy; the leader is an original.
The manager maintains; the leader develops.
The manager focuses on systems and structure; the leader focuses on people.
The manager relies on control; the leader inspires trust.
The manager has a short-term view; the leader has a long-term view.
The manager asks why and how; the leader asks what and why.
The manager has his/her eye on the bottom line; the leader has his/her eye on the horizon.

Warren Bennis and Robert Townsend
Reinventing Leadership

Introduction

Hard-core Core Values

Hard-core core values are the gut-level, heartfelt moral beliefs that are the foundation for how you conduct your life and, in turn, the activities associated with your financial planning practice. Hard-core core values *happen*—whether or not you formally define your core values, you are going to be known by the values that are evident to others in how you conduct your activities. A common behavior of great leaders is that they are deliberate in the articulation and communication of their core values.

You need to identify and communicate clear, concise values, priorities, and direction so that everyone associated with your financial planning practice understands what constitutes acceptable behavior. In turn, once defined, your role is to ensure that the hard-core core values are nurtured, monitored, and honored.

Understand that hard-core core values will have a measurable impact on your practice. As an example:

- **They come with risks:** Unfortunately, in today's world where *caveat emptor* has become the acceptable business standard, hard-core core values such as honesty and integrity often result in lower short-term profits. But, in return, they are essential for long-term success.
- **They have an impact on your assets:** The nurturing of hard-core core values will involve the expenditure of time, staff, and money. Hard-core core values don't come cheap, and you have to be willing and committed to pay the price.

Central to almost all hard-core core values are two themes—"stewardship" and the corollary "covenants":

Stewardship – Simply defined: Having the passion and willingness to take responsibility for others, and/or for the property of others. As an example, "stewardship" involves a commitment to be responsible for your staff, your clients, your profession, and the communities you touch. Words often associated with "stewardship" include:

Integrity
Honesty
Respect for diversity
Client focus
Responsibility

Examples of "*Ethos*" in Action

Example #2 – Ritz Carlton

The Ritz Carlton hotel company is known for delivering the highest in luxury service across their worldwide network of hotels. Horst Schulze, the founder, and key members of his staff are now developing a new, six-star brand of hotel "Capella."

Horst is quick to discuss the internal value system that guides his hotels and is at the heart of their attention to detail and focus on customer services. The Ritz has what are referred to as their "20 Basics." These form the philosophical framework that all employees are taught and live by in making decisions each and every day at the Ritz.

The key thing to note about these "Basics" is that they are the framework of the culture at the Ritz, and everyone learns and reinforces them in daily sessions held for every shift for every employee from the top of the hotel to the janitorial staff. They are designed to give all employees the guiding principles they can use and rely on in making decisions that affect customers daily—decisions where there are no processes in place to guide them.

In the words of Horst Schulze, "The difference between poor organizations and good organizations is the definition of effective business processes. Great organizations are built on a clear framework of values used by all employees to deliver the business mission understood by everyone in the organization."

Introduction

Covenants – the corollary to "stewardship": A solemn, one-party promise—it represents your discipline. A covenant is not the same as a contract, where there is an expectation that each party will fulfill certain promises. A covenant is one-sided. It is your willingness to do something, regardless of how the other side responds. It is what you are willing to go to the mat for; what you are willing to fight for. Words often associated with "covenants":

Accountable
Competent
Professional
Diligent
Innovative

The public position of the Indian has always been entirely dependent upon our private virtue. We are never permitted to forget that we do not live for ourselves alone, but for our tribe and clan. Every child, from the first days of learning, is a public servant in training.

– Ohiyesa (Charles Eastman), Santee

"Effective leadership emerges naturally out of a foundation of well-thought-through purposes and principles that become the center of a person's life."

– Stephen Covey, ***The 7 Habits of Highly Effective People***

Indigenous Wisdom as a Mentoring Spirit

The concepts of "stewardship" and "covenants," which are the cornerstones of ***Fiduciary Ethos***, are global and as old as the written and spoken language. Whether we are studying the ancient writings of the Abramic religions (Judaism, Christianity, and Islam), Greek and Roman philosophy, or the indigenous wisdom of American Indian tribal leaders, the concepts remain the same. It could be said that their meanings are part of our genetic makeup; a DNA all people have in common.

Although the concepts of stewardship and covenants are something we all should understand, headlines continue to be filled with stories of fiduciary breaches. Even well-informed and well-intentioned financial planners struggle with the juxtaposition of their responsibilities against an increasingly complex and conflicted world.

The financial planner is highly regulated: It would seem that almost every decision that could be made comes complete with its own set of rules and regulations. Regulations are a necessary feature, and can be constructive (as are checklists); but regulations (and checklists) alone will never fully inform you of your duties and responsibilities. For this reason, we will be using indigenous wisdom quotes to further illuminate the critical role you play as a financial planner.

Introduction

From indigenous wisdom comes *Fiduciary Ethos*

Situational Ethos

At this point, you might be wondering whether you can trust an author who is advocating that indigenous wisdom and leadership behaviors be used alongside a text about fiduciary responsibility. There's a method to my madness.

I have been writing and preaching about fiduciary responsibility for more than twenty years. During this time, it was evident that people really hate the subject! And why not? When the subject of fiduciary responsibility is discussed in our industry, we typically talk about the liabilities, risks, and responsibilities—all negative subjects.

It doesn't have to be that way. ***Fiduciary Ethos*** is about improving the decision-making process we employ when we have the responsibility—the awesome responsibility—for managing someone's financial plan. It's about the journey, the destination, and our leadership role along the way.

How you get your clients there—to planning excellence—is your primary responsibility. But in addition you need to determine how you're going to think about your role: You may find that you respond best to indigenous wisdom, or to discussions about essential leadership behaviors and traits.

The choice is yours.

Use of Quotes and Indigenous Wisdom

I like to use quotes to illustrate my points—some would say I like to use them a lot! Loosely quoting Winston Churchill: *"If you don't have the time or money to go to college, study quotes."*

Certain leadership quotes will be essential in understanding of the concepts I'm trying to make, and these quotes will be embedded in the text. Other quotes support the concept, but are not essential, so these leadership quotes will be set aside in a "shadowbox" depicted with the statue *Britannia.*

I have chosen this image for the leadership quotes since it provides a wonderful visual reminder of your role as being part **Steward**, **Strategist**, and **Sentinel**.

Likewise, indigenous wisdom also can serve as a means to illuminate a *fiduciary ethos.* The indigenous wisdom will be set aside with a medicine wheel which depicts the 6-Step ***Ethos*** process in Native American symbols.

step 1

DEFINE

Overview

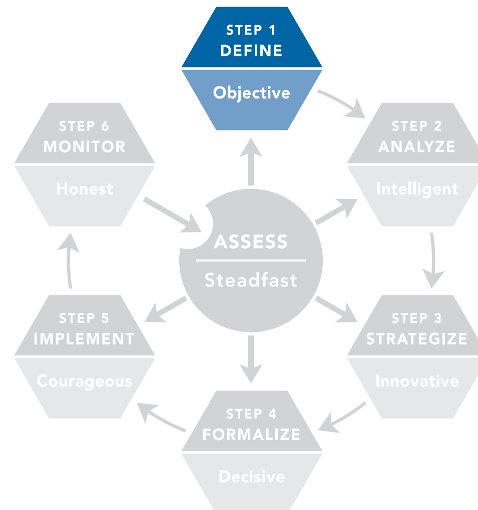
Essential Leadership Behavior:

OBJECTIVE

Defined as: The ability to provide appropriate solutions to client goals and objectives based on inductive and deductive reasoning; and recognize and neutralize personal biases.

What does the organization, my stakeholders, need me to be today: a coach, a teacher, a decision-maker, a supporter, a listener, a pilgrim, a servant, someone who makes waves?

– Ken Melrose on becoming a Servant Leader



Supports the FPA and CFP Board's *Code of Ethics*

Principle 2 – Objectivity

Provide professional services objectively.

Objectivity requires intellectual honesty and impartiality. Regardless of the particular service rendered or the capacity in which a certificant functions, certificants should protect the integrity of their work, maintain objectivity, and avoid subordination of their judgment.

Supports CFP Board's *Practice Standards*

100-1: Defining the Scope of the Engagement

The investment management process begins by you defining for the client the scope of the proposed financial planning engagement. Paraphrasing CFP Board's *Practice Standard 100-1*, you need to:

- Identify the service(s) to be provided;
- Disclose any material conflict(s)-of-interest;
- Disclose your compensation arrangement(s);
- Identify your responsibilities and those of the client;
- Establish the duration of the engagement; and
- Provide any additional information necessary to define or limit the scope.

Step 1: DEFINE	OBJECTIVE
Decision-making Dimension	Leadership Behavior
1.1: Define roles and responsibilities of decision-makers.	*Competent*

1.1

Define Roles and Responsibilities of Decision-makers

DEFINE

step 1

The Dimension under Step 1 is to: "Define roles and responsibilities of decision-makers."

Successful financial planners have many different approaches, but virtually all develop clear, unambiguous planning strategies and apply them consistently. This discipline is the key defining behavior of all great planning professionals.

As the financial planner, you play the most critical role in the decision-making process—you are the manager of the process. But what role will other professionals and trustees play, and are they aware of their responsibilities? Who is serving in a fiduciary capacity, and who is not?

The parties that may be involved include:

- Trustees of personal trusts (usually deemed to be fiduciaries);
- In the case of retirement plans, foundations, or endowments, investment committee members (usually deemed to be fiduciaries, but check for the existence of bylaws that will normally specify whether or not committee members are fiduciaries);
- Money managers (usually deemed to be fiduciaries, but confirm fiduciary acknowledgement in the manager's services agreement);
- Custodian (usually deemed to be a "narrow scope" fiduciary); and
- Accountants and attorneys (ordinarily not fiduciaries).

To ensure alignment, that all parties involved in the decision-making process are in sync, each party's role and responsibilities should be communicated in writing, either by a services agreement or in the investment policy statement (Step 4–Dimension 4.3). Alignment enables decision-makers to delegate with confidence, and those empowered to act without hesitation.

Essential Leadership Behavior:

COMPETENT

Defined as: Self-assured; having the requisite skills suitable for a defined purpose; ability to lead staff.

The real need in most investment relationships is not for more ***investment*** *management, but for more* ***management*** *management, and this set of skills is far more likely to be found among corporate executives, foundation trustees, and makers of trusts with general management experience and orientation than among investment management specialists.*

– Charles D. Ellis

Supports the FPA and CFP Board's *Code of Ethics*

Principle 3 – Competence

Maintain the knowledge and skill necessary to provide professional services competently.

Competence means attaining and maintaining an adequate level of knowledge and skill, and application of that knowledge and skill in providing services to clients. Competence also includes the wisdom to recognize the limitations of that knowledge and when consultation with other professionals is appropriate or referral to other professionals necessary. Certificants make a continuing commitment to learning and professional improvement.

step
1

DEFINE

Leaders need not be the best performers.

– Tom Peters, *Leadership, The Essential Series*

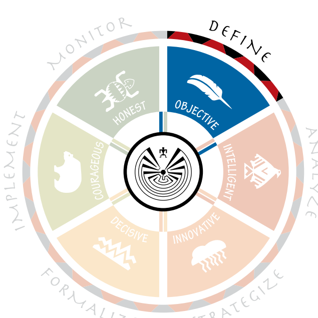
In organizations, real power and energy is generated through relationships. The patterns of relationships and the capacities to form them are more important than tasks, functions, roles, and positions.

– Margaret Wheatley, *Leadership and the New Science*

The best executive is the one who has sense enough to pick good men to do what he wants done, and self-restraint to keep from meddling with them while they do it.

– Theodore Roosevelt

Among the Indians there have been no written laws. Customs handed down from generation to generation have been the only laws to guide them. Anyone might act different from what was considered right if he chose to do so, but such acts would bring upon him the censure of the Nation. This fear of the Nation's censure acted as a mighty band, binding all in one social, honorable compact.



– *George Copway, Ojibwa Chief*

1.1

Define Roles and Responsibilities of Decision-makers

This book is not going to focus on CFP Board's *Rules of Conduct* except when they may apply to certain Dimensions, such as this Dimension. (You always should consult with the *Rules* to ensure compliance and not rely solely on this book as an authoritative source.)

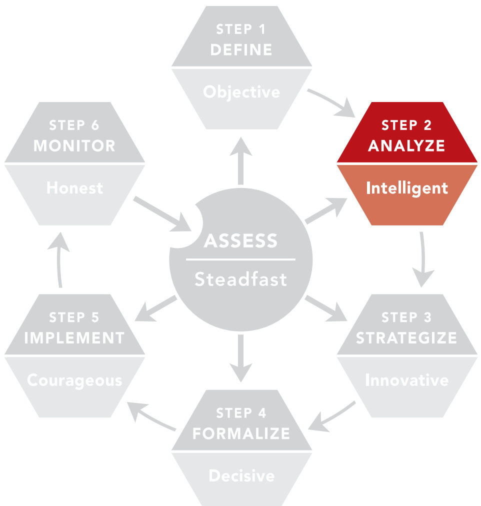
The *Rules* specify certain requirements that must be fulfilled at the start of the client engagement. Besides the requirements associated with *Standard 100-1, Rule 1.2* lists additional obligations of the financial planner:

> *1.2 If the certificant's services include financial planning or material elements of financial planning, prior to entering into an agreement, the certificant shall provide written information or discuss with the prospective client or client the following:*
>
> a. The obligations and responsibilities of each party under the agreement with respect to:
>
> *i. Defining goals, needs, and objectives*
> *ii. Gathering and providing appropriate data*
> *iii. Examining the result of the current course of action without changes*
> *iv. The formulation of any recommended actions*
> *v. Implementation responsibilities, and*
> *vi. Monitoring responsibilities.*

Overview

ANALYZE

step 2



Essential Leadership Behavior:

INTELLIGENT

Defined as: Great judgment; practical; has the ability to quickly comprehend new information.

True genius resides in the capacity for evaluation of uncertain, hazardous, and conflicting information.

– Winston Churchill

In Step 1, we defined for the client the scope of the proposed engagement, specifically your roles and responsibilities. In this next step, we are going to define the goals and objectives of the client, and ensure that all the decision-makers involved with the client's portfolio are aware of their roles and responsibilities; and of the standards, policies, and regulations that will impact the investment process.

To implement the process, it is necessary to obtain a complete understanding of the client's current financial position, legal and regulatory constraints, current service providers and professional advisors, and investment risk/return profile. This understanding is obtained from an in-depth analysis of the current facts and circumstances pertaining to the funds to be invested.

There are two Dimensions (Dimensions define the details) to this Step—note also the leadership behavior quintessential to each Dimension:

Step 2: ANALYZE	INTELLIGENT
Decision-making Dimensions	Leadership Behaviors
2.1: State goals and objectives ("objectives").	*Deliberative*
2.2: Brief decision-makers on objectives, standards, policies, and regulations.	*Procedural*

Supports the FPA and CFP Board's *Code of Ethics*

Principle 3 – Competence

Maintain the knowledge and skill necessary to provide professional services competently.

Competence means attaining and maintaining an adequate level of knowledge and skill, and application of that knowledge and skill in providing services to clients. Competence also includes the wisdom to recognize the limitations of that knowledge and when consultation with other professionals is appropriate or referral to other professionals necessary. Certificants make a continuing commitment to learning and professional improvement.

Supports CFP Board's *Practice Standards*

200-1: Determining a Client's Personal and Financial Goals, Needs, and Priorities

200-2: Obtaining Quantitative Information and Documents

step 2

ANALYZE

2.1

State Goals and Objectives ("objectives")

Essential Leadership Behavior:

DELIBERATIVE

Defined as: Persuasive; ability to build consensus; identify strategic needs of the organization/client; be able to listen to different and opposing opinions in order to galvanize common goals and objectives.

When you first assemble a group, it's not a team right off the bat. It's only a collection of individuals.

– "Coach K" (Duke Basketball Coach Mike Krzyzewski)

Supports the FPA and CFP Board's *Code of Ethics*

Principle 4 – Fairness

Be fair and reasonable in all professional relationships. Disclose conflicts-of-interest.

Fairness requires impartiality, intellectual honesty, and disclosure of material conflicts-of-interest. It involves a subordination of one's own feelings, prejudices, and desires so as to achieve a proper balance of conflicting interests. Fairness is treating others in the same fashion that you would want to be treated.

The first Dimension under Step 2 is to: "State goals and objectives."

Investment decisions should never be managed in isolation or in a vacuum. All factors that may have a bearing on investment decisions should be identified, analyzed, and integrated into the process; particularly the determination of the client's goals and objectives.

As with the running of any business, definitive objectives must be established. Here, you and the client play a key management role in defining the objectives that are realistic and consistent with the client's current and future resources, and with the client's values and priorities.

Quoting from *Practice Standard 200-1*:

> *The process of "mutually-defining" is essential in determining what activities may be necessary to proceed with the client engagement. Personal values and attitudes shape the client's goals and objectives and the priority placed on them. Accordingly, these goals and objectives must be consistent with the client's values and attitudes in order for the client to make the commitment necessary to accomplish them.*
>
> *Goals and objectives provide focus, purpose, vision, and direction for the financial planning process. It is important to determine clear and measurable objectives that are relevant to the scope of the engagement. The role of the practitioner is to facilitate the goal-setting process in order to clarify, with the client, goals and objectives. When appropriate, the practitioner shall try to assist clients in recognizing the implications of unrealistic goals and objective. …These areas are subjective and the practitioner's interpretation is limited by what the client reveals.*

2.1

State Goals and Objectives ("objectives")

ANALYZE

step 2

You begin by collecting, reviewing, and analyzing all of the documents pertaining to the management of the client's portfolio:

- Investment policy statements (IPS);
- Applicable trust documents (including amendments);
- Custodial and brokerage statements so that current fees and expenses for investment management can be analyzed;
- Service agreements with investment management vendors (custodians, money managers, investment consultant, actuary, accountant, and attorney);
- Information on retained money managers, such as in a prospectus or similar documents; and
- Any other files pertaining to the management of the client's portfolio.

If the client is an "institution"—the retirement plan of a corporation, or the assets of a foundation or endowment—additional information should be collected and analyzed:

- Organizational mission, values, culture/norms statements, and strategic plans;
- Descriptions of the organization's history, including people, growth, acquisitions, etc.; and
- Policy and procedures manuals, corporate minutes, and any other files pertaining to the management of the investable assets.

Particular attention should be paid to documents which: identify trustees and named fiduciaries; restrict or prohibit certain asset classes; or allow for investment decisions to be prudently delegated.

An inquiry also should be made as to whether the client desires to incorporate in the investment strategy socially responsible investing (SRI)—related terms you may encounter include:

- Mission-based investing;
- ESG (environmental, social, and corporate governance);
- Sustainable investing; and
- ETI (economically targeted investing).

In general terms, SRI (and related terms) seeks to align the client's values with the investment portfolio. The social investor looks beyond a stock price to consider how the company serves society as a whole.*

The outcome of this initial analysis should be the establishment of the client's strategic, long-term goals and objectives—the client's tactical short-term performance expectations will be identified in Step 3–Dimension 3.4. Strategic objectives:

- Need to align with the client's financial resources, values, and priorities;
- Must be within the limits and constraints of any applicable regulations and statutes (Dimension 2.2); and
- Should be periodically assessed in light of current results and future trends.

*The guide, ***Socially Responsible Investment Handbook for Native Tribes and Organizations***, produced by the Social Investment Forum (www.socialinvest.org) contains additional information on SRI and the investment process that should be followed by a fiduciary.

step 2

ANALYZE

2.2

Brief Decision-makers on Objectives, Standards, Policies, and Regulations

Essential Leadership Behavior:

PROCEDURAL

Defined as: Supports and has an understanding of standards, procedures, policies, rules, and regulations.

Society depends upon professionals to provide reliable fixed standards in situations where the facts are murky or the temptations too strong. Their principal contribution is an ability to bring sound judgment to bear on these situations. They represent the best a particular community is able to muster in response to new challenges.

– Dr. Robert Kennedy, St. Thomas University

Supports the FPA and CFP Board's *Code of Ethics*

Principle 7 – Diligence

Provide professional services diligently.

Diligence is the provision of services in a reasonably prompt and thorough manner, including the proper planning for, and supervision of, the rendering of professional services.

The second Dimension under Step 2 is to: "Brief decision-makers on objectives, standards, policies, and regulations."

It is essential that you determine the legal character or ownership of the client's investable assets, which reveals quite a bit about what is and isn't permissible or appropriate among potential asset classes or investment strategies. For example, if the client is a retirement plan, there are very specific limitations on whether the plan can invest in the sponsor's own stock, or in real estate being used by the plan sponsor.

Here again, the subject of fiduciary responsibility plays a central role. The client that is a fiduciary—retirement plan, foundation, endowment, or personal trust—presents more challenges (and potential liability) than the individual investor. In addition, there is a requisite that you and the other professionals involved in the fiduciary's decision-making process demonstrate more evidence of procedural prudence.

One of the best examples of the need to brief decision-makers on the client's goals and objectives and, in turn, to analyze standards, regulations, and policies in light of these objectives is the subject of SRI (see Dimension 2.1). The type of the client may have profound implications.

- Trustees of retirement plans are required to demonstrate their procedural prudence (that they are following generally accepted investment theory), and the appropriate consideration and inclusion of SRI is now recognized as an important element of a sound, long-term, decision-making process;
- Foundations and endowments may actually breach their fiduciary duties if they don't consider SRI, and the investment strategy is perceived to be inconsistent with the mission of the charitable institution; and
- Trustees of personal and charitable trusts may be in breach of their fiduciary duties if trust documents specify the inclusion or exclusion of SRI, and such direction is not taken into consideration.

2.2

Brief Decision-makers on Objectives, Standards, Policies, and Regulations

ANALYZE

step 2

It also is critical that you make a careful inquiry as to whether there are defined rules or regulations that could insulate you, or your fiduciary clients, from liabilities associated with certain investment decisions. These voluntary procedures are commonly referred to as "safe harbor procedures." As a general overview, safe harbor procedures often share similar requirements:

1. Use prudent experts to make the investment decisions.
2. Demonstrate that the prudent expert was selected by following a due diligence process.
3. Give the prudent expert discretion over the assets.
4. Have the prudent expert acknowledge their fiduciary status.
5. Monitor the activities of the prudent expert to ensure that the expert is performing the agreed upon tasks.

If you consider the decision-making process outlined in this book, these safe harbor procedures can be easily incorporated. In fact, an effort has been made to define the decision-making process in this book to withstand any investment audit or compliance review. However, and I mentioned this before in the **Introduction**, I caution you not to fall into a "check-list mentality"—putting a checkmark in the process "box" without fully investigating the appropriateness of a procedure.

Finally, full discourses on all the regulations and compliance procedures that may impact your financial planning practice are beyond the scope of this book—another reason why I need to caution you to discuss your planning procedures with knowledgeable legal counsel.

M. A. Rosanoff: "Mr. Edison, please tell me what laboratory rules you want me to observe."

Edison: "There ain't no rules around here. We're trying to accomplish somep'n!"

– Thomas Edison

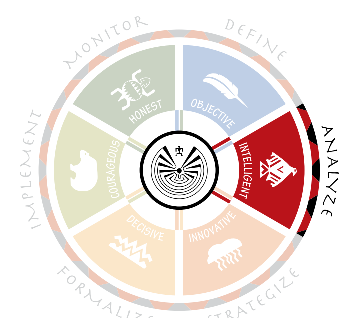
Too many rules get in the way of leadership. They just put you in a box. … People set rules to keep from making decisions.

– "Coach K" (Duke Basketball Coach Mike Krzyzewski)

If you have ten thousand regulations, you destroy all respect for the law.

– Winston Churchill

The Plains tribes arranged their knowledge in a circular format—which is to say, there were no ultimate terms or constituents of their universe; only sets of relationships that sought to describe phenomena. The purpose of such an arrangement was to be certain that all known aspects of something would be included in the information that people possessed and considered when making decisions and reaching conclusions.

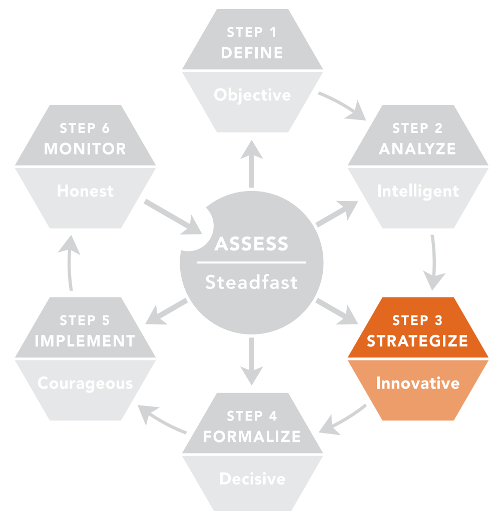


– *Vine Deloria, Jr.*
Spirit & Reason

step 3

STRATEGIZE

Overview



Essential Leadership Behavior:

INNOVATIVE

Defined as: Advanced views; creative; opportunistic; problem-solver.

Innovation—any new idea—by definition will not be accepted at first. It takes repeated attempts, endless demonstrations, and monotonous rehearsals before innovation can be accepted and internalized by an organization. This requires courageous patience.

– Warren Bennis

Supports the FPA and CFP Board's *Code of Ethics*

Principle 6 – Professionalism

Act in a manner that demonstrates exemplary professional conduct.

Professionalism requires behaving with dignity and courtesy to clients, fellow professionals, and others in business-related activities. Certificants cooperate with fellow certificants to enhance and maintain the profession's public image and improve the quality of services.

Supports CFP Board's *Practice Standards*

300-1: Analyzing and Evaluating the Client's Information

In Step 1, we defined for the client the scope of the proposed engagement, specifically your roles and responsibilities. In Step 2, we defined the goals and objectives of the client, and ensured that all the decision-makers involved with the client's portfolio were aware of their roles and responsibilities and of standards, policies, and regulations that would impact the investment process.

In this next Step, we are going to identify the inputs that will be used to develop the client's investment strategy. There are four Dimensions to this Step:

- **R** Risk tolerances of the client
- **A** Assets and asset class preferences of the client
- **T** Time horizons associated with the client's goals and objectives
- **E** Expected outcomes—the quantifiable measures of success

Step 3: STRATEGIZE	INNOVATIVE
Decision-making Dimensions	Leadership Behaviors
3.1: Identify source and levels of **Risk**.	*Prudent*
3.2: Identify **Assets**.	*Analytical*
3.3: Identify **Time Horizons**.	*Patient*
3.4: Identify **Expected Outcomes**.	*Purposeful*

STRATEGIZE

step 3

Overview

Quoting from *Practice Standard 200-2*:

> *Prior to making recommendations to the client and depending on the scope of the engagement, the financial planning practitioner shall determine what quantitative information and documents are sufficient and relevant.*
>
> *The practitioner shall obtain sufficient and relevant quantitative information and documents pertaining to the client's financial resources, obligations, and personal situation. This information may be obtained directly from the client or other sources such as interview(s), questionnaire(s), client records, and documents.*
>
> *The practitioner shall communicate to the client a reliance on the completeness and accuracy of the information provided and that incomplete or inaccurate information will impact conclusions and recommendations.*
>
> *If the practitioner is unable to obtain sufficient and relevant quantitative information and documents to form a basis for recommendations, the practitioner shall either:*
>
> *(a) Restrict the scope of the engagement to those matters for which sufficient and relevant information is available; or*
> *(b) Terminate the engagement.*
>
> *The practitioner shall communicate to the client any limitations on the scope of the engagement, as well as the fact that this limitation could affect the conclusions and recommendations.*

Leaders love the mess.

Leaders create new opportunities and markets

–Tom Peters, *Leadership, The Essential Series*

Don't worry about people stealing your ideas. If your ideas are any good, you'll have to ram them down people's throats.

– Howard Aiken

step 3

STRATEGIZE

3.1

Identify Sources and Levels of Risk

Essential Leadership Behavior:

PRUDENT

Defined as: Wise or judicious in decision-making; circumspect in planning and action; controlled work approach.

Uncertainty always will be part of the taking-charge process.

– Harold Geneen

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Principle 2 – Objectivity

Provide professional services objectively.

Objectivity requires intellectual honesty and impartiality. Regardless of the particular service rendered or the capacity in which a certificant functions, certificants should protect the integrity of their work, maintain objectivity, and avoid subordination of their judgment.

The first Dimension under Step 3 is to: "Identify Sources and Levels of Risk."

The analysis of risk often is the first topic of concern among clients. Risk can never be completely avoided, but it can be managed through proper implementation of this decision-making process.

The term "risk" has different connotations, depending on the client's frame of reference, circumstances, and objectives. Typically, the investment industry defines risk in terms of statistical measures such as standard deviation. However, these statistical measures may fail to adequately communicate the potential negative consequences an investment strategy can have on the client's ability to meet objectives; particularly those covering short-term liability requirements.

For this book, risk is defined as the probability or likelihood that the client will not achieve their goals and objectives (Dimension 2.1). Applying such a definition means that cash could be "riskier" than equities if the investment strategy has not been structured to offset the effects of inflation; or the client abandons their strategy at precisely the wrong time and for the wrong reason because of unwelcomed volatility. For this reason, I have found the most effective way to conduct a gut check with the client is to ask: "How much money are you willing to lose in a given year?" The response to that question often is more revealing than any information I can glean from portfolio modeling and optimization software.

This is the reason why the quintessential leadership behavior for this Dimension is "Prudent." The client can't avoid risk, but you can lead the client through the process of prudently managing their risks.

3.1

Identify Sources and Levels of Risk

STRATEGIZE

step 3

It's a good idea to develop a "Risk Checklist" and discuss whether any of the following factors may be relevant to the client's situation:

- **Liquidity risk** – the inability to have cash when obligations come due.
- **Asset allocation risk** – the asset mix associated with the investment strategy has a low probability of meeting the client's goals and objectives.
- **Purchasing power risk** – the adoption of an investment strategy that will not keep pace with inflation.
- **Lost opportunity risk** – the right investment strategy is developed, but not implemented: "Yes, I know I should have a larger allocation in equities, but now is not a good time to buy."

If the client is a retirement plan, foundation, or endowment:

- **Boardroom risk** – the investment committee has shown evidence that it may not have the stomach to ride out short-term volatility in favor of an appropriate long-term investment strategy.
- **Funding risk** – a sponsoring organization can no longer make contributions (for example, the plan sponsor of a retirement plan).

Leaders are optimists.
– Tom Peters, *Leadership, The Essential Series*

The things we fear most in organizations—fluctuations, disturbances, imbalances—are the primary sources of creativity.
– Margaret J. Wheatley

The spirits warn you twice,
The third time you stand alone.
– Cree Prophecy

Volatility per se … tells us nothing about risk until coupled with consequence. The determining question in structuring a portfolio is the consequence of loss: this is far more important than the chance of loss.
– Robert Jeffrey, "A New Paradigm for Portfolio Risk"

step 3

STRATEGIZE

3.1

Identify Sources and Levels of Risk

Finally, don't overlook managing the risks associated with running your financial planning enterprise. As a best practice, you may want to consider conducting a periodic risk assessment of your own business. The following risk matrix can be used to assess the risks of any business setting, particularly a financial planning practice.

	Risks that emanate from within the organization	Risks that emanate from outside the organization
Strategic Risks	Loss of key employees; failure to keep up with R&D; unanticipated M&A activity	New competition; changes in customer or industry preferences; innovation
Hazard Risks	The release of tampered or unsafe products and services; landlord liability (slip and fall)	Breached contracts; natural disasters; terrorist attacks
Operational Risks	A breach of financial controls; a breakdown in the chain-of-command; IT or system support failure; supply chain failure; inability to recruit new hires	A change in regulations; a new Board of Directors; guilt by association (a bad actor within an industry group)
Financial Risks	Lack of liquidity – poor cash flow management; poor investments	A change in interest rates; currency risk when trading overseas; tighter credit
Social, or Entitlement, Risks	Executives acting in their own self-interests; displaying behavior inconsistent with the organization's ethos	*Everyone else is doing it*; a change in what is considered culturally or politically acceptable

3.2

Identify Assets

The second Dimension under Step 3 is to: "Identify Assets."

As the financial planner, your role is to decide which asset classes, optimally allocated, will produce the greatest probability of achieving the client's stated objectives (Dimension 2.1).

As with "risk," an asset class discussion can have different connotations, depending on the client's frame of reference and preferences. For example, a client could have misplaced confidence/comfort in a fixed-income strategy simply because it is labeled as a "bond portfolio"—think about the 2008 economic crisis and the fixed-income portfolios that were virtually wiped out because of investments in mortgage-backed securities.

The process begins with a thoughtful discussion with the client focusing on the relative attractiveness of the broad asset classes, ensuring that the client has a good understanding of the risk/return of each. Once a decision is made regarding the allocations of equities, fixed income, and cash (the primary determinants to the risk/return profile of the client's overall portfolio), consideration should be given to diversifying the portfolio further into a broad global mix.

A key question that typically emerges at this stage is: *What is the appropriate number of asset classes for the client's investment strategy?* The answer—*it depends on the facts and circumstances*. I know, you already hear that answer a lot from legal counsel, so let me expand on my response—it depends on:

- **Your expertise:** Stick to what you know best, and stay clear of any asset class or strategy where you lack the time, inclination, and knowledge to properly conduct your due diligence, or to monitor.

Essential Leadership Behavior:

ANALYTICAL

Defined as: Ability to identify the different elements or parts of a defined universe; ability to network; team builder.

Never hire or promote in your own image. It is foolish to replicate your strength and idiotic to replicate your weakness. It is essential to employ, trust, and reward those whose perspective, ability, and judgment are radically different from yours. It is also rare, for it requires uncommon humility, tolerance, and wisdom.

– Dee W. Hock, *Fast Company*

Supports the FPA and CFP Board's *Code of Ethics*

Principle 3 – Competence

Maintain the knowledge and skill necessary to provide professional services competently.

Competence means attaining and maintaining an adequate level of knowledge and skill, and application of that knowledge and skill in providing services to clients. Competence also includes the wisdom to recognize the limitations of that knowledge and when consultation with other professionals is appropriate or referral to other professionals necessary. Certificants make a continuing commitment to learning and professional improvement.

3.2
Identify Assets

- **Your client's expertise:** No great insight here—the investment-savvy client will likely be more willing to accept a more sophisticated investment approach. The less-sophisticated client might accept your initial suggestions, but will likely bolt during periods of market volatility.
- **Sensitivity to fees:** You have a responsibility to control and account for all of the expenses associated with the client's investment strategy (Dimension 6.2). More asset classes will mean higher expenses. Does the addition of more asset classes justify the additional expense?
- **The size of your staff, and whether you are taking full advantage of technology:** If you have made a decision not to complicate your life with additional staff or technology, than you should keep your investment strategies just as uncomplicated.
- **Potential liability:** Diversification is intended to reduce risk. However, diversification into esoteric strategies or asset classes may increase liability.

Once you and the client have decided on the number of asset classes that should be included in the development of the client's investment strategy (Dimension 3.1), the question turns to: *Which asset classes?*

At the risk of over-simplifying a very complex and highly debatable answer, this is how I would structure an asset class table:

Number of Asset Classes in Strategy	Asset Classes	Added Asset Classes
3	Domestic Equity, Fixed Income, Cash	
4	Domestic Equity, Fixed Income, Cash	International Equity
5	Domestic Equity, International Equity, Fixed Income, Cash	Small Cap (Split Domestic Equity into Large Cap and Small Cap)
6	Large Cap Equity, Small Cap Equity, International Equity, Fixed Income, Cash	Broad Fixed Income and Intermediate Fixed Income (Split Fixed Income to Broad Fixed Income and Intermediate Fixed Income)
7	Large Cap Equity, Small Cap Equity, International Equity, Broad Fixed Income, Intermediate Fixed Income, Cash	Large Cap Value and Large Cap Growth (Split Large Cap Equity into Large Cap Value and Large Cap Growth)
8	Large Cap Value, Large Cap Growth, Small Cap Equity, International Equity, Broad Fixed Income, Intermediate Fixed Income, Cash	Emerging Markets
9	Large Cap Value, Large Cap Growth, Small Cap Equity, International Equity, Emerging Markets, Broad Fixed Income, Intermediate Fixed Income, Cash	Real Estate and/or Commodities

3.2
Identify Assets

STRATEGIZE

step 3

The identification of *assets* should not merely be limited to a discussion of *asset classes*. As a best practice, you may want to consider conducting a periodic inventory of the assets employed in managing your own practice. Such an inventory may reveal an obstacle that had not previously appeared on your radar screen. As with the risk matrix, the following checklist can be applied to any business setting or financial planning practice:

- Personnel, and their individual talents—regarded by most to be the most important asset;
- Senior leadership and capable people in critical roles;
- Cash reserves and other available funding sources;
- Technology and systems infrastructure;
- Goodwill, integrity, and brand recognition;
- Proprietary knowledge, trademarks, and copyrights;
- Vendor relationships and alliances;
- "Bricks and mortar" and cyber presence; and
- A strong organizational *ethos*!

Leaders are networking fiends.
Leaders are relationship mavens.
– Tom Peters, *Leadership, The Essential Series*

There are five fundamental qualities that make a team great: communication, trust, collective responsibility, caring, and pride.
– Coach K" (Duke Basketball Coach Mike Krzyzewski)

step 3

STRATEGIZE

3.3
Identify Time Horizons

Essential Leadership Behavior:
PATIENT

Defined as: Ability to prioritize; bear uncertainty (risk) with fortitude and calm; optimistic.

You are educated when you have the ability to listen to almost anything without losing your temper or self-confidence.

– Robert Frost, *Quotes*

Supports the FPA and CFP Board's *Code of Ethics*

Principle 2 – Objectivity

Provide professional services objectively.

Objectivity requires intellectual honesty and impartiality. Regardless of the particular service rendered or the capacity in which a certificant functions, certificants should protect the integrity of their work, maintain objectivity, and avoid subordination of their judgment.

The third Dimension under Step 3 is to: "Identify Time Horizons."

One of the critical roles you play as the financial planner is to help ensure that the client has sufficient liquidity to meet financial obligations when they come due. As a best practice, I would suggest that you prepare a cash flow statement for every client that shows anticipated contributions and disbursements for, at least, five years out.

Such a cash flow analysis is essential in determining the client's *investment time horizon*:

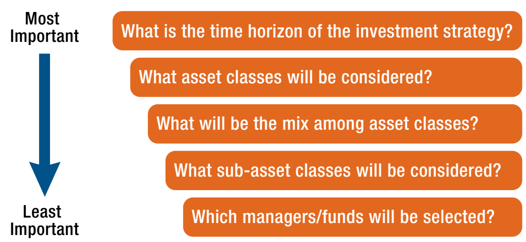
> **That point in the future when more money is flowing out than coming in from contributions and portfolio growth.**

The identification of the client's investment time horizon often is the key variable in determining the allocation between equity and fixed income. As a general rule of thumb, time horizons of less than five years should be implemented with cash and fixed income; while time horizons of greater than five years should be allocated across a broad range of asset classes. Even if an investor has a very high risk tolerance, the investor should not invest in equities if the money is required in the next year.

3.3
Identify Time Horizons

To illustrate the importance of determining the client's time horizon, I have developed the following "Hierarchy of Decisions":

THE HIERARCHY OF DECISIONS



There is a hierarchy to the decisions that you have to manage; the most important being:

1. What is the client's investment time horizon? Based on the time horizon, you can then work to determine, in order:
2. Which asset classes can be appropriately considered?
3. What the allocation should be between the selected asset classes?
4. Should there be an allocation made among sub-asset classes (i.e., large cap versus small cap stocks)?
5. Which money managers or mutual funds should be implemented for each asset class?

Note that when clients are left to their own devices, they often reverse the *hierarchy of decisions*, chasing the latest "hot" manager and, in essence, abdicating their asset allocation decisions to a complete stranger—the hot money manager.

Another mistake individuals tend to make is to confuse their date of retirement with their investment time horizon. The start of retirement plan distributions does not determine the time horizon unless the investor is withdrawing more money than the portfolio is able to replace through investment growth. Under normal circumstances, when an individual has sufficient assets to retire, the time horizon will be the time over which one will consume retirement income.

Quoting from *Practice Standard 300-1*:

> *Prior to making recommendations to a client, it is necessary for the financial planning practitioner to assess the client's financial situation and to determine the likelihood of reaching the stated objectives by continuing present activities.*
>
> *The practitioner will utilize client-specified, mutually-agreed-upon, and/or other reasonable assumptions. Both personal and economic assumptions must be considered in this step of the process. These assumptions may include, but are not limited to, the following:*
>
> - *Personal assumptions, such as: retirement age(s), life expectancy(ies), income needs, risk factors, time horizon and special needs; and*
> - *Economic assumptions, such as: inflation rates, tax rates, and investment returns.*

step 3

STRATEGIZE

I have just three things to teach: simplicity, patience, compassion. These three are your greatest treasures.

– Lao Tzu

Don't tell people how to do things; tell them what to do and let them surprise you with their results.

– General George S. Patton

Leaders know when to wait.

– Tom Peters, *Leadership, The Essential Series*

Historically, the Six Nations Iroquois Confederacy required that chiefs consider the impact of their decisions on the seventh generation. For every decision they made, they had to consider how it would impact the families and communities that would be alive seven generations from now.

– First Nations Development Institute

3.3

Identify Time Horizons

Analysis and evaluation are critical to the financial planning process. These activities form the foundation for determining strengths and weaknesses of the client's financial situation and current course of action. These activities may also identify other issues that should be addressed. As a result, it may be appropriate to amend the scope of the engagement and/or to obtain additional information.

Other "time" issues that may impact strategy development—be it an investment or business strategy:

- Time frames have shrunk – with instant communication, just-in-time inventory, and rapid cycle times for development.
- The world is flat – decision-makers must keep their eyes on the horizon and see "issues" before they materialize, and have contingency plans in place.
- Decisions need to be made closer to the action – decision-makers at all levels must be aligned with the organization's ethos, strategies, plans, resources, and timelines.

3.4

Identify Expected Outcomes (Performance)

The fourth Dimension under Step 3 is to: "Identify Expected Outcomes (Performance)."

Expected outcomes differ from the goals and objectives identified in Step 2, Dimension 2.1, in that they represent quantifiable results expected to be achieved over a shorter, specified time horizon. For example, an expected outcome may be to produce a total rate of return that exceeds the rate of inflation by a certain amount.

The identification of expected outcomes serves three purposes:

1. They are necessary inputs to the investment strategy inputs (Dimension 4.1);
2. They are important components of the investment policy statement (Dimension 4.3); and
3. They facilitate the establishment of benchmarks for the monitoring phase (Dimension 6.1).

Neither regulators nor courts expect you to be able to forecast future returns or events, but they do expect you to be able to demonstrate that the client's investment strategy was based on thoughtful and realistic performance expectations.

Essential Leadership Behavior:

PURPOSEFUL

Defined as: Determined, directed toward a specific outcome; client-focused.

People want to be on a team. They want to be part of something bigger than themselves. They want to be in a situation where they feel that they are doing something for the greater good.

– "Coach K" (Duke Basketball Coach Mike Krzyzewski)

Supports the FPA and CFP Board's *Code of Ethics*

Principle 2 – Objectivity

Provide professional services objectively.

Objectivity requires intellectual honesty and impartiality. Regardless of the particular service rendered or the capacity in which a certificant functions, certificants should protect the integrity of their work, maintain objectivity, and avoid subordination of their judgment.

3.4

Identify Expected Outcomes (Performance)

In preparing performance expectations, a "smart" general purpose process to employ is SMART. (The origin and source of SMART are unknown; however, Peter Drucker is credited with first using the acronym in a published paper.) Performance expectations should be:

S	Specific	Tells you precisely what, when, and how
M	Measurable	Stated in terms of quantity, quality, timeliness, or cost
A	Attainable	Provides an objective which is aggressively obtainable
R	Results-oriented	Practices, relevant and conforming with client goals
T	Time-bound	Beginning, end, and specific milestones are defined.

Leaders are focused.
Leaders break down barriers.
– Tom Peters, *Leadership, The Essential Series*

Remember that it is far better to follow well than to lead indifferently.
– John G. Vance

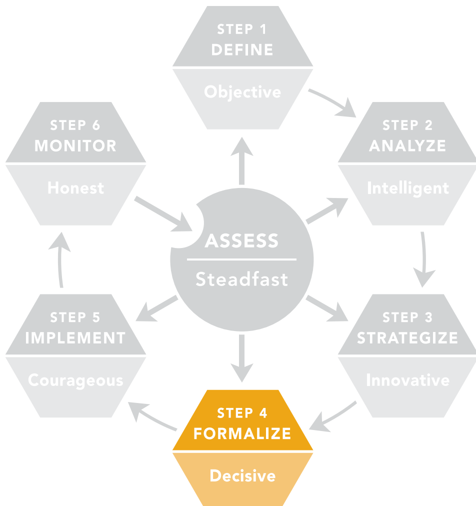
To be successful, the thing to do is fall in love with your work.
– Sister Mary Lauretta

You also should not overlook defining performance expectations for your own practice—some examples:

- Taking care of people: conducting performance reviews, training new personnel, preparing the organization's future leaders;
- Taking care of financials: staying on budget and estimating cash flow needs;
- Taking care of business: catching up on maintenance, and implementing new technology;
- Taking care of clients: developing new markets; and
- Taking care of you: taking well-deserved vacations.

FORMALIZE

step 4



Essential Leadership Behavior:

DECISIVE

Defined as: Resolute; determined; assertive; competitive.

If I had to sum up in a word what makes a good manager, I'd say decisiveness. You can use the fanciest computers to gather the numbers but, in the end, you have to set a timetable and act.

– Lee Iacocca, former Chairman, Chrysler

In Step 1, we defined for the client the scope of the proposed engagement, specifically your roles and responsibilities. In Step 2, we defined the goals and objectives of the client, and ensured that all the decision-makers involved with the client's portfolio were aware of their roles and responsibilities; and of standards, policies, and regulations that would impact the investment process.

In Step 3, we gathered the information that would be critical to the development of the client's investment strategy. We deliberated with the client on their:

R Risk tolerances;
A Asset class preferences;
T Time horizon; and
E Expected outcomes.

Step 4: FORMALIZE	DECISIVE
Decision-making Dimensions	Leadership Behaviors
4.1: Define the strategy that is consistent with **RATE**.	*Strategic*
4.2: Ensure the strategy is consistent with implementation and monitoring constraints.	*Pragmatic*
4.3: Formalize the strategy in detail and communicate.	*Communicative*

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Principle 6 – Professionalism

Act in a manner that demonstrates exemplary professional conduct.

Professionalism requires behaving with dignity and courtesy to clients, fellow professionals, and others in business-related activities. Certificants cooperate with fellow certificants to enhance and maintain the profession's public image and improve the quality of services.

Supports CFP Board's *Practice Standards*

400-1: Identifying and Evaluating Financial Planning Alternative(s)

400-2: Developing the Financial Planning Recommendation(s)

400-3: Presenting the Financial Planning Recommendation(s)

step 4

FORMALIZE

In this next Step, we're going to develop the investment strategy that:

1. Represents the greatest probability of achieving the client's goals and objectives;
2. Is consistent with the client's unique risk/return profile; and
3. Is consistent with our own implementation and monitoring constraints.

Once these requirements are satisfied, we have the inputs to prepare the client's investment policy statement (IPS), considered to be the most important role you play as an financial planner.

Leaders do.

– Tom Peters, *Leadership, The Essential Series*

A good plan implemented today is better than a perfect plan implemented tomorrow

– General George Patton

Overview

Quoting from *Practice Standard 400-1*:

> *After analyzing the client's current situation (Practice Standard 300-1) and prior to developing and presenting the recommendation(s) (Practice Standards 400-2 and 400-3), the financial planning practitioner shall identify alternative actions. The practitioner shall evaluate the effectiveness of such actions in reasonably meeting the client's goals, needs, and priorities.*
>
> *This evaluation may involve, but is not limited to, considering multiple assumptions, conducting research, or consulting with other professionals. This process may result in a single alternative, multiple alternatives, or no alternative to the client's current course of action.*
>
> *In considering alternative actions, the practitioner shall recognize and, as appropriate, take into account his or her legal and/or regulatory limitations and level of competency in properly addressing each of the client's financial planning issues.*
>
> *More than one alternative may reasonably meet the client's goals, needs, and priorities. Alternatives identified by the practitioner may differ from those of other practitioners or advisers, illustrating the subjective nature of exercising professional judgment.*

4.1

Define the Strategy That Is Consistent with RATE

FORMALIZE

step 4

This is the first Dimension for Step 4: "Define the Strategy That Is Consistent with RATE."

Now that you know the client's goals and objectives, and you have the client's inputs to RATE (Dimensions 3.1–3.4), you are ready to define the asset allocation strategy that produces the greatest probability of achieving the client's goals and objectives. Considerable research and experience has shown that the choice of assets (staff and money managers) and asset classes, and subsequent allocation of each, will have more impact on the long-term performance of an investment strategy than any other factor.

It is generally agreed by theoreticians and practitioners alike that the asset allocation decision is by far the most important made by the investor.

– William F. Sharpe, Nobel Prize Winner

The single most important dimension of investment policy is asset mix; particularly the ratio of fixed-income investments to equity investments.

– Charles D. Ellis

How assets are deployed among various competing objectives requires a thorough knowledge of:

- The assets, their availability and usefulness;
- Other available choices/options;
- The risk/reward ratio of deploying (or not deploying) different assets; and
- Redeployment, rebalancing, as the market or the client's situation changes.

Essential Leadership Behavior:

STRATEGIC

Defined as: Ability to multitask over a protracted period; accurate; focused; has situational awareness.

Leadership is a combination of strategy and character. If you must be without one, be without the strategy.

– General H. Norman Schwarzkopf

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Principle 3 – Competence

Maintain the knowledge and skill necessary to provide professional services competently.

Competence means attaining and maintaining an adequate level of knowledge and skill, and application of that knowledge and skill in providing services to clients. Competence also includes the wisdom to recognize the limitations of that knowledge and when consultation with other professionals is appropriate or referral to other professionals necessary. Certificants make a continuing commitment to learning and professional improvement.

step 4

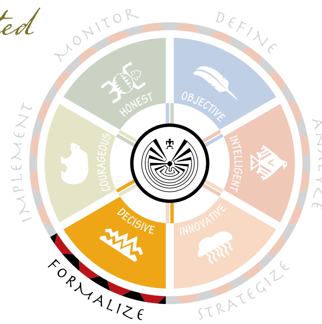
FORMALIZE

4.1

Define the Strategy That Is Consistent with RATE

The old Indians ... were interested in finding the proper moral and ethical road upon which human beings should walk. All knowledge, if it is to be useful, was directed toward that goal.

– Vine Deloria
Spirit & Reason



At this point, it may be worthwhile to comment on the use of optimization software. Yes, you need to have good asset allocation tools—particularly in determining the allocation between equities, fixed income, and cash. However, due to the great disparity between different software offerings, I would caution you to carefully research the investment expertise of the developer. The old adage "garbage in, garbage out" has never been more applicable.

Most asset allocation software is driven off three inputs—the modeled or expected:

1. Risk (standard deviation of returns) of each asset class;

2. Return of each asset class; and

3. Correlations of each asset class's return with that of the other asset classes.

Your responsibility is to ensure that these expected or modeled inputs are reasonable, which is no easy task. Experience suggests that historical data on different asset classes appears to be quite useful with respect to developing standard deviation estimates, *"reasonably useful for correlations, and virtually useless for expected returns"* (William Sharpe). Simple extrapolations of historical data are not only likely to be poor estimates of future performance, they also may lead to the development of expectations that cannot be met.

Over the years, I have seen advisors make some of the following mistakes when developing an asset allocation strategy:

- Believing that asset allocation is a science, and implying a level of precision/confidence that simply is unwarranted. There is still an element of art and uncertainty involved in the development of an appropriate asset strategy. Once the critical allocations have been made between equity, fixed income, and cash, the allocation to additional asset classes can be determined with common sense through an intuitive process. Despite advances in portfolio modeling, not all asset allocation decisions have been reduced to a computerized solution.

- Not involving the client in the asset allocation discussion. If the client is not fully engaged in the process—not understanding the rationale for the asset strategy you are suggesting—it's likely that the client will bolt at the first sign of market volatility.

- Over-allocating—making an allocation of less than 5% rarely makes good sense: (a) it probably will not materially change the risk/return profile of the overall portfolio; and (b) it will be costly, both in terms of implementation and monitoring.
- Making an allocation to an asset that cannot be properly implemented or monitored (discussed further in Dimension 4.2). The classic example is an allocation to hedge funds. Because of the lack of transparency and the complexity of the financial instruments employed, the typical advisor cannot employ the same level of due diligence as could be applied to a mutual fund or a separate account manager. A good rule of thumb to follow: *If you lack the time, inclination, or knowledge to conduct appropriate due diligence—be it of an asset class or an investment manager—stay clear of the strategy or the manager.*

Leaders master their organization.

– Tom Peters, *Leadership, The Essential Series*

There is nothing more difficult to take in hand, more perilous to conduct, or more uncertain in its success than to take the lead in the introduction of a new order of things.

– Niccolo Machiavelli, *The Prince*

step 4

FORMALIZE

4.2

Ensure the Strategy Is Consistent with Implementation and Monitoring Constraints

Essential Leadership Behavior:

PRAGMATIC

Defined as: Realistic; sensible; politically astute; team-oriented.

Keep away from people who belittle your ambitions. Small people always do that, but the really great make you feel that you, too, can become great.

– Mark Twain

Supports the FPA and CFP Board's *Code of Ethics*

Principle 2 – Objectivity

Provide professional services objectively.

Objectivity requires intellectual honesty and impartiality. Regardless of the particular service rendered or the capacity in which a certificant functions, certificants should protect the integrity of their work, maintain objectivity, and avoid subordination of their judgment.

This is the second Dimension for Step 4: "Ensure the Strategy Is Consistent with Implementation and Monitoring Constraints."

What starts out as strategy must be translated into reality with implementation, and what is implemented needs to be monitored. The proposed asset allocation strategy (Dimension 4.1) now must be carefully evaluated to determine whether the suggested strategy can be prudently implemented (discussed in more detail in Dimension 5.1), and then effectively and efficiently monitored (discussed in more detail in Dimension 6.1) on an ongoing basis.

"Execution is not just tactics—it is a discipline and a system. It has to be built into a company's strategy, its goals, and its culture. And the leaders of the organization must be deeply engaged in it."

– Larry Bossidy, *Execution*

You demonstrate prudence by the process through which your client's investment decisions are managed. No investments are imprudent on their face. It is the way in which they are used, and how decisions as to their use are made, that will be examined to determine whether the prudence test has been met. Even the most aggressive and unconventional investment can meet the standard if arrived at through a sound process; while the most conservative and traditional one may not measure up if a sound process is lacking.

4.2

Ensure the Strategy Is Consistent with Implementation and Monitoring Constraints

FORMALIZE

step 4

Quoting from *Practice Standard 400-2*:

> *After identifying and evaluating the alternative(s) and the client's current course of action, the practitioner shall develop the recommendation(s) expected to reasonably meet the client's goals, needs, and priorities. A recommendation may be an independent action or a combination of actions which may need to be implemented collectively.*
>
> *The recommendation(s) shall be consistent with and will be directly affected by the following:*
>
> - *Mutually-defined scope of the engagement;*
> - *Mutually-defined client goals, needs, and priorities;*
> - *Quantitative data provided by the client;*
> - *Personal and economic assumptions;*
> - *Practitioner's analysis and evaluation of client's current situation; and*
> - *Alternative(s) selected by the practitioner.*
>
> *A recommendation may be to continue the current course of action. If a change is recommended, it may be specific and/or detailed or provide a general direction. In some instances, it may be necessary for the practitioner to recommend that the client modify a goal.*
>
> *The recommendations developed by the practitioner may differ from those of other practitioners or advisers, yet each may reasonably meet the client's goals, needs, and priorities.*

The greatest risk in the development of any strategy is omission—leaving something vital out. *"It is easier to see the cheese than it is to find the holes."* This is why a defined decision-making process, such as the one provided in this book, is so critical. At this point, you should be able to demonstrate that you have documented the following inputs that are going to be used to develop the client's investment strategy:

1. The current and projected resources and obligations of the client;
2. The rationale for the choice of performance goals, time horizons, and permissible asset classes, and the sensitivity to variations in each; and
3. The basis for the validity of the capital markets data utilized in determining the client's asset allocation.

To serve others, to be of some use to family, community, nation, and the world is one of the main purposes for which human beings have been created. Do not fill yourself with your own affairs and forget your most important talks. True happiness comes only to those who dedicate their lives to the service of others.

– The Sacred Tree

step 4

FORMALIZE

The pioneers in any movement are not generally the best people to carry that movement to a successful issue. They often have to meet such hard opposition, and get so battered and bespattered, that afterward, when people find they have to accept reform, they will accept it more easily from others.

– Abraham Lincoln

Leaders connect.

– Tom Peters, *Leadership, The Essential Series*

Good leaders must first become good servants.

– Robert Greenleaf

4.2

Ensure the Strategy Is Consistent with Implementation and Monitoring Constraints

In his book on Winston Churchill, ***Churchill on Leadership***, Steven Hayward outlines several rules for effective decision-making that Churchill followed:

- *Always* keep the central or most important aspect of the current problem in mind.
- Know how to balance the chances (risk) on both sides of a decision, and keep these factors in proportion.
- Remain open to changing your mind in the presence of new facts.
- *Don't* try to look too far ahead, try for excessive perfection, or make decisions for decision's sake that would better be postponed or not made at all.

4.3

Formalize the Strategy in Detail and Communicate

This is the third Dimension for Step 4: "Formalize the Strategy in Detail and Communicate."

In my opinion, the development and ongoing maintenance of the client's investment policy statement (IPS) is the most important function you perform as a financial planner when you are providing investment advice. So critical is this role, **Appendix B** is a sample IPS template which is based on the *Ethos* framework.

The IPS should be viewed as the business plan and the essential management tool for directing and communicating the activities of the client's investment strategy. It should be a formal, long-range, strategic plan that allows you to coordinate the management of the investment strategy within a logical and consistent framework. All material investment facts, assumptions, and opinions should be included.

Quoting from *Practice Standard 400-3*:

> *When presenting a recommendation, the practitioner shall make a reasonable effort to assist the client in understanding the client's current situation, the recommendation itself, and its impact on the ability to meet the client's goals, needs, and priorities. In doing so, the practitioner shall avoid presenting the practitioner's opinion as fact.*
>
> *The practitioner shall communicate the factors critical to the client's understanding of the recommendations. These factors may include, but are not limited to, material:*
>
> - *Personal and economic assumptions;*
> - *Interdependence of recommendations;*
> - *Advantages and disadvantages;*
> - *Risks; and/or*
> - *Time sensitivity.*

Essential Leadership Behavior:

COMMUNICATIVE

Defined as: Articulate and persuasive in the written and spoken word; effective in both formal and informal communication; cordial and has a sense of humor.

Communication is the real work of leadership.

– Nitin Nohria

Supports the FPA and CFP Board's *Code of Ethics*

Principle 3 – Competence

Maintain the knowledge and skill necessary to provide professional services competently.

Competence means attaining and maintaining an adequate level of knowledge and skill, and application of that knowledge and skill in providing services to clients. Competence also includes the wisdom to recognize the limitations of that knowledge and when consultation with other professionals is appropriate or referral to other professionals necessary. Certificants make a continuing commitment to learning and professional improvement.

step 4

FORMALIZE

4.3

Formalize the Strategy in Detail and Communicate

The practitioner should indicate that even though the recommendations may meet the client's goals, needs and priorities, changes in personal and economic conditions could alter the intended outcome. Changes may include, but are not limited to: legislative, family status, career, investment performance, and/or health.

If there are conflicts-of-interest that have not been previously disclosed, such conflicts and how they may impact the recommendations should be addressed at this time.

Presenting recommendations provides the practitioner an opportunity to further assess whether the recommendations meet client expectations, whether the client is willing to act on the recommendations, and whether modifications are necessary.

> *Many of the white man's ways are past our understanding .... They put a great store upon writing; there is always paper. The white man must think that paper has some mysterious power to help them in the world. The Indian needs no writings; words that are true sink deep into his heart, where they remain. He never forgets them. On the other hand, if the white man loses his paper, he is helpless.*
>
> *– Four Guns, Oglala*

You need to develop an IPS with the understanding that it will be implemented in a complex and dynamic financial environment. The IPS will produce the greatest benefits during periods of adverse market performance—the IPS acting as a stabilizer for clients who otherwise would be tempted to alter their sound investment strategy because of irrational fears. Its mere existence will cause clients to pause and consider the external and internal circumstances that prompted the development of the IPS in the first place. This is what the substance of good policy development is all about: the framework and process that will allow cooler heads and a longer-term outlook to prevail.

In periods of financial market prosperity, almost any investment program, no matter how ad hoc its strategy, will likely generate impressive results. In those circumstances, the advantages of a comprehensive IPS and the time devoted to its development may appear to be marginal. However, even under favorable market conditions, the IPS may reduce the temptation to increase the aggressiveness of an investment program as clients attempt to extrapolate positive current market trends into the future.

There are a number of reasons why the IPS is so critical:

1. In the case of clients serving in a fiduciary capacity (trustees or investment committee of a retirement plan, foundation, or endowment, or a personal trustee), the IPS is the essential document that auditors, regulators, and the courts will review to help determine whether investments are being prudently managed.

2. For the individual investor, the IPS provides logical guidance during periods of market volatility and uncertainty.

3. For the investment committee, particularly one with a high turnover of members, the IPS ensures continuity of the investment strategy and keeps future members from second-guessing the actions of the original members.

4. The IPS provides a paper trail of polices, practices, and procedures for investment decisions. The document can serve as critical evidence used in the defenses against litigation or accusations of imprudence.

5. The IPS provides a baseline from which to monitor investment performance of the overall portfolio, as well as the performance of money managers.

6. For estate planning purposes, the IPS should be included and coordinated with other estate planning documents, providing less sophisticated heirs and executors appropriate guidance for continuing the prudent management of the client's investment program.

The IPS should combine elements of planning and philosophy, and should address all six Steps of the investment management process discussed in this book.

The sample IPS included in Appendix B has the following main sections and subheadings (note that the IPS follows the same structure as the decision-making framework):

Executive Summary

Section I: Statement of Goals and Objectives
Background
Purpose
Objectives
Duties and Responsibilities

Section II: Inputs to the Investment Strategy
Risk Tolerances
Asset Class Preferences
Time Horizon
Performance Expections

Section III: Implementing the Investment Strategy
Money Manager Selection

Section IV: Monitoring the Investment Strategy
Performance Criteria
Rebalancing of Strategic Allocation
Measuring Costs
IPS Review

"Investment policies must be simple, forthright, and understandable to a competent stranger."
– John Guy, *How to Invest Someone Else's Money*

Leaders are great storytellers.
Leaders convey a grand design.
– Tom Peters, *Leadership, The Essential Series*

Regardless of the changes in technology, the market for well-crafted messages will always have an audience.
– Steve Burnett, The Burnett Group

Precision of communication is important, more important than ever, in our era of hair-trigger balances when a false or misunderstood word may create as much disaster as a sudden thoughtless act.
– James Thurber

step 5

IMPLEMENT

Overview

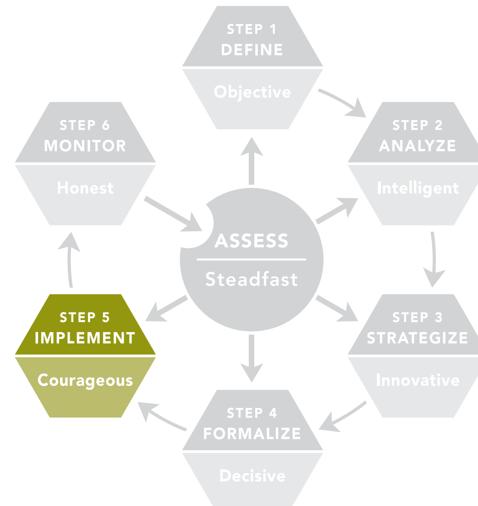
Essential Leadership Behavior:

COURAGEOUS

Defined as: Willingness to face risk and uncertainty; deals effectively with stress.

Courage is rightly esteemed the first of human qualities … because it is the quality which guarantees all others.

– Winston Churchill



Supports the FPA and CFP Board's *Code of Ethics*

Principle 1 – Integrity

Integrity demands honesty and candor which must not be subordinated to personal gain and advantage.

Certificants are placed in positions of trust by clients, and the ultimate source of that trust is the certificant's personal integrity. Allowance can be made for innocent error and legitimate differences of opinion, but integrity cannot coexist with deceit or subordination of one's principles.

Supports CFP Board's *Practice Standards*

500-1: Agreeing on Implementation Responsibilities

500-2: Selecting Products and Services for Implementation

In Step 1, we defined for the client the scope of the proposed engagement, specifically your roles and responsibilities. In Step 2, we defined the goals and objectives of the client, and ensured that all the decision-makers involved with the client's portfolio were aware of their roles and responsibilities; and of standards, policies, and regulations that would impact the investment process.

In Step 3, we gathered the information that would be critical to the development of the client's investment strategy. We deliberated with the client on their:

- **R** Risk tolerances;
- **A** Asset class preferences;
- **T** Time horizon; and
- **E** Expected outcomes.

In the previous Step, we developed the investment strategy that was based on the RATE inputs; ensured that the strategy was consistent with our implementation and monitoring constraints; and then prepared the business plan for managing the client's investment strategy—the client's IPS.

Overview

IMPLEMENT

step 5

Quoting from *Practice Standard 500-1*:

> *The client is responsible for accepting or rejecting recommendations and for retaining and/or delegating implementation responsibilities. The financial planning practitioner and the client shall mutually agree on the services, if any, to be provided by the practitioner. The scope of the engagement, as originally defined, may need to be modified.*
>
> *The practitioner's responsibilities may include, but are not limited to, the following:*
>
> - *Identifying activities necessary for implementation;*
> - *Determining division of activities between the practitioner and the client;*
> - *Referring to other professionals;*
> - *Coordinating with other professionals;*
> - *Sharing of information as authorized; and*
> - *Selecting and securing products and/or services.*
>
> *If there are conflicts-of-interest, sources of compensation, or material relationships with other professionals or advisers that have not been previously disclosed, such conflicts, sources, or relationships shall be disclosed at this time.*
>
> *When referring the client to other professionals or advisers, the financial planning practitioner shall indicate the basis on which the practitioner believes the other professional or adviser may be qualified.*
>
> *If the practitioner is engaged by the client to provide only implementation activities, the scope of the engagement shall be mutually defined in accordance with Practice Standard 100-1. This scope may include such matters as the extent to which the practitioner will rely on information, analysis, or recommendations provided by others.*

What starts out as strategy must be translated into reality with implementation. Step 5 will include an overview of a due diligence process that can be used to select money managers; procedures on how to select the right investment vehicle (separate account manager or mutual fund) to implement the client's investment strategy; and procedures to ensure that service agreements and contracts with selected money managers and services vendors do not have provisions which conflict with the client's investment management program.

Step 5: IMPLEMENT	COURAGEOUS
Decision-making Dimensions	Leadership Behaviors
5.1: Define the process for selecting key personnel to implement the strategy.	*Exemplary*
5.2: Define the process for selecting tools, methodologies, and budgets to implement the strategy.	*Disciplined*
5.3: Ensure that service agreements and contracts do not contain provisions that conflict with objectives.	*Fair-minded*

Success is not final, failure is not fatal: it is the courage to continue that counts.
– Winston Churchill

You gain strength, courage, and confidence by every experience in which you really stop to look fear in the face. You must do the thing you think you cannot do.
– Eleanor Roosevelt

You have enemies? Good. That means you've stood up for something, sometime in your life.
– Winston Churchill

step 5

IMPLEMENT

5.1

Define the Process for Selecting Key Personnel to Implement the Strategy

Essential Leadership Behavior:

EXEMPLARY

Defined as: Self-starter; shows initiative; loyal and supportive; has the ability and bearing which sets the standard of excellence.

The quality of a person's life is in direct proportion to his commitment to excellence, regardless of his chosen field of endeavor.

– Coach Vince Lombardi

Supports the FPA and CFP Board's *Code of Ethics*

Principle 6 – Professionalism

Act in a manner that demonstrates exemplary professional conduct.

Professionalism requires behaving with dignity and courtesy to clients, fellow professionals, and others in business-related activities. Certificants cooperate with fellow certificants to enhance and maintain the profession's public image and improve the quality of services.

This is the first Dimension for Step 5: "Define the Process for Selecting Key Personnel to Implement the Strategy."

This Dimension continues with the decision-making process involved in implementing the investment strategy; specifically the development of due diligence criteria for selecting money managers.

Quoting from *Practice Standard 500-2*:

> *The financial planning practitioner shall investigate products or services that reasonably address the client's needs. The products or services selected to implement the recommendation(s) must be suitable to the client's financial situation and consistent with the client's goals, needs, and priorities.*
>
> *The financial planning practitioner uses professional judgment in selecting the products and services that are in the client's interest. Professional judgment incorporates both qualitative and quantitative information.*
>
> *Products and services selected by the practitioner may differ from those of other practitioners or advisers. More than one product or service may exist that can reasonably meet the client's goals, needs, and priorities.*
>
> *The practitioner shall make all disclosures required by applicable regulations.*

Effective management skills are most critical at this stage, not because you need to become the money manger—just the opposite. I strongly encourage you to follow the time-proven maxim of doing what one does best, and delegating the rest to other qualified professionals. Your primary function is to set the overall strategy; and the primary function of the money manager is to maximize returns within the parameters defined by your strategy.

5.1

Define the Process for Selecting Key Personnel to Implement the Strategy

IMPLEMENT

step 5

> *We are what we repeatedly do. Excellence then, is not an act, but a habit.*
> – Aristotle
>
> *The quality of a leader is reflected in the standards they set for themselves.*
> – Ray Kroc, Founder of McDonald's
>
> *Great and good are seldom the same man.*
> – Winston Churchill
>
> *Leaders make big mistakes.*
> – Tom Peters, *Leadership, The Essential Series*

Developing uniform search criteria that can be applied to each and every asset class is difficult, and the task is made even more challenging if you are considering separate account managers as well as mutual funds. However, it is strongly suggested that you develop a process that: (1) can be consistently applied in any manager search; (2) can be easily communicated to your clients; and (3) can be used in both the search and monitoring phases of the decision-making process.

Several points to keep in mind when you're developing your due diligence criteria:

1. "Simple" is preferable to "complex" when operating in a complex and dynamic environment (same philosophy used to develop the decision-making framework used in this book).

2. Know the strengths and weaknesses of your databases. For example, if separate account manager returns are being reported by a database provider, have the returns been independently verified, or were they provided by the manager?

3. Know how peer groups have been constructed, particularly when comparing information on two managers who are providing performance comparisons from two different database providers. Was the manager's peer group based on the manager's returns being correlated with other managers', or were they based on the actual holdings of the manager?

4. When comparing managers, make sure you are comparing statistics with the same end-points (time periods) and benchmarks (both compared to the S&P 500, instead of one to the S&P 500 and the other to the Russell 1000).

The following is a comprehensive due diligence process—it is intended to provide you both the breadth and depth of an institutional approach, so feel free to lighten the list if your practice is focused primarily on retail individual investors. Furthermore, you probably will need to consult more than one database to conduct this thorough due diligence process, so the best advice is to start with a handful of the criteria (for example, risk-adjusted performance and consistency to peer group) to come up with a short list (six to ten candidates), and then apply the more comprehensive process to identify the finalists.

step 5

IMPLEMENT

5.1

Define the Process for Selecting Key Personnel to Implement the Strategy

Suggested Institutional Due Diligence Process

Organization

Type	**Must be a bank, insurance company, investment management company, or SEC-registered investment advisor.** Rationale: Previously mentioned "safe harbor requirements" (Dimension 2.2) define a "prudent expert" in terms of a regulated entity, such as those listed.
Professionals	**Same portfolio team in place for a period commensurate with performance evaluation period.** Rationale: It makes little sense to analyze performance returns for a portfolio management team that is no longer in place, or has materially changed in composition. It would be like analyzing baseball stats for players who are no longer on the field. The exception would be for an index fund or ETF where a lot of the "human factor" is taken out.
Depth	**There are two parts: (1) the capacity to handle the type of client (if advising a high net worth, the firm has the demonstrated capacity to offer a tax overlay); and (2) the capacity to handle growth in assets under management.** Rationale: (1) Certain clients need more interaction with their managers than others. Here your role is to serve as matchmaker and ensure that the client's managers are willing to work with your client. (2) Watch the growth of assets under management and ensure that the manager can absorb the growth—both in terms of client servicing, and also by investment strategy. For example, a small-cap manager may begin to struggle when they get to $1 billion under management
Fee Structure	**Fees and expenses compare favorably to those of peers, and the manager has a stated policy for managing "soft dollars" and directed brokerage mandates.** Rationale: Fees do matter—in my opinion they matter a lot, and a high fee schedule that is accompanied by marginal performance should be unacceptable. As for soft dollars and directed brokerage—both are subject to abuse, so you want to make sure that the manager has a clearly stated policy which indicates both are closely monitored.
Reputation	**The firm has no outstanding legal judgments or past judgments that may reflect negatively on the firm.** Rationale: The investment industry is based on trust; once lost it can take years for a firm to regain its reputation. During the recovery phase, the firm may find it difficult to retain and recruit top people.

5.1

Define the Process for Selecting Key Personnel to Implement the Strategy

IMPLEMENT

step 5

Philosophy/Strategy

Behaviors	**The manager must be able to demonstrate that the same strategy or style has been consistently applied, and that portfolio holdings are consistent with the stated strategy or style.** Rationale: You should be hiring the manager to fulfill a specific role within the overall portfolio, and fill a slot defined by a specific risk/reward profile. If the manager floats between styles, it will be difficult knowing whether your overall portfolio structure is aligned to meet the client's goals and objectives. Furthermore, the performance evaluation and monitoring will be complicated by the fact that the manager may be compared to inappropriate peers and indexes.
Buy Discipline	**The manager must be able to clearly articulate the buy discipline that will be followed, and demonstrate that the strategy has been successfully adhered to over time.** Rationale: You're the manager of the overall process; it's your responsibility to be intimately familiar with each investment strategy you suggest to a client. If you don't understand the manager's strategy, move on to someone who can provide you greater comfort.
Sell Discipline	**The manager must be able to clearly articulate the sell discipline that will be followed, and demonstrate that the strategy has been successfully adhered to over time.** Rationale: From experience, I can tell you that managers have an easier time buying—the more difficult task is knowing when to sell.
Use of Cash	**The manager must be able to demonstrate that the manager is not a market-timer.** Rationale: Managers that routinely hold more than 20 percent in cash need to demonstrate that the cash is being held in reserve for buying opportunities, as opposed to being used for market-timing.
Turnover	**Portfolio turnover is compared to those of peers; is appropriate for taxable clients; and does not generate excessive transaction costs.** Rationale: Turnover is largely an issue for taxable clients, but even for tax-exempt clients an unusually high turnover will drive up the costs of managing the portfolio. Also, a high turnover should be analyzed to determine whether it is consistent with the manager's stated strategy, because a high turnover could be an indication of turmoil on the portfolio management team.

step 5

IMPLEMENT

5.1

Define the Process for Selecting Key Personnel to Implement the Strategy

Return Performance

Consistency	**Returns are evaluated on a quarterly, one-, three-, and five-year basis and are favorable in both rising and falling markets.** Rationale: Isolating your view on 3- or 5-year performance may obscure short-term volatility. On the other hand, short-term performance is rarely a reliable indicator of strong, long-term performance. Both long-term and short-term performance need to be analyzed for consistency. From experience, the manager who is consistently just above average typically will end up producing stronger long-term performance than peers who are at the top of the charts two years in row, and drop to the bottom of the charts the third year.
Relative	**Returns are evaluated on a quarterly, one-, three-, and five-year basis and are favorable in comparison to an appropriate index and peer group.** Rationale: The trick is ensuring that you are measuring the manager against the right index and peer group. Here, you're looking for dispersion—unusually high and low returns compared to peers may be a good indication that the manager is in the wrong peer group.
Results	**Performance has been calculated by an objective third-party.** Rationale: Two reasons: (1) The third-party should be able to provide you a more robust back-ground universe for comparing the manager to peers; and (2) An independent audit is almost always preferable to a self-audit. The same holds true for performance evaluations.

Risk Performance

Control	**The manager must be able to clearly articulate the risk strategy that will be followed, and demonstrate that the strategy has been successfully adhered to over time.** Rationale: Whether we're asking the manager about their buy or sell discipline, or the manager's risk strategy, the manager should be able to articulate a process that you can understand, and that the manager can demonstrate has been consistently applied.
Risk-adjusted	**Risk-adjusted returns—whether measured by Alpha, Sharpe, or Sortino Ratios—are favorable to those of peers.** Rationale: Although appearing low on the due-diligence list, it is perhaps one of the more critical components. Performance adjusted for the risk the manager took, and then compared to peers', speaks volumes about the manager's ability.
Results	**Risk-adjusted performance has been calculated by an objective third-party.** Rationale: As with the performance numbers, a best practice is to analyze risk-adjusted performance figures that have been prepared by an independent third-party.

step 5

IMPLEMENT

5.1

Define the Process for Selecting Key Personnel to Implement the Strategy

Another service provider that needs to be prudently selected at this point is the custodian for the client's portfolio—a greatly unappreciated key player, for the choice of custodian(s) will greatly impact the quality of monitoring services you provide the client (Step 6).

The role of the custodian is to:

1. Maintain separate accounts by legal registration;
2. Value the holdings;
3. Collect all income and dividends;
4. Settle all transactions (buy-sell orders) initiated by the money managers; and
5. Provide monthly reports that detail transactions, cash flows, securities held and their current value, and change in value of each security and the overall portfolio since the previous report.

In conducting due diligence on the custodian, consider the following:

- If using a brokerage firm as a custodian, assets may be held in street name (commingled with the assets of the brokerage firm). If so, does the brokerage firm have sufficient insurance (SIPC) to cover the client's account?
- The quality of the custodian's electronic protocol (connection between you and the custodian)—ease of use, and the frequency of their updates.
- The expense ratio of the money market accounts attached to the client's account. (If you don't ask, your client most likely will be put into a retail money market account. Ask, and often your client may be able to get the institutional class, which will have a considerably lower expense ratio.)
- Will the custodian provide tax reporting and performance measurement services? (As with the money market accounts, you often have to inquire and, if negotiated at the start of the engagement, these services may be provided at no extra charge.)
- Will the custodian provide a monthly statement that provides the details of any trading that was conducted by the separate account managers? The details are necessary for you to properly monitor whether the manager is seeking best price for an execution in trading the client's account (Dimension 6.2).

5.2

Define the Process for Selecting Tools, Methodologies, and Budgets to Implement the Strategy

This is the second Dimension for Step 5: "Define the Process for Selecting Tools, Methodologies, and Budgets to Implement the Strategy."

Now that you have defined the investment strategy (Dimension 4.1), and identified the money managers to implement the strategy (5.1), the next two decisions you have to prudently manage are:

1. Whether to implement an asset class with a passive or active strategy; and
2. Whether to engage a manager on a separate account basis or through a mutual fund or collective trust.

Active versus Passive

Much has been written about the virtues of passive investing, and I cannot add to the arguments that have been made by more scholarly authorities. However, here are what I believe to be the salient arguments:

1. It's not an "either or" decision—prudent investors will use both passive and active strategies in a portfolio.
2. If the client is indifferent regarding the use of active or passive strategies, go passive in implementing the large cap, core portions of the investment strategy. Use active managers in small cap mandates or emerging markets, where managers have a greater probability of finding a gold nugget that has not been discovered by all the Wall Street analysts who are focused on the large cap stocks.
3. If you decide to go active, document the fact that you believe the added costs are justified (see Dimension 6.2). There are no regulatory or even fiduciary requirements that you choose the cheapest alternatives in building your client's portfolio, but you do need to be able to justify paying more for a service or product when there is a less-expensive alternative (value versus price).

Essential Leadership Behavior:

DISCIPLINED

Defined as: Self-restrained; regimented; driven; high-endurance; committed; sets appropriate pace for self and staff.

Exemplary leadership is a way of being; whether you're leading others or leading your own life. … Leadership is about living our purpose while engaging deeply with others.

– Richard Strozzi-Heckler, *The Leadership Dojo*

Supports the FPA and CFP Board's *Code of Ethics*

Principle 6 – Professionalism

Act in a manner that demonstrates exemplary professional conduct.

Professionalism requires behaving with dignity and courtesy to clients, fellow professionals, and others in business-related activities. Certificants cooperate with fellow certificants to enhance and maintain the profession's public image and improve the quality of services.

step 5

IMPLEMENT

5.2

Define the Process for Selecting Tools, Methodologies, and Budgets to Implement the Strategy

Charts, graphs and statistics are irrelevant to most tribes. Their concern is the reality of the goals: the eventual effect a program will have on the tribe.

– Vine Deloria, Jr.
Custer Died for Our Sins

4. How much do you believe in the science behind asset allocation? The stronger your belief system, the more faith you can put into passive investing —*Amen brothers and sisters!*

Separate Account Managers versus Mutual Funds or Commingled Trusts

The client's account size may limit your choices to a mutual fund or collective trust. But improved electronic protocol between managers, custodians, and intermediaries has made it easier for managers to lower their account size minimums; thereby making it easier for you to access good managers on a separate account basis.

However, just because your client meets the minimum account size requirement for a particular manager doesn't mean that a separate account is the best vehicle. For this reason, I am going to give you an outline of some of the pros and cons for each of the different types of investment vehicles so that you can make the appropriate choice.

- **Costs:** Mutual funds spread their costs across all shareholders—a good thing if your client has a small investment in the mutual fund; a potentially bad thing if your client has a large investment (which may be the case with a 401k plan). Also, you may be able to negotiate lower fees with a separate account manager—regulations prohibit mutual funds from such negotiations.
- **Audits:** Mutual funds are required to be audited by independent accounting firms. Separate account managers are only encouraged to have their performance audited.
- **Performance Information:** Despite advances in technology, mutual fund databases are still a bit more reliable; and performance information is reported sooner than separate account data, and probably always will be. The mutual fund only needs to calculate the performance of one portfolio, whereas the separate account manager needs to calculate performance across a wide range of portfolios.
- **Tax Management:** The taxable client, particularly one with low-basis stock, will likely fare better with a separate account manager that is willing, and has the ability, to provide a tax-sensitive investment strategy.
- **Phantom Tax Gain:** When the client is put into a mutual fund, there may be unrealized capital gain tax liabilities in the portfolio.
- **Fund Liquidations and Purchases:** The mutual fund manager is disadvantaged in that the manager must also contend with purchases and liquidations within the fund. This can be a major problem in a down market when the investing herd tries to move out of a fund, forcing the manager to sell securities against the better judgment of the manager.
- **Diversification:** Generally speaking, mutual funds tend to be more diversified than separate account managers. For this reason, the client who is willing to accept more volatility may prefer a concentrated, separately managed account.
- **Specific Identification of Securities:** Some clients prefer seeing "their" portfolio as opposed to being invested with the masses.

5.3

Ensure That Service Agreements and Contracts Do Not Contain Provisions That Conflict with Objectives

This is the third Dimension for Step 5: "Ensure That Service Agreements and Contracts Do Not Contain Provisions That Conflict with Objectives."

The purpose of this Dimension is to ensure that money managers and other service providers understand the role they are intended to play, and the performance objectives or conditions that must be met to achieve that purpose. Successful implementation of an investment strategy is a combination of rigorous process and execution and, like any other worthy endeavor, no job is complete until the paperwork is done!

The review of contracts and agreements is an important additional step to ensure that there are no misunderstandings about the roles and responsibilities of all parties involved in the management of the client's investment decisions. My suggestions regarding reviewing contracts and agreements are very general in nature, and again I need to caution you to discuss legal matters with a knowledgeable attorney.

1. Define the scope of the relationship;
2. Refer to documents which govern the investment strategy (IPS), particularly documents that define performance criteria; and
3. Refer to regulations or trust documents which establish the legal character of the relationship, and may define or limit certain investment practices.

A good practice is to periodically review contracts and service agreements to ensure that the client still requires the contracted services, and that the vendor's pricing is still competitive; or to discover new services the vendor may be able to provide the client.

Essential Leadership Behavior:

FAIR-MINDED

Defined as: Sensitive; just and impartial; values diversity; empathetic; strong interpersonal skills (high emotional intelligence); persuasive.

We must combine the toughness of the serpent and the softness of the dove—a tough mind and a tender heart.

– Dr. Martin Luther King, Jr.

Supports the FPA and CFP Board's *Code of Ethics*

Principle 4 – Fairness

Be fair and reasonable in all professional relationships. Disclose conflicts-of-interest.

Fairness requires impartiality, intellectual honesty, and disclosure of material conflicts-of-interest. It involves a subordination of one's own feelings, prejudices, and desires so as to achieve a proper balance of conflicting interests. Fairness is treating others in the same fashion that you would want to be treated.

step 6

MONITOR

Overview

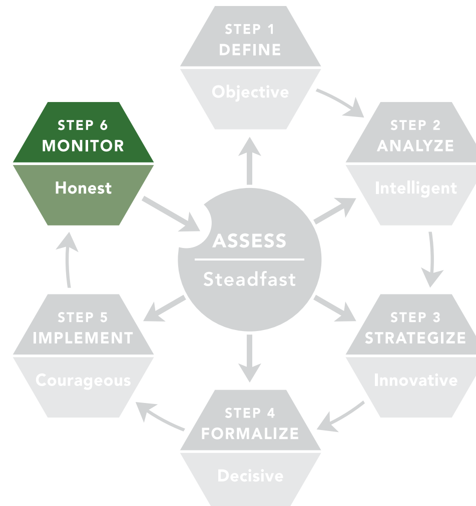
Essential Leadership Behavior:

HONEST

Defined as: Marked by integrity; reputable; moral.

In looking for people to hire, you look for three qualities: integrity, intelligence, and energy. And if they don't have the first, the other two will kill you.

– Warren Buffet



Supports the FPA and CFP Board's *Code of Ethics*

Principle 1 – Integrity

Integrity demands honesty and candor which must not be subordinated to personal gain and advantage.

Certificants are placed in positions of trust by clients, and the ultimate source of that trust is the certificant's personal integrity. Allowance can be made for innocent error and legitimate differences of opinion, but integrity cannot coexist with deceit or subordination of one's principles.

Supports CFP Board's *Practice Standards*

600-1: Defining Monitoring Responsibilities

Once the optimal investment strategy has been designed, the IPS prepared, and the strategy implemented, the final critical step is the ongoing monitoring of the investment program. Monitoring the resulting performance of selected money managers and evaluating the continuing viability of the client's goals and objectives constitutes the next-to-final step of the investment management process.

The monitoring function extends beyond a strict examination of performance: by definition, monitoring occurs across all policy and procedural issues. Monitoring includes an analysis of not only what happened, but also why.

Step 6: MONITOR	HONEST
Decision-making Dimensions	Leadership Behaviors
6.1: Prepare periodic reports that compare performance with objectives.	*Diligent*
6.2: Prepare periodic reports that analyze costs, or ROI, with performance and objectives.	*Accountable*
6.3: Perform periodic examinations for conflicts-of-interest and self-dealing and breaches of a code of conduct.	*Genuine*
6.4: Prepare periodic qualitative or performance reviews of decision-makers.	*Motivational*

Overview

MONITOR

step 6

Quoting from Practice Standard 600-1:

> *The purpose of this Practice Standard is to clarify the role, if any, of the practitioner in the monitoring process. By clarifying this responsibility, the client's expectations are more likely to be in alignment with the level of monitoring services which the practitioner intends to provide.*
>
> *If engaged for monitoring services, the practitioner shall make a reasonable effort to define and communicate to the client those monitoring activities the practitioner is able and willing to provide. By explaining what is to be monitored, the frequency of monitoring and the communication method, the client is more likely to understand the monitoring service to be provided by the practitioner.*
>
> *The monitoring process may reveal the need to reinitiate steps of the financial planning process. The current scope of the engagement may need to be modified.*

Leaders are the brand.
Leaders engender trust (credibility).
– Tom Peters, *Leadership, The Essential Series*

Successful leadership is not about being tough or soft, sensitive or assertive, but about a set of attributes. First and foremost is character.
– Warren Bennis

Good character is more to be praised than outstanding talent. Most talents are to some extent a gift. Good character, by contrast, is not given to us. We have to build it piece by piece—by thought, choice, courage, and determination.
– John Luther

step 6

MONITOR

6.1

Prepare Periodic Reports That Compare Performance with Objectives

Essential Leadership Behavior:

DILIGENT

Defined as: Steady; earnest; energetic; stays on task.

When we're under pressure, stress, conflict, or some form of transition, we will inevitably fall to the level of our training and rarely, if ever, rise to our level of expectation.

– Richard Strozzi-Heckler, *The Leadership Dojo*

Supports the FPA and CFP Board's *Code of Ethics*

Principle 7 – Diligence

Provide professional services diligently.

Diligence is the provision of services in a reasonably prompt and thorough manner, including the proper planning for, and supervision of, the rendering of professional services.

This is the first Dimension for Step 6: "Prepare Periodic Reports That Compare Performance with Objectives."

The preparation and maintenance of the client's IPS is the most critical function you perform as an investment advisor. The second most critical function is monitoring. This is the Step and the Dimension where you will likely make the most mistakes and, even when executed properly, will be the costliest component of your practice—in terms of your time, the staff required, and the technology to be employed.

When done properly, monitoring triggers a number of periodic reviews:

Monthly: At least monthly, you should analyze custodial statements. Particular attention should be paid to transactions initiated by separate account managers: (1) Are the trades consistent with the manager's stated strategy? and (2) Is there evidence that the manager is seeking best price and execution (Dimension 6.2)?

Quarterly: At least quarterly, you should compare:

1. The client's asset allocation to the strategic asset allocation defined in the IPS to determine whether the portfolio should be rebalanced back to the strategic asset allocation (Dimension 4.1). The discipline of rebalancing, in essence, controls risk and forces the client's portfolio to move along a predetermined path. Rebalancing limits should be set so they do not trigger continuous readjustment to the portfolio—I have found that a collar of +/- 5% around the strategic asset allocation works fine.

2. Money manager performance against benchmarks established in the IPS, including a comparison of each manager's performance against an appropriate index and peer group.

6.1

Prepare Periodic Reports That Compare Performance with Objectives

MONITOR

step 6

Annually: At least annually, there should be a formal review of the IPS to determine whether the client's goals and objectives have changed, and whether the investment strategy still holds the highest probability of meeting the client's goals and objectives.

Central to the monitoring function is *performance attribution analysis*, which consists of two overlapping and sequential procedures: (1) *performance measurement*, the science; and (2) *performance evaluation*, the art.

Performance measurement consists of calculating portfolio characteristics, statistics (standard deviation, Alpha, Sharpe, and Sortino Ratios), and rates of return. Although performance measurement is referred to as the "science," it is far from being exact.

The source and handling of the data used in performance measurement may have an impact on calculations. For this reason, you should request performance information from different sources to try to catch potential errors. For example—the rate of return calculated by the client's custodian may differ from the rate of return reported by the money manager; and both of these returns may yet be different from the rate of return you calculate using your own performance measurement software. Like navigating a ship at sea, the prudent sailor takes as many bearings as possible to try to triangulate an exact fix.

Performance evaluation is where your skills as a financial planner come into play: the client will be looking to you to identify the appropriate call to action. It is this phase of the analysis where you compare the results of the performance measurement to the client's IPS and, if needed, suggest appropriate action to bring the investment strategy back into alignment.

1. What is the current asset allocation of the overall portfolio?
2. Does it need to be rebalanced? If so, what are the client's cash flows for the coming six months; and can these cash flows (contributions or disbursements) be used to rebalance the portfolio?
3. How has each money manager performed relative to the manager's index and peer group? Is there evidence that a money manager may be deviating from their strategy?
4. Are there managers that should be placed on a watchlist, or even terminated?

Out of the Indian approach to life there comes a great freedom – an intense and absorbing love for nature; a respect for life; enriching faith in a Supreme Power; and principles of truth, honesty, generosity, equity, and brotherhood as a guide to mundane relations.

– Luther Standing Bear, Oglala

step 6

MONITOR

Leadership is an action, not a position.
– Donald H. McGannon

Test fast, fail fast, adjust fast.
– Tom Peters

On the other hand…
Leaders take breaks.
Leaders know when to leave.
– Tom Peters, *Leadership, The Essential Series*

Character cannot be developed in ease and quiet. Only through experience of trial and suffering can the soul be strengthened, ambition inspired, and success achieved.
– Helen Keller

6.1

Prepare Periodic Reports That Compare Performance with Objectives

The decision to terminate a manager should not be taken lightly, since there are a number of costs associated with changing managers. When poor performance becomes an issue, it is important that you approach the evaluation process with the same rigor you applied when you conducted your due diligence process on the manager. In fact, I would then suggest it is prudent to apply the same criteria that you used in the due diligence phase:

1. Has there been a change in the portfolio team?
2. Has the firm encountered legal or regulatory problems?
3. Has there been a change in the manager's strategy?
4. Has there been a change in the asset allocation structure of the manager's portfolio (for example, is the manager beginning to hold more cash)?
5. Has there been a marked increase in portfolio turnover?
6. Has the manager consistently performed below the returns of an appropriate index, or below the manager's peer group?
7. Has risk-adjusted performance (Alpha, Sharpe, Sortino Ratio) dropped below the performance of an appropriate index, or below the manager's peer group?

Over the years, I have seen a lot of advisors try to come up with a quantifiable way to determine when a manager should be terminated—for example, so many quarters below a certain benchmark. I think a disciplined methodology is essential; however, I think the best approach is remarkably simple: *Fire the manager when you have lost confidence in the manager's ability to do the job.*

6.2

Prepare Periodic Reports That Analyze Costs, or ROI, with Performance and Objectives

MONITOR

step 6

This is the second Dimension for Step 6: "Prepare Periodic Reports That Analyze Costs, or ROI, with Performance and Objectives."

No matter what the business, decision-makers have a responsibility to control and account for expenses. Your business as a financial planner is no exception. A good financial planner will provide the client a *value* that exceeds the cost of the planner's services. A bad planner will cost the client far more than the fees paid.

Investment management costs and expenses can be broken down into four broad categories. I caution you that certain expenses can be obscured or moved from one category to another to create apparent savings, so it is important that you consider costs across all four categories.

1. **Money manager fees and/or the annual expenses of mutual funds:** The differences between traditional money manager and hedge fund strategies have begun to blur, yet the costs associated with hedge funds are considerably higher. Why pay many multiple times more for an investment strategy that is largely accomplished by a traditional money manager with lower fees and expenses?

2. **Trading costs for separately managed portfolios, including commission charges (soft dollars) and execution expenses (best execution):** This large and important component of cost control is often overlooked and can be the subject of abuse if not carefully monitored. A simple check you can employ is to analyze the client's custodial statement and see which brokerage firms are being used by the separate account manager to trade the client's account. (If that level of detail is not being provided by the custodian, you may want to consider changing custodians, or request the trading information directly from the manager.)

Essential Leadership Behavior:

ACCOUNTABLE

Defined as: Takes responsibility; dependable; budget/cost/ROI conscious.

I am a leader by default, only because nature does not allow a vacuum.

– Bishop Desmond Tutu

Supports the FPA and CFP Board's *Code of Ethics*

Principle 5 – Confidentiality

Protect the confidentiality of all client information.

Confidentiality means ensuring that information is accessible only to those authorized to have access. A relationship of trust and confidence with the client can only be built upon the understanding that the client's information will remain confidential.

step 6

MONITOR

Leaders are profit mechanics.
Leaders are responsible—
accept responsibility.

– Tom Peters, *Leadership, The Essential Series*

However beautiful the strategy, you should occasionally look at the results.

– Winston Churchill

Get to know two things about a man—how he earns his money and how he spends it—and you have the clue to his character, for you have a searchlight that shows up the innermost recesses of his soul. You know all you need to know about his standards, his motives, his driving desires, and his real religion.

– Robert J. McCracken

People eyeing you as a potential leader tend to ask three questions:

1. *Are you committed?*
2. *Do you care about me?*
3. *Can I trust you?*

– Coach Lou Holtz

6.2

Prepare Periodic Reports That Analyze Costs, or ROI, with Performance and Objectives

Ideally, you want to see that the manager is using a host of different brokerage firms for executing the trades, and that commission charges are in the range of 4–8 cents per share. If that is not evident, a call to the manager is warranted for an explanation.

3. **Custodial charges, including custodial fees, transaction charges, and cash management fees:** As previously mentioned, check the expense ratio of the client's money market fund being used by the custodian. If the expense ratio is north of 60 basis points, the client has likely been put into a retail money market. If that is the case, make a request to the custodian to have the client put into an institutional money market where the fees will be in the range of 25–35 basis points. (This tip alone probably will pay for the cost of this book!)

4. **Consulting, recordkeeping, or administrative costs and fees:** Particular attention should be paid to revenue sharing features associated with the use of mutual funds—as an example, 12b-1 fees. These fees should be applied to the benefit of your client and should not be left on the table or directed for any purpose other than the benefit of your client. One of the customary uses of 12b-1 fees is to apply the amount toward recordkeeping or administrative expenses.

As the financial planner, you should be able to identify every party that has been compensated from the client's portfolio, and be able to demonstrate that the compensation was fair and reasonable for the level of services being provided to the client.

6.3

Perform Periodic Examinations for Conflicts-of-interest and Self-dealing and Breaches of a Code of Conduct

MONITOR

step 6

This is the third Dimension for Step 6: "Perform Periodic Examinations for Conflicts-of-interest and Self-dealing and Breaches of a Code of Conduct."

The legal and practical scrutiny you undergo as a financial planner is tremendous. It comes from multiple directions and for various reasons. Over the last few years, this scrutiny has increased the liability of financial planners. Consider the following factors which are bringing more pressure down on the financial services industry:

- There is a higher propensity for investor litigation because of the failure of so many financial institutions and investment products, and dissatisfied investors are more vocal and more visible.
- Congress is going to insist that regulators step up enforcement and auditing efforts of the financial services industry.
- Retirement crisis: The public will soon realize that Social Security will not be able to continue to pay a retirement supplement at current levels. Couple this with the fact the average worker is not saving enough through defined contribution plans (401k plans); traditional defined benefit plans are being abandoned; many public retirement plans are underfunded, and taxpayers have demonstrated an unwillingness to bail the plans out.
- Bank trust departments have come under attack for only offering investment services tied to their proprietary products—products which often underperform the market.
- Charitable trusts and institutions are under greater scrutiny from donors and regulators, making it more difficult for these institutions to attract effective and experienced board members.

Hopefully, the relationship you have with each and every client is based on trust—and with trust comes the duty of loyalty.

Essential Leadership Behavior:

GENUINE

Defined as: Sincere and honest; free from pretense; supportive.

There are seven things that will destroy us: Wealth without work; Pleasure without conscience; Knowledge without character; Religion without sacrifice; Politics without principle; Science without humanity; Business without ethics.

– Mahatma Gandhi

Supports the FPA and CFP Board's *Code of Ethics*

Principle 4 – Fairness

Be fair and reasonable in all professional relationships. Disclose conflicts-of-interest.

Fairness requires impartiality, intellectual honesty, and disclosure of material conflicts-of-interest. It involves a subordination of one's own feelings, prejudices, and desires so as to achieve a proper balance of conflicting interests. Fairness is treating others in the same fashion that you would want to be treated.

step 6

MONITOR

In all your official acts,
self-interest shall be cast aside.
You shall look and listen to
the welfare of the whole people
and have always in view,
not only the present but the
coming generations – the unborn
of the future Nation.

– Dekawidah, Cherokee

All genuine leadership is built on trust.

– Ken Blanchard, *The Heart of a Leader*

6.3

Perform Periodic Examinations for Conflicts-of-interest and Self-dealing and Breaches of a Code of Conduct

The undivided loyalty you owe your clients means that you do not invest or manage client assets in such a way that there arises even a hint of a personal conflict-of-interest. You have a duty to employ an objective, independent due diligence process at all times and have defined policies and procedures to manage potential conflicts-of-interest.

It's worth repeating *Rules of Conduct*, Rule 1.4 and introduce Rule 2.2:

> *1.4 A certificant shall at all times place the interest of the client ahead of his or her own. When the certificant provides financial planning or material elements of financial planning, the certificant owes to the client the duty of care of a fiduciary as defined by CFP Board.*
>
> *2.2 A certificant shall disclose to a prospective client or client the following information:*
>
> *a. An accurate and understandable description of the compensation arrangements being offered. This description must include:*
>
> *i. Information related to costs and compensation to the certificant and/or the certificant's employer, and*
>
> *ii. Terms under which the certificant and/or the certificant's employer may receive any other sources of compensation, and, if so, what the sources of these payments are and on what they are based.*
>
> *b. A general summary of likely conflicts-of-interest between the client and the certificant, the certificant's employer or any affiliates or third parties, including, but not limited to, information about any familial, contractual, or agency relationship of the certificant or the certificant's employer that has a potential to materially affect the relationship.*

6.3

Perform Periodic Examinations for Conflicts-of-interest and Self-dealing and Breaches of a Code of Conduct

c. Any information about the certificant or the certificant's employer that could reasonably be expected to materially affect the client's decision to engage the certificant that the client might reasonably want to know in establishing the scope and nature of the relationship, including but not limited to, information about the certificant's areas of expertise.

d. Contact information for the certificant and, if applicable, the certificant's employer.

e. If the services include financial planning or material elements of financial planning, these disclosures must be in writing. The written disclosures may consist of multiple written documents. Written disclosures used by a certificant or certificant's employer that include the items listed above, and are used in compliance with state or federal laws, or the rules or requirements of any applicable self-regulatory organization, such as the Securities and Exchange Commission's Form ADV or other disclosure documents, shall satisfy the requirements of this Rule.

The certificant shall timely disclose to the client any material changes to the above information.

The most common mistake made by investment decision-makers is the omission of one or more prudent practices, as opposed to the commission of a prohibited transaction or being involved in a conflict-of-interest. However, instances of the latter are common enough that you should monitor the client's investment program for possible problems. Any activity that is not in the best interests of the client will cause problems, and it is crucial that you ensure that no party has been unduly enriched by the client's portfolio

We make a living by what we get, but we make a life by what we give

– Winston Churchill

Whoever is careless with the truth in small matters cannot be trusted with the important matters.

– Albert Einstein

The ultimate measure of a man is not where he stands in moments of comfort, but where he stands at times of challenge and controversy.

– Dr. Martin Luther King, Jr.

The respect that leadership must have requires that one's ethics be without question. A leader not only stays above the line between right and wrong, he stays well clear of the gray areas.

– G. Alan Bernard, President, Mid-Park, Inc

step 6

MONITOR

6.4

Perform Periodic Qualitative or Performance Reviews of Decision-makers

Essential Leadership Behavior:

MOTIVATIONAL

Defined as: Ability to persuade others to take positive action; committed to the success of the organization, and the well-being of staff and clients.

I don't know what your destiny will be, but one thing I know: The ones among you who will be really happy are those who have sought and found how to serve.

– Albert Schweitzer

Supports the FPA and CFP Boards' *Code of Ethics*

Principle 6 – Professionalism

Act in a manner that demonstrates exemplary professional conduct.

Professionalism requires behaving with dignity and courtesy to clients, fellow professionals, and others in business-related activities. Certificants cooperate with fellow certificants to enhance and maintain the profession's public image and improve the quality of services.

This is the fourth Dimension for Step 6: "Perform Periodic Qualitative or Performance Reviews of Decision-makers."

There is a reason why the disclosure *"Past performance is no indication of future performance"* is printed on every mutual fund prospectus—because it's true! Your review of a money manager needs to extend beyond an examination of the money manager's past investment performance.

Money management organizations are subject to the same challenge that every other organization faces—managing people. Disturbances in the workplace will eventually be reflected in investment performance. Conversely, as we witnessed with certain firms caught up in the mutual fund scandals of 2003, a decline in investment performance may lure senior investment professionals to compromise principles, and permit practices which conflict with the best interests of their clients.

Enough with the bad apples—how do we spot the good? A common characteristic of quality money management firms is that decision-makers have the ability to:

"… observe subtleties, make judgments and weigh thousands of facts and observations in a powerful, analytical and intuitive way."

– Frank Fobzzi, *Pension Fund Investment Management*

MONITOR

step 6

6.4

Perform Periodic Qualitative or Performance Reviews of Decision-makers

Even firms that state that they rely on a quantitative model (black box) still need professionals to interpret and implement the output. The best and brightest decisions-makers need a good home. Although not true in every case, there are some general observations that can be made about solid investment organizations:

Ownership: Decision-makers who are owners of their investment firms tend to outperform those who are employees.

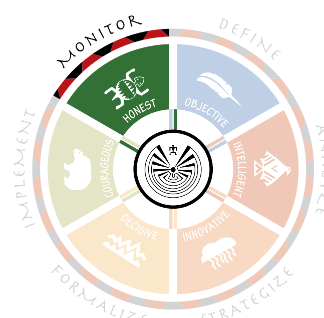
Size of the Firm: Smaller organizations tend to be more focused and concentrated in one style. As a result, performance tends to be more volatile—they bounce between the top of the performance universe, and sometimes the bottom.

Assets under Management: This is a close corollary to the size of the firm. One should ensure that the firm can properly invest the dollars being placed, which will vary depending on the asset class. The manager fulfilling a large cap equity assignment can effectively manage larger amounts than a small cap manager.

Change in Personnel: When there has been a change in personnel, or when a decision-maker has left one firm to join another, prudence dictates that the firm be placed on hold until sufficient time (two years) has passed in order to determine the impact the change may have on performance.

Trading Capability: Execution costs have a great impact on performance (Dimension 6.2). You should inquire about the firm's in-house trading capability, as well as how the firm ensures the client is receiving favorable or best execution of trades.

Research: The research analysts often are the unsung heroes: They're the ones in the trenches reading the fine print of annual reports and bond indentures to find the gold nuggets for the portfolio managers. How a firm treats, and values, its research analysts will say a lot about the firm. As an outsider, asking the simple question: *"What percentage of your research is purchased from the Street?"* will give you a good insight into the qualitative decision-making process of the firm. A firm that is relying heavily on research bought from the "Street" (research bought from third-party vendors) is going to have difficulty outperforming other managers who are looking at the same data.



Indian society is founded on status and social prestige. This largely reduces competition to inter-personal relationships instead of allowing it to run rampant in economic circles .... With competition confined within social events, each man must be judged according to his real self; not according to his wealth or educational prowess. Hence, a holder of great wealth is merely selfish unless he has redeeming qualities besides his material goods

– Vine Deloria, Jr.

Custer Died for Our Sins

6.4

Perform Periodic Qualitative or Performance Reviews of Decision-makers

Leaders are visionary.
Leaders are passionate.
Leaders do stuff that matters.
Leaders nurture other leaders.

– Tom Peters, *Leadership, The Essential Series*

If your actions inspire others to dream more, learn more, do more, and become more; you are a leader.

– John Quincy Adams

Anytime you use your influence to affect the thoughts and actions of others, you are engaging in leadership. … Remember, the best leaders are those who understand that their power flows through them, not from them.

– Ken Blanchard, *The Heart of a Leader*

The task of leadership is not to put greatness into people but to elicit it, for the greatness is there already.

– John Buchan

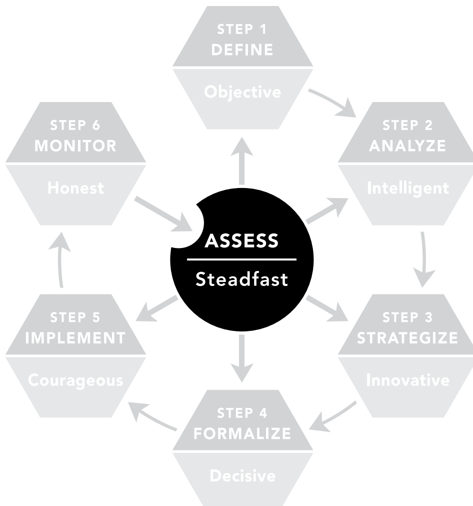
Soft Dollars: Managers who purchase "Street" research usually pay for the information from commissions generated from client transactions. Under such a scenario, you should understand that part of the manager's costs for running their shop is paid for by transactions generated from your client's accounts.

The Company Jet: When the portfolio manager flies in on his personal jet; starts sporting facial hair; trades in the Brooks Brothers dark blue suit for Hawaiian shirts so that he can show off his assortment of gold chains—then it may be time to terminate the manager.

A final comment about this Dimension—what are you doing to nurture a *fiduciary ethos* with your staff?

- Can your own practice withstand the same level of qualitative due diligence as you would apply to a money manager?
- Do you have a formal process for performance reviews?
- Do you have a defined process for mentoring future financial planners? Do you allow for their mistakes, and do you encourage and support their training?
- Do you delegate, when warranted, and bestow trust?

Assessment Procedures



Essential Leadership Behavior:

STEADFAST

Defined as: Focused on achieving goals and objectives; efficient; practical; capacity to balance the needs of the organization and client.

Every night, I try myself by court-martial to see if I have done anything effective during the day. I don't mean just pawing the ground; anyone can go through the motions; but something really effective.

– Winston Churchill

The final element of a procedurally prudent investment process is assessing whether the process is effective—for your client, as well as for you.

A long-term investment strategy requires alteration only when the underlying factors of the client's goals and objectives change. These changes tend to be infrequent, if not rare, and reviews directed toward constantly reassessing existing policy tend to be counter-productive. You should be particularly cautious of making changes during periods of market extremes.

Despite the infrequent need for policy modifications, periodic reviews can serve a very productive purpose. When aimed at educating the client, reviews can reinforce the logic for current policy and therefore reduce the chances of unnecessary alterations.
In addition, whenever significant events occur that warrant a review, you should ensure that the strategy is examined in an orderly fashion.

Supports the FPA and CFP Board's *Code of Ethics*

Principle 7 – Diligence

Provide professional services diligently.

Diligence is the provision of services in a reasonably prompt and thorough manner, including the proper planning for, and supervision of, the rendering of professional services.

Assessment Procedures

The true Indian sets no price upon either his property or his labor. His generosity is limited only by his strength and ability. He regards it as an honor to be selected for a difficult or dangerous service, and would think it shameful to ask for any reward, saying rather: "Let the person I serve express thanks according to his own bringing up and his sense of honor."

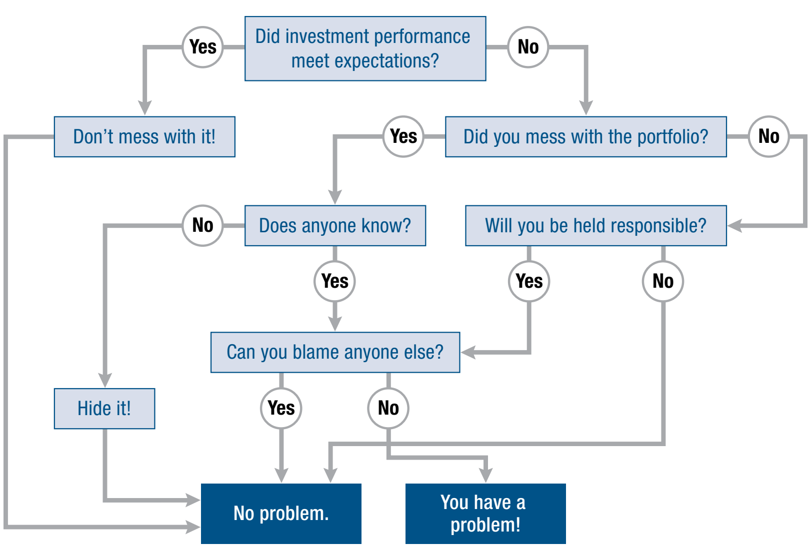
– Charles Alexander Eastman, Santee Lakota

Whether you are helping the client define their goals and objectives, developing the client's investment policy, or implementing and monitoring the strategy, the success of the client's financial plan will be determined by the quality of your decision-making process. For that reason, you also should develop effective assessment procedures to evaluate the strengths and weakness of your practice, and also to assess your effectiveness as the leader of that practice.

We are one of the last professions not to have defined standards and assessment procedures. Standard-setting and corresponding assessment procedures are the norm today, with more than 15,000 internationally recognized standards. Assessment procedures, in turn, all share certain attributes—the procedures help determine whether:

1. There is conformance to a defined standard (to the Dimensions in this case);
2. The entity (your practice) can comply with statutory, regulatory, and contractual requirements;
3. The entity can meet its goals and objectives; and
4. There are areas for potential improvement.

Typical Assessment Procedures!



Assessment Procedures

There are numerous benefits to having a defined assessment process:

1. It demonstrates to clients, compliance officers, and regulators that you have a procedurally prudent investment process in place.

2. The assessment process can double as a training curriculum—for educating your clients and staff.

3. It may help you discover blind spots—shortfalls and omissions to your investment process.

4. It can facilitate the sharing of best practices with other financial planners.

5. At some point in the future, P&C insurers providing liability insurance for financial planners will likely start providing "good planner" discounts to those planners who can demonstrate conformance to a defined standard.

6. It can help improve the financial planning you provide to your clients—an objective worthy of all of our efforts.

I have prepared an assessment instrument (see Appendix C) which is based on the decision-making dimensions and leadership behaviors covered in this book. The assessment instrument will help you gain a better understanding of your own strengths and weaknesses so that you have a basis for considering additional professional development.

And, finally, don't overlook the need to periodically conduct other general purpose assessments:

- Financial audits;
- Customer and vendor satisfaction surveys;
- Risk management audits;
- Compliance audits; and
- Security audits.

Change is hard because people overestimate the value of what they have—and underestimate the value of what they may gain by giving that up.

– James Belasco and Ralph Stayer,
Flight of the Buffalo

We shall have to create leaders who embody virtues we can respect, who have moral and ethical principles we can applaud with an enthusiasm that enables us to rally support for them based on confidence and trust. We will have to demand high standards and give consistent, loyal support to those who merit it.

– Dr. Martin Luther King, Jr.

Conclusion

When you were born, you cried and the world rejoiced. Live your life so that when you die, the world cries and you rejoice.

– White Elk

The intelligent and prudent management of financial planning requires that you maintain a rational, consistent planning process. You can accomplish the lion's share of your client's goals and objectives by implementing a simple decision-making process, such as the one defined in this book.

Your ultimate success as a financial planner can be measured by the answers to these simple questions:

- Are your clients meeting their goals and objectives?
- Are you meeting your own goals and objectives?
- Do your clients, staff, and peers view you as an effective leader?

If the answer to these questions is a resounding "yes," you have found your own *fiduciary ethos*.

I wish you all the best.

Don Trone
Mystic, CT
don@5ethos.com

Appendix A

This form is a compilation of templates first developed by the FPA Fiduciary Task Force. The form is designed to help you, the FPA® member, walk through a step-by-step process to help you conform to the requirements of CFP Board's *Rules of Conduct* and *Standards of Professional Conduct.*

Client Name ____

Initial Meeting Date ____

Section I: Establish the Basis for the Engagement

For Nonfinancial Planning Services

- ☐ Prospective client has not previously been a financial planning client.
- ☐ Prospective/current client sought meeting to discuss a specific issue or product (such as information about an insurance product, a mortgage, or an IRA-rollover).

Proceed to Section II

For Financial Planning Services

- ☐ Individual was previously a financial planning client.
- ☐ Client is seeking a financial planning engagement for the first time.
- ☐ You anticipate employing material elements of the financial planning process.
- ☐ Client has reasonable expectation that financial planning services will be provided.

Proceed to Section III

Appendix A

Financial Planning Services Checklist

Section II: Define Relationship for Nonfinancial Planning Services

- ☐ List the nonfinancial planning services to be provided.
- ☐ Identify the services you will provide to the client:
  - ☐ Determine client's goals and objectives
  - ☐ Gather client data
  - ☐ Identify appropriate products or services
  - ☐ Provide a costs/benefits analysis of the various products
  - ☐ Explain terms and conditions
  - ☐ Assist in the application process
  - ☐ Deliver and explain products or services when provided.
- ☐ Describe the obligations and responsibilities of each party, including that you are not providing financial planning services.

Proceed to Section IV

Section III: Define Relationship for Financial Planning Services

- ☐ The prospective client and you agree on the financial planning services to be provided (Step 1.)
- ☐ The client is provided, prior to entering into an agreement, written information regarding your role and responsibilities (Step 1):
  - ☐ Determine client's goals and objectives (Step 2)
  - ☐ Gather client data (Step 3)
  - ☐ Develop strategies (Step 4)
  - ☐ Implement the strategies (Step 5)
  - ☐ Monitor the strategies (Step 6).

Note: The rest of the form is to be completed for both nonfinancial planning and financial planning engagements.

Appendix A

Section IV: Disclosures

- ☐ Provide to the client written disclosures prior to executing the agreement:
    - ☐ Your qualifications, education, and experience
    - ☐ Your sources of compensation, including those of affiliated firms:
        - ☐ Factors that determine costs to the prospective client
        - ☐ How decisions of the prospective client may benefit you, or an affiliate, and the relative benefits to you.
    - ☐ Your conflicts-of-interest:
        - ☐ Provide a general summary of material conflicts-of-interest between the client and you, and/or affiliate. (Potential conflicts include: Familial, agency and/or contractual relationships, any material financial incentives that you and/or affiliate may receive, referral fee arrangements, etc.)
        - ☐ Describe any limitations placed on your recommendations. These limitations may be caused by licensing, regulatory, or employer policy constraints including terms under which proprietary products are sold.
- ☐ Your use of other entities to meet the agreement's obligations
- ☐ Describe to the client other material or information relevant to the professional relationship that the client should know before making an informed decision, including publicly available disciplinary history during the past 10 years.
- ☐ Encourage the prospective client to review all written disclosures, and offer to answer any questions.
- ☐ Following the disclosure of the above items, prepare for the client a written agreement governing the proposed services. Such agreement shall specify:
    - ☐ Parties to the agreement
    - ☐ Date of agreement and duration
    - ☐ Terms for termination of the agreement
    - ☐ Services to be provided under the agreement.

Appendix A

Financial Planning Services Checklist

Section V: Obligations to Client

- ☐ At all times, you shall:
  - ☐ Place the interest of the client ahead of your own and act in the capacity of a fiduciary as defined by CFP Board.
  - ☐ Provide reasonable and prudent supervision or direction to any subordinate or third-party to whom you have assigned client services.
  - ☐ Notify current clients in a timely manner of any certification suspension or revocation received from CFP Board.

Section VI: Other Information to Be Provided to the Prospective Client

- ☐ All material items on your standard disclosure form and Website are accurate and up-to-date, including minimum net worth requirements, special discounts to standard asset fees, etc.
- ☐ The client is provided your contact information in writing, including that of an affiliated firm, if applicable.
- ☐ The client is provided timely disclosures of any material changes to the above information.

Section VII: Product Analysis, Recommendations, and Professional Referrals

- ☐ Inform the client of any limitations on product selection or professional referrals.
- ☐ Obtain from the client all necessary information, and disclose any material deficiencies.
- ☐ Provide the client information on the pros and cons of recommendations, including product characteristics such as costs, risks, and the basis for making a given recommendation.
- ☐ Only offer to the client advice in those areas in which you are competent to do so.
- ☐ Disclose to the client information about any practice areas in which you are not qualified or licensed to work if the client requests certain products or services in those areas.
- ☐ Only make recommendations that are suitable to the client's situation.

Best Practices Tip! Consider having the client sign any written acknowledgement of material deficiencies in information noted by the certificant.

Section VIII: Handling Prospective and Current Client Information

- ☐ Maintain the confidentiality of prospective and current client information, subject to legal or third-party obligations.
- ☐ Secure prospective and current client information from identity theft, fire, flooding, or other natural catastrophes.
- ☐ Do not commingle client funds with personal funds. Client funds are promptly forwarded to the appropriate entity.

Appendix B

Sample Investment Policy Statement

Investment Policy Statement

For Don and Pearl Wisdom

Approved on ____________

This Investment Policy Statement should be reviewed by an attorney knowledgeable in this specific area of the law. Any changes to this policy should be communicated in writing and on a timely basis to all interested parties. If any term or condition of this Investment Policy Statement conflicts with any trust and/or plan document, the document shall control, as long as such term or condition is consistent with the law.

Appendix B

Table of Contents

Appendix B

Sample Investment Policy Statement

Executive Summary

Client:	Don and Pearl Wisdom
Type of Portfolio:	Wealth Management
Tax Status of Portfolio:	Taxable
Current Assets:	$2,000,000
Time Horizon:	Greater than 5 years
Modeled Return Expectation:	7.6% (4.6% over CPI)
Modeled Loss:	-8.9% (Probability level of 5%)

Asset Allocation:	**Lower Limit**	**Strategic Allocation**	**Upper Limit**
Domestic Large-Cap Equities			
Value	5%	10%	15%
Blend	5%	10%	15%
Growth	5%	10%	15%
Mid-Cap	5%	10%	15%
Small-Cap	5%	10%	15%
International Equities	5%	10%	15%
Intermediate-Term Fixed Income	30%	35%	40%
Cash Equivalents	0%	5%	10%

Evaluation Benchmark: The portfolio's total return should be compared to a weighted index return representing the same asset classes, at the same allocation, as the client's asset allocation.

Sample Investment Policy Statement

Appendix B

Section I: Statement of Goals and Objectives

Background

Don and Pearl Wisdom ("Client") are both successful entrepreneurs who have an investment portfolio in excess of $2,000,000. Both Clients have significant salaries and are able to continue to contribute to the investment portfolio. They have two school-age children, the oldest of which will be starting college in three years. Both Clients are fully vested in a defined benefit plan.

Purpose

The purpose of this Investment Policy Statement (IPS) is to assist the Client in effectively supervising, monitoring, and evaluating their investment portfolio. The Client's investment program is defined in the various sections of the IPS by:

1. Stating in a written document the Client's attitudes, expectations, objectives, and guidelines for the management of the portfolio.
2. Setting forth an investment structure for prudently diversifying the portfolio.
3. Providing guidelines that control the portfolio's level of risk and liquidity.
4. Defining due diligence for the selection of money managers.
5. Establishing formal criteria to monitor, evaluate, and compare performance results to the Client's goals and objectives.

Appendix B

Sample Investment Policy Statement

Section I: Statement of Goals and Objectives (continued)

Objectives

This IPS has been arrived at upon consideration by the Client of a wide range of policies, and describes the prudent investment process the Client deems appropriate. This process includes offering various asset classes and investment management styles that, in total, are expected to produce a sufficient level of overall diversification and total investment return over the long term. The objectives are:

1. Maintain the purchasing power of the current assets and all future contributions by producing positive real rates of return;

2. Have the ability to pay all liabilities when due;

3. Maintain a funding cushion for unexpected developments and for possible future increases in expense levels;

4. Maximize return within reasonable and prudent levels of risk; and

5. Control costs associated with the management of the investment portfolio.

Duties and Responsibilities

Financial Planner

The Client has retained an objective Financial Planner ("Planner") to assist the Client in managing the overall investment process. The Planner is a fiduciary and will be responsible for managing a disciplined and rigorous investment process consisting of the following steps:

Step 1 – Define the scope of the Client relationship.

Step 2 – Analyze the goals and objectives of the Client.

Step 3 – Strategize on the inputs that will be used to develop the Client's asset allocation.

Step 4 – Formalize the investment strategy and develop the Client's IPS.

Step 5 – Implement the investment strategy.

Step 6 – Monitor the investment strategy.

Section I: Statement of Goals and Objectives (continued)

Money Managers

As distinguished from the Planner, who is responsible for managing the investment process, money managers are responsible for making investment decisions (security selection and price decisions). The specific duties and responsibilities of each money manager are:

1. Manage the assets under their supervision in accordance with the guidelines and objectives outlined in their respective Service Agreements, Prospectus, or Trust Agreement;

2. Exercise full investment discretion with regard to buying, managing, and selling assets held in the portfolio;

3. Vote promptly all proxies and related actions in a manner consistent with the long-term interest and objectives of the Client as described in this IPS. Each investment manager shall keep detailed records of the voting of proxies and related actions, and will comply with all applicable regulatory obligations;

4. Communicate to the Client all significant changes pertaining to the fund it manages or the firm itself. Changes in ownership, organizational structure, financial condition, and professional staff are examples of changes to the firm in which the Client is interested;

5. Effect all transactions for the Client subject to best price and execution. If a manager utilizes brokerage from the Client's portfolio to effect soft dollar transactions, detailed records will be kept and communicated to the Client;

6. Use the same care, skill, prudence, and due diligence under the circumstances then prevailing that experienced investment professionals would use, and in accordance and compliance with all applicable laws, rules, and regulations; and

7. If managing a separate account (as opposed to a mutual fund or a commingled account), acknowledge fiduciary responsibility by signing and returning a copy of this IPS.

Section I: Statement of Goals and Objectives (continued)

Custodian

Custodians are responsible for the safekeeping of the Client's assets. The specific duties and responsibilities of the custodian are:

1. Maintain separate accounts by legal registration;
2. Value the holdings;
3. Collect all income and dividends owed to the Client;
4. Settle all transactions (buy-sell orders) initiated by the money managers; and
5. Provide monthly reports that detail transactions, cash flows, securities held and their current value, and change in value of each security and the overall portfolio since the previous report.

Section II: Inputs to the Investment Strategy

Risk Tolerances

The Client recognizes the difficulty of achieving their investment objectives in light of the uncertainties and complexities of contemporary investment markets. The Client also recognizes some risk must be assumed to achieve their long-term investment objectives. In establishing the risk tolerances of the IPS, the ability to withstand short- and intermediate-term variability were considered. These factors were:

1. The Client's strong balance sheet enables the Client to adopt a long-term investment perspective.
2. Liquidity requirements are minimal over the next five years, which implies that a higher risk profile is acceptable.

In summary, the Client's current financial condition and several other factors suggest, collectively, the Client can tolerate some interim fluctuations

Section II: Inputs to the Investment Strategy (continued)

Asset Class Preferences

The Client believes long-term investment performance, in large part, is primarily a function of asset class mix. The Client has reviewed the long-term performance behaviors of the broad asset classes, focusing on balancing the risks and rewards.

History shows that while interest-generating investments, such as bond portfolios, have the advantage of relative stability of principal value, they provide little opportunity for real long-term capital growth due to their susceptibility to inflation. On the other hand, equity investments, such as common stocks, clearly have a significantly higher expected return, but have the disadvantage of much greater year-by-year variability of return. From an investment decision-making point of view, this year-by-year variability may be worth accepting, provided the time horizon for the equity portion of the portfolio is sufficiently long (five years or greater).

The following eight asset classes were selected and ranked in ascending order of risk (least to most):

Money Market
Intermediate Bond
Large-Cap Value
Large-Cap Blend
Large-Cap Growth
Mid-Cap Blend
Small-Cap Blend
International Equity

The Client has considered the following asset classes for inclusion in the asset mix, but has decided to exclude these asset classes at the present time:

Global Fixed Income
Real Estate

Time Horizon

The investment guidelines are based upon an investment horizon of greater than five years. Interim fluctuations should be viewed with appropriate perspective. Similarly, the Client's strategic asset allocation is based on this long-term perspective. Short-term liquidity requirements are anticipated to be minimal.

Section II: Inputs to the Investment Strategy (continued)

Performance Expectations

The desired investment objective is a long-term rate of return on assets that is at least 7.6%, which is 4.6% greater than the anticipated rate of inflation as measured by the Consumer Price Index (CPI). The target rate of return for the Client has been based upon the assumption that future real returns will approximate the long-term rates of return experienced for each asset class in the IPS.

The Client realizes market performance varies and a 7.6% rate of return may not be meaningful during some periods. Accordingly, relative performance benchmarks for the money managers are set forth in the Control Procedures section. Over a complete business cycle, the Client's overall annualized total return; after deducting for advisory, money management, and custodial fees, as well as total transaction costs; should perform above a customized index comprised of market indices weighted by the strategic asset allocation of the Client's portfolio.

Section III: Implementing the Investment Strategy

Money Manager Selection

The Planner will use the following due diligence process to evaluate the appropriateness of a money manager.

Organization

Type	Must be a bank, insurance company, investment management company, or SEC-registered financial planner.
Professionals	Same portfolio team in place for a period commensurate with performance evaluation period.
Depth	Has worked with other high net-worth clients: manager has the capacity to handle the current growth of assets.
Fee Structure	Fees and expenses compare favorably to those of peers, and manager has a stated policy for managing soft dollars and directed brokerage mandates.
Reputation	The firm has no outstanding legal judgments or past judgments that may reflect negatively on the firm.

Section III: Implementing the Investment Strategy (continued)

Philosophy/Strategy

Behaviors	Be able to demonstrate that the same strategy or style has been consistently applied, and that portfolio holdings are consistent with the stated strategy or style.
Buy Discipline	Be able to clearly articulate the buy discipline that will be followed, and document that the strategy has been successfully adhered to over time.
Sell Discipline	Be able to clearly articulate the sell discipline that will be followed, and document that the strategy has been successfully adhered to over time.
Turnover	Portfolio turnover is compared to those of peers, and deemed appropriate.

Return Performance

Consistency	Returns are evaluated on a quarterly, one-, three-, and five-year basis and are favorable in both rising and falling markets.
Relative	Returns are evaluated on a quarterly, one-, three-, and five-year basis and are favorable in comparison to an appropriate index and peer group.
Results	Performance has been calculated by an objective third-party.

Risk Performance

Control	Be able to clearly articulate the defined strategy for managing risk.
Risk-adjusted	Risk-adjusted returns—measured by Alpha, Sharpe, or Sortino ratios—are favorable to those of peers.
Results	Risk-adjusted performance has been calculated by an objective third-party.

Section IV: Monitoring the Investment Strategy

Performance Criteria

The Client acknowledges that fluctuating rates of return characterize the securities markets, particularly during short-term time periods. Recognizing that short-term fluctuations may cause variations in performance, the Client intends to evaluate money manager performance from a long-term perspective.

The Planner has determined performance objectives for each money manager. Manager performance will be evaluated in terms of an appropriate market index (e.g., the S&P 500 stock index for large-cap domestic equity manager) and the relevant peer group (e.g., the large-cap growth mutual fund universe for a large-cap growth mutual fund).

Asset Class/Peer Group	Index	Peer Group Universe
Large-Cap Equity		
Large-Cap Value	S&P 500	Large-Cap Value
Large-Cap Blend	S&P 500	Large-Cap Blend
Large-Cap Growth	S&P 500	Large-Cap Growth
Mid-Cap Equities	S&P 400	Mid-Cap Blend
Small-Cap Equities	Russell 2000	Small-Cap Blend
International Equity	MSCI EAFE	Foreign Stock
Fixed Income		
Intermediate Bond	Barclays US 5–10 Year Govt./Credit	Intermediate-Term Bond
Money Market	90-day T-Bills	Money Market Database

The Client is aware that the ongoing review and analysis of money managers is just as important as the due diligence implemented during the manager selection process. The performance of the money managers will be monitored on an ongoing basis, and it is at the Client's discretion to take corrective action by replacing a manager if they deem it appropriate at any time

Section IV: Monitoring the Investment Strategy (continued)

On a timely basis, but not less than quarterly, the Planner will meet to review whether each money manager continues to conform to the search criteria outlined in the previous section, specifically:

1. The manager's adherence to the Client's investment guidelines;
2. Any legal or other regulatory agency proceedings affecting the manager;
3. Whether there are any changes to the manager's organization
   a. Change in professionals;
   b. Significant account losses, or account growth;
   c. Change in ownership;
4. Whether there are any changes to the manager's investment strategy, and that holdings are consistent with the investment strategy;
5. There is no dispersion unaccounted for in the manager's returns;
6. The manager's investment performance relative to peers. Concern is raised when the manager is performing in the bottom-quartile (75th percentile) of their peer group on a quarterly, one-, three-, or five-year basis;
7. The manager's relative risk-adjusted investment performance relative to peers:
   a. Concern is raised when the manager falls to the southeast quadrant of a scattergram for a three-year period; or
   b. The manager is performing in the bottom-quartile of peer rankings in Alpha, Sharpe, or Sortino ratios.

The decision to retain or terminate a manager cannot be made by a formula. It is the Client's and Planner's confidence in the manager's ability to perform in the future that ultimately determines the retention of a money manager.

Rebalancing of Strategic Allocation

The percentage allocation to each asset class may vary as much as plus or minus five percent, depending upon market conditions. When necessary and/or available, cash inflows/outflows will be deployed in a manner consistent with the strategic asset allocation of the portfolio.

If there are no cash flows, the allocation of the portfolio will be reviewed quarterly.

If the Planner judges cash flows to be insufficient to bring the portfolio within the strategic allocation ranges, the Planner will seek the Client's approval to effect transactions to bring the strategic allocation within the threshold ranges. (Strategic Allocation)

Section IV: Monitoring the Investment Strategy (continued)

Measuring Costs

The Planner will review, at least annually, all costs associated with the management of the Client's investment program including:

1. Money manager fees and/or annual expense ratios of mutual funds;
2. In the case of separate account managers, trading costs including commission charges and execution expenses;
3. Custodial charges, including fees, transaction charges, and cash management fees; and
4. Consulting and administrative costs and fees.

IPS Review

The Client and the Planner will review this IPS at least annually to determine whether stated investment objectives are still relevant, and whether realistically they can be achieved. It is not expected that the IPS will change frequently. In particular, short-term changes in the financial markets should not require adjustments to the IPS.

Prepared:	Approved:
______________________	______________________
Financial Planner	Don and Pearl Wisdom

Self-Assessment Instrument
for Financial Planners

Appendix C

Instructions: This assessment instrument is designed to help you evaluate your practice against a defined *fiduciary ethos*. It will guide you through an examination of your decision-making process, as well your leadership behaviors. For each statement, indicate whether it represents one of your strengths (1), one of your weaknesses (4), or an area where you need some improvement (2 or 3).

		Dimension	Strength — Weakness
1	You ensure each client understands your roles and responsibilities, and the scope of the engagement.	1.1	**1 2 3 4**
2	Each client understands the roles and responsibilities of the various decision-makers involved with the client's portfolio.	1.1	**1 2 3 4**
3	You use a deliberative process to help each client develop and identify their goals and objectives.	2.1	**1 2 3 4**
4	You ensure that client goals and objectives are consistent with all applicable regulations, statutes, and established policies and procedures.	2.1	**1 2 3 4**
5	Documents which substantiate each client's goals and objectives are centrally filed.	2.1	**1 2 3 4**
6	You support and have an understanding of the standards, procedures, policies, rules, and regulations which impact your financial planning practice.	2.2	**1 2 3 4**
7	When you lack expertise, you delegate to experts who have been prudently selected.	2.2	**1 2 3 4**
8	Each client understands the risks associated with their investment program.	3.1	**1 2 3 4**
9	You are circumspect in planning and action to mitigate or manage risks.	3.1	**1 2 3 4**
10	You have the capacity to bear uncertainty (risk) with fortitude and calm.	3.1	**1 2 3 4**
11	You consider the asset class preferences of each client.	3.2	**1 2 3 4**
12	You have analyzed the time horizons associated with each client's goals and objectives.	3.3	**1 2 3 4**
13	You demonstrate situational awareness and maintain contingency plans.	3.3	**1 2 3 4**
14	You have identified each client's tactical, short-term objectives.	3.4	**1 2 3 4**
15	Each client's investment strategy is consistent with the client's risk tolerances, asset class preferences, time horizon, and expected outcomes.	4.1	**1 2 3 4**
16	You have utilized optimization software to develop each client's asset allocation, and you have analyzed the appropriateness of the inputs to the optimizer.	4.1	**1 2 3 4**
17	You are capable of multitasking over protracted periods.	4.1	**1 2 3 4**

Appendix C

Self-Assessment Instrument for Financial Planners

		Dimension	Strength — Weakness
18	You ensure each client has appropriate liquid assets to meet near-term obligations.	4.1	**1 2 3 4**
19	You ensure each client's investment strategy is consistent with your implementation and monitoring constraints.	4.2	**1 2 3 4**
20	You have prepared an IPS for each client.	4.3	**1 2 3 4**
21	Each client IPS has sufficient detail that a "competent stranger" could execute it with confidence.	4.3	**1 2 3 4**
22	The IPS has been reviewed and approved by each client.	4.3	**1 2 3 4**
23	You are persuasive in the written and spoken word, and effective in both formal and informal communication.	4.3	**1 2 3 4**
24	You have a detailed due diligence process for selecting money managers.	5.1	**1 2 3 4**
25	You can demonstrate that the due diligence process has been consistently applied.	5.1	**1 2 3 4**
26	You have a due diligence process for evaluating each client's custodian.	5.1	**1 2 3 4**
27	You are a self-starter, you show initiative, and you exemplify a standard of excellence.	5.1	**1 2 3 4**
28	You have considered the pros and cons of active and passive managers, and you have appropriately implemented each client's investment strategy.	5.2	**1 2 3 4**
29	You have considered the pros and cons of separate account managers and mutual funds (commingled trusts), and you have appropriately implemented each client's investment strategy.	5.2	**1 2 3 4**
30	You have high endurance, and you have set an appropriate pace for yourself and your staff.	5.2	**1 2 3 4**
31	Client and service agreements are in writing, and are consistent with each client's goals and objectives.	5.3	**1 2 3 4**
32	You are sensitive, just, and impartial, and you value diversity.	5.3	**1 2 3 4**
33	You have a system in place to periodically monitor and evaluate each client's investment performance to determine whether the client will be able to meet their goals and objectives.	6.1	**1 2 3 4**
34	You are energetic, earnest, and stay on track.	6.1	**1 2 3 4**
35	You look beyond investment performance to analyze whether you are meeting each client's goals and objectives.	6.1	**1 2 3 4**
36	You have a defined process for determining when a money manager should be terminated, and the process is consistently applied.	6.1	**1 2 3 4**

Appendix C

		Dimension	Strength — Weakness
37	You control and account for each client's investment expenses.	6.2	**1 2 3 4**
38	When employing separate account managers, you ensure that the manager is seeking best execution and is appropriately applying soft dollars.	6.2	**1 2 3 4**
39	When employing mutual funds, you ensure that 12b-1 fees and other revenue-sharing fees are appropriately applied.	6.2	**1 2 3 4**
40	You avoid conflicts-of-interest (and you disclose any potential conflicts that are unavoidable), and you adhere to a code of ethics.	6.3	**1 2 3 4**
41	You conduct periodic investigations into possible conflicts-of-interest of other investment decision-makers.	6.3	**1 2 3 4**
42	You are genuine and supportive.	6.3	**1 2 3 4**
43	You conduct periodic qualitative reviews of money managers.	6.4	**1 2 3 4**
44	You are committed to the success of your clients, your staff, and your peers.	6.4	**1 2 3 4**
45	You have a process in place to periodically assess your *fiduciary ethos.*	6.4	**1 2 3 4**

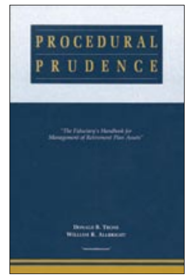
About the Author

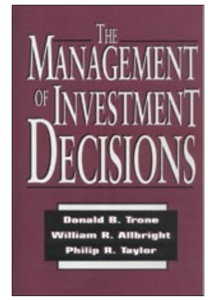
Don Trone is the CEO (Chief Ethos Officer) of Strategic Ethos, which develops programs on how an individual or organization can define a standard of excellence in terms of a decision-making process and the corresponding leadership behaviors. Don is the founder of the Foundation for Fiduciary Studies and Fiduciary360, and is the former Director of the U.S. Coast Guard Academy Institute for Leadership.

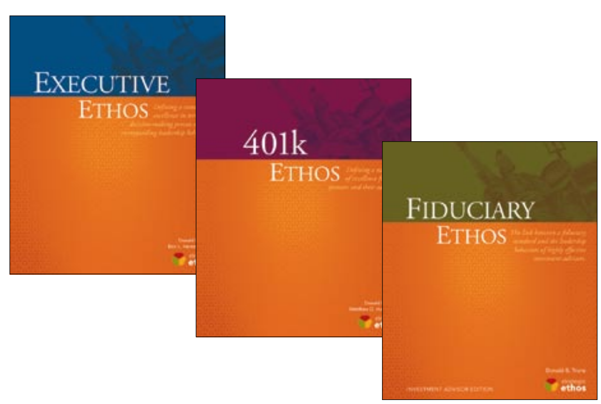
Don has been named by numerous organizations as “one of the most influential people” in the retirement, financial planning, and investment advisory industries. In 2003, he was appointed by the U.S. Secretary of Labor to represent the investment counseling industry on the ERISA Advisor Council, and in 2007, he testified before the Senate Finance Committee on fiduciary issues associated with retirement plans investing in hedge funds and alternative investments.

Don graduated as president of his class from the United States Coast Guard Academy, and served on active duty for ten years, including six years as a long-range search and rescue helicopter pilot. He is the 1997 recipient of the U.S. Coast Guard Academy Alumni Medal of Achievement for his distinguished military and business career. He received his Master’s degree in Financial Services from the American College, and has completed post-graduate studies at Pittsburgh Theological Seminary and Trinity Episcopal Seminary.

A listing of books and handbooks Don has authored or coauthored include:







Thornburg Investment Management®

Strategies for Building Real Wealth

Over 28 Years of Providing Investors

Strategies for Building Real Wealth

At Thornburg Investment Management, we have always taken our role as trustee and fiduciary very seriously. Thornburg has consistently focused on helping investors build real wealth, after inflation, taxes, and investment expenses. Whether our clients select one investment product or a diversified portfolio utilizing multiple Thornburg investments, our goal has remained the same: providing investors with strategies for building real wealth.

A History of Stewardship

Throughout Thornburg Investment Management's 28-year history, our focus on investors has been the cornerstone of our investment management business. Instead of directing our attention towards marketing and gathering assets under management, our efforts have been focused on two things – generating strong investment returns and servicing our clients. We operate under the belief that if you do those things well, the rest will take care of itself. This commitment to our investors has enabled Thornburg to earn an enviable reputation for both strong historical performance and responsible stewardship.

Our conscientious dedication to our clients is further illustrated by our involvement with the Centre for Fiduciary Excellence (CEFEX). CEFEX is an independent organization which provides comprehensive assessments of adherence to best practices of Investment Fiduciaries. As a sign of our commitment to our investors, Thornburg Investment Management became the first company to be certified by CEFEX for its Fiduciary Practices for Investment Managers.

A Unique Perspective

We recognize that Santa Fe, New Mexico is not a conventional hub for investment management, but at Thornburg Investment Management we embrace our distinctive location. There is a considerable advantage to being based a few thousand miles from Boston and New York, far away from the accompanying ancillary noise of the crowd: you can hear yourself think.

Santa Fe is known as "the City Different," and Thornburg's investment professionals take pride in developing our own independent perspective. While we send our research teams across the globe, follow the research of Wall Street analysts, and visit company managements regularly, we insist on reaching our own conclusions about the value of an investment. Operating outside the clamor of the major financial centers allows us to ignore the static and focus on the fundamentals.

Private Ownership

Thornburg's private ownership structure allows us to avoid being driven solely by short-term results, from both a business and an investment standpoint. Instead, our ability to look beyond the upcoming quarter gives us the flexibility to seek out the best long-term investment opportunities for our clients.

Meeting Investors' Long-Term Needs

At Thornburg, we strive to deliver consistent investment results for our shareholders. Our past success in this endeavor is grounded in our culture of placing investors first. While markets come in and out of favor, we believe that this commitment will enable us to service our most valued constituency – our investors – for the next 28 years and beyond.

For additional information, please visit our web site at www.thornburg.com or call 877-215-1330.

The Centre for Fiduciary Excellence (CEFEX) is an independent global certification organization that promotes fiduciary practices among Investment Stewards, Investment Advisors, and Investment Managers. A CEFEX Fiduciary Certification is an independent recognition of an Investment Manager's conformity to the Global Fiduciary Standards of Excellence developed by CEFEX. The Fiduciary Certification is performed by a qualified CEFEX Analyst and is reviewed by the CEFEX Certification Committee to ensure complete impartiality.

Investments carry risks, including possible loss of principal. Investments are not FDIC insured, nor are they deposits of or guaranteed by a bank or any other entity.

Before investing, carefully consider the Fund's investment goals, risks, charges, and expenses. For a prospectus containing this and other information, contact your financial advisor or visit thornburg.com. Read it carefully before investing.

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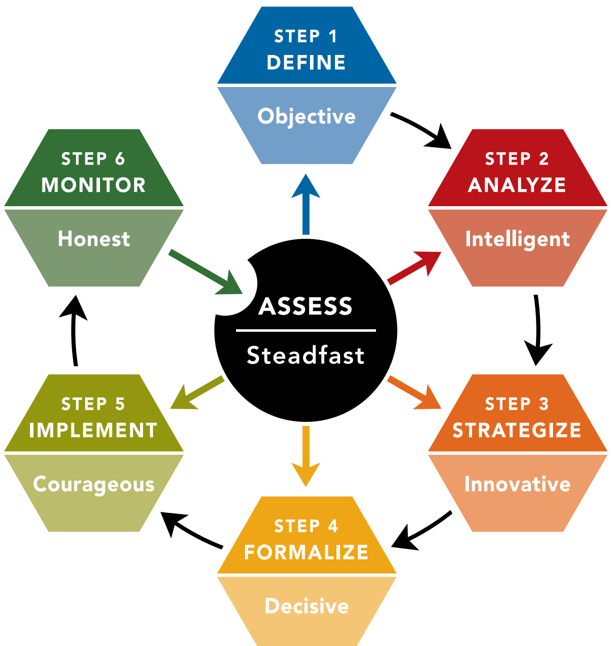
FIDUCIARY ETHOS



Fiduciary Ethos is based on a hierarchical framework which begins with a traditional, six-step investment process (Define, Analyze, Strategize, Formalize, Implement, and Monitor). For each Step, we also have identified the leadership behavior that is essential for the execution of that Step (Objective, Intelligent, Innovative, Decisive, Courageous, and Honest). Central to this process is the need to assess performance on an ongoing basis, and to make necessary adjustments.

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