Lecture 1: Financial Planning and the Profession

Unit 1.1: Financial Planning, Economic Conditions, and Behavioural Biases

Discuss the need for financial planning service

Needs for financial planning:

- Ageing population leads a shift of retirement funding responsibility to individuals
- Homes in certain locations are not very affordable and hence prospective home owners need to save up
- People need to save and do have more wealth to manage and protect
- Complexity in taxation, superannuation, social securities and asset protection laws and regulation

How can a financial planner help?

- Up-to-date, relevant and reliable information
    - Tax and other regulations, e.g. superannuation
    - Financial and insurance products
- Technical expertise to interpret information, create appropriate strategies and coach individuals to be more rational (less emotional) in making financial decisions
- Specialisation of labour and capital

Discuss the relevance of economic conditions and behavioural biases to financial planning

Economic environment is cyclical in nature and thus planner must be aware of the impact of the economic environment on investment market and client psychology, as risk aversion changes to according to the **business cycle**.

- In financial planning, having an indicator of which phase of the business cycle is important because cyclical change is a significant factor in the timing of investment decisions.

Two reasons why it is necessary for an advisor to have an understanding of the economic environment:

1. Knowing about the behaviour of key economic variables (e.g. interest rates, unemployment rates and inflation) and monitoring such variables → provide possible insight into trends over time → valuable tool for predicting possible future movements
2. Any change in the economic environment affect both industries and firms with respect to consumption-investment patterns → impact share price → reflects company earnings and investor confidence
    - Changes in consumption-investment patterns affect the stability of the share market and the economy. Being able to predict behaviours make it possible to cushion or modify the economic impact

Data for economic conditions:

- **Interest rate** – important factor in making recommendations → it may affect clients either favourably or unfavourably
- **Inflation** – plays a major role in determining interest rates
    - High inflation rate increase the costs of borrowing → reduce individual's ability to save and invest (vice versa)
    - High inflation tend to have a detrimental effect on share prices, generally, share price decline as interest rates rise
    - Can impact retirement plans and long-term financial goals
- **Unemployment rates** – affect financial stability
    - High unemployment → reduced disposable income and relatively negligible saving capacity. Usually accompanied with high rates of bankruptcy and rising interest rates (recession) → affect level of investment and wealth creation ability of clients
- Economic activity (GDP)
- And others (e.g. exchange rate, consumer confidence, etc.)

Business cycles are about the past and present – a recession is typically defined as two consecutive quarters of GDP decline, i.e. always need data.

Market cycles are about the future and changes in investor expectations and risk tolerance

- This is expressed in the buys and sells in the market

- Risk capital of individuals and institution is in short supply after major downturn
- Aggregate risk aversion is likely to be higher after significant market downturn
- E.g.: GFC – downturn in the U.S. housing market and bursting of credit bubble significantly reduced aggregate risk bearing capacity and increased funding needs → seller dominates markets of risky assets and price undershoot the 'fundamentals'
- Vice versa, in boom phase of a market cycle → fundamentals improve, investor confidence increases, leverage increases, asset price increases, real investment activity increases
- Growth prospects and asset valuation ratios also fluctuate over market cycles

These cyclical behaviours have implications for asset allocation and security selection strategies

Individuals are potentially susceptible to **behavioural biases** in making investment decisions. Common ones include:

- **Propensity to save** (choose suboptimal levels)
- **Limited attention** (focus on attention grabbing assets)
- **Overconfidence** (underestimation of risk or variance, excessive trading and incur high transaction costs)
- **Disposition effect** (ride on losses and cut profit)

A financial advisor might be able to reduce the impact of these biases on the financial health of clients.

Media/attention effect – news channels and popular press report may affect how individual investor behaves during boom/recession. Generally, we should consider whether individual's biases aggregate to the market level and affecting prices.

Unit 1.2: The Financial Planning Process

List the six steps of financial planning

Financial planning is the **process** of **developing strategies** to assist clients in managing their financial affairs **to meet life goals**, which involves reviewing all relevant aspect of a client's situation across a large breadth of financial planning activities, including **inter-relationships among often conflicting objectives**.

The financial planning process (embodied in the FPA's Code of Professional Practice):

1. **Collect and assess the financial data of the client**
    - The **first meeting** with the client is important in building trust – this is the opportunity for the financial advisor to demonstrate good interpersonal skills
    - A lack of trust can result from:
        - Body language (e.g. sitting with arms crossed, looking at the ground, etc.)
        - Overuse of technical terms or jargon (e.g. ASIC, FPA, etc.)
        - Attitude (e.g. being patronising or condescending)
        - Tone of voice
        - Eye contact (avoiding such contact)
        - Poor listening skills (e.g. excessive note taking)
    - **Data-gathering instrument** is used to obtain *all* necessary information/circumstances about the client, in order to provide optimal financial advice
        - Advisor must show a clear understanding of the client's current circumstances – in some cases, it may be better for advisors to initially work through the document with the client
        - Other advisors may allow the client to take the fact-finder home and complete it at their own leisure
        - Generic questions are not used – questions must be specific to client's circumstances
        - Several types of information required:
            - **Technical information** – information relating to the client's current situation (e.g. age, sex, martial status, dependants, financial information, etc.)
            - **Psychological information** – assist the advisor in determining the risk profile of the client
            - **Marketing information** – used to assist in market segmentation. Enables advisor to target a certain clientele through a referral network. Assists dealers/brokers/advisors to identify their current market and develop future marketing strategies

        - The instrument should obtain both quantitative (relates mostly to the client's financial situation; concentrating on assets, liabilities and budgets) and qualitative information (financial goals, financial decision-making style, learning style, general attitude to risk, financial risk-taking, psychological and social needs, client's family relationships)
        - Data-gathering instrument generally involves a staged approach:
            - First stage considers the personal details of the client (name, address, sex, marital status, dependants, etc.)
            - Then the instrument considers employment history of the client and the spouse
            - The next stage considers information relating to the client's financial position (personal budget, income and expenditure statement and a personal balance sheet)
            - Then we consider superannuation/retirement, insurance and estate coverage
            - Then we consider savings and lifestyle priorities, both financial and non-financial
            - Last stage relates to investment objectives and risk tolerance

2. **Determine the objectives and goals of the clients**
    - Consider: present goals, anticipated future goals, financial and non-financial goals, psychological capabilities

3. **Analyse the client's needs and identify any financial problems in strategy formulation**
    - Once the information has been collected and the client's goals are determined, it is important to analyse the information to determine the client's current cash-flow situations, the client's current net worth and a dollar value for the client's future needs
    - Benchmarks should be established to determine whether goals are achievable. A client may need to increase saving or net worth to meet an overall objective
    - Now that the client's current position is apparent, consider what the client wants to be at some future date and how to get there – goals should be considered in the short, medium and long term

4. **Structuring the Statement of Advice (SOA)**
    - Task required given the information provided in step 1 and 2:
        - Formulate the asset-allocation proportions
        - Select the appropriate investment types
        - Select the appropriate investment products given the determined investment types
        - Provide a comprehensive document, which make explicit recommendations and details how these will meet the goals of the clients
    - **Behaviour finance: the risk-assessment process** – successful investing requires understanding the 'risk and return' relationship (higher risk is likely to generate higher returns in the long term. The higher the long-term returns, the more volatility the investor may have to endure in the short term)
        - Risk-tolerance instrument draws these factors together by helping the client understand how he/she feels about risk – e.g. investment risk profile
        - Provides guideline that may help the client and the advisor determine how to allocate the funds that the client has available for investing among the major asset classes (i.e. shares, property, fixed-interest, cash)
        - The tool does not provide financial advice about any particular financial product
    - **Client risk profile** – five categories of risk, which advisors translate into risk/investor types:
        - **Very conservative** – averse to growth investments, such as shares or property. Prefer term deposits, fixed-interest securities or debentures
        - **Conservative** – also risk averse but his/her portfolio would include products such as capital stable fund (small proportion of the portfolio), with fixed interest comprising ~80%
        - **Average investor** – more balanced approach to investment. Portfolio would have equal exposure to both growth and income investments in both domestic and international markets
        - **Growth investor** – likely to have a large proportion of growth asset in the portfolio (higher emphasis on shares and property). I.e. more emphasis on the use of direct investments rather than managed funds