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Thriving in a Time of Crisis

John M. Nicola, CLU, ChFC

We are in a mess. Maybe we could call it another fine mess. These two comedy actors from the 1930s, Laurel and Hardy, made a movie with that name that was at the beginning of the last crisis, the Great Depression. We are now fast forwarding 80 years and we see ourselves in the middle of another crisis. In terms of the people in this room, clients are on the move. If you have any doubt about that, consider this Herman cartoon where she says to him, "I don't want you to worry, but the guy who delivered the pizza was your financial planner."

Clients have a right to ask the real questions here. How am I doing? How much have I lost? If you're so smart why didn't you see this coming? And, how does this affect my plans for retirement, my business, my estate, legacy such as charities, my current lifestyle, and education for my kids? In fact, as Homer Simpson might say, "If you want me to stay with you, you better start communicating." Looking at this picture of Homer I couldn't help but notice that I think he would be a great client for me. We seem to share the same taste in underwear and we certainly have the same hairline.

A little bit about our firm. We are based in Vancouver. We're licensed as investment counselors. We are also licensed as personal producing MTA with three different life companies. We have 500 client families and a typical profile for us is owner-manager-professional or retired, equivalent to that. We manage \$1 billion under assets, which is about \$2 million per family. That doesn't mean much, it's sort of the classical equivalent of saying the average height of a dwarf and a giant walking into a room is six feet. In many cases our young professionals have no money and just debt. Our largest account is \$25 million.

We have 10 advisors and four portfolio managers with CFAs; 48 total staff. I was thinking about what W.J. said the other day, that if you went from half a person as support to two or three, you could triple your income. So I'm going to talk to him later today and ask him how much I should be making with 48 people.

We do a business plan every year and, in doing the plan, we look at how the prior year went. There is a quote here and I'm going to try to read it. It's from Rudyard Kipling. It goes, "If you can keep your wits about you while others are losing theirs and blaming you, then the world will be yours and everything in it." I thought that was appropriate for 2008.

If we take a look at the things that went wrong last year, they included the following: our gross revenue dropped 7 percent. The prior seven years it had gone up 21 percent a year. Our insurance revenue fell 50 percent in 2008 over the prior year. We were profitable last year, but our net operating income dropped to 17 percent from 26 percent. Our average client return was -7 percent. The increase in assets we had was 5 percent, the lowest in a decade. We spent \$300,000 on a database which had to be completely written off. In fact, when I started making this list, I was wondering what the heck am I doing up here talking about thriving in a crisis. But of course, there's always a "glass half full" approach to life as well, and I tend to lean that way, as most people in this room would.

So, on the positive side, we'll recover all of our insurance business by the end of 2009. That -7 percent return last year put us in the 99th percentile of balanced portfolios in Canada, the median return for these portfolios was -19.5 percent last year. Level revenue is now 84 percent of our total revenue, which makes a big difference to the business value we have and also makes a very stable cash flow. We implemented a client Web site and six different investment pools for clients. Last year, we added 72 families and \$75 million of new assets. This year in the first nine months of the year, our assets have grown by \$200 million even though the goal for the entire year was \$100 million. The year-to-date return for clients is now 11.5 percent. So, basically, we've made up all of the losses the clients suffered in 2008 and then some.

We measure ourselves against an industry, and the mutual fund industry in Canada has had a 20 percent shrinkage in assets between January 2008 and August 2009. Our assets are up 32 percent during the same time period.

We have a certain strategy and part of these other people have explained and are using here. W.J. mentioned this yesterday, being a planning-based firm which we are as well. We focus a lot on planning, that's the primary reason clients come to see us. We're fee-based in that area. We focus on cash flow versus price. On investments versus insurance, we're fee-based. We're commission based on insurance. We spend a lot of time on client communications and services. We have a newsletter, a Web site and we do a lot of client seminars as well.

Last year, as you know, it didn't matter what asset class you bought, virtually every one of them lost money, and the elephant in the room was housing. If we take a look at, the economist did this review in March 2009. It said at the time that global equities were down \$30 trillion, 50 percent around the world. Total net worth was down \$50 trillion when you take into account housing and private equity. That's a serious amount of money, even for a guy like Jim Rogers.

If you looked at last year, you take a look at the Wiley Coyote type of investing. This is where you're always chasing Road Runner but you always feel like you're falling off a cliff. Well, that's what last year felt like when prices dropped 50 percent. This year they've gone out 50 percent. But, unless you're mathematically challenged, you have to appreciate that it has to go up 100 percent just to get back to square one. I would argue that the rise has been more rapid arguably than it should be based on fundamentals. So it begs the question, is this a dead cat bounce? I'm not sure why they call it a dead cat bounce, but that's what you use whenever a market rises and it's a false bull market.

The economists also took a look, and I think this is more important for our industry because we're not talking about a year or so of bad returns, they took a look at what happened if somebody took \$100 a month, put it in a typical equity fund and \$100 a month and put it in a balance fund and a bond fund. They compared it to, of all things, putting it in a mattress. Well the mattress beat the balance funds and the equity funds for the last decade. So that means people investing, they know they're not getting anywhere. It feels like they're treading water. Well, they are treading water and that is a very challenging issue if you're trying to build wealth, especially for issues like retirement.

This book would be one I would recommend anybody get if they think they would like to learn more about how to invest in this kind of environment. It was written by Battelle Kesnesos and recently there was an article on him in *Barron's*. This market could last another five to six years. We think that that's very likely going to be the case and that affects the strategy we use in the way we invest.

In a way, you could say the bull is taking a nap. But my chief investment officer gave me this. As you can recognize this first image, it is the Wall Street bull of course, except he's not in this position anymore, he's in this position taking a rest.

If you go back to 2006, the housing crisis started back then. We have been writing. We have a newsletter we write every month and we try to tackle issues we think are fundamental to our clients. We were trying to be a little bit ahead on the curve where housing was going in both the U.S. and Canada. If you look at the U.S. issue, this guy is probably the best predictor of crises in the U.S. in the last decade. He predicted the stock market crisis in 2000. He predicted the real estate crash in 2005. His name is Robert Shiller. Today prices are back to where they were in 2003, they've dropped 29 percent, and 14 million people have negative equity in their houses. I don't want to sound too depressing, but just consider the fact if 14 million people have negative equity in their homes. Why wouldn't they try to rent the same home, because in the end it would be 50 percent cheaper than making those mortgage payments and paying the taxes. A lot of people are going to do just that.

It's a philosophical question, but this wealth that was created, was it real or an illusion? I would argue it was the latter.

If you want to get a good sense of where the high net worth marketplace is, I recommend you go to a Web site run by Capgemini. They do a great report every year on what's going on in the high net worth marketplace all over the world. It's free, so it's hard to beat.

The January 2008 report reported 10 million people with \$1 million of investable assets or more and \$41 trillion of total assets, an average of \$4 million each. You know what, of course, happened subsequent with the market crashes. That shrank that group from 10.1 million to 8.6 million and a lot of them are looking to change advisors. That is danger and, of course, it's an opportunity, depending on what side of the coin you're looking at.

This is an article, and again this goes back to some of the comments made yesterday about avoiding the commoditization trap. This is an article from Doug Davidoff. It asks the question: Why should people buy from you instead of your competitors? If your response is something like our clients get a better return with us, we know what we're doing better than our competitors, our products and services are better, you're in the commoditization trap which is the same as blah, blah, blah. There's nothing unique and specific about any of these responses. They suggest that maybe the question you have to ask is the following: Who cares about what you do? Define your market first and then ask the following questions. What is unique about the products and services you offer when compared to your competitors? What wisdom can you offer that cannot be offered by your competitors? What are the potential negative consequences to your clients if they ignore your solution and try to solve the problem alone? Or, if they ignore it entirely?

You take these questions, you take your definition of your market and you build a matrix. Our matrix looks like this. The questions are on the left and, on the top, is our marketplace made up of professionals, business owners, retired clients \$1 to 5 million, and high net worth clients with more than \$5 million of investable assets with us. We then say define the markets, answer the questions and use these answers to design our marketing material and our entire sales process. It should be driven by what this tells us.

One of the things it told us was clients were looking for online information, but of a more in-depth variety. We have a client Web site we built, but we waited to build it so it wouldn't just be reporting information, but it would be a document storage center for the clients on a confidential basis.

They come in and login and, if they want to look up how they're doing, they can. The statements we designed about 10 years ago provide this information on a single page. The first thing it shows is the year-to-date and since-inception rates of return. It shows what they made in each of the last five to six years, and it shows exactly what their asset allocation is in terms of percentage and dollar amounts. It's all on one page. There are a lot of other pages to the statement, in terms of detail, but if they simply want to cut to chase, they can get it from this one page.

Another example is we took their wills and decided to make a visual out of the wills. Most people really don't understand the implications of the wills that they write. We were explaining to clients this is what's going to happen visually if the husband dies, if the wife dies, if they both die. The bottom line is, if they don't like this picture, what kinds of changes do we have to implement so they get the picture they like. That is what should be driving the will process, not having the lawyer decide what should be in the will on behalf of the client. That's where, of course, you can add value. I can't tell you how many clients have told us that they really don't have a clue about the implications of their will.

So, regarding the client Web site, our long-term capabilities, our objectives are this: to have a wow factor when clients see it; to be an effective marketing tool for the business development that we do; to be used by our planners as their client work site when they're sitting down with clients; and an overall a differentiator.

We are also a firm that focuses on cash flow, because investment management is quite important to us. This is a quote from Oscar Wilde. He said, "A cynic is somebody who knows the price of everything and the value of nothing." And if you were to change the word cynic for bad investor, you could actually make some sense in terms of the marketplace we're in now. A bad investor is a person who knows the price of everything and the value of nothing. This is because we are in a society, and I would bet this is true for most people in this room, I bet everybody in this room can tell me within 1 to 5 percent exactly what their investments are worth. They know the price of their investments. But if I were to ask you, do you know how much you're collecting every year in rents, dividends and interest, a lot fewer hands would go up. And if I were to ask your clients that, hardly any hands would go up.

Is your wealth defined as the price of your assets or the cash flow they generate? In my opinion wealth is defined by cash flow, first, and price, second.

We don't use a traditional investment allocation. We don't have 70 to 60 percent in stocks and 30 to 40 percent in bonds. We use a lot of alternative strategies, including insurance and annuities. It's a very important part of our practice. Mortgages, investment-grade commercial real estate, income trusts, preferred shares. These are vehicles that generate a lot of cash flow. We typically only have about a third of our assets in equities.

The result of that has been, over the last decade since January 2000 (I picked that because that's more or less when this bear market started), when we compare our sales to our peer groups, our peer group in terms of balanced portfolios has averaged 1.4 percent a year. That's very close to break-even. We've generated 6.1 percent, which is hardly a huge return, but it's 4.5 percent per year higher, net of fees, and it's 60 percent cumulative difference today in terms of what accounts are worth on a per-dollar basis.

The other thing we report on is the cash flow that a client generates. We, for example, will not just say to a client here's what you are holding in the way of investments, this is how much income you're making. Why is this important? That's our philosophy. But, more importantly, we think 70 percent of the return they're going to get will come from the cash flow, dividends, rents and interest they earn being reinvested. In actual fact, in the last 10 years, it's been 100 percent. There has been no increase in capital gains in our portfolios, on a net basis. It's all come from the cash flow.

This brings us to an issue. I mentioned we're a fee-based firm. And do fees matter? If you Google "fees," you'll find you get 36 million hits on just the question of mutual fund fees. Obviously, somebody thinks it matters. You can get better results. I do agree, trump fees, so the cost issue is not the driving issue. On the other hand, if you can get the same results with lower fees, you have a compelling story to tell. We created a pool fund about four years ago that's an equity income fund focusing on dividends, interest and covered writing. It has a very low expense ratio, 0.5 percent. We add our advisory fee, but overall our clients are still paying between 1 and 2 percent when they are combining both together and they're tax deductible. We needed about \$20 million to break even and we're now at \$125 million of assets in the pool, so we make money at that rate. This is a commoditization issue where we basically disintermediated a lot of other parties to try to figure out how to create a mutual fund at a low cost. We have done this in real estate, and the new pools for this last year include the following: high yield bonds, mortgages, global equity and real estate trusts.

This is a little diagram about dividends and they gain something that almost seems like a paradox. What it's saying is the following: If you were to buy in a portfolio of the highest dividend paying stocks as opposed to the lowest dividend paying stocks, you would have made a lot more money over the last 22 years. This is interesting, because the highest dividend paying stocks are basically widows and orphans stocks, and the lowest dividend paying stocks are the so-called growth stocks. We assume we need to take greater risk when we buy our investments, but that is not by any stretch always the case. We saw this late last year when we decided to buy

and create a pool for high yield bonds. The compelling issue there was their yield was up to 10 percent-plus, and their net asset value had dropped by one-third.

The same argument was made when we invested in REITs in February of this year. At that time, Canadian REITs were paying 11 percent cash-on-cash returns. But, more importantly, they were selling for the first time in a decade below the break-up value of the REIT, meaning that the cheapest place to buy investment grade real estate was in the stock market for the first time in a decade. REITs are made up of a number of companies in Canada that have very strong balance sheets. They have good cash flow and we want to own these within the next five years. We look at this as a long-term hold. But, even so, what's happened, which we didn't expect, was that the pool has risen in value by 45 percent since February, but it still cash flows at 8 percent. So, basically, we're not going to be liquidating it. We're going to be holding it.

In case you wondered whether or not we'd forgotten about insurance as an asset class, we haven't. Insurance is important to us. It's only 20 percent of our total revenue, but as an asset class it's a significant asset class. So we look at the IRR of a life insurance policy and we say what can you do to increase my cash flow? I liked the presentation that Tom made yesterday focusing on the annuities as an income stream. We have been doing this for many years. Also, when we combine insurance with annuities we can create twice the income that the client could get from AA corporate bonds. Since we're managing their wealth, this is a very easy transition for a client to make.

We will use life insurance with bank loans to minimize the investment tax that clients pay on their portfolios with foundations to create tax credits to increase their cash flow and with statutory plans like 401(k). We don't deal with them in Canada, but ours are RSPs. We can increase income on distributions by 50 percent and, more importantly, we can eliminate 100 percent of the estate tax that would normally apply. So, we're not using insurance to pay the tax, we're eliminating the tax with these strategies.

In a way, life insurance has been punching above its own weight for quite a while now. If I were to compare the returns we get on life insurance and its connected attributes, it has outperformed all four of these asset classes in the last decade by a pretty big margin. So it's a very impressive story and not one we tell often enough because sometimes we don't think of insurance as an asset class.

Our matrix, this comes back to the Capgemini report. We have evolved primarily from a commission-based firm to a primarily fee-based firm. That's what the high net worth marketplace is looking for. They also want their advisors to move from being transaction oriented, brokerage oriented, to being planning oriented. We want to be in that top quadrant as a wealth planner and a relationship manager. That's where we are now. We see, eventually, becoming a personal CFO to our top clients and effectively running a multifamily office.

So, the observations I had just as we're wrapping this up and making sure that I'm actually on time are the following.

There's massive deleveraging occurring throughout the world and this is highly deflationary. Our view is that wealth equals cash flow versus price. We do think there's another five or six years to go of a very challenging marketplace. Consumers have to rebuild their balance sheets. If they're not making money, and they're not, they're going to have to start increasing their savings. House prices I think will continue to fall to trend. I have no idea how much it's going to be, but it wouldn't surprise me if it's another 10 or 15 percent.

I do agree with what Tom said yesterday, that the printing of money will be eventually inflationary but, in the short run, and I'm thinking the next year or two, we're much more likely to see deflation being what occurs. And life insurance is an asset class, it's not an expense.

My final suggestions for all of you would be increase the level of communication with your clients. They want to hear what you know, what you've read. Consider a fee-based approach. The client's perception is when we charge a fee to a client and they know we're not paid a commission on their investment products, they at least feel we're able to be very objective about what we're recommending. So there's no incentive for us to pick product A over product B.

We include cash flow in client reporting. I think that's a very important thing and, again, it's a differentiator. Your advantages are planning and creativity, so use them to be unique. Maybe specifically clients are willing to change advisors more than ever so you want to sort of be the mover as opposed to the moved.

Just to finally wrap up, I think it's the Chinese words for crisis or danger and opportunity as you all know. The opportunities here I think are huge. I don't think there's ever been a better chance for individuals to acquire high net worth clients in the last 30 years than there is right now. If you position yourself well this is actually a wonderful growth opportunity for your practice.

I hope there's a few things here I've given you that are useful. Thanks very much for your time this morning.

John M. Nicola, CLU, ChFC is a 28-year MDRT member with four Court of the Table and 21 Top of the Table qualifications. He has served as a member of various committees, including serving as Top of the Table Chair in 1999. He is founding partner of Nicola Wealth Management, where he provides innovative solutions to clients' problems. His areas of expertise include wealth accumulation and management by use of trusts, creative pension and insurance arrangements, and professional investment managers. He is a founding member of the Conference for Life Underwriters and served as chair in 2003.

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