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The Risk Management Components of Financial Planning

by Howard W. Wolosky

"Successful businesses and individuals take calculated risks on a daily basis. It's important that they are aware of the risks, work to minimize them, and, to the extent possible, strategize to the best advantage. Clients have four choices when it comes to risk—eliminate, transfer, minimize, or accept," says Jack Capron, principal with The Bonadio Group, in Syracuse, N.Y. Allison Shipley, who is a principal with PricewaterhouseCoopers Private Company Services Practice in Miami, basically agrees, but adds a fifth possibility that of avoiding the risk.

Capron believes that as a general proposition "setting realistic client expectations with regard to objectives, processes, goals, and anticipated results are the keys to successful risk management in financial planning engagements. In practice, we seek to document in a letter to the client the nature of services to be performed, the objectives to be sought, a process to monitor the results, and the fees to be charged."

Jonathan Albano, senior financial planner with CCR Wealth Management in Westborough, Mass., explains, "From the start of our relationship, combining a client's required rate of return on their assets and their tolerance for market volatility is a hallmark of our firm. Explaining the 'math' behind planning projections and then articulating how systematic effects upon their assets may impact values needs to happen.

"Our firm completes the proper due diligence with regard to a clients' time horizon and existing net worth, and then targets goals to be attained given required rates of return as well as intended savings rates. Risk management is an essential component of integrating a target allocation with clients' assets, once it has been fully explained what their required rate is versus what they establish as acceptable amounts of volatility."

Integral Tie to Investments

"We feel that risk management is the foundation of the financial planning engagement. That is why we perform a detailed evaluation of risk management for every aspect of a client's wealth management plan prior to making any recommendations," explains **Donald Hoffman**, partner with Hertzbach & Company, and president of The Prosperity Consulting Group, both in Owings Mills, Md. **Donna Gestl**, senior vice president at The Prosperity Consulting Group, adds, "We evaluate a client's risk tolerance, and design individual asset allocation models to correspond with their needs to achieve the proper risk management in each client's portfolio. It's very important to manage the client's expectations of their average annual growth in the portfolios so they understand the relationship between risk and reward in the design process."

Mark Smith, president and branch manager of M. J. Smith and Associates, in Englewood, Colo., which is affiliated with Raymond James Financial Services, primarily focuses on retirement planning for the firm's client and uses Monte Carlo simulations software to analyze portfolio risk. "In helping clients assess their financial independence, we look at various asset allocations and analyze their risk/return characteristics going back to 1973, so that we can include two of the nation's worst bear markets. We typically diversify between cash, bonds, U.S. large stocks, U.S. small stocks, and foreign stocks, as well as REITs and tangibles," he explains.

Donald N. Hoffman (President) & Donna Gestl (Senior Vice President) of The Prosperity Consulting Group, LLC.

Theodore Sarenski and Gail Gardner with DB&B Financial Services (affiliated with Dermody Burke & Brown) in Syracuse, N.Y., indicate that risk management is dealt with in all DB&B's financial plans by using very conservative assumptions for inflation, investment returns, cash flow needs, and assets available for use. "We set high-assumed values to factors that would negatively affect the future, such as inflation or cash outflows, and we set low-assumed values to factors that would positively affect the future, such as investment returns and assets available for use. Our method gives the client a very high probability of being able to achieve real results similar to the planned results," they explain.

Analyzing Insurance Coverage

Gestl stresses the importance of managing non-portfolio risk such as business, disability, and long-term care risk, pointing out that most people don't properly plan, and that can result in an untimely liquidation of invested assets. Albano focuses on identifying gaps or weakness in insurance coverage. "A major part of the due diligence comes is evaluating insurance options: assisting the client in understanding the coverage; comparing providers: product costs and benefits; examining other protection techniques; and tailoring the insurance product to the need," says Capron. In addition to looking at adequacy, planners have to look at whether the insurance is still needed in the same amount and same way.

Life insurance is a perfect example. Various options can be considered including transferring a policy to irrevocable life insurance trusts, terminating the policy, cashing in, converting to a more desirable policy, and the life settlement option where the policy is sold to third parties for syndication into investment products.

Business and Occupation Wrinkles

Shipley points out, "Owners of closely held businesses face unique issues because for many the business itself is the largest single asset the owners own, and the disproportionate allocation can't be avoided. Mitigating business risk can include purchasing key-person life insurance to ensure the business can continue in the event of an untimely disability or death." She does add that the concentrated level of the family's investment in "the business" versus other investments is by its nature a risk absorbed by many owners.

Sarenski and Gardner work with owners of closely-held businesses and executives with extensive holdings in company stock to diversify their investible dollars to reduce the risk they have with a large concentration of wealth in a specific business. They add that "diversification usually takes a much longer time frame to implement compared to other plans, so planning and diversifying earlier is important." Smith observes, "If the stock is publicly traded and there is an ability to sell, we discuss stop/loss strategies with regard to these securities." Albano also favors a specially designed plan of diversification on any outside assets integrated with the type of business owned. He cautions, "Depending upon the characteristics of the business (volatility, resale possibilities, cash flow, seasonality, etc.) special care of balancing the risks of the business and the portfolio assets is exceptionally important."

Disability insurance is an absolute requirement for doctors, according to Albano. He also usually recommends professionals have business continuation policies should the principal become incapacitated in some manner and is unable to render services.

Hoffman takes the type of business into consideration. "It's very important to evaluate the amount of risk that many business owners have signed up for with the ownership of their companies. For example, a homebuilder who is in a volatile market should consider the high level of risk of the business when designing portfolios for their investible assets," he explains.

Capron believes that professionals subject to potentially exaggerated claims should be advised about corporate, trust, and partnership planning options. He explains that means informing them about protections provided by both offshore and onshore jurisdictions and the ancillary benefits, costs, and potential tax issues. For professions where there is a propensity for litigation, Hoffman says, "It's important to evaluate the vehicles used to minimize risk, including trusts, annuities, insurance, titling of assets, and asset protection venues." According to Sarenski and Gardner, service professionals insure their risk of errors and omissions in a manner similar to how doctors cover malpractice risk adding that contractors need liability coverage. With regard to business owners, they observe that some take out insurance on key employees.

No Longer Always Until Death

"With the increase in divorce and second marriages, pre-marital planning is more common, whether through setting aside premarital assets in a separate account, or through prenuptial agreements. Prenuptials are useful when the parties bring a lopsided amount of assets into a marriage. For estate planning, we've seen people use irrevocable trusts, specific bequests in their wills, and QTIP (qualified terminal interest property) trusts where there are children from prior marriages," reports Sarenski and Gardner. Gestl believes it's critical to understand the desires of both spouses, and create a plan that will safeguard assets brought into the marriage and to protect children in the event of marital dissolution.

Capron points out that marriage dissolution can have disruptive, and, in some cases, disastrous implications on family finances. "Usage of bank accounts and credit cards can be disrupted. Access to financial records can be delayed. Litigation expenses can be consuming. And all types of planning, including child custody, education, parental assistance, and retirement plans may be threatened," he observes. Therefore, Capron advises, any financial plan should take into account family dynamics, and the professional should seek to provide as much future flexibility as possible as part of the planning process.

Often a Moving Target

"We find that most people overestimate the amount of risk they are willing to take on personally. In time periods when markets fall or when housing prices plummet as they have over the past couple of years, we find that clients quickly reassess, and most times lower the amount of risk they are willing to endure. Unfortunately, in a very short time after markets are rising, they tend to forget why they became more conservative, and look to take on more risk as they feel they are missing out on market gains," concludes Sarenski and Gardner.