The Business of Relationships

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The investment management business is at a critical point in its development. The industry is currently over capacity and maturing. Many firms are providing low value-added service—particularly over the past six years, when 70 percent of the managers underperformed the S&P 500 Index. The profitability of the business is high and too conspicuous. Also, there recently have been several highly visible ethical problems.

Because of these problems, the investment management business is due for a change. Some of the changes are already evident, such as the trends toward consolidation, indexing, and globalization. It is likely that one out of every three people currently working in this industry will not be here in three to four years as a result of these changes. So the question is: Who will survive and prosper? Four types of investment professionals will pull through: (1) the superior (as always); (2) the niche players and value-added players; (3) the firms which run a good business; and (4) those who have very good relationships with their clients. In this presentation, I will describe what it takes to have a good relationship with a client.

WHAT IS A RELATIONSHIP?

Serving the individual investor is a business of relationships. To be successful in this profession, therefore, it is necessary to understand the dynamics of relationships, how to develop them, and how to strengthen them. The dynamics of relationships are complex. The most important aspect of a business relationship is *emotion*—emotion based on perception, experience, and expectations. At the outset of a business relationship, clients have only their perception to rely on in assessing the manager's capabilities. Experience comes with time, after a client can assess the manager's performance and say, "This is good." Finally, clients begin to form expectations about how the manager is going to behave.

Relationships are strengthened through confidence. Confidence is a form of comfort and predictability. If one knows what is going to happen—good, bad, or indifferent—one is more confident. In the business relationship, clients must know what is going on; they need to be able to predict what is going to happen. Predictability provides a sense of comfort; predictability and comfort reduce the level of fear because they reduce the level of uncertainty.

Confidence is based on both experience and dependability. In the business relationship, experience is built over time; but it is also important to build a reputation for dependability. Are you there when the money comes in? Are you there when the phone rings? If you are dependable, the client's comfort level and confidence goes up. Do your clients understand what you are doing? Do they trust you? Are they proud to be with you? Pride is interesting and powerful. In some relationships, people are very secretive about their money managers; but most would rather boast about their money manager.

Simply stated, the business of relationships centers on the concept that clients must believe that you believe you understand the process: Their belief gives them confidence, and thus a good relationship exists. In addition, the relationship must be built on honesty and fairness. This is a business of perception, not deception. Money managers who deceive their clients will eventually lose them.

HOW TO ESTABLISH AND STRENGTHEN RELATIONSHIPS

The process of establishing and strengthening relationships with individual investors involves many steps. First, there must be a "meeting of the minds." At the outset, the portfolio manager must work with the client to establish a series of objectives and how these objectives might change. These objectives will depend on where the client is in the life cycle. The investment manager and client must decide whether they are investing to sleep or to eat. It is very important that all involved understand the objectives and what their respective roles are in meeting those objectives.

It is important to the success of a business relationship to have clients involved in the investment process; they should at least understand

it. When clients identify with the process, they defend it because they believe in it. They must understand what you are doing, why you are doing it, and how you do it: They must understand your investment process. Then, follow through on what you have discussed. Do not sell them one process and then use another. Be consistent.

It is important to be able to state your investment philosophy clearly. Table 1 shows a statement that summarizes our investment approach: "We invest in attractively-priced, financially-powerful companies; when they are not, we sell them." Table 1 also lists the investment characteristics associated with this style. Whatever your style, it is important to encourage your clients to focus on it rather than on the Dow Jones Industrial Average or the evening news. Help your clients feel proprietary about your investment approach because *that* is what they have, not the index. They will be very happy when their investment objective is met and you are the catalyst. Everyone has heard about the importance of referrals and networks. If your clients are happy and they understand what you are doing, they will talk about it. If they do not understand, they will most likely leave you in time.

Establishing your clients' expectations is an important part of a relationship because the client is going use these expectations to evaluate your performance. Each investment professional is responsible for his or her clients' expectations. These expectations are created at the beginning and throughout the course of the relationship. As you take on this burden, make sure that these expectations are realistic, if not conservative. Remember, stocks go up when earnings exceed expectations; similarly, portfolio managers are retained when they exceed expectations.

Greed is a permanent mindset, only temporarily displaced by fear. The portfolio manager's job is to introduce fear occasionally, because clients, like their portfolio managers, are human. When the market is on a roll, clients begin to think that 15 percent per annum is a given; and then they want to do something *really* meaningful. So, occasionally, one must inject fear. When clients get greedy, they get brave and forget the original game plan.

It is important to remind clients how well you are doing relative to their expectations. Life is made up of small victories. If along the way you have little victories, remind your clients of them; it will give them comfort, as well as provide evidence that you are making progress.

As you talk about performance, explain what happened and what the implications are for the future. Prepare clients for the down years. They must understand that it is going to happen. The more you prepare them, the better they will respond. Remember the changing environment. For example, when discussing performance expectations, remind your clients that their income will be different when interest rates are 14 percent than it will be when interest rates are 7 percent. Also, be consistent in discussing performance with your clients. When the numbers are high, just relax and be humble; when they are low, be persuasive. If you always go into meetings happy when the numbers are good and then depressed during the bad quarter, the client will get nervous and probably leave.

TABLE 1. Statement of Investment Philosophy

Style Statement:
We invest in attractively-priced, financially-powerful companies; When they are not, we sell them.

Investment Characteristics:
High/Improving ROE
Low Financial Leverage
High Dividend Growth
Low Price/Book
Relative P/E

Source: Fred H. Speece, Jr.

To be successful in the individual investor market, you must broaden the scope of your relationship. If you only want to sell—and rise and fall with performance—so be it; but if you want a good business, then strive for scope and dimension. The more your clients depend on you for different services, the more useful you are to them. When a client requests something extra, something not germane to what you are trying to do, respond rapidly. For example, the mother of one of my clients called me and said, "Fred, we have an antique store and six-and-one-half horses in my daughter's portfolio. We have to do something about this." I said, "I don't know anything about horses, and very little about antiques." Two years later, I was able to tell the mother that we were down to one-half of a horse and 40 cats. Within a year, she gave me her account.

Communication means a world of things. In the investment business, communicating means raising the confidence level—increasing the client's understanding of what you are doing, how you are doing, and the stated objectives. Remind them over and over about what you set out to do; because although we think about clients all the time, they think about us only occasionally.

There are four aspects of communication that should be addressed. First, communication should occur on an irregular basis as well as on a regular basis. Everyone sends out economic and market letters; people generally do not read them, but they remember getting them. Once in awhile, send your clients a short letter that says simply that you have been reviewing their account. Or, call them at an irregular time to say that something very small happened and that you took care of it, or to inform them of something that happened to one of their stocks. Clients expect you to call them for the quarterly meeting, but when you contact them in the interim, you are showing them that you actually care, that you have enough interest to pick up the telephone or drop them a line. That has a big impact, because it is something that they did not expect, and it is something positive.

Second, communication involves listening. When clients say something, are they trying to tell you in their own way that they have fear or uncertainty? Listen carefully, because they might be trying to tell you something in a subtle fashion. Also, portfolio managers have a bad habit of thinking they understand everything, so they talk and talk and talk. Once in awhile, your clients—who are probably very successful people—may have an opinion or a theory. Hear them out. Listen, you may learn something from them. If nothing else, they will feel better because they expressed an opinion about this money (which happens to be theirs) and feel part of the process.

Third, be direct in your communication. Economists are made fun of because they hedge too much. Run the risk of being wrong when the penalty is low. If you think interest rates are going to go up, tell the client that you are going to adjust the portfolio to deal with higher interest rates (although you are not going to bet the barn). Clients will appreciate that you are willing to take a stand, even though you may be wrong once in awhile. Clients do not hire investment managers to hedge. They hire investment managers for an opinion, for execution. Similarly, when the numbers are bad or short of expectations, explain why. Address the problem directly. If you raise the issue first, you have the advantage: "The numbers are not quite as good as we expected, and these are the reasons." When the numbers are good, make sure they understand and appreciate why, because these events will repeat. Communicating what happened may also help a portfolio manager understand why he or she did or did not do as well as expected. Portfolio managers need to understand that the investment management business is not a perfect science and that strategies do not always work out, even though they seemed to make sense at the time.

Fourth, use humor in your communication. Anyone who has been in this business for more than six months knows that you must have a sense of humor. Do not be afraid to make fun of yourself or to make light of a situation. It takes the chill out of the meeting and lets the client know that you feel comfortable with yourself and with what you are doing for the client. If you wring your hands over a problem, your clients are going to wring their hands and worry about the problem twice as much. Soon, they will find someone who does not make them worry so much. Then you will be wringing your hands for a different reason: a shortage of portfolios to manage.

Timeliness is an important ingredient in business relationships. You must be timely in the preparation of accounting statements, as well as in all your interactions with the client. Investment managers should make timely calls to clients and be punctual at meetings. Timeliness is a way to express appreciation and respect for clients and their needs; it is also an expression of competence.

Meetings are an essential part of a business relationship. Every meeting should have at least four objectives: first, to reaffirm the objectives, the respective roles, and the approach. You must tell the clients at every meeting why they are there, what you are going to do, and how you will do it. This is particularly important in the beginning of a relationship, as you work toward that "meeting of the minds." The second objective is to increase the client's confidence. If a client leaves a meeting with more confidence than he or she came in with, you have had a good meeting. Third, prepare the client for what is coming. After reviewing what you have done, prepare them for the future. I often tell clients not to be surprised if in the next six months I come back with, for example, more stocks or more bonds. Thus, you set a predictable pattern. If you do not do what you said, however, do not wait until the meeting to tell them. Call them before the scheduled meeting to explain why you decided not to do it. Finally, thank the client for his or her business.

Good relationships need a transition plan. It is inevitable: people die. Prepare your clients for this. Tell them what you are going to do with their money when they are gone. Try to set up a transition plan for them that involves you. Do not say you will give their money to your competition. Tell them you want to be involved with the transition because your firm will be in business, and because you are good for them. Also, it is important to discuss the possible transition of portfolio managers. Clients can see gray

hair; they know when someone is getting ready to retire. So prepare them for the transition; introduce them to your partners.

A good relationship also involves knowing how to deal with third-party consultants. Consultants can be your enemy or your best salesperson. If you treat them as adversaries, they will behave as adversaries. If you increase their comfort and they know what you are doing and see it working, you have an unpaid salesperson. They have relationships with people you do not. Rather than take the negative approach and decide the best you can do is neutralize or ignore them, make sure the consultant has at least as high a comfort level as your client. A consultant or adviser who has been with the family for many years has more credibility than you do. So make sure that they are comfortable with you. Have them help you; take their advice if it is compatible with your own approach—and make sure they know you are taking their advice.

The business of relationships involves honest self-evaluation. Review your best and worst accounts. Try to determine why they are what they are. Analyze what you do, why you work harder on some accounts. Explore the strengths of the good accounts and apply them to those that are not as good. Also, be selective. When you are starting your own business, being selective sounds foolish; but you must be selective. Be strong enough in your commitment to providing good service to tell a client you are not right for them, and then refer them to someone who is. Do not be afraid to refer someone who wants something that you do not do very well.

Finally, remember the four Cs: competence, clarity, consistency, and confidentiality. Use the four Cs to develop strong relationships with your clients.

Question and Answer Session

QUESTION: How do you feel about using consultants to find clients?

SPEECE: I think that consultants can be very beneficial to one's business. As with clients, it is very important to cultivate a good relationship with consultants; one never knows when the relationship will pay off.

QUESTION: Do you give clients performance numbers? If so, how often and in what format?

SPEECE: We give clients performance numbers at every meeting. It is important to show the numbers in the same format every time. Clients get suspicious when managers keep changing the format, and rightfully so.

QUESTION: In the investment contract with the client, how much time does the client have to terminate the relationship?

SPEECE: Our agreements allow termination with 30 days notice, but if a client wants to get out faster and it is not harmful, we let them go. We do not want clients who do not want to be with us. Terminations usually occur because clients are unhappy. If the portfolio manager is gracious, competent, responsive, and thorough when the client leaves, the client may ask himself if he made the right decision. You want to put doubt in their mind. The doubt will dampen any negative comments they might make. If you are in the individual business and the community is tight, the current, past, and prospective clients will be talking to each other. They might not have as much venom if there is doubt.

QUESTION: If the absolute number of investors grows, assuming that a total financial collapse does not happen, why do you believe that the number of investment managers will decline?

SPEECE: There are about 7,000 firms vending this service; 1,000 to 2,000 advertise that they are in the top 10 percent. In fact, a large number of firms are generating returns below the S&P 500. In addition, there is overcapacity in the industry. Therefore, assuming performance is important, there is no reason to have so many firms that have high fees and little to no value added in the business. The industry will have to change. Economics will do it.

QUESTION: The industry is going through a period of consolidation. Because one of the important aspects of a relationship is consistency, how do you handle personnel changes?

SPEECE: Turnover is part of the process: people change jobs. In this industry, portfolio manager turnover is a problem. This hurts the relationship. This is vulnerability. When people leave, it creates a gap in the confidence. The firm should create incentives for people to stay. Incentives can take the form of monetary reward or work culture. Because you cannot make people stay, you may want to have dual coverage on the accounts.