ADVISERS SEARCH FOR NEW FEE FORMULAS · MICRO-CAPS: MANY HAPPY RETURNS

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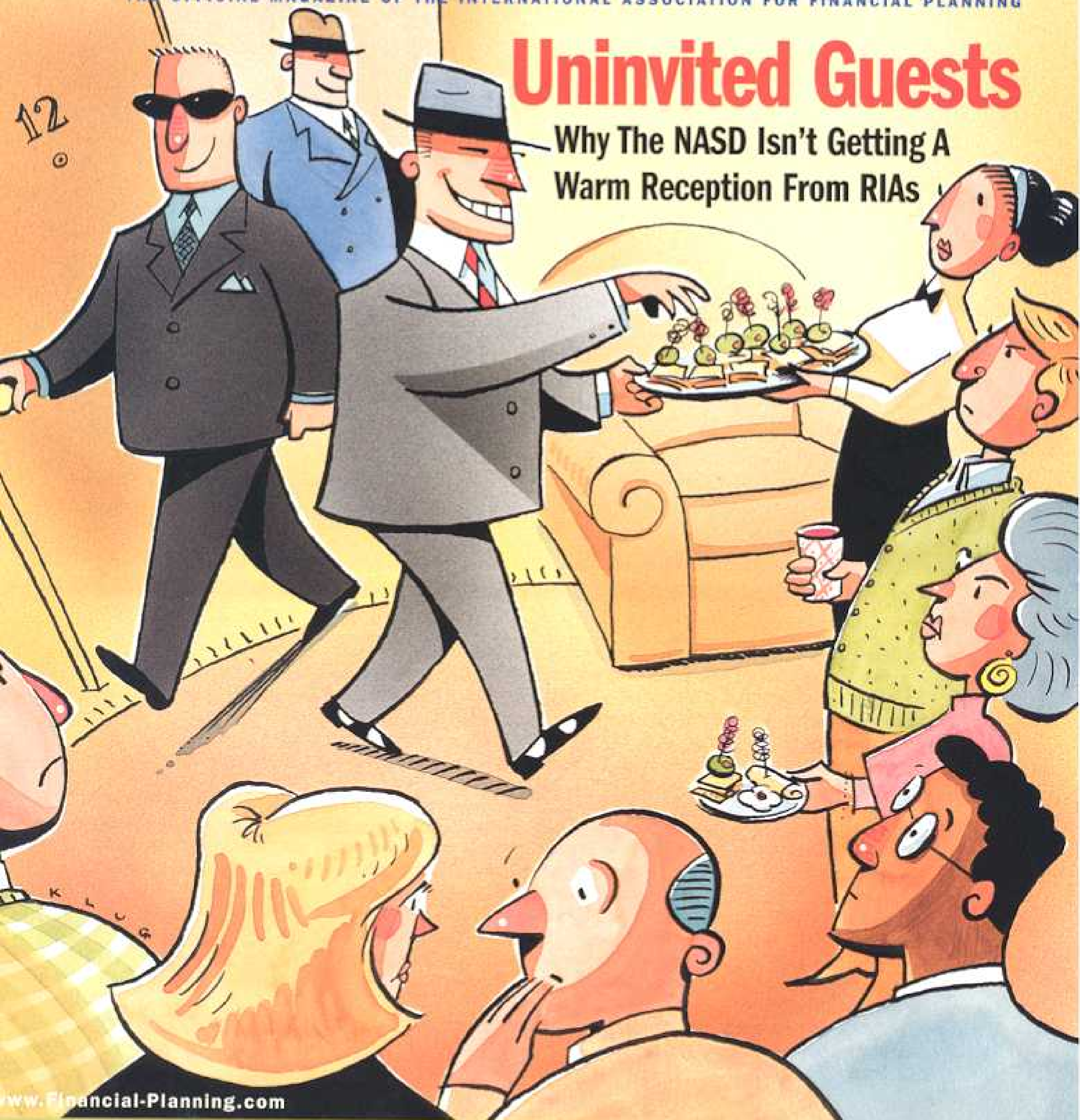
## Uninvited Guests

Why The NASD Isn't Getting A Warm Reception From RIAs

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1999 CLEARING AND EXECUTION SURVEY

# Cool Heads Prevail

*Maybe advisers need to raise their expectations of client behavior.* BY CAROL CLOUSE

IF NOTHING ELSE, THE MARKET CORRECTION WAS A REAL EYE-opener. The downturn appears to be just the wake-up call 401(k) investors needed to lure them back down to earth, a quick shot of reality sorely needed to bring expectation levels down into a healthy range, advisers say.

Just as the third quarter taught 401(k) participants something about expectations, so too did it teach their educators and advisers something: When it comes to how participants will react in a down market, maybe expectations should be raised.

"Pleasantly surprised" probably best sums up the mood of financial planners and representatives from mutual fund companies given the general response 401(k) investors had to the third quarter. While there was a general sense of concern and an increase in calls from participants, only a very small number acted on their concerns. Moreover, the general response was muted and the calls fewer than advisers and fund companies expected. Advisers offer a few factors to explain this participant overperformance, the most common being education—an answer that leaves planners not only pleased with participants, but also with themselves as educators.

"We've been very pleased with the way our clients have reacted," says Dan Moisand, president of Optimum Financial Group in Melbourne, Fla. "In theory, all of this counseling we've done about how the market is going to go into the dumper at some point has worked."

Advisers and fund company representatives say that, despite the fact they had long been warning clients a downturn was inevitable, they were still taken aback by the fact the warnings seemed to have worked. "It's been surprising. We expected to receive higher call volume," says Barbara Burdett, a manager in the T. Rowe Price participant service center, which handles inquiries from participants in the Baltimore company's defined contribution plans. The volume was higher in July and August than it was in September and October, when participants received their statements for the quarter ending September 30. However, it was lower than projections for all four of those months, Burdett says, though declining to disclose actual numbers.

"We had very high volume on August 31," she says. "Then people became a little bit more desensitized and the number of calls in September went down."

Other fund companies report similar experiences. Karnig Durgarian, managing director and chief of the defined contribution business for Putnam Investments of Boston, says the firm usually has a 15% to 20% increase in phone activity after a statement, and probably had an additional 5% increase over that after the third-quarter statement went out.

By the time people received their statements—10 days after the quarter ended—and made the call, the funds were already up 3% to 5% and that tended to quell people, he says. "For about 80% it became a nonevent," Durgarian adds. "When they heard that their statement had generated the absolute bottom, the markets were rebounding and their returns were higher than what was on the statement, they said, 'OK, bye.' "

**"The most panicked phone call I got was from one employee who asked, 'Can I put more money in while the market's down?'" says Dennis Filangeri, a planner in New Orleans.**

Advisers add that most of the concerned calls they received came from investors nearing retirement. "They seem to be more concerned because their account balances are so large they can make or lose in a month more than their average salary, which can be pretty difficult psychologically," says Moisand, who has a significant number of clients nearing retirement, many of them employed at the NASA Science Center.

"Basically we remind them why they're invested the way they are," he says. "Even though they're nearing retirement, they can't stuff it all under the mattress."

Moreover, clients with the smaller balances said it didn't seem so bad when they got their statement, he says, partially because they've listened and diversified and partially because their contributions are going in.

Robert W. Tull Jr., president of RW Tull & Associates in Chesapeake, Va., reports a similar experience in that it was primarily older clients who were concerned about equity exposure. Among his 401(k) clients—he works with two large 401(k) plans along with some smaller 401(k)s and a 403(b)—the main concern was international exposure. "They wanted to hear again why it is they're investing part of their money in international funds, especially in emerging markets," Tull says. In the 403(b) plan, a few clients actually did reduce their international investments.

Overall, advisers and fund company representatives say there was some movement away from equities among 401(k) investors, but the majority did not shift money to safe havens. Putnam reported that less than 0.5% was reallocated from mutual funds and company stock to guaranteed investment contracts, money markets and bonds from August through October.

The vast majority of 400 investors questioned in a late August phone survey conducted by Fidelity Investments of Boston said

they had not moved money out of equities. Additionally, 74% said they would do nothing if the market continued to fall, while 10% said further declines would present a buying opportunity.

Advisers also report that actual fund movement among 401(k) clients was minimal during and following the third quarter. Dennis Filangeri, an independent planner in New Orleans who assists in designing and advising 401(k) and 403(b) plans—primarily for companies in the medical sector with up to 100 employees—says there was virtually no movement away from equities among participants in the plans with which he works. "The most panicked phone call I got was from one employee who asked, 'Can I put more money in while the market's down?' " he says. "Most of my clients, who range in age from their mid-twenties to 60, understand what their immediate and long-term goals are. The young person who has a long-term goal is more aggressive. They see the downturn as a buying opportunity."

Another adviser who works with small-business 401(k)s says there wasn't enough movement in that direction to suit him. Steven Kaye, president of American Economic Planning Group in Watchung, N.J., says that less than 10% of his clients moved money, and most of that movement was to safe havens or less volatile areas like utilities. "There's not pervasive investor fear, but there's enough fear to keep people from acting," Kaye says. "People are not moving their large-cap into small-cap. They're not moving some of their large-cap into technology. They're not following through and taking advantage of the fact that [those stocks] are on sale. They have both feet in the water—and it's cold—and they don't want to get up to their waist."

Most advisers were pleased with the overall response of 401(k) participants. In addition to the much-cited benefits of education, some offered a couple of other reasons as to why investors were not running for safer ground. "What I find fascinating is that clients differentiate in their head between their 401(k) and other money," says Delia Fernandez, owner and principal of Fernandez Financial Advisory in Los Alamitos, Calif. "They see their 401(k) clearly as money they can't get to. I've had people come to me and complain about their [401(k)] returns, but then they say, 'I can't touch it for 10 or 15 years anyway, so I'm just going to leave it there.' "

They tend not to react as strongly and emotionally to the 401(k) fund as they do to others, she adds—not unless they're very close to retirement. Even if they have other funds earmarked for retirement, they're more concerned about those because they can get to them easier.

Another reason, which may also help explain why advisers were somewhat surprised by the subdued reaction from plan participants, is that investors simply aren't watching every movement of the market the way those who work in the industry are. "I spend quite a bit of my time in front of the screen," says Malcolm Greenhill, president of Sterling Futures in San Francisco. "[Investors are] very busy in their own work. We're much closer than they are. They're much more detached and let things play themselves out. They're certainly not panicking and certainly not reallocating money helter-skelter."

Greenhill, who primarily works with small-business 401(k)s—such a law firms and architectural firms with fewer than 50 employees—adds that he got a few more calls than usual and that there were a few people who "used the opportunity to rid themselves of the part of their portfolio that was leaving them sleepless. I did not get the feeling that people were mindlessly selling or mindlessly reallocating. Most were sticking to their guns."

This pleases advisers, especially since a good number of those now participating in 401(k)s hadn't previously been through a down market. For many investors, their third-quarter statement was the first to reflect negative returns. According to Morningstar, the average domestic large-cap mutual fund reported a return of -11.50% for the quarter ending September 30, 1998, compared to a return of 8.49% for the same quarter the year before. For large-cap value, 1998's third-quarter return was -12.37%, compared to 8.98% for third-quarter 1997; large-cap growth returned -11.21% in 1998 compared to 9.96% in 1997 (see Figure 1).

Figure 1

## Third Down

| Fund Category | 3rd Qtr '98 Return | 3rd Qtr '97 Return | 1 Year Return Through 9/98 | 1 Year Return Through 9/97 |
|---|---|---|---|---|
| Large Growth | -11.21 | 9.96 | 5.84 | 32.02 |
| Mid-Cap Growth | -17.32 | 14.37 | -10.17 | 20.06 |
| Small Growth | -22.19 | 17.94 | -23.60 | 20.99 |
| Large Blend | -11.50 | 8.49 | 2.80 | 35.26 |
| Mid-Cap Blend | -15.85 | 13.88 | -10.28 | 34.38 |
| Small Blend | -22.21 | 18.40 | -21.55 | 36.21 |
| Large Value | -12.37 | 8.98 | -2.51 | 35.89 |
| Mid-Cap Value | -16.98 | 11.60 | -11.76 | 37.01 |
| Small Value | -20.57 | 15.39 | -19.03 | 40.76 |

*Source: Morningstar Inc.*

In the domestic small-cap arena, the average mutual fund reported a -22.21% return for the quarter ending September 30 compared to 18.40% in 1997.

Again, many advisers say they had been warning their clients that the good times were not going to last forever and returns of the past few years were far above what should be expected. Sometimes it takes a dose of the real thing before investors truly understand what their educators are saying. In that way, advisers say, a quarter like the third quarter is a good thing.

Some advisers admit that the quarter brought with it something else that wasn't so bad: a little vindication. "The last five years have been tough [for advisers]," Greenhill says. "We have been warning people of these corrections that never happened. This is something that, for most people, is long overdue." **FP**