Episode 13: The importance of communication in managing risk

Dan Miles of Innova Asset Management and **Nat Webb of Dobbrick Financial Services** discuss;

- Recent market volatility and outlook
- Approaches to risk management
- What works for clients and the value of education
- Benefits of managed accounts and using external investment experts

Moderated by David McDonald, CFA - IMAP Investment Specialist

IMAP

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David McDonald - IMAP Management

Welcome to this podcast in the IMAP Independent Thought series today, we're going to be discussing risk management, a very relevant topic, given the volatility we've seen in markets in the first half of this year.

Joining me to talk about risk in the current environment today we have

Dan Miles, who is the Chief Investment Officer of Innova Asset Management and

Nat Webb, who is a principal of Dobbrick Financial Services.

So welcome Dan and Nat

Dan Miles - Nat Webb

Thank you very much for having us.

David McDonald - IMAP

Dan perhaps if we can start with you and you can just give us a rough idea of what you have been seeing. I mean, we all know that markets have been very volatile in the first half. Perhaps you can talk a little bit about that, but also I guess more importantly, where do you see it going from here?

Have we factored in all the worries about rate rises, Ukraine, et cetera? Is it going to be smooth sailing or do you see more volatility ahead?

Dan Miles - Innova Asset Management (01:21):

Okay. I think you'd have to have lived under a rock if you're not aware of what has caused the durations in markets since the start of this year. You know, the first quarter we saw the USA CPI and PCE figures above market expectations. And then in February 2022 obviously there was the invasion of the Ukraine by Russia. And that took up a lot of the rhetoric for the first quarter of this year. And then in the second quarter, it was really that spike in energy prices and food prices feeding through to that inflation narrative that led to a lot of the volatility in markets.

And then post the end of June and so far in the second half of this year the USA posted a CPI print that went from 9.1 down to 8.5.

Dan Miles - Innova Asset Management (02:17):

That's not core CPI. That's the overall CPI so includes volatile items like energy and food. And the market interpreted that as meaning that rate hikes were working and the future path of rate hikes might be eased and that we might have seen peak inflation now, whether or not we have, who knows, but that has led to what we can are concerned is a bit of a relief rally because the underlying fundamentals still appear to be somewhat deteriorated in terms of the US entering a technical recession.

They're not actually in recession unless you go by the strict definition of two negative quarters of GDP growth, but they've got extremely high employment numbers or very low unemployment numbers is probably a better way to put it. And you see the same in the UK and Europe and we've seen it domestically here, but our concerns are that we think the probability of further volatility is higher than it is lower because those underlying fundamentals that underlying inflation. I mean going back from 9.1 to 8.5 is still eye wateringly high.

Dan Miles - Innova Asset Management (03:32):

It is still extreme and it's nowhere near 2%. For us to get core CPI back down to 2.0, as well as overall CPI back down to two, well, energy price are going to have to come down. Cost of labor is going to have to come down.

We're going to have to see price drops and negative CPI prints till the end of the year. And that has never occurred before. We think it's pretty unlikely to occur now. So we just don't think that things are going to level out at a level that the market is overly comfortable with.

David McDonald - IMAP (04:05):

Right thanks Dan. So Nat from a client point of view a lot of things that they probably worried about in the first half of the year … the news every night was talking about big market falls, particularly for equities, even bonds giving negative returns. Have you been seeing a getting a lot more calls and clients being a bit more concerned than normal?

Nat Webb - Dobbrick Financial Services (04:30):

First and foremost we are quite enjoying all the rhetoric of massive falls from market declines because especially on the news, all you ever hear is the ASX and the "all ords".

However, when we're speaking with clients, they're understanding, okay, well, I'm in a diversified portfolio. So when we actually print or detail to them, the returns that they're receiving, it's quite a relief. They're used to these high high numbers or double digit number declines where we're offering something much less. So the media's actually playing into our hands a little bit there.

But yes client interactions have certainly pivoted to more of like a macro and geopolitical focus recently in meetings. And just in general like Dan mentioned before, there's no shortage of topics be it inflation, rising interest rates, the invasion of Ukraine, COVID supply chain issues. So lots to talk about with our clients, and our focus with them is really to educate them.

Nat Webb - Dobbrick Financial Services (05:28):

So we haven't had a large number of phone calls, and that might just be the fact that when we discuss the current market with clients we always consider the long-term nature. They're aware of what's happening, but they know that this is a long term play. We're not thinking in short term cycles.

So that's always good. I mean, we're always really proactive with our emails and communication with clients. So I think there, when we started experiencing those declines earlier in the year, we were on a weekly or fortnightly basis just providing some sort of peace of mind and, and clarity around what was happening.

And a lot of the times Dan and the team at Innova were really handy there by providing collateral that was really client friendly and that gave their opinion on what was happening. And also maybe some changes to the portfolio that were occurring because of that.

Nat Webb - Dobbrick Financial Services (06:19):

I think that client education and keeping them informed is really important for those that may have called or sent an email, we just pick up the phone and, and just have a conversation with them, make them aware of what's happening, what we think is occurring. And if we need to change strategies then we discuss that.

For a lot of retirees over the last few years, strategies really have been … do you really need to be getting, or receiving that much income from your pension because you're not doing your traveling, you're not doing all that spending, so that can help in these kind of current markets that might limit some of those losses by reducing pension payments equally for some clients who are wealth accumulators or pre-retirement, it might just be that pinch on the cash flow, where we might reduce the salary sacrifice, or their investment contributions just in the short term, or they adjust to the current market.

I mean, I don't think anyone's removed from these inflation spikes when you only have to fill up the car or go get a loaf of bread and everyone knows what's happening. So yes we're just big on education with clients I'd suggest, and that's why we've been able to limit a lot of those panic phone calls and those phone calls of… let's get out or let's sell. So we're really lucky

David McDonald - IMAP (07:40):

And Dan, maybe just getting back to you, we've talked about what's happened and what might be happening and, you know, and Nat's touched on the client communication and so on. And I know you have an interesting, or maybe a different approach to risk management to a lot of outfits. Would you like to perhaps just explain a little bit about your focus and particularly the behavioral aspects, which I think are interesting.

Dan Miles - Innova Asset Management (08:05):

Yeah, sure. Well for years we've been speaking to advisers about what it is that derails clients and leads to client behaviors that are value destructive, and largely you can kind of largely bucket that into two things.

It's either getting out at the bottom because people are concerned with what's going on, panic selling, which, you know, I have to echo what matters said from the adviser we've spoken to, we really haven't seen a lot of that this year, which has been pleasing. But then it's also the delay in actually reinvesting.

So it's not just that they might have sold out at the wrong time, but when do they get back in or when do they deploy their capital? And there's almost nobody in the world who can time this sort of stuff.

Dan Miles - Innova Asset Management (08:50):

What we think is that we should from a portfolio construction point of view aim to provide client services so they really don't care what their asset allocation is. As long as you provide them a level of risk that they can tolerate, because when they come in to see an adviser, you know, they might come out as balanced or growth, or whether they're conservative.

What they're really saying is there's a risk threshold. There's a maximum amount of risk I can really get, and they really don't care how much you vary in your asset allocation to get that, as long as you give them something that is in the ballpark of what they're expecting to achieve. What they receive instead is a fixed asset allocation portfolio with variable risk associated with it.

So what we think is that take a proactive approach to asset allocation.

Dan Miles - Innova Asset Management (09:31):

And in reality, it's risk management, the amount of risk budget that you want to allocate to different asset classes as opposed to having a fixed asset allocation, because if you've got a fixed asset allocation, you've got a reasonable amount of equities.

Well, all of the volatility, all the draw down, apart from the first six months of this year, where bonds were sold off, but almost all the volatility is going to come from equities. It's not going to come from the other parts of the portfolio.

And so if you can budget your risk at the asset class level, and also at the sub-asset asset class level. So whether they're factors or styles of different investment within those broad based asset classes, the combination of those to provide a reasonably fixed amount of risk that you write on the box and say, you know, this is the kind of draw down you'd expect in a maximum draw down scenario.

Dan Miles - Innova Asset Management (10:18):

This is the amount of volatility you expect on an annual basis. As long as you're not breaching that you're trying to maximize the returns to clients, and you need to deliver what it says on the box. We think that clients are more likely to stay engaged.

And this is one thing that can be not removed, but is hopefully a lot easier in conversations to have with clients and helps advisers to manage that behavior that that short termism or that recency bias that they can have, which is, oh, wow…the world's falling to hell in a hand basket. Therefore I better get out.

Whereas usually at that, that point in time that's an inflection point and that's the time that you actually want to dial up. Yes. And when everybody's buying back in the market's already turned and gains have already been made.

And so you want to be kind of systematic in dialing down risk, as things get expensive and dialing up risk as things get cheap, as opposed to trying to time anything. I mean there might be a few people around the world that can get this timing right. But how consistently they can do it and how robust they can explain it. I'd argue that's pretty hard to do.

David McDonald - IMAP (11:26):

So valuation is still an important thing you look at in the process, Dan.

Dan Miles - Innova Asset Management (11:31):

Absolutely, and it's valuation not just relative to each other asset cost, but relative to whatever the sub asset class itself is to its own history. So things like really high quality equities or you know, floating rate like AA rated floating rate securities, you would expect to pay a premium for those over the long term.

But it's the magnitude of that premium compared to what is reasonable. And we've just gone through a period where we would argue that some of those valuations for those really highest quality assets just got too stretched.

And that's why they were the ones that got punished at the start of this year. And we think that they're probably still a bit too stretched given what the outlook for inflation is …..it's unlikely to come back to you know, that 2% or even sub 2% level anytime soon. And so therefore you need to apply a high discount rate to it.

When you do that, then the valuations still look reasonably stretched, but that's not to say that's for every asset class or for everywhere. There's plenty of opportunities out there, but if you don't take valuation into account, then it doesn't matter how good the asset is. You've bought. If you've overpaid for it, you're going to get a rubbish return unless you wait 20 or 30 years.

David McDonald - IMAP (12:40):

I guess we've been told for a long time that diversification is important, and you can diversify away your risk, but I get the impression that that's not necessarily a focus for you.

You don't see that as the most important thing.

Dan Miles - Innova Asset Management (12:58):

No. So we would argue that diversification makes sense to hedge your bets, but you don't want to just diversify for diversification sake. So the way we describe it, we do this mathematically and we use fairly sophisticated statistical processes. If anyone's interested to look up the Kelly criteria in its application and its not hard to Google, but it's not that easy to understand, but the way that it practically translates is that if the level of upside in an asset that you're looking at is reasonably limited and the amount of uncertainty is quite high.

Well, then you probably want to own more. You don't want to have a whole lot of your risk budget allocated to it, and you want to diversify more. So you want to have more in terms of diversification because there's a lot of uncertainty and there's limited upside, but when you have an opportunity for certain assets where the upside is much greater, and you've got a lot more confidence in that forecast and therefore the realms of variability and the uncertainty around it is shrunk…It's lower.

Then diversification is just going to do nothing but destroy your returns. And so you actually want to concentrate more in those opportunities that are made available to you. And we think you need to be dynamic about that throughout time and model that for each of the potential assets that you can allocate to. You're never going to get it exactly right.

You're not going to get it right all the time, but if you get more right than wrong and the magnitude on the way up is higher than the magnitude on the way down, then it's going to lead to more robust and smoother ride for clients and provide them a greater level of confidence over the longer term.

David McDonald - IMAP (14:34):

And Nat I know Dan said that he hasn't seen people panicking and so on earlier this year, or he hasn't been hearing that from advisers. And you've said that sort of communication, the handholding has helped a lot with clients, but I know when we talked earlier, you mentioned a few examples of people coming to talk to you who are not clients yet who've been great examples of what not to do.

Nat Webb - Dobbrick Financial Services (15:02):

Yes… last week I had a potential new business client who will be a good client with a bit of education. But he made me aware that he was sitting at work with a couple of mates and they had the discussion around selling out around what must have been back in April or May. But the problem was they sold out, but they haven't returned to the market. So my question to him was, well, when do you return to the market?

And what factors are you looking at in order to achieve that result and to make that decision? And he just looked at me puzzled. So I think he's just relying on his mates at work, to be honest. Who's to say that they're like Dan alluded to before, where there's not too many people who can time markets consistently.

Nat Webb - Dobbrick Financial Services (15:45):

And I don't think three blokes sitting around at work site are probably those three in the world. So yes our job is to educate clients and to ensure they don't make those mistakes. And that they consider the long term nature.

We don't want them to be obviously leaning on behavioral biases of loss aversion that I alluded to it before, but a really big part for us as adviser in this firm is just education. So we really want to ensure that the clients that we bring on board are the right clients for us and that they want to be educated. | Not every client wants to come in here and wants to learn. We do get clients who just say, look, deal with it. I don't really care, just deal with it. That's not really who we want.

Nat Webb - Dobbrick Financial Services (16:26):

We want people who are educated that know and place some importance on what we do. Because it's times like now when markets are volatile and there were situations previously where the market declines, where we don't want to be fielding 400 phone calls from clients saying, we have no idea what's going on. Why is this happening?

We would rather be much more proactive, educate them in the initial stages. So they know exactly what the strategies are. They know how the investments work. They know the role that an overplay within the advice process. And it just provides that level of comfort understanding our broad client base of pre-retiree and retirees. So they're kind of at that pointier end where they don't have, they've got time on the side, but they're also a lot more nervous about what's happening now.

Nat Webb - Dobbrick Financial Services (17:11):

They've had that last paycheck and now they're looking towards, well, now I've going to be drawing down on these funds. So how do I protect it? And I think that's where an Innova play a really pivotal role, because we can say we're outsourcing this to a professional asset consultant.

We've had 23 plus years of a relationship there we've been through in thick and thin. And we have a really good relationship. And for clients to know that that's outsourced to a professional firm, I think that's probably better than them thinking on a Friday night, we open up the dart board and just throw darts at the next investment that pops up in the local paper.

So I think that really works well for us as a firm. We can rely and concentrate our strengths on, on building relationships with clients being in front of clients and building the strategies. And then we can outsource the investment to professionals who have got years of experience, and that works for us.

David McDonald - IMAP (18:05):

Yeah. I mean you've talked about the, the outsourcing, obviously that's a benefit for you, but I mean, that, you also mentioned you know, you can't field 400 phone calls, and I guess that's the benefit of

there of managed accounts, isn't it? That you don't have 400 clients that you might have to ring up to say, we're going to sell some equities or put more money into bonds or whatever.

Nat Webb - Dobbrick Financial Services (18:28):

Yeah, absolutely. I mean we're currently looking to upsize, but we've got 450 clients, three advisers, and about seven support staff. So it would be, it it'd be logistically be a nightmare to try and be managing and reviewing portfolios on sometimes quarterly half yearly basis. Preparing ROIs.

It just wouldn't be profitable. I don't think we'd be here for long. So we made a decision a while ago to, to move to that managed accounts. And we've never looked back. I mean it just allows, like I said before, it allows us as advisers and as a team to concentrate on our strengths, which is providing advice and, and recommendations and strategy, and being able to field those calls.

We just wouldn't have the resources if people are ringing up or we're having to reach out to them about various portfolio changes. I just couldn't see how that would be profitable for us.

David McDonald - IMAP (19:23):

Very good. Okay. Dan, let's touch there on the outsourcing and, and allowing you guys as the professionals as it were to, to run the portfolios. Can you just perhaps talk a little bit about some of the changes that you have made with your process, given what we've seen the last few years? You know, we go back to the initial stages when markets collapsed and then you've touched on this year with inflation fears and interest rate hikes, Ukraine, and so on. How do those sort of events impact what you do, or what changes might you have made when things like that happen?

Dan Miles - Innova Asset Management (20:02):

Yeah. something like COVID, we didn't come into the market, overly prepared for it. We had a short period of time, but we were fairly quick to react. So early March, we were already, or late February, we were preparing for an early March. We were able to execute on changes in the portfolio to be able to de-risk the portfolios. And then if you think back to March 23rd, 2020, we got the timing exactly right. Which was a fluke.

Like we weren't intending the time at, you know, around that end of March period. We were thinking, wow, we have no idea how far this could go. But the reality was that valuations were cheap enough that we needed to be buyers. We had to be risk on. And so we were dialing the risk back up into the client's portfolios. We didn't get all of the risk budget deployed that we would've liked to.

Dan Miles - Innova Asset Management (20:48):

Because everybody remembers the market just ripped over the following couple of months. Yes. And we were trying to use a dollar cost averaging strategy to get back in because we thought there could be a second or a third downturn in markets if there was a second or third wave that came through and obviously didn't occur. So thankfully we got enough risk budget back in the portfolios that we were able to fully participate in the rebound. But we didn't get as much deployed as in hindsight, would have been the ideal positioning and then coming into this market down downturn being largely inflation in interest rate driven, we were kind of preparing for inflation anyway, but I think February 2021 was when I started publishing a few things in our quarterly, or our portfolio insights, or our weekly updates, or our monthly publications saying that it's the market's pricing in a non-zero chance of inflation and it's not non zero.

Dan Miles - Innova Asset Management (21:40):

And so therefore where things look relatively attractive, nothing looked outright attractive, but things that relatively attractive, we want a position in those. And so that was more in floating rate instruments,

higher up the capital structure. Above investment grade and into shorter duration equities, believe it or not. So equities that weren't overly interest rate sensitive and that's generally those that were cheaper in nature and so more of a value bias.

And I guess that's something to keep in mind as well, is that we get paid to do a job. We are not going to get everything right all the time. But one of the things that I think Nat expects from us is that we actually do make changes in client portfolios, and we have to communicate what those changes are, and why we made them so that clients can understand what it is that's going on.

Dan Miles - Innova Asset Management (22:30):

But there are a lot of offerings out there that just have these static allocations to particular managers or styles or whatever the case may be. And they stay static throughout time, irrespective of conditions, which is fine if all clients have a 10 to 15 year time horizon, but a lot of them, they might say that they will have a long term time horizon, but it's really that short term nature and getting caught up in the moment that can you can really see how they respond.

Nat Webb - Dobbrick Financial Services (23:06):

Dan. I was just about to chime in there and just say that's such a great value ad for our clients because Innova do provides so much marketing material, and what they do on a regular basis is if there's been changes to the portfolio, then we will get information, and will get graphs, we'll get whatever we want. Essentially we can actually provide that to clients in a review meeting. I had it this morning where obviously when you are in a review meeting that you've seen a client, you haven't seen a client for 12 months you don't want to just be talking of negative returns.

So I provide some information around why it's negative and then you can actually show the benefit and how it has been limited. And the negative returns have been limited by what Innova has actually done.

Nat Webb - Dobbrick Financial Services (23:47):

So we put up the chart and say, okay, Innova made this change. In February, they've moved into agriculture fund here for these reasons and you can actually talk to it. And it rather than just sitting in front of a client, trying to explain to yourself why a return is negative and it's not the fault of anyone, it's just the broader market, but you can actually say, these are what we're doing to limit those losses. And they really see the other side of it. And then also indicating that this is a really good opportunity for Dan and the team at Innova.

They're actually seeking opportunities here where they've been purchasing at such high levels. Now there's so much opportunity in the market this bought for choice. So trying to put change and use that narrative a bit and so you're not just sitting in front of a client saying well remember the last couple of years that we've spoken and you've had gangbuster returns. Well, unfortunately now it's negative. Well, we can kind of turn that narrative and make it a little positive for them. And they walk out and think, oh, this is good. We're on the right track. So that is certainly a good thing.

David McDonald - IMAP (24:44):

Yes probably the one key thing I get out of all of this discussion is the communication angle and how important it is, whether it's from Dan's side and explaining what's going on with the portfolios and when, and why they're making changes to talking to the clients and being able to explain clearly what's happened and how they might have benefited from the way the money's being looked after and so on.

Dan Miles - Innova Asset Management (25:11):

Yes I can't comment from an adviser's perspective, but I think from an investment manager's perspective, when I founded the business, I said, look, half of our job is to run the money. Well, the

other half is to communicate what we're doing and why. And I think that's paid dividends. And I think the first half of this year has shown the benefit of doing that. And the advantage is not to us because it's, a lot of work and we don't have marketing backgrounds, and we don't necessarily have writing backgrounds.

I think the benefit is then to the adviser and the end client, and really the focus is on the end client and trying to prevent those value destructive behaviors. And as Nat said it's worked quite well so far. so hopefully it'll continue to do so into the future.

Nat Webb - Dobbrick Financial Services (25:50):

I think with technology now too, we're just saturated with information. So the expectation or the way that I look at it from a client perspective and from a principal perspective is people expect communication. I know me personally, if someone doesn't within a few days or a week for respond to me, I'm, I'm trying to question why, because we play such a big importance in the firm here of ensuring that we get back to clients.

When we say we will and actually communicate. I think that's just the nature of society these days. So it's really important to keep up with that. And I think second to that is it's a point of difference because in our industry I feel like it's probably lacking for a lot of firms. We have a lot of clients coming here saying, oh, you're sending out these emails once a week or once a fortnight. I've never had that before with our previous adviser, we never got anything. The only time we heard anything was at a review meeting if they called. So it's not hard, those little one percents to really exceed those expectations of clients. And it's just that adds to that value client value proposition. So it is really important. Especially in times when markets are down.

David McDonald - IMAP (26:56):

That's great. Look we have covered some really interesting ground in our podcast today. I think we've talked about different way of looking at risk perhaps, and, and obviously talked a lot about the importance of communication. Just remains for me to thank our participants today. Dan Miles from Innova Asset Management and Nat Webb from Dobbrick Financial Services.

Thank you both for taking part in this.

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