

CHAPTER 1

Client Investment Recommendations and Strategies

30 of 100 Questions on Series 66 Exam

THIS CHAPTER CORRESPONDS TO SECTION 3 ON THE NASAA OUTLINE

INVESTING IN YOUR FUTURE

Have you ever wondered if you'll be able to stop working someday? Even if you keep at it well into your 70's, wouldn't it be nice to know you could afford to stop if you wanted? The answer to both questions is usually yes, which is why you are probably already saving for retirement through a 401(k) or IRA account. That means your retirement money is subject to factors such as inflation, interest rates, recessions, corporate profits, credit ratings, and other important topics covered on the exam called the "Series 66." Actually "Series 66" is just the nickname for this test, which is properly entitled "The Uniform Combined State Law Examination." Notice how the word "law" is right there in the title. That's because this is primarily a test about securities law, rules and regulations. Approximately 50 of the 100 questions on your test will be concerned with regulatory issues for investment advisers, broker-dealers, agents, and investment adviser representatives.

There will also be many questions that relate directly to your own situation as an investor. This test will delve into the same economic and market factors that determine your success or failure to achieve your retirement goals. It will help you better understand your returns, your appetite for risk, your time horizon, your investment objectives, etc.

If you're not thinking about retirement yet, maybe you're wondering how you'll be able to afford college for your kids. Chances are, you will set up an investment account and use a mix of stocks, bonds, and money market securities to cover the ever-rising costs of higher education. If you're too aggressive in chasing after growth stocks, you could

lose a big chunk of Junior’s college fund. On the other hand, if you’re too conservative in your investment choices, Junior might end up at junior college when you both had your hearts set on Harvard.

The purpose of this book is to help you pass the Series 66 exam, but we will try to help you do that by relating these topics to your own situation. We will speak to you in Plain English and use real-world examples that make sense and help you remember this material well enough to deal with the rather tricky questions the exam will throw at you.

If you aren’t careful, you could end up actually enjoying this book and learning a few things that will help you understand your own investments a little better. But, really, we’re just trying to help you pass the test.

If you bought the full package, you’ll be able to do the suggested activities given at the end of the reading sections, which means you can get started simply by reading the first chapter of the book and continuing from there. In fact, this is the first chapter of the book, so—guess what—you’ve already started studying for the Series 66. Congratulations. Let’s keep the fun moving and start talking about clients of investment advisers.

Ready?

Too late—you’ve already started.

CLIENT PROFILES

If you are taking the Series 66 exam, you are either starting your own investment advisory firm or you are going to sell the services of an investment advisory firm. Either way, you need to learn as much as possible about your investing clients. You must gather key financial information such as:

- Income sources
- Current expenditures (bills, obligations)
- Discretionary income (what’s left after paying bills)
- Assets (cash, real estate, pension/retirement accounts, life insurance)
- Tax bracket

Probably the most important figure to obtain from a client is known as “discretionary income” or “excess cash flow.” This is the money left over after covering all essentials. Because if the client has no money after paying “the bills,” he really has no money to invest. A personal income statement might look like this:

MONTHLY INCOME	
Salary	\$7,000
Investment Income	\$1,000
Other Income	\$ 500
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Total Monthly Income	\$8,500

MONTHLY EXPENDITURES

Taxes	\$2,000
Mortgage Payment	\$2,000
Living Expenses	\$2,000
Insurance Premiums	\$ 300
Loan Payments	\$ 200
Travel/Entertainment	\$ 300
Other Expenses	\$ 200
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Total Monthly Expenses	\$7,000
Monthly Capital for Investing	\$1,500

So, a client with the above income statement has excess cash flow or discretionary income of \$1,500. If you start talking him into investing \$3,000 a month in speculative investments...well, you'd never do a thing like that, right? Instead, you'd make recommendations that make sense given the fact that he has \$1,500 available for investing in a typical month. If he has a long time horizon of, say, 10+ years, the money could go into stock mutual funds investing for growth/capital appreciation. If he has a lower tolerance for wide fluctuations of yearly performance, he might choose growth & income, equity income, or balanced funds. And, if his time horizon is shorter, he might stay out of the stock market entirely and invest, instead, in short- or intermediate-term bond funds.

Of course, taxes always play a part in an investment strategy. If your client is in a high marginal tax bracket, you may want to recommend municipal bonds, which, generally, pay interest that is tax-exempt at the federal level. A high-tax-bracket client probably doesn't want to do a lot of short-term trading, either, since any gain taken within the space of a year will be taxed at the short-term capital gains rate (which equals the ordinary income rate). He also might want to buy stocks that pay qualified dividends rather than real estate investment trusts (REITs) or royalty trusts, which will force him to pay his ordinary income rate on the dividends. Or, maybe he puts the REITs and royalty trusts into a tax-qualified plan that allows the dividends to grow tax-deferred until withdrawn in retirement when he is in a lower tax bracket. In other words, different clients will require different recommendations and strategies.

A business has both an income (earnings) statement and a balance sheet (statement of financial condition). So do your clients. Remember that assets represent what somebody owns, while liabilities represent what he owes. The difference would be his net worth. A client's assets would include the value of his home(s), automobiles, personal possessions (furniture, jewelry, Armani suits), investments, savings, and checking accounts. Liabilities would include mortgages and other loan balances, credit card balances, and, perhaps, debit balances in margin accounts.

A personal balance sheet might look like this:

ASSETS	
House	\$400,000
Automobiles	\$ 30,000
Personal Possessions	\$ 15,000
Stocks and Bonds	\$100,000
Keogh Plan	\$ 80,000
IRA	\$ 20,000
Checking	\$ 5,000
Savings Account	\$ 5,000
Money Market	<u>\$ 5,000</u>
Total Assets	\$660,000
LIABILITIES	
Mortgage	\$250,000
Auto Loans	\$ 10,000
Credit Card Balances	<u>\$ 15,000</u>
Total Liabilities	\$275,000
Net Worth	\$385,000

Since some assets are difficult to liquidate, we could exclude those items (house, limited partnerships, rental property) to calculate “liquid net worth.” If a client has high total net worth but low liquid net worth, an investment adviser might try to steer the client toward more liquid investments, like short-term debt versus a long-term zero coupon bond, or heavily traded stocks and bonds as opposed to some funky thing trading on the Pink Sheets.

Watch out for a tricky test question that says that Joann Johnson recently took \$5,000 out of her savings account and paid down her mortgage balance by \$5,000—how much did that increase her net worth?

Not one penny. If you remove a \$5,000 asset in order to remove a \$5,000 liability, your net worth is unchanged. Joann’s net worth will only rise if the value of her assets rises—the house appreciates, the value of the investments inside her IRA increases, etc. To check that, simply look at our balance sheet again and see what would happen to net worth if you removed the \$5,000 in savings in order to remove \$5,000 of the mortgage balance. Does the net worth change? What if the value of the house increased by \$20,000? Now the net worth goes up by \$20,000, right?

While gathering information on a client’s assets, you’re also uncovering his current

securities holdings. Many investors have a huge percentage of their portfolio tied up in one company's stock—their employers'. If a client has too much money concentrated in just one stock, an advisor might advise him to sell some of that holding in order to diversify. Other clients will already be diversified, which is just as important to determine before recommending investments. If they already hold 20 large cap stocks, you probably don't want to recommend that they plow the rest of their discretionary income into Dow Jones Industrial Index funds, which would be sort of redundant.

But there are also non-financial considerations, and these are just as important. So, you need a sort of personality profile of the investor:

- Age
- Investment experience
- Investment objective
- Need for withdrawals, liquidity
- Marital status
- Attitudes and values
- Number and age of children
- Employment stability
- Employment of family members
- Current and future educational needs for the family or individual
- Current and future health care needs

The questionnaire that the client fills out will try to gauge what is more important to the client—going for large returns or maintaining a stable principal. Do they need to withdraw a large portion of their portfolio at a moment's notice? If so, let's put that portion in the money market and short-term bonds. If they don't have any need to make withdrawals, then it's probably okay to tie their money up long-term in the stock market, or possibly even hedge funds if they can deal with the high risk involved. Remember that risk tolerance has to do with both the financial resources and the psychological resources necessary for sustaining wide fluctuations in market value and the occasional serious loss of principal that makes investing so much fun in the first place. The terms risk-averse, conservative, and low risk tolerance all mean the same thing—these investors will not tolerate big market drops. In fact, I wouldn't even try to slip a small one past them. If somebody is risk-averse, steer him away from the following investments: small cap, emerging markets, sector/specialized funds, high-yield bonds, and aggressive growth. A low-risk investor might tolerate equity income funds, balanced funds, and investment-grade bond funds—the shorter the maturities, the better. High risk tolerance, aggressive, and speculative also go together, more or less. These investors will typically purchase the investments I just took off the table for the risk-averse client.

In general the longer the time horizon the more volatility an investor can withstand.

If you have a three-year time horizon, you need to stay almost completely out of the stock market and invest, instead, in high-quality bonds with short terms to maturity. If you're in for the long haul, on the other hand, who cares what happens this year? It's what happens over a 20- or 30-year period that matters. With dividends reinvested the S&P 500 has historically gained about 10% on average, which means your money would double approximately every 7 years. Sure, the index can drop 30% one year and 20% the next, but we're not keeping score every year—it's where we go over the long haul that counts.

When the investor has a long time horizon and capital appreciation as an objective, we would probably recommend a “small cap fund,” or “growth stock” on the exam unless the question points out that she has only a moderate risk tolerance. In that case, the stock would be “large cap” or “blue chip.” If the exam makes you choose between large cap growth and large cap value, remember that growth is more aggressive than value. In today's investing-as-science environment, the answers that a client gives concerning income needs, time horizon, investment objectives, and risk tolerance will automatically generate an asset allocation that might look like this:

- 20% large cap growth
- 25% large cap value
- 10% mid cap growth
- 15% mid cap value
- 20% long-term investment grade bond
- 10% tax-exempt money market

More aggressive answers to the client questionnaire would have increased the allocation toward stock and more toward mid and small cap growth stock versus large cap growth or value. If the investors' answers are pointing out that they may need to withdraw much of this money over the short-term and would rather sacrifice potentially larger returns for safety of principal, we'd have to put a huge piece in the money market and keep it out of stocks.

Younger investors saving for retirement have a long “time horizon,” so they can withstand more ups and downs along the road. On the other hand, when you're 69 years old, you probably need some income and not so much volatility in your investing life. So the farther from retirement she is, the more likely she'll be buying stock. The closer she gets to retirement, the less stock she needs and the more bonds/income investments she should be buying. In fact, you may have noticed that many mutual fund companies are taking all of the work out of retirement planning for investors, offering “target funds.” Here, the investor picks a mutual fund with a target date close to her own retirement date. If she's currently in her mid 40's, maybe she picks the Target 2030 Fund. If she's in her mid 50's, maybe it's the Target 2020 Fund. For the Target 2030, we'd see that the fund is invested more in the stock market and less in the bond market than the Target

2020 fund. In other words, the fund automatically changes the allocation from mostly stock to mostly bonds as we get closer and closer to the target date.

As we'll see, an investment adviser often provides services to many different types of clients. On the adviser's brochure we would see which of the following they provide services to: individuals, high-net-worth individuals, banking or thrift institutions, investment companies, pension and profit-sharing plans, hedge funds, charitable organizations, corporations or other businesses, and state or municipal government entities. The Series 66 exam wants you to understand that different clients have different investment profiles.

INDIVIDUALS

If the client is an individual, the exam wants you to understand that an agent, broker-dealer, adviser, or adviser representative may take orders only from this individual. Not the individual's husband or wife, secretary, attorney, etc. Now, if your firm has third-party trading authorization on file, which means that somebody other than the client has the power to call up and enter orders, that's different—but make the question point out that this authority has been granted to somebody else by the client, with his/her legal signature. This trading authorization is sometimes called "power of attorney." Limited trading authorization (power of attorney) means the other party may place buy and sell orders; full trading authorization (power of attorney) means the other party can do that as well as request a distribution of securities and/or cash, payable to the name on the account.



There is a relatively new type of account called "Transfer on Death" or "TOD." In a TOD account, the owner specifies a beneficiary who will receive the assets upon death of the account owner. This can be advantageous, as a joint account's assets could be held up due to a lawsuit (divorce, for example), while the assets would not be at risk of legal action in a TOD account.

JOINT ACCOUNTS

When two or more people jointly own the assets in the account, we call it a "joint account." All the owners sign a joint account agreement. We can take orders from any of the parties, and we can send mail to any of the parties. But, when we cut a check, it has to be payable to all names on the account. In other words, if the account is entitled Barbara Williams and Joann Stevens, Joint Tenants in Common, do not cut the check to Barbara and tell her to settle up with Joann next time they have lunch. Cut the check to "Barbara Williams and Joann Stevens, Joint Tenants in Common." A Joint Tenants with Rights of Survivorship (JTWROS or JTROS)

account gives the survivor rights to all the assets, meaning that if one account owner dies, the other owner (the survivor) owns all the assets, regardless of how much he/she put in. But, if the account is a Joint Tenants In Common (JTIC) account, when one party dies, the assets go to that person's estate. For JTIC accounts, the account owners would indicate what % each party owns in the account agreement, so we know what % goes to the estate. For JTWROS, that wouldn't matter, as all assets go to the survivor, bypassing probate court, should the exam decide to go there.

DISCRETIONARY ACCOUNTS

When an adviser or broker-dealer can trade the customer's account without talking to the customer first, we call this situation a "discretionary account." In other words, what is purchased and sold for the customer is up to the firm's discretion or choosing. That means if the broker-dealer or adviser wants to buy 1,000 shares of MSFT, they can do so without even bothering to call the client. The client would have to sign a trading/discretionary authorization form, and the account would be reviewed more frequently, but that's about it. From then on, the firm can choose any of the following three A's:

- Action
- Asset
- Amount

That means the broker-dealer or advisory firm can choose whether to buy or sell, what to buy or sell, and how many shares to buy or sell without contacting the customer. Without discretionary authority no one can determine any of the three A's. Unless the account is a discretionary account, the only thing that can be determined is the time or price at which to execute a transaction. So, if a client calls you up and says, "Buy me some computer chip manufacturers today," do you need discretionary authority before you buy 100 shares of Intel?

Yes. If you choose the asset (or the activity, or the amount), that requires discretionary authority.

If a client calls up and says, "Pick up 1,000 shares of Intel today," do you need discretionary authorization? No, your client has chosen the asset (INTC), the action (buy) and the amount (1,000) shares. Only thing left for you to decide is the best time and price to do it, and time/price discretion does not require authorization.

Each discretionary order ticket would be marked "discretionary" at the broker-dealer and a particular principal would be assigned to make sure the securities purchased are appropriate and that the agent isn't churning in order to win the big trip to Hawaii. Advisers also have to keep detailed records of every discretionary order placed on behalf of clients. Remember that having the power to choose investments is often convenient, but the securities professional still has to purchase what is suitable for the client given

her objectives, time horizon, risk tolerance, and capital resources. If an investment professional purchases unsuitable investments for a discretionary account, it's not just a bad idea—it's a violation of SEC, SRO, and state securities regulations.

TRUST

A trust is a type of account in which assets are held for the benefit of one or more beneficiaries and for which investing activities are guided by a trust instrument. A trust is created when a trust instrument is in place and the trust is funded. The grantor removes some assets and places them in a trust, and the trust instrument spells out all the details of how the trust is set up, how the assets are to be used, and for whose benefit the trust is established. The trust can be established through a will (a testamentary trust) or during the grantor's lifetime (an inter vivos trust). If the inter vivos trust is revocable, the trust structure is essentially ignored for income tax purposes, but if the grantor establishes an irrevocable trust while alive, or if the trust is established upon death, the trust is treated as a separate entity from the grantor, like a corporation or estate.

The most likely test point would seem to be that for tax purposes, there is a big difference between a revocable and an irrevocable trust. If the trust is revocable, that means that after the grantor transfers assets to the trust, the assets could still end up being revoked by the grantor. Therefore, the grantor has not relinquished control over the assets and would still be responsible for taxation on the income generated by the trust. He hasn't really set up a separate entity for tax purposes, in other words. This type of trust is usually referred to as a "grantor trust" because the grantor still has control over the assets. In an irrevocable trust, on the other hand, the grantor relinquishes control over the assets and, therefore, is not taxed on the income of the trust. In this case, the income generated from stocks and bonds inside the trust can be distributed to the beneficiaries, or held in the trust. If it is distributed to the beneficiaries, the beneficiaries are taxed on their own income tax forms. If not distributed to the beneficiaries, the trust pays tax on the income.

To avoid paying taxes on the trust income, the grantor needs to make sure that he does not have access to the income generated by the trust himself or through his spouse. If you get a test question about a grantor whose spouse can make withdrawals, remember that husband and wife are one economic unit. If the wife can withdraw from the trust, that, by definition, means the husband can. Also, if the grantor retains a "reversionary interest," he may end up being taxed.

The trust can be either a simple or a complex trust. A simple trust is required to distribute all income currently. The simple trust does not make distributions from "principal," which is usually called "corpus," which means "body" for you Latin fans. The body or principal of the trust is one thing; the income it generates is another. The simple trust

doesn't pay tax on the amount that the trust instrument requires to be distributed to the beneficiaries. This distributable net income (DNI) is exactly what it sounds like—the trust distributes the dividends and bond interest, for example, to the beneficiaries. The beneficiaries will pay tax on that income, and the trust will deduct that amount from its own taxation. That assumes the income is taxable, of course—municipal bond interest, for example, is tax-exempt, period.

A trust that is allowed to accumulate income, or one that claims a charitable contribution deduction, is called a complex trust. The trust instrument might authorize distributions of principal or at the trustee's discretion. In those years that the trust makes distributions from "corpus" or principal, the trust is considered a complex trust, even if it is a simple trust in other years.

Sorry about that.

A trust account is run, not surprisingly, by a trustee. The trustee manages the account for the benefit of the "beneficiaries" of the trust and has to do things prudently and in keeping with the trust documents. The trustee could be the typical "bank & trust" company you've probably driven by thousands of times, or it could be an investment adviser. Either way, the trustee would be ultimately responsible for either managing the assets or choosing the right adviser to manage the assets. The investment adviser must have a copy of the trust instrument/document on file and must follow all the stipulations spelled out there. Remember that the advisory fees are deducted along with other fees required to administer the trust, so as your firm is being compensated, it's also reducing the taxable income of the trust and/or the beneficiaries. Later we'll see what the Uniform Prudent Investor Act has to say about the obligations of the trustee to the beneficiaries, and I know you can't wait for that.

But, please, try to curb your enthusiasm long enough to read about the next item: estates.

ESTATE

An estate account is overseen by an executor, whose job is to execute legal and financial transactions on behalf of someone who has died. The executor is often just the oldest child in the family or the one who was assumed to be the best with numbers and paperwork. Grandma named Jason the executor of her estate in the legal document known as her will, for example. That means that Jason is responsible for distributing Grandma's bank accounts, investment accounts, farm land, house, etc., to the heirs named in the will. Maybe he and his two sisters each get a third. Or maybe a certain amount goes to the Salvation Army, a certain amount to Grandma's church, and then a whole set of specific percentages that correspond to Grandma's affection and lack thereof for each of the kinfolk. Jason might just be a trustworthy guy with a good head on his shoulders;