

# Issues in Comprehensive Personal Financial Planning

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## Abstract

Increasing numbers of firms within the financial services industry continue to organize around the concept of delivering comprehensive personal financial planning (PFP) services. PFP delivery models reflect the desire to control client relationships and realize economies of scope. In this article, we argue that the need for comprehensive PFP is well grounded theoretically, although research to guide the appropriate application of the theory remains lacking. Comprehensive PFP is not without its potential costs, including risks associated with lessened advisor diversification at the client level, reduced transparency, and agency problems. To address these risks, consumers likely will turn to credentials as a proxy for quality and trustworthiness. © 2002 Academy of Financial Services. All rights reserved.

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## 1. Introduction

As academics, we must portray our ideas as new and convince editors that they are. For invited articles, we enjoy some relief from the second requirement, but readers bind us to the first.

We offer readers three ideas to consider in this article. Each is delivered in a conceptual framework. Each cries out for empirical investigation, largely lacking at present. Finally, each matters to individuals, bringing the article into the aim and scope of the *Financial Services Review*.

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First, we step back from the contemporary financial trends to examine the theoretical foundation of comprehensive personal financial planning (PFP). There are several reasons for this analysis; the most important of which is that the PFP field has evolved largely devoid of a theoretical foundation. Although PFP has been recognizable for decades (Black and Black, 1987), the continuing omission of conceptual underpinnings is hindering the development of PFP as a distinct profession. Borrowing from modern portfolio theory (MPT) and considering net worth in a broader context, we argue that comprehensive PFP is theoretically supported and conceptually necessary.

Second, assuming that comprehensive PFP connotes consolidated delivery (or, at least, oversight), we offer our thoughts about the costs and benefits of applicable delivery models. Consolidated delivery offers the potential for economies of scale, including reduced search, monitoring, information, and transaction costs for clients. The potential downsides of consolidated delivery have received less attention. We examine two in particular: the client's lack of diversification at the level of the advisor and greater opacity. Rigorous research is lacking on all of these matters, again, with negative implications for the PFP profession.

Third, we examine how consolidated delivery affects financial service credentials, another topic begging for research. We argue that the credential of the advisor closest to the client (generically, the planner) will have special significance. Credentials address information asymmetry, and the largest gap is between client and planner. As to other advisors (generically, the specialists) the client might engage, the relevant information asymmetry is between the planner and the specialist. While specialist credentials will still have value in signaling competence to planners, they will be less relevant to clients.

## **2. The underpinnings of comprehensive PFP**

### *2.1. The theoretical need*

Few disciplines achieve recognition and respect without a strong theory base, particularly within higher education. We believe that PFP will prove no exception. Thus, unless PFP can articulate a conceptually sound basis on which to build, its study will remain largely outside mainstream academia. The consequences of this exclusion cannot be forecast with precision, but they would seem to be negative. We know of no respected profession without academic underpinnings and recognized academic standing.

We believe that the lack of a clearly articulated theoretical base for PFP and a corresponding lack of rigorous PFP-related academic research explain, in large part, why there are so few doctoral programs in PFP. Moreover, Masters-level programs in PFP are also rare—contrary to the situation in other professions. Thus, our underlying thesis is that the comprehensive PFP advisor is unlikely ever to be recognized as a true professional without greater attention being given to these conceptual matters and, ultimately, to study falling within university settings, particularly at the graduate and doctoral levels.

In this paper, we argue that comprehensive PFP finds its theoretical home in MPT. MPT teaches us to consider the risk and expected return of portfolios, and not the risk and expected

return of the individual securities within them. The underlying concepts of MPT are applicable to all economic assets.

From a comprehensive PFP perspective, therefore, the question is what should be considered as comprising the portfolio? Comprehensive PFP helps individuals consider the totality of their wealth, not just their accounting net worth wealth as measured by their holdings in readily marketable financial assets. Thus, a family's economic portfolio whose risk and expected return we seek comprises the economic value of real assets, government benefits, insurance, expected inheritances or other family support, and human capital, in addition to marketable financial assets (Fraser et al., 2000; Richtenstein, 1998). To assess net worth in this context, a similarly broad view of liabilities should apply. Beyond accounting for revolving credit or mortgage balances, this involves an assessment of expected outflows, including but not limited to tax, housing, education, and health care. As with assets, these might not be limited to self or nuclear family, but could involve support for (or from) parents and siblings. The professional literature, including magazines such as *Forbes*, has addressed these coordination issues under titles such as *Family Inc.*

Similar to piecemeal analysis of a financial portfolio, piecemeal analysis of an individual's entire economic portfolio will yield misleading results. By focusing only on stocks, bonds, and cash, individuals and their advisors routinely ignore the majority of the portfolio (Scott, 1995). As a consequence, resulting financial plans are suboptimal, potentially devastatingly so.

Adopting a broad economic view of portfolios helps to minimize the possibility of two errors that MPT identifies: (1) having an inefficient portfolio by taking too much risk for a given expected return (or by achieving too low of an expected return for a given risk level); and (2) maintaining an efficient portfolio but at the wrong (either too conservative or too risky) level of risk tolerance. For example, the latter is arguably chronic among retired individuals who fail to consider the fixed nature of economic value flowing from Social Security benefits, pensions, and real assets in their considerations of investment portfolio allocations (Fraser et al., 2000).

The issue of how to incorporate contingent assets, such as human capital and inheritance, into portfolio decision making poses particularly interesting theoretical challenges (Delaney and Richtenstein, 1996). If an individual were the beneficiary of an irrevocable trust that was heavily invested in equities, e.g., that fact should be taken into consideration and influence the allocation of her other assets.

Though MPT instructs us to consider the covariance of assets in a portfolio, the raging bull market of the 1990s distracted a number of individuals from this tenet (Statman, 1999). Combining assets that are less than perfectly positively correlated reduces portfolio risk. This technique is commonly applied to financial assets alone. Beyond just stocks and bonds, recent product innovations recognize covariance between longevity and the probability of long-term care (Murtaugh et al., 2001). Adopting a broad economic approach to portfolio management yields a number of interesting results that are worthy of research.

An example is the correlation between human capital and the stock market. One individual's situation may reveal a high positive correlation between the two, whereas another's may suggest a near zero correlation. Employees participating in a 401(k) plan that invests heavily in company stock (like Enron) are one example of the first situation. In this case, the

individual places human capital, retirement provision, and financial investments in the same basket. Others might have jobs tied closely to the market as a whole. Individuals in investment banking or brokerage are an example. Yet other human capital might have essentially a zero correlation to the market. An example might be the tenured English professor. MPT suggests that consideration of human capital should influence financial portfolio selection.

Another interesting implication of covariance analysis involves a consideration of the interaction between inheritance and human capital. The growth of incentive trusts (Scroggin, 2000) is testimony to concerns that fixed inheritance distributions can erode a beneficiary's desire to work and build his own human capital. Such a reaction by a beneficiary can be rational, given that a hedge on human capital has been added to his portfolio. The presumption is that such negative covariance between inheritance and human capital is countered by use of incentive trust.

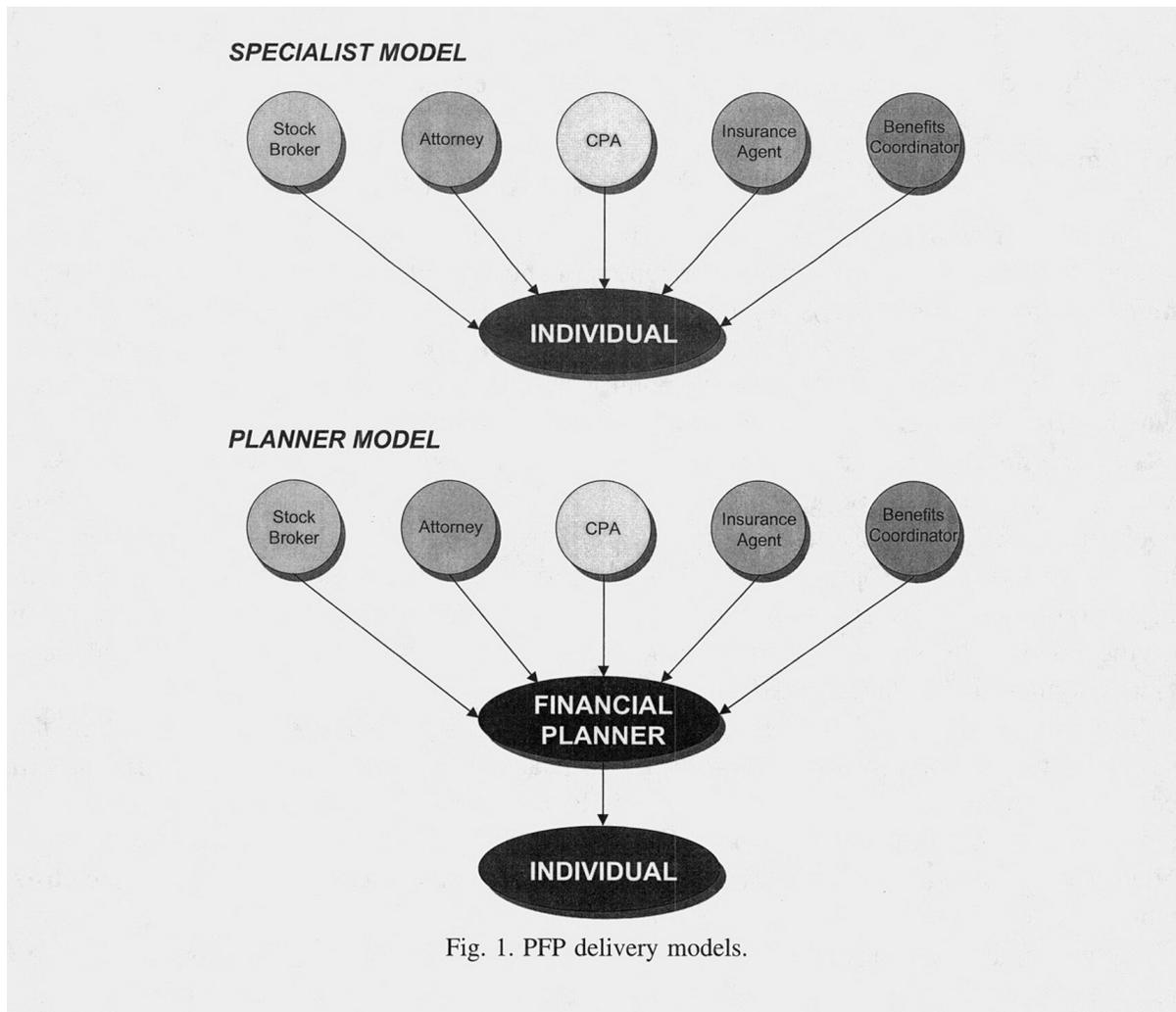
## *2.2. The conceptual need for a coordinator*

The preceding section argues for the necessity of a comprehensive, portfolio-based approach to the PFP function. Someone must evaluate the family's portfolio as a whole or the errors MPT identifies will occur. The family could perform this coordination function itself, but the acumen required is substantial and growing in this era of privatized financial decision making.

Most companies now outsource important aspects of retirement decision making to employees (the defined contribution plan), and many outsource other benefits decisions via cafeteria plans. Any privatization of Social Security will simply exacerbate the complexity of decision making. Combined with the challenge of making more decisions, the growing complexity and number of financial products and services are overwhelming to many individuals. Even if the individual understood products and services in isolation, she faces the challenge of understanding them in combination.

Relying on multiple financial advisors poses theoretical and practical problems, particularly as relates to coordination. Most advisors are specialists, and not certified as generalists. They typically operate on part of the client's portfolio only. They may not grasp, even at a basic, intuitive level, the concept of asset covariance. Several examples illustrate the benefits of coordination.

- In practice, a will might contemplate a bypass trust, but, without analysis of nonprobate asset transfer, the provision could prove ineffective from an estate tax planning perspective. Assets bypass the probate estate if they have a named beneficiary or are owned in joint tenancy with right of survivorship.
- An investor might have a stock broker who picks "good" stocks, but that same advisor might be ill equipped to handle the complexity associated with distribution needs.
- The presence or lack of a long-term care insurance policy may influence investment strategy, requiring advice on the interaction between insurance and investment.
- Distributions from tax-deferred accounts will influence distributions from taxable accounts and vice versa.



- Tax planning should take into account not only the individual's investment and human capital portfolio, but consideration and valuation of the contingent asset of inheritance, as well.

The end result is that a client might get optimal advice for each portion of his portfolio but bad advice systemically. Consider a patient who takes one pill from his cardiologist, another from his internist, and a third from his endocrinologist. Without coordination, these treatments could be a systemic catastrophe. Clearly, some type of coordination function is needed.

### 3. Pros and cons of PFP delivery models

Fig. 1 illustrates two possible models for delivery of PFP services. The specialist model assumes that the individual coordinates activities, working with advisor specialists in each area. The planner model places an intermediary between the specialist advisors and the individual. We label that intermediary generically as a financial planner. Under the argu-

ments of the previous section, the coordination function must be performed. In the specialist model the individual does it; in the planner model, the planner does it.

### *3.1. Advantages of the planner model*

The planner model offers the clear possibility of economies of scope in consumption (also known as demand-side economies of scope). Economies of scope in consumption exist if multiple products (services) can be procured at less cost than the sum of the costs of procuring them separately. Reduced costs could be realized in several ways, including lower information, search, transactions, or monitoring costs. Unfortunately, we do not know whether such economies of scope exist because of an absence of scholarly research.

Lower information costs could be realized via the coordination function, as discussed above. In the absence of a planner, and if the individual were unable to perform the coordination activity himself, this vital task would not be accomplished. A planner should be able to create value by optimizing the client's entire portfolio, as opposed to just a piece of it. Moreover, as an informed coordinator, planners should be able to reduce the possibility of the client using poorly qualified or unethical specialist advisors. This helps avoid a "lemons problem" (Akerlof, 1970).

The planner model also offers clients the possibility of reduced search costs. In the specialist model, the client must find each of the advisors herself. In today's world, search costs matter (Sirri and Tufano, 1998). In the planner model, the individual who has found a planner has also found his specialist advisors. Either the planner performs the functions in house (often investment management and tax planning) or sets up the client with specialists whose work the planner oversees (e.g., attorney).

Although advisors in the specialist model might refer the client to other specialists, the relationship between advisors in the specialist model is more horizontal than vertical. As such, it is more of a recommendation than oversight. The planner bears responsibility for the referral in the planner model. Whether a specialist can also be a planner is an interesting issue, however, and worthy of research.

The planner model also offers the possibility of reduced transactions costs. Accounting, billing, correspondence, certain sales activities, and many other activities should be amenable to consolidation and, thereby, lower costs. For example, several financial products are complements and lend themselves to contemporaneous purchase and administration, such as mortgage loans and mortgage life insurance, auto loans, and auto insurance, and wrap accounts and investments. Products, however, need not be complements to lend themselves to lower transactions costs.

Finally, the planner model could yield lower monitoring costs. As coordinator, the planner should monitor the client's portfolio, including that falling under specialist advisors, to ensure that the plan is accomplishing its objectives. In this process, any evolving agency or "lemons" problems otherwise associated with specialist advisors should be minimized by virtue of oversight by a well-informed coordinator. For example, conflicts of interest (agency problems) such as attempts at account churning or stuffing and twisting (improper life insurance replacement) should be more easily thwarted under the planner model.

### 3.2. *Disadvantages of the planner model*

As with the potential advantages of the planner model, our empirical knowledge of potential disadvantages is slight. Perhaps the greatest disadvantage to working through a single coordinator flows from the information asymmetry between the planner and client coupled with the lack of diversification at the advisor level. Thus, agency problems and “lemons” problems, if they occur, could be made more severe under this model.

Hence, if the planner is incompetent, dishonest, or both, the adverse consequences to the client can be multiplied vis-à-vis the adverse effects of such information problems through the specialist model. In the planner model, the individual is undiversified at the level of the advisor. In the specialist model, individual advisors control only part of the financial wealth and future of the client. If the specialist advisor is either incompetent or dishonest, only a portion of the portfolio is affected. Conceptually, in the planner model, the planner can do more damage as she might control the client’s entire portfolio.

Even if a client suspects the planner to be poorly qualified, disengaging from the relationship can be cumbersome (i.e., exit costs can be high). The larger the percentage of the client’s accounts (share of wallet) controlled by the planner, the higher the likely exit costs. The thought of starting over completely with another planner might dissuade clients from switching.

Individuals instinctively hedge against advisor risks by spreading their assets around. Ironically, keeping part of one’s assets or information from an advisor might return the individual to the problems discussed in relation to MPT. Moreover, in the specialist model, the client’s advisors do act somewhat as a check on each other. A Certified Public Accountant (CPA) might notice excessive trading in a brokerage account at tax time, for example. To the extent that a planner controls most of the activities in house, such outside checks and balances are reduced. Outside specialists can offer independent opinions in the planner model as well, but incentives will not be as strongly aligned if referrals between the planner and the specialist represent repeat business.

As the financial services business becomes more integrated and consolidated both at the production and delivery levels, the result can be a structure less transparent to the client than a series of pure-play products and advisors. This information asymmetry can result in market power for the supplier or advisor. When a client deals directly with a specialist advisor, cost is more transparent (and comparable to other potential advisors). So while administrative costs of dealing with multiple sources grows, so does the visibility of the costs of transacting with each. A consolidated service (or product) is more difficult to price and compare. There might be an analogy here between conglomerates and pure-play firms. The conglomerate discount pertains because analysts have great difficulty discerning how conglomerates function.

## 4. **What does PFP mean for professional credentials?**

Beneath the restructuring of financial institutions to deliver comprehensive PFP, a contest among financial credentials has emerged. In the planner model, the advisor who coordinates

the client's financial affairs likely will have meaningful control over the choice of specialists. What credential(s) will the planner hold?

The Certified Financial Planner (CFP®) credential is a prime candidate, but it is not without challengers. CPAs are moving aggressively into financial planning, and the CPA credential brings strong reputation and large size into the equation. There are ~10 times more CPAs than CFPs. Moreover, CPAs have recently gained the freedom to enter multidisciplinary organizations. In contrast, lawyers have not been given this freedom, so the JD degree is unlikely to become the credential occupying the planner position in the model.

Other potential candidates include the Chartered Financial Analyst (CFA), but the credential is heavily focused on investment analysis and excludes much of the breadth contemplated by the CFP. Similarly, the Chartered Life Underwriter (CLU) credential specializes in insurance, and lacks the breadth of the CFP. The Chartered Financial Consultant (ChFC) credential offers the clear possibility of playing the planner role. To this point, however, the ChFC has been identified closely with insurance and has not achieved the market recognition or penetration of the CFP.

The Certified Employee Benefits Specialist credential might serve the position well, as benefits affect several financial areas. Employer-centered planning could also prove to be a growth area. However, the Certified Employee Benefits' reach is presently quite small compared with the other credentials such as the CFP and CPA.

A new financial credential could be also put forward, probably by a large financial services conglomerate, with the intent of capturing market share free from the costs associated from obtaining any of the existing credentials.

The credential held by the planner will take on added significance in the planner model. Credentials become the proxy for quality and trustworthiness with information asymmetry between provider and client (Leland and Pyle, 1977). The information asymmetry between client and planner will be larger than that between planner and specialist. Therefore, the credentials of those financial service specialists will be comparatively less valuable, *ceteris paribus*.

This dynamic explains the desire to cast oneself as a financial planner, regardless of whether one does financial planning. To build credibility with clients, it appears likely that some individuals will want to hold both generalist (such as CFP) and specialist (such as CFA, CLU, or perhaps, CPA) credentials. Research in this area is sorely lacking and would be of great interest to *Financial Services Review*.

## 5. Conclusion

This review presents several issues relevant to PFP as a profession. First, we argue that the theoretical underpinnings for comprehensive PFP lie in MPT, but its examination in this context has been sparse and its application to PFP practice has been exceptionally limited. This failure to develop a strong theoretical basis for PFP coupled with the lack of rigorous scholarly research must be rectified if the profession is to be recognized as distinct.

Relying on MPT, we suggest that comprehensive PFP has a theoretical basis. Regardless of how advice, services, and products are delivered, comprehensive PFP is necessary. PFP

delivery models with a planner intermediary, however, offer clients both benefits and costs. The benefits on integration and convenience tend to be heavily advertised, but with virtually no sound empirically based confirmation. Potential costs—particularly the lack of diversification at the advisor level and the loss of transparency in advisor relationships—also have been little researched.

Finally, we observe the race to be the client's planner has implications for financial credentials. The credential of the planner will have great value as it is perceived as helping to address the information asymmetry with the client. Specialist advisors' credentials might span the information asymmetry with the key advisor only.

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