Exhibit VII: The 5 Core Causes of Stock Price Decline and How Advisors Must Disclose Their Risk Management Approach

Overview:
This exhibit outlines the five most common causes of significant stock price declines. For each, it explains what competent advisors *should* be doing to detect and manage these risks—and what they should be *required* to disclose to clients. This framework helps investors understand what questions to ask, and helps regulators ensure advisors meet minimum standards of competence and care.

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1. Financial Deterioration of the Company

Cause:
A company's balance sheet or income statement worsens: rising debt, falling earnings, negative cash flow, shrinking margins, or liquidity problems.

Advisor Obligation:
- Monitor quarterly and annual financial statements.
- Identify deteriorating trends early (e.g., worsening debt-to-equity, declining net income, reduced free cash flow).
- Use objective, data-driven tools to detect red flags.

Disclosure Requirement:
- Advisor must explain whether and how they review a company's financial condition regularly.
- Must inform clients if they do **not** have a system for detecting financial deterioration.

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2. Excessive Overvaluation / Price Far Exceeds Intrinsic Value

Cause:
Stock prices become disconnected from financial fundamentals. High P/E or P/S ratios may signal unsustainable valuations driven by hype, speculation, or excessive optimism.

Advisor Obligation:
- Evaluate whether the stock's valuation is justified by its earnings, sales, and financial condition.
- Compare current valuation to long-term historical norms for similar companies.
- Consider Net Present Value (NPV) modeling based on realistic growth expectations.

Disclosure Requirement:
- Disclose whether the advisor uses any valuation models or historical benchmarking tools.
- If not, disclose that valuation is not a core part of their investment process.

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3. Broad Market Corrections or Systemic Shocks

Cause:
Even strong companies can fall during recessions, financial crises, or panic-driven sell-offs (e.g., 2008 crisis, COVID crash).

Advisor Obligation:

- Reduce client exposure to equities when systemic risks rise.
- Adjust allocations using macroeconomic and/or volatility indicators.
- Diversify with low-correlation assets or high-quality fixed income during turbulent periods.

Disclosure Requirement:

- Explain how the advisor determines when systemic market risk is high.
- Disclose whether they have a process for reallocation or de-risking during such periods.

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4. Changes in Business Conditions or Competitive Threats

Cause:
A company loses its competitive advantage, faces disruption (e.g., new technologies), or sees declining demand for its products/services.

Advisor Obligation:

- Stay informed on the company's industry, regulatory environment, and competitive threats.
- React when business fundamentals change, especially if forecasts are revised downward.
- Avoid long-term holding of companies in secular decline.

Disclosure Requirement:

- Advisor must disclose whether and how they evaluate changing business conditions.
- If no process exists for monitoring such risks, that must be disclosed.

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5. Speculation, Momentum, and Investor Euphoria

Cause:
Stocks may become dangerously overpriced due to herd behavior, media hype, or speculative buying (e.g., meme stocks, tech bubbles).

Advisor Obligation:

- Avoid chasing performance or investing based on momentum without valuation support.
- Use historical drawdown data to evaluate downside potential.
- Alert clients when risk-reward ratios become asymmetric.

Disclosure Requirement:

- Advisor must disclose whether they use any historical volatility or downside probability models.
- If they do not evaluate downside risk statistically, this must be disclosed.

Summary Requirement for RIAs:

Advisors should be **required to provide a written explanation** to each client that includes:

1. **The advisor's process for identifying these five major risk categories.**
2. **The tools, training, or software they use (if any) to manage those risks.**
3. **A statement about their ability to reduce or prevent losses when one or more of these risks arise.**
4. **Whether they have a track record of successful risk avoidance during past downturns.**

If an advisor cannot speak confidently about these risk factors—or if they have no system in place to identify them—**that alone is a red flag for the investor and should be made explicit in writing to both clients and prospective clients.**