

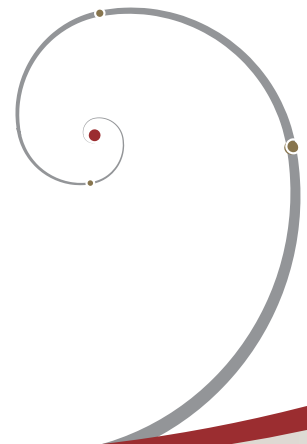


## Inside the Mind of the Client

“The Advisor’s Dilemma: The Complicated Art of Making Things Simple”

“Risk Tolerance and Behavioral Finance”

“Blind Spot: Expectations, Emotions, and Investor Behavior”



## THE ADVISOR'S DILEMMA

# The Complicated Art of Making Things Simple

By Sarah Newcomb, PhD, and Samantha Lamas

*Everything should be made as simple as possible, but no simpler.*

—Albert Einstein

The field of behavioral economics emerged from within the broader study of decision-making. Suspecting that there were problems with the “rational agent” concept in economics, Daniel Kahneman and Amos Tversky conducted a series of experiments to test people’s decision-making processes. The result was their Nobel Prize-winning prospect theory, which explains how people view tradeoffs based on a mental reference point and give unequal weights to losses and gains (Kahneman and Tversky 1979).

The asymmetrical S-curve of prospect theory was able to more accurately model and explain actual human decisions in choice experiments, and it served as the basis of other foundational concepts of behavioral economics such as loss aversion, and the endowment effect. This work gave birth to the heuristics-and-biases approach of behavioral economics, which focuses on the ways people deviate from rational choices and how to shape their environment to aid in better decision-making.

### Heuristics, Biases, and Choice Architecture

Behavioral science supports the two-system theory of psychology, which states that there are two different modes of thinking, commonly labeled as System 1 and System 2. System 1 is the automatic or unconscious form of thought and System 2 is the home of deliberate and effortful mental activities. Kahneman and Tversky’s

heuristics-and-biases approach focuses on the functions of System 1. When confronted with a choice, before making any form of effortful thought, System 1 provides the mind with “facts and suggestions,” which are then used by System 2 when making a conscious decision. For an overview of this work, see *Thinking, Fast and Slow* (Kahneman 2011).

As with all processes, garbage in equals garbage out. Biases occur when the contributions of System 1 are incorrect and lead the decision-maker to the wrong conclusion. Kahneman and Tversky’s work ignited a movement toward the investigation of these biases and their effect on our lives. Researchers have now identified close to 200 behavioral biases that we resort to when confronted with four general obstacles: too much information, the need to act fast, lack of meaning, and over-complexity (Benson 2016).

Recently, behavioral scientists have identified a way to help people avoid their decision-making biases by shaping their environments. This process is also known as choice architecture. Richard Thaler and Cass Sunstein championed this process in *Nudge*, a book aimed at utilizing the teachings of behavioral science in real-life decisions.

Choice architecture is any sort of environmental change that guides a person to the right decision. Thaler and Sunstein (2009) give the classic example of changing the location of unhealthy foods in a cafeteria. Placing the desserts or vegetables first can change the consumption of either by up to 25 percent. This gives the choice architect

(in this example, the person establishing the layout of the cafeteria) the ability to encourage diners to make healthier dietary choices; the choice architect can “nudge” people in a specific direction.

The effectiveness of nudging and choice architecture has inspired myriad changes in a wide range of processes, from small business policies to government legislation.

The implementation of automatic enrollment and escalation in 401(k) retirement accounts is arguably the most successful example of choice architecture. Saving for retirement is an essential but cumbersome and complex task for most individuals. For many, just thinking about the process of retirement saving (contacting the 401(k) provider, signing up for the service, choosing the investments, increasing the savings rate) gives way to a swarm of behavioral biases that cloud our better judgment. The onslaught of confusing information forces us to resort to biases such as inertia, status quo bias, confirmation bias, naïve diversification, and more. Behavioral economists have developed a way to avoid these behavioral biases by minimizing the amount of action the person must exercise.

Using automation and defaults, programs such as automatic enrollment in retirement plans cut down on the number of decisions a person must make and are extremely effective. Thaler and Shlomo Benartzi utilized the power of automation in their “Save More Tomorrow” program, which automatically synchronizes a person’s retirement savings rate with pay increases. Participants quadrupled their savings rates

throughout the course of the study (Thaler and Benartzi 2004).

However, not all forms of choice architecture have been accepted graciously. The Sugary Drinks Portion Cap Rule implemented in New York in 2013 drew tremendous backlash. Choice architecture presents a fine line between guidance and manipulation, and some argue that the soda ban crossed that line. The legislation attempted to ban the sale of sugar-sweetened drinks in cups larger than 16 ounces, therefore nudging people into drinking less. Critics claimed it infringed on freedom of choice, and the ban was reversed by the New York Court of Appeals in 2014 (Young 2014).

The heuristics-and-biases approach to behavioral science mainly focuses on the cognitive biases, or the negative side of decision-making shortcuts. These shortcuts can be extremely detrimental to an individual. Naïve diversification in a portfolio can cause a person to reject a risk-minimizing option, or loss aversion can prevent someone from making a profitable trade-off. Much of the work in behavioral economics has focused on mitigating the damage of these biases by designing the decision-maker's external environment in a way that makes the decision easier or altogether unnecessary.

### Biases and Heuristics: Bad or Good?

Biases and heuristics are simply shortcuts, or rules of thumb. Shortcuts fail us in some contexts, but they can be very helpful in others. A second school of thought in the decision sciences believes mental shortcuts may be adaptive tools that help humans make good choices with reasonable accuracy in situations with limited information or time to decide. The mental shortcut that moves us to follow the herd might trip us up when the herd is speculating on stock prices, but the very same heuristic could save our lives when several people flee a room at once.

The researchers at the helm of this work assert, "If we want to understand how real human minds work, we must look not only

at how our reasoning is 'limited' ... but also at how our minds are adapted to real-world environments" (Gigerenzer and Todd 1999, p. 21). This body of work argues that many decisions can benefit from the use of heuristics, provided that the shortcut fits the decision environment. The trick is to find the right cognitive shortcut for the right environment, because the same rule of thumb can be a hazard or a help depending on context. "Environmentally rational" shortcuts are often referred to as "fast and frugal heuristics" in academic literature. For ease, we will refer to them simply as "smart shortcuts" from this point on.

A common example of a smart shortcut is the way ballplayers catch a fly ball. Rather than calculate trajectories and probabilities, the player uses just one criteria: Fix the ball with the gaze, then adjust running speed and direction to keep the angle of the ball constant within the gaze (Gigerenzer and Brighton 2009). This smart shortcut is fast because it does not require detailed calculations. It is frugal because it eliminates all unnecessary information. It focuses on the one thing necessary to bring about the desired result.

This may be fine for catching a ball, but what about financial decisions? One famous study of a smart shortcut in finance showed that building a portfolio based solely on whether laypeople from another country recognized the name of a stock led to outperforming the market index over a six-month period. International brand recognition may be a smart shortcut for identifying profitability (Borges et al. 1999). Other researchers tried, and failed, to replicate these findings, however (Anderson and Rakow 2007), so we do not recommend building portfolios on this heuristic. The point here is not that shortcuts can always beat the market, but that not all heuristics lead us astray.

If we widen our definition of smart shortcuts to think about rules of thumb, the practical use is more apparent. Investing at least to your company's match in your 401(k), allocating assets by the 100-minus-your-age = equity percentage, and the five-minute rule (if you can't understand

it in five minutes, don't invest in it), are all smart shortcuts that help people make good (if admittedly imperfect) decisions without overwhelming their mental or emotional capacity.

A study of small business owners showed that people who were taught basic rules of thumb for accounting did significantly better than those who took a traditional accounting course in terms of business practices and outcomes. Specifically, when people have low overall financial literacy, rules of thumb may be more beneficial than sifting through all of the information (Drexler et al. 2014).

### When Small Changes Aren't Enough

Default enrollment can help people start saving. Rules of thumb, such as limiting school debt to one year's expected salary after graduation or keeping one's credit balance under 20 percent of the credit limit, can help people avoid financial crises. Yet, some financial decisions don't lend themselves easily to nudges or rules of thumb. When people routinely overspend, carry large debt balances, or repeatedly raid their stores of long-term assets for items with only short-term gains, they might not be easily moved by a rule of thumb or a nudge. In these cases, it is good to remember that behavioral economics has its roots in social psychology and look to that field for answers.

Many financial decisions are influenced by our sense of social and personal identity, our propensity to plan, and our personal relationship with money itself. In many cases, money management is less about numbers and more about the stories we tell ourselves because of those numbers. Each of us has a unique history that includes financial role models, class comparisons, gains, losses, stresses, and/or privileges that has shaped our perspective about money. This personal history is incorporated into our sense of the world and colors decisions about money itself and how we interact with it (Newcomb 2016).

We understand the world and our place in it through stories and metaphors (Lakoff

and Johnson 2003), and so the metaphors we use for money (money is power, money is the root of all evil, money makes the world go ‘round) can have a profound impact on our financial choices.

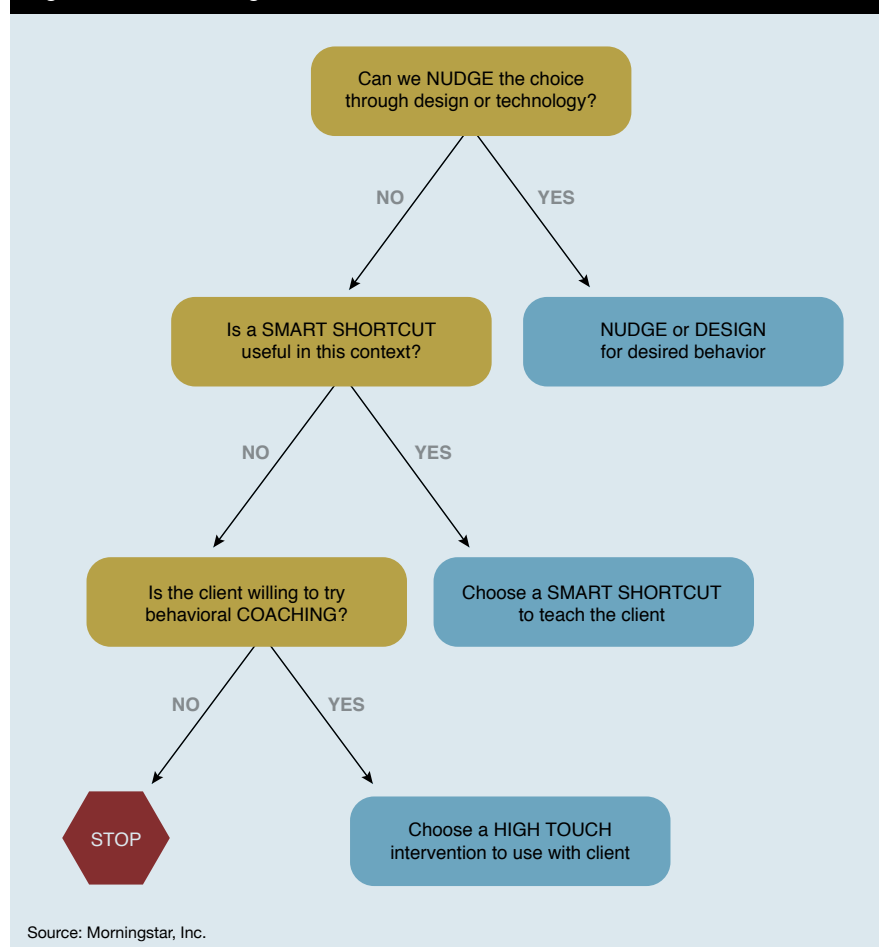
When a financial behavior does not change through nudges or rules of thumb, advisors can intervene by taking on the role of behavioral coach. If the client is willing, the advisor can use simple assessment tools to discover the possible roots of the behavior and help the client deal with the underlying issue. This is not the same as psychotherapy, but it does incorporate findings from financial psychology.

For example, many people do damage to their personal finances by prioritizing their children’s education over their own financial security. This may be due to a belief that “a good parent pays for college” or something similar. When a personal narrative leads us to poor decisions, working to rewrite that narrative may bring about change (McAdams 1993). Helping a client to rewrite the narrative above by giving examples of great parents who could not, or did not, pay for higher education (and whose children succeeded nonetheless) might help the client to reframe this belief. Replacing “a good parent pays for college” with “a good parent sets a good example of financial priorities” or “good parents help their children find ways to reach their goals” could lead to discussions about scholarships, alternative education opportunities, loans, apprenticeships, and other ways of helping children to thrive without sacrificing one’s own financial security.

In a similar vein, Morningstar’s Behavioral Insights Team has found that people who struggle to save often have a very short-term mindset. By working with your clients to extend their mental time horizons, over time they may become intrinsically motivated to save more. Other people have plenty of assets but still feel ill-at-ease with their finances, always fearing they will not have enough. These people may benefit from focusing on the power they have in their financial lives and learning to feel a

Table 1: Three Behavioral-Science Dilemmas That Advisors Face		
Dilemma	Dilemma Description	The Advisor’s Dilemma
Knowledge dilemma	Financial ignorance leaves clients vulnerable to predatory practices. Too much information leads to choice paralysis.	Do I keep it simple or do I give them all the facts?
Shortcut dilemma	Heuristics leave out vital information and can lead to poor decisions. Heuristics can help people make good, quick decisions.	Do I teach clients a fitting rule of thumb or do I teach them a more precise formula?
Willpower dilemma	Some changes can be made easily with good choice architecture. Some changes are difficult and take time to make.	Do I choose the path of least resistance or the path of perspective change?

Figure 1: Fast and Frugal Intervention Selection



stronger sense of control (Newcomb 2017). In each case, a personal narrative or a mental representation of one’s financial life needs adjustment in order to help the client make better decisions and enjoy the peace of mind that financial security can offer.

Personal narratives might not be easily nudged or subject to rules of thumb, but they can be changed, and advisors can guide that change through the use of visualization, writing tasks, and other targeted activities designed for the purpose.

## The Advisor's Dilemma

Such is the state of behavioral finance: one camp teaching the dangers of heuristics and another lauding their merits. Then there are the choices that may not be suited to shortcuts or choice architecture at all—the choices that require a more hands-on approach to changing our behaviors. Advisors who wish to use behavioral techniques are left to choose the appropriate intervention for their clients' needs from a swarm of complex and conflicting ideas that overwhelm their own ability to decide, an irony that is not lost on us. The deluge of information that has come out of the behavioral sciences in recent years leads to at least three dilemmas for advisors (see table 1).

The dilemmas described in table 1 are not an artifact of faulty science or conflicting findings. They are the simple consequence of the fact that all financial decisions are not the same. Some are habitual, possibly unconscious, and can be largely influenced by the choice environment. Others require a bit of thought and can benefit from learning smart, appropriate rules of thumb. Still others are rooted in identity, society, and our personal narratives, and they may require conscious revisions to our current ways of thinking.

“Advisors who wish to use behavioral techniques are left to choose the appropriate intervention for their clients' needs from a swarm of complex and conflicting ideas that overwhelm their own ability to decide, an irony that is not lost on us.”

Thankfully, when we examine the field as a whole, there is a smart shortcut to help us through the fog.

The decision tree shown in figure 1 assumes that less is usually more. If you can guide the client's behavior without having to resort to long conversations and high-touch interventions, all the better. Automatic savings accounts, default enrollment in 401(k)

plans, automatic increases to savings every year, etc., are examples of nudges that can eliminate the need for more time-intensive interventions. If you cannot nudge the best choice but a rule of thumb can bring about a good outcome, by all means use it. If, however, the problem persists despite these measures, or the situation is not suitable for nudges or rules of thumb, then advisors can guide willing clients through the process of perspective change. Lastly, if the behavior cannot be nudged, there is no useful rule of thumb, and the client is not interested in coaching, then stop. Without a willing participant or a tool of choice architecture, it is not a productive use of your time.

## Conclusion

Decision science is a vast and complex field of research, but real-life decisions often benefit from simplicity. To date, science has not been able to prove that financial decisions benefit from utilizing all available information. Advanced modeling software has yet to be able to consistently outperform market index funds, raising questions about the usefulness of complexity in making financial decisions. Providing consumers with thick prospectuses and technical data does not necessarily improve their ability to make good investment decisions. On the other hand, nudges, smart shortcuts, and

best here to distill this labyrinthine field of work into a framework that is clear, practical, and useful for you and your clients. ●

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# Risk Tolerance and Behavioral Finance

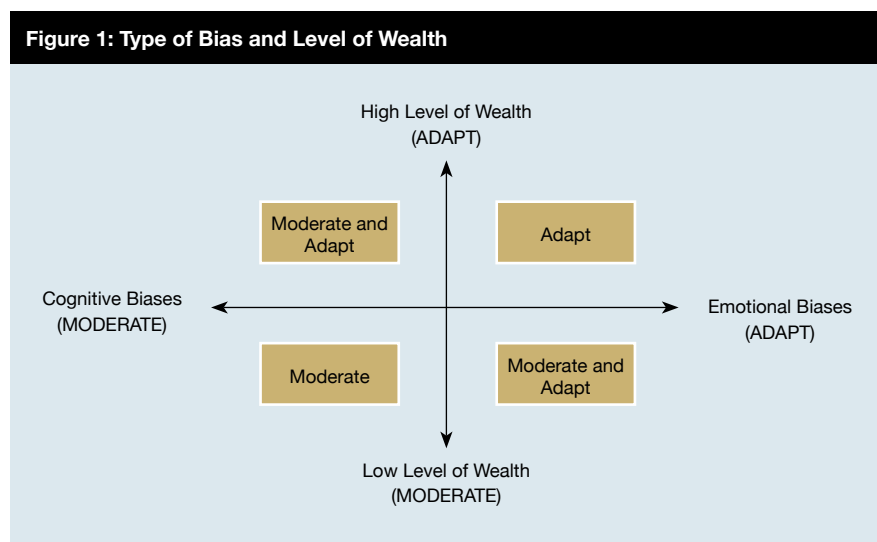
By Michael M. Pompian, CFA®, CAIA®, CFP®

We have seen a powerful recovery in asset prices in the wake of the global financial crisis (GFC).

We cannot forget, however, that more than \$15 trillion in asset values evaporated in 2008–2009, wiping out gains earned in the bull markets of the 1990s and early 2000s. During the GFC, clients were horrified and did not know what to do. Of course, in hindsight, the right thing to do was to ride out the storm; some investors sold out and regret it to this day. History has shown that markets are cyclical, so another bear market will occur again, it is just a matter of time. When times are good, as they have been for the past eight years, our skills as advisors can get dull because we haven't had to deal with panicky, stressed-out clients. But we need to stay on top of our game. Knowing that markets can grow suddenly violent, financial advisors must be able to diagnose irrational behaviors and advise their clients accordingly. That means incorporating behavioral finance into our practices.

## Behavioral Finance

The way investors think and feel affects their investment behaviors. Some investor behaviors are unconsciously influenced by past experiences and personal beliefs to the extent that even intelligent investors may deviate from logic and reason. These influences, or behavioral biases, can affect the way risk is perceived. In Pompian (2006), I introduced a way to categorize biases. The broadest category is cognitive and emotional. Cognitive biases involve how people think and emotional biases involve how people feel. Cognitive errors result from memory and information-processing errors—that is, faulty reasoning. Emotional



biases lead to reasoning influenced by feelings. This distinction is critical.

Cognitive biases can be broken down into belief-perseverance and information-processing biases. Belief-perseverance biases affect people who have a hard time modifying their beliefs even when faced with information to the contrary. It is a very human reaction to feel uncomfortable when new information contradicts information you hold to be true. For example, for decades many people have been under the false impression that eating sugar produces hyperactivity in children. Twenty years ago, several studies examined the effects of sugar on children's behavior and concluded that sugar in the diet does not affect children's behavior (Wolraich et al. 1995). But many people continue to believe that it does; this is an example of belief perseverance. Related biases include cognitive dissonance, conservatism, confirmation,

representativeness, illusion of control, and hindsight.

Information-processing biases affect people who make thinking errors when processing information. The simplest example is anchoring, where people tend to estimate something based on an initial default number. If I asked you to estimate the population of Canada and remarked that I did not know whether it was higher or lower than 30 million, you would probably "anchor" your estimate to that number and adjust from there rather than make an independent estimate. Information-processing biases include anchoring and adjustment, mental accounting, framing, availability, self-attribution, outcome, and recency.

Emotional biases are based on feelings rather than facts. Emotions can overpower our thinking during times of stress. All of us likely have made irrational decisions



during our lives. Emotional biases include loss aversion, overconfidence, self-control, status quo, endowment, regret aversion, and affinity.

The distinction between cognitive and emotional biases is critical when assessing risk tolerance. Advisors often need to adapt to client behaviors caused by emotional biases because it is hard to change the way people feel. With cognitive biases, however, advisors have an opportunity to modify or change clients' thinking and moderate clients' behaviors.

Figure 1 shows a simple framework for applying behavioral finance in practice that I have used in my advisory practice over the past 20 years to solve vexing challenges of client relationship management.

### Defining Risk

There are lots of aspects to risk. Risk appetite generally is the willingness to take risk, and risk capacity is the ability to take risk. We further define risk appetite and risk capacity in terms of known and unknown risks, because when clients can understand and measure the risks they are taking, they can accept the results. But problems arise when the risks fall outside the bounds of what they expect or understand.

Risk appetite is the amount of risk that one is willing to take in pursuit of reward. Risk

appetite varies per expected return; it may be expressed qualitatively and/or quantitatively. Investors with a high risk appetite focus on the potential for significant gains and are willing to accept a higher possibility or severity of loss. Conversely, investors with a low risk appetite are risk-averse and focus on stability and preservation of capital.

The level of both risk appetite and risk capacity varies by individual; obviously, investors should not define their risk appetite without considering their risk capacity, but sometimes they do. In the end, risk capacity is the amount of risk a person can actually bear. On the one hand, an investor may have a high risk appetite but lack the capacity to handle the potential volatility or impact. Or risk capacity may be high but the investor may have a lower risk appetite. Advisors can get a handle on these issues with their clients relatively easily for known risks. Unknown risk, which is not so easily measured, is often associated with irrational investor behavior.

### Known and Unknown Risk

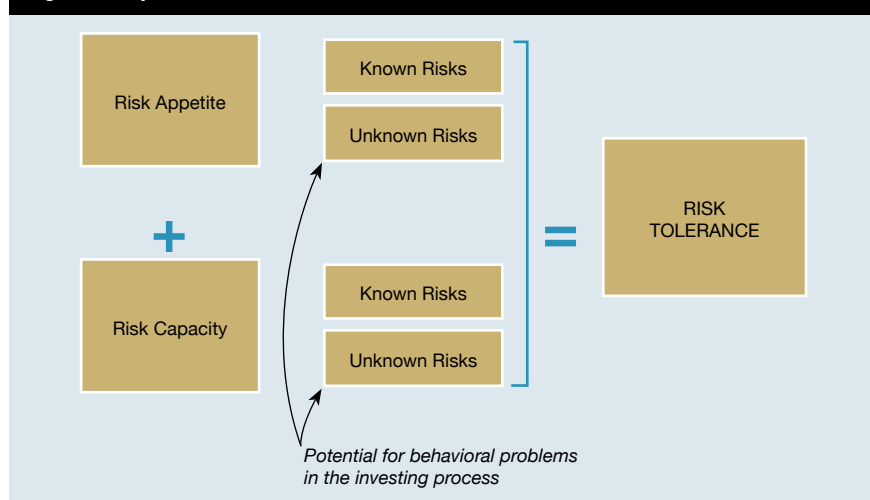
Donald Rumsfeld, U.S. secretary of defense under President George W. Bush, famously described known and unknown risk: "There are known knowns. These are things we know that we know. There are known unknowns. That is to say, there are things that we know we do not know. But there

are also unknown unknowns. There are things we don't know we don't know."<sup>1</sup>

Clients may tell advisors that they have certain risk appetites and risk capacities. But do the advisor and the client agree on what is meant by risk? How much known risk and how much unknown risk can the client handle? Known risk is what we might call "normal risk"—risk we can comprehend easily and quantify using historical data from observations of financial markets. But what about unknown "abnormal" risk, the kind that occurs once every 10 or 20 years and falls outside expectations? We can think of normal risk as one or two standard deviations from the normal. We can think of unknown risk as three or more standard deviations from the normal. Although severe bear markets and crashes occur from time to time, 2008–2009 can be categorized as an unknown or abnormal risk. At that time, portfolio return fell outside the expected range of most models based on a normal distribution of returns.

When a decision is made about how much risk to take (risk appetite) or a measurement is taken of how much loss can be tolerated without jeopardizing financial goals (risk capacity), unknown risk can cause investors to behave irrationally. People must consider their likely reaction to known risk and especially unknown risk to get a complete picture of their risk tolerance. Figure 2 combines these concepts to graphically represent an equation for risk tolerance.

Figure 2: Equation for Risk Tolerance



### Risk Tolerance and Behavioral Finance

Consider the concept of behavioral investor types (BITs). BITs can be identified using my Behavioral Alpha® (BA) process. BA is a multi-step diagnostic process that classifies clients as one of four investor types. Bias identification, which is done near the end of the process, is based on the client's risk tolerance.

BITs were designed to help advisors make rapid yet insightful assessments before recommending an investment plan. By ascertaining investor type at the outset of a

relationship, an advisor can mitigate client behavioral surprises that might dispose a client to change the portfolio because of market turmoil. If an advisor can limit traumatic episodes by delivering smoother (or closer-to-expected) investment results by tailoring an investment plan to the client's behavioral makeup, a stronger client relationship is the result. Here each BIT is characterized by a certain risk tolerance level and a primary type of bias—either cognitive (driven by faulty reasoning) or emotional (driven by impulses and/or feelings).

Advisors should keep in mind that the least risk-tolerant investors and the most risk-tolerant investors are driven by emotional biases, whereas the two types between these extremes are driven by cognitive biases (Pompian 2012). Emotional clients, however, tend to be more difficult to work with. Advisors who can recognize the type of client they are dealing with before making investment recommendations will be much better prepared to deal with irrational behavior when it arises.

### Guidelines for Practitioners

As discussed, the least risk-tolerant BIT clients and the most risk-tolerant BIT clients are emotionally biased in their behavior. In the middle of the risk scale are BITs that are affected mainly by cognitive biases. This dynamic should make intuitive sense. Emotion drives the behavior of clients who have a high need for security (i.e., a low risk tolerance); they get emotional about losing money and are uneasy during times of stress or change. Similarly, highly aggressive investors are also emotionally driven people who typically suffer from a high level of overconfidence and mistakenly believe they can control the outcomes of their investments. Between these extremes are the investors who suffer mainly from cognitive biases, and education and information about their biases can help them make better investment decisions. With aggressive clients, the best approach is to deal with their biases head-on and discuss how their investment decisions

will affect family members, legacy, and standard of living.

Clients who are emotional about their investing need to be advised differently from those who make mainly cognitive errors. When advising emotionally driven investors, advisors need to focus on how an investment program can affect important emotional issues such as financial security, retirement, and the impact on future generations—rather than focusing on portfolio details such as standard deviations and Sharpe ratios. A quantitative approach is more effective with clients who are less emotional and tend to make cognitive errors. The goal is to build better long-term relationships with clients, and BITs were designed to help in this effort. The four BITs are conservative, moderate, growth, and aggressive; brief descriptions of the types, their common biases, and thoughts about how to advise each type of client are included.

### Conservative Investors

Risk tolerance level: Low

Behavioral bias orientation: Emotional

BIT description: Conservative Investors (CIs) place great emphasis on financial security and preserving wealth. Many have gained wealth through inheritance or by not risking their capital to build wealth (e.g., by working in a large company). Because they tend to be risk-averse, CIs may be worriers; they obsess over short-term performance and are slow to make investment decisions because they are uncomfortable with change and uncertainty. This behavior is consistent with their approach to their professional lives—they are careful not to take excessive risks. Many CIs focus on taking care of family members and future generations, especially by funding life-enhancing experiences such as education and homeownership.

The biases of CIs tend to be emotional—loss aversion, status quo, and endowment bias—but CIs also exhibit anchoring and mental accounting, both of which also have cognitive aspects.

### Conservative Biases

#### *Loss Aversion Bias*

Bias type: Emotional

CIs tend to feel the pain of losses more than the pleasure of gains compared with other client types. Thus, these clients may hold losing investments too long, even when they see no prospect of a turnaround. Loss aversion is a very common bias and is seen by large numbers of financial advisors.

#### *Status Quo Bias*

Bias type: Emotional

CIs often like to keep their investments (and other parts of their lives, for that matter) the same—that is, they maintain the status quo. These investors tell themselves that “things have always been this way” and thus feel safe keeping things the same.

#### *Endowment Bias*

Bias type: Emotional

CIs, especially those who inherit wealth, tend to assign a greater value to an investment they already own (such as a piece of real estate or an inherited stock position) than to one they neither possess nor have the potential to acquire.

#### *Anchoring Bias*

Bias type: Cognitive/Emotional

CIs often are influenced by purchase points or arbitrary price levels and tend to cling to such numbers when facing questions like, “Should I buy or sell this investment?” Suppose that the stock falls to \$75 a share from a high of \$100 five months ago. Frequently, a conservative client will resist selling until the price rebounds to at least \$100/share.

#### *Mental Accounting Bias*

Bias type: Emotional/Cognitive

Conservative clients often treat various sums of money differently on the basis of where the sums are mentally categorized. For example, these investors segregate their



assets into safe and risky “buckets.” Although this behavior is usually not harmful, returns almost certainly will be suboptimal if all the assets are viewed as safe money.

**Advice for Conservative Investors:** CIs can be difficult to advise because they are driven mainly by emotion. They greatly need good financial advice, and advisors need to take time to interpret the behavioral signs provided by CI clients. CIs need big-picture advice, so advisors should not dwell on details such as standard deviations and Sharpe ratios lest they lose the client’s attention. CIs need to understand how their portfolios will deliver desired results concerning such emotional issues as family members and future generations. Once they feel comfortable discussing these important emotional issues and trust is established, they will act. After a while, CIs are likely to become an advisor’s best clients because they value the advisor’s professionalism, expertise, and objectivity in helping them make the right investment decisions. In addition, CIs usually can benefit from the added risk that a competent advisor persuades them to take—so long as the advisor carefully monitors the risk and does not allow it to become too large.

### Moderate Investors

Risk tolerance level: Moderate

Behavioral bias orientation: Cognitive

BIT description: Moderate Investors (MIs) often do not have their own ideas about investing but instead follow the lead of their friends and colleagues in making investment decisions. They are comfortable with being invested in the latest, most popular investments, often without regard to a long-term plan. One of the key challenges of working with MIs is that they often overestimate their risk tolerance. Advisors need to be careful not to suggest too many “hot” investment ideas—MIs likely will want to do all of them. Some dislike, or even fear, the task of investing, and many put off making investment decisions unless they have professional advice; the result is that they maintain, often by default, high cash

balances. MIs generally comply with professional advice when they get it, but they can sometimes be difficult because they do not enjoy, or they have no aptitude for, the investment process.

The behavioral biases of MIs are mostly cognitive: recency, hindsight, framing, cognitive dissonance, and regret aversion.

### Moderate Biases

#### *Recency Bias*

Bias type: Cognitive

Recency bias is a predisposition to recall and emphasize recent events and/or observations and to extrapolate patterns where none exist. Recency bias ran rampant during the bull market of 2003–2007, when many investors wrongly presumed that the stock market—particularly energy, housing, and international stocks—would continue to gain indefinitely. A similar mentality is emerging now that the more recent bull market of 2009–2017 has become entrenched in some investors’ minds. MIs may invest when prices are peaking, materially hurting long-term returns.

#### *Hindsight Bias*

Bias type: Cognitive

Moderate clients may be susceptible to hindsight bias, which occurs when an investor perceives past investment outcomes as if they had been predictable. An example of hindsight bias is the response by investors to the financial crisis of 2008. Initially, many viewed the housing market’s performance from 2003 to 2007 as normal (i.e., not symptomatic of a bubble), only later saying, “Wasn’t it obvious?” when the market had a meltdown in 2008. Hindsight bias gives investors a false sense of security when making investment decisions, emboldening them to take excessive risk without recognizing it as such.

#### *Framing Bias*

Bias type: Cognitive

Framing bias is the tendency of investors to respond to situations differently based on

the context in which a choice is presented (framed). The use of risk tolerance questionnaires provides a good example. Depending on how questions are asked, framing bias can cause investors to respond to risk tolerance questions in either an unduly risk-averse or an unduly risk-taking manner. For instance, when questions are worded in the “gain frame” (e.g., suppose an investment goes up), a risk-taking response is more likely. When questions are worded in the “loss frame” (e.g., suppose an investment goes down), risk-averse behavior is the likely response.

### *Cognitive Dissonance Bias*

Bias type: Cognitive

In psychology, cognitions represent attitudes, emotions, beliefs, or values. When multiple cognitions intersect—for example, a person believes something is true only to find out it is not—people try to alleviate their discomfort by ignoring the truth and/or rationalizing their decisions. Investors who suffer from this bias may continue to invest in a security or fund they already own after it has gone down (i.e., they double down), even when they know they should be judging the new purchase objectively and independently of the existing holding. A common phrase for this concept is “throwing good money after bad.”

### *Regret Aversion Bias*

Bias type: Emotional

MIs often avoid taking decisive actions because they fear that, in hindsight, whatever course they select will prove unwise. Regret aversion can cause MIs to be too timid in their investment choices because of losses they have suffered in the past.

**Advice for Moderate Investors:** Clients with the biases of MIs need to recognize that they tend to follow the lead of others and may not have their own ideas about investing. They may not fully grasp their own risk tolerance but simply plow ahead with the task of investing. When an investment goes their way, they may convince themselves that they “knew it all along,” a

view that also increases future risk-taking behavior. Advisors need to handle MIs with care because they are likely to say yes to investment ideas that make sense to them regardless of whether the advice is in their best long-term interest. Advisors need to lead MIs to take a hard look at behavioral tendencies that may cause them to overestimate their risk tolerance. Because MI biases are mainly cognitive, educating MI clients on the benefits of portfolio diversification and sticking to a long-term plan is usually the best course of action. Advisors should challenge MI clients to be introspective and should provide data-backed substantiation for their recommendations. Offering information to MI clients in clear, unambiguous ways so they have the chance to “get it” is a good idea. If advisors take the time, this steady, educational approach will generate client loyalty and adherence to long-term investment plans.

### Growth Investors

Risk tolerance: Medium to high

Behavioral bias orientation: Cognitive

BIT description: Growth Investors (GIs) are active investors with medium to high risk tolerance; some are strong-willed and independent thinkers. GIs are often self-assured and “trust their gut” when making decisions; when they do their own research, however, they may not be thorough enough with due diligence tasks. GIs sometimes make investments without consulting anyone. This behavior can be problematic because, owing to their independent mindsets, these clients maintain their views even when those views are no longer supportable (e.g., because of changed market conditions). GIs often enjoy investing and are comfortable taking risks, but they may resist following a financial plan. Of all the behavioral investor types, GIs are the most likely to be contrarian, which sometimes can benefit them. Some GIs are obsessed with trying to beat the market and may hold concentrated portfolios.

The behavioral biases of GIs are cognitive: conservatism, availability, representativeness, self-attribution, and confirmation.

### Growth Biases

#### *Conservatism Bias*

Bias type: Cognitive

Conservatism bias occurs when people cling to a prior view or forecast at the expense of acknowledging new information. GIs often exhibit this behavior. For example, assume that an investor purchases a security based on knowledge about a forthcoming new-product announcement. The company then announces that it is experiencing problems bringing the product to market. GIs may cling to the initial, optimistic impression of the new-product announcement and fail to act on the negative announcement.

#### *Availability Bias*

Bias type: Cognitive

Availability bias occurs when people estimate the probability of an outcome based on how prevalent that outcome appears to be in their lives. People who exhibit this bias perceive easily recalled possibilities as more likely than prospects that are harder to imagine or difficult to comprehend. For example, suppose that GIs are asked to identify the “best” mutual funds. Many of them would perform a Google search and, most likely, find funds from firms that engage in heavy advertising. Investors subject to availability bias are thus influenced to pick funds from such companies, even though some of the best-performing funds advertise very little, if at all (they do not need to).

#### *Representativeness Bias*

Bias type: Cognitive

Representativeness bias occurs because of a flawed perceptual framework when processing new information. To make new information easier to process, some investors project outcomes that resonate with their own pre-existing ideas. For example, a GI might view a particular stock as a value stock because it resembles an earlier value stock that was a successful investment, but the new investment is not a value stock. Suppose that a high-flying biotech stock

with scant earnings or assets drops 25 percent after a negative product announcement. Some GIs might take this situation to be representative of a “value” stock because the stock is cheap. But biotech stocks do not typically have earnings, whereas traditional value stocks have had earnings in the past but are temporarily underperforming.

#### *Self-Attribution (Self-Enhancing) Bias*

Bias type: Cognitive

Self-attribution bias (or self-enhancing bias) refers to the tendency of people to ascribe their successes to their own innate talents and to blame failures on outside influences. For example, suppose that a GI invests in a particular stock that goes up in price. The investor believes it went up because of the GI’s investment savvy rather than external factors such as economic conditions or competitor failures (the most likely reasons for the price rise). This behavior is classic self-enhancing bias.

#### *Confirmation Bias*

Bias type: Cognitive

Confirmation bias occurs when people observe, overvalue, or actively seek information that confirms their claims while ignoring or devaluing evidence that discounts their claims. Confirmation bias can cause investors to seek only information that confirms their beliefs about an investment and not to seek information that contradicts their beliefs. This behavior can leave investors in the dark regarding, for example, the imminent decline of a stock. GIs are often subject to this bias.

**Advice for Growth Investors:** GIs can be difficult clients to advise owing to their independent mindsets, but they usually are grounded enough to listen to sound advice when it is presented in a way that respects their independent views. As we have learned, GIs firmly believe in themselves and their decisions but can be blind to contrary thinking. As with MIs, education is essential to changing the behavior of GIs, whose biases are predominantly cognitive.

A good approach includes regular educational discussions during client meetings, in which the advisor does not point out unique or recent failures but, rather, educates clients and incorporates concepts that are appropriate for them. Because GI biases are mainly cognitive, educating GIs on the benefits of portfolio diversification and sticking to a long-term plan is usually the best course of action. Advisors should challenge GIs to reflect on how they make investment decisions and should provide data-backed substantiation for their recommendations. Offering information in clear, unambiguous ways is an effective approach. If advisors take the time, this steady, educational method should yield positive results.

### Aggressive Investors

Risk tolerance: High

Behavioral bias orientation: Emotional

BIT description: Aggressive Investors (AIs) are the most aggressive BIT. These entrepreneurial clients are often the first generation in their family to create wealth. They are even more strong willed and confident than GIs. Very wealthy AIs often have been in control of the outcomes of their business activities and believe they can do the same with investing—they are overconfident. AIs often like to change their portfolios as market conditions change, which often creates a drag on investment performance. AIs are quick decision-makers; they may chase higher-risk investments that their friends or associates are investing in. Some AIs do not believe in basic investment principles such as diversification and asset allocation; they are often hands-on types and want to be involved in the investment decision-making.

The behavioral biases of AIs are overconfidence, self-control, affinity, outcome, and illusion of control.

### Aggressive Biases

#### Overconfidence Bias

Bias type: Emotional (with cognitive aspects)

Overconfidence is best described as unwarranted faith in one's own thoughts and abilities—which contains both cognitive and

emotional elements. Overconfidence manifests itself in investors' overestimation of the quality of their judgment. Many AIs claim an above-average aptitude for selecting stocks; however, numerous studies have shown this claim to be almost always a fallacy. For example, a study done by researchers Barber and Odean (2000) showed that after trading costs (but before taxes), the average investor underperformed the market by approximately 2 percent a year owing to the investor's unwarranted belief in his ability to assess the correct value of investment securities.

#### Self-Control Bias

Bias type: Emotional

Self-control bias is the tendency to consume today at the expense of saving for tomorrow. The primary concern for advisors is a client with high risk tolerance coupled with high spending. For example, suppose that you have an aggressive client who prefers aggressive investments and has high current spending needs—and suddenly the financial markets hit severe turbulence. To meet current expenses, the client may be forced to sell solid long-term investments that have been priced down owing to current market conditions.

#### Affinity Bias

Bias type: Emotional

Affinity bias, another emotional bias, refers to investors' tendency to make irrationally uneconomical consumer choices or investment decisions based on how they believe a certain product or service will reflect their values. AIs are often subject to this bias.

#### Outcome Bias

Bias type: Cognitive

This bias occurs when investors focus on the outcome of a process rather than on the process used to attain the outcome. In the investment realm, this behavior consists of focusing on a return outcome without regard to the process used (i.e., the risk taken) to achieve the return. It is important for clients to understand how the outcome was achieved, not simply the outcome itself.

### Illusion of Control Bias

Bias type: Cognitive

The illusion of control bias occurs when people believe that they can control or at least influence investment outcomes when, in fact, they cannot. AIs who are subject to this bias believe that the best way to manage an investment portfolio is to constantly adjust it. For example, trading-oriented investors, who accept high levels of risk, believe that they possess more control over the outcomes of their investments than they actually do because they are "pulling the trigger" on each decision.

**Advice for Aggressive Investors:** AIs are the most difficult clients to advise, particularly if they have experienced losses. Because they like to control, or at least get deeply involved in, the details of investment decision-making, they tend to eschew advice that might keep their risk tolerance in check. They are excited and optimistic that their investments will do well, even if that optimism is irrational. Some AIs need to be monitored for excessive spending, which, if out of control, can inhibit the performance of a long-term portfolio through withdrawals at inopportune times. In my view, the best approach to dealing with these clients is to take control. Advisors who let an aggressive client dictate the terms of the advisory engagement always will be at the mercy of the client's irrational decision-making, and the result likely will be an unhappy client and an unhappy advisor. Advisors need to prove to AI clients that they can help make great, objective, long-term decisions and that they can effectively communicate the results. Advisors who demonstrate the ability to take control of a situation will see their aggressive, emotionally charged clients fall into line and be better clients who are easier to advise.

### Conclusion

In this piece, I have discussed risk tolerance using a behavioral finance lens and then provided some practical steps for advisors to follow when working with behaviorally biased clients.

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## RISK TOLERANCE AND BEHAVIORAL FINANCE

*Continued from page 14*

When viewing risk tolerance from a behavioral finance perspective, try to identify how your clients will react to known risks as well as unknown risks. Unknown risks that come to pass are often the source of behavioral issues that can derail an investment plan.

When advising clients, it is essential to distinguish between the various types of biases encountered. If you are dealing with emotional biases, your advice should be tailored to that type of behavior; if you are dealing with cognitive biases, your advice should reflect that situation.

I suggest that as an advisor, you try to discuss these issues with your clients as often as possible. I know it is not always easy to discuss psychological issues during the investment process, but if you are successful, you will have very satisfied, long-term clients. ●

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**Endnote**

1. This phrase is from a response that former U.S. Secretary of Defense Donald Rumsfeld gave to a question at a U.S. Department of Defense news

briefing with General Richard Myers, chairman, Joint Chiefs of Staff, on February 12, 2002, about the lack of evidence linking the government of Iraq with the supply of weapons of mass destruction to terrorist groups, <http://archive.defense.gov/Transcripts/Transcript.aspx?TranscriptID=2636>.

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## BLIND SPOT

## Expectations, Emotions, and Investor Behavior

By David Goodsell

Financial advisors know all too well the influence that emotions and expectations hold over investor behavior.

When markets are volatile or down, clients seek refuge from uncertainty and the challenge is talking them off the ledge. When markets are up, the challenge is offering a reasonable argument for not going all-in on the momentum. It's not surprising that financial advisors around the globe say preventing clients from making emotional decisions is the number-one success factor for their businesses.

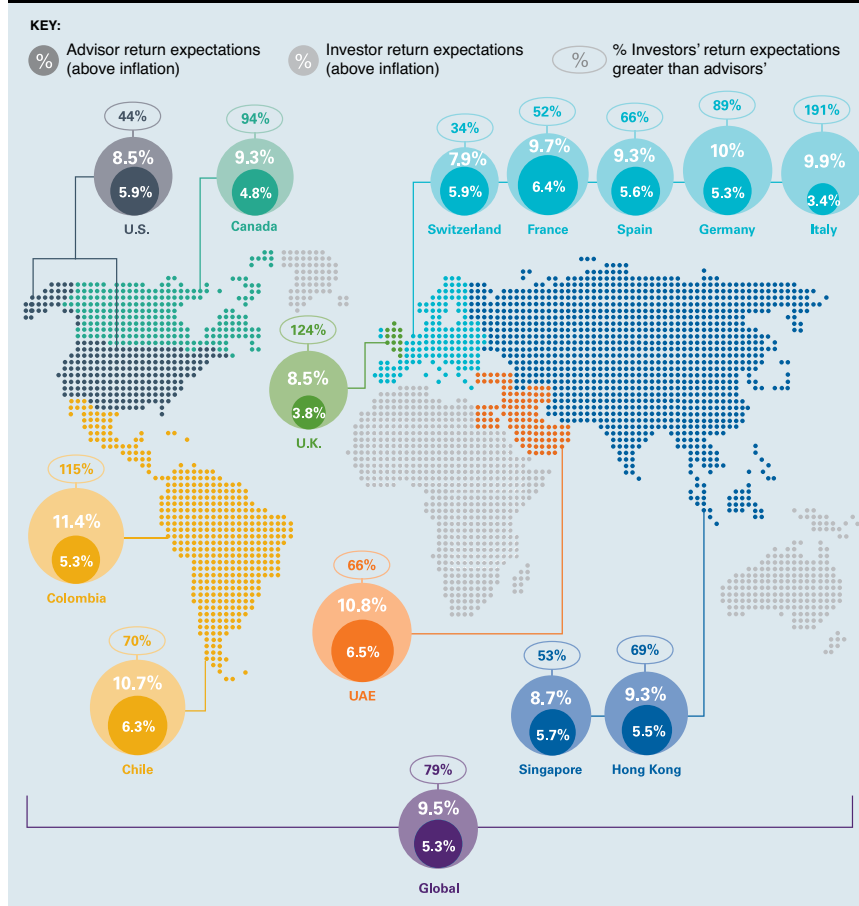
If only investors felt the same way.

According to our most recent investor survey, fewer than one-quarter of individuals in the United States believe they would be better able to meet financial goals if they could stop making emotional decisions. This emotional blind spot manifests itself across a wide range of investor behaviors, which we have observed over five years in our survey program. We commonly see investors let their emotions get the better of them in the following three areas:

- Failing to rationalize return expectations with risk tolerances
- Making reactive decisions in periods of market stress
- Assuming one advantage adds up to greater benefits

Each presents a significant obstacle in the pursuit of investment goals. Together, these behaviors can be an all-out roadblock for investors striving to achieve financial security.

Figure 1: The Expectation Gap



## Risk, Return, and Investor Expectations

Investors across the globe have an optimistic outlook for the performance of their investments, but their expectations are significantly higher than what financial professionals say is realistic. Globally, individuals say they expect returns of 9.5 percent above inflation, a

figure that is 79 percent greater than the 5.3 percent that financial advisors believe investors can expect. While the gap is not as great in the United States, investor expectations are still 44 percent higher than what advisors say is realistic. Investors expect 8.5 percent above inflation, U.S. advisors call for 5.9 percent (see figure 1).



**Table 1: Most Individuals Want a Sure Thing**

Payoffs		Expected Payoff	Minimum Payoff	Percent of Investors	Percent of Institutions
50% Chance	50% Chance				
Win \$28,000	Win \$28,000	\$28,000	\$28,000	40%	20%
Win \$36,000	Win \$24,000	\$30,000	\$24,000	19%	19%
Win \$44,000	Win \$20,000	\$32,000	\$20,000	18%	22%
Win \$52,000	Win \$16,000	\$34,000	\$16,000	12%	10%
Win \$60,000	Win \$12,000	\$36,000	\$12,000	6%	21%
Win \$70,000	Win \$2,000	\$36,000	\$2,000	6%	8%

Source: MIT/Natixis project. Based on findings from the Natixis 2016 Global Survey of Individual Investors conducted by CoreData Research, February–March 2016, which included 7,100 investors in 22 countries, and the Natixis 2016 Global Survey of Institutional Investors conducted by CoreData Research in October and November 2016. Survey included 500 institutional investors in 31 countries.

Factor in an average inflation rate of 2–3 percent as experienced over the past 50 years and investor expectations move into the range of 12–13-percent annual returns. Pursuing this level of return generally would require significant investments in equities and, in turn, significant exposure to market volatility. The problem with this scenario is that 77 percent of individuals describe themselves as cautious rather than aggressive investors.

Over the past five years we have consistently seen that the majority of investors are not willing to take on high levels of portfolio risk. In our 2015 survey 79 percent of investors said, if forced to choose, they would take safety over investment performance. The percentage of investors agreeing with this premise has changed little since we first posed the question in our 2014 survey, when 75 percent agreed with this statement. This disconnect between the returns individuals expect and the risk they can accept often leads to emotional decisions and critical investment mistakes that ultimately may keep investors from achieving their goals.

### Manage Risk by Managing Expectations

Outsized expectations can derail the most well-conceived investment plans. One way to keep expectations in check is to continually profile clients to learn what could be shifting their outlook on investment performance:

- Is it time to review risk tolerance? Life-changing events like babies, houses,

college, grandchildren, or inheritance can alter how clients view investment risk.

- Do they know how much they need to retire? Many individuals ballpark their retirement income goals. It's important to revisit the assumptions with solid math, especially if yields are low.
- Do you have an investment policy statement in place for each client? If not, it may be time to get client expectations on paper. If you do, it may be time to determine if assumptions have changed or success metrics are clear.

### A Blind Spot for Emotional Decisions

Advisors recognize the pitfalls presented by emotional investors. They know that emotional decisions are a huge source of investment mistakes for individuals. Moreover, most advisors (88 percent) say that preventing their clients from making such mistakes is a critical success factor for their businesses. This leads to another significant disconnect for investors: They fail to see how emotions can get in the way of rational investment decisions.

When asked which factors would better enable them to achieve their goals, only 29 percent of investors worldwide and 24 percent in the United States said they could do better by avoiding emotional decisions. But by their own admission, they know they are susceptible to emotions. Six in 10 U.S. investors say they struggle to avoid emotional decisions when markets are volatile. Based on their response to hypothetical market losses, many investors may be losing the struggle.

In a research partnership with the Massachusetts Institute of Technology's (MIT) Lab for Financial Engineering, we have examined how individual investors say they will react to potential market movements. Over the course of two years, more than 20,000 respondents, including individuals, advisors, and institutions, have been presented with a question about how they would respond if the market dropped 10–20 percent over a six-month period. The results demonstrate glaring differences between the inclinations of individuals and professionals.

Buying low and selling high is a foundation of conventional investment wisdom. In the case of a down market, we see that professional investors are more likely to adhere to this principle by adding to their equity positions. Two-thirds of institutional decision-makers say they would increase their equity allocations in this scenario, and only 18 percent said they would sell off stock. Advisors see the same opportunity in the turbulence; 52 percent say they would add to equity allocations. Investors are of another mind altogether. Only 18 percent of investors say they would add to their equity investments when markets are down; 45 percent say they would sell off stock holdings, and 38 percent say they would do nothing. Motivation for these decisions is clearly reflected in investor attitudes toward risk.

When we asked individuals in our 2015 survey how they define risk, they most frequently (35 percent) defined it as losing assets or wealth. This was followed by



20 percent who defined risk as exposing assets to volatility. Only 8 percent said they defined risk as missing out on investment opportunity. With this definition of risk in mind, investors may not be properly equipped to capitalize on market turbulence; they clearly prefer to retreat.

In another test case presented in our collaboration with MIT, investors were presented with a series of gambles. Again we found significant differences between the attitudes of institutions and individuals. Given a series of risk propositions ranging from one that guaranteed a win of \$28,000 to another that presented a 50-percent chance of winning \$70,000 and a 50-percent chance of winning just \$2,000, individual investors were most likely to choose the largest guaranteed payoff—and not gamble for a still larger payoff (see table 1).

Institutions, on the other hand, are more likely to look at the proposition as an exercise in risk optimization. More than six in 10 of institutional respondents selected the propositions presenting the greatest risk-reward trade-off.

These results certainly reflect a greater level of sophistication among institutions, but they also illustrate just how much the risk assumptions of investors can cloud investment decisions even when individuals assume they are doing the right thing.

### Frame Risk in More Personal Terms

Financial professionals see risk as something that can be measured and quantified. We consider the standard deviation, correlation, and tracking error, but clients often see risk in more absolute terms: Will I lose my assets? The following are some ways advisors can help individual clients measure and quantify risk on their own personal terms:

- Meet clients where they are. Make goals, rather than returns, the focal point of investment discussions. Of course you'll need to explain the how and why of market volatility.
- Remind clients that portfolio decisions have been made with their risk tolerance in mind. Explain holdings in terms of their purpose in the portfolio: "We can expect this investment to be more volatile at times because it is a growth driver. To get exposure to the upside, we'll also be exposed to market downturns." Or conversely: "This investment was included with the goal of helping to mitigate risk. It may not have the highs of the overall market, but it also is less likely to have the lows."
- It's perhaps most important to recognize a client's personal definition of risk, then show how portfolio decisions fit with the client's goals.

“Remind clients that portfolio decisions have been made with their risk tolerance in mind. Explain holdings in terms of their purpose in the portfolio . . . ”

### Assumptions Expose Investors to Hidden Risks

We see how the tendency to rely on basic emotional assumptions comes into play with investor perceptions of passive investments. Our 2016 survey asked a series of questions about the benefits of index investments. Their responses indicated that three-quarters of investors in the United States understood that index investments offer market returns at a lower fee. But although investors could identify this basic advantage, they also assumed greater benefits than these strategies may offer.

Beyond being aware of the lower fees, about two-thirds of investors also believe that index funds are less risky (71 percent) and will help them to minimize losses (64 percent). It would appear that investors forget the basic physics of investing: Index

funds will deliver positive returns when markets are up, but they also will produce losses when markets are down. These misconceptions could be particularly costly for those who are unnerved by market volatility and predisposed to sell in down markets, a decision that could mean realizing significant losses.

We also found that 61 percent believe that passive investments offer access to the best investment opportunities. This is another misconception that could be costly. By their very nature, index funds offer every investment opportunity—the best along with the worst. Financial professionals realize that investors may not have all the facts about their index investments. In the United States, 75 percent of financial advisors believe that investors do not understand the risks associated with index investing. Globally, 77 percent of institutional investors say they believe investors have a false sense of security about passive investments.

### Low Price Doesn't Always Add Up to Good Value

Knowing that clients may have misconceptions about passive investments, it's important to help them understand where active and passive fit in their portfolio strategy.

- Start by explaining why you are willing to pay different fees for actively managed and passive strategies and outline your own expectations for each of their holdings. This is where having command of the numbers can be essential.
- Active share, which measures how an investment's holdings differ from a benchmark, is an important measure to determine if your active managers are delivering active management. Walking clients through the concept and the numbers on your managers can be a helpful validation of your strategy.
- With advisors and institutions expressing concern over closet benchmarkers—those managers that charge an active fee but deliver something much closer to

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## EXPECTATIONS, EMOTIONS...

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passive management—it's important to demonstrate that you are getting what you pay for.

### Removing the Blinders

Understanding investor behavior can be a critical step forward in helping individuals achieve positive investment outcomes. Advisors who recognize the factors that can help change counterproductive behaviors will help get clients closer to their goals. We find that 71 percent of investors believe professional advice is worth the fee, but they also have a clear view of what that advice should look like.

More than investment performance, investors want insight. In fact, U.S. investors rank learning more about their investments as the number-one step they can take toward better enabling themselves to achieve their long-term goals. In short, they want their advisors to help them make better-informed investment decisions. ●

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from 22 countries. Global Survey of Financial Advisors conducted by CoreData Research (July). Survey included 2,550 financial advisors in 15 countries. Global Survey of Institutional Investors conducted by CoreData Research in October and November. Survey included 500 institutional investors in 31 countries.

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