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Focus

Rational Investing Despite Irrational Behaviors

by Nancy Opiela
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Under the pressure of a Major League Baseball pennant race, Boston Red Sox pitcher Derek Lowe, who had until that point in the season delivered less-than-expected performance, told the Boston press to stop dissecting his every move and facial expression on the mound. Why did they have to portray him as an emotional wreck? Lowe wondered. Why couldn't they just say he was pitching poorly and leave him alone?

What Lowe may have realized in going on to become the winning pitcher in the deciding games in the wild card playoff, American League Championship Series, and World Series, a feat no pitcher ever has achieved, is that successful pitching has emotional and physical elements. And if there's a lesson in his experience for the rest of us, it's that success in any human endeavor, even investing, has emotional and rational pieces.

In recent years behavioral finance, a field that applies scientific research to our cognitive and emotional biases to better understand how we make financial decisions, has emerged from the shadows and into the limelight. In 2002, Daniel Kahneman, a psychology professor at Princeton University, won the Nobel Prize in economics for his work exploring the emotional biases that govern our financial decisions. And reflecting the fact that behavioral finance is front and center in many comprehensive financial planning practices, Kahneman spoke last fall at the Financial Planning Association's annual convention.

Sean Curley, CFP®, of Retirement Planning Specialists in Greenwood Village, Colorado, says the topic of behavioral finance comes up in almost every client meeting. "There's always an issue that illustrates how difficult it is to make good, rational investment decisions," he says. "A big part of what financial planners offer is standing by their clients and helping them control their emotional responses to the market."

Paula de Vos, CFP®, of Synergist Wealth Advisors LLC in Carmel, California, agrees. "Planners provide value by being more dispassionate and objective, helping clients control some of their prevalent instinctive behaviors that can harm investment performance. Discussing behavioral finance with clients leaves them more open to having personal discussions and making the changes they need to succeed."

Here, planners identify the most common behavioral patterns and issues that impair financial decision making and share strategies for helping clients temper their emotions and succeed in making rational investment decisions.

A Bunch of Cockeyed Optimists

Planners say that problem number one for many new clients is procrastination. And it often comes, they say, from a combination of (1) optimism that leads us to believe that no matter what we have to overcome, it will all work out okay in the end, (2) overconfidence in our own abilities, and (3) information overload.

Susan Zimmerman, ChFC, CLU, of Zimmerman Financial Group in Apple Valley, Minnesota, says the first step in motivating these clients to take meaningful action in their financial lives is to not overload them with new information. "These clients already have too much information to manage, so planners need to choose carefully what information to share," she notes.

To determine what information will be most useful to a new client, Zimmerman conducts a brief money personality or style assessment. "It's a half-hour exercise, but it gives me useful insight into how clients make financial decisions and how they view money," she says.

In all her educational efforts, Zimmerman carefully monitors what her clients understand. "I try to ask open-ended questions when I'm explaining something," she says. "I don't want bobble-heads nodding in agreement without understanding a concept. I might ask a client, "What part of what I'm saying makes sense?" or ask them to explain to me what I've just conveyed. I'm careful not to create a threatening, pop-quiz environment, but rather a casual give-and-take to ascertain their understanding."

Zimmerman stresses that it's important to understand the root of a client's inability to move forward. "Sometimes it is simply a busy lifestyle that prevents them from managing their finances. Another possibility is flat-out avoidance—and that's different problem," she says.

Steven Shagrin, J.D., CFP®, of Planning For Life in Youngstown, Ohio, has observed that conflicting views of money between life partners often lead to inaction or dissatisfaction in the personal finance arena. He explains, "I remember working with a couple about to inherit a substantial sum from the husband's paternal grandfather. The results of my assessments of their current level of financial well-being and satisfaction showed them to be far apart in several key areas. So, we worked in a number of sessions to bring a higher level of recognition and awareness of the issues driving their behavior. It was especially helpful talking about money messages from their past that were directing their present financial behaviors."

While clients' financial decision making certainly can be impaired by their own upbringing, the media also plays a role in creating an unhealthy decision-making environment. Says de Vos, "The media has magazines to sell, so they appeal to emotional hot buttons in order to attract readers and boost sales. Clients need to understand this is what happens and how it perpetuates looking at finances in an emotional way."

Bob Foland, CFP®, of the IRA Specialists in Englewood, Colorado, says he reads the personal finance magazines his clients might read so he's aware of the messages they are being bombarded with. "I am confident that there is an inherent conflict of interest in all media—the pull of selling newspapers works against the pull of accurate reporting," he says. "That is, the market was not as good as it was reported in the late 1990s, nor as bad as it was reported in the early 2000s. My job is to temper the impact of the financial press on my clients' thinking."

Foland says softening the extremes on either side for his clients and drawing parallels between the financial world and issues they understand helps clients make more rational decisions. "I have a lot of engineers for clients—so I'l find some article in the newspaper that relates to their experience. When I share my understanding of the issue, often their response is, "That's what the news says, but I see it differently." It's an easy transition from there to point out how a magazine may portray an investment in a very positive light, but on further review it's not what it seems."

Planners also note that in a corporate setting, this problematic optimism can translate into what is known in the field of behavioral finance as the herd mentality. In this case, executives of a company look at their prospects through rose-colored glasses and are certain in their positive assessment because the entire group feels the same way.

William B. Burns, Jr., CFP®, CLU, ChFC, of Burns Matteson Capital Management in Corning, New York, works with employees and retired employees of Corning Incorporated. Although Corning's share price has declined from an all-time high of $113 in 2000 to its current level of approximately $10 a share, many of Burns' clients cling to their large amounts of Corning stock. "They feel that the normal rules of diversification and risk management do not apply to Corning stock because they believe they have a better feel for the prospects of the company than do research analysts," explains Burns.

"We have met many potential prospects who have one-third to two-thirds of their net worth tied up in Corning stock. Twelve months ago, one of these prospects told me that because Corning has many good products in the pipeline, he was comfortable with two-thirds of his money in Corning stock. Our firm was recommending a

diversified portfolio of other stocks, bonds, and real estate investments, and the prospect wanted to move even more money into Corning. As a result, we told the prospect that we didn't think our firm would be a good fit for him, and we decided to part ways. Twelve months later, the share price of Corning has gone nowhere, but after Corning's annual stockholder meeting, this prospect was quoted as saying he felt Corning would be at $20 by the end of the year. What is most comical about this is that other prospects or clients of ours have since referred to his quote, saying they heard that Corning should be $20 by the end of the year."

How does Burns nudge executives away from their emotionally charged over-concentration in Corning stock? He begins by asking, "At what point would you be willing to sell your stock?" and then proceeds with an analysis of Corning's historical price.

Says Burns: "For most of the 1990s, Corning traded between $30 and $36 a share. We remind people that since the three-for-one split, $30 or so dollars in the late 1990s is equivalent to $10 to $12 dollars a share now. I use a very helpful Web site, www.bigcharts.com, to graph Corning's 30-year history of spilt-adjusted returns. If a client says, "I'll sell when the stock gets to $30," I can show them that Corning has only been above $30 for about 13 months over that period and that occurred during the technology bubble. When clients see that, they begin to understand that their goal may be unreasonable, especially when the majority of Corning's returns have been less than $15 a share."

If Burns cannot convince a client to reduce his or her exposure to Corning, he presents a planned selling strategy using publicly traded call options. "The call options not only provide income for the investor's portfolio—which is a plus because Corning doesn't issue dividends—they also provide a predetermined exit strategy," he says. "The client selects a price in the future when we will sell Corning. If we select $15 for the call option, we are locked into selling at that price. Because we're obligated to sell, we're gaining control of those behavioral issues that keep clients hanging onto the stock. Without a call option, if a client says to sell at $15 and the stock closes at $14.75 on Friday afternoon, I get e-mails over the weekend saying, 'You know, maybe $15 is too low. Let' try for $20.' Call options force you to pick a price and don't give you the opportunity to change your mind."

Aaron Newland, CFP®, of Marina Advisor Group LLC in Long Beach, California, also sees the need to help his clients who work for public companies to escape the "closed corporate systems." He says, "When I ask clients what they think of the company they work for, rarely will I hear that it's terrible. And because clients often socialize with the people they work with, the group's thinking is very closed. It's my job as an advisor from outside that group to present the third-party perspective."

To convince executives with an over-concentration of company stock to sell, Newland discuses the risk to their family if they continue to hold the stock. "I'll begin the conversation with something along the lines of 'I'm guessing your family comes before your job. They are the reason you work so hard.' I then say the company's intent is not to protect the client and his or her family, but to grow over time. When clients understand the difference between their goals and the company's goals, they are more open to making changes."

Adds Newland, "Whether clients make the move to diversify is often based on the depth of the relationship. Planners need to build trust by offering valuable advice, not by our definition but from our clients' perspective. Clients need to see the advice we offer as something that isn't readily available elsewhere."

Finally, Newland says he tries to keep the first meeting positive, hoping to tap into the very optimism that can result in decision-making errors. "I tell clients, 'You're here because there's something nagging in the back of your head that you are not sure you're managing your money in the best way possible. You're here and that's a great start, so let's get to work.' "

From Isolation to the Big Picture

For Marc Thomas, CFP®, of Lesjak Planning Corporation in Westlake, Ohio, clients' harmful practice of viewing investment decisions and accounts in isolation manifests itself with questions like "Why is this fund not up as much as that fund?" or "The market has not done well the past month—what should we do?" In his opinion, viewing investment decisions in isolation may have the greatest negative impact on clients reaching their goals.

"When clients become fixated on one particular investment's underperformance, it's crucial to help them step back and view their investments as a whole with a long-term perspective," he explains. "We spend a lot of time

educating clients how funds with different objectives move on separate cycles."

Thomas also notes clients' harmful practice of thinking of their investments in separate buckets. "Clients may take one approach with their 401(k) assets and another approach with their retirement money or the college money. We help them understand the value in constructing one big picture and building an appropriately diversified portfolio."

Greg Friedman, CFP®, of Friedman & Associates in Novato, California, spends a lot of time on the value of diversification and maintaining a long-term perspective in order to get clients to buy into the big-picture approach to financial planning. "We go step-by-step through our belief system of global diversification. At all opportunities, we enforce the wisdom of a diversified portfolio. I can see it's working because newer clients are the ones who are market driven and talking about what their friends are doing," he says.

Friedman also notes that it's important to reinforce the diversification message in different ways. "We don't want clients to feel like they are getting hit again and again with the same thing. We stress the message in letters, phone calls, and meetings. Even our own reporting stresses long-term results."

Friedman points out that some planners' quarterly market update letters actually feed clients' natural inclination to think in the short term and not maintain a long-term perspective. "Our market letters talk about historical performance and try to highlight areas where rewards have come through diversification," he notes.

Robin Kessler, CFP®, and Eyal "Alan" Galinksy, ChFC, are partners at Arch Financial Group LLC in Boca Raton, Florida. They see clients' inclination to view portfolio decisions in isolation reflected in the fact that few new clients have compared their investment performance to an appropriate benchmark.

"We tell our clients they cannot look at their portfolio's rate of return as an isolated number. We have to establish a relevant measure, their individual benchmark," says Kessler.

Galinksy adds that another factor affecting performance that many clients overlook is taxes. "I can't emphasize enough it's not what you make, but what you keep," he says.

Kessler and Galinsky advocate a kind of Finance 101 as a foundation for getting clients to see the big picture. Explains Galinksy, "We go back to the basics. We discuss what a stock is and what a bond is and what your objectives are when owning such vehicles. Planners describe their new clients as so emotional, but we need to realize that's because they don't have the basic investment knowledge that enables them to make rational financial decisions."

Aaron Klopfenstein, of Ronald Blue & Co. in Indianapolis, Indiana, offers an additional strategy to help clients frame their investment decisions in a broader context. "I help clients see their portfolio, and its return, in the context of both their comprehensive financial plan and stock market history," he explains. "This helps them adopt a more well-rounded investment perspective that is less prone to mental accounting and a short-term mindset. For example, I review their statement of net worth with them annually. This helps them see their investment portfolio not as an isolated account, but rather one asset among many, including cash, real estate, and other investments that are not always correlated to the stock market. Thus, despite a decline in their investment account, the client's net worth may well have increased. This is critically important to communicate to a client if you want them to adopt a broad mindset."

Klopfenstein also uses an illustration he recently developed that shows, in the form of a bar graph, the annual performance of the S&P 500 Index and the Nasdaq Composite, which over the periods 2000–2002 was –9 percent, –12 percent, and –22 percent for the S&P 500, and –39 percent, –21 percent, and –32 percent for the Nasdaq. He then contrasts this performance with his client's portfolio return over the same period. "The performance for their broadly diversified portfolios was considerably more favorable," he reports. "While not an apples-to-apples comparison (100 percent equity versus broadly diversified, including multiple asset classes), this illustration has helped my clients understand that their portfolio was spared from the dramatic declines in the broad stock market. By putting their return in perspective, in relative terms rather than in absolute returns, I've helped my clients realize that they did not experience much of the dramatic market declines that they were hearing in the media."

Losses Loom Larger Than Gains

Because losses always hurt psychologoically more than gains, many clients choose investments such as certificates of deposit that appear safe, but may actually be losing money when inflation is factored in. This loss aversion is also at the root of the harmful practice of hanging onto stocks that have been hammered by the market.

Kessler says many clients have a false sense of security while holding CDs and long-term bonds. "Many clients who need to live on the income from their investments often request very secure bond holdings, which will not provide sufficient income for them to live without invading principal at some point," she says. "Many own long-term bonds and they don't understand how the rate of return fluctuates with the market price. We spend a lot of time explaining why we have been using short durations and lower quality bonds."

David Shore, ChFC, CLU, of Marin Financial Advisors in Larkspur, California, deals with many clients who are "anchored to their prior decisions," unable to sell fallen angels such as Sun Microsystems. He often begins his discussion on the merits of selling with this question: "If you inherited $100,000, would you invest that in Sun Microsystems today? And if not, why not?"

If that doesn't work, and because "clients" eyes tend to glaze over when discussing money," Shore often tries to take the spotlight off their finances and just talk about decision making. "I ask clients if they have an example in their life where they didn't think they could make a decision to change something and they did. Maybe they changed jobs, moved, or ended a relationship or marriage. I'll ask them to tell me about their thought process in that situation and then I make the connection with money. Of course, planners can't play too much psychiatrist or be too much of a parent. It's better if clients simply see their situation more clearly and conclude what a better move would be," he explains.

Finally, because losses hurt emotionally more than comparable gains, it is, Sean Curley says, imperative to discuss how bad things can get. "Clients need to know what might happen so they don't jump out of the market at the wrong time. You hear that 95 percent of your return is asset allocation, but I believe 95 percent of your return depends on your behavior."

We Want to Keep It Simple

Planners' complaints in the simplification category are universal: investors are shortsighted. They care only about recent performance and can't keep a long-term perspective. All this may be traceable to behavioral issues that tempt us to identify patterns in random events, such as stock price movements, and take mental shortcuts when faced with complex issues. Because we prefer things that are predictable and familiar, we often analyze new information improperly and make wrong decisions.

Shore says planners need to work hard to ensure clients don't over-simplify. "Like all of us, clients want to believe they have some special insight into the market, but it's not that simple. By the time they get the information they want to act on, it's already been assimilated into the market. What clients need to understand about the market is that something is always hot and that it's easy to see what's performing well at the moment. It's just like when you go into a casino: it's easy to see who has just won the jackpot. But you wouldn't give your money to that gambler and say, "Here you go, I know you'll continue to be lucky." You'd probably opt to get the odds in your favor by making lots of little bets. It's the same way with a diversified portfolio. That approach gives us the best odds of success."

Planners say sometimes a client's desire for simplification results in expecting that the planner is capable of waving a magic wand and fixing all their financial woes. Ben Lipschitz, CFP®, CHFC, CLU, of Elite Financial Solutions in New York City, says the desire for a quick fix is illustrated in his new clients' unwillingness to identify their current spending habits.

Lipschitz says, "People want me to meet with them for an hour and say, 'I see 14 percent of your income goes here. Make this change, and you'll be on the right track.' They don't want to do the work of accounting for where their money goes. We ask them to bring in their bank statements and credit card statements and get them started. We set up some spreadsheets, but we also ask that they carry a memo pad for four months and mark

down every dime they spend. There is no quick fix without accurate information."

Klopfenstein adds that he sees clients exhibit *hindsight bias*, which is the perspective that events that happen should have been predictable and events that didn't happen should have been viewed as unlikely all along. "Hindsight bias suggests that recent financial history, specifically the movement of the investment markets, is more predictable than it really is. This makes it hard to distinguish between good and bad decisions," he says.

To overcome this tendency, Klopfenstein encourages clients to make decisions based on principle, set forth in an investment policy statement, so that they can look back and, no matter what unpredictable events have transpired, say, "Knowing what I knew at the time, it was still the wisest decision I could have made."

Finally, Curley capitalizes on clients' desire for simplification by offering them the "really short version" of his investment philosophy:
1. Behavior, not performance
2. Reason, not emotion
3. Markets, not managers
4. Decades, not years
5. Signal, not noise

Fear and Greed Rule

Try as they might to educate clients away from harmful, emotional decisions, planners know that they will not change 100 percent of bad behavior. Sales of lottery tickets will always spike as the jackpot rises, even though the likelihood of winning diminishes.

In their quest to help clients, however, it's important for planners to remember that they, too, run the risk of having their emotions intrude on investment decisions. In fact, some planners structure their practices to control their own emotional responses to the market.

For example, as Alan Galinsky says, "Because our firm's investment decisions, such as whether to invest in a fund, are made as a team, we have a checks-and-balances system. I need to justify why I want to hold a particular investment."

Kessler adds that the firm's use of model portfolios also helps control planners' impulses. "When we make a move in or out of a stock, it affects more than just one portfolio," she says. "The fact that these decisions cut across many portfolios forces us to consider our decision more thoroughly. You need to have more confidence in decisions you make that affect a great number of people."

In summary, from a client's and planner's perspective, the study of behavioral finance is the logical companion to comprehensive financial planning. If you spend the time to develop goals and investment plans, why not give your clients their best chance of success?

"Most often, clients come to our door knowing that there is value in an objective viewpoint," says Paula de Vos. "Most are open to understanding how their emotions intrude on their ability to be objective. Many advisors focus on investment returns, but that's not where we add the most value. As we focus on managing expenses and overall costs, what we learn from the field of behavioral finance allows us to improve decision making—and that can have a positive impact on the client's bottom line without adding risk."

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