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Wealth Management Psych Out

Behavioral finance has moved from theory to practice, informing tools and techniques for connecting with wealthy clients.

By Donna Mitchell
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Behavioral finance can no longer be considered a fringe idea, a burgeoning concept, a field that is gaining traction among financial advisors. It is a full-fledged discipline that offers tools serious wealth management firms are using to understand and serve high-net-worth clients. For instance, Commonwealth Financial Network, the Waltham, Mass.-based independent broker-dealer, is using behavioral finance techniques to help advisors work out solutions on a range of issues, such as long-term care, for their wealthy clients. Even large international banks like ING are using behavioral finance concepts to build resources that investors and advisors can use to avert bad money management decisions. If you want to be a valuable resource for your clients, you need to be conversant with these state-of-the-art tools.

J. Richard Joyner, a managing director at Tolleson Wealth Management, a multifamily office in Dallas, is one of a growing number of financial planning professionals who have gone out of their way to build behavioral finance concepts into their business models. Tolleson Wealth Management serves 90 families whose individual net worth averages roughly $50 million. Joyner started using behavioral finance in his practice after attending a series of conference presentations on the subject; he then realized that Tolleson's approach was out of alignment with those principles.

Joyner often advised his clients about their money from an analytical standpoint. He started to educate himself, reading well-known behavioral finance books and incorporating some of their ideas into training for the staff. In one session last August, for example, Tolleson asked an advisor to convince a client to curb extravagant spending. (A facilitator took the client's role.) About 20 staffers attended. They learned to use a framing technique-showing them the future results of their decisions-to get clients to make better choices.

One of Joyner's reads, Your Money & Your Brain by Jason Zweig, explains the neuroscience of investing and why people often make horrible mistakes with money-it's physical. Joyner recalls one chapter about prediction, in which Zweig explained that individuals often see patterns that do not actually exist. The human brain, developed to survive in the wild, needs to be able to interpret signs quickly-and sometimes does so too quickly for accuracy when it comes to random, complex market activity. The human proclivity for recognizing (or creating) patterns leads investors to believe that, after three or four days of positive stock market returns, they're

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witnessing a new bull market. Joyner says that he didn't need to sharpen his technical expertise on financial products to become more effective as a financial planner. He did need to improve how well he understood his clients' biases and decision-making patterns, however.

lients tend to get emotionally invested in specific stock decisions. When a stock is down, for example, they try to conjure up ideal situations by saying things like "If only that stock would double, then I can offset my losses," Joyner observes. Theirs is wishful thinking, of course, and Joyner responds by asking clients a series of questions meant to dissuade them from making potentially bad decisions. "I say, 'Help me understand what is particularly fearsome to you,' or 'What are you scared of?'" Joyner says. He can usually get clients to breathe deep, calm down and take a step back from the issue.

Clients are not the only ones who may approach money management situations with the wrong perspective. Many advisors are so focused on investment management and products, Joyner complains, that they completely overlook how the client feels. Advisors tend to become overly invested in their recommendations, especially if they devoted a lot of time to preparing a stock or bond analysis. The project becomes about them. "They lose sight of the fact that it is not about them," Joyner says. "What is right for the client is the only important question."

He cites a chapter on happiness at the end of Zweig's book in which the author says that possessions have the least permanent impact on an individual's happiness. Experiences are far more powerful. "I certainly see people with more of a bent toward simplifying their lives," Joyner says. "For wealthy clients, it means they are not trying to create seven different entities to squeeze every bit of tax savings out of everything they have."

None of this means that your rich clients will swear off money and go live off the grid in the Mojave. But their emotions are close to the surface, making behavioral sophistication more important now. Sorting through a client's biases and emotions and might seem antithetical for this industry, but not when you consider that financial planning is a people-driven business. What's more, in a 2009 Gallup study of 10 companies over a one-year period, those that used behavioral economics principles outperformed peers by 85% in sales growth and more than 25% in gross margins. Customers who have a strong emotional connection will give a firm 23% more business, in terms of share of wallet, profitability, revenue and relationship growth when compared with the average customer.

Irrational, but Not Exuberant

The primary lesson in behavioral finance is that clients are not rational. Of course, any independent advisor who has been around clients longer than a nanosecond knows this. In recent research on 401(k) plan participants, for example, David Laibson, the Robert J. Goldman Professor of Economics at Harvard University, found that neither education nor incentives consistently changed investor's behavior for the better. So advisors might as well come to terms with clients' emotions.

Loss aversion is a great place to start; it is one of behavioral finance's bedrock ideas. The Importance of Losses Versus the Significance of Gains, the classic heuristic experiment in

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behavioral finance, illuminates the concept. The subject is offered a choice: pocketing $50, or flipping a coin either to win $100 or get nothing. Chances are, the person will take the $50. Next, the subject is offered a second choice: paying $50, or flipping a coin either to lose $100 or lose nothing. In this case, the person will choose the coin toss. The lesson: Clients will take more risk to avoid loss than to capture a potential gain. This area of investigation, called loss aversion or prospect theory, won Daniel Kahneman the Nobel Prize in economics in 2002.

Today, many of your wealthy clients are dealing with acute cases of loss aversion. From the second quarter of 2007 to about mid-August 2010, American households lost $11.7 trillion in net worth, according to the Federal Reserve. It's no wonder that today's weakening economic reports have triggered all kinds of questions in the minds of high-net-worth clients. Will the stock market ever get out of the doldrums? Are we going to borrow our way into total economic collapse?

The doomsday scenarios are not likely ever to materialize, but it is hard to convince some wealthy clients otherwise. In May, Capgemini Financial Services in New York City released the World Wealth Report 2010, its annual global study, with Merrill Lynch, of the investing habits of high-net-worth clients. Capgemini found that 31% of assets were held in fixed income, up from 20% a year before.

This means that wealthy investors are keeping chunks of their investable assets off the table, sometimes investing as little as 30% of their portfolios in stocks, says Ileana van der Linde, principal of Capgemini. Despite the best efforts of bankers and advisors to talk them into opportunities that might actually work for them, clients are not taking chances. "Clients are saying, 'Screw the opportunity,'" van der Linde says. "'You can talk to me all you want about how I'm missing an opportunity. I don't care.'"

Three Types of Adopters

In the 2010 report, Capgemini acknowledges the mainstreaming of behavioral finance. Many wealth management firms, regardless of size or channel, have started incorporating behavioral finance principles into their service delivery, including JP Morgan, Merrill Lynch and Chicago-based Northern Trust.

Over time, brokerage firms and banks will adopt behavioral finance in three different ways, according to Capgemini. "Breakthrough visionaries/true believers" will embrace behavioral finance fully and optimize its principles in their business models. "Tactical movers" will make limited adjustments, such as revamping their risk profiling methods while using standard asset-allocation techniques. Other firms will stick with tried- and-true methods of serving their clients, preferring to build customized products and services to specific client needs and goals. The general trend, however has competitive implications for every practice.

About five years ago, Commonwealth Financial in Waltham, Mass., began infusing its advisor resources with behavioral finance principles. "We were finding the place where advisors struggle the most is really around client behavior," says Kol Birke, Commonwealth's financial behavior

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specialist. "So we wanted to arm them with the tools they need to be really, really good at what they do."

Wealthy clients cannot turn to just anyone to discuss money-related issues. They have to be discreet about their family affairs, and sometimes not even friends and other family members will do. Financial planners end up being the confidante about anything that has to do with money, Birke says. Estate planning is particularly fraught. Wealthy clients want to provide for their sons and daughters but don't want to demotivate them by giving them too much money. That is more prevalent issue these days.

A lot of the tools Birke recommends center around decision theory, a line of thinking that often runs parallel to behavioral. Advisors have access to conversation guides. These are not scripts, but they tell advisors how to guide clients through a conversation and unlock issues that might paralyze them.

Advisors can also use worksheets to deepen their understanding of a client's risk tolerance and provide investment parameters. A couple of suggested conversation cues: "Tell me about a good financial decision you made. What led you into that?" Or, "Tell me about one you regret. What would you do differently next time?" "If you have been stressed out about losing money in the past, what did you do to get through that stress?" Armed with the clients' responses, the advisor can help client build resilience and weather financial storms, Birke says.

"Advisors who are successful at this-who prepare well and prepare their clients well-really frame investment conversations differently than the ones who struggle," Birke says. They get clients to affix a photo-quality vision in their minds of the life they want. Conversations are centered on goals, and how the client feels about reaching them. Investment and other product decisions are secondary.

Long-term-care insurance is one area where advisors need to become better listeners, says Birke. Commonwealth's wealth management group developed a four-step process to help advisors guide clients to the right products. First, the advisor has to help clients figure out what they want to do. Next, the advisor has to make sure that they understand completely where they stand. Then the advisor makes sure that the clients feel like their advisor understands them.

Advisors keep clients engaged by asking, "Do you feel like I understand where you are with this?" It is a simple but critical step, Birke says, because wealthy clients are often more aware of the choices available to them. They want to be part of the winnowing process, and the advisor has to ensure that clients are confident that they have a say. Once that critical third step is locked in-but not before-then the advisor can proceed to step four and say: "Would it be helpful if I present some options?"

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Understanding Risk

Advisors and clients alike are thinking much more carefully about risk these days. Behavioral techniques often come into play when advisors need to get wealthy clients to understand how risk really works. What often happens is that investors will complete a risk profile assessment, but stray from it when the financial markets become volatile.

Investors might believe that they are investing stalwarts and their risk profile might even indicate that they are capable of taking on highly aggressive positions. When the stock market plummets, however, they lose their nerve and order their financial advisor to sell everything. It works the other way for conservative investors too-usually, sadly, when the market is near a top.

ING Investment Management, based in New York City, developed a guide to help investors understand their true behavioral biases and what they should consider discussing with their advisors to ensure that they make more rational decisions. The guide, What Kind of Investor Are You? Managing Market Volatility, sorts investors into four general types based on behavioral finance principles: the snake-bite effect, recency bias, mental accounting and overconfidence. Instead of functioning as another risk assessment, the guide attempts to identify the exact point where investors abandon logic in their investment decisions, says Joe Hart, national sales manager for ING Investment Management.

For instance, ING used the September 2008 mortgage market meltdown, when the government struggled to resolve the subprime crisis, as a backdrop to demonstrate recency bias in a hypothetical client named Janice. She saw the collapse and takeover of many industry-leading corporations as a signal of a continuing crisis, and asked her financial advisor to liquidate any holdings that exposed her to the financial services industry. Janice feels there is money to be made elsewhere, and is looking to make up her losses in asset classes that have performed well. The guide suggests that Janice-and investors like her-discuss investment options that fit her short- and long-term goals, look for investments that will allow for greater diversification. It also suggests she understand that planning is more important than timing.

These techniques have helped advisors at ING Investments reach high-net-worth clients, Hart claims. "By highlighting some of those behaviors, it has allowed investors to say, 'How do I avoid that?'" Hart says. "Advisors are having better and more meaningful conversations with clients. They can get to the root of poor decision-making and reduce the impact."

Another major financial institution, Allianz Global Investors, is using behavioral finance as a business tool. AGI launched the Center for Behavioral Finance and named Shlomo Benartzi as its chief behavioral economist. Benartzi co-chairs the behavioral decision-making group at the UCLA Anderson School of Business, and is one of the leading thinkers in this field. The goal of the partnership is to use the loss aversion, mental accounting and inertia concepts to build resources that defined contribution participants can use, as well as wealth management experts.

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The Art of Framing

Framing is one of the most applicable and widely used concepts in behavioral finance. The beauty of framing is that, properly used, it can build communication and trust between the client and the advisor.

One popular approach to framing is to benchmark clients' investment performance against their goals, rather than against stock market returns, says Harold Evensky, chair of Evensky & Katz in Coral Springs, Fla. In fact, Evensky's firm waits about 12 months after engaging a client to discuss portfolio performance. At that meeting, the company compares the client's performance to the inflation rate in order to calculate a real rate of return.

Financial DNA Resources, an Atlanta-based company, provides advisors with a popular toolkit to help them communicate in better ways with their clients. Hugh Massie, president of Financial DNA Resources and a former financial advisor for wealthy families and entrepreneurs, developed the program after someone asked him what he was passionate about. "I decided I was passionate about the human side of wealth management," Massie says.

There are four components to the system, beginning with a Communication DNA report, which assesses the client's primary communication style. The client's answers are used to measure how receptive he or she is to four communication styles. The goal-setting focus style calls for the advisor to talk about the client's life's vision. Conversations about a product should be framed in terms of how the product will help the client achieve goals. This client is not likely to be interested in chitchat about home and family until the objective of the meeting has been met.

Another style is called stability need. With these clients, do start the conversation by asking about the house and the dog, because clients who fall into in this area prioritize these concerns. Massie recalls one instance when an advisor called a client to give her an update on her portfolio. Her stocks were up about 20%, but she cut him off. She explained that she wasn't interested in a portfolio performance update because her 16-year-old daughter was floundering at school. The family needed to figure out a different educational situation for her, so the pat on the back would have to wait.

Clients with the third orientation, lifestyle desired, value a fun, lighthearted experience-they'll prefer to talk about a vacation, for instance, before a prospectus. It is best to avoid launching into details. "They'll think you're competent, but not emotionally engaged," Massie says.

Clients driven by the fourth style, information-need, can handle those heavy details. If you want to gain their trust, answer their 65 questions from the prospectus, and give them time to leave the meeting, reflect and follow up with you later.

Here is something else that builds trust-do the Communication DNA questionnaire (it is a quick assessment that generates results in under a minute) and share the results with the client. Being open and a bit vulnerable with the client does a lot to strengthen the bond between the advisor and client, Massie says. "We're trying to give advisors a much better chance of understanding the

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client quickly so that they build an unbreakable trust," Massie says. "If you can ask your clients one powerful question a year, you will never lose them."

The Tight Bond

Rick Helbing advises a lot of wealthy dentists and physicians as a principal at Suncoast Advisory Group in Sarasota, Fla. Even medical professionals are worried about the impact that the recession could have on their practices, especially if patients start to skip routine cleanings or physicals to save money, Helbing says. They are looking for their advisors to be proactive and communicative across the board.

Helbing says the Communication DNA questionnaire lets clients know right away that he and his staff are using a reliable process to set their financial agenda. "It assists me so much in understanding my clients, and how I can avoid making errors of presentation with them when we are discussing their situation," he says.

Some clients have broken down and cried about their situations in his office. Once, Helbing says, a dentist talked about how overworked he was at his practice, and that he wanted to scale back his schedule to spend more time with his six-year-old daughter. Success was not sweet-it was devouring his priorities. "He was just overworked and it was driving him nuts," Helbing says. "I was already deep into his psyche, so we were able to put together a plan" to scale back his practice and remain on financially sound footing.

That deft touch with clients will go a long way toward sustaining a financial planning practice. Today, stock trading and selection, and other mechanics of money management have become commoditized. Where you land in Capgemini's three-band spectrum of adopters may well determine whether your practice keeps pace with the changes in the industry or falls behind.

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*To view the article on the Financial Planning website, as featured in the September 2010 edition of Financial Planning magazine, click here.

BEHAVIORAL FINANCE RESOURCES

The field of behavioral finance has produced a canon of influential academic papers and popular books ever since Richard Thaler, Daniel Kahneman and Amos Tversky launched the subject at Stanford University 30 years ago. Here are a few to help get you started:

* Behavioral Finance, by Joachim Goldberg and Rudiger von Nitzsch

* Beyond Fear and Greed, by Hersh Shefrin

* Inside the Investorâ€™s Brain, by Richard L. Peterson

* The New Financial Advisor: Strategies for Successful Family Wealth Management, by Scott Budge

* The Winnerâ€™s Curse: Paradoxes and Anomalies of Economic Life, by Richard H. Thaler

* Your Money and Your Brain, by Jason Zweig

WEBSITES

* Financial DNA

http://www.financialdna.com

* National Bureau of Economic Research/Working Group on Behavioral Economics

http://www.nber.org/workinggroups/papers/BE.html

* Yale School of Management/International Center for Finance

http://icf.som.yale.edu/research/behav_finance.shtml

* Institute of Behavioral Finance

http://www.journalofbehavioralfinance.org

* Academy of Behavioral Finance and Economics

http://www.aobf.org/

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