

INVESTMENTS & WEALTH MONITOR

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The Behavioral Wealth Advisor

By C. Thomas Howard, PhD, and Lambert Bunker



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As volatility returns to normal levels and questions abound about the duration of the current bull market, many financial advisors are focused on client behavioral coaching, hoping to prevent panicky sell-off requests that can destroy long-term wealth.

From 2007 to 2012, investors withdrew an estimated \$620 billion from U.S. equity mutual funds.¹ Estimated losses in the stock market alone in 2008 totaled \$6.9 trillion (Merle 2009) and many investors stayed on the sidelines for years, missing the opportunity to recover their wealth.

On the other end of the spectrum, the massive push of low-cost investment solutions combined with the long bull market has led many investors to view investing as a commodity. For many, it's considered as easy and as simple as buying the lowest-cost investment.

In response, an increasing number of advisors are beginning to provide

planning and behavioral coaching as part of their services. At the same time, there is an emerging category of behavioral wealth advisors who go beyond simple reactive coaching.

A behavioral wealth advisor (BWA) takes a holistic and proactive approach to wealth management, creating a behavioral discipline throughout the client service model that is designed to increase the client's confidence and minimize behavioral biases. Making the changes outlined here will result in better client relationships and improved client retention. Having an explicit behavioral positioning will differentiate your practice and help to attract and acquire higher-net-worth clients.

DIFFERENTIATION AS A BEHAVIORAL WEALTH ADVISOR

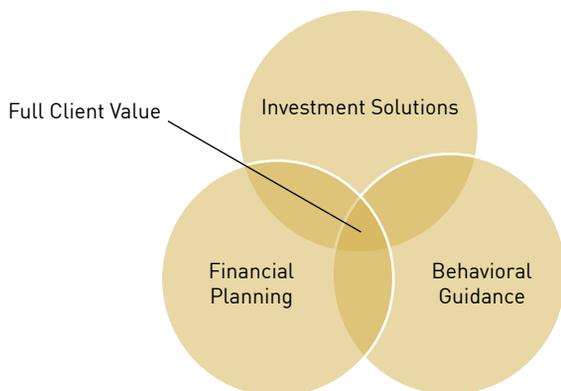
As the wealth management industry evolves to accommodate changing investor demands, a host of new players are now available to service them. The robo-advisor, for example, offers

financial solutions through full automation with lower costs, putting pressure on advisors to justify their fees. The BWA, in contrast, addresses the client's comprehensive financial needs, providing more custom planning and behavioral guidance. Research by Vanguard (2016), Russell Investments (2017), and others has quantified the value of behavioral guidance in terms of investor returns, estimating that it accounts for between one-third to one-half of annual returns. This research is helping to educate advisors about their potential full value, which can be realized only when combining investment solutions, financial planning, and behavioral guidance, as illustrated in figure 1.

BEHAVIORAL FINANCE AND BEHAVIORAL BIASES

Behavioral finance is the application of psychology to financial behavior and the subsequent effect on markets. It continues to increase in relevance for the financial services industry, fueled by research published over the years by Daniel Kahneman and Amos Tversky and featured in the book *Thinking, Fast and Slow* (Kahneman 2011). Their research reveals the "repeated patterns of irrationality, inconsistency, and incompetence in the ways human beings arrive at decisions and choices when faced with uncertainty." As the sole survivor after the completion of their research, Kahneman was awarded the Nobel Memorial Prize in Economic Sciences in 2002. Further validation of behavioral finance principles occurred with additional Nobel Prizes awarded to Robert Schiller in 2013 and Richard Thaler in 2017.

Figure 1 AN ADVISOR'S FULL POTENTIAL VALUE



Kahneman (2011) strongly suggests that investors often make decisions based on their emotions rather than on logic and historical data, even with the data right in front of them. Evidently the conditioning around money that we are raised with or experience as adults evolves into hardwiring in our brains. Trigger events can produce common emotional reactions that are called cognitive behavioral errors and biases. A few of the common biases you'll encounter are described below.

- **Loss aversion:** Feeling twice as bad about a loss as we feel good about an equivalent gain.
- **Herding:** The tendency to conform to group behavior, following the crowd.
- **Recency effect:** Overemphasizing recent experiences when making a decision.
- **Availability bias:** Overweighting information that comes most easily to mind or is readily available.
- **Heuristics:** Cognitive shortcuts or rules of thumb that simplify decision-making.
- **Overconfidence:** When confidence in one's own judgment is greater than the objective accuracy of that judgment.

These mistakes can be expensive, but investors who work with a BWA have a much better chance of avoiding them.

KEY FUNDAMENTAL INVESTING PRINCIPLES

To set the stage for a client experience aimed at managing behavioral biases, we put forth a set of fundamental investment principles that we consider to be pillars of a behavioral wealth management practice.

REFRAMING RISK BEYOND VOLATILITY

One core principle is recognizing short-term volatility in the stock market for what it is, the emotions of buyers and sellers. Volatility is a natural phenomenon of a marketplace and it is the price one pays for the return premium of equities.

We do not view volatility as risk, despite the industry's practice of over-emphasizing volatility as a risk measure (e.g., risk tolerance, drawdown, standard deviation, tracking error). A long-term equity investor can learn to expect short-term movements in the equity markets and ignore them, much as they would the turbulence on an airplane flight. Just as they would focus on the destination of that flight, investors should focus on long-term returns and goals.

We consider the most common and most critical type of risk to be portfolio under-performance risk, which most often translates to the opportunity cost of not having adequate exposure to equities. Looking historically, that opportunity cost is significant. For example, the retiree who has been overly conservative in equity holdings faces the potential of running out of money, instead of enjoying long-term equity returns.

As shown in figure 2, over the 30 years ending December 31, 2017, stocks (the S&P 500) returned 10.6 percent versus 6.4 percent for bonds (10-year U.S. Treasury notes) and 3.1 percent for cash (three-month U.S. Treasury bills). The differences in returns are significant. In dollars, the differences are even more pronounced. Over the 30 years, \$10,000

in cash netted \$24,728, bonds provided \$65,123, and stocks earned \$205,557. Avoiding stocks due to volatility means settling for much lower returns.

We also acknowledge individual single stock risk (poor fundamentals) and foundational risk (an extremely unlikely event of complete market or economic failure) are potential real risks.

ACTIVE EQUITIES FOR WEALTH CREATION

Understanding the importance of equities in the creation of long-term wealth is another pillar of behavioral wealth management. We are strong proponents of active equity investments. The overwhelming presence of emotions involved in investment decisions creates inefficiencies in the marketplace. Those inefficiencies, when systemically analyzed, can generate terrific opportunities for superior investment selection and portfolio performance. We see active equity portfolios as significant contributors to the goal of wealth-creation.

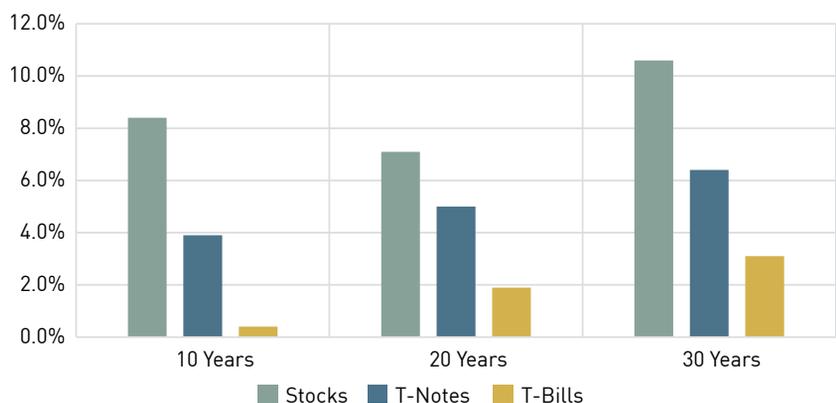
PLANNING IS KEY, AND INVESTING IS A LONG-TERM ENDEAVOR

Planning is the most effective way to allocate resources to meet short- and long-term needs. Optimized allocation improves long-term performance by allocating resources based on real needs

Figure 2

ANNUAL RETURNS THROUGH 2017

ANNUALIZED RETURNS AS OF DECEMBER 31, 2017: STOCKS (S&P 500); BONDS (10-YEAR U.S. TREASURY NOTE); CASH (THREE-MONTH U.S. TREASURY BILL)



Source: New York University, http://pages.stern.nyu.edu/~adamodar/New_Home_Page/datafile/histretSP.html

rather than conceptual risk tolerance. In addition, it increases client confidence and comfort by making sure that both short- and long-term needs are met.

When planning is combined with a long-term investing approach, it almost entirely removes emotions from the equation and investors sleep better at night. Clients also are more apt to ignore media hype about daily events if they understand the reality of short-term volatility and the year-over-year variance in market returns.

Although we can't accurately forecast annual market returns, we do know from history the rule of 55/65/75: The stock market produces a positive return in 55 percent of days, 65 percent of months, and 75 percent of years.

THE BEHAVIORAL WEALTH ADVISOR CLIENT SERVICE MODEL

A BWA manages a client's overall financial plan, including services performed by external parties. As such, the suggestions provided here apply to services that the advisor directly manages as well as the services integrated into the financial plan, such as risk management, tax planning, and estate planning. The BWA's goal is to create clients who are confident that all aspects of the financial plan are appropriately considered and managed in an integrated fashion. As illustrated in figure 3, the BWA is the client's central point of contact for any questions or issues that arise.

Every stage of the BWA client service model includes steps to take to address

and mitigate behavioral biases. We view the client service model in two distinct sections, the front-end process and ongoing servicing. Figure 4 illustrates the overall process and each component is described in more detail below.

Step 1: Discovery

The main goal of discovery is to gather the financial and emotional data needed to create a financial plan and to determine the best approach to working with the client based on the client's behavioral profile. This is the opportunity to understand the client's goals, behaviors, and perceptions about risk. It means asking thoughtful questions about the client's values and motivations and understanding how the client made prior investment decisions.

An important takeaway should be a behavioral profile for each client. By segmenting clients into persona types, you can tailor the communications process and plan more appropriately for meetings. Figure 5, for example, shows Morningstar's behavioral profiles, which are segmented by time horizon and control.

The BWA also should assess if the firm's capabilities align well with the client's needs and desires. If the client appears to be a good fit, the final discovery step is to get a complete financial picture so

Figure 3

RELATIONSHIP MODEL—MATCHING NEEDS AND SOLUTIONS



Figure 4

SERVICE PROCESS MODEL

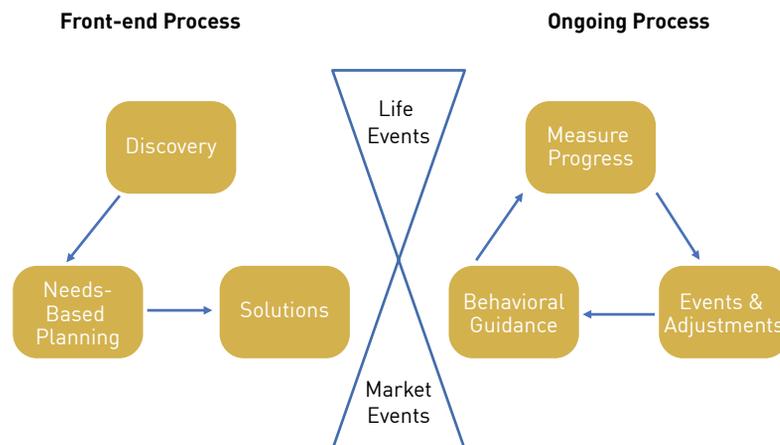
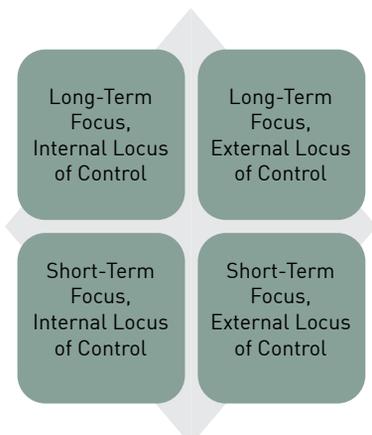


Figure 5

BEHAVIORAL PROFILES



that the advisor and client have a comprehensive understanding of resources available and what is already in place. This includes financial assets and liabilities, income and expenses, insurance, wills, trusts, and other important relationships including spouses, dependents, trustees, and beneficiaries.

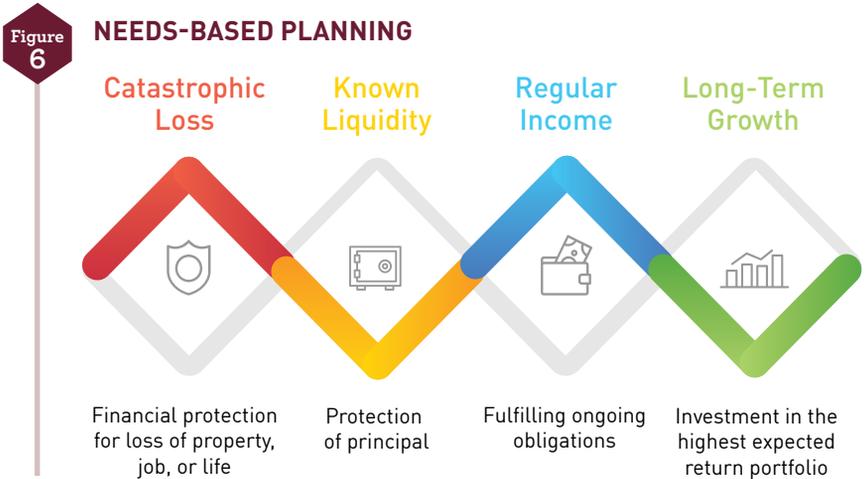
Step 2: Needs-based planning

Once the advisor-client relationship has been formally established and the client's current financial situation has been fully inventoried, it's time to move to planning.

The plan can help manage client behaviors over time if it is carefully designed to meet client needs, separating them according to short-term and long-term. This separation feature allows for a portfolio of liquid assets to meet emergency needs and income, if necessary, over a three- to five-year period, so there is no need to liquidate the stock portion of the portfolio. Separating assets dedicated to growth is also important to reduce concerns about the future. The plan is managed continually to keep short-term needs in balance with long-term growth.

The BWA designs a plan to address the client's principal needs, as illustrated in figure 6. The plan has a disciplined process for coordinating with experts about more specialized needs, such as protecting the client from the potentially devastating impact of various unexpected life events that may otherwise endanger the plan (risk management), to optimize the plan for net income (tax management), and to customize the plan with the intelligent divestiture of wealth according to the client's wishes (estate planning).

The advisor's client-management goal at this step is to ensure that the client is confident in the plan details. This confidence will help maintain the discipline to follow the plan during difficult life stages and market events. The most critical step in establishing this confidence is to comprehensively identify needs



within the following five distinct financial areas:

Catastrophic risks. Clients need to insure against the large financial risks associated with unpredictable catastrophic life events. Although insurance and investing are distinct areas of expertise, no financial plan is complete without a thoughtful plan for high-impact risks such as death of a spouse, long-term disability, and liability exposure.

Known liquidity. This category of need includes known future expenses beyond normal household operating expenses that are expected in the next three to five years. Job transitions, new vehicles, or planned vacations can be among these expenses. From a behavioral perspective, the idea is to provide a very high level of confidence that the client's short-term liquidity needs are completely covered.

Regular income. For clients still in the workforce, this need usually is met with household earnings from employment. For those in retirement, the regular income need is calculated as the shortfall of combined monthly income from Social Security and pension payments versus monthly expenses. Clients with greater wealth or limited incomes may rely on their portfolios for distributions to supplement income. Any ongoing

distributions for the next three to five years should be considered.

Long-term capital growth. All assets not committed to short-term liquidity or income generation should be dedicated to investments focused on growth and long-horizon wealth accumulation.

Estate and legacy. For those clients who have successfully covered the first four needs, the focus shifts to financial stewardship and how a lifetime of accumulated wealth can be best utilized in the future. These needs can include the financial well-being of children and grandchildren or contributing toward a cherished cause.

Step 3: Solutions

Now that all the client's needs have been captured in the planning process, the advisor can seek the optimal solution to meet the specific needs in each category.

Catastrophic risk solutions. The clear majority of catastrophic event solutions should take the form of insurance policies. It is critically important to address these large financial risks with insurance rather than personal assets or investments. Failing to do so can result in significant capital misallocations. Depending on the client's specific situation, term life, disability, long-term care, and umbrella policies may make sense.

With other forms of insurance such as home and auto, there may be gaps that can be filled that can protect a client's assets.

Known liquidity solutions. The sole function of a known liquidity solution is to deliver a guaranteed stable value. This is typically delivered with a federally insured demand deposit account for amounts less than \$250,000 or a cash-equivalent investment with immediate liquidity and low volatility for larger amounts. For more-complex situations, specific liabilities can be funded with investments such as Treasury or investment-grade bonds. In certain situations, accessing credit to fund unexpected or short-term liquidity also may be utilized to avoid untimely liquidation of assets and unnecessary tax burdens. The key point is to inventory specific items and assign values to determine concrete liquidity needs. Only investments with no or minuscule price volatility should be employed to meet known liquidity needs.

support a sustainable distribution rate. This ensures the principal can then be left untouched to target growth that outpaces inflation. With interest rates hovering around historic lows, advisors have had to look beyond traditional fixed income portfolios to deliver the necessary yield. Currently, high-yielding investments such as dividend-paying equities, real estate investment trusts, and master limited partnerships are well-suited for this need.

From a behavioral perspective, it is important for advisors to help clients separate the income stream and the principal value. For perspective, dividend research shows that 80-90 percent of dividend-paying companies keep dividends constant or increase them each year, which translates into a high level of confidence for the dividend stream. Meanwhile, the impact of stock volatility shrinks dramatically over longer time horizons. Separating the portfolio's income from its price variability can help to reduce client

in equities. With a little research, high-quality active management can be identified to potentially add significant value, providing as much as 4-6 percent in excess returns over time (Howard 2016).

Based on our research and that of others, equity strategies that meet the following criteria have the greatest chance to outperform over the long run:

- Pursue a narrowly defined strategy with consistency and conviction
- Manage less than \$1 billion in a single strategy
- Do not closely track an index (R-squared below 0.80)

Constructing an equity portfolio of three to five truly active managers who pursue different strategies enhances the client's ability to stay invested over time by allowing different strategies to perform in different market environments.

We believe investments that have low expected return or place volatility reduction before capital appreciation have no place in this portfolio.

Estate and legacy solutions. The estate and legacy area is focused on intelligent divestiture of the client's wealth in accordance with the client's wishes. Because no two clients will be alike in this area, custom tailored solutions will be the norm. Estate-planning and tax expertise can be leveraged effectively to create trusts, foundations, and charitable structures that help clients make a personal and meaningful impact with their lifetime of hard work.

Advisors should compile and maintain inventories of financial assets, where they are held, account numbers, how they are titled, and beneficiaries. This provides a complete financial picture and can be an invaluable resource when unexpected life events occur.

Separating the portfolio's income from its price variability can help to reduce client concerns about both short-term market volatility and the long-term risk of running out of money.

Regular income solutions. To meet regular income needs, an investment portfolio that generates reliable income on a regular basis should be the desired solution. It is critical that the portfolio's principal outpace inflation over time, so as not to lose its ability to generate a sufficient and growing income over time. Often a sustainable distribution range, such as 4 percent, is set to inform portfolio construction and to set reasonable client expectations. With many investors living longer, incomes need to last much longer, too.

The portfolio should be constructed such that it produces a yield that can

concerns about both short-term market volatility and the long-term risk of running out of money.

Only investments that can generate the required income reliably should be included in this portfolio.

Long-term capital growth solutions. Solutions in this arena should be tuned entirely for maximum capital appreciation over the long term. The most important factor should be expected returns, because the rate of return and compounding over time will dominate all other considerations. For this reason, the growth portfolio should be invested

Step 4: Ongoing support

Figure 7 summarizes the full BWA process. We have discussed the activities in the first two circles; we now focus on the ongoing behavioral support that is a hallmark of the BWA.

MEASURING PROGRESS AGAINST GOALS

Ongoing management of the client's financial life requires organization, discipline, and communication. The communication process is an important part of managing client behaviors, particularly as it aligns with the client's behavioral profile and the expectations set at the onset.

Although the type of communication may vary, we recommend several meetings during each calendar year as an ongoing check-in to measure progress.

The face-to-face meeting provides a touchpoint for the ongoing relationship. Being well-prepared and organized can help to further the advisor's credibility. It is also an opportunity to review the plan and progress, to reinforce that maintaining the plan is just as important as its creation. The meeting should allow some time for free-form discussion as part of the greeting, but otherwise it should be well-structured with an agenda and a checklist of items to review.

The following are some specific recommendations to help guide the discussion and continue to manage client expectations as you report the performance of the financial plan:

1. Measure progress toward a client's goals rather than performance. Was liquidity met, income provided, and growth achieved?
2. View results since the beginning of the relationship to show the cumulative difference you are making.
3. Break out contributions, withdrawals, and capital appreciation (since inception and into the future) to

Figure 7

BEHAVIORAL WEALTH MANAGEMENT



Table 1

EVENTS, CHECKLISTS, INVENTORIES

Financial Plans	Risk Assessment	Inventory	Estate Documents
Liquidity Plan	Life Insurance	Accounts	Document
Income Plan	Liability Insurance	Titles	Location
Tax Projections	Disability	Beneficiaries	Last Updated

illustrate how client choices are important drivers of outcomes.

LIFE EVENTS AND ADJUSTMENTS

The checklist for every meeting should include a review and update of any life events or changes to the client's financial circumstances and goals. Advisors need a well-defined process whereby each major area of the plan is updated and reviewed at predetermined meetings to avoid trying to cover too much in a single sitting. This also will allow for specialists handling other parts of the financial plan to be included. Some common groupings are provided in table 1.

ONGOING BEHAVIORAL GUIDANCE

Educating clients and providing behavioral coaching is an ongoing process. Many parts of the client service model are designed to manage client behaviors but likely will not be apparent to the client. There may be opportunities to point out specific actions and activities that are behavioral-centric in design, reinforcing to the client the important goal of managing behavioral biases. For example, the needs-based plan is a perfect opportunity to reinforce that its design is intended to help the client

disregard the volatility that often triggers emotional selling.

Because a BWA is differentiated by this type of guidance, we also suggest providing timely communication geared to helping clients recognize common emotional triggers to avoid. A growing number of resources are available to help advisors and their clients gain a deeper understanding of how behavior shapes the investing landscape.

CONCLUSION

Behavioral wealth advising is an ongoing process with concrete behavioral elements and deliverables. The comprehensive needs-based plan is the foundation of the BWA service model because it builds control, confidence, and comfort that helps clients manage behavioral triggers. Redefining risk beyond volatility is also critical to making the transition. Behavioral education and coaching occurs throughout the overall service model. That coaching will help the client understand how a BWA is helping them avoid destructive behaviors and follow their long-term plans. The result will be more satisfied clients, better client retention, and additional referrals. ●

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ENDNOTES

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