BEHAVIORAL FINANCE

Practical Applications and Changes Related to It

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Over the past 15 to 20 years, behavioral finance has become an increasingly talked-about topic in the world of wealth management. The ideas that led to the Nobel Economics prizes for Daniel Kahneman in 2002 and Richard Thaler in 2017 should have revolutionized the industry. Applications offered by Meir Statman, Hersh Shefrin, and Terrence Odean among academics and Ashvin Chhabra, Michael Pompian, Franklin Parker, and many others, including the author, among practitioners would have seemed to have great potential. Yet, the actual impact of these insights has so far been almost minimal. Why is that?

Two potential answers come to mind. The first—the simplest—points to the fact that, for a long time, private asset management was viewed as a subset of institutional asset management, at times not much more than a variant on a theme or a distribution channel. The industry was dominated by asset managers who were not about to accept material change to their routine, even when that change related to something as elementary as recognizing the importance of income taxes: Most individual investors pay income taxes, and most institutional investors benefit from tax-deferred or tax-exempt statuses. The second is more complex but rests on similar foundations. Processes that had been developed within the institutional world would have to be materially changed, and the costs associated with such changes appeared prohibitive to practitioners who did not enjoy large profit margins to begin with.

So, rather than focusing on the insights that behavioral finance—and several associated disciplines—brought to the front, many industry players first ignored the potential new paradigm and then, when that was no longer possible, simply tweaked their marketing literature to pay lip service to the new and continue to practice the old.

This article focuses on three important areas where behavioral finance and related insights are making a change in the wealth management industry, though the impact of these changes is still too moderate. The first relates to goals-based wealth management.

Though one can quip that goal-based wealth management (note that detractors often use goal in the singular here rather than in the plural in the earlier formulation) is about as insightful as oxygen-based breathing, a true focus on the nature of individual goals changes both the advisory and investment processes, as well as the needed structure of advisory firms. The distinction between “goal” and “goals” is crucial (as we shall discuss later on) because not recognizing that there are multiple goals and thus not a single goal effectively misses the whole of the distinction between institutional and individual investors; the former have a single goal and a single utility function or risk profile, while the latter have multiple goals, with multiple time horizons and multiple risk profiles, effectively a unique sense of urgency for each goal. The second relates to the implementation of investment processes, be they dealing with security or manager selection decisions. Understanding the biases that individuals bring to the party is essential to being able to help them manage their assets, and all the more so because portfolio managers often share many of these biases. The third deals with the interactions between advisors and clients. Knowing how to offer advice is frequently more important than the advice itself.

GOALS-BASED WEALTH MANAGEMENT

Proposed as early as 2003, by Brunel (2003), Nevins (2004), Pompian and Longo (2004), and Chhabra (2005), goals-based wealth management is the first really novel application of behavioral finance principles to asset management. Its premise is deceptively simple: In contrast with institutions, individuals have a multiplicity of goals, a potentially different horizon for each goal, and, as proposed by Das et al. (2010, 2011) as a better measure of risk, a different sense of urgency for each goal. Though simple, goals-based wealth management literally upset the whole apple cart, because it forces asset managers to view strategic asset allocation as a bottom-up rather than a top-down exercise. More importantly, it requires that the rate used to discount future cash flows be set based on the horizon for each goal and its sense of
urgency; this is the minimum return that one expects to beat over the time horizon and with the required probability of success. Also, it requires the advisor to create the client’s overall portfolio by aggregating as many buckets as the client has goals.

Such a process changes the way one thinks because the client’s risk profile is determined from the bottom up rather than the top down. The client can have widely different goals, a few with a high to very–high required probability of success (they can be called needs or wants) and others with a much lower required sense of urgency (one can call them wishes or even dreams). Each of these goals is then “funded” by the creation of the appropriate asset bucket. The advisor needs to aggregate each of these individual buckets into an overall portfolio and observe that the client’s expected risk profile is really the weighted average of the risk profiles of each bucket with the weight used in the averaging process being the percent of total capital required by and committed to each goal. Note how different this is than asking the proverbial question, “What is your risk profile?”

Depending upon the size of total client assets and the business model adopted by each advisor—or advisory firm—the actual implementation of the approach can lead to a consolidated overall portfolio (where the commitments to each asset class or strategy in each module are added together to create an overall detailed investment policy) or, at the other extreme, to a portfolio of model portfolios. Conceptually, this is not materially different from the approach used by many advisors, except that they choose one model portfolio that meets the client’s perceived overall risk profile, rather than choosing one model portfolio for each goal.

One of the major shortcomings of the approach is the ransom of its major benefit. The resulting portfolio is as perfectly tailored to each client’s individual circumstances as possible. Thus, it can very well be that no two client portfolios look alike. That would create potentially serious implementation and control management issues, unless the advisor also adopts a systematic portfolio rebalancing and tilting process. It is probably not unreasonable to postulate that it is precisely this apparent complexity that has led advisors not to adopt the approach, though a close second might be the reluctance of portfolio managers to give up individual control over each portfolio, focusing instead on large decisions made at the firm level, and on the management of each model portfolio.

Developing an overall investment policy goes beyond the simple focus on asset allocation. It also must incorporate the important issues related to asset location: Where should which position be held so that it plays the role that has implicitly been assigned to it? This amounts to assessing how best to fund each goal, given tax and other constraints imposed on each asset-holding structure.

For such an approach to work, each advisory firm needs to make two important changes. The first is to recognize that it makes decisions in two dimensions: firm-wide with respect to capital markets, both strategically and tactically; and client-wise with respect to each client’s specific goals. Simultaneously, the firm needs to recognize that a critical success factor has to be the need for the main client contact to be the advisor who must play the role of interpreter—explaining the client’s needs to the firm and communicating realistic capital market expectations to the client. Culture has been one of the most difficult hurdles in moving in that direction.

IMPLEMENTING THE INVESTMENT PROCESS

On the surface, three key decisions must be made, on a continuous basis, with respect to the implementation of the investment process. How is each asset class or strategy represented in the portfolio—individual securities or commingled structure, internally or externally managed, active or passive investment process, with active here, as per Stein and Narasimhan (1999), divided into active with respect to security selection or active with respect to taxes? How are managers selected for those strategies that require some form of active management? How are tactical portfolio rebalancing and tilt decisions made and implemented?

Answering these questions has never been easy, but traditional finance gives the institutional investor many tools for dealing with them. Most of these tools rely on objective data that can then be analyzed and applied to specific circumstances. Choosing to adopt an active versus a passive stance across the whole portfolio or in selected areas but not in others can be based on a plethora of literature that discusses the benefits and costs of active decision-making. Decision-makers usually rely on the real odds of generating value added, slicing and dicing the individual decision components along such lines as pure excess return, risk-adjusted excess return, tracking error in absolute term, pre- and post-management fee analyses, and many others. Traditional finance, which tends to be prescriptive and normative, can rely on data to argue which decisions make sense and which do not.

Do these analyses work in the world of the individual investors? Ostensibly, the first-level answer is negative. Behavioral finance is not prescriptive, it’s descriptive. It tells us how individuals make decisions, not which decision they should make. It therefore follows that the actual individual decision process can be viewed as an interaction between data-driven suggestions and bias- and preference-influenced positions. Behavioral finance teaches us that individuals have many biases—and Kahneman (2011) goes somewhat further. Individuals indeed have two distinct processes within their brains.
that tend to work at cross purposes: They can think fast when they need to react quickly or almost instinctively to some external stimuli. They can think slow when they take the time to go through a detailed process using appropriate measures to reach a well-reasoned decision. Sharot (2012) investigates the optimism bias that affects most individuals and offers a tour of the irrationally positive brain. Sharot makes the case for the need to help individuals understand how this irrational optimism can lead to disastrous decisions. Many advisors likely have observed the momentum tendency that prevails in many individual investors: It functions in the opposite direction of the classic Bernstein Paradox, which suggests that one should hope that security prices keep going down for as long as one is buying and vice versa when one is selling. Irrationally optimistic investors tend to believe that the past is prelude both when things are good and bad. They tend to buy what has been going up and sell what has been going down.

Similarly, these irrationally optimistic investors have ingrained beliefs as to what ought to be possible and often find it hard if not impossible to believe that a decision axis does not make sense. Sharot (2018) tells readers “what the brain reveals about our power to change others” and points out the difference between data and stories. Using a primary presidential debate in the United States, Sharot contrasts two arguments about the link between autism and certain vaccines, one based on scientific data and the other based on a simple story. Sharot shows that stories can be considerably more powerful, even when wrong, than data. This finding applies in spades when dealing with investment decisions, particularly but not solely with regard to the active versus passive debate, both with respect to security selection and portfolio rebalancing or periodic tilting toward or away from certain policy weights. Brunel (1999), among others, showed why taxable investors should be quite careful when considering investment activity that has certain market timing dimensions.

The crucial lesson for advisors here is thus twofold, with both elements containing a heavy dose of behavioral finance. The first involves identifying the kinds of biases that each client may have and refraining from any immediate, harsh value judgment. Ostensibly, ethical considerations require all advisors to offer their best professional advice, and thus to warn clients of the risks they are taking. However, the second involves helping advisors use the insights of behavioral theory to couch and deliver this advice in a way that does not rely solely on hard and fast rules. Sharot (2018) clearly illustrates that just being given access to data more often than not will fail to swing the client in the right decision. Rather, the critical insight is to ensure that rules and data are presented together in as much of a “story context” as possible. Illustrating without condemnation the principles at play can prove to be a much more powerful tool to bring clients to a more reasonable and yet still comfortable decision. Note that this may mean that one is looking at a journey-like process rather than a binary switch away from one toward another decision. Thus, even when the client is not prepared to let go of a bias, as predicted in Sharot (2018), finding some common ground may allow the advisor to moderate the amplitude of the decision that the client may otherwise have been tempted to select.²

**MANAGING HUMAN INTERACTIONS**

Regular manager or advisor interactions occur in at least three sets of circumstances. The first recalls the effort associated with the development of an investment policy. The second has to do with the discussion of investment and individual manager performance. The third may be the most complex because it involves discussions between client and advisor about issues such as dealing with concentrated positions, asset location, or investment ideas that are brought to the client’s attention through friends or the infamous “cocktail circuit.” Generically, the challenge relates to helping clients deal with situations where one normally would expect a variety of biases to be at play.

Having used the goals-based wealth management approach for 15 years now, I can state categorically that changes in investment policy over time were more often the result of alterations in client circumstances than glaring errors with respect to capital market expectations, and that the most radical change often occurred early on. This would be when the client is least familiar with the questions that need to be answered, and the advisor hasn’t yet gotten to know the client and the client’s reactions very well. Typically, cash-flow predictions were off the mark or the degree of urgency associated with a goal, a need, a want, a wish, or a dream had to be modified. Clients should not be blamed for this. This is natural both because they did not always look at their finances the way one is asking them to do it now and because they are in a process of self-discovery. Yet, one can draw a lot of assistance, in practice, being aware of the biases and preferences that behavioral finance predicts. At the very least, this can help reassure hesitant clients and convince them that they are on a journey and that they must move one step at a time.

Assessing manager performance, and more importantly making decisions about whether a manager should be held or eliminated offers classic insights into the risks associated with narrow framing, the lack of the appropriate perspective, or even hindsight biases. Traditional finance provides simple tools to help measure and assess manager performance; however, behavioral finance warns us that clients will not always feel comfortable using these tools. First, except for strategies that are perfectly described by some well-known and accepted benchmarks, one quickly can find issues with benchmark choices.
when looking at a manager’s relative performance. Although a client might have accepted the selection of a manager to fill a particular slot in the manager line up, experience suggests that the logic offered in order to accept the manager may not be the full story. I have personally seen numerous instances where the client wanted to use a particular manager and found a way to get that manager selected. Thus, one cannot accept as a given that simple relative performance comparisons and analyses will do the trick, particularly if the recommendation is that the manager should be lightened up or terminated. Second, there is always the risk that a client will want to replace a poorly performing manager in the short term, despite a solid long-term record. This could be even more frequent in the case of a manager whose strategy is at a low point in a normal performance cycle: Why not get rid of both the manager and the strategy, replacing them with someone else, whose strategy is then forced into the asset allocation?

By comparing, for each manager, relative performance records during the pre-investment, investment, and post-divestment periods, I have found that manager hiring and firing decisions are at best suboptimal. The good news is that the choices proposed by the manager selection advisor were in fact quite good; the average manager outperformed the benchmark, often in all three timeframes—prior to the investment decision, during the investment period, and after the manager had been fired. The bad news is that more managers were chosen among the best relative performers prior to investment and the degree of outperformance diminished by a factor of 2 or 3 after the manager was selected. Further, the dispersion of manager results among these managers was higher the more excess return they had produced before being hired. A cold head would understand this: The best past relative returns reflect by definition a combination of risk taken and success, the latter comprising some element of luck and hopefully skill. Managers who take more risk eventually must run through a difficult patch.

The insights in Sharot (2018) can help. Sharot (2018) considers how we (i.e., advisors) can influence clients without undue pressure and subsequent hard feelings. Sharot lists six elements that one could argue should inform advisors. First, evidence does not always change beliefs, because data often is used for confirmation rather than changing a view. Second, as mentioned earlier, the author outlines the incredible power of emotion to sway people’s views. Third, Sharot highlights that trying to scare people into action is less effective than enlisting them as partners in an effort by providing the correct incentives. Fourth, Sharot makes the controversial and counterintuitive point that it is better to let go of some power, to share that power, rather than to use the power of a position to impose a view. Fifth is the paradox of the so-called value of information and the burden of knowledge: Providing clients what they really want to know is considerably more powerful than drowning them in the whole complex body of knowledge. Finally, Sharot argues that stress can play a very important role in decision-making in certain circumstances and recommends the need to help clients overcome it.

As is often the case with social sciences, the foregoing list may appear so intuitively obvious that one could fairly ask, “So what?” Unfortunately, I have observed that very few advisors make use of these tools. More importantly, I have found interactions considerably more fruitful when I followed these principles. Often, indeed, advisors try to look smart or want to impress their clients, when, in fact, the better approach would be to work so that clients effectively discover what we want them to find out on their own. The image of parenting comes to mind as a valid analogy.

**CONCLUSION**

Behavioral finance should not be viewed as a discipline that comes up with a great deal of complex surprises. It should be seen as an informed state of mind that should help advisors better help their clients. This has been a hard journey to acceptance for a mathematics and physics major (me). I once had a client who told me, “I asked you what time it was, not how to make a watch!” Too often, I, for one, have been guilty of thinking aloud in my conversations with clients, and thus of taking them through a rationale that would have been best kept to myself at the time. A better prepared approach would have been for me to rehearse all these conversations ahead of time and focus on the issues of greatest importance to clients during the limited amount of time they share with me.

Senior management should focus on simultaneously creating a culture that is truly centered around the client (and not simply so in the marketing literature) and on verifying that the tools available to their employees incorporate all the diverse insights of social science disciplines, many of which are still in a state of flux. Ostensibly, the insights of behavioral finance must lead to changes in certain tools that we use. Goals-based strategic asset allocation algorithms, systematic portfolio tilting tools, better performance measurement processes, more useful graphics, and many other elements must be made part of the tool kit. Similarly, advisors must recognize their crucial roles as two-way interpreters within their firms; wealth management firms have to accept that officers who prefer to live in silos have their place in the firm but rarely as leaders in client-facing situations. Finally, why would any firm in the business of serving wealthy individuals incorporate “asset management” in its name when it should be obvious that the mission extends considerably more broadly?
A simple look at how the individual asset management industry evolved over the past half century should serve as a reminder that many went at it the wrong way. Why have many industry leaders in private banking failed to capitalize on their positions and strong brands and found themselves replaced by multi-family family offices or registered investment advisor firms? Recall that General Motors defined itself as a leader in the automobile manufacturing business yet failed to understand it was in fact a player in the broader business of transportation. Many have fallen into the trap of failing to appreciate that wealth management is a joint venture between a client and an advisor. Understanding the fundamentals of behavioral finance and managing client interactions is the foundation of a successful practice.

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ENDNOTES

1. Assume a model portfolio with a 5.6-percent expected return and a 7.2-percent expected standard deviation. Rather than using the 5-percent expected return to discount the cash flow associated with a goal for which that model portfolio appears the most suitable, one would need to use 3.6 percent, a return that one would expect to match or exceed 80 percent of the time compounded over 10 years. Raise that required probability of success to 95 percent and the discount rate falls to 1.8 percent. Still with a required probability of 95 percent, cut the time horizon to five years, and the discount rate falls to 0.1 percent. In fact, one should only expect to match or exceed 5 percent 50 percent of the time, thus failing short of one’s expectation of achieving the goal 80 percent of the time by 30 percent.

2. In the vaccine versus autism example, Sharot recommends shifting the focus toward concern for the long-term health of the child rather than on demonstrating that there is no proven link between vaccination and autism.

REFERENCES


PRACTICAL APPLICATIONS . . .

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