Managing Client Behavioral Biases

By Harold Evensky, CFP®
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It’s no secret that behavioral finance is a hot topic in the financial services universe. Rarely does a professional publication fail to pay homage to the subject with at least one related article. Unfortunately, all too often the material is too academic or too simplistic to be of much help for the practitioner. This article is my attempt to bridge the gap and provide useful and actionable ideas for integrating behavioral concepts for those of you in the trenches.

IN THE BEGINNING
We start the process with what our firm refers to as “The Risk Coaching Questionnaire.” This document is designed to begin the process of educating our clients regarding the concepts of behavioral theory. The following are examples from the questionnaire.

Question 1 asks:
What is the approximate value of this investment portfolio? $_________
What percentage of your total investments is represented by this portfolio? ________%

This is based on the behavioral concept of framing (the primary tool we use). By having the client focus on the specific dollar amount we will be planning for, it helps guide their responses to subsequent questions.

Question 4 asks:
Is there an immediate or near-term (i.e., within five years) need for income from this portfolio(s)? YES NO
If YES, when will it become needed? __________ years
Approximately how much will be needed in after-tax dollars, per year? $________

Question 5 asks:
Will significant cash withdrawals of principal be made over the next five years? YES NO
Before asking questions 4 and 5, we warn our clients that there will be further redundant questions but that’s by design. If they answer “yes” we explain our “five-year mantra”; i.e., five-years five-years five-years. We explain that we do not believe any lump sums they may need in the next five years (e.g., college tuition, new home, special trip) should be invested because we believe “investments” and “long term” are synonymous. Regarding the need for income to supplement a client’s annual cash flow, we use one year. Once we’ve determined if these needs exist, we carve the necessary amount out of the investment portfolio and adjust the numbers in Question 1.

Question 6 asks:
What is the portfolio’s investment time horizon?
Investment time horizon refers to the number of years you expect the portfolio to be invested before you must dip into principal. Alternatively, how long will the objectives stated for this portfolio continue without substantial modification? Please mark your choice.

☐ Three years
☐ Five years

If you have indicated less than 10 years, please explain when the funds will be needed:

☐ Ten years
☐ More than 10 years

This is a continuation of our emphasizing and educating our clients on the concept of “long-term” investing. This becomes an important reference during bear markets.

Question 7 is optional:
My (our) goal for this portfolio is an annual return of ________%.

This is based on an expected inflation rate of ________%.
We explain that this question is optional. If clients have nothing in mind, we skip it; however, if they do, we explain that we need some idea of what the economy is like when they’re earning the desired return; i.e., what’s the inflation rate? After all, 12 percent may be realistic if inflation is 10 percent but not so credible if it’s 2 percent. The question helps us introduce the concept of real return and, in some cases, helps us recommend that clients might be better served by another advisor if we believe their expectations are unreasonable.

Question 8 is another framing question, which we refer to as “gotcha”:

For each of the following attributes, circle the number that most correctly reflects your level of concern. The more important, the higher the number. You may use each number more than once.

<table>
<thead>
<tr>
<th>Attribute</th>
<th>Most</th>
<th>Least</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital Preservation</td>
<td>6</td>
<td>1</td>
</tr>
<tr>
<td>Growth</td>
<td>5</td>
<td>1</td>
</tr>
<tr>
<td>Low Principal Volatility</td>
<td>4</td>
<td>1</td>
</tr>
<tr>
<td>Inflation Protection</td>
<td>3</td>
<td>1</td>
</tr>
<tr>
<td>Current Cash Flow</td>
<td>4</td>
<td>1</td>
</tr>
<tr>
<td>Aggressive Growth</td>
<td>3</td>
<td>1</td>
</tr>
</tbody>
</table>

“This is to distinguish between principal loss and principal volatility. Selecting a 6 suggests the client would be concerned if the portfolio value dropped in one year, a 4 they may not be happy but could survive a drop over three years and a 2 means they would simply not be paying any attention to market fluctuations.

Frequently clients will circle 6 for capital preservation and 3 or 4 for growth and 5 or 6 for inflation protection (especially if they are retirees). This gives us an opportunity to point out their conflicting goals. A capital preservation 6 would suggest Treasury bills, but this investment won’t provide much growth or inflation protection. This helps later when we get to the portfolio design process and need to include investments that the client may consider risky.

Now we come to the redundant questions 10 and 11:

Question 10. What percent of your investments are you likely to need within five years? _________ %

Question 11. Up to what percentage of this portfolio can be invested in long-term investments (i.e., more than five years)? _________ %

There is only one right answer for both; i.e., 0 percent and 100 percent, because in questions 4 and 5 we’ve already adjusted for any short-term needs. If, as is often the case, the client responds, “Well, maybe 5 or 10 percent,” we ask: “What did we miss? Remember, we discussed that earlier and already have carved out those short-term needs.” Again, we are refocusing clients on the concept of long-term investing and providing something to refer back to if they become nervous during a bear market.

Question 17 continues:

Several portfolio performance projections are listed below. Also provided are hypothetical potential losses for these portfolios. Check the portfolio that most nearly reflects your goal for your portfolio.

<table>
<thead>
<tr>
<th>Overall Risk Level</th>
<th>Hypothetical Nominal Return in a 3% Inflation Environment</th>
<th>Hypothetical Risk Exposure “Worst Case” (12 months)</th>
<th>Bear Market (October 2007–February 2009) (12 months)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Low/Low</td>
<td>6.0%</td>
<td>-4.09%</td>
<td>-10.6</td>
</tr>
<tr>
<td>Low/Low</td>
<td>6.8%</td>
<td>-7.0%</td>
<td>-14.5</td>
</tr>
<tr>
<td>Mod/Low</td>
<td>7.2%</td>
<td>-9.0%</td>
<td>-16.2</td>
</tr>
<tr>
<td>Mod/Low</td>
<td>7.4%</td>
<td>-10.0%</td>
<td>-20.1</td>
</tr>
<tr>
<td>Mod/Low</td>
<td>7.6%</td>
<td>-11.0%</td>
<td>-22.9</td>
</tr>
<tr>
<td>Mod/Mod</td>
<td>7.8%</td>
<td>-13.0%</td>
<td>-25.7</td>
</tr>
<tr>
<td>High/Mod</td>
<td>8.0%</td>
<td>-14.0%</td>
<td>-29.1</td>
</tr>
<tr>
<td>High/Mod</td>
<td>8.3%</td>
<td>-16.0%</td>
<td>-32.4</td>
</tr>
<tr>
<td>High/High</td>
<td>8.6%</td>
<td>-20.0%</td>
<td>-35.2</td>
</tr>
<tr>
<td>High/High</td>
<td>8.8%</td>
<td>-22.0%</td>
<td>-40.8</td>
</tr>
<tr>
<td>High/High</td>
<td>9.0%</td>
<td>-24.0%</td>
<td>-45.9</td>
</tr>
<tr>
<td>High/High</td>
<td>9.4%</td>
<td>-27.0%</td>
<td>-50.9</td>
</tr>
</tbody>
</table>

Note: We explain that it can obviously be worse and that these numbers are based on a two-standard-deviation theoretical calculation. That’s why we include the 2007-2009 bear market.

This is the ultimate framing question. Everyone wants to pick diagonally; i.e., high return/low risk but we explain they have to pick one or two horizontal lines. This helps frame the concept of risk and reward as well as bring performance expectations into line with what we believe is realistic for us to use in our planning process.

Question 22. Now you have a test to take. There are two parts to the test. For each question, please circle (a) or (b).

#1
(a) You win $800,000
(b) You have an 80–percent chance of winning $1 million (or a 20–percent chance of winning nothing)

#2
(a) You lose $800,000
(b) You have an 80–percent chance of losing $1 million (or a 20–percent chance of losing nothing)

This is one of my favorites. Almost everyone selects 1(a) and 2(b); obviously conflicting answers to basically the same question. This helps us explain the behavioral difference between risk averse and loss averse. A broker may meet a prospect with
significant cash and say, “We need to move x percent of your portfolio into the market to make you some money!”—at which point the prospect heads for the exit. We explain that we may well make the same recommendation, but it will be so that you can maintain your lifestyle, not “make you some money.” On many occasions we had very conservative clients say: “I finally get it! I’m ready to make a move.”

WE’RE READY TO INVEST
A number of issues may arise at this stage.

DOG STOCKS
The client owns a position with a big loss and is reluctant to sell because the client doesn’t want to take a loss. We ask, “Would you buy that stock tomorrow?” And the typical reply is, “I wouldn’t touch that stock with a 1,000-foot pole!” We explain, “If you sell today and buy it back tomorrow, you’ll be in exactly the same position, but Uncle Sam will absorb some of your pain by allowing you the capital loss on your tax return.” Needless to say, not many buy it back the next day.

GREAT INVESTMENTS
It’s not uncommon for a client to say, “I’d like to keep x dollars out for this great opportunity I have for an investment. Here are a few strategies for addressing this scenario.

What might go wrong? If you try to explain the potential risks of the proposed investment, you’re not likely to get much traction. As an alternative, ask the client to frame the decision by asking, “Well, that sounds like a terrific investment, but I’m not very familiar with the field, tell me about it.” The client will then wax eloquently about how terrific it’s likely to be based on what a next-door neighbor (or brother-in-law, etc.) explained to him. When he’s finished, follow up with: “That really sounds attractive, but as I said, I’m not familiar with XYZ. What might go wrong?” The client is unlikely to have ever considered this possibility and after a bit of reflection may be less inclined to proceed.

Mental math. Ask about what steps need to be accomplished for the investment to be successful and how likely they are to be successfully completed. The client may say something like: “There are five steps—prototype development, prototype testing, regulatory approval, fundraising, and market testing. I’m confident that each has a 90-percent likelihood of success.” Needless to say, your client concludes that there is a 90-percent likelihood of investment success. Now is the time for a basic math lesson in the probability of linked events. The actual likelihood of success even given the optimistic “only five steps” and “90-percent success” is

\[0.9 \times 0.9 \times 0.9 \times 0.9 \times 0.9 = 0.59\]

What happens if? This discussion is similar to “What might go wrong?” but it is framing with regard to financial planning: “Let’s take a look at how that investment might impact your plan.” Response to this question could be: “This is terrific! If it’s a success, instead of taking that $20,000 cruise you have planned you can take $50,000 cruises for each of the next five years. Of course, if it doesn’t work out, you’ll have to keep working an extra three years.”

Representativeness. Representativeness is a behavioral heuristic that comes into play when making judgments about the probability of an event. The classic example is the “hot hand.” Simply warning a client about the risk of relying on a “representative” history may not be very successful but here’s a simple example to get the point across.

“Mr. Client, I have two coins.

The first one I toss 10 times and they come up HHTHTTTHTH

The second I toss 10 times and they come up HHHHHHHHHH

Which one is the fair coin?”

High probability he will answer the first, although the second is equally likely to be fair. Ten heads in a row is just as random as the first series of flips. Why do most people get it wrong? Representativeness. We know that tossing a coin is a random event and the first series looks random; the second certainly does not, so our simple behavioral conclusion is some thing is wrong with it. How is that likely to get an investor in trouble? How about relying on Morningstar Stars?

Over the years we’ve used all of these techniques and they do work.

INVESTED
Performance reporting. It is amazing how as a profession we emphasize the concepts of long-term investing and diversification, but when reporting to our clients we frame performance in just the opposite manner. A typical performance report will include last month and year-to-date. It’s also typically benchmarked against the S&P 500. Consider instead reporting performance only after a full year and then, over time adding three- and five-year data. Also, provide both dollar- and time-weighted performance. The dollar-weighted will provide your clients with information regarding how their own funds have performed, but if there have been deposits and/or withdrawals it will not appropriately reflect the value of your investment selections and allocation hence the time-weighted data. Finally, instead of the S&P 500 (or at least in addition to it) benchmark against a real return consistent with your planning assumptions. For example, if your client’s capital needs analysis (i.e., the plan) is based on a 4-percent real return and inflation has been 2-percent, use a 6-percent nominal benchmark.

Good and bad letters. During turbulent and prosperous market cycles I typically send clients a letter describing at some length my observations on what’s been going on and my thoughts about why. A number of years ago after an extended bull market one of my associates asked, “When are you going to send a positive letter?” During the bull
market my letters were mostly focused on what might go wrong. My answer was, “As soon as we have a bear market.” The point is, managing client expectations requires some counter-intuitive communication.

Why didn’t you tell me? More framing. One Tuesday morning after a three-day holiday weekend, a client came barreling into my office demanding, “Why didn’t you tell me about these great opportunities in real estate?” Once I had him calmed down, I asked for some background on his frustration. It seems he attended a program on the beach at a high-class Miami Beach resort over the weekend. I asked about the speaker and he told me, “He was terrific, very polished, and dressed in a $1,000+ suit.”

I asked my client what he was wearing and he said: “Why I was in my swimsuit sipping a piña colada. It was terrific!” Mind you, this was in Miami in the summer. I said, “Let me get this straight, it was a holiday and you were on the beach on a holiday weekend, in your swimsuit drinking a piña colada, and this expert was standing in the Miami heat dressed in a suit and tie and you believe he has the answer to successful investing?” My client didn’t invest.

Overconfidence. This is a false sense of skill, talent, or self-belief. Market timing is the holy grail of overconfidence. As professionals, hopefully you know market timing is not a particularly successful long-term strategy, but it’s often difficult to persuade a client. Here’s a technique you might try if your client comes in and says he’d like to make an investment with a fantastic money manager he was introduced to who has a very sophisticated market-timing strategy. Ask the client to name the 10 all-time best—musicians, baseball players, movie actors, golfers, etc. You choose based on knowing your client’s interests. Once the client has made the list, point out that you or others might debate the names selected but there likely would be some overlap and no one would have trouble coming up with 10 names. Then ask, “Name the top 10 market timers of all time.” Silence.

“OK, name the top five.” Silence. “How about the top one?” Again silence. By then the client will have gotten the point—that the likelihood of having discovered the one person in the world who will be the “one” is pretty slim.

More overconfidence. Professors Brad Barber and Terry Odean (2000) wrote a seminal paper titled “Trading is Hazardous to Your Wealth.” I refer to it as “The Cost of a Good Idea.” It’s an excellent piece to share with clients who believe they are great stock pickers. Working with a database of the trades of 66,465 households over five years, Barber and Odean asked a simple question: How would the investors have done if they simply held a stock rather than trading it for a “better” one? They found that the average household earned an annual return of 16.4 percent. Those with more good ideas, i.e., more active traders, earned 11.4 percent. The market return was 17.9 percent.

Recently Barron’s ran its annual forecasting challenge attracting 4,000+ presumably savvy participants. When asked, “What will the DOW industrials return in 2018, including dividends?” only 11.6 percent answered correctly: “negative.” When asked, “Which of these developments is most likely to occur in 2018?” only 8.1 percent answered correctly: “an equity bear market.”

Institutional investors don’t fare much better. Morningstar reported that in 2018 only 38 percent of active U.S. stock funds survived and outperformed their average peer passive funds in the past year, and only 24 percent of all active funds beat their passive fund rivals over the 10-year period ending December 31.

Even the media loves to be overconfident. For helping educate clients I collect examples from the popular media. One of my favorites has been Money magazine covers. Although I think it is a fine publication with some of the best financial writers in the country, the covers were my favorite. Many years ago, the February issue highlighted “The 12 Funds to Buy Now.” Those 12 didn’t last very long because two months later the April cover headlined “11 Funds That Always Lead the Pack.” Unfortunately, only one of the 12 made it in the 11. But then the following September the cover proclaimed “The 10 Best Funds Today.” How many of the 12 and 11 made it to September? Zip.

Why aren’t we invested in XYZ? It’s out-performed the S&P for the past 10 years. Even more framing. A favorite marketing strategy of money managers is to measure their performance against inappropriate benchmarks. Don’t fall for it. A second strategy is to benchmark against a peer universe. A second-rate benchmark. Again, don’t fall for it.

Instead, select an appropriate inexpensive asset class benchmark, e.g., Vanguard Small Cap Value ETF or iShares S&P Small Cap 600 Value Index ETF to benchmark an active small-cap value manager. Using Morningstar’s website, compare the performance. It’s very likely the exchange-traded funds have outperformed. To really test the results, compare after-tax returns and Sharpe ratios. It’s a rare active fund that will win that contest.

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REFERENCE
