



## INCORPORATING BEHAVIORAL FINANCE INTO YOUR PRACTICE

If you are a regular reader of Envestnet's Practice Management white papers, you will note that behavioral finance was addressed in an article last summer.

This is not a static topic, however, and, whether driven by "irrational exuberance" or deep disappointment, extreme markets create extreme reactions. Now, spurred by the economic crisis that began in late 2008 – financial advisors and their colleagues in allied fields are making a serious review of the emotions that drove clients to sell, or, with luck, to resist their emotional reactions and stay the course in the recent highly volatile market.

As market participants are taking a hard look at their investment decisions over the past 15 – 18 months, one of the ways they are approaching this analysis is through the still-youthful discipline of behavioral finance. In fact, the conversation on this topic is becoming broader with more indications that individuals and retail clients are increasingly aware of these newly defined concepts.

(In fact, many investor web sites allow individuals to test their "investor personality." For example, a full array of self-tests await you and your clients at Market Psych, LLC, "where mind meets money." The web site, [www.marketpsych.com/index.php](http://www.marketpsych.com/index.php), is a launching site for consultants and speakers on investor psychology. It offers many quizzes that can be fun to take and will possibly provide some insight. You or your clients can take most of the tests for free, but you have to register to get the feedback report.)

As the discussion that links investor behavior with behavioral finance expands beyond the realm of academics, advisors will find more ideas for applying the ideas of behavioral finance in real-world, practical ways that can potentially help their clients.

### ***Why Should You Care?***

If you want better investment performance and stronger client relationships, you must understand what behavioral finance concepts in your practice management platform can do for you *and your clients*. If you can help clients manage their emotions better, you can help support them through extreme markets, both on the upside and downside. And that can potentially improve their investment returns, as they better reflect the disciplined approach that professional investment managers take.

### ***Disciplined Investment Managers Outperform Individuals***

Professional investors outperform individuals. The evidence for that phenomenon has been documented countless times, and researchers point to the professionals' more disciplined approach as one of the key factors in their results.

As investment managers aim for ongoing strong performance, they are adapting the message of behavioral finance for their own purposes. You can find funds that incorporate "behavioral finance" into their names and others that claim to include practices that reflect the discipline.

A global investing team has documented its strategy for incorporating behavioral finance concepts into its decision-making process. In a white paper, "Behavioral Finance and Implications for Equity Investors," the author notes that it is "one of the many ways we can improve our skill level and culture to enhance our investment process. ... designing workflows and decision-making tools that minimize [biases] are ways in which we as investors can protect the integrity of our investment process."<sup>1</sup>

Addressing both emotional biases, "typically driven by a desire to avoid feelings of loss and regret," as well as cognitive biases, "the result of investors looking for shortcuts in the decision making process," the investment team continually tests their models and focuses on a consistent, structured fundamental research process to avoid falling into bias traps. A workflow process that incorporates these ideas has been implemented.

### ***Incorporating Behavioral Finance Into Your Practice***

Just as the global equity team of analysts and portfolio managers have made a deliberate move to incorporate anti-bias procedures into their process, it is important to take a purposeful approach in your own practice. Steps to take include:

- Develop a level of understanding that you are comfortable with. Behavioral finance is a complex field that is in a state of growth, so you will never be completely sure that you know everything! You can start with the "further reading" and footnoted articles mentioned in this paper.
- Ask yourself: what are the most common biases that I do and will encounter, and what are the best ways to handle them? One of the most common bias is loss aversion, whereby individuals experience greater pain for a loss than they experience pleasure for an equal amount of gain.

Anchoring bias is another, and it is aligned with current market issues; for example, people say they will not buy back into the market until it reaches a level they have personally predetermined.

- Then approach the issue by considering individual clients: what are the biases that mostly affect this client, and ask: how can I manage in light of his or her predispositions?
- Identify ways that you can incorporate this discipline into your existing prospecting and new business meetings, as well as your work with existing clients.

Once you are able to identify investor biases, you will be able to more closely match your presentation to their needs and ultimately make stronger decisions.

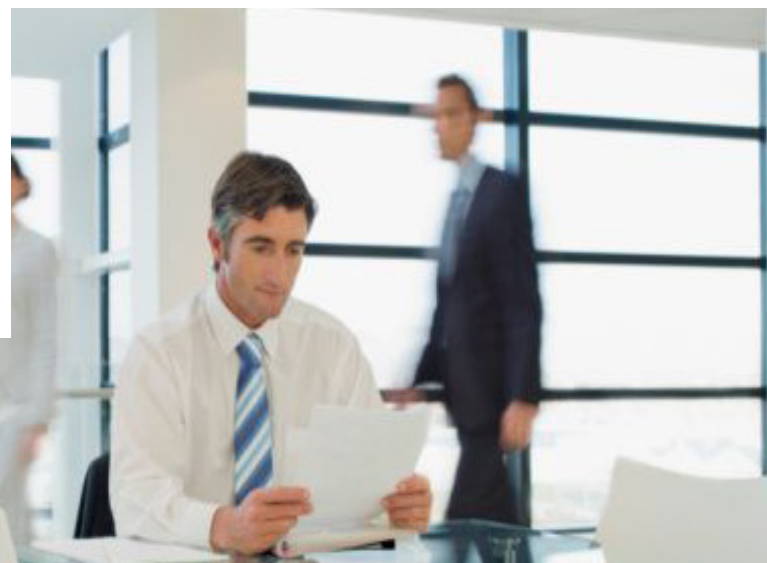
One more critical item: be sure to communicate! You may frame your newsletter, emails, phone calls and social networking to a target group of clients, but be aware of how they will perceive your messages, based on their emotional and cognitive biases.

### ***Advisors Who Are Taking The Lead***

One of the leaders in tightening the link between practice and theory is Michael M. Pompian. Pompian cites his survey of 290 sophisticated financial advisors. Of these, 93% said that individuals make irrational investment decisions, and 96% used techniques related to behavioral finance to improve relationships with clients.

According to Pompian, advisors believe that the more deeply they understand their clients, the better they are able to build strong, ongoing relationships and retain clients.

In "Using Behavioral Investor Types to Build Better Relationships with Your Clients," Pompian lays out a structure using theory to make a difference in your practice. He identifies four types



of clients, each with specific biases that affect their investing behavior. The four types are: Passive Preserver, Friendly Follower, Independent Individualist and Active Accumulator.

The Friendly Follower, for example, is marked by hindsight bias, among others. That means he or she “perceives investment outcomes as if they were predictable—even if they weren’t.” Pompian says that Friendly Followers often overestimate their risk tolerance and “don’t like situations of ambiguity.” Advisors can do well with this investor type if they offer education and clear, unambiguous recommendations.

Pompian offers a 10-question test to identify active and passive investors along with a decision tree to help identify investor behavior types.<sup>2</sup>

You may not agree with all of Pompian’s ideas, but he does offer a solid starting point for expanding your insights and developing your own process.

### **Carl Richards And The Behavior Gap**

Carl Richards is another advisor who is actively practicing and promoting behavioral finance. The sketches on his web site, Behavior Gap at [www.behaviorgap.com](http://www.behaviorgap.com) underscore his strategy for long-term, slow-and-steady investing.

Recently Carl responded to New York Times readers’ personal finance questions.<sup>3</sup> For example:

- Asked whether to invest a bonus all at once, or over time, Richards responded: “because the pain of loss is so much greater than the pleasure of gain, you should space your investment out over a predetermined schedule (dollar cost averaging). This is a strategy for managing behavior.
- Asked how to prevent losses that come from investing at the wrong time due to emotions, Richards says, “if you keep making the same mistake over and over again, and it

is costing you real money, then either avoid the problem (stocks) or get real professional help.

Whether or not you agree 100% with Pompian or Richards, through their media efforts, and those of others, individuals will begin to recognize that a financial advisor can help manage the emotional side of investing. As such, these Pompian and Richards are doing all advisors a favor.

### **A New Year’s Resolution**

In this current period of investing self-analysis, it’s an excellent time to be direct with clients as to their psychological makeup. As a successful advisor, you probably already employ practices based on behavioral finance practices without realizing it. You may just be aware that a certain technique works for a client with a specific mindset.

But it just may be worthwhile to make a New Year’s Resolution: make deliberate effort to deepen your knowledge and incorporate a new, behavioral-based process into your daily work with clients. You and your clients have everything to gain – a stronger, more enduring relationship and potentially better investment results as well.

#### ***Further Reading***

- Ariely, Dan. Predictably Irrational. New York: HarperCollins, 2008.
- Pompian, Michael. Behavioral Finance and Wealth Management. New York: Wiley, 2006.

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1 Behavioral Finance & Implications for Equity Investors by Joel Fortney, CFA. Principal Global Investors. [www.principalglobal.com/knowledge/download.aspx?id=41308](http://www.principalglobal.com/knowledge/download.aspx?id=41308)

2 “Using Behavioral Investor Types to Build Better Relationships with Your Clients,” by Michael M. Pompian, CFP, CFA. Journal of Financial Planning, October 2008, pages 64-74.

3 “Ask the Expert,” New York Times, November 2-10, 2009, <http://bucks.blogs.nytimes.com/2009/11/02/answers-about-investor-behavior/>



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