

Incorporating Behavioral Finance into Your Practice

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Executive Summary

- Irrational investor behavior is commonly observed by wealth management practitioners when creating and administering investment solutions for their private clients. Many advisors would like to address behavioral issues, but lack diagnostic tools and application guidelines to employ behavioral finance research with clients.
- Many clients would be well served by adjusting their asset allocations to account for biased behavior. By doing so, they would stand a better chance of adhering to their investment programs and enjoy better long-term investment results.
- In applying behavioral finance research to client situations, practitioners must decide whether to attempt to change their clients' biased behavior or adapt to it. Furthermore, quantitative guidelines need to be available when modifying asset allocations to account for biased behavior.
- Practitioners should adapt to biases at high wealth levels and attempt to modify behavior at lower wealth levels. They should adapt to emotional biases and moderate cognitive biases. These actions will lead to a client's *best practical allocation*.
- Three case studies illustrate how these guidelines are applied. A quantitative model is also unveiled that calculates acceptable discretionary distances from the mean-variance output for determining the best practical allocation.
- The article offers practitioners a framework to better understand how behavioral finance can be applied to their individual clients.

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Mr. Pompian and Dr. Longo have published several articles on the subject of practical application of behavioral finance.

For many experienced wealth management practitioners, the task of creating and delivering investment solutions to private clients cultivates both a keen awareness of "less than rational" decision-making and a potential interest in the branch of economics—behavioral finance—that provides insights into irrational investor behavior. Why, then, has the robust body of behavioral finance research not enjoyed mainstream application? Practitioners employ but a few of the significant number of investors' behavioral "biases"—defined as systematic errors in judgment—that have been identified by researchers. Why not more, and why have practitioners failed to consider behavioral biases in the critical duty of designing asset allocation programs for their clients? The authors offer two primary explanations for this phenomenon, and contend that once these issues are resolved, behavioral finance will represent a new and vast frontier in serving clients.

First, behavioral biases, as presently articulated, are not user-friendly because there is not a widely accepted "industry standard" methodology of identifying an individual investor's biases. Researchers have done a significant amount of work to reveal behavioral biases, which are certainly usable, but practitioners would enormously benefit from a comprehensive volume, which does not presently exist. Second, if an investor's behavioral biases *have* been identified, practitioners lack the guidelines necessary for incorporating these biases

during the process of determining asset allocation.

Developing proper guidelines for incorporating biases in asset allocation decisions—the focus of this paper—requires answering central questions:

1. When should advisors attempt to *moderate* the way clients naturally behave to counteract the effects of behavioral biases so that they can "fit" a pre-determined asset allocation? (For purposes of this paper, we will call this *moderating* a client.)
2. When should advisors create asset allocations that *adapt* to clients' biases, so that clients can comfortably abide by their asset allocation decisions? (For purposes of this paper, we will call this *adapting to a client*.)
3. Once the decision is made to either *moderate* or *adapt*, what quantitative parameters should be in place when putting the moderate or adapt recommendation into action?

These questions will be explored, and guidelines will be delineated for taking investor biases into account to create what the authors have termed the *best practical allocation* for a client. Thus equipped, practitioners may more easily and fruitfully apply the body of behavioral finance research.

Best Practical Allocation

Practitioners are often vexed by their clients' decision-making process when it comes to allocating their investment portfolio. Let's explore why this may happen. In designing a standard asset allocation program with a client, practitioners first administer a risk tolerance questionnaire, then discuss the client's financial goals and constraints, and then typically recommend the output of a mean-variance optimization. Although this process may work well for institutional investors, it often fails for individuals, who are susceptible to behavioral biases. In a common scenario, a client demands, in response to short-term market movements and to the detriment of the long-term investment plan, that his or her asset allocation be changed.

Nobel prize-winner Daniel Kahneman and co-author Mark Riepe (1998), who have made significant contributions to behavioral finance, describe financial advising as "a prescriptive activity whose main objective should be to guide investors to make decisions that serve their best interest."

Serving the best interest of the client may be the recommendation of an asset allocation that suits the client's natural psychological preferences—and may not be one that maximizes expected return for a given level of risk. More simply, a client's best practical allocation may be a slightly under-performing long-term investment program to which the client can comfortably adhere.

Conversely, another client's best practical allocation may be one that goes against his or her natural psychological tendencies, and the client may be well-served to accept more risk than he or she might otherwise be comfortable with—to maximize return for a given level of risk.

Guidelines for Determining Best Practical Allocation

The authors offer two propositions for guiding practitioners in identifying the best practical allocation for their clients while considering behavioral biases:

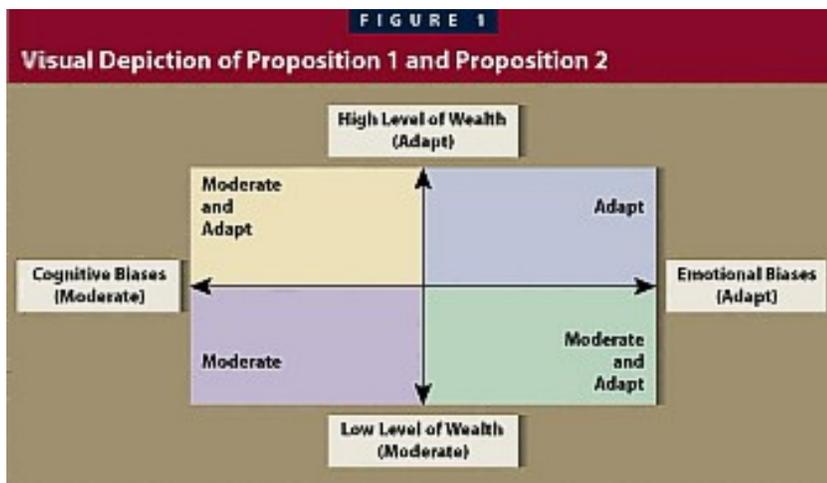
Proposition I. The decision whether to moderate or adapt to a client's behavioral biases during the asset allocation process depends fundamentally on the client's level of wealth. Specifically, the wealthier the client, the more the practitioner should adapt to the client's behavioral biases. The less wealthy, the more the practitioner should moderate a client's biases.

Rationale. A client's outliving his or her assets constitutes a far graver investment failure than a client's inability to amass the greatest possible fortune. In the former case, the client's standard of living may be jeopardized; in the latter, the client's standard of living will remain in the 99.9th percentile. In other words, if bias is likely to endanger a client's standard of living, moderating is the best course of action. But if only an unlikely event, such as a market crash for those clients with market-based wealth, could jeopardize the client's standard of living, bias becomes a lesser consideration, and adapting may be the more appropriate action.

Proposition II. The decision whether to moderate or adapt to a client's behavioral biases during the asset allocation process depends fundamentally on the type of behavioral bias the client exhibits. Specifically, clients exhibiting cognitive biases should be moderated, while those exhibiting emotional biases should be adapted to.

Rationale. Behavioral biases fall into two broad categories—cognitive and emotional—though both types yield irrational decisions. Because cognitive biases stem from faulty reasoning, better information and advice can often correct them. Conversely, because emotional biases originate from impulsive feelings or intuition—rather than conscious reasoning—they are difficult to correct. Cognitive biases include heuristics, such as anchoring and adjustment, availability, and representativeness biases. Other cognitive biases include selective memory and overconfidence. Emotional biases include regret, lack of self-control, loss aversion, hindsight, and denial. These biases will be described in more detail in the next section of the paper.

Propositions I and II can, for some clients, yield a blended recommendation. For instance, a less wealthy client with strong emotional biases should be both adapted to and moderated. Figure 1 illustrates this concept. Additionally, clients may exhibit the same biases, but should be advised differently. The cases of three hypothetical investors—Ms. Smith, Mr. Jones, and the Adams family—will add clarity to these complexities, while illustrating how practitioners can apply these propositions to determine best practical allocation.



Case Studies

Case A. Ms. Smith is a single 65-year-old with a modest lifestyle and no income beyond what her investment portfolio of \$1 million generates. Her primary investment goal is to not outlive her assets; she does not, under any circumstances, want to lose money because she recalls that her relatives lost money in the crash of 1929. Ms. Smith exhibits these behavioral biases:

- Loss aversion—the tendency to feel the pain of losses more than the pleasure of gain
- Anchoring and adjustment—the tendency to believe that current market levels are "right" by unevenly weighting recent experience
- Selective memory—the tendency to recall only events consistent with one's understanding of the past

Case B. Mr. Jones is a single 50-year-old pharmaceutical executive earning \$250,000 a year. He lives extravagantly, occasionally spending more than his income, but has saved approximately \$1.5 million. His primary investment goal is to donate \$3 million to his alma mater, but he cannot obtain life insurance. Mr. Jones exhibits the following biases:

- Loss aversion
- Overconfidence—the tendency to overestimate one's investment savvy
- Lack of self-control—the tendency to spend today rather than save for tomorrow

Case C. The Adams family includes a financially well-informed couple, both aged 36, and two children aged 4 and 6. They are financially sound, but were not invested during the bull market of the 1990s as many of their neighbors were. The couple's total income, \$120,000, is, like the family itself, not expected to grow significantly. They have saved \$150,000, which they hope will be the financial foundation from which they will send their children to college and retire comfortably. The Adams suffer from:

- Loss aversion
- Regret—the tendency to feel deep disappointment for having made incorrect decisions
- Availability bias—the tendency to believe that what is easily recalled is more likely¹

Further assume that it is 2001; capital markets are off their highs (for stocks) and lows (for bonds), but not yet at the extremes of the recent market cycle. After you, the practitioner, administer a risk tolerance questionnaire, the mean-variance optimizer yields the following allocations for each of the three investors:

- Ms. Smith: 75 percent bonds, 15 percent stocks, 10 percent cash
- Mr. Jones: 85 percent stocks, 10 percent bonds, 5 percent cash
- The Adams family: 70 percent stocks, 25 percent bonds, 5 percent cash

These case studies were designed to help practitioners answer three fundamental questions:

1. What effect do a client's biases have on the asset allocation decision?
2. Should you moderate or adapt to these biases?
3. What is the best practical allocation for each investor?

Solution to Case A: Ms. Smith

1. **Effect of biases.** Ms. Smith's biases are very consistent and lead to a clear allocation preference. Because Ms. Smith does not tolerate risk (loss aversion) and recalls that her relatives lost money (selective memory), she would naturally prefer a safe and secure allocation. Additionally, since the market has dropped recently, she will likely make faulty conclusions about current market prices (anchoring and adjustment); she will be wary of any exposure to equities. Thus, if you, as her advisor, presented her with an allocation of 100 percent bonds, she would be likely to immediately agree with that recommendation. However, you need to consider her bias toward such an allocation.
2. **Moderate or adapt?** Given Ms. Smith's level of wealth, if you adapt to her biases, and recommend an allocation to 100 percent bonds, your financial planning software tells you that Ms. Smith runs the risk of outliving her assets, a clearly unacceptable outcome. Additionally, her biases are principally cognitive (selective memory, anchoring, and adjustment), and these types of biases can be corrected with advice and information that will help her understand that she would be at risk if she accepted a 100 percent bond portfolio. This being the case, the correct course of action is to moderate her bias preferences and recommend that she accept some risk in her portfolio. Your recommendation is to help her overcome her behavioral biases and advise her to "fit" the slightly more aggressive allocation the optimizer recommended.
3. **Best practical allocation decision.** As we have decided to moderate Ms. Smith's biases, the best

practical allocation is the precise allocation that the mean-variance optimizer provided, 75 percent bonds, 15 percent stocks, 10 percent cash. You recommend this allocation to Ms. Smith, and administer a continuing program of investor education on the risk of outliving one's assets.

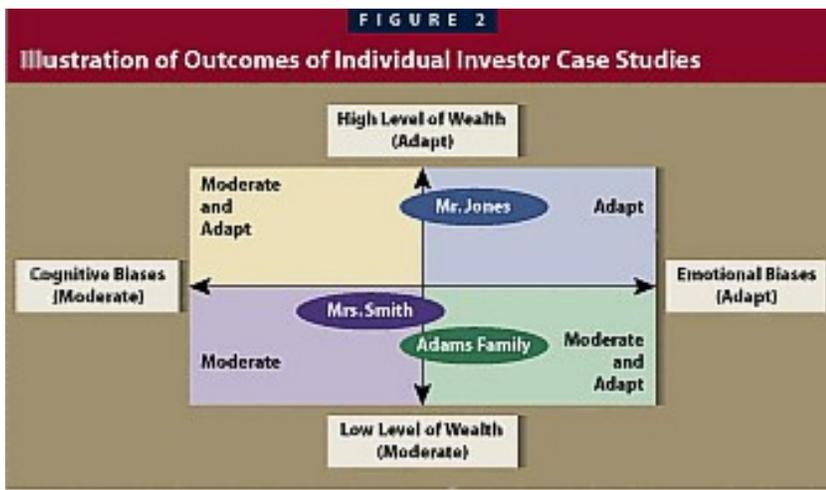
Solution to Case B: Mr. Jones

1. **Effect of biases.** Mr. Jones's biases do not provide a clear indication of what allocation he would naturally prefer. On the one hand, his overconfidence may lead him to be more comfortable with equities than is appropriate for him. On the other hand, because he does not tolerate losses (loss aversion) and has a high need for current income that supplements his "spend today" mentality (lack of self-control), he sees the benefit of fixed income investments. In this case, biases favoring fixed income outweigh those favoring equities, but further analysis is required.
2. **Moderate or adapt?** When considering level of wealth, Mr. Jones clearly does not run a standard-of-living risk. Additionally, his behavioral biases are principally emotional (loss aversion, lack of self-control). Given these two facts, and given that he naturally prefers an allocation favoring fixed income, you decide that indeed the appropriate recommendation is to adapt to his biases and create a less aggressive portfolio to which he will be able to adhere and be comfortable with.
3. **Best practical allocation decision.** The mean-variance optimizer's recommended allocation was 85 percent stocks, 10 percent bonds, 5 percent cash. Using guidelines presented a later section of this paper, "How Much to Moderate or Adapt," your judgment is that an allocation of 75 percent stocks, 15 percent bonds, 10 percent cash is appropriate. You also caution Mr. Jones that his alma mater may receive \$2.5 million versus his original goal of \$3 million.

Solution to Case C: The Adams Family

1. **Effect of biases.** We are once again presented with biases that lead us in different directions. Because the Adams family's portfolio has not kept pace with their neighbors', the Adamses regret having made incorrect decisions in the past, which may prompt them to take on more equity risk than may be appropriate. But because they do not tolerate risk (loss aversion) and have shrunk from the latest information about the skidding equity market (availability), they are more comfortable with less exposure to equities. Again in this case, biases favoring fixed income appear to outweigh those favoring equities—we need to thoughtfully consider the situation further.
2. **Moderate or adapt?** The Adams family's biases are mainly emotional (loss aversion, regret). Thus, your instinct is to adapt to a lower allocation to equities of 50 percent because you believe that the Adamses are likely to be comfortable with, and be able to adhere to, such an allocation. But given their level of wealth, your financial planning software suggests that a lower equity allocation would not provide a secure retirement given their college expenses; that is, their standard of living is at stake. You decide to compromise, and your recommendation is to moderate and adapt, striking a balance between their investment goals and biases.
3. **Best practical allocation decision.** The mean-variance optimizer's recommended allocation was 70 percent stocks, 25 percent bonds, 5 percent cash. You had contemplated dropping the equity allocation to 50 percent based on their biases, but realized that such an allocation would present a standard-of-living risk. Thus you bring the equity allocation up to 60 percent, which results in a compromise of 60 percent stocks, 35 percent bonds, 5 percent cash allocation. You recommend this allocation to the Adams family.

These case studies have demonstrated the process by which we can arrive at the best practical allocation while considering behavioral biases. Figure 2 supplements Figure 1 by providing a visual description of these three cases.



How Much to Moderate or Adapt

The decision to override the mean-variance optimizer will cause a deviation from the "rational" portfolio. The authors offer a method of calculating acceptable discretionary "distances" from the mean-variance output. It is recommended that allocations not stray more than 20 percent from the mean-variance optimizer without extensive client consultation. The justification for the 20 percent range is that most investment policy statements permit discretionary asset class ranges of plus or minus 10 percent in either direction. For example, if a "sample" balanced portfolio is defined as 60 percent equities/40 percent fixed income, practitioners normally have the discretion to have equities range from 50 percent to 70 percent, and fixed income might range from 30 percent to 50 percent.

Method for Determining Appropriate Deviations from the Rational Portfolio

1. Subtract each bias-adjusted allocation from the mean-variance output.
2. Divide each mean-variance output by the difference. Take the absolute value.
3. Weight each percentage change by the mean-variance output base. Sum to determine bias adjustment factor.

Tables 1 and 2 show the calculations that justified the best practical allocations for Mr. Jones and the Adams Family. Ms. Smith's bias-adjusted allocation did not differ from the mean-variance output; her bias adjustment factor is 0 percent.

TABLE 1

Distance from Mean-Variance Output for Mr. Jones

	Mean Variance Output	Bias Adjusted Allocation	Difference	Change In Absolute Value Percent	Change In Weighted Average Percent
Fixed Income	10	15	-5	50%	5%
Equities	85	75	10	12%	10%
Cash	5	10	-5	100%	5%
	100	100		Bias Adjustment Factor =	20%

	Mean Variance Output	Bias Adjusted Allocation	Difference	Change In Absolute Value Percent	Change In Weighted Average Percent
Fixed Income	25	35	-10	40%	10%
Equities	70	60	10	14%	10%
Cash	5	5	0	0%	0%
	100	100	Bias Adjustment Factor =		20%

Conclusion

The propositions and cases presented here provide guidelines for practitioners to incorporate behavioral finance into asset allocation design to create what the authors have termed the best practical allocation for a client. The authors undoubtedly believe that the future of advising private clients will include behavioral finance research, and the result will be that practitioners will better serve clients' best interests.

Endnote

1. For purposes of this paper assume that Mr. and Mrs. Adams have a common set of behavioral biases.

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Helpful Web Sites

- Investor Personality Type Testing— www.investorpsych.com
- Journal of Psychology and Markets— www.psychologyandmarkets.com
- Journal of Wealth Management— www.ijournals.com/JPPM/default.asp
- Meir Statman— www.isb.scu.edu
- Richard Thaler— www.gsb.uchicago.edu
- Robert Schiller— www.econ.yale.edu/
- Daniel Kahneman— www.princeton.edu
- Undiscovered Managers listing of behavioral finance researchers— www.undiscoveredmanagers.com/Behavioralpercent20Finance2.htm

