The Behavior Gap

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Investment advisers are tasked with not only finding the best-performing fund for their clients' portfolios, but also helping them avoid falling into the "behavior gap." Even with a sound investment plan, a single, hasty, emotional decision can cause a client's portfolio to significantly underperform. There are ways to promote trust between advisers and their clients to make it easier for them to pull clients away from the behavior gap and to benefit the industry as a whole.

In 1995, I got married and my job was digging ditches for a landscaping company. About two weeks after the wedding, my wife was looking in the help-wanted section in the newspaper. She found what we both believed was a job as a security officer. I applied through a temporary agency, but during the interview, there were no questions about my self-defense skills. I was asked about things that I did not really know about, such as mutual funds. As it turns out, the interview was for a *securities* job, not a *security* job. I ended up at the Salt Lake City call center of Fidelity Investments doing a job that completely changed the trajectory of my career. Of course, I did not know anything about mutual funds and had to learn a lot very quickly.

Futile Search for the Above-Average Manager

In the midst of training at Fidelity, the big event of Netscape going public took place. On 9 August 1995, Netscape's scheduled initial public offering (IPO) price of $14 doubled to $28 because it was heavily oversubscribed. During the first day of trading, Netscape's price went as high as $75 before closing the day at $58. In the middle of training, and still not knowing much, I was called out to help with answering the phones, which were ringing nonstop. I remember being awed by the energy in the air, which I later learned was related to the Netscape IPO, and also feeling confused and a little unnerved.

My next job was with a big brokerage firm, at which I had an amazing experience and learned a lot. Part of the process in the investment industry is that it can be challenging to figure out what your job is. I wish that I had kept all my business cards through the years. In the course of my career, it seems as if I have had 20 different titles, including adviser, consultant, and wealth management adviser.

My grandfather was an intellectual property attorney, so I was taught that the process is more important than the result. At my jobs, I was asking the annoying questions, such as "What is the process for building a portfolio?" I was not getting particularly great answers, so I earned the Certified Financial Planner (CFP) designation. My goal was to figure out the process for finding good money managers. Back then, I thought my job was to conduct manager search and selection on behalf of my clients. I identified what I thought would be the above-average manager. But after I committed my money or a client's money, the seemingly above-average manager would eventually become the not-so-great manager, no matter how complex I made the process.

I had a detailed process to identify U.S. large-cap value managers. I would run a particular screen once a month, and one month, the screen identified Davis New York Venture Fund. But 12 months later, the screen kicked Davis out and replaced it with another company that I will call "XYZ Manager." Unsurprisingly, a year later, that company did not pop up again, but Davis did. I had to call all of my clients and inform them that XYZ was being fired and Davis was being hired.

One of my clients asked for a performance comparison of his account against Davis and XYZ for the entire two-year time period. His account had dramatically underperformed both of the managers. This situation created so much stress and worry for me that I came to the conclusion that I should get out of the investing business.

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Closing the Behavior Gap

Soon after that experience, I came across a study (and several others that were similar) that found the average *investor* underperforms the average *investment*. This finding implies that investors could just own an average fund, and if they behave correctly, they will outperform 99% of their peers.

This realization excited me because I was capable of picking average investments. So, if I could just get clients to behave correctly, I could save my career. I realized that my job was to close my client's own behavior gap, not choose above-average managers. I started drawing a sketch, shown in **Figure 1**, on whiteboards during meetings with clients. The sketch has a tall bar labeled "investment return," a shorter bar labeled "investor return," and the space difference labeled "behavior gap." The size of the behavior gap varies between different investors and investments. There is an interesting German study of more than 8,000 investor accounts with an average of 200 trades per year. On average, the excessive trading cost those investors 8.5% per year.[1]

[1]Steffen Meyer, Dennis Schmoltzi, Christian Stammschulte, Simon Kaesler, Benjamin Loos, and Andreas Hackethal, "Just Unlucky? A Bootstrapping Simulation to Measure Skill in Individual Investors' Investment Performance" (6 June 2012): http://ssrn.com/abstract=2023588.

One day a client asked for the behavior gap sketch to take home. A couple weeks later, another client asked for a digital copy of the sketch. Those requests sparked the idea of making it available to other people. As I realized how people were able to understand concepts more easily with the simple sketches, I started drawing more.

Buy High, Sell Low

My next sketch, shown in **Figure 2**, was of a wavy line with the peak labeled "greed/buy" and the valley labeled "fear/sell." At the end of the line are the words "…repeat until broke!" To understand the meaning, recall how crazy the stock market was during 1997–1999. The S&P 500 Index went up more than 80% over those three years, and the NASDAQ doubled. As the craziness continued, I do not think anyone would claim to have known in January 2000 what was going to happen next. The record for monthly net inflows into equity mutual funds before January 2000 was $29 billion, and the average was about $15 billion. But in January 2000, inflows to equity mutual funds was $46 billion, mostly in large-cap technology, followed by $54 billion in February and $39 billion in March. The then record high for the NASDAQ occurred on 10 March, reaching 5,048.62. The top of the stock market occurred between January and March 2000, with greed driving frenzied equity purchases.

Figure 1. Behavior Gap Sketch

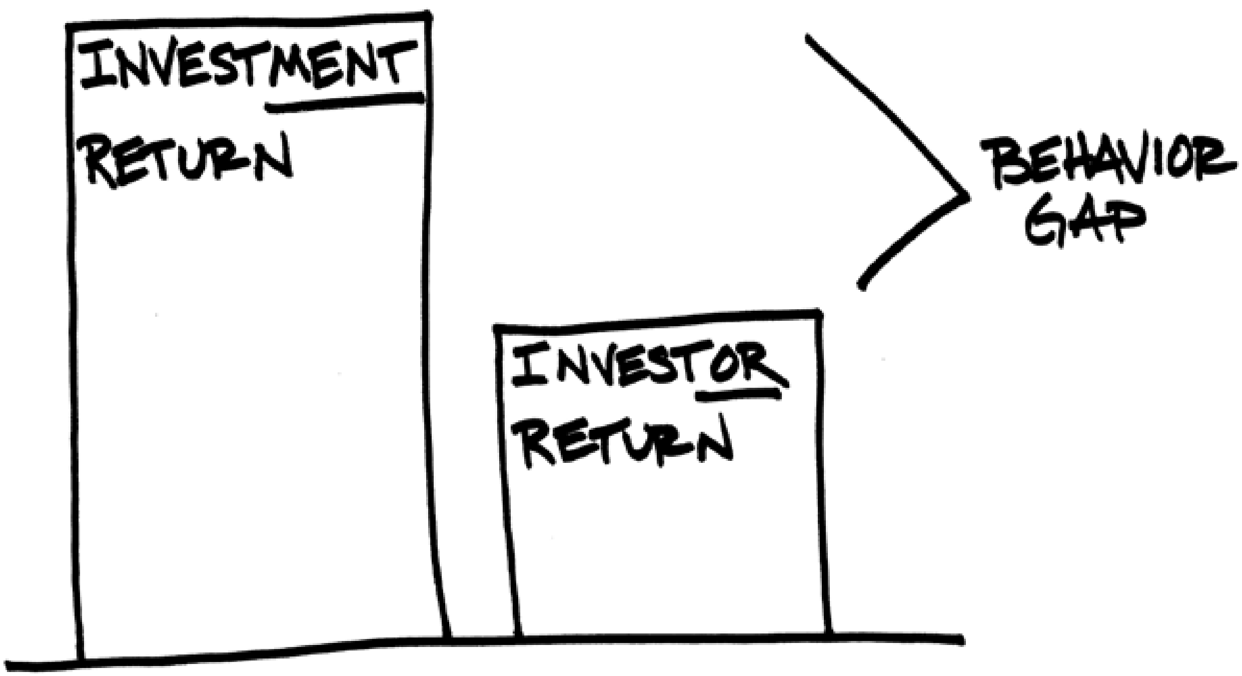
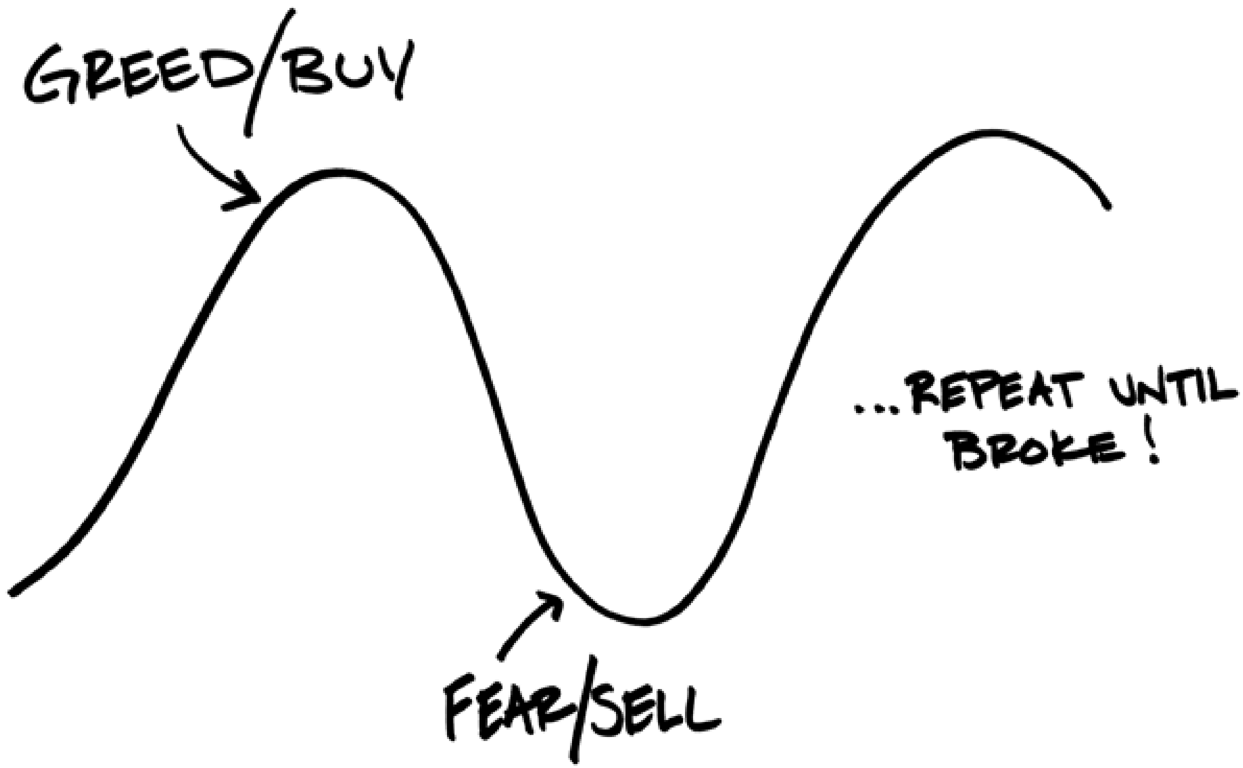


Figure 2. Fear and Greed Sketch



Investors also act crazily at the bottom of the equity cycle. October 2002 was the first time in recorded history of five consecutive months of net outflows, with October being the fifth monthly decline. On 9 October 2002, the NASDAQ bottomed out at 1,114.11, down almost 80% from its peak in March 2000. Stocks are the only thing that investors buy when they are marked up, and that investors rush to sell when they are on sale. Collectively, investors repeat this pattern over and over, even with other asset classes, such as emerging markets and real estate. Somehow it has to stop.

Evolution of My Financial Illustrations

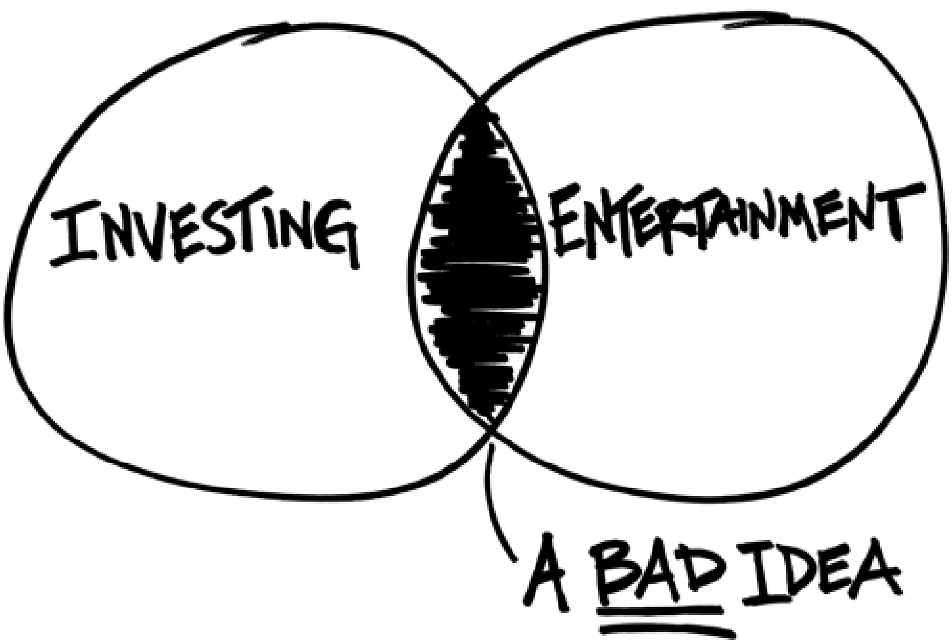
I published some of my illustrations on my website (www.behaviorgap.com) and became the basically self-declared king of the obvious. Somehow, an investment conference came across the sketches and asked me to come speak. For the talk, I had some t-shirts printed with the fear/greed sketch described earlier. In the middle of my talk, I tried to give away the t-shirts, but it did not go particularly well. I came home with 45 of the 50 that I had. So, I put them up for sale on my website, and surprisingly they sold. A blogger at the *Wall Street Journal* found out about the t-shirt story and wrote about it.

Eventually, I started my own independent registered adviser firm in Las Vegas. It is a lonely existence as an independent financial adviser. Much to my surprise one day, I received an e-mail from Ron Lieber, the "Your Money" columnist for the *New York Times* and author of the "Bucks" blog, asking me to be part of a network of experts that answer questions from readers. I stayed up all night trying to answer Ron's inaugural question.

The sketch that I came up with, shown in **Figure 3**, is two linked circles, one labeled "investing" and the other labeled "entertainment." Where the two circles overlap is labeled "a bad idea." That first sketch for the *New York Times* was meant to illustrate that at some point people collectively decided that investing is entertainment, with the stock market being the United States' greatest spectator sport. It is troublesome when CNBC is showing at the dentist's office and people have nothing to talk about apart from owning Infospace shares (share price peaked at $1,305 in March 2000 and then fell to $2.67 by June 2002) or Pets.com shares, a high-profile dot-com company notorious for going bust within a year of its IPO.

The sketch is meant to capture the idea that investing is all about action, and that taking bold, swift action is fun. But the idea that investing is

Figure 3. Investing and Entertainment Sketch



fun and entertaining can lead to costly mistakes. Despite knowing at some level that market timing, stock picking, and day trading are hazardous to our wealth, people choose to do them anyway. Investing can be fun when the market is going up and people are making money. But bear markets serve as a painful reminder that investors do not always make money, and no one enjoys losing money. People need to remember that investing is not a game; it is real life with real money and real goals. By confusing investing and entertainment, investors almost always end up with bad results.

Another sketch I did for the *Times* was meant to illustrate how following the herd does not make investing safe. Buying because everyone else is buying is not an investment strategy. People are social animals who feel safer in numbers, but so are sheep. People take comfort in doing what everyone else is doing, and in the back of their minds, they know that even if they are wrong, at least they will be wrong with a bunch of other people. But that is the same line of thinking that leads young people to do stupid things just because "everyone else is doing it." This view sounds obvious and easy to scoff at, but the fact that it is obvious did not keep investors from loading up on tech stocks in the late 1990s, bonds in 2002, and real estate in 2006.

I have a friend who is a self-made real estate developer, the type of person who starts one small project and rolls the proceeds into the next, larger project. Self-made developers go through huge booms and busts and hope that their last project goes well. So, my friend was working on his last real estate project in the late 1990s because he was going to retire. Recall that during that time is when U.S. equity markets doubled during the dot-com mania, and my friend had a bunch of money set aside, along with slowly liquidating his real estate business, that he was moving into the equity markets.

My friend's financial adviser recommended that he put 50% of his wealth in the Alliance Premier Growth Fund (large-cap growth) and 50% in Davis New York Venture Fund (large-cap value stocks). As a brief history lesson, the Alliance Premier Growth Fund was highly exposed to technology companies, with a concentrated exposure to Enron, which would eventually file for bankruptcy, causing investors to lose everything. (At the time, other Alliance funds also had concentrated exposures to then-favored companies, only to suffer significant losses and underperformance versus their peers during the dot-com collapse.)

In 1997, the Alliance fund significantly outperformed the Davis fund. At the end of the year, my friend wanted out of Davis and all in Alliance, but his adviser recommended staying with the 50/50 balance. In 1998, Alliance again outperformed Davis, and his adviser recommended the same course of action.

In 1999, instead of following a consistent strategy of rebalancing to 50% Alliance/50% Davis, my friend wanted to invest based on past performance; he had become impatient and tired of Davis's underperformance. So, he demanded that his adviser move all the money into Alliance Premier Growth. If investors have a disciplined plan, they will lose a little bit of money consistently. The irony is that those who stick to the disciplined plan the longest and then capitulate based on emotion are the ones who lose the most. Unfortunately, my friend lost almost all of his investment and continues to work as a real estate developer today.

The question is what to do about the problem of people making emotional decisions and how do wealth managers convince people to let them help. I believe that the financial industry is part of the problem. Studies that talk about the difference between the investment return versus the investor return do not address the fact that a significant portion of money in mutual funds comes under the purview of an adviser. So, if that much is being managed by professional financial managers, then they are part of the problem.

Six Strategies to Control Emotions

The wealth management process needs to be simpler for investors because they are making incredibly important decisions and they are not getting the help they need from advisers. I want to propose six strategies that advisers could pursue that will better put the client's interests first by helping them avoid the behavior gap while restoring trust in the industry.

1. Start Talking About Money. We need to start getting more comfortable talking about money. As professionals, we are really good at spreadsheets and calculators, and that is what we *think* our job is about. Then one day we are sitting in our office and one of our clients is crying, and we are not prepared to deal with that kind of counseling. It has been surmised by some that in 2012 the top cause of adult male suicide was financial issues. Children will not learn to understand the value of money if we do not talk about it, especially if they do not have to earn it like their parents did. Money concerns, good and bad, need to be topics of conversation.

2. Focus on "Why". We need to help people understand why. Simon Sinek's popular book, *Start with Why*, contends that people spend all of their time doing things and never really stop to ask "why?"[2] Asking why gets to the root of why personal finance can be so emotional. From the client's perspective, money is not about spreadsheets but about values and goals.

I had an amazing experience with a client one day when we were having a discussion about values. I am a fan of Bill Bachrach's book *Values-Based Selling: The Art of Building High-Trust Client Relationships*, in which he asks, "What is important about money to you?"[3] This question can be uncomfortable for both the adviser and the client, but it gets to the root of the problem. I have learned to embrace that discomfort. In the discussion, I asked my client, who is a surgeon with a type-A personality, that question. Her initial answer, which is fairly standard, was that she just wanted freedom. I next asked, "What is important to you about freedom?" As the answers become more deeply personal, it is probable that the client might start to cry. In fact, it is a goal of mine; I do not mean that from a manipulative standpoint, but just to get to the heart of the emotion that is at the root of the problem. With the second question, my client started to get emotional because she believed that if she had some freedom, she would have more time. I then asked, "What would you do with more time?" As she started to answer, she paused and then replied, "I really want to have a child, and I do not have time because I am working so much."

The nature of the adviser/client relationship can be shifted completely with this type of questioning. I can learn things that put me in a much better position to help my clients make good decisions, and they know that I understand. That gives me trust, which becomes the capital that I can use later to pull them back from the behavior gap. With trust, I can help prevent my clients from doing something stupid by reminding them why it is so important to get it right. For that one client, getting it right meant freeing up time so that she could start a family.

3. Eliminate the Noise. I think if we can do something to eliminate noise in our lives, we can maybe help eliminate noise in our clients' lives. For our clients, eliminating noise means that we should not be spending so much energy worrying about how our portfolio's performance compares with an index as a benchmark. How much does that matter if you beat some index and you still do not have enough money to satisfy goals? It is important to be informed, but it is more important to be clear on what information is actually helpful and what information is just making people anxious.

4. Embrace Simplicity. Simplicity is a fascinating problem. Professionals, whether money managers, accountants, or attorneys, are used to dealing with complex problems. They get in the habit of thinking that complexity is some sort of sign

[2] Simon Sinek, *Start with Why: How Great Leaders Inspire Everyone to Take Action* (New York: Portfolio Trade, 2011).

[3] Bill Bachrach, *Values-Based Selling: The Art of Building High-Trust Client Relationships* (Stamford, CT: Aim High Publishing, 1996).

of an intellectual gift. Even worse, in some areas they think complexity is a good selling tool. Clients want us to make the investment process simple for them. The popularity of the simple sketches speaks to how people want financial advice that is easier to understand.

Advisers will often start approaching a problem and then get right into solving it. They believe that they need to build big spreadsheets and hire a lot of staff to help their clients solve their complex wealth problems. It is at that point when clients' interest is lost; they just want to know the outcome delivered in simple, easy-to-understand language.

At its simplest level, the adviser's job is to help his or her clients ensure that their incomes are equal to or greater than their expenses. Show them how to create a personal balance sheet that explicitly shows assets and liabilities, and teach them that assets need to be equal to or greater than liabilities.

5. Make Wealth Management Planning a Process. People working in the more traditional parts of the financial services industry have used the product-first approach for decades. Only after pushing a client to buy a certain investment do many advisers even attempt to fit it into a larger plan. And often the traditional financial plan is a bunch of assumptions combined with a long time frame. Whatever the approach, we need to invert the traditional decision triangle. Start with the plan as the foundation (ask why), then move on to the process (ask how), and then look for specific products (ask what).

Starting with "why" means achieving clarity about personal financial goals and creating a plan. To reach that point, consider the client's values and then set some broad goals. If somebody has a plan—it may just be an investment policy statement that articulates investment objectives and constraints—that can be good enough. The plan becomes the touchstone to bring clients away from the behavior gap if they start to get pulled in. It is important to stay in touch with clients so that we can have frequent conversations, especially if there are any significant changes in their lives that would affect how their portfolios are structured.

6. Love Your Clients. In the context of the adviser/client relationship, I used to say trust, but I am not going to be scared anymore to say love. Love is the ultimate financial planning spreadsheet and the ultimate wealth management calculator. I think if we love our clients, trust can be restored because they will know that we will do the right thing. If everyone in the industry starts treating clients the way they should be treated, then the industry will slowly change. That will be a remarkable experience. Imagine if clients believed that their wealth adviser loved them and was not trying to steal money from them. At a professional level, we should not worry whether we have a fiduciary duty; instead, we should just act as if we do.

Conclusion

Investing is about behavior, not skill. Buying high and selling low is dumb. Even by owning an average mutual fund, investors who behave correctly can outperform 99% of their neighbors. Alternatively, for investors who spend their whole lives searching for the best investment, an entire lifetime's return can be wiped out by one single behavioral mistake. There are steps that advisers can take to help their clients avoid the behavior gap and in the process improve the reputation of the wealth management industry.

This article qualifies for 0.5 CE credit inclusive of 0.5 SER credit.