Applying Behavioural Finance Today
... for Your clients' and Your Benefit.

Geoff Davey, March 2009

The current edition of Bob Veres' Inside Information reports on the standout presentation from February's Technology Tools for Today conference in Dallas. The presentation, "How to Plan When the Sky is Falling", was made by Bob Curtis, principal of PIE Technologies, the creators of the MoneyGuidePro planning software.

From a client perspective there are two arms to the current crisis: they are hurting because their net worth has decreased dramatically and they are fearful because they envisage a truly bleak future.

The question today is: how do you pull your clients back from the abyss to a more reasonable view of what's going on? How do you convince them that even though the markets have retreated dramatically, the sky is not falling in with regards to their lifestyle and their goals?

Bob Veres' report is précised as follows:

> *The fundamental problem is that most advisors have given their clients a plan that either succeeds or fails, a binary set of outcomes to which we then (if we're very sophisticated) attach a Monte Carlo-generated chance of success. If your clients are like those in Curtis's slides, they have seen their plan move from a 90% chance of success down to something in the mid-40s. No wonder they're panicking!*
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> *But … What if the plan is more nuanced?*
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> *Curtis noted that the traditional financial plan includes all of the aspirational goals that a client has given you, as well as what might be called the substantitive. You have the costs of eating and keeping a roof over their heads, and also the costs of traveling to Europe once a year and buying a new Lexus every couple of years. This "single point goal," as Curtis called it, will have a fixed retirement date of, say, age 63.*
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> *Here's the point: if you were to strip out some of the aspirational goals, or scale them back a bit, and rerun the numbers, clients will discover that they are in far greater danger of driving a Honda instead of a Lexus than they are of eating dog food. And, Curtis added, most clients are already mentally scaling back their aspirational goals far beyond what will be necessary.*
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> *The issue then becomes: how do you present this to them so that they can see not only that they're all right today, but that they will be all right even if the markets drop another 30% or so before resuming a more normal upward flight path?*
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> *If you rerun the plan as is, you will be showing clients the scary drop in chances of success from 90% to 40%. Instead, Curtis demonstrated some features in MoneyGuidePro version G-2 which are VERY cool, but which are not totally outside of your ability to replicate with another program.*
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> *The process starts by taking a more nuanced look at client goals. You ask when they want to retire, and get an "ideal" and "acceptable" number. Ideally, they would like to retire at age 64. But they give you age 66 as acceptable, something they would still be satisfied with. "Notice that we are not talking about the absolute worst outcome", Curtis said to the group. "We are talking about an outcome, which they define, where they will still be satisfied."*
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> *You do the same with travel, the same with the expense of the car they will buy every two (or, maybe, four) years, and all the other expense variables. The substantitive goals, like food and shelter, are held steady. "The goal is to look at where you are below the ideal, but are comfortably inside the acceptable range," said Curtis.*

MoneyGuidePro's latest G-2 version offers a process called "supersolve," which lets the client see that even though the chances of succeeding with the aspirational plan (the plan that you probably offered your clients) is down to 40%, they're still in the 85% range somewhere in the middle of the "acceptable" range of the spectrum, and at the far left side of the acceptable range (still not substantitive, but scaled back to their bare minimum acceptable), their chances of success is up over 90%.

They're not only not going to be eating dog food; they are still in the comfortable, acceptable range--AS THEY HAVE DEFINED IT.

Then you rerun the numbers with a 30% drop, and Curtis recommends that you add in the value of the house--some kind of reverse mortgage income at some point late in retirement. For the hypothetical couple that Curtis used in his slides, the market drop and the addition of the reverse mortgage very nearly balanced each other out. The client was still deeply in the acceptable range.

Of course, there will be some clients who can't get a high chance of success in their acceptable range, which means you need to have a conversation around what is acceptable. The clients may decide they won't travel as much in their late 70s and may stop traveling altogether in their 80s. They may scale back the costs of their automobiles, decide to live in a smaller house or otherwise make compromises which will almost certainly not be as drastic as where their imaginations were taking them.

Curtis summed up by saying "Things are worse than clients like, but generally better than they fear."

All advisers, no matter which planning software is used, should be able to follow the review process described above. Intuitively, we can sense that this reviewing will be a very useful exercise, but why?

The answer lies in behavioral finance. We know, thanks to Kahneman and Tversky, that our happiness/unhappiness depends more on the magnitude and direction of recent changes than it does on where we finished. So, even if ten years ago a client would have been quite satisfied with their current situation, this counts for far less than the recent deterioration. The issue here is one of anchoring. Today, clients will be anchored on where they were recently and so today looks bad. However, the reviewing process can switch the anchor point to their current situation, which given the likelihood that they can achieve an acceptable set of goals, won't seem too bad at all. Additionally, for clients who only knew that there previous goals were no longer achievable without knowing how 'bad' things were, it can be demonstrated that acceptable goals are still achievable. Where previously the future was unknown, an acceptable future is now likely. The unknown is a key element in the degree of risk perceived and it will have been greatly reduced, leaving clients feeling far less at risk than they had thought.

And, of course, your state of mind will be greatly improved by being able to help clients deal with their unhappiness and fears, and by the resulting improvements in their states of mind.

Inside Information is an extremely influential information service for US financial planning professionals, published by respected US financial services industry commentator, Bob Veres. It summarises the best thinking from 10 US industry conferences a year and the most important articles published in US trade and consumer magazines, as well as Bob's thinking on new trends in planning, practice management and client service.
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