ADVISOR PERSPECTIVES

What Investors Really Want

By Robert Huebscher
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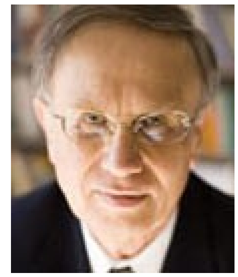
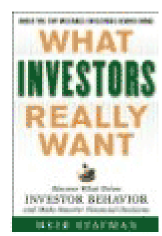


Pleasurable dining depends several elements working harmoniously – each course prepared carefully and served at the proper temperature, delivered with attentive and courteous service, and enjoyed in a rich and elegant ambiance. Though it might provide the same nutritional value, nobody would consider ordering their meal pureed in a blender.

Using a mean-variance optimizer to construct a retirement portfolio that sits on the efficient frontier is tantamount to dining on blended food, believes Meir Statman, a professor of finance at Santa Clara University who is also currently a visiting professor at Tilburg University in the Netherlands. Statman's research focuses on behavioral finance. His widely cited paper, *What Do Investors Want?,* was published in the Journal of Portfolio Management in 2004. He has expanded that work into a book, *What Investors Really Want,* which will be published this fall and can be advance-ordered through the link to the right.

I spoke with Statman last week about his research and how he believes advisors can help investors make smarter decisions.



The failure of mean-variance optimization

Statman's concerns about mean-variance optimizers stem in part from objections that are well known to most advisors. To obtain reasonable answers from an optimizer, one must constrain the allocations to each asset class; otherwise, optimizers will over-invest in the asset classes with the highest expected returns, irrespective of liquidity or other concerns. The result will be a portfolio that is an imperfect mixture of the mathematical benefits of the optimizer and the likes and dislikes of users for particular assets classes, such as international stocks or hedge funds.

More importantly, though, advisors typically use optimizers – and other tools – to construct a single portfolio to meet their clients' retirement needs, and do so with the aim of finding the asset allocation that provides the best risk-adjusted return. Statman finds that approach too simplistic. Investors' needs are far more complex, and Statman believes that they must be deconstructed into their utilitarian, expressive and emotional components before an appropriate asset allocation can be determined.

Advisors should consider themselves "managers of well-being more so than managers of wealth," Statman told me. "It is really a matter of connecting money to life."

Utilitarian benefits are those provided by a mean-variance optimizer: low risk and high return. Focusing on those benefits in isolation, though, can be dangerous. Statman recounted research that took 77 food items and constructed a diet optimized to provide the most nutritional value at the lowest cost. The result was an annual diet consisting of 370 pounds of wheat flour, 57 cans of evaporated milk, 11 pounds of cabbage, 23 pounds of spinach, and 285 pounds of dried navy beans.

Just as no person would consider such a diet – blended or not – no investor should rely on an asset allocation constructed solely with an optimizer, according to Statman.

Expressive and emotional needs

To correct for the deficiencies of optimizers, Statman said advisors need to consider the expressive and emotional needs of investors as well.

Expressive needs are those that let you convey your status and "who you are" to others, Statman said. He drives a Toyota because a Mercedes Benz, would make him feel awkward, yet the walls of his home display art worth thousands of dollars, "even though $20 posters would suffice." He also buys index funds rather than active funds because he considers himself "an index fund kind of person." In Statman's conception, the financial planning process must accommodate the unique ways in which clients want to express their wealth.

Emotional needs relate to how clients feel about their wealth and how they spend their money. Clients may take emotional pride in being able to say that they provide for their children, or they may experience fear when the market crunches, Statman said. They may also derive joy from playing the market or a feeling of security from buying home insurance.

Those expressive and emotional needs may, and often do, lead to unwise and conflicting decisions. An investor may go through elaborate and expensive convolutions – which may land them in prison – in order to avoid taxes, Statman said. Yet the same investor may donate millions of tax-deductible dollars to universities for research.

"The attempt to separate one's life from one's money is absurd," Statman said.

Statman's behavioral finance research has explored many other ways in which emotional and expressive needs have molded behavior, such as how investors adjust decisions to reflect preferences for social responsibility, status, and patriotism (i.e., a "home bias" preference for investing in one's own country).

The portfolio pyramid

How should advisors and clients work together to build portfolios that incorporate utilitarian, expressive and emotional factors? Statman's solution is to use a pyramid-based construction. The base of the pyramid should support a client's core needs: to sustain a reasonable life style in retirement and meet other basic expenses. Those needs should be supported by a very low-risk portfolio, where risk is defined concretely as the probability of losing one's money – not in abstract terms of standard deviation or volatility.

The next layers should reflect a client's desire to pay for the educational needs of their children, and then other aspirational needs, such as the purchase of a second home or expensive vacations. Those portions of the portfolio should be supported with investments with successively higher levels of risk.

At the top of the pyramid are pieces of the portfolio to support bequests and donations, and to allow clients to "play the market," Statman said. At these layers, clients should be able to afford to lose all their capital, and they can be supported with investments that reflect the highest level of risk.

A pyramid portfolio places losses, such as we have sustained recently, in perspective. If an investor lost 30 percent of his portfolio, what does it mean other than feeling like a loser? A pyramid portfolio answers the question. The bequest layer of the portfolio is decimated. A favorite charity would get no money unless the market recovers in time and the bequest to one's children would be diminished. But the retirement layer is intact. There is money for food and shelter and for buying a new car when needed. The client is surely not happy about the loss but has a realistic and reassuring sense of the situation and how to plan for the future.

Mean-variance optimization can be used to construct a sub-portfolio to support each layer of the pyramid, Statman said. Indeed, each of the sub-portfolios and the amalgamated portfolio resides on the efficient frontier, but the assets in each sub-portfolio look very different from the assets in the amalgamated portfolio. And the amalgamated portfolio is different from a portfolio that is constructed without reference to the individual layers of the pyramid.

Statman told me that he once sent a note to Harry Markowitz, who was awarded the Nobel Prize for Economics in 1990 for applying mean-variance optimization to financial modeling, describing some of his research.   Markowitz' reply indicated that he agreed that investors typically think of their financial needs in terms of "mental accounts." The two have since collaborated on research to redefine the appropriate role for mean-variance optimization in portfolios with layers or mental accounts..

An advisor once asked Statman how he should explain correlation and covariance to his clients. Statman said that teaching a basic course in statistics is not the primary role of an advisor. .Advisors should be focused on understanding clients' goals and helping them reach these goals. . Without sacrificing the utility of the mathematical tools, like optimization, that have been developed, "Investors need to move away from the perspective of meals prepared with a blender and not think about all their money as one lump sum," he said.

When one experiences stomach pains, he or she often see a doctor to be certain that their illness is due to something they ate and not to something more serious. "Doctors give you peace of mind that you're not about to die," Statman said. Advisors should play an analogous role. Like physicians, who have specialized knowledge that their patients do not possess, advisors must apply their specialized skills to the unique needs of each of their clients.

"When you look at financial advisors and you choose one," Statman said, "if the advisor tells you that his or her main service to you is to beat the market, I'd say go down the street to another financial advisor, because you want a financial advisor that is not just about your wealth but also about your well-being." Avoid using an advisor who merely strives to beat the market, according to Statman, and instead choose one who considers the layers of one's financial needs, and serves them as would a fine restaurant offering a carefully prepared meal.