New Research – Helping Clients Make Better Decisions
By Joe Tomlinson
September 4, 2012

Making decisions is not something human beings are very good at. We do a poor job of predicting what will make us happy in the future, we often misjudge our ability to handle risk, and our decisions are plagued by subtle biases that throw us unwittingly off course. Because the essence of financial planning is making decisions about the future, it’s critical that clients and advisors understand how decision-making biases can be identified and overcome.

The latest research in psychology, behavioral economics and neuroscience has underscored these decision-making frailties. But, rather than be discouraged by the challenge this poses, advisors should embrace our constantly improving understanding of how decisions can go awry for what it is: an opportunity to face up to the uncertainty and complexity and to improve the decision-making as best we can.

I’ll focus on research on three important topics that are at the core of good financial planning: cognitive biases that most affect financial decision-making; problems with risk-tolerance assessments; and what we understand – or don’t – about what will make us happy.

How biases affect financial decision-making

If there were a Bible of the frailties of decision-making, it would be Daniel Kahneman's 2011 book, *Thinking Fast and Slow*, where he discusses biases, which he defines as "systematic errors in decision making." Since financial advice is about decision-making, Kahneman's research, showing that much of our decision-making is beset by these systematic errors, does not offer much good news. His book, which was reviewed by Laurence Siegel in Advisor Perspectives in June, offers a rich discussion of the various errors and biases his work and others' have identified. I'll highlight a few of the most important here.

Central to the book is Kahneman's description of two different types of thinking the brain does:

- System 1, which "operates automatically and quickly, with little or no effort and no sense of voluntary control"
- System 2, which "allocates attention to effortful mental activities that demand it, including complex computations"

System 1 performs simple calculations (you can see 2 x 2 and know the answer in an instant), while System 2 is called upon to tackle more complex problems (you’d be calling
on this one for, say, 17 x 24). Overreliance on System 1 underpins many biases. Kahneman uses the term WYSIATI (what you see is all there is) and talks about how System 1 often assumes a coherent, complete picture from incomplete information, making bad decisions as a result.

For example, Kahneman discusses the optimistic bias, which leads to overconfidence. For its far-reaching consequences, Kahneman declares that this “may well be the most significant of the cognitive biases.” The propensity for System 1 to unconsciously construct seemingly coherent cause-and-effect models based on the past is what gives rise to overconfident predictions of the future.

This bias may actually be a bigger problem for advisors than for clients, and Kahneman devotes specific attention to the investment management business, describing it as "an industry built largely on the illusion of skill." He does not deal with the industry as an advocate for passive investing, such as Burton Malkiel, John Bogle, or Charles Ellis, would, but he adds the important insight that overconfidence is deeply ingrained in System 1 thinking. Investment managers do not choose to be overconfident; it happens automatically. It's ingrained and therefore difficult to overcome.

Kahneman discusses a host of other biases, and he illustrates how they often work together. For example, the status quo bias relates to people’s tendency to prioritize avoiding the feeling of regret. Clients who are reluctant to convert a portion of savings into an annuity or purchase long-term care insurance may be exhibiting status quo bias and by fixating on the potential regret for themselves or their heirs that might eventually result if that decision one day appears to have been “wrong”. “People expect to have stronger emotional reactions (including regret) to an outcome that is produced by action,” Kahneman explains, “than to the same outcome when it is produced by inaction.” People may be reluctant to purchase annuities, but most people would be equally reluctant to give up their Social Security benefits for a lump sum.

Kahneman’s earlier work on prospect theory with his research partner, the late Amos Tversky, highlighted the importance for decision-making of how choices are framed, and Kahneman brings that earlier work forward into this book. A financial planning example is that purchasing a single-premium immediate annuity may look risky when the decision is framed narrowly: "I lose if I die early and win if I live a long time." When living expenses are also considered in a broader framing, however, the picture turns around: "I've purchased an income that will provide for my living expenses regardless of how long I live." An important role for advisors is to help clients broaden such frames of reference.

The availability heuristic is another influencer of financial decisions that Kahneman highlights. This is an error in statistical thinking that Kahneman describes as "judging frequency by the ease with which instances come to mind." The ready recollection of the 2008 financial crisis certainly has helped the sale of products like variable annuities with guaranteed living benefits and fixed-index annuities, both of which protect against stock
market losses. From a purely statistical standpoint, there’s no reason these should be any
more popular now than before the crisis; as the risks of a future financial crisis haven’t
gotten significantly greater or more knowable, but the freshness of the crisis in people’s
minds mean they are paying more attention to the risk of a significant market crash and,
unconsciously, judging it to be greater than they otherwise would.

Kahneman’s book provides a wealth of insights and examples to help advisors and clients
become more aware of how biases may affect their recommendations or decisions. By
developing a better awareness of behavioral tendencies, advisors should be able to coach
their clients out of certain biases and accept and work around others.

But advisors need to be aware of their own biases. For example, are they allowing their
own status quo bias to get in the way of pushing a client to make tough choices?

The problems with risk-tolerance assessments

For many advisors, an early step toward developing a client’s financial plan may involve
their filling out a risk-tolerance assessment, which is then used to guide asset allocation.
Some planners and researchers, however, have pointed out that measuring risk tolerance
doesn’t provide a full picture. For example, planners Rick Miller and Paula Hogan recently
published a paper, Explaining Risk to Clients: An Advisory Perspective, in which they
referred to three key definitions:

- "Risk tolerance" is the client’s forward-looking assessment of his or her ability to
be psychologically comfortable with financial risks in general, and stock market risk
in particular.
- "Risk capacity" is the maximum amount of risk a client can take on while still en-
suring that a bad outcome (like running out of money before the end of retirement)
will not impose unacceptable harm.
- "Stomach for risk" is the client’s "in-crisis" ability to avoid panic, and, in particular,
to avoid bailing out in down markets.

My own view is that "stomach for risk" may be the most important of the three measures
and "risk tolerance" may be the least. During the financial crisis, my own clients with the
highest pre-crisis risk tolerance scores ironically became those with the highest inclination
to bail out. They tended to be the confident, take-charge types — mostly men.

Economists Carrie Pan and Meir Statman have recently published a paper that specifically
addressed problems with risk tolerance questionnaires from a behavioral economics
perspective. They noted the following:

- Investors have multiple risk tolerances, which vary by category or mental account
  (e.g., retirement fund versus discretionary spending fund).
There is no clear linkage between risk tolerance scores and recommended asset allocations. Loose rules of thumb predominate in the industry.

Risk tolerances vary as circumstances change (e.g., during up markets as opposed to down markets) and prompt different emotional responses.

Risk tolerance is a hot topic right now, in large part thanks to the financial crisis. Some have argued, for example, that the crisis caused many individuals to lose their tolerance for risk. However, researchers Michael Roszkowski and Geoff Davey, who developed the FinaMetrica risk-profiling system, make the case that what changed was investors' perception of how risky stocks are, rather than their tolerance for risk. This "risk perception" may tie back to "stomach for risk."

Neuroscience offers a compelling explanation of problems with risk tolerance measurement, as I’ve found based on my reading of Jason Zweig's *Your Money and Your Brain* and Dan Ariely’s *Predictably Irrational*. The basic idea is that the thinking parts of the brain engaged in filling out a risk tolerance assessment are different from the more primitive parts involved in panicking and bailing out in a down market. It’s as if the person who fills out the risk tolerance questionnaire is a different person than the one who makes the decision to bail out. Other industries have figured out this dichotomy already – airline pilots, for example, are trained to handle emergencies using flight simulators, rather than relying strictly on textbooks.

Unfortunately, none of the research on risk tolerance has yet provided a clear best way to properly assess clients' capacity to handle risk. But the problems with our current approach are becoming increasingly clear, which should encourage more research into and experimentation with ways to do better.

**Understanding the sources of happiness and regret**

Financial planning involves lots of decision-making, and underlying the planning process is the assumption that we are capable of accurately predicting how we will react to what happens to us in the future. Unfortunately, it turns out that we are not very good at predicting our future feelings – even something as simple as what will make us happy and what will make us unhappy.

Daniel Gilbert, a psychology professor at Harvard, has focused much of his research on human happiness and in 2006 authored an entertaining and illuminating book on the subject, *Stumbling on Happiness*. Much of the book talks about how the mind works and why we are so bad at predicting what will make us happy. In 2008, he was interviewed by the New York Times and discussed some of the findings from his research.

Here, briefly, are a few of the major takeaways from his work:
• Bad outcomes, such as depleting savings during retirement, don't affect people as profoundly as they would expect, and the same is true of good things, such as being able to spend more money in retirement. Humans are remarkably resilient and, when bad things happen, we often return to a baseline level of happiness sooner than we expect.

• The best predictor of human happiness is human relationships and the amount of time spent with family and friends.

• Dollars spent on experiences generally bring more happiness than money spent on things.

The bottom line is that there is a lot more to financial planning than just making the dollars work. Advisors might do well to expand their narrow focus on dollars and cents and take some cues from Gilbert and from the discipline of life planning, which attempts to help clients focus on what they need to live a fulfilling life, then secondarily how to achieve it financially.

At the very least, given the other frailties in decision-making this article will discuss, it may be more important for the financial planning profession to focus on helping clients protect themselves against big risks, rather than spend too much time on fine-tuning.

Conclusion

Applying advances in psychology and behavioral finance to the practice of providing financial advice may result in slow and uneven progress; these decision-making frailties are, after all, deeply ingrained in both clients and advisors. But a phase of initial confusion about how to respond to these challenges will hopefully give way to better insights and a richer, more complex approach to helping clients with financial decisions.

As Daniel Kahneman notes, "Sometimes scientific progress leaves us more puzzled than we were before."

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