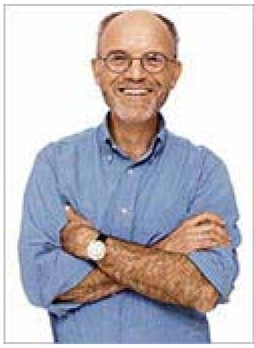
ADVISOR PERSPECTIVES

Our Interview with Jason Zweig

Elaine Floyd, CFP®



Jason Zweig is a senior writer and columnist for *Money* magazine. He is a guest columnist for *Time* magazine and previously directed *Forbes'* coverage of mutual funds. He frequently appears on ABC, CNBC, CNN, and NPR. His first book, Intelligent Investor: A Book of Practical Counsel was published in 2003. His most recent book, Your Money and Your Brain: How the New Science of Neuroeconomics Can Help Make You Rich, was published this summer and has received much critical acclaim.

We had the opportunity to interview Jason Zweig on October 26, 2007.

Advisors who read your latest book, *Your Money & Your Brain*, are likely to nod knowingly when you talk about irrational behavior by individual investors and squirm uncomfortably when you note that the experts are not infallible either. What are some of the traps financial advisors might fall into when helping clients manage their money?

> The first thing advisors need to be careful about is overconfidence. Some professionals tend to make fun of individual investors for buying high and selling low, but mutual fund flows comparing load funds to no-load funds show that there are very few historical cases of a market run-up or a market collapse where the people earning sales commissions did not behave at least as badly as the general public acting directly. When you are overconfident, by definition you don't believe you are wrong. This is really a key thing for advisors to bear in mind.

You distinguish between our *reflexive* system, which sits at the base of the brain and reacts quickly and intuitively to stimuli, and our *reflective* brain, which is located in the prefrontal cortex and is capable of solving more complex problems. Is there a way for us to know which system is operating at any given time, and do we have control over it? For example, if we have a compulsion to buy a stock which we've analyzed to some degree, how do we know whether we are being driven by unconscious greed or rational thought?

> How people think and how they ***think*** they are thinking can be very hard to resolve. A vast body of psychological research has proven that people don't really know how they get the answers they get. They may think

they've reasoned their way through a solution when they've really felt their way. The book gives lots of examples of this. I think the simplest way to answer the question is to say that if you are in a situation where thinking methodically is likely to be important, you need to have checklists and policies and procedures which you interact with. You can't just look at the checklist. You have to check the boxes or click on the dialogue box on the software. Structure is the only way you can be sure that you're being more mindful.

You mention that engineers are bad investors because they are trained to calculate and measure every possible variable. Do you think overly analytical people could improve their results if they were to allow their reflexive brain to participate more in their decision-making? How can they do this?

People who are quantitatively inclined often get swept up in mechanical investing systems, but I don't think they've actually checked their emotions at the door. They just think they have. Whenever you rely on quantitative analysis alone you tend to forget the very obvious question: am I the only person who has analyzed these variables? When the model breaks down people find that they've neglected to model their own emotion, which always goes haywire. Look at the collapse of Long-Term Capital Management in 1998. Here you had squadrons of the most mathematically brilliant people in the financial markets all working under one roof, all incredibly smart, gifted people who had never actually asked themselves what would happen if their analysis didn't work anymore. People who are quantitatively gifted like the idea that they won't get emotional if something goes wrong, but they're human and they do.

You mention that the instantaneous decision-making described by Malcolm Gladwell in *Blink* is just about the worst way to go about investing. How can people whose reflexive brains are firing like crazy operate more from their reflective brain?

The key is to become more mindful about what you are doing. The more decisions you make, the more likely you are to be making them in response to emotional factors. If investors made fewer decisions and instead acted only when their rules and their policies called for action, they would be much less likely to decide on the basis of emotion. One of the things I talk about in the book is Warren Buffett's "don't know" pile. If he doesn't know the answer to something, it goes in the "don't know" pile and stays there until he does know – which, even for him, can be a very long time.

The financial advisors reading this all have observed in their clients many of the phenomena you describe in your book: chasing hot stocks, becoming paralyzed with fear, letting regret over a bad decision overcome their ability to move forward. At the same time, clients who are in the grip of these emotions often turn a deaf ear to wise counsel and may even look for another advisor who will do what they want. Some advisors lost clients during the tech bubble because they refused to buy into it. How can advisors overcome these deep emotions and help clients do the right thing without alienating them?

I sympathize. Not every advisor has the luxury of being able to fire bad clients, but I think it's important to be able to do so. Before you get to that point, you can train clients before things go wrong. When clients are convinced they knew what was coming and believe the advisor should have known also, they are acting with hindsight bias. So a very good exercise in your annual reviews is to have a simple list of predictions that the client has to make. What do you think the best performing stock market in the world will be over the next 12 months? What do you think the value of the Dow will be 12 months from now? What do you think the 30-year Treasury yield will be 12 months from now? What do you think the best performing stock in your portfolio will be? The worst stock? If you ask a series of questions and the client writes the answers down, then later you both can go back and find out what the client actually predicted 12 months previously.

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You suggest that the classic risk tolerance questionnaires used by advisors are ineffective because people's risk tolerance is constantly changing. You state in your book, "To an astonishing degree, how much risk you can stand depends on what mood you happen to be in." But it is crucial for advisors to match their recommendations to a client's risk tolerance, both for compliance reasons and to meet the needs of the client. How should they go about this in light of your research?

It's very unfortunate that the regulatory regime and compliance departments are essentially built around a big fat lie. People simply do not know what their risk tolerance is. They can't predict it, so it's hopeless to ask them. There's a reason why. There's no such thing as risk tolerance, only risk circumstance and risk situations. You can take the exact same person and present them with the exact

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same choice under different situations and they will pick completely different outcomes. Here's an example. If you ask people to put their hands up if they're comfortable eating a hamburger that's 90% lean, every hand in the room goes up except the vegetarians. Then you ask how many would be comfortable eating a hamburger that's 10% pure fat, and every hand goes down. When software tells people they have an 82% chance of meeting their savings goals it sounds good. But if it said they have an 18% chance of failure, it sounds completely different. When people are angry they will seek risk that they would completely avoid if they were sad. The fallacy is thinking that the risk is only in the investments; it is also, and primarily, in the investors -- in people's heads and hearts, in what they ate that day, what their spouse said to them, whether you have a lot of red upholstery in your office, whether they smelled something bad on their way into your office. All these things can change people's risk tolerance.

You have to get people out of the business of making decisions. The incredible variability in people's tolerance for risk would matter a lot less if they only made decisions under identical circumstances. To the extent that an advisor can set up a regular meeting, on the same day every year or quarter, under the same conditions, same time of day, in the same place, surrounded by the same environment, and structured in the same way, they can take a lot of the variability out of the situation.

You devote an entire chapter to confidence, citing many studies that show that people are not as smart as they think they are. Overconfidence has been widely studied by behavioral finance researchers, but what about under-confidence? Financial advisors are more likely to face clients who are so lacking in confidence that they want the advisor to take full responsibility for the outcome of their investments or are reluctant to invest because they are so unsure of themselves. Have you seen any studies on this? What can advisors do to help their clients build confidence without turning them into overconfident investors?

Advisors should work on making decisions seem simpler. If you have under-confident clients the last thing you should be doing is spewing out data about your Monte Carlo simulations and the formulas that go into building your efficient frontier. You have to speak to clients in terms they'll understand. There's nothing wrong

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with using data to prove your argument, but you should pair it with simpler ideas. For example, if you're going to talk about portfolio optimization, show them your formulas and then say, "Don't put all your eggs in one basket." People will get that. Complexity is very scary to people. It causes them to go even more with their gut because they don't know what to do.

People come to financial advisors for help in planning and investing for the future. But you make the point that nobody can predict the future and that people should expect to be surprised. How can advisors maintain the notion that the future is unknowable and still deliver advice that will help their clients?

Tell clients that you will not try to predict what the financial markets will do but that you will build portfolios that will do well no matter what the financial markets do.

In referring to the fable of the ant and the grasshopper, you note that the grasshopper instinct of a person's reflexive brain makes it hard to save for the future. The trick is to make future goals as specific and measurable as possible. Can you give some examples of how advisors can identify client goals to motivate them to save?

The key is to realize that concreteness is what motivates people. No one gets motivated by an abstract goal. No one will act like an ant in a grasshopper situation unless you can make the future vivid and bring it into the present. The way you do that is by bringing out the emotion that matters to people. If you put a date on the goal and remind them of what dreams it enables them to achieve, you pull the goal out of the future into the present. Talk to people about their hopes and dreams. Instead of calling their retirement fund a 401(k), call it the June 19, 2027, Waikiki Condo fund. Include photos of Hawaii, play Polynesian music, serve pineapples or macadamia nuts. Then they'll think twice before cutting their contribution rate or taking a loan.

Do you believe that the biases which exist in the markets due to investor behavior are pervasive enough to create investing opportunities for those who are savvy enough to capitalize on them?

The evidence is mixed. Some extraordinarily smart people have implemented behavioral finance principles in portfolios. Some

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have done well with it, others haven't. I think you have to be very humble about your ability to be smart enough to exploit other people's stupidity. While they might be as stupid as you think they are, you're probably not as smart as you think you are.

You did a tremendous amount of research for this book, including having your own head examined. In all of your research what did you learn that most surprised you? Have you changed anything about the way you personally invest?

The biggest surprise is that people don't know why they do the things they do. This can get us into trouble when it comes to making financial decisions. Take anchoring, for example. Anchoring is a psychological phenomenon that says that whenever you have a number in mind, it will influence your judgment. In one experiment people were asked to spin a wheel of fortune. After it landed on a number they were asked whether the percentage of nations in the UN was larger or smaller than that number. When the wheel of fortune landed on 10, people estimated that 25% of the members of the UN were African. When it landed on 65, they estimated that 45% of the countries in the UN were African. If you asked them why they came up with the number, they said it was their best guess. But clearly the wheel of fortune had an enormous influence. Anchoring is everywhere in the financial markets. When a stock goes to $100 and splits 2 for 1 so that you now have two shares worth $50 each, you naturally expect both shares to go back up to $100. Anchoring informs a lot of our decisions even though we think it doesn't. When professional auditors were asked whether the incidence of fraud is greater or lesser than 10% and then asked what they thought the actual incidence of fraud was, they gave a number that was close to 10%. But when they were asked if it was greater or lower than 1%, they picked a lower number. When asked why they picked that number, they talked about their experience and how many frauds they've encountered. They had no idea their number came from being anchored. Another disturbing problem is familiarity. Individual investors are very prone to this. It's why people put too much money into their own company stock. Financial advisors are prone to this too. Both anchoring and familiarity are examples of unconscious bias. Unconscious bias has led me to become much more skeptical about my own limitations. It caused me to get rid of all my company stock.

What do you think advisors will do differently after reading this book?

This book is really about understanding human nature. I hope that advisors will understand themselves better and recognize themselves in some of the mistakes and errors of judgment told in some of the anecdotes. The key is measuring. How do you know if the manager you just hired is better than the one you fired if you don't measure the performance of the one you fired? How do you know your sell discipline works if you don't follow stocks after you sell them? If all you're measuring are your successes, you can't learn from your failures.

Are there any particular issues at the forefront of behavioral finance research today -- that is, problems related to investing that researchers are trying to solve?

Neuroeconomics is still a developing field. The important thing is for advisors to keep their eyes and ears open. Read books like this to get up to speed. Become familiar with some of the principles and terms so you can learn from the research. The future is really exciting in this field and it can be very helpful to clients and advisors. None of us can control the markets, but if we can control ourselves, we can become better investors no matter what the markets do.

Elaine Floyd, CFP® is a financial writer based in Bellingham, Washington.