DNA Behavior®

Dealing with Financial Planning Risk - Directing Portfolio Decisions or Navigating Human Behavior?

Why Financial Client Management is more important than Investment Management

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1

Clients and Portfolios – It's Not Just About Investments. Risk is Everywhere

"Risk touches on the most profound aspects of psychology, mathematics, statistics and history"
Peter Bernstein, financial historian, economist and author of "Against The Gods: The Remarkable Story of Risk"

When the words "portfolio", "client" and "risk" are used in the same sentence, the topic of discussion is more than likely investment advice and investment management. Around the world, advisers routinely categorise investment funds based on established regulatory and industry norms and impart this analysis to their clients. For them, this is what identifying risk is all about. While this is not unexpected, the reality is that, globally, many financial advisers are, aside from providing investment advice, also involved in providing direction to clients in their purchases of other financial products, so the categorisation of risk with respect to their investments is only one aspect of risk management for any given client.

Risk is synonymous with danger and chance and suggests an uncertain outcome which can have pleasing or devastating consequences. Generally, people will be happy with a good outcome and unhappy with a bad outcome, but the degree to which they are happy to take a chance on exposing themselves to the possibility of a negative outcome and, subsequently, to live with it, must be a key consideration in any advice offered to a client. Understanding how a client will react to a possible negative outcome is a huge advantage to both adviser and client alike.

Indeed, after the medical profession, the advice of the financial services industry has the greatest capacity to bestow the most benefit or inflict the most damage on the lives of the people they serve. Perhaps the biggest failing that the financial services industry has is the lack of realization that the real threat to client wealth creation lies not in investment markets but in the behavior of the clients themselves.

This may come about through making investment decisions, borrowing too much or just spending blindly without any consideration for the future. Financial advisers are responsible for guiding their clients through the mass of data and financial news sources that exist. Such guidance requires the education of clients in the structured matching of their resources against their goals and aspirations in a manner which does not expose them to risks that they cannot tolerate, financially or emotionally.

Of particular relevance, but rarely considered, is the unconscious transference to clients of the adviser's own attitude to risk and money. Advisers can, and do, have blind spots in allowing their own investment and financial preferences

to overly influence a client's decision-making process. Just because an adviser feels comfortable with taking risk does not excuse him from assuming that the client should have the same approach, even if a similar perceived approach by the client might exist. Likewise, an adviser's approach to spending money, borrowing or bestowing trust can mask risk that might be present in specific financial products or a particular financial planning approach.

In a leading study of 91 USA pension funds for the period 1974-1983, investment policy decisions accounted for 93.6% of the total plan returns[1]. This meant that decisions by investors at a strategic level rather than decisions by fund managers at a tactical level were the source of the actual investment returns. Such decisions were then, and still are, rooted in emotional responses and are driven by the behavior of the individuals vested with the control decisions. These behaviors could, if handled poorly, result in badly executed decision processes that extend far beyond the impact of asset class investment returns.

What needs to be understood by clients and implemented by advisers is the requirement for a strong individual financial management and investment mandate process that is unswervingly applied to meet clients' goals. By having all parties recognise their own emotional preferences and positioning them within the investment and financial product selection process, an adviser can not only be seen by their client to be far more engaged but also far more valuable than an adviser who focuses on product selection only. This, in turn, provides the foundation stone for a long-term profitable business relationship for both adviser and client.

This paper sets out not only to educate financial advisers but also to assist their clients in appreciating why understanding and working with their own risk attitudes is more important than the performance of fund managers, the use of a well marketed credit card or the owning of a home in a desirable location. The self awareness of the financial client and the adviser is paramount to the financial success of both, since without financially successful clients, financial advisers have no future.

Risk is not just a function of investment selection. It is present in every financial decision.

The impact of bad financial advice is life changing.

Clients can lose more from bad financial habits than from bad investment decisions and need protection from themselves.

Financial Planners need to be able to provide directions to their clients and be client managers rather than investment managers.

Advisers need to avoid transferring their financial bias to clients.

Advisers need robust processes that are consistently applied.

1 Brinson, Hood and Beebower (1986)

2

The Case for Managing Financial Clients Rather Than Their Assets.

“Be fearful when others are greedy. Be greedy when others are fearful”
Warren Buffett“

The Traditional View

Financial history is peppered with stock market crashes, property market booms and busts and a vast array of stories of individuals who have either made or lost fortunes, or even both. Irrespective of the past, a financial adviser deals with the here and now as well as the future, keeping one eye on clients’ possible expenditure requirements. In doing this, giving the right advice is a subjective process in terms of possible investment portfolio construction and asset mix or promoting beneficial financial habits. Irrespective of the type of client or their individual requirements, the adviser’s methodology in giving financial advice needs to be robust, easily understood and capable of consistent application.

In the investment arena, many clients find stock markets and matters such as asset allocation and volatility complex or even scary. A common experience of most investment advisers is that even when the client confirms verbally that they understand an investment concept that has just been explained to them, true understanding usually requires the explanation to be repeated several times before the issue is grasped.

In order to simplify matters, many investment advisers have, by and large, focused historically on fund selection and objective matching. While this is understandable to a certain extent, it is also dilutes the skill necessary to advise clients and risks falling into the trap of letting investment advice be led by the most convenient product or “off the shelf” fund being marketed by an investment manager. Hindsight is wonderful, but replicating the investment choices that have performed best in the recent past does not guarantee future success. This lemming-like behavior has led to housing bubbles and the dot.com crash, to name but two. Simplification can also lead to oversights such as a failure to recognize the impact of inflation or the effect of taxation on investment growth.

Any document dealing with investment risk needs to acknowledge the trade off between investment return and the possibility of loss together with ongoing volatility, especially with asset classes that experience wide variations in pricing. While the concept of the Efficient Frontier is a familiar one with experienced investment advisers, many clients interpret the drawing of such a graph as almost a guaranteed level of performance without realizing that losses can and do occur.

The Rise of Investment Profiling Systems

Risk profiling is possibly the single most important regulatory issue facing investment advisers and financial institutions at this time, as the consequences of getting it wrong or even not doing it can be severe for both investor and adviser. Getting it right confers major benefits, for example, by allowing diversification to dilute risk or identifying when to stretch investors to go beyond their usual comfort zone and take slightly more risk in order to achieve desired goals.

In recent years, especially in the UK, there has been a steady growth in advisers' use of investor risk profiling tools provided by investment companies. These alone, however, are not silver bullets for defining risk, despite the encouragement by such companies who have a vested interest in providing the shortest possible route to a client selecting their investment funds.

Advisers using them assume that these profiling systems have been constructed correctly and are properly validated.

In 2011, a review carried out by the UK's Financial Services Authority found that out of 11 risk-profiling tools that it assessed, nine had weaknesses which could lead to "flawed outputs". Even with the systems that the FSA did not criticise, leaving a product selection to such automated matching of a person's risk profile to a fund with an apparently identical ESMA[1] rating is not only wrong, it is highly dangerous. Such an approach ignores the wider process of risk evaluation which begins with the client definition of required investment return, rather than an assumed client preferred investment risk.

Clients don't often acknowledge their own lack of understanding.

Profile systems used indiscriminately ignore clients required investment return in favour of a preferred risk approach.

Investment risk is only part of the individual financial risk.

Financial risk is present in underpurchasing of relevant protection cover and poorly thought through borrowing.

Emotional responses to spending can be more damaging than bad investments.

Really knowing the client has long term financial benefits for both client and adviser.

Financial Risk Is More Than Just Investment Risk

The traditional understanding of risk is, however, only half the picture. By solely focusing on investment return, investors and their advisers ignore the reason for investment return, namely the satisfying of a need for capital growth. Such a need is based around a future requirement for expenses to be met, especially those that are based in the reality of current needs. Current financial behavior also needs to be addressed. Blind purchasing by clients of financial products other than investments as well as overreaching in borrowings and spendthrift behavior merely because cashflow is available, are not sustainable long term financial behaviors. Nevertheless, not only can clients lose the run of themselves but advisers who fail to advise these clients otherwise could lead to such behavior being interpreted as acceptable and in some way a part of their future financial planning approach.

The spectre of financial risk is also present in the need to purchase life assurance, income protection or specified illness cover. Maintaining these safeguards requires that a person remain solvent and have access to cash, both of which can be influenced by arbitrary decisions on the part of the individual, many of which are emotionally driven.

1 ESMA (European Securities and Marketing Authority) deals with securities legislation and regulation to improve the functioning of European financial markets, strengthening investor protection and cooperation between national competent authorities. It replaced CESR (Committee of European Securities Regulators) in January 2011

The acknowledgement of risks other than the traditional views of investment risk is key to good financial planning. Even more important is the education of clients in such regard. Individuals can, and do, in periods of economic buoyancy, become blinded to the possibility of future financial loss due to steep rises in interest rates on large loan portfolios. Similarly, a lifestyle that has been funded by the existence of easy credit through credit cards, overdrafts or interest-only borrowings has led, post-Lehmans and other similar circumstances, to personal financial destruction. If financial education is only acquired through personal losses in the troughs of economic cycles rather than through an understanding of these cycles and a long-term perspective, the possibility of personal financial recovery may be rather slim.

The Real Benefits of Financial Planning

What financial planners need to recognize is that they are primarily investor managers as opposed to investment managers and client leaders rather than product sellers. Such leadership has been severely lacking as, in many instances in the past, advisers sought to take shortcuts to generate business income without necessarily examining the true emotional makeup of their clients and the financial impact of such clients' natural preferences in dealing with money. By this failure they have also overlooked the consequences of their advice on the long-term relationship with their clients.

In fairness, the financial services industry has historically veered towards defining and managing risk as being investment related. Such an approach was easy to rationalise and led to the design of easily marketable products which suited those investment companies that relied on earnings from annual management charges from investment funds.

The realms of individual financial planning do not, unfortunately, fit easily into systemized investment marketing and, traditionally, what does not fit is usually ignored for the sake of profitable expediency. To be an excellent financial planner not only requires product knowledge and an ability to analyze but also a willingness to spend more time getting to know the client, which leads to an understanding of and empathy for the client , rather than focussing on the quick sale.

While "knowing the client" is a prerequisite by any financial regulatory code, too few advisers take the trouble to know the client from the inside out since to do so takes time and may create additional workload. Rather than looking at such "work" as a negative, it should be viewed as a key building block in not only providing the right understanding of the clients' needs, financial and emotional, but also in establishing long term successful business relationships for the adviser. By understanding clients on a personal level rather than just viewing them in terms of a financial factfind, the relationship strengthens as does the likelihood that the client will respond positively to any advice given. This can only help to ensure that a long term business relationship will develop and thrive beyond any short term product sale.

3

Understanding Financial Client Psychology

"Telling people that they can't beat the market is like telling a six year old there is no Santa Claus"
Burton Malkiel - author of "A Random walk down Wall Street"

It's all very well to talk in abstract terms about macro economics with regard to international finance but real economics happens at the personal level of billions of individuals worldwide. It is here that decisions to save or spend, take low risk or high risk investment strategies, borrow to invest or use their own capital occur. All of these actions depend on each individual's deep rooted emotional reactions to and understanding of financial market events.

Time and time again, investors and their advisers focus more on their perception of stock-picking and market timing even though empirical studies over the last thirty years have indicated that strategies not based on asset allocation have less of an impact on investment returns and may, in fact, produce negative outcomes[1].

In many cases, possibly because of good brand marketing, investors have sought to select the best investment management on the premise that such individuals will beat the market in the future, though subsequent analysis shows otherwise. One such study of 8,755 investment hiring decisions made in the period 1994 to 2003 showed that, in the three years before hiring, such firms outperformed the market by an average of 2.91% p.a. while in the three years after hiring, the same firms' return showed an average underperformance of 0.47% p.a.[2]

Financial advisers, for their part, have placed too little value on their ability to educate their clients as to the best way to invest. Instead, such advisers have allowed themselves to be sucked into recommending an investment product merely because a client shows a predilection towards it or something similar. If advisers emphasized the need for strategic asset allocation that was most consistent with an investor's financial and emotional needs as well as educating such clients on the impact of their approach to risk taking, there would likely be a far better understanding of the trade-off between expected returns and risk, and far less client dissatisfaction with the perceived performance of their investments and, indeed, their financial advisers.

Understanding Risk Behavior

The window into the investor soul, so to speak, is to obtain an understanding of their personal behavior and then to integrate this into their own personal investment planning process. Of particular importance is the need to measure

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1 Studies by Brinson, Singer and Beebower (1991), Ibbotson and Kaplan (2000) in comparing mutual fund and pension fund performances versus related indices.

2 Source: The Selection and Termination of Investment Management Firms by Plan Sponsors Amit Goyal of Emory University and Sunil Wahal of Arizona State University.

the investor's propensity to take risk as well as their willingness to suffer a decline in the value of their investments while waiting for a reversal in fortune should market conditions decline. Both Risk Propensity and Risk Tolerance are unique to each investor as they are with each investment adviser who must ensure that their own risk persona does not overpower those of their clients and result in the client being dislodged from their natural comfort zone in stressful markets. A lack of acknowledgement of these behaviors can and does lead to investors making poor decisions which can cause extreme financial loss – to both investor and adviser.

The field of study concerned with the theory and practice of psychological measurement is termed "Psychometric Evaluation" and includes the measurement of attitudes and personality traits. This practice is primarily concerned with the construction and validation of measurement instruments such as questionnaires, tests and personality assessments. The database that is generated is built upon the answering of the same questions from a sufficiently large population.

In a financial context, psychometric assessment provides a tried and tested methodology of assessing risk characteristics as well as being a key tool in positioning the most appropriate investment portfolio. It is not, however, the only component in the designing of an investment strategy as others, such as defining the required rate of investment return, the financial capacity of an individual to rebuild capital after an unexpected loss and the need to rebalance portfolios, all play vital roles as well. Nevertheless, a negative emotional response at some future point in time can result from an investment loss. This may occur irrespective of whether the loss is crystallized or appears only on paper and could inflict irreparable damage on a client adviser relationship. This might result in not only financial loss for the client but also reputational loss for the adviser. In turn, and in the worst case scenario, it could also lead to uncomfortable interaction with regulatory authorities and even a removal of a licence to trade.

Risk is not just present in investment decision making, it is also present in every emotion that impinges on all financial decisions we make. Despite the potential downsides of not understanding client personalities and making ill placed assumptions on their risk perspective, many advisers continue to assume that they know their clients very well and know what is best for them when in fact such a perspective may be far from the truth. Furthermore the internationally accepted regulatory need to "Know Your Client" seems to have been given little attention by financial advisers when it comes to aspects of risk propensity, risk tolerance, risk capacity, spending tendencies and focus on targeted goals. Risk comes in many dimensions and the failure to recognise all hues and all circumstances can, if mishandled, result in serious financial losses from which a client may never recover.

Inadequate life assurance, heavy spending habits and the lack of adherence to goals that have been previously agreed with a financial adviser are possibly even more dangerous than the lack of an investment mandate framed around traditional risk profiling. Even if the risk profiling of underlying investments

results in a balanced approach to diversified investing, the fact that an individual could spend freely merely because they enjoy spending and just because cash is available can, if left unchecked, seriously erode a client's wealth as much, if not more, than an underperforming investment portfolio. Such financial risk is heightened further if the individual is weak in pursuing goals, financial or otherwise. A financial adviser who has such a client will find that goals will need to be constantly revisited until such time as the client acquires self-discipline, something which may feel unnatural to them initially. Fuller examples of this conundrum are given later on in this paper, as indeed are some suggestions as to how clients' behavior can be focused to educate them to their own best practice.

Why Investment Policy Statements Need To Be Revisited

What financial advisers especially investment advisers need, therefore, is a personal risk-based investment policy statement designed in much the same way that institutional fund managers construct benchmarks. However, in the latter case, professional investors who have a deep understanding of the mathematics of investment returns and related volatility structure theoretical portfolios where the only negative outcome to the fund manager is possibly a loss of performance bonus.

The key difference when an investment policy statement is constructed for a personal investor is that the loss is specific to them and represents a forfeiture of, usually, past earned income or the lack of future resources for provision for family members. This, in turn, leads to a more emotive connection with investment funds or protection covers. Unless properly framed at the outset of financial planning, this can lead to extreme client dissatisfaction in periods of market downturns or even overwhelming stress in the event of an insurance claim.

To counter such possibilities, financial advisers need to be cognisant of their clients' potential emotional reactions, some of which are so deeply buried that they only surface when extreme events occur and usually long after financial portfolios are first constructed. Many involved in personal investment advice would point to the role that various risk profiling tools available through investment management companies play in identifying investor risk preferences. At the heart of several risk profiling tools is the concept of behavior arrived at through life experiences. Putting such behavior in a simple everyday context, examples might range from knowing not to put your hand in boiling water to wearing warm clothes when out in cold weather. In a financial environment, people are invariably conditioned through their most recent financial experiences. An excellent example would have been the attitudes of many investors both before and after the Lehmans and Bear Stearns collapses and the subsequent global financial crisis. Before the collapse, many investors would have been bullish investors, while following the meltdown, such optimism turned to extreme pessimism. Such reactive behavior is termed "Learned Behavior" and reflects a temporary or situational emotion that can change again when better financial outcomes are experienced.

Real economics is driven by the combined emotional decisions of billions of consumers.

Selection of fund managers based on past performance is a flawed emotional response.

Mismanagement of Individual Risk Propensity and Risk Tolerance can lead to regretted investment decisions.

Psychometric Analysis provides a window into an individual's risk personality.

Investment Policy Statements need to deal with more than the traditional risk framework.

Learned (Situational) Behavior Investment Risk profiling tools are inadequate and need to be replaced by Natural Behavior based systems.

Knowing the behavior of the life partners of clients is as important as knowing that of the client.

Staff, and not just principals, of financial planning firms need to be as engaged with clients as much as the direct client adviser.

Why Natural Behavior Profiling Works for Financial Advice

For any professional adviser such swings in emotional responses and, therefore, risk patterns make it impossible to guide a client over a long-term relationship especially one that is founded around long-term goals such as raising families and eventual retirement. Any financial advice needs to be based on an understanding of the individual's deep-rooted emotional responses such as is available through the measurement of the individual's natural behavior. Rather than using leading questions, as is the common approach with most financial risk learned behavior questionnaires, but instead asking apparently unrelated abstract questions, the true personality of an individual is allowed to surface unfettered by any outside agenda. Such an approach facilitates the framing of an individual's attitude to many unrelated issues including financial risk and is a far better tool for financial advisers to apply in assessing their clients' natural risk appetites. This is because it shows normal points of regression when life stresses are experienced, such as when stock markets fall dramatically or property crashes occur.

What is needed in analyzing client financial behavior is not, therefore, a primed question such as "how would you feel if you lost "x" amount of money as a result of a bad investment decision", the answer to which will vary over time, sometimes quite radically. Instead, such learned behavior needs to be set against the natural emotional preferences of the client. These embrace not only the traditional risk elements but also the need to feel good about oneself which is sometimes expressed by, for example, heavy spending or inversely by substantial saving patterns.

An ability to stick to goals is as important, if not more so, than a stated preference for one asset class over another. Investment planning fades in importance if the other issues related to the goals suffer through reduced savings or increased spending. An individual who has a predisposition to take extreme investment risk may also demonstrate a reluctance to purchase life assurance, preferring to rely on their own long-term ability to provide for their family's welfare.

The Benefits of Implementing an In Depth Client Analysis

All regulatory authorities around the world place great emphasis on financial advisers "Knowing The Client". This requirement has, historically, resulted in the use by advisers of a financial factfind in an attempt to justify to the regulator, should an audit ever arise, that relevant questions were asked of the client before a specific recommendation is given. Depending on how developed the market is and how sophisticated the regulatory regime has become, the quality of information gathering may be quite varied. In any event, what has developed generally is a "tickbox" approach to satisfying regulatory codes of conduct, where advisers can say with some impunity that they have "done their duty".

To give not only the required level of professional advice but also truly engage with a client requires a mixture of skill and adequate information gathering. To give the correct level of investment advice, for example, requires key elements of financial planning, and often the level of work involved is either beyond many advisers or requires a complete re-engineering of the adviser's business practices, something that many are reluctant to change. After all, if the regulatory authorities have not legislated for such changes, why should financial advisers incur costs and or interfere with their current business model which is geared primarily around a commission model? The international trend, albeit moving relatively slowly at this point in time, towards fee-based advice as is being introduced in the UK and Australia, is slowly pushing advisers to differentiate their client offering. This is being done with one eye on justifying the charging of a fee where none was charged before. This, in turn, means that advisers need to make a greater connectivity with their clients so as to ensure the clients appreciate their service.

However, an appreciation of service is, like beauty, in the eye of the beholder. Depending on the individual, some may require more information than others while some will absorb such information more easily through the use of graphics or auditory communication rather than the written word. Without knowing the key communication "buttons" that are unique to each individual, an adviser runs the risk of not connecting emotionally with the client. If no connection is made, then more than likely neither is business carried out.

The skill in analyzing and understanding clients' needs lies in drawing their hard-wired behavior and other untraditional risk issues out into the open. This is the area where many advisers falter. In their rush to generate an income through a short-term commission on a product sale, the long-term objectives of clients may become compromised. Digging into a client's psyche takes time but the results are well worth it.

Research by Gallup in 2009 showed that when clients are fully engaged and have a strong emotional connection to the organization, be it a financial or investment adviser, they spend, on average, 23% more[3]. The same research showed that businesses that simultaneously engage both their employees and clients emotionally are likely to experience up to a 2.4 times increase in financial performance. Thus, understanding clients' emotions is not sufficient in itself. Client-facing staff need to be emotionally engaged as well and this issue will be examined further on in this paper.

Often it is not only the perceived client whose natural behaviors need to be examined but also those of the people closest to them who exert the greatest influence over their decision making. For example, a male adviser whose main

3 "The Next Discipline: Applying Behavioral Economics to Drive Growth and Profitability" (2009), the Gallup Organization.

relationship is with a male client can, and quite often does, overlook the preferences of the client's female life partner. In many cases, such women are actually the effective financial controller for the family unit.

Another study in 2009, this time by the Boston Consulting Group (USA)[4] showed that women now control $12 trillion of the overall $18.4 trillion in global consumer spending, with this percentage likely to increase into the future. Any smart adviser should look to understand the woman in the male client's life as well as the client himself. The truth is, however, most male advisers do not seek to build any such relationship or reach out to communicate appropriately. Over time, this could be business suicide.

By having structured checks and balances in advisory processes with at least the minimum information to the clients by way of suitability letters, clients should, in theory, be well informed. This assumes, of course, that all clients are not only fully financially literate but also that they assimilate such information in the same manner. In order to ensure that clients properly interpret the advice being given, the adviser needs to be able to communicate the salient facts in a manner that makes sense to the client.

Every person has their own inbuilt way of absorbing information. If the delivery of information can be matched to an individual's learning style then it is more likely that client awareness will increase of the risks that they may be undertaking with their finances. But how does an adviser determine how each client learns?

Reference has already been made to learned behavior and natural behavior. While learned attributes are transitory, natural preferences are deep-rooted and apply as much to communication preferences as to emotional responses under stress. If an adviser is committed to understanding clients, educating them and truly serving them rather than using them as a means to an end, then psychometric engagement focusing on natural responses needs to be a key tool in the business of any forward-thinking financial adviser. This does not require them to be a part time psychoanalyst or counsellor but instead they will need to change their discovery process to unearth their clients' behavioral preferences. Such an assessment can be completed online and take no more than 15 minutes. Once it has been carried out, the results are available as a continuous reference point for not only the current adviser but any other future adviser as part of a corporate "memory bank" process.

For those advisers who have a different vision for their business other than a commission-led model and want to future-proof their business from both regulatory change and industry trends, an in-depth knowledge of their client is required. By really knowing their client they will not only communicate better but also be able to package their own business' client offering in a more personal manner than before. All of this can only assist in improving profitability and safeguarding the business.

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4 Women Want More: How to Capture Your Share of the World's Largest, Fastest-Growing Market", Michael Silverstein, Kate Sayre, September 2009

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Moving The Goalposts – Why Traditional Investment Planning Needs Emotional Input

"The four most dangerous words in investing are "This time it's different"
Sir John Templeton, founder of Templeton Mutual Funds.

Many peoples' experiences with bad investments have resulted from being impressed by someone else's reassurances about the possibility, not the probability, of financial success. Because of an innate greed, a personal blindspot or desperation to make good previous losses, there is usually an investor focus on the upside of the transaction rather than the financial and emotional impact of potential losses. Sometimes such behavior is reinforced by the financial planner's own personal bias and brings an unwanted distortion to portfolio construction that is not obvious until unwelcome investment losses become apparent.

To protect investors from themselves (and the bias of their advisers) it is incumbent on all financial planners to ensure that they have a process that establishes an investment mandate from the client and that this process is applied consistently, irrespective of the investor's personality. A key part of this process is the broad area of addressing risk. Risk is not simply a number that is used for a classification process in order to meet a regulatory directive. Ultimately, it is personal – what may be perfectly suitable for one individual may cause significant unease to another.

In the traditional approach to investment management, a properly constructed investment mandate process that addresses all aspects of the risk equation has six key determinants:

1. The **required risk** - the overall level of investment return needed to achieve the investor's objectives.
2. The **risk tolerance** of the investor - how much financial loss an investor will endure before cutting losses.
3. The **financial capacity** of the investor - the financial limit that, once breached, makes it impossible for future goals to be achieved.
4. The need to **re-examine the level of investment return** to ensure that it does not result in the client taking unnecessary and or misunderstood risk.
5. The documentation of all elements and expectations so that future reviews can revisit the basis for the investment portfolio set in place.
6. The need to conduct regular ongoing reviews in order to examine whether the portfolio objectives, required investment risk or financial capacity have changed. If necessary, rebalance the asset allocation in line with an on-going investment mandate.

To this investment equation must be added the **risk propensity** of the investor - how inclined an investor is to take risk. Sometimes Risk Propensity has been confused with Risk Tolerance and to do so overlooks the difference between the willingness to take a risk on a future event and the ability to live happily with the results.

Risk is personal. What may be perfectly suitable for one individual may cause significant unease to another.

Risk Propensity needs to be considered as a key investment advice detail.

Reduced Future Financial Capacity caused by overspending or over borrowing needs to be addressed as a priority.

The client is directly responsible for his own financial welfare. The adviser can provide a system of consistent reminders.

Drawing up and following goals with a financial planner can influence the creation of wealth as much as the technical construction of an investment portfolio.

An over willingness to trust can result in an investor being drawn to persons that could totally unbalance a financial portfolio.

Such behavior is particularly prevalent in those who have a discomfort in both establishing and maintaining expenditure goals. In such circumstances, not only will income and capital fall over time but the required investment return will need to be increased merely in an attempt to make up the shortfall that was not anticipated at the time of creation of the investment mandate.

Where a client has a high **willingness to trust**, it can lead to being easily influenced by third parties who may not have the client's best interest at heart. A prime example is those that are willing to "follow the crowd" and invest on a "me too" basis, rather than focusing on the assets that would best suit their own particular investment return.

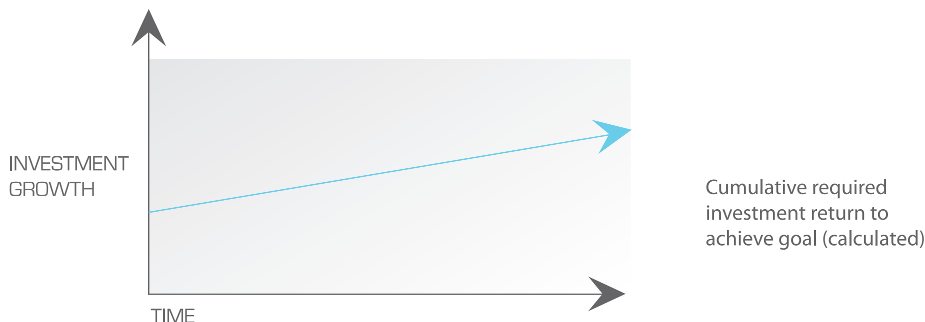
With all of this in mind, we have presented below a revised Investment Policy Statement process that we believe all investment advisers and financial planners should follow:

1. Determine the overall level of annual investment return needed to achieve the investor's objectives.

Many investors, if not most investors, make investments based on emotional responses to the proposition put before them. Do they like the person presenting the idea to them? Is the investment marketed in a nice brochure? Has the adviser come recommended? Their friends may have invested in the same investment!

These are all flawed approaches but understandable for many people in an emotional context. The starting position should, however, be what is the needed rate of investment return in order to generate sufficient capital to achieve their objectives. Such an approach would also take into consideration all sources of income and identify a target for trade off between risk and return.

Having identified what the required rate of return is, an adviser then has to examine what the possibility is of achieving such a return. In identifying the assets that may provide the return, one should always be aware of the possibility that a required high rate of return may also result in a substantial loss since the more risk that is required to achieve the high return, the greater the potential of investment failure.

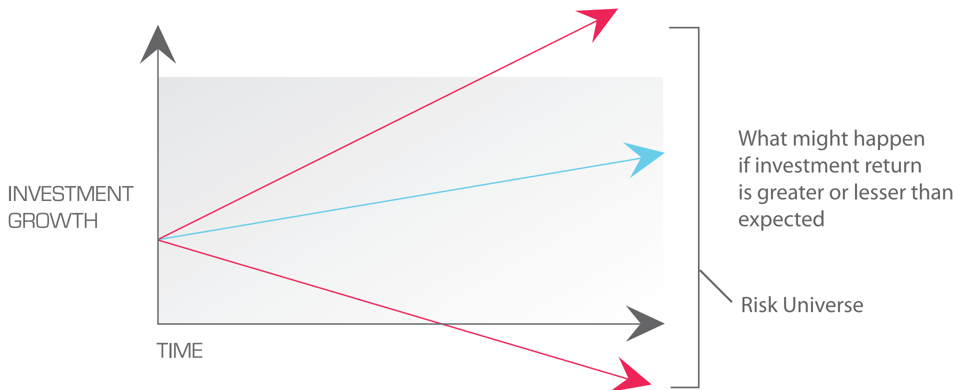


2.The Risk Propensity of the Investor

Risk propensity is a measure of an investor's willingness to accept higher risk or volatility in exchange for the possibility of higher potential returns. This element is personal to each investor and is rooted in their emotional makeup.

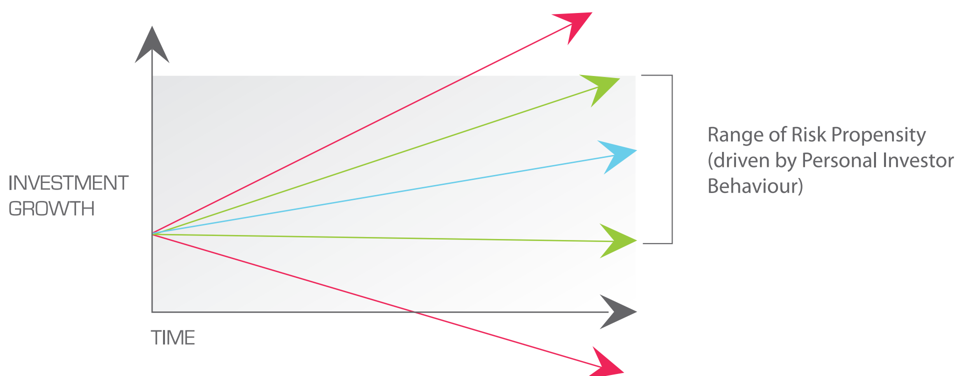
Those with high propensity may unwittingly expose themselves unnecessarily to risk levels that are not required in order to meet their financial goals when a lower investment return would suffice. Quite often, such a person may unintentionally seek out an investment high risk / higher prospective return even if such investments add little of value in terms of risk dilution or overall return.

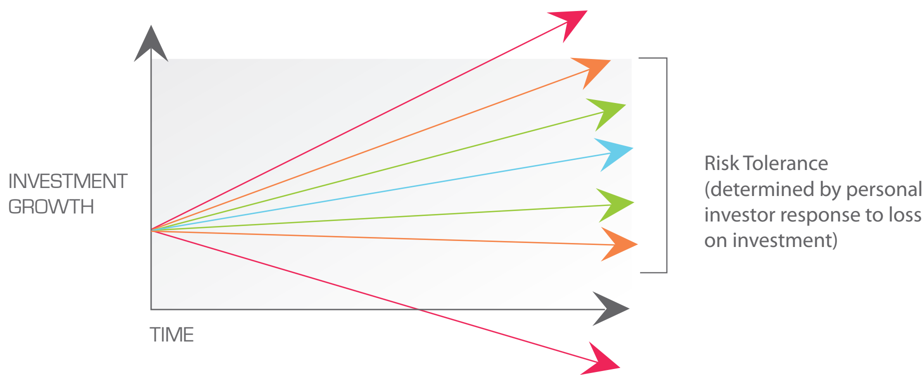
Those with a low propensity to take risk would feel uncomfortable with any possibility of financial loss. They would usually be referred to as a conservative investor who is more contented with capital protection.



3.The Risk Tolerance of the Investor

Equally, once the required risk has been determined to meet a given financial goal from an examination of the expected return of various assets that form an Efficient Frontier, the task of any investor is simply to decide if they are willing to accept that required level of risk. This means that an investor who is unwilling to take the required level of risk to meet a particular financial goal may have to modify that the goal. Quite often in reality, however, risk tolerance only comes to the fore when a loss has actually been incurred and it is obvious that such a loss may not be recoverable.

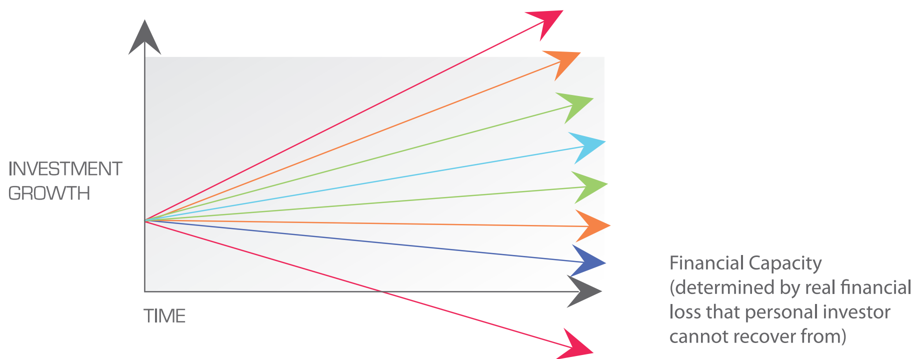




4.The Financial Capacity of the Investor

This deals with the financial ability to generate sufficient capital in the remainder of the investment period in order to meet the investor's personal goals. The issues that may influence capacity are:

Time horizon – When is the capital required to deal with the objective. The longer the term, the more achievable such a recovery is in the event of a serious financial loss. For example, the younger the investor, the longer they have to recoup losses (with earned income) before they have to use the money for its intended purpose. Even though most people's time frame is long term because their assets will, in theory, pass to, and be used by their heirs, there is still substantial repositioning needed based on age.



Liquidity – How much cash is required to service current expenses? How easily can it be raised? The more difficulties in this area, the more unlikely a recovery can be made.

Net worth - Those with high wealth can make higher risk investments because they have money coming in regardless of the market conditions. A higher net worth allows an investor to be able to bear more risk in their portfolio. However, this does not necessarily mean that they need to take more risk. For many High Net Worth investors, wealth preservation is more important than increasing their wealth.

Ongoing after tax income – The legal requirement to pay taxes that have been ignored to date is a further obstruction to restore the required capital levels.

Need to service specific level of expenses and or debt - An important factor in determining an appropriate asset mix is the amount of investment income or withdrawals that will occur in the future. In general, the more income or withdrawals required, the more the portfolio is weighted toward safer, fixed-income securities and away from assets that are exposed to significant short-term principal risk (there are exceptions to almost all investment generalities).

Logically, the investor's financial capacity should always be to the forefront of the mind of both the investor and his adviser. Even if an investor has both the propensity to take risk and the fortitude to bear the loss, an investor should never take more risk than he or she has the capacity to absorb and then recover from by being able to generate replacement capital.

Rewriting The Client Rulebook

Defining and applying a risk process is not just about the creation of a once off snapshot that drives future financial risk management. It is rather a process which needs constant revisiting and the awareness of an individual's hard wired risk behavior countered against their learned behavior informed by current experiences.

Investing is always an emotional undertaking and, unless educated in the doctrines of behavioral finance, many investors may, at various stages, unintentionally undermine their targeted portfolio returns through irrational actions even though they may have appeared rational at the time.

To counter this possibility, it is necessary to go beyond traditional approaches especially in the light of growing overarching regulatory involvement. If an adviser is to know his client for regulatory purposes then he must truly understand his client. As can be seen above, financial damage can occur outside of the traditional parameters of risk. Just because a regulator does not codify that emotions need to be considered in financial planning does not mean that a regulator would overlook such emotional responses in the event of a substantiated claim.

Rather than base their business solely around current codes of conduct, we would feel that advisers need to plan to be ahead of the curve by anticipating future changes even if the regulator has not actually thought of them yet. By having the clients' best interests uppermost at all times, financial advisers can ensure that they impact on the lives of their clients in a most positive manner rather than leave their clients' emotions to the vagaries of financial markets and product producers.

What is needed therefore is an additional element to the Investment Policy Statement which records the client's emotional preferences for issues such as spending, goal monitoring, financial accountability and trust. By having clients acknowledge their own behavioral strengths and struggles, advisers will be able to build upon their current relationship and expand it over time, provided that the various behavioral issues are continually revisited as part of any regular investment review.

In the same way that the IRR calculation, risk propensity, risk tolerance and financial capacity are key elements of the Investment Policy Statement, the emotional elements of spending habits, focus on goals, control and accountability to the client himself need to be integrated and the client reminded at each major review meeting of their behavior in these latter areas. These elements should prompt both adviser and client to revisit recent and upcoming expenditure as well as previously agreed goals, especially if these also impact on third parties such as spouse, children, parents or business partners.

5

Everyone Is Different – Dealing With Emotions and Risk, Some Case Studies

"I can calculate the motions of heavenly bodies... but not the madness of people!"
Isaac Newton

The above quote by Newton was not, as some people might think, a slight on others but rather a commentary by him on his own behavior after he had lost a substantial amount of money in the South Sea Bubble. Even great minds such as his were prone to making irrational decisions and this has been perpetuated by other well-known individuals. Those who were defrauded by Bernard Madoff in recent years included many of America's rich and famous who queued up to join his funds. Madoff even had an elitist application process thus adding more mystique and desirability to potential investors. This even extended to several high profile investment advisers who recommended Madoff's funds to clients despite the fact that they could not rationalise his methods and blindly trusted him.

Such blind trust is not confined to celebrities as can be demonstrated by the global proliferation of Pyramid Schemes wherein investors are promised a multiple of their original investment only to see that the first investors are the only ones who make money, usually off the back of the last investors in.

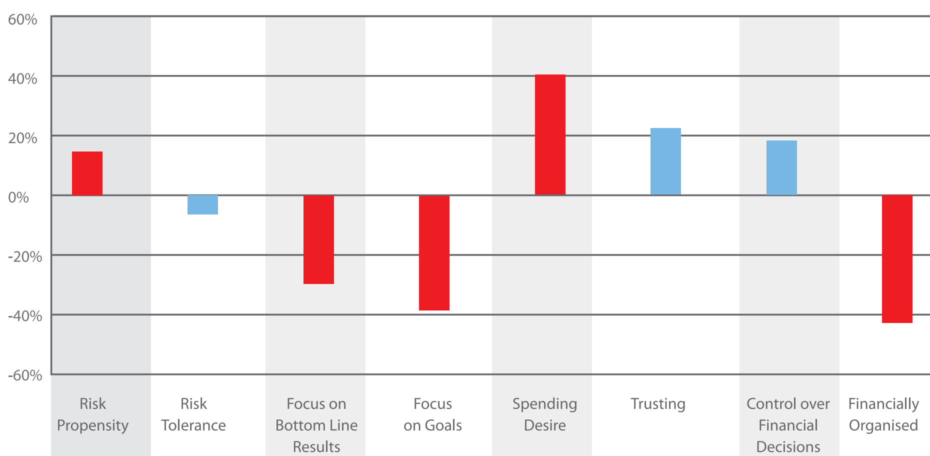
Applying conventional thinking to risk does not satisfactorily measure such irrational behavior. While most of the major losses to fraud are rooted in greed, this emotion is in many cases merely another behavioral response to someone else's wealth. Similarly, the willingness to trust also influences people's decision making as does an overriding desire to achieve a goal.

It is the careful balancing of each of these additional attributes as well as the traditional measures of risk which can make the difference, not only between successful or unsuccessful investing, but also the success of a long term client adviser relationship and the personal journey experienced by investors in reaching their goals. Every person's emotional makeup is unique to them which, in turn, means that the financial advice, whether it is in respect of investments or the purchase of other financial products, must be shaped to their whole personal emotional outlook.

Rather than just examine Risk Propensity and Risk Tolerance, the Financial DNA™ Discovery Process details a wide range of other behaviors all of which have a direct influence on both long term accumulation of capital and the short term destruction of wealth.

The power of the analysis can be best explained by some examples of real recordings of individuals who have been profiled using the Financial DNA™ Discovery Process.

Jack



Jack is in his mid-thirties and, before the Global Financial Crisis, was worth $6 million as a result of an inheritance he received from his late father. Being the trusting person he is, he assumed that because he was dealing with well known and respected firms that his money would be properly managed. Unfortunately, this did not prove to be the case and his wealth has now shrunk to a third of its original level. How did this happen?

Firstly, Jack has a high propensity to take risk – he enjoys the possibility of achieving high returns. Under the Financial DNA™ Discovery Process he is in the top 30% of the population who take risk. Not only is he comfortable taking risk with his finances he also enjoys high risk adventure sports. When he experiences losses he is more balanced in his outlook and would not be upset for a long period. The willingness to take risk that is countered by a medium tolerance has allowed him to stray into investments that he should never have been involved with.

In his case no personal investment policy statement was drawn up which would have defined what his required rate of return was from his overall portfolio. Because he was very trusting he found himself drawn to parties who seemed very plausible with their approach and as he had no previous investment experience he allowed himself to be distracted among several advisers none of whom actually drew up a financial plan or enquired about other investments.

The main interest for each of these advisers was whether he could write a sufficiently large cheque for an investment product they were promoting and, being a person who likes to spend, he happily obliged. His spending habit was also reflected in his purchasing of three automobiles despite the fact that all his children are below 12 years of age and only he and his wife drive. Similarly he has a penchant for fine dining and vacationing in five star resorts travelling on first class air tickets. All of this is despite the fact that he actually has no business or employment and is living off his capital.

On the plus side, a trusting individual can also be less likely to interfere with financial plans agreed with his adviser. Unfortunately he is also an individual who does not focus on goals, is not financially organized and has a low control over financial decisions. All in all, he is his own worst enemy when it comes to financial decisions and needs protection from his own decisions. In his case, $4 million worth of protection!

While investment risk accounted for him being in investments that he should probably not have been in, his spending habits have eroded his wealth considerably. Indeed, in the last four years he has spent over $1.3m on his lifestyle when he could have easily spent only half of this amount and still had an extremely enjoyable lifestyle.

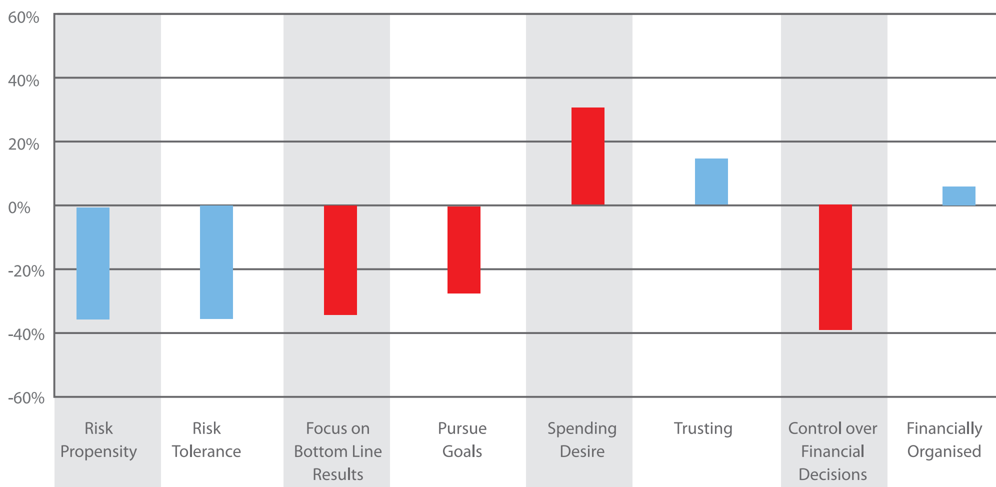
If he had met his latest adviser first, these behaviors could have been explored thoroughly and explained to him in the context of his own investments and financial planning.

Jack was, however, not alone in handling his financial affairs. His wife, Jill, had similar attributes in the areas of spending, trust, lack of focus on goals and bottom line results. As such his approach to financial behavior was reinforced by her comfort with what he was doing. The main difference lay in her attitude to risk. Both her propensity to take risk and her tolerance of any negative outcome are extremely low. Until the financial losses became self evident, her trusting nature allowed her to overlook the financial shortcomings of her husband who had previously lead all decisions in financial matters due to his need to exert control on such issues.

The management of risk needs to consider the possibility of client irrational behavior.

The Financial DNA™ Discovery Process identifies risk tolerance, risk capacity, potential to overspend and not following agreed goals.

Jill



From a couple who would appear to mirror each other's behavior, take a look at Edward who is self employed, single and in his mid forties. He has a moderate mortgage but has actually accumulated a large retirement fund even at this point in his life. Nevertheless from an investment perspective he is not only prepared to take risk, he shows an even higher tolerance in suffering losses. Subsequent discussions with him investigating this apparent mismatch indicated that he researches any large financial decision in detail before proceeding. Indeed, this is also how he runs his business. Such attention to detail is also reflected in his focus on bottom line results and pursuance of goals.

Edward

He has no lifestyle demands that are satisfied by heavy spending which is also reflected in his desire to exert control on financial decision making. These together with his low trust threshold combine to make him a difficult individual for any financial planner to advise. Typically, such individuals tend to need options to be presented to them and then to be left to their own devices to mull them over before making a final decision. Any attempt to push them to make a quick decision will not only result in a slower decision but may also be seen as an attempt by a pushy salesperson to overly influence them.

6

Wealth Mentoring – The Skill Behind Financial Client Management

"It's one of the most important things at the end of the day, being able to say no to an investment"
Henry Kravis, co-founder of Kohlberg Kravis Roberts & Co.

As every client is different emotionally, so too is every adviser. The skill of the adviser is to recognise the strengths and struggles of each of his clients as well as his own strengths and struggles. While the core of the advice should always be the natural, hard-wired behavior of the client, the adviser may need to adjust what appears to be his own perceived personality. Clients are more likely to deal with people who they feel are similar in personality or who appreciate their particular personality type.

A more aware adviser will always seek to educate his client in all matters financial as well as heightening the client's awareness about those behaviors that may cause financial loss. This will entail not only using the natural personality profile as a base but also asking a wide range of questions that will identify the client's current learned behavior and then investigating why such behaviors may now seem different.

A case in point might be someone who has a high tendency to take risk but who now wishes to take minimal or no risk at all. Such a total reversal in attitude would always need to be explored. Based on global events of the recent years, it is possible that such individuals have incurred large financial losses either through investments falling in value, bank covenants being withdrawn or hoped for rental income dissipating or even drying up. In any event, their natural propensity to be a risk taker has been curtailed and it is incumbent on the adviser to dig deep and fully explore the issues involved.

In many cases, even when such a high risk investor asks for a low risk option which an adviser promptly arranges, the client may feel shortchanged when the investment product did exactly what was intended but the general investment markets have considerably outperformed it. In such a circumstance, the client will most likely look at his adviser in a poor light and may even terminate the relationship through no fault of the adviser.

A key point often missed is the need to act as the guide. This means that the adviser needs to listen well and then learn how to help the client make their own decisions rather than push them to make a specific choice that the adviser wants. For the client to have emotional buy-in, they must be the central part of the decision-making process with the adviser stepping in to provide the wisdom, experience and knowledge on the potential courses to follow. If the adviser makes the decision for the client, the deeper commitment will not be there and there is a reduced probability of maintaining a long term business relationship .

Based on our extensive research since 2001, 70% of typical advisers are not natural

client guides based on their behavior style. This is because their nature is to set the agenda and control the process. So, they need to learn how to modify their behavior to build long term advisory relationships that are profitable.

On the other hand, it is important to recognise some clients will want to set the agenda and others will want more direction. Even those more co-operative clients who want more direction should not be allowed to abdicate responsibility to the adviser and the adviser should not just take over because it is easy.

Wealth mentoring is not just for the main client relationship. It is also for life and business partners of the client. By ignoring these important associations, an adviser leaves himself exposed to these third-party influences changing the main client's mind or causing confusion at some later stage. Good wealth mentoring goes beyond what is directly visible in the client adviser relationship and explores the reason for these outside influences.

Advisers need to be aware of their own behavioral strengths and struggles.

Advisers can make clients feel more comfortable with them by mirroring client attributes.

Advisers need to mentor their clients to have better financial attributes and educating them to understand themselves better.

Wealth mentoring goes beyond the direct formal client relationship and even extends to related third parties.

7

Mismanaging Financial Clients – The Real Cost To Advisers

The relationship between a client must be 'we.'
Billy Baldwin

Despite the proliferation of technology, people still "buy" people irrespective of the business sector. Those that can form deep relationships are more likely to be sought out for their advice instead of others where no relationship exists. Yet despite this basic tenet, most businesses fail to form a "corporate memory bank" of the client's emotional makeup. The hard facts are often quite correctly gathered as these are very important in generating relevant financial analysis and broad recommendations. The soft facts that relate to behavioral requirements to spend or save, the emotional need to exert control on finances, the deliberate pursuit or avoidance of goals which are more important to the client than just a product purchase, are routinely ignored.

Sometimes this ignorance comes about as a result of lack of foresight on the part of the individual financial service business leaders. Other times, it is because it slows down a mass market sales focus on transactional sales. The long term benefit is therefore sacrificed for the short term gain. This year's profit is more important to a salesman's year-end bonus than the successful long term expansion of the business. While all businesses espouse to provide the customer with exactly what they want, why is it that many lose sight of who the customer really is? Maybe, the real answer is that they never knew who the client actually was to start with and so could never really provide the best advice and service to them at all.

By truly knowing the client, the client could be matched up with an adviser that has broadly the same emotional style as the client. Even if the personalities are not a best fit, an adviser trained in such an approach could alter their own behavior so that it is more appealing to the client. Our experience has been that advisers who use such profiling systems regularly with clients become more adept at noticing many behavioral traits of individuals that they encounter on a daily basis even if they do not get an opportunity to examine such personalities in great detail.

On a business macro level, the obvious cost of not knowing your client may eventually result in litigation as well as the eventual higher professional indemnity insurance costs. In some cases the ultimate cost is the withdrawal of a licence to trade by the financial regulator. However, advisers also need to consider the time and energy costs of clearing up mistakes some years after the initial advice was provided. This is a huge hidden cost for advisers. What is startling is how so little time is actually spent on client discovery by advisers.

Research conducted in February 2010 by DNA Behavior showed that 53% of advisers with assets under management of $50 million spend 1 to 2 hours on client discovery and a further 29% spend 3 to 6 hours. These statistics are even worse when you consider that 50% of advisers are spending less than 6 hours in total in preparing the financial plan and a further 25% of advisers are spending 6 to 10 hours.

The reality is that these advisers and their businesses are setting themselves up to fail. Yes, they are saving time on the front end but what is the cost down the track? With such little time invested up front there is little chance of building a lasting connection with the client and demonstrating value for the work done. Clients have become better educated over time and know the advice that they are given is based on standard models. Unless an adviser can demonstrate that the advice is considerably more personal there is little likelihood that they will wish to continue paying fees, So, why would an adviser not spend more quality time up front and increase the certainty of a better plan, a better relationship and far less wasted time addressing problems later?

All industries and the businesses within them undergo phases of "Creative Destruction"[1] whereby super profitable business models of the past are replaced by more customer focused lower cost models which leads to profitability emanating from a new source. Financial Planning is being caught up in such worldwide changes and its practitioners must adapt going forward. By focusing on the client rather than the sale of generic products, financial planners will be able to ensure their own business continuity long after the impact of fee only planning has taken root.

Personal Relationships still override technological relationships.

Many business overlook the need for a corporate memory bank of client behavior.

The short term need for profit needs to be replaced by the long term need for building a long term business.

Professional Indemnity Insurance claims could be avoided.

In the worst case scenario, the adviser may lose their licence to trade.

Financial Planners need to adapt their businesses going forward in order to survive.

1 Joseph Schumpeter (1883 – 1950) introduced the term "Creative Destruction," as a shorthand description of ongoing changes brought through the Capitalist model in his book "Capitalism, Socialism, and Democracy "(1942)

The Authors of This White Paper

Hugh Massie, DNA Behavior® International

Hugh is the President and Founder of DNA Behavior International, which he established in Sydney, Australia before relocating the business to Atlanta, Georgia, USA. He founded DNA Behavior® International to pioneer the design, development and marketing of proprietary client centered human behavior solutions for building successful businesses and to help people "Live with Meaning" by providing insights into themselves to enable them to unblock their potential.

Hugh has more than eleven years of technical and practical international experience in using and developing human behavioral systems for a wide range of business applications. With an international team of behavioral experts, he envisioned and led the development of the Financial DNA™ Discovery Processes which are currently applied to more than twenty specific applications worldwide under 8 different DNA brands. He is a world authority on the connection of natural DNA behaviors to life, financial, and business decisions and provides consulting and training services to international corporations and financial service firms including Fortune 500 companies.

Hugh has spoken at leading industry, corporate and not-for-profit events around the world on the strategic application of behavioral insights for business and personal benefit.

He has written extensively on the areas of human behavior, human performance, communication and relationships, customer and employee engagement, and behavioral finance. Hugh is the author of a book "Financial DNA® – Discovering Your Unique Financial Personality for a Quality Life", published by John Wiley & Sons.

Hugh worked with Arthur Andersen for 10 years in Sydney, Singapore and Thailand before founding the Coddington Group in March 1996, a leading provider of financial and business services to families and entrepreneurs. He has significant commercial and business experience through the provision of a broad range of financial advisory, financial product packaging, capital raising and business consulting services.

Hugh has a Bachelor of Commerce (Accounting and Finance) degree from the University of New South Wales, Australia and is a Member of the Institute of Chartered Accountants in Australia. He also holds a Diploma in Financial Planning.

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Eamon represents DNA Behavior® International in Ireland and the UK and is the Principal of Aspire Wealth Management, a fee based financial planning and wealth mentoring business operating in Dublin, Ireland.

Eamon is a Past President of the Life Insurance Association (LIA), one of the primary educational bodies for financial advisers in Ireland, having been an examiner and corrector for the LIA's examinations as well as previously being joint editor of the LIA's own technical publication "The Professional". He was also one of the inaugural judges of the Moneymate Investment Awards.

In recent years, he has served on the Council and various committees of the Irish Broker Association (IBA) and in 2009 was the Chairman of its Financial Services Committee. He had previously served on the IBA's Technology Committee being one of its first representatives on the board of Assurelink, the computer company founded by life assurance companies to provide technology support to Irish life assurance and pension brokers.

Eamon has over 35 years' experience in the Irish Financial Services sector having worked for two life assurance companies and a stockbroker before becoming a co-owner of a general insurance and financial services brokerage for 15 years. In 2005, he established Aspire Wealth Management, based in Malahide, Co. Dublin, through which he operates as a financial planner specializing in investments and retirement. He also acts as an Expert Witness in cases of recklessness or negligence involving personal financial advice.

His career roles have involved him in policy administration, pensions servicing, financial accountancy, management accountancy, stockbroking, computer strategy development, personal financial advice and behavioral finance analysis.

Eamon is a Qualified Financial Advisor (QFA), A Fellow of the Life Insurance Association (FLIA) and an Associate of the Chartered Insurance Institute (ACII). He holds a Graduate Diploma in Financial Planning (First Class Honours) from University College Dublin and in October 2011 was among the first accredited Certified Financial Planners (CFP®) in Ireland.

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