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Behavorial Finance and Wealth Management

How To Build Investment Strategies That Account for Investor Bias

second edition

MICHAEL POMPIAN

Behavioral Finance and Wealth Management

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I would like to dedicate this book
to my brother Dave and his family.

Contents

Preface

It is with great satisfaction that I write this preface. Fifteen years ago, I embarked upon a quest to introduce the benefits of applying behavioral finance in practice with my first published article. Six years ago the first edition of this book was published. In that edition, I noted that behavioral finance was an emerging topic and that, hopefully, it would become a well-recognized discipline in finance. At the time, the debate as to whether or not behavioral finance was to be taken seriously by, mainly, academics and some practitioners, was in full force. Six years on, this debate appears to essentially be over. Behavioral finance is now part of the financial lexicon in many circles, such as the advisor-client relationship, the financial press, the academic literature, financial journals, and so on. It's not whether behavioral finance exists, but rather how can we begin to learn from the research that has been done and help ourselves become better investors. This second edition continues to help both clients and their advisors benefit from the practical application of behavioral finance.

This book is intended to be a guide both to understanding irrational investor behavior and to creating individual investors' portfolios that account for these irrational behaviors. The investment business is dominated by "benchmarks" against which performance of an investment portfolio should be judged. Often, investor think they should "beat the market" just because that is what they think defines success. In my view, private clients should begin thinking about their benchmarks in terms of how well they help them progress toward their financial goals, not so much whether an investment manager beats their benchmark or their portfolio outperformed the policy benchmark. Knowledge of behavioral biases and their affect on the investment process can go a long way to changing the way we view investment success. Often times, when applying behavioral finance to real-world investment programs, an optimal portfolio is one with which an investor can comfortably live, so that he or she has the ability to adhere to his or her investment program, while at the same time reach long-term financial goals.

The last edition of the book was written in the wake of the run-up in stock prices in the late 1990s and the subsequent popping of the technology bubble. This time, the latest financial bombshell was the 2008–2009 bursting of the housing and credit bubbles. And given the response to this financial crisis by central banks around the world, by keeping interest rates ultra-low, similar to the years preceding the most recent crisis, my view is we may be in store for continued volatility. Therefore, understanding irrational investor behavior is as important as it has ever been, probably more so. This is true not only for the markets in general but most especially for individual investors. This book will be used primarily by financial advisors, but it can also be effectively used by sophisticated individual investors who wish to become more introspective about their own behaviors and to truly try to understand how to create a portfolio that works for them. The book is not intended to sit on the polished mahogany bookcases of successful advisors as a showpiece: It is a guidebook to be used and implemented in the pursuit of building better portfolios.

The reality of today's advisor-investor relationship demands a better understanding of individual investors' behavioral biases and an awareness of these biases when structuring investment portfolios. Advisors need to focus more acutely on why their clients make the decisions they do and whether behaviors need to be modified or adapted. If advisors can successfully accomplish this difficult task, the relationship will be strengthened considerably, and advisors can enjoy the loyalty of clients who end the search for a new advisor.

In the past 250 years, many schools of economic and social thought have been developed, some of which have come and gone, while others are still very relevant today. We will explore some of these ideas to give some perspective on where behavioral finance is today. In the past 30 years, the interest in behavioral finance as a discipline has not only emerged but rather exploded onto the scene, with many articles written by very prestigious authors in prestigious publications and now is consistently in the mainstream media. We will review some of the key people who have shaped the current body of behavioral finance thinking and the work done by them. The intent is to take the study of behavioral finance to another level: reviewing the most important behavioral biases in terms that advisors and investors can understand, and demonstrating how biases are to be used in practice through the use of case studies—a "how-to" of behavioral finance. We will also explore some of the new frontiers of behavioral finance, things not even discussed by today's advisors that may be commonly discussed in the next 30 years.

A CHALLENGING ENVIRONMENT

In the last edition, I noted that investment advisors have never had a more challenging environment to work in. I wrote: "Many advisors thought they had found nirvana in the late 1990s, only to find themselves in quicksand in 2001 and 2002." Now, we merely need to substitute the years 2005 through 2007 and 2008–2009 into the same sentence. As the old adage goes, the more things change the more they stay the same. And once again we find ourselves in a low-return environment. Like then, advisors are still being peppered with the vexing questions from their clients:

"Why is this fund not up as much as that fund?"

"The market has not done well the past quarter—what should we do?"

"Why is asset allocation so important?"

"Why are we investing in alternative investments?"

"Why aren't we investing in alternative investments?"

"Why don't we take the same approach to investing in college money and retirement money?"

"Why don't we buy fewer stocks so we can get better returns?"

Advisors need a handbook that can help them deal with the behavioral and emotional sides of investing, so that they can help their clients understand why they have trouble sticking to a long-term program of investing.

WHY THIS BOOK?

The first edition of the book was conceived only after many hours, weeks, and years of researching, studying, and applying behavioral finance concepts to real-world investment situations. When I began taking an interest in how portfolios might be adjusted for behavioral biases back in the late 1990s, when the technology bubble was in full force, I sought a book like this one but couldn't find one. I did not set a goal of writing a book at that time; I merely took an interest in the subject and began reading. It wasn't until my wife, who was going through a job transition, came home one night talking about the Myers-Briggs personality type test she took that I began to consider the idea of writing about behavioral finance. My thought process at the time was relatively simple: Doesn't it make sense that people of differing personality types would want to invest differently? I couldn't find any literature on this topic. So, with the help of a colleague on the private wealth committee at NYSSA (the New York Society of Securities Analysts—the local CFA chapter), John Longo, PhD, I began my quest to write on the practical application of behavioral finance. Our paper, entitled "A New Paradigm for Practical Application of Behavioral Finance: Correlating Personality Type and Gender with Established Behavioral Biases," was ultimately published in the *Journal of Wealth Management* in the fall of 2003 and, at the time, was one of the most popular articles in that issue.

Since that time, I have written several papers, a new Wiley book entitled *Advising Ultra Affluent Clients and Family Offices*, and a monthly column for MorningstarAdvisor.com that have expanded my work. In 2008, I published "Behavioral Investor Types," an article that ran in the *Journal of Financial Planning*. This work attempts to categorize investors into four "behavioral investor types," which will be reviewed in this book briefly and fully explained in my next Wiley book, entitled *Behavioral Finance and Investor Types*, coming out later in 2012 or 2013. As a wealth manager, I have found the value of understanding the behavioral finance and have discovered some useful ways to adjust investment programs for behavioral biases. You will learn about these methods. By writing this book, I hope to spread the knowledge that I have developed and accumulated so that other advisors and clients can benefit from these insights.

WHO SHOULD USE THIS BOOK?

The book was originally intended as a handbook for wealth management practitioners who help clients create and manage investment portfolios. As the book evolved, it became clear that individual investors could also greatly benefit from it. The following are the target audience for the book:

- *Traditional Wire-house Financial Advisors*. A substantial portion of the wealth in the United States and abroad is in the very capable hands of traditional wire-house financial advisors. From a historical perspective, these advisors have not traditionally been held to a fiduciary standard, as the client relationship was based primarily on financial planning being "incidental" to the brokerage of investments. In today's modern era, many believe that this will have to change, as "wealth management," "investment advice," and brokerage will merge to become one. And the change is indeed taking place within these hallowed organizations. Thus, it is crucial that financial advisors develop stronger relationships with their clients because advisors will be held to a higher standard of responsibility. Applying behavioral finance will be a critical step in this process as the financial services industry continues to evolve.
- *Private Bank Advisors and Portfolio Managers*. Private banks, such at U.S. Trust, Bessemer Trust, and the like, have always taken a very solemn, straightlaced approach to client portfolios. Stocks, bonds, and cash were really it for hundreds of years. Lately, many of these banks have added such nontraditional offerings as venture capital, hedge

funds, and others to their lineup of investment product offerings. However, many clients, including many extremely wealthy clients, still have the big three—stocks, bonds, and cash—for better or worse. Private banks would be well served to begin to adopt a more progressive approach to serving clients. Bank clients tend to be conservative, but they also tend to be trusting and hands-off clients. This client base represents a vast frontier to which behavioral finance could be applied because these clients either do not recognize that they do not have an appropriate portfolio or tend to recognize only too late that they should have been more or less aggressive with their portfolios. Private banks have developed a great trust with their clients and should leverage this trust to include behavioral finance in these relationships.

- *Independent Financial Advisors.* Independent registered representatives (wealth managers who are Series 7 registered but who are not affiliated with major stock brokerage firms) have a unique opportunity to apply behavioral finance to their clients. They are typically not part of a vast firm and may have fewer restrictions than their wire-house brethren. These advisors, although subject to regulatory scrutiny, can for the most part create their own ways of serving clients; and with many seeing that great success is growing their business, they can deepen and broaden these relationships by including behavioral finance.
- *Registered Investment Advisors.* Of all potential advisors that could include behavioral finance as a part of the process of delivering wealth management services, it is my belief that registered investment advisors (RIAs) are well positioned to do so. Why? Because RIAs are typically smaller firms, which have fewer regulations than other advisors. I envision RIAs asking clients, "How do you feel about this portfolio?" "If we changed your allocation to more aggressive, how might your behavior change?" Many other types of advisors cannot and will not ask these types of questions for fear of regulatory or other matters, such as pricing, investment choices, or others.
- *Consultants and Other Financial Advisors.* Consultants to individual investors, family offices, or other entities that invest for individuals can also greatly benefit from this book. Understanding how and why their clients make investment decisions can greatly impact the investment choices consultants can recommend. When the investor is happy with his or her allocation and feels good about the selection of managers from a psychological perspective, the consultant has done his or her job and will likely keep that client for the long term.
- *Individual Investors.* For those individual investors who have the ability to look introspectively and assess their behavioral biases, this book is ideal. Many individual investors who choose either to do it

themselves or to rely on a financial advisor only for peripheral advice often find themselves unable to separate their emotions from the investment decision-making process. This does not have to be a permanent condition. By reading this book and delving deep into their behaviors, individual investors can indeed learn to modify behaviors and to create portfolios that help them stick to their long-term investment programs and, thus, reach their long-term financial goals.

WHEN TO USE THIS BOOK?

First and foremost, this book is generally intended for those who want to apply behavioral finance to the asset allocation process to create better portfolios for their clients or themselves. This book can be used:

- *When there is an opportunity to create or re-create an asset allocation from scratch*. Advisors know well the pleasure of having only cash to invest for a client. The lack of such baggage as emotional ties to certain investments, tax implications, and a host of other issues that accompany an existing allocation is ideal. The time to apply the principles learned in this book is at the moment that one has the opportunity to invest only cash or to clean house on an existing portfolio.
- *When a life trauma has taken place*. Advisors often encounter a very emotional client who is faced with a critical investment decision during a traumatic time, such as a divorce, a death in the family, or job loss. These are the times that the advisor can add a significant amount of value to the client situation by using the concepts learned in this book.
- *When a concentrated stock position is held*. When a client holds a single stock or other concentrated stock position, emotions typically run high. In my practice, I find it incredibly difficult to get people off the dime and to diversify their single-stock holdings. The reasons are well known: "I know the company, so I feel comfortable holding the stock," "I feel disloyal selling the stock," "My peers will look down on me if I sell any stock," "My grandfather owned this stock, so I will not sell it." The list goes on and on. This is the exact time to employ behavioral finance. Advisors must isolate the biases that are being employed by the client and then work together with the client to relieve the stress caused by these biases. This book is essential in these cases.
- *When retirement age is reached*. When a client enters the retirement phase, behavioral finance becomes critically important. This is so because the portfolio structure can mean the difference between living a comfortable retirement and outliving one's assets. Retirement is

typically a time of reassessment and reevaluation and is a great opportunity for the advisor to strengthen and deepen the relationship to include behavioral finance.

- *When wealth transfer and legacy are being considered*. Many wealthy clients want to leave a legacy. Is there any more emotional an issue than this one? Having a frank discussion about what is possible and what is not possible is difficult and is often fraught with emotional crosscurrents that the advisor would be well advised to stand clear of. However, by including behavioral finance into the discussion and taking an objective, outside-councilor's viewpoint, the client may well be able to draw his or her own conclusion about what direction to take when leaving a legacy.
- *When a trust is being created*. Creating a trust is also a time of emotion that may bring psychological biases to the surface. Mental accounting comes to mind. If a client says to himself or herself, "Okay, I will have this pot of trust money over here to invest, and that pot of spending money over there to invest," the client may well miss the big picture of overall portfolio management. The practical application of behavioral finance can be of great assistance at these times.

Naturally, there are many more situations not listed here that can arise where this book will be helpful.

PLAN OF THE BOOK

This edition of the book has an updated structure. In the last edition, Part One of the book not only provided an introduction to the practical application of behavioral finance but also an introduction to incorporating investor behavior into the asset allocation process for private clients. In this edition, Part One includes a definition of behavioral finance, a review of its history, and a new chapter that introduces behavioral biases. Asset allocation topics are covered in Part Five, Case Studies. Parts Two, Three, and Four are a comprehensive review of some of the most commonly found biases, complete with a general description, technical description, practical application, research review, implications for investors, diagnostic, and advice. This time, biases are broken out into three categories: Belief Perseverance Biases, Information Processing Biases, Emotional Biases to correspond to Part's Two, Three, and Four. Part Five includes completely updated case studies as well as the previously referenced "Application of Behavioral Finance to Asset Allocation" section. Lastly, Part Six includes my latest research into defining four "Behavioral Investor Types."

MICHAEL M. POMPIAN

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I would like to acknowledge all my colleagues, both present and past, who have contributed to broadening my knowledge not only in the topic of this book but also in wealth management in general. You know who you are. I would also like to acknowledge all of the behavioral finance academics and professionals who have granted permission for me to use their brilliant work. I also would like to acknowledge Cristina Hensel and all Wiley staff for their help in editing the book. Finally, I would like to thank my parents and extended family for giving me the support to write this book.

M. M. P.

Behavioral Finance and Wealth Management

PART One

Introduction to Behavioral Finance

In Part One, we present three chapters: Chapter 1 poses the question "What is Behavioral Finance?" This chapter also includes a review of some of the most important figures in the field of behavioral finance. In Chapter 2, we review the history of behavioral finance placing particular emphasis on understanding the differences between rational and irrational behavioral economic theories that have been developed over the year. Chapter 3 provides an introduction to behavioral biases, 20 of which will be reviewed in the book.

Throughout this part of the book, the goal is to have readers understand the basics of as well as the effects of behavioral biases on the investment process. By doing so investors and their advisors may be able to improve economic outcomes and attain stated financial objectives.