

What investors really want, need

New book highlights behavioral finance aspects of resolving conflicts, achieving goals

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 - [By Charles Widger and Daniel Crosby](#)
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The current system for providing investment advice is premised on the belief that education and disclosure will lead to rational investor behavior and prudent decision making. The Dalbar Effect proves the system has not worked. This suggests that what we are offering as advisers isn't what investors really want or need.

In reflecting on our experiences as advisers and investors, we've come up with what we believe are the key and often unspoken wants and needs of our investors.

Investors bring conflicts to advisers for them to resolve:

- Investors want safety and, on the other hand, growth.
- When markets are volatile, investors want advisers to do something to stabilize the swing in the value of their portfolios.
- Investors want an adequate pool of investment dollars in the future and, on the other hand, to enjoy consumption today.
- When the stock market is high, investors don't want bonds until the market corrects.
- Investors want equity-like returns without the volatility.
- Investors want to perform favorably against selected capital market indexes while making steady increases in purchasing power.

These conflicting desires and the behaviors they inspire often lead to disappointing and even devastating results. It is our task as advisers to resolve these and many other conflicts for investors.

HELP ME ACHIEVE GOALS

To encourage and create successful participation, advisers and investors should ask the question, What is it investors want? and in turn, develop the investment offerings that deliver what they want. Unfortunately, this has not been a focus of the advice delivery system until recently.

One way to define what investors want is in terms of the personal financial goals they want to achieve. Goals may include:

- Setting money aside for near-term spending or an emergency or rainy-day fund.
- Current income.
- Some appreciation in investment value with reduced volatility.
- Long-term growth to fund retirement.

The Money Management Institute, the \$3.5 trillion industry association for sponsors (e.g., Morgan Stanley, Merrill Lynch, UBS, Edward D. Jones) and investment managers participating in the managed solutions industry (e.g., Lord Abbett, Nuveen, Lazard), has increasingly recognized that goals-based investing delivers a better experience for investors.

At the April 2014 MMI board meeting, members overwhelmingly approved as its mission embracing this approach as the primary focus in providing investment advice.

At the 2014 Tiburon Conference in New York, well-known industry leaders also emphatically embraced goals-based investing. Tiburon conference attendees are limited to C-Suite executives from prominent financial services firms. Chip Roame, Tiburon's chief executive, emphasized, "We need to care about the fund owner doing well."

Mark Casady, CEO of LPL Financial, echoed Mr. Roame's message during his panel presentation when he said, "We should be about outcomes, not returns."

On the same panel, Mary Mack, president of Wells Fargo Advisors, continued the argument for shifting from a relative-return focus to outcomes.

Ms. Mack identified raising risk consciousness as a significant opportunity for advisers. "It's no longer about keeping up with the Joneses," she said. "It's about keeping up with the plan."

On another panel, Don Phillips, managing director of Morningstar Inc., amplified investor outcomes.

"What matters is the investor experience," Mr. Phillips said. "We as an industry will only thrive to the extent of good investor outcomes."

Another way to define what investors want is in terms of the experience they seek. This may include competitive returns, managed volatility or return per unit of risk.

This concept also can be understood in terms of what investors value, such as

- Return, both alpha and beta.

- Income management: the creation and management of income independent of earned income.
- Managed volatility (too much is simply too much).
- Transparency.
- Objectivity.
- More predictable outcomes.
- Communication.

Delivering an investment experience that contains the mix of these elements and fits the investor's personal goals or desired outcomes is what advisers must do. Whatever investors' personal goals and desired experience, these serve as the personal benchmark for the investing strategy advisers must develop and execute.

Lee Gordon, CEO of Mesirow's Private Wealth Group and a 22-year veteran adviser, oversees \$5 billion in assets and seeks to help investors finance the lifestyles they have worked hard to achieve. In his words, "To achieve your financial goals, you've got to get on and stay on the train. Otherwise, you'll never reach your destination."

Investors often talk about and think about comparing their investment strategy performance to capital market indexes to assess their investment experience. The problem is, capital market return and risk is not relevant for achieving personal goals. Capital market indexes measure speed, not the actual progress toward the goal.

HELP MY PURCHASING POWER

To determine progress toward goals, another metric is required: purchasing power. What gets measured gets done. Capital market indexes have risk/return characteristics that tell investors their rate of speed and the potholes (level of volatility) they may encounter, not their destinations.

The near-term tendency of focusing on capital market indexes has been reinforced for more than 30 years as advisers adopted a common practice of guiding the development and measurement of investment strategies. A simple index might typically be a 60/40 blend of the S&P 500 and the Barclays Aggregate Bond Index.

The historical risk/return characteristics of these indexes are well-known and are typically seen as the best guide to the likely future investment experience. So, the theory goes, capital market index outcomes, or experience, will produce the desired return and acceptable risk for individual investors.

However, this theory hasn't played out in reality. Many investors do not want the risk experience or outcome that market indexes at times provide. All too often the practice of using capital market indexes to create investment strategies leads to a beat-the-index mentality.

All investment advisers have had clients ask, "How am I doing in comparison to the S&P 500? Did I beat it?" This leads to a discussion of relative return, not absolute return. Relative-return analysis is about comparing the client's investment return (and risk) to the S&P 500's return for given periods.

This is the wrong question, and it leads to the Dalbar Effect.

David Poole, an adviser in Columbia, S.C., has built a successful advisory practice. In establishing his clients' personal goals through the financial planning process, he stresses that the recommended investment strategies are designed to achieve purchasing power.

Even though Mr. Poole emphasizes purchasing power, investor clients want to compare strategy performance to the S&P 500 rather than the purchasing-power goals.

"The consumer is so bombarded — it's in the water," he said. "Too much index comparison is a distraction from focusing on the goals developed in the financial plan."

The right questions investors should ask are, "Am I comfortable with the level of volatility in my portfolio, and am I able to stick to my long-term plan?"

Indexes can be used to provide context in various market environments, but the real performance comparison should be to the investor's long-term goals and objectives.

In short, articulated or not, the achievement of desired purchasing power is the investment experience most investors want. This makes purchasing power the objective and destination of a long-term investment strategy.

HELP ME WEATHER VOLATILITY

Bill Wallace, a talented and successful adviser from Northern California, recently remarked that reasonably affluent and high-net-worth investors understand purchasing power.

These investors are saying, "We like this world. What do we need to do to remain here? Give us strategies that will keep us here."

Potholes happen. Death and taxes do, too. But our focus here is potholes. What happens when our investor's well-planned and well-implemented investment hits one?

Take the case of highly volatile markets like 2000-02 and 2008-09, when markets declined more than 40%. Investors developed an intolerance for risk. They rushed to sell their risky assets (stocks) and moved into conservative assets (bonds).

Whew, crisis averted. Or, was it?

The paradox is that the risky assets they dumped recovered, because in market-based economies, governments must pursue policies that promote economic growth to sustain social benefits promised to their populations.

To have sustainable economic growth, there must be investment, and in order to have investment, there must be return on (and of) capital.

Capital market returns within recent years demonstrate these dynamics. Since March 2009, the Federal Reserve has pursued monetary policies designed to stimulate economic growth.

Its two key monetary policies have been a near-zero discount rate to stimulate lending by banks, and the expansion of its balance sheet by buying Treasuries and mortgage-backed securities.

The large purchases of government securities have pushed down the yields on fixed-income securities to very low levels. Investors seeking income, or yield, are thus forced to buy or invest in riskier assets like high-dividend-paying stocks. The result is the value of riskier assets is “forced” up, while yields on less risky assets are “repressed.”

This monetary policy is called financial repression. It is a policy tool that monetary authorities, like the Federal Reserve, use when the ratio of the government’s debt to GDP is too high.

Lower interest rates make it easier for the government to service its debt while increased prices for riskier assets encourage investment and consumption; increased investment and consumption are likely to produce sustainable economic growth.

So although they were well-intentioned, the government’s tactics didn’t work out for investors who fled from riskier stocks for safer havens.

The result? Dramatic underperformance.

DRASTIC DIFFERENCE

From the equity market bottom in March 2009, the S&P 500 has returned an annualized 25.8% compared to a return of 4.9% for fixed income. For the 30-year period ending Dec. 31, 2013, the average fixed-income fund investor yielded a paltry 0.7% annualized return, in comparison to Barclays Aggregate Bond (+7.67%) and the S&P 500 indexes (+11.11%).

This reveals a substantial performance gap between average individual investors and well-known asset classes.

This investor behavior during the 2008-09 financial crisis is an example of why the Dalbar Effect exists.

The lesson from the last 12 or so years is that investors do not want high volatility. They did not enjoy nor do they want to repeat the bear market experiences of 2000-02 and 2008-09. These big potholes disrupted many plans for creating purchasing power, the desired destination.

Investment strategies guided by, or measured in comparison to, capital market indexes delivered an investment experience like the S&P 500, which included declines of more than 40% in both the aforementioned bear market periods.

These declines meant that even if investors weathered the precipitous drops, they required more time to accumulate or grow principal to create the needed purchasing power.

This is an edited excerpt from “Personal Benchmark: Integrating Behavioral Finance and Investment Management,” by Charles Widger and Daniel Crosby (Wiley, 2014).