Kahneman: Clients Driven by Losses, Not Gains

Further advice from the father of behavioral finance on the perils of hindsight, the power of client regret and what really sets apart Warren Buffett

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In an address that was part social science, part high-end psychology and part homespun advice, with lessons from the “idiotic call” at the end of Super Bowl XLIX, Daniel Kahneman gave behavioral finance advice directly to advisors on Tuesday on day two of the IMCA New York Consultants Conference.

Kahneman, a psychologist who won the Nobel Prize in economics and recently published "Thinking Fast and Slow," began by speaking about loss aversion: that human beings feel and fear loss much more than they enjoy gain.

Saying that “your grandmother knew it and so did mine,” the Princeton professor said “your clients are more sensitive to loss than gain,” that they can be “infinitely loss averse when ruin” is one of the possible outcomes and that when it comes to wealth preservation, “people aren’t concerned about their level of wealth, but about changes in their wealth.”

To illustrate a related loss aversion principle known as the endowment effect, Kahneman related the findings of a famous experiment he and behavioral economist Richard Thaler conducted with coffee mugs and two groups of people. One group was given mugs and the others were given a sum of money: the mug owners, it turned out, demanded an average of $7 to sell their recently acquired mugs to the moneyed group; but the mug-less group was only willing to pay an average of $3 to buy the same mug.

As Thaler defined it, the endowment effect found that “people often demand much more to give up an object than they would be willing to pay to acquire it.” When working with clients on investing, Kahneman suggested that advisors recall this effect, that “people don’t like giving up things” even when they’ve only owned those things for a short time, like stocks in a portfolio.

He then turned to the concept of hindsight, in which “an event seems predictable after the fact.”

His example came from Super Bowl XLIX. “Look at the amount of credit the Patriots got after that stupid play” in which the Seahawks attempted a goal-line pass that was intercepted. “If the Seahawks had won, everything would have been different,” with commentators praising the Seahawk players. As it was, however, “everyone should have known, after the fact, that the Patriots were the stronger team.”

Much of life comes down to luck, Kahnemann preached: While the Patriots had “no control over the Seahawks’ idiotic call,” the winning Patriots after the fact felt they deserved to win. Since “the world is not predictable, a lot of what happens is luck. We greatly underestimate the role of luck; we overestimate the management” of good firms.

“Hindsight induces us to believe we understand the world because we understand the past,” which is a particularly dangerous belief for advisors to exhibit.

“Advisors will get blamed for not knowing what will happen” by their clients, he said, despite the fact that the future is unknowable.

While many observers claimed they saw the financial crisis coming, there’s a big difference between “thinking” and “knowing an event will happen. All too often, he said, the people who predict events, especially in the markets, are writing in “invisible ink”; only later will they say such predictions are “written on the wall” for all to see.

Returning to how clients feel, Kahneman warned of the “emotion of regret,” saying that clients will “feel the pain acutely” of lost investment opportunities and then will, regrettably, seek to act on that regret. He suggested that’s why so many investors, having seen an investment rise in value, will seek to buy that investment after it’s had its run. It’s also why, as research has shown, that mutual fund investors will rarely profit from the increase in a fund’s value, since the investors will far too often buy into and get out of funds, to their detriment.

“Try to prevent people from acting out of regret,” he counseled advisors, and look at the discussion of regret with clients as a “form of vaccination.” In fact, he suggested that advisors should build different portfolios for clients prone to tregret, because they are more prone to “changing their mind at the wrong time.”

Citing the findings of his former student Terrance Odean, now at the University of California, Berkeley, Kahneman said that advisors should realize that “having fewer ideas” about opportunities in stocks “is better” because of the "disposition effect," which shows that clients tend to sell their winning investments and hold onto their losers.

Addressing the issue of overconfidence, Kahneman told advisors not to “trust your own confidence” and to remember that “you cannot predict the future.” Instead, “be confident in the principles and processes you use to work with people, not in what stocks, bonds or the markets will do.”

“If you think you’re an expert on picking stocks, then you should be fabulously rich. If you’re not, you’re probably not” a very good stock picker. However, advisors are “experts on many aspects of financial decision-making.“

He acknowledged that advisor face a particular challenge: “your clients want you to be overconfident.”

He then noted that women in general are less likely to fall prey to the overconfidence effect. “Women are better at figuring out the emotional state of clients," he said. "Men should emulate them.”
Kahneman then presented four suggestions for advisors working with clients.

1) “Get clients to think large,” rather than to focus on the specifics of a portfolio.

2) Encourage long-term thinking among clients, and get them to commit to that approach.

3) Avoid the disposition effect (the tendency to sell winners and hold on to losers) and overconfidence

4) Ask yourself why you should know more than the market. After all, he said, very few active managers beat the indexes, and ‘the market’ is actually the value that all the market participants provide for a given investment.

In response to a question about Warren Buffett and whether his sterling investments are a result of luck or skill, Kahneman pointed out that Buffett is “not in the business of stock picking; he picks companies and managers” that he knows well.

Moreover, Buffett can rely on one effect that the rest of investors can’t: because of his reputation as a great investor, “when he buys a company, the markets” tend to nearly immediately “make the investment more valuable.”

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10 Commandments of Investor Behavior

By Emily Zulz Staff Reporter

Psychologist and behavioral finance expert Daniel Crosby provided 10 rules to manage clients' investment behavior at FSI summit

The market has returned 11.1% a year on average for the last 30 years; investors have gotten 4%.

Investor misbehavior: It's the scurvy of the financial services industry.

So suggested Daniel Crosby, the psychologist and behavioral finance expert who recently co-authored *Personal Benchmark*, during the Financial Services Institute's second annual Financial Advisor Summit on Wednesday. It took over 500 years for the official cure for scurvy, Vitamin C, to be established — despite the fact that cures were discovered time and time again throughout history. Citrus fruit was known to cure the sick when the Crusaders frequently suffered from the disease during the expedition of Vasco da Gama; years later French explorer Jacques Carter used natives' knowledge of boiling cedar needles containing Vitamin C to make a tea to save his men dying from scurvy — and yet the direct evidence of Vitamin C as the cure wasn't established until the 1930s.

“Something similar is afoot in financial services today,” said Crosby, who is also president of IncBlot Behavioral Finance, during a Wednesday session at FSI’s Financial Advisor Summit. “We now know because of behavioral finance in the last 40 or 50 years of research, we know that some of the greatest good that an advisor can do is hold the hands of their clients, to manage their behavior.”

As evidence, Crosby pointed to how the market over the last 30 years has returned 11.1% a year while the average investor has held onto less than 4% “because of their bad behavior.”

Crosby said a recent study showed that 77% of financial advisors are talking about behavioral finance concepts — and yet investor misbehavior continues.

In an attempt to cure what ails the financial services industry, Crosby provided ways advisors can help manage their clients’ behavior in the form of 10 commandments:

First Commandment: In all markets, up down and sideways, you control what matters most.
Crosby said that most of the people he’s talked to that have failed to invest in their future haven’t done so because they feel helpless.

“They feel rocked back-and-forth by volatility of capital markets,” he added. “They feel scared, they feel helpless, they feel afraid. They don’t understand that in all markets they control what matters most. That more important than all of this onslaught of information that they’re getting from financial news networks is managing their behavior.”

<u>Second Commandment</u>: Thou shall understand risk.
Instead of the volatility-based notion of risk that everyone is familiar with, the idea of "risk" should be thought of in regards to behavioral finance and goals-based investing.

"Risk is not a number," he said. "Risk is not benchmark risk. Risk is not underperforming your golf buddy. Risk is the probability that you won't have the money you need to do the things that matter most to you."

Even think of risk as volatility as a good thing, Crosby said.

<u>Third Commandment</u>: Start now, start again tomorrow, and start again the next day.
Mathematically, he added, this just makes sense.

"If you're trying to end up with $2 million in retirement, you're greatly improving your chances of getting there by starting earlier," Crosby said. "If you start at 22, you can give $6000 a year. If you start 18 years later, you're going to have to ramp that up pretty significantly."

But the other part of this is psychological, by forming and cementing habits in one's mind.

"If you can get your clients to start saving, deferring, investing, being appropriately aggressive, whatever it is today, they are going to start to cement those behaviors for tomorrow," Crosby said.

Fourth Commandment: Trouble is opportunity.

Crosby, who has created a 0-to-100 index of market sentiment called the Irrationality Index, talked about when a few years ago that irrationality index reached the lowest point in its history, indicating revulsion with the markets.

"It got down to five out of a potential 100," he said. "You were there, you understand people's reactions to this. But, if you had gone in at that 5, by this point you would have about doubled your money."

To help illustrate this point, Crosby quoted Sir John Templeton.

"[Templeton] had this to say about this concept: 'The time of maximum pessimism is the best time to buy and the time of maximum optimism is the best time to sell,'" Crosby said. "And we're all familiar with Warren Buffett's admission about being greedy and fearful. Trouble really is opportunity."

<u>Fifth commandment</u>: Do less than you think you should.
Elsewhere in life, to get something done or to get ahead, hard work is required.

“[A]nd, yet, in financial markets we know that is not the case,” Crosby said. “Your clients ought to do less than feels appropriate … When things get scary, we want to do the most when it’s exactly when we [need] to be doing the very least.”

<u>Sixth Commandment</u>: Forecasting is for weathermen.
“The fact is we’re just not very good at forecasting much and especially not what the market’s going to do,” Crosby said.

He added that listening to these types of “experts” is considered easier than educating oneself or talking to a financial advisor for an hour.

“You need to be the ones that are the expert in their minds so they would not dream of going anywhere else,” Crosby said. “Part of the way you can do that is by getting them away from forecasting and move them toward doing the right thing every day.”

<u>Seventh Commandment</u>: If you’re excited about an investment, it’s probably a bad idea.
“You do everything in your power to try and keep people on the straight and narrow and do what they need to do, but they still want to do the exciting thing *du jour*,” Crosby said. Tale initial public offerings, for example. Crosby said his phone was blowing up all day after the recent Alibaba debut with clients asking if they should buy.

“[Y]ou need to help (clients) understand that on average IPOs underperform the benchmark by 21% three years on because they’re born on excitement,” he said. “They’re born in irrational exuberance, and people tend to do IPOs, of course as we all know, when the market is relatively elevated or there’s a lot of popular sentiment.”

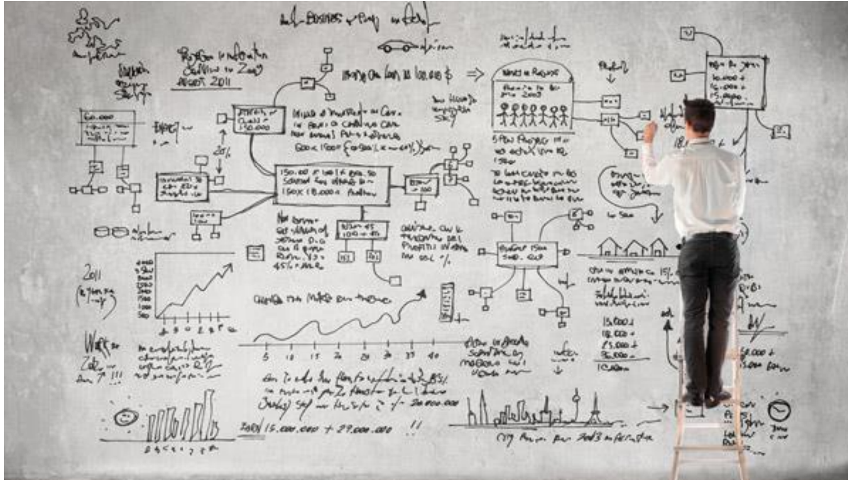
<u>Eighth Commandment</u>: This time isn’t different, and neither are you.
In addition to having brevity of financial memory, Crosby added that people tend to have a belief in whatever is new in the world.

"This has happened time and time again. When it’s some new product – whether it’s 3D printing, or a new drug, or airplanes, or the Internet – we believe when something new comes in the world we believe that this time is

different," he said. "We believe that this will be the thing that revolutionizes everything and so often even when that's true it doesn't mean that that's a good investment."

A belief in uniqueness and specialness, Crosby added, is usually correlated with bad things happening.

"This time isn't different, and you and your client aren't different."



Ninth Commandment: You should be the benchmark.
What Crosby means is goals-based investing.

"One of the things that goals-based investing and personal benchmarking does is that it motivates positive saving behavior," he said. Adding, "it's not a matter of whether or not we're going to benchmark. It's a matter of what are we going to benchmark to, and I would recommend to you all that you benchmark to your client's very specific needs and goals instead of an external index, like the S&P or SPY."

Tenth Commandment: Take this process and tailor it to your needs.
As Crosby said, every client is different.

"That's what we're talking about today," he added. "Taking this process and tailoring it to the individual needs of the person you're serving."