



Predictably Incorrect

By Bob Veres
September 6, 2011

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I had to read through this [commentary](#) (originally published [here](#)) by behavioral economics researcher Dan Ariely twice before I was willing to draw the obvious conclusion.

It's the biggest bunch of hooley I've ever read in the financial planning press.

This is surprising because Ariely has done some good work in the behavioral finance arena, and he's an entertaining speaker on the planning circuit. But I have to wonder: Is this an example of the depth of research he does in his studies?

Here are some examples. Ariely, citing no references, tells us that "for the most part, professional financial services rely on clients' answers to two questions: 1. *How much of your current salary will you need in retirement?* 2. *What is your risk attitude on a seven-point scale?*"

Where, exactly, Prof. Ariely got this inside scoop on how advisors ply their trade is uncertain; there is no reference cited. But I suspect that every single advisor reading this message knows that the initial client assessment process is many orders of magnitude more complex and detailed than this. Going back as far as the late 1980s, the late Lynn Hopewell created a series of articles, later awarded a prize by the CFP Board, outlining how advisors should define client retirement income needs. Simplifying the three articles that became the bedrock articulation of this service, a professional advisor starts by:

1. looking at current expenses and lifestyle in some detail, subtracting out expenses that you project won't be there in retirement (college tuition for children, mortgage payments on the house, costs related to commuting to work etc.),
2. adding in expenses that will show up in retirement (travel, additional health care costs, maybe a golf club membership etc.), and then
3. evaluating the chances of meeting those spending goals based on current savings and a variety of reasonable assumptions. In most cases, today, there is a Monte Carlo analysis that identifies likely best case and worst case scenarios.

More recently, we've made significant strides in post-retirement goal planning and assessment. Bob Curtis, who created the [MoneyGuidePro](#) software program, gives



entertaining talks about one of the more advanced features of his technology. Advisors can compare the chances of living an "ideal" retirement (where all goals are met, including that recreational boat and second home on the lake), with the "acceptable" retirement (where the client can live comfortably, afford food and shelter, but doesn't take a trip to Europe every year or buy the second home). When there is a market downturn like the last quarter of 2008, many clients discover that the "acceptable" needle hasn't moved nearly as much as they expected.

As for the risk tolerance on a scale of one to seven, my first thought was whether Ariely thinks that advisors have only seven digits on their hands. Why not, at the very least, a scale of one to ten? But of course, no advisor I've ever met would rely on such a simple client self-assessment; it would be suicide to act on a client's impulsive initial assessment and then, when the markets suddenly tumble (as they will), you discover that instead of a "6," you're actually working with a "2."

Most advisors that I've talked with use one of two methodologies for guesstimating how queasy their clients are likely to be when they get on the investment roller coaster. The most scientifically-based (it's called psychometrics) methodology is to have clients fill out the online questionnaire at [Finametrica](#). Finametrica has collected so much data from hundreds of thousands of persons that we can now identify three distinct components to a person's tolerance for investment risk:

1. Their propensity for risk in general; i.e., whether they enjoy the simple pleasures of skydiving, bungee jumping or putting all their chips on a single number at the roulette wheel. The Finametrica researchers have discovered that this willingness to engage in risky activities doesn't change with market behavior; in late 2008, a person who had previously enjoyed mountain biking on the steep cliffs of Yosemite STILL enjoyed riding along the ragged edges of a 4,000 foot drop.
2. Their ability to live through a drop in their portfolio without suffering significant lifestyle changes. This is sometimes called risk sustainability; if the market goes down 30%, are they suddenly reduced to eating dog food for dinner? Or, alternatively, if the market goes in the tank, does that mean they can no longer make the payments on the second yacht? If Ariely had taken more than a casual look at the discussions in the profession, he would see some interesting debate about how best to improve sustainability – including setting aside three years worth of living expenses in cash, so the client doesn't have to liquidate risk assets in a down market, and, of course, having adequate life, health and disability insurance coverage.
3. The clients' perception of risk in the markets. This is the component that changes when the market goes through its dips and swerves. Every advisor has examples of clients who want all their chips on the table during bull markets when they think the equity world does nothing but appreciate in value, but who want to stuff their



portfolio under a mattress when the markets suddenly take their inevitable bearish turn.

Advisors who have not yet discovered Finametrica might use the alternative approach of showing their new clients the real world impact of recent bear markets, and the magnitude of losses in dollar and percentage terms. You look for where they begin to experience serious discomfort.

And, of course, no sane advisor would rely on that first assessment for the entire relationship. Everybody monitors their clients' response to changing markets. The most accurate risk tolerance evaluation comes from years of working together.

Ariely seems charmingly innocent about all the other services that advisors routinely provide their clients, including helping take the emotion out of investing, helping them avoid the usual panic-induced pitfalls of buying high and selling low, streamlining their insurance coverages and a host of technical evaluations including estate and tax planning, various aspects of optimizing the money set aside for children's education, figuring out the most tax-advantaged ways of allocating assets among taxable and tax-deferred accounts, and how to take that money back out of the portfolios in retirement with maximum efficiency.

And I suspect that Ariely would be astonished at the variety of services that are growing up around the life planning service model.

In his commentary, Ariely confidently builds a castle of analysis on his sandpile of assumptions. He tells us that he's discovered through empirical research that the 75% rule of thumb is often wrong. (The reader is advised to write this down somewhere where you'll remember it.) Then he questions the profession's 1% of assets under management fee for financial planning services, which is a lot to get paid for basically asking two dumb questions. One can envision his mental shortcut calculation: *\$1 million under management times 1% equals \$10,000 a year, divided by 15 seconds of dumb-question-asking equals \$40,000 a minute or about \$4.2 million an hour...*

The article concludes that "money is hard to think about, and we do need help with making financial decisions." Ariely helpfully recommends that advisors reinvent themselves to service this need.

I think, based on his evaluation methodology, that we can recommend some other research initiatives that Ariely could pursue. For example, start with the assumption that doctors only ask people if they're feeling all right on a scale of one to seven, and then ask if they like medicine or not. And look at what THEY get paid! I think Ariely could offer the medical profession an excellent lecture on how real maladies are much more complicated than those two questions imply. Doctors should reinvent themselves to address the actual health needs of their patients. They might even look up the symptoms of actual diseases.



From there, I envision a whole cottage industry of evaluation and advice to professionals. Attorneys (*How likely are you to be sued on a scale of one to seven?*) should probably reinvent themselves to meet real litigation needs, and don't get me started on CPAs (*Do you prefer a 15% chance of being audited? Or would 10% be more suitable?*).

This is a lesson for all of us, for two reasons. First, advisors, laypersons and behavioral finance researchers should all beware of drawing conclusions based on lazy assumptions that haven't been researched with any degree of rigor. Ariely should know that; we should take this lazy effort at evaluating advisors to heart, as a great example of precisely what should never be permitted in a working relationship between advisor and client.

In addition, I am afraid that Ariely might be articulating a common assumption about financial advice professionals, perhaps drawn from reading articles in Money magazine or those awful online calculators that tell you how much to save based on the answers to a couple of basic questions. The medical and legal professions aren't handicapped by magazines devoted to telling the lay public how to self-diagnose or litigate on a do-it-yourself basis; nor do they have the equivalent of online retirement calculators. (*How badly does your shoulder hurt on a scale of one to seven? Is there a bone sticking out of the skin? Press "next" to find out if you need surgery...*)

We do. That means that, like it or not, financial advisors have an uphill battle convincing the public that there is more to your professional service menu than asking two dumb questions. Instead of reinventing our service model, as Ariely recommends, we should probably look for ways to reinvent our communication and outreach so that he and others like him will understand that real professional financial advice is a tad more helpful than asking dumb questions and drawing dumb conclusions.

(I would like to issue a challenge to Dan Ariely. If you'd be willing to come to our Business & Wealth Management Forum, October 13-15 in Chicago, I'd make a place on the schedule where you and I could debate and discuss this issue in front of 250 of the top advisors in the country.)

Bob Veres publishes the Inside Information newsletter service (www.bobveres.com), and co-chairs the Business & Wealth Management Conference in Chicago, (www.signupforconference.com), which features presentations by William Bengen, Harold Evensky, Tom Giachetti, Michael Kitces, Don Phillips, Michael Aronstein, George Tamer, John Rogers, Stephanie Bogan, Gary Miller and Mark Tibergien.

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