Breakthroughs in Behavioral Finance

By Kerry Pechter *Tue, Aug 9, 2011*

As an advisor, you can actually put clients in an annuity 'frame of mind.' These and other findings from behavioral finance research were presented at the 2011 Boulder Summer Conference on Consumer Financial Decision-Making last June.

Leather therapy couches aren't typically found in financial advisors' offices, but many advisors might admit that they often have to focus their powers of analysis on the psyches of their clients as well as on their securities.

The fast-growing field of behavioral finance is built on the notion that—no surprise here—most clients' decisions about money are driven as much by their egos and ids as by objective research and reasoning.

Thanks to the retirement crisis, a number of specialists in behavioral finance have published work related to aging and annuities, and a few of them presented their latest research at last June's Summer Conference on Consumer Financial Decision Making in Boulder.

A psychologist from Duke's business school showed how advisors can actually put people into a annuity frame-of-mind. An economist from Columbia presented evidence that older people compensate for lost mental agility with other stored wisdom. And Meir Statman, the recent author of "What Investors Really Want" (McGraw-Hill, 2011) explained why people—even rich people—seek risk.

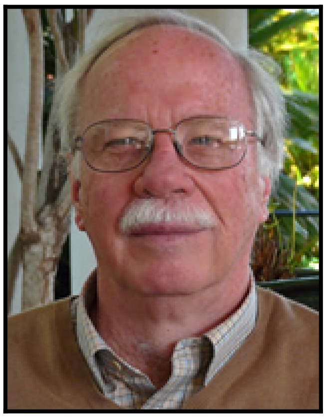
Taken together, their presentations showed that much in the science of behavioral finance can be applied to an advisor's daily interactions with clients.

Positive reinforcement

No one knows how long he or she will live, but actuaries know that people who buy annuities tend to be healthier and live longer than average. "Adverse selection," as this factor is called, has been shown to drive up the cost of annuities by as much as 10%.

But why do these annuity-buyers think that they will live longer? And is it possible for an advisor to make clients more optimistic about their chances (or at least more aware of the probabilities) of living longer than average?

John W. Payne (below) thinks so. A psychologist at Duke University's Fuqua School of Business, he was the lead author of a study in which some adults were asked if they "expected to live to" various ages and others were if asked if they "expected to die by" a certain age.



That subtle difference in “framing” an otherwise equivalent question had a huge impact. More than half (57%) of the “live to” subjects expected to live to age 85, while only a third (33%) of the “die by” subjects expected to be alive at that age.

The researchers also found that while half of the live-to group expected to reach age 85, half of the die-by group expected to die by age 75. A positive framing of the question, in other words, produced a 10-year increase in subjective life expectancy.

To Payne, these results had a potentially powerful real-world application. If people who expect to live longer are more likely to buy life annuities, then asking clients about their life expectancy in a positive way might result in more annuity sales.

“This 10-year difference in the median expected age of being dead or alive is not only statistically significant but also highly meaningful to a number of important life decisions such as how to finance one’s consumption during retirement,” Payne and his colleagues wrote in their paper, “Life Expectation: A Constructed Belief? Evidence of a Live-to or Die-by Framing Effect.”

In fact, those who judged themselves more likely to live to age 85 rated their likelihood of buying a life-only annuity at 39%. Those who judged themselves less likely to live to age 85 rated their likelihood of buying a life-only annuity at 26%. People were also more prone to say they were likely to buy an annuity if they were asked at all about their life expectancy.

Not that the study revealed a latent passion for life annuities. On average, people rated themselves as only 33% likely to buy a life annuity. Only 3% preferred to buy a life annuity while 26% preferred to manage their own money in retirement. An aptitude for numbers, confidence about managing money, and the need for liquidity were all *inversely* correlated with a preference for a life-only annuity. (Preference for a life-with-period-certain annuity or cash refund—the types that most people buy—was not tested.)

The pathway for these effects, Payne told *RIJ*, isn’t just psychological; it’s neurological. When we’re asked a question, our first thoughts have been shown to carry greater weight than the thoughts that follow. If we’re asked the longevity question positively, the positive thoughts (“I exercise and eat right”) eclipse the negative ones (“My father died at age 60”). And vice-versa.

“I don’t think our conclusions are all that surprising—it’s just that the size of the framing effect was significant. It might make only a one percent difference in whatever you’re selling,” Payne told *RIJ*. “But in a lot of businesses, a one percent difference would be a big difference.”

Payne said he wasn't interested in the sales aspect, but in helping advisors and individuals make the right financial decisions. "I want to try to elicit the best thing for each person," he said.

Risk-taking with a purpose

At some point near the beginning of their relationships, advisors typically try to gauge the so-called risk tolerance of their clients. The assessment may consist of nothing more than a question like, "Could you tolerate a 5% drop in the market value of your portfolio? A 10% drop? A 15% drop?"

But some behavioral economists, like Meir Statman of Santa Clara University, believe that risk tolerance is a much more complex trait than we give it credit for. Unlike a tolerance for physical pain or for a drug, it arises from a range of motivations and has many implications.

For Statman (right), the author of *What Investors Really Want* (McGraw-Hill, 2011), an advisor's question about risk tolerance can and should be the starting point of a more interesting conversation. His presentation in Boulder was entitled, "Aspirations, Well-Being and Risk-Tolerance."

"When people say that they can take a certain amount of risk, you have to ask, For what? The way we usually ask that question, it as if we assume that some internal risk inside you is propelling you to act. I would say that *goals* propel you, and you take risks to achieve those goals.

"It is the role of the advisor to ask, why is this person taking risks? Is it for a reason that makes sense? Instead of buying a risky portfolio, maybe we should talk about his goals." Once a client's goals are known, Statman believes, an advisor will have a better idea whether taking financial risk is the best way to achieve them.

Regardless of their wealth, people who *feel* poor—who have "low financial well-being"—tend to take risks to improve their current situation so that it matches their aspirations and expectations more closely. And in fact, he says, risk-taking often leads to self-improvement.

But risk-taking can also be destructive, Statman points out. Low financial well being, for instance, leads millions of people to waste money on the lottery day after day. Nor are the rich immune to it. It apparently led wealthy investment banker Rajat Gupta, who reportedly envied his billionaire friends, to risk his reputation and freedom by colluding with hedge fund manager Raj Rajaratnam in an insider-trading scheme.

Once an advisor knows why his or her client wants to take more financial risk, they both might realize that there's a better way to achieve the same goal. If a rich man feels poor because he lacks fulfillment, for instance, then perhaps he should give money to a worthy cause rather than try to accumulate more wealth. "We have to figure out what the money is for," Statman said, "and ask, 'To what extent does it make me a happier or better person.'"

Decision-wise, we peak at 56

How far should an advisor trust the decision-making ability of his older clients? Is there an age past which a client's own decision-making capability should be questioned?

At the Center for Decision Sciences at Columbia University in New York, they ask these questions all the time. One researcher there, Ye Li, recently co-authored a study on that topic called "Financial Literacy and Decision-Making over the Lifespan."

"Not to be a downer, but we're all getting older. How does that affect our decision-making?" said Li (at left) during a slide presentation at the Boulder conference.

The mind, like the body, apparently loses agility and flexibility with age. But, like an aging base-stealer in professional baseball, people in their 50s and 60s seem to use accumulated wisdom to make up for what they've lost in speed.

As we age, we lose "fluid intelligence," a skill sometimes measured by the ability to solve Raven's progressive matrices. In these visual tests, people are shown an array of shapes or figures where one figure is clearly missing. Then, given multiple options, they're asked to name the shape or figure that would "complete the pattern." Ability to solve these puzzles declines with age.

But there's an upside to aging. Mature people tend to have more experience, an advantage that decision researchers call "crystalline intelligence." This advantage, which can manifest itself in the ability to solve crossword puzzles, rises until about age 60 and then plateaus.

When it comes to financial problem-solving, age tends to trump youth—to a point. The researchers tested a group of young people, ages 18-30, and a group of older people, ages 60-82), and found the older group to be more financially literate, slightly more patient, less loss-averse, and more knowledgeable about debt than the younger group.

Age isn't the only factor. Higher education and higher income also enhance financial decision-making skills. Eventually, however, age catches up. Decision-making skill, according to research that Li cited, peaks somewhere between age 55 and 60 and declines throughout retirement.