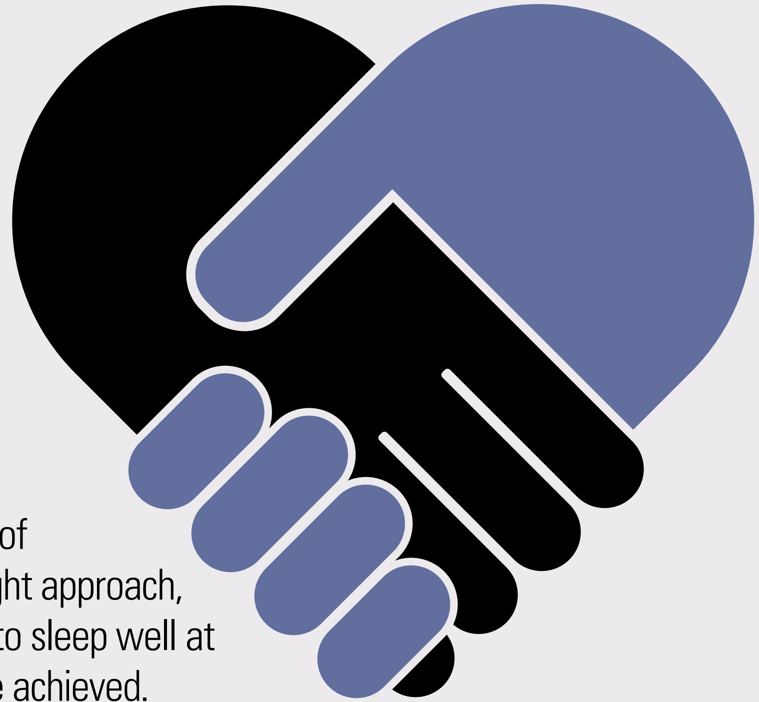
SPEED READ

- investors can't ignore the important influence of emotions
- the risk of glibly assuming complete economic rationality
- emotional comfort is necessary – but costly if not planned for
- do not allow the 'best' to become the enemy of the 'good'

THE PRICE OF *emotional comfort*



We get it wrong when we ignore the power of emotions in advice to wealthy clients. The right approach, says GREG B. DAVIES, is to accept the need to sleep well at night – and then ask how cheaply this can be achieved.

How much would you sacrifice to sleep better at night? A strange question, perhaps, for investors. Classical finance theory certainly makes no room for such sentimentality when deploying wealth in the quest for returns. But the surprising reality is that the failure of economic theory, and subsequently the financial services industry, to address the emotional question is one of the primary sources of poor advice to investors.

This is one of the key questions addressed in our new book (with Arnaud de Servigny) Behavioural Investment Management: an Efficient Alternative to Modern Portfolio Theory. We examine how our 'rational' model of portfolio theory should be updated to reflect the advances in behaviour knowledge we've achieved over the last half a century. And, having updated the theoretical model to guide optimal long-run investment behaviour, we ask when this might not be enough.

The problem is that none of us lives in the long run. We all live continually in the here and now, and this can make following the optimal prescription for long-term performance tremendously difficult from an emotional perspective.

The industry's traditional approach has essentially been to hand over 'optimal' portfolios built on the assumption that the investor will be completely rational at all times: 'Here's your ideal portfolio; it's mathematically optimal for your level of long term risk tolerance, and financially efficient. Now it's your problem!' This places a huge practical and emotional burden on investors – making it their problem to actually implement the portfolios and then to manage them through the often quite dramatic ups and downs of the investing cycle.

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In borrowing the glib assumption of complete economic rationality from the theorists, the industry has been effectively washing its hands of responsibility for a very large part of what it means to invest well – that's not just knowing what to invest in, but also effectively acting on this knowledge and controlling one's very normal human emotional responses to experiences along the way.

By ignoring the important role of emotions, traditional portfolio solutions end up making investors uncomfortable along the investment journey, and that can lead to poor decision making and lower performance. By insisting that investors strive for rational perfection in their portfolios, they end up making

WHEN OFFERED A CHOICE BETWEEN THE SCARY BUT MATHEMATICALLY PERFECT PORTFOLIO, AND NOT INVESTING AT ALL, MANY THINK IT'S MORE COMFORTABLE TO LEAVE THEIR WEALTH SITTING IN CASH.

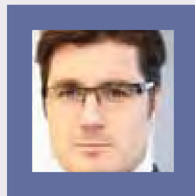
them more likely to make emotionally driven knee-jerk decisions along the way.

When we're stressed, we naturally take decisions that help us to get more comfortable:

- We pay too much attention to the short-term.
- We over-react to market movements.
- We invest in local assets or ones we're familiar with and shun similar (or better) risks which are less familiar.
- We buy when markets are doing well and sentiment is high.
- We sell when markets are low and everything feels very risky.
- We retain, in particular, large portions of our wealth in cash, unused and unproductive.

On average, all these behaviours drag down our long run returns. The truth is, we need emotional comfort. We need to be able to sleep well at night. But a sequence of comfortable short-term decisions doesn't often add up to optimal long run performance.

Despite what the theorists may tell us, however, none of these actions is necessarily 'irrational'. Yes, they reduce long run returns, but we do get something in return – we get to sleep at night! Many investors sold in despair at the bottom of the markets in late 2008 and early 2009. In one sense, this was perfectly reasonable: if you're stressed, anxious, or even terrified that markets will keep falling, selling out provides an instant sense of relief from knowing you won't lose any more.



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ENORMOUS COST

The trouble is that this is short term emotional comfort purchased at enormous financial cost. Once you've sold out of a turbulent market for emotional reasons, it's almost impossible to get back in again, no matter how good the logical case for it. You lock in the losses and miss the eventual rally.

So, how much should you pay for emotional comfort? Traditional finance says 'zero': emotion is to be controlled, not pandered to. But when we aim for perfection betting against the obvious and powerful force of human fallibility, we often fail completely and pay a huge premium to eliminate our emotional turmoil.

One easy and natural way of purchasing emotional insurance is simply to take less risk than is appropriate given our long-term risk tolerance and risk capacity. But this also reduces long term returns, sometimes dramatically. When offered a choice between the scary but mathematically perfect portfolio, and not investing at all, many choose the latter because it's more comfortable: leave their wealth sitting in cash.

An investor with large amounts of wealth in cash is, in fact, purchasing emotional insurance at a very high premium. By not investing, a moderate risk investor in a globally diversified portfolio is missing out on long-term annualised returns above what you'd get from holding cash (averaged over many years) of about 4%-5% per year – a large amount to forego because investing feels too uncomfortable!

Unlike the traditional industry, we don't believe this is irrational. Emotional comfort is important and necessary – but it can also be very expensive. The right approach is to accept the need to sleep well at night, and then ask how this can be achieved as cheaply as possible. Identify the aspects of investing that make you most nervous and find targeted ways of reducing this anxiety as cheaply as possible.

DIFFERENT DIMENSIONS

At Barclays Wealth we use our proprietary Financial Personality Assessment to assist with this. It measures six different dimensions of your emotional responses to investing, three related to different aspects of your risk attitudes, and three to your decision making style. We use this to guide the selection of specific solutions that focus on providing the emotional comfort that is most psychologically important to each individual investor.

This may be achieved by keeping some reasonable portion of your wealth in cash for security. It may mean purchasing downside protection in the event of extreme market moves. Or it may mean accepting some inefficiency in your portfolio relative to the technically perfect solution (like accepting some home bias). But all of these mean you can invest your wealth productively for the long term, and get to sleep at night. Yes, some people need a little more emotional comfort than others – but no-one needs to pay 5% of their wealth per year to get a little rest. In investing, as with every in life, do not let the 'best' be the enemy of the 'good'. ◘

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The emotional reality of financial phobia

Financial services providers have long been frustrated by the seemingly irrational behaviour of their customers, but the cause of this "irrationality" has not received serious attention. Is it laziness? Is it stupidity? Research by Brendan Burchell analyses the emotions behind the phenomenon.

Emotion

Ten steps to create an emotional response in the consumer when advertising financial services products.