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Stairway To Heaven By Mitch Anthony

The opposite of your recommendations may be what's best for clients to reach financial nivana.

If you stood in front of a mirror with the words "asset allocation" written on a piece of paper, seeing the words backwards would help prepare you for the intellectual calisthenics you are about to engage in. Here is my thesis:

1. Common asset allocation models make little sense to the right (emotional, sensory, risk-gauging) side of the brain.
2. The allocation model that offers the right emotional fit for many of your clients is the mirror opposite of what is widely recommended.

Before we set out on this journey of emotional perspective, let me say that I'm not here to debate asset allocation through a mathematical lens but rather through a filter of emotional/sensory interpretation that guides the right side of our brain in the decision-making process.

Intuition and "gut feeling" are the right brain's sensory faculties at work. While the left side of the brain is trying to settle the question, "Does this make sense?" the right side of the brain is attempting to resolve, "Does this feel right?" By and large, models we are telling clients "make sense" in allocation do not "feel right"—and therefore, no longer make real sense. Once you obtain a clearer picture of the emotional impact of these models, it is the math that you begin to doubt.

Markowitz's Theorem

I'm guessing that you don't draw out Harry Markowitz's Theorem of Diversification when you are presenting asset allocation to your clients.

This would only serve to confuse them further. As I looked at this theorem, I deduced that Markowitz wasn't weighing any right brain, abstract, contextual, emotional, intuitive, or sensory factors in the development of his theory. I don't know how many left-handed economists there are, but my suspicion is that right-brainers are in short supply in this crowd.

We intuitively understand that emotional comfort/discomfort is the engine that drives the "decisions" train. Logic (and math) is what the engine pulls in the boxcars behind. People make decisions when they feel comfortable. When they no longer feel comfortable, they change their direction. Have you ever stopped to consider how the right brain function processes asset allocation? You'd better buckle up for this because the conclusions reached may not allow you to continue with business as usual. Following is an example of a right-brain approach to the subject of asset allocation.

Stairway To Financial Heaven

The following "Stairway to Financial Heaven" (© Mitch Anthony, 2005) analogy offers a path for clients to choose an allocation they can live with (That is a part of the equation, isn't it?) If there was a stairway to financial heaven and I offered you the following two climbing scenarios, which would you prefer? In scenario one, you would climb ten stairs in an average year. In a bad year, you would tumble down 18 stairs. In a really good year, you would climb 38 stairs. In scenario two, you would climb eight stairs instead of ten in your average year, but you would only fall down six stairs in a bad year. In a really good year, you would climb 35 stairs. Which scenario most appeals to you?

Now, what is your choice? If you are like the majority of those who I have presented this scenario to, you will choose the scenario with an average of eight stairs in the average year, losing six stairs in a bad year, and gaining 35 stairs in a really good year.

If that is your choice, you just chose a 30/70 (stocks/bonds) asset allocation based on research over a 50-year period (Ibbotson). Not 70/30, but 30/70—the mirror opposite of what is typically recommended to clients!

If clients understand the emotional realities of the asset allocation recommendations they are agreeing to ahead of time, my suspicion is that a majority would choose the exact opposite of what is being commonly recommended. I presented this scenario to about 50 people before printing this article and the vast majority went with the 30/70 scenario. A couple of individuals asked, "Can I get a scenario

in between those two (which would be a 50/50 allocation)?” A couple others asked, “What is the difference over time between the projected total of the two scenarios?” Very few asked for the 70/30 allocation when presented with an analogy that registered emotionally. Analogies and metaphors speak to the right side of the brain and make instant emotional sense. Percentage points—the convenient professional parlance of financial services—are a different matter altogether in terms of emotional comprehension.

CHART 1 – 70/30 VERSUS 30/70 (In terms of percentage with a 95% probability of being within the high and low numbers.)	
70/30 ALLOCATION	30/70 ALLOCATION
Average year: 10.03%	Average year: 8.08%
Worst year: -17.96	Worst year: -5.96
Best year: 37.83	Best year: 34.46

CHART 2 – 70/30 VERSUS 30/70 (In terms of dollars with a 95% probability of being within the high and low numbers.)	
70/30 ALLOCATION	30/70 ALLOCATION
Average year: \$110,030	Average year: \$108,080
Worst year: \$82,040	Worst year: \$94,040
Best year: \$137,830	Best year: \$134,460

In a moment you will see the exact numbers from the study of historical returns expressed in percentages, which by the way, are not clearly comprehended by the right side of the brain. Percentage points mean nothing to the right side of the brain. As soon as the right side of the brain hears, “You lost 18%,” it demands to know, “How much real money is that?”

If I told little Johnny that 18% of his Hot Wheels cars had turned up missing, Johnny would instantly want to know, “How many cars is that?” and, “Which ones? I hope my silver Mustang isn’t gone.” The right brain needs a picture—something real, visual and tangible to understand.

Percentage points are the devil’s pitchfork in financial services—a tool that can be easily used to distort, deceive, manipulate and cloud reality. The story of the ParaMutual Fund Company is my favorite example of the field day a fund company could have with the percentage point at their side. In this story, a man invested \$10,000 and in the first year, he lost 50% and was down to \$5,000. The second year he gained 50% and was up to \$7,500. The third year he gained 33% and was back up to his initial investment (less fees, of course). Imagine this man’s surprise when he received the ParaMutual Fund Company’s prospectus with their three-year returns listed as “Up an average of 11% per year!” (-50%+50%+33%, divided by 3=11%) All this fellow knows is that he’s not even at even money after three years of a roller coaster ride. Percentage points are but soft clay in the hands of those with creative impulses—as ongoing accounting scandals aptly demonstrate.

As you read The Stairway to Financial Heaven analogy, the right side of your brain shifts through layers of emotional reasoning. For example:

- That’s an awful lot of downside risk for just two extra stairs in an average year. (Three times the downside risk in the 70/30 scenario)
- The downside in a bad year is much more pronounced than the upside in a good year (three times the risk in a bad year but only 9% more gain in a great year).

In mathematical terms, your emotional reasoning is standing on solid ground. Chart 1 illustrates the scenarios in terms of percentage points. Chart 2, which illustrates the scenarios in real dollars based on \$100,000 invested, clearly illustrates why clients are emotionally unsettled with the allocations they are often directed toward.

Now, as a concession to the “real money” reality sought by the right side of the brain, let’s look at these results in terms of “real return” after one year:

Tune in to what the intuitive side of your thought process is trying to say as you view this “real money” chart. Following are obvious emotional conclusions (followed by the math substantiating the thought):

- Is this average year upside worth the worst year risk? (The average year gain is 19% better, but the worst year loss is 300% worse.)
- If my potential downside is that bad, shouldn’t my potential upside be just as good? (Whereas the downside is 300% worse, the best year scenario is only 9% better.)

Who would want to take any sort of risk where the loss in the worst-case scenario was 30 times greater than the gain in the best-case scenario? Sounds more like Russian roulette than investment logic to the emotional ledger—that limbic scale that monitors our comfort levels. When you shift the discussion to the analogy of either climbing or falling down stairs instead of percentage points, the discussion shifts from being nebulous to easily processed. Am I comfortable with the idea of falling down 18 stairs in a bad year? Is that risk worth getting to climb an extra two stairs in an average year

and getting to climb three extra stairs in a really great year? And, what is the difference between falling six stairs or 18 stairs in a bad year? The difference between a band-aid and traction.

Reframing Asset Allocation

I can already sense the blood pressure of the quant-focused, number-crunching, reasoning advisor going through the roof over what I'm saying here. I can hear him or her screaming, "That's not rational! What about the difference in returns over the long period? The market is twice as likely to go up as it is to go down! The rational thing to do is stay the course with a weighting toward stocks."

Allow me to clarify my purpose here. This article is as much about what we communicate as it is about how we communicate. Clients deserve to understand what it is they are agreeing to—and they deserve to be in allocations they can live with. Why do we need to "stay the course" in some allocation theory that has no guarantees and requires Xanax to survive?

Let's also review one inescapable fact of brain function: It is with reasoning that we draw conclusions, but it is with emotion that we make decisions. We need to take some time and reframe asset allocation for our clients through the emotional filter. Here are some of the common emotional responses to the rational, quantitative arguments for popular allocation recommendations. It all sounds reasonable but ...

- "You don't know how bad a bad year will be."
- "If I have two bad years in a row, it will wipe out years of gains."
- "We may never again see returns like we saw in the late '90s."
- "I can't afford to gamble my life on your projections."
- "Why should I have to gamble so much more on the downside for just a few points on the upside?"
- "It's easy for you to tell me what I should do, but I have to be able to sleep at night."
- "You really have no idea what's going to happen tomorrow. Eighty years of history couldn't help predict the things we've seen happen in the last few years."

And, The Big "WHAT IF" Questions

- "What if research on patterns back to the 1920s isn't sufficient for drawing any reliable conclusions?"
- "What if history doesn't repeat itself?" (It rarely does.)
- "What if what happens in the next 25 years doesn't follow what happened in the last 25 years?"
- "What happens to all your projections and probability analysis then?"

These are questions based in emotion, and they are valid questions. They have been certified as valid by the events of last five years and have led many consumers to subconsciously conclude that the industry's projections are usually far more optimistic when compared with what happens in real life.

It's not just fees that people are paying for asset management, but emotional fees as well. Your clients pay far more in emotional fees in the 70/30 scenario than they do in the 30/70 allocation, and you'll pay far more in emotional fees by having clients placed in a portfolio with manic tendencies. Emotionally it comes down to whether a client wants to ride something resembling a roller coaster or something resembling an escalator that occasionally stalls or speeds up. (The plot thickens further when we stop to consider how the bond market has likely reached a point of being overbudget and postured for a correction.)

The Cost Of Sleep

The other day as I sat down in first class next to a 55-year-old executive, he spotted The Wall Street Journal in my hand and said, "It's sure no fun for the 401(k) when the market goes down 170 points."

We chatted about his 401(k), and I asked about his planned date of retirement and allocation. He said he wants to retire in five years and had an allocation of about 80/20 overall.

I commented that he must have had more than one restless night with that kind of exposure within that short of a time frame.

"Way too many nights," he admitted.

I told him the "Stairway to Financial Heaven story," and he immediately chose the 30/70 allocation. I also demonstrated to him that with this allocation—if all five years were average—he was only conceding \$10,000 or so. But, in the case of one bad year in the next five years, he just removed the potential for calamity from his retirement nest egg.

"If it's the possibility of missing out on \$10,000 that bothers you, you might ask yourself what five years of peaceful sleep are worth," I offered.

As a case in point, allow me to illustrate what happens when things don't go as we hoped in a 70/30 allocation. This illustration may serve as a clue as to why investors are slaves to the emotional swings that accompany market fluctuations. Bear in mind as you view this illustration that when you take the probability of extreme downside market swings out of the picture, you also remove the downside emotional swing with it.

All the extrapolation and probability analysis in the world is a waste of time when one single variable changes such as "when a bad year happens." If the bad year comes early, we're OK, but if it comes late in the game, it becomes a personal financial disaster.

Chart 3 is a scenario I designed with a financial planner and ran through probability software to play out what would happen if things didn't turn out as rosy as projected for a 45-year-old client in a 70/30 allocation versus a 30/70 allocation. The first column demonstrates the returns in our "rose garden" scenario—where returns play out to historical averages. In the scenario in the right-hand column, the "you-never-know" scenario, the client is going to get the historical average return in 18 out of 25 years. In two separate years (years 9 and 19), the client will get the high return, and in five separate years (years 5, 6, 17, 23, and 24), the client will get the low, and two of those low years are toward the end

of the 25-year period (kind of like how 2001-2002 came late in the game for a lot of unsuspecting folks looking to retire). The chart shows what happens in real dollars to an original investment of \$100,000 over 25 years for our 45-year-old client.

Chart 3

After 25 Years...	"Rose Garden" Scenario	"You Never Know" Scenario
70/30 Allocation	\$815,900	\$394,470
30/70 Allocation	\$631,190	\$538,470

If you are comfortable gambling that what happened yesterday will happen again tomorrow (and you can bear the bruising of falling down those 18 stairs every few years), then the 70/30 portfolio is for you. If, however, you choose to believe that you never know what will happen next, and that you are better off being insulated against worst-case scenarios, then you might choose the 30/70 approach.

When you play out the real percentages of return between the two portfolios in the "you never know" projection, the average return for the 70/30 allocation drops from 10.08% to 6.65%. The 30/70 allocation average drops from 8.08% to 7.38%. Could it be that over time the market rewards reasonable caution and "measured" optimism (or what some might call realism)?

One financial planning sage offered, "But maybe they need the 70/30 returns over time to live the lifestyle they want. How do you answer that?"

I would answer with these three thoughts:

If you're convinced they need it, make sure they emotionally comprehend what they are committing to before they commit.

If they can't handle manic swings, they might need to reconsider what they think they'll need and then make adjustments in spending or lifestyle to compensate.

As the preceding example illustrates, you really have no guarantee that they'll end up with more money as a result of the 70/30 over 30/70 allocation. It's all a matter of timing. Retire at the right time, and you're in luck.

If the industry is going to continue to recommend 80/20 and 70/30 allocations, you'd better pray for the "rose garden" scenarios to come through—as clients will need the extra income to fund a 30-year supply of Pepto Bismol!

"Average" Expectations

Perhaps we ought to be more careful how we use the word "average," because that word sets up an emotional expectation that real life experience will contradict, thereby sending the emotions into tilt. Many advisors will tell clients that the S&P has averaged 11% for the last 20 years. Emotionally that message is often embraced as, "OK, so we're going to be around 11%, give or take a few points each year." The reality is that the actual return on the S&P fell within 3% of the mean only four out of those 20 years. The other 16 years, the returns were either much higher or much lower than the average.

This leads to either much glee or much panic—neither of which is going to lead to good decisions going forward. This has been amply demonstrated by mountains of evidence showing that over that same time frame, the average investor failed to get the average return. Investors were either driving too fast in their glee or overriding the brake pedal in their state of panic and consequently, failed to reap an "average" harvest. The proper emotional explanation upfront and accompanying allocation would have solved this problem and the unrealistic expectations that go with it.

We might also do well to do a better job of defining and illustrating the impact of "standard deviation." The most useful metaphor I can find for understanding standard deviation is the market's roller coaster. How steep are the rises and falls? That is standard deviation. In retirement income planning, standard deviation becomes a most deviate force.

Lewis Walker, CFP illustrates the impact this way:

"If you had \$100,000 and were taking out 8% and the market declined 10%, you're left with \$82,000. The following year you need a return of 9.769 just to be able to take your 8% and stay at \$82,000 as a base. To take out your 8% and get back to your original look, you would need a return of 31%." No wonder people's emotions turn to mush when faced with the realities of standard deviation.

Please Behave

Before anyone starts quoting behavioral finance and lamenting how stupid clients are constantly buying high and selling low, allow me to ask, "Who was there to help accommodate and even make recommendations regarding this stupidity?" It's easy to point the finger at the whimsical client and to ignore those who "helped" them leap from the frying pan into the fire.

An advisor recently said to me, "But you don't understand how hard it was in the late 1990s to tell clients that they shouldn't be buying these high-risk stocks." My question is, "Why weren't your clients better educated on the law of gravity?" It's like I've told my teenagers, "If you're going to fall for the thrill of driving 100 mph, don't expect to be able to stop when you need to." The faster you go, the harder you crash, and the more profound the consequences.

If we help clients get a better understanding of the emotional aspects of recommended asset allocations and make emotional comfort one of the primary goals of the selected allocation, we might end up with much better conversations during the highs and lows. Today's risk assessment tools don't do the job. If you had asked clients their risk tolerance in 1999, they would've probably told you that they were aggressive or moderately aggressive—but that didn't stop them from running for the exits when the ride got rough. By and large, many common risk tolerance questionnaires are useless. It's like asking someone, "In the case of an earthquake, what would you do?" To which they respond, "Oh, I would help everyone else out first." Sure you would. Nobody can predict his or her behavior in a panic. A better way to help people understand the emotional impact of asset allocation is by using an analogy like the "Stairway to Financial Heaven" so that they can "feel" the impact of their choice. You can't feel enough with these risk tolerance profiles to make an honest decision. Go back and check your clients' answers to those risk profiles, and see for yourself how many of their answers corresponded with their actions throughout 2001-2002.

This essay is about emotion. I believe that the industry has failed to paint the proper emotional context for the recommendations it has been making to clients regarding asset allocation.

Now is the time to become emotionally forthcoming about how rough this ride might feel and what happens when things don't work out the way they are illustrated on four-color laminated brochures. All the optimism in the world won't soften the landing of a bear market or major retraction. Do your best to demonstrate what these allocations are going to feel like over time (think of it as "market emotion projections"), and you might possibly see clients choosing the mirror image of the allocations that have been historically recommended for them. It may surprise you to know that of the 50-some people I tested this theory on, almost all of them were financial advisors—and 70% of them were CFPs.

When you frame the choice in emotional instead of mathematical terms, people are going to make different choices—real world choices. Nothing is more real than the emotions people feel when they are losing their hard earned wealth. Mathematical and logical reasoning leads people toward making conclusions, whereas, emotional reasoning leads to people making decisions. It's time to present asset allocation in a manner that makes emotional sense. After all, what fun is the ride and "getting there" if the experience is filled with nausea?

Mitch Anthony is the author of Your Clients For Life, The New Retirementality and Your Client's Story and is a regular keynote speaker at industry events.

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