

Advisors struggle to keep their clients from irrational investing

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Whether the market behaves rationally or irrationally is often the subject of raging debate in both academic and popular financial literature.

Advisors have personal experience with the answer to that conflict. Though their clients are more rational than most investors, it's often a struggle to keep them that way.

"There are some new clients that resist effective strategies, and react to what's just happened," said James M. Luffman, CPA/PFS, of Chas Smith & Associates, in Lakeland, Fla. "They wanted aggressive growth in the late 1990s. Now they won't touch equities."

Melanie Hummer, CPA, CFP, CFA, at Hummer Financial Advisory, in Chicago, said that the Internet boom was a more difficult time to effectively manage assets. She reported that some client jumped at just the wrong time from her conservative, balanced approach. "I know the brokers put them in their preferred Internet stocks and they ended up getting burned," said Hummer.

Hummer pointed out that it's not always the market climate that drives irrational behavior. Lifestyle changes prompt investors to make stupid moves. "Lots of things affect how investors act. People get discouraged with their career. They look at their assets and realize they can't retire any time soon," she explained. "The frustration drives them to make bad decisions."

For Chas Smith & Associates' new clients, the answer is education. Every new client spends two hours in a formal training session. During the training they get a crash course on the realities of investing.

"We show how stocks, bonds and inflation have performed over the last 75 years and at what level of risk," said Luffman. "We show returns and risk on individual securities. We show that even on conservative stocks the prices swing 30 percent to 40 percent a year from high to low. They have to be prepared for that."

After the formal session, each client spends another couple of hours in private consultation with an advisor to tailor the financial plan. Luffman described the planning process as steering or coaching them into the direction of an asset allocation that best meets the clients' needs. "We try to educate them on the outcomes of what their different choices might be," he said. "Most of them make the right selection after the whole process."

Kochis Fitz, in San Francisco, starts with the planning process, as well. Not only do the advisors cull important information about the clients' financial lives while making the plan, but the process is an important part of gaining the trust of those clients.

"Clients actively participate in the macro-decisions of allocating assets," said Thomas Tracy, CFA, CFP, Kochis, Fitz, Tracy, Fitzhugh & Gott Inc. "They decide, along with us, how much should be in small cap or emerging markets, for instance."

Tracy said that he and his colleagues don't score risk for clients but personally assess a client's capacity for risk. "People don't know their risk tolerance or they're misinformed," said Tracy. "We base our decisions on how much capital they have and their investment time horizon."

Nor does the job of education stop once the account is established. Markets change and clients need additional knowledge. Hummer fulfills this need by sending an additional article or short research piece with every client performance report.

"I know I've succeeded with this effort when clients parrot back to me what I've been teaching them about wise investing," she said. "When they're more educated they take a realistic view of performance across the whole portfolio, not just at one asset class or one stock."

Based on the planning education, advisors present an individual investment plan for each client. Luffman describes the investment planning as a negotiated conclusion. "Being a CPA, I'm conservative by nature," said Luffman. "I am automatically going to present the most conservative choices. But it's not my plan, it's the client's plan. I want the client to come away from the planning process feeling, 'At least he cares about me enough to listen to what I wanted.'"

"If I'm persuasive enough, I'll succeed. I might feel he should be 50/50 in stocks and bonds. I'll feel I've succeeded if he agrees to 20 percent or 30 percent in stocks where he wanted to be in no stocks."

Tracy involves the client in the planning process but once decided, he works only on discretion for the assets that the client places with the firm. "We used to do non-discretionary planning and advice-driven management," he said. "We evolved over time because, as we grew, we couldn't allocate the time to ongoing advice. That's definitely a harder business model because it's much more labor intensive."

Despite all the planning and education, some investors don't have access to professional advice because of irrational decisions. Hummer conceded that most clients who are realistic and knowledgeable about investing walk in the door that way. "The best clients are those who are not really interested in the market," she said. "And that's not a function of the amount of capital they have. My most wealthy and my least wealthy client each express the attitude of long-term, diversified investing."

After 16 years of working with clients, Hummer has sized up potential problems. She has turned away clients whose expectations were too high. "I don't do it directly, I just don't follow up by sending information after their phone call," she explained. "Or I quote them my fee for non-discretionary accounts which is 25 percent higher than for discretionary accounts."

Luffman said that whether they should accept investors with irrational potential as clients is an ongoing consideration at Chas Smith. "It's my entrepreneurial spirit coming out," said Luffman. "I think it will take some work to bring them around, but maybe we will be able to work together."

Investors who go along with professional advice are likely to do better in the long term. Luffman pointed out that one reason is those clients reveal more information about their financial lives as time goes on. That makes it easier for the advisor to provide comprehensive advice.

"It comes back to more than financial planning," said Luffman. "It's much like the accounting relationship. The closer the communication flow, the better the quality of advice."