YESKE BUIE

Policy-Based Financial Planning as Decision Architecture

presented to the

FPA of Orange County

Quarterly Education Meeting

presented by

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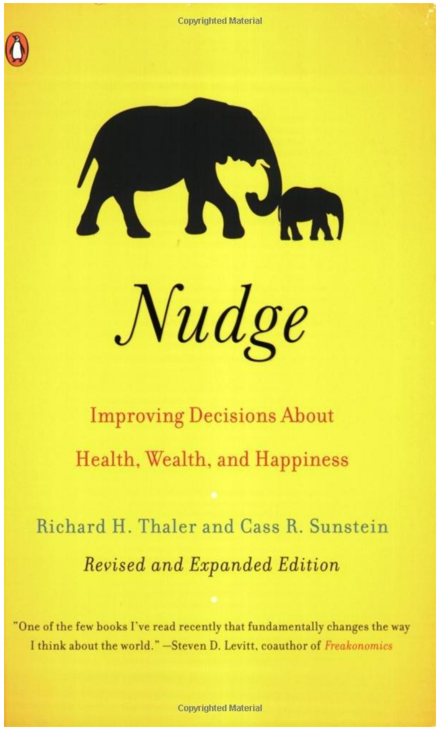
LIVE BIG℠

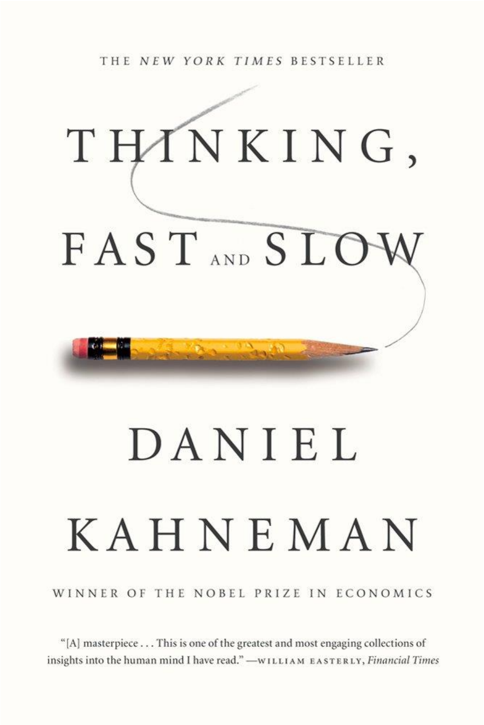
Agenda

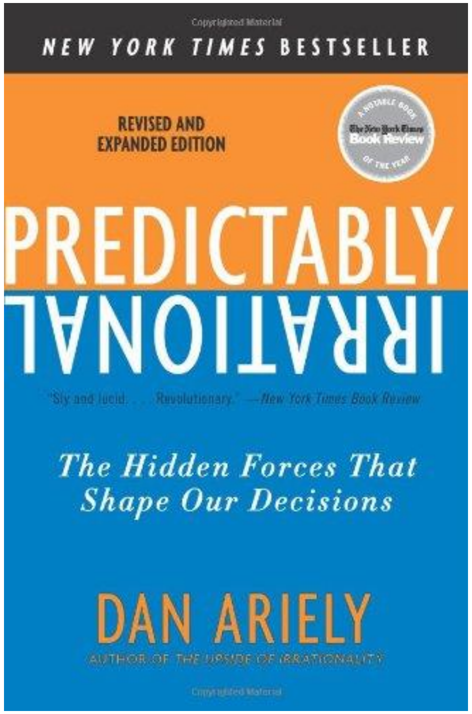
- Thinking Fast and Slow
- Behavioral Biases in the Context of Financial Planning
- Nudges
- Principles of Choice Architecture
- Policy-Based Financial Planning as "Decision Architecture"
- Examples and Case Studies

Thinking Fast and Slow

Decision-making in a "behavioral" world: a few resources.







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Thinking Fast and Slow

Two systems for interacting with the world:	
Automatic System	Reflective System
System 1	System 2
Human	Econ
Bureaucracy of Habits	Beginner's Mind
Fast	Slow

Thinking Fast and Slow

- The automatic system allows for fast decision making.
- Time and repetition move functions from the reflective to the automatic. *(this is why younger drivers are more accident-prone, they're using their reflective system so reaction times are slower)*

Thinking Fast and Slow

- The Automatic System is fast because it uses short-cuts (heuristics) which can lead to biases:
  - Anchoring
  - Availability
  - Representativeness
  - Loss Aversion
  - Overconfidence
  - Mental Accounting

Behavioral Biases in the Context of Financial Planning

- Availability Heuristic
  - Clients are biased by information that is easier to recall.
  - A client's willingness to buy life or disability insurance will be influenced by whether or not they know someone who became disabled or died prematurely.
  - Likewise their willingness to plan for a long retirement or update their estate plan.

Behavioral Biases in the Context of Financial Planning

- Representativeness
  - Clients will see or anticipate patterns that don’t exist.
  - Trading based on presidential elections.
  - Fukushima and the retired nuclear engineer: answering the wrong question.

Behavioral Biases in the Context of Financial Planning

- Optimism, Overconfidence, Loss Aversion, and Anchoring
  - Overconfidence led employees of tech companies to hold too much in employer stock during the tech boom against their financial planner's advice.
  - Loss Aversion and Anchoring caused them to continue holding the stock after it plunged when the tech bubble burst.

Nudges

- You can't fight a client's Bureaucracy of Habits (*"habits eat change"*) but you can enlist those habits to effect desired changes (Heller and Surrenda).
- Likewise, you can use Behavioral Biases to structure choices in a way that "nudge" decision makers toward better outcomes (Thaler and Sunstein).

Nudges

- *"People will need nudges for decisions*
- *that are difficult and rare*
- *for which they do not get prompt feedback, and*
- *when they have trouble translating aspects of the situation into terms they can easily understand."*

Thaler and Sunstein, 2008

Nudges

"Give people an easy off ramp"

Daniel Pink

The Power of the Nudge

- Germany and Austria
  - Cultural Similarity Index = 0.846*
- Organ Donation Rate
  - Austria = 99%
  - Germany = 12%
- System for Electing
  - Austria = opt out
  - Germany = opt in

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*European Social Survey

Principles of Choice Architecture

- Incentives
- Understand Mapping
- Defaults
- Give Feedback
- Expect Error
- Structure Complex Choices

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Thaler and Sunstein, 2008

Policy-Based Financial Planning

- Hallman and Rosenbloom (1975)
- Turn of the 21st Century turmoil.
- Yeske and Buie (2006)
- Compact decision rules that allow for rapid decision-making.
- A form of Decision Architecture to keep clients committed to a consistent course in a rapidly changing world.

What Policies Are **Not**

- Beliefs or Values
- Action Items
- Implementation
- Observations
- Goals and Aspirations

Policies vs. Values, Beliefs, Observations, Goals, Action Items

- **Belief**: Too much inheritance blunts ambition.
- **Goal**: To provide for spouse without leaving too much money to our grown kids.
- **Policy**: We will own life insurance for our survivor needs only, establishing charities as contingent beneficiaries.
- **Action Item**: Buy term insurance based on capital needs analysis; coordinate beneficiary designations; monitor regularly.

Policies vs. Values, Beliefs, Observations, Goals, Action Items

- **<u>Belief</u>**: Preschool enrichment programs greatly enhance lifetime educational success.
- **<u>Goal</u>**: To devote a sustainable portion of my annual income to supporting preschool enrichment programs.
- **<u>Policy</u>**:
  ***i.*)** I will focus my charitable giving exclusively on preschool enrichment programs and
  ***ii.*)** I will annually donate to such organizations an amount not to exceed 10% of the annual safe-withdrawal spending target for my portfolio.

Two-Part Test

- **Is it a policy?**
- **Is it a good policy?**

Is It a Policy?

- Does the policy return new answers as external circumstances change?
  (if not, it's probably a belief, observation, goal, or action item)

Is It a Good Policy?

- Dual Characteristics:
  - Broad enough to encompass any novel event that might arise.
  - Specific enough so that we are never in doubt as to what actions are required.

Debt Policy Example

- We will use credit cards for convenience only for purchases that are part of the monthly budget.
- For purchases equal to 10% or less of annual after-tax earnings, we will set aside funds monthly until needed sum is accumulated.
- For purchases equal to more than 10% of annual after-tax earnings, we will use amortized debt.

Roth Conversion Policies

- We will convert IRA assets to Roth whenever we can do so at a 15% or lower federal tax rate.
- We will only convert IRA assets to Roth when we have after-tax assets with which to pay the tax. Or . . .
- We will only convert IRA assets to Roth up to the degree that estate taxes will be payable.

Financial Planning Policies
The Six-Step Process

- Step 1: Discovery
- Uncover client's history, beliefs, values, and goals.
- Identify "**bureaucracy of habits**" or **behavioral biases**.
- Good discovery helps ensure that clients see their personal goals and values reflected in policies, encouraging them to embrace and act on them.

Financial Planning Policies
The Six-Step Process

- Step 2: Identify Planning Area and Related Principles
  - What Planning Area(s) are the Policies going to need to address based on the client's circumstances?
  - What are the Best Practices in that/those Planning Area(s)?
  - Evidence-Based Best Practices *(see Buie and Yeske, 2011)*.

Financial Planning Policies
The Six-Step Process

- Step 3: Combine Client Goals and Values with Planning Principles
  - Draft statements that you believe reflect the client goals, values and attitudes, and the relevant planning principles.
  - Make sure the policy reflects everything you learned during the discovery process.
  - Use the client’s own words where possible.

Financial Planning Policies
The Six-Step Process

- Step 4: Test Policies and Develop Specific Recommendations
  - Is it a policy?
    - Does policy return new answers as external circumstances change?
  - Is it a good policy? (scenario planning)
    - General enough to encompass a wide range of circumstances.
    - Specific enough to leave one in no doubt as to the actions to be taken.

Financial Planning Policies
The Six-Step Process

- Step 5: Test Policies with Client
  - Formalize for discussion with client.
  - Does the wording resonate with them?
  - Do clients see their goals and values reflected in the Policies?
  - Interactive process / wordsmith.

Financial Planning Policies
The Six-Step Process

- Step 6: Periodic Review and Update
  - Policies change based on ***structural*** or ***fundamental*** changes, ***not cyclical*** changes.
    - Laws and Regulations.
    - Best Practices (evolving, evidence-based).
    - Change in Client Values or Goals or Structural Circumstances.
      - An interior shift that has changed the exterior goals
      - An exterior change that has changed the structural circumstances

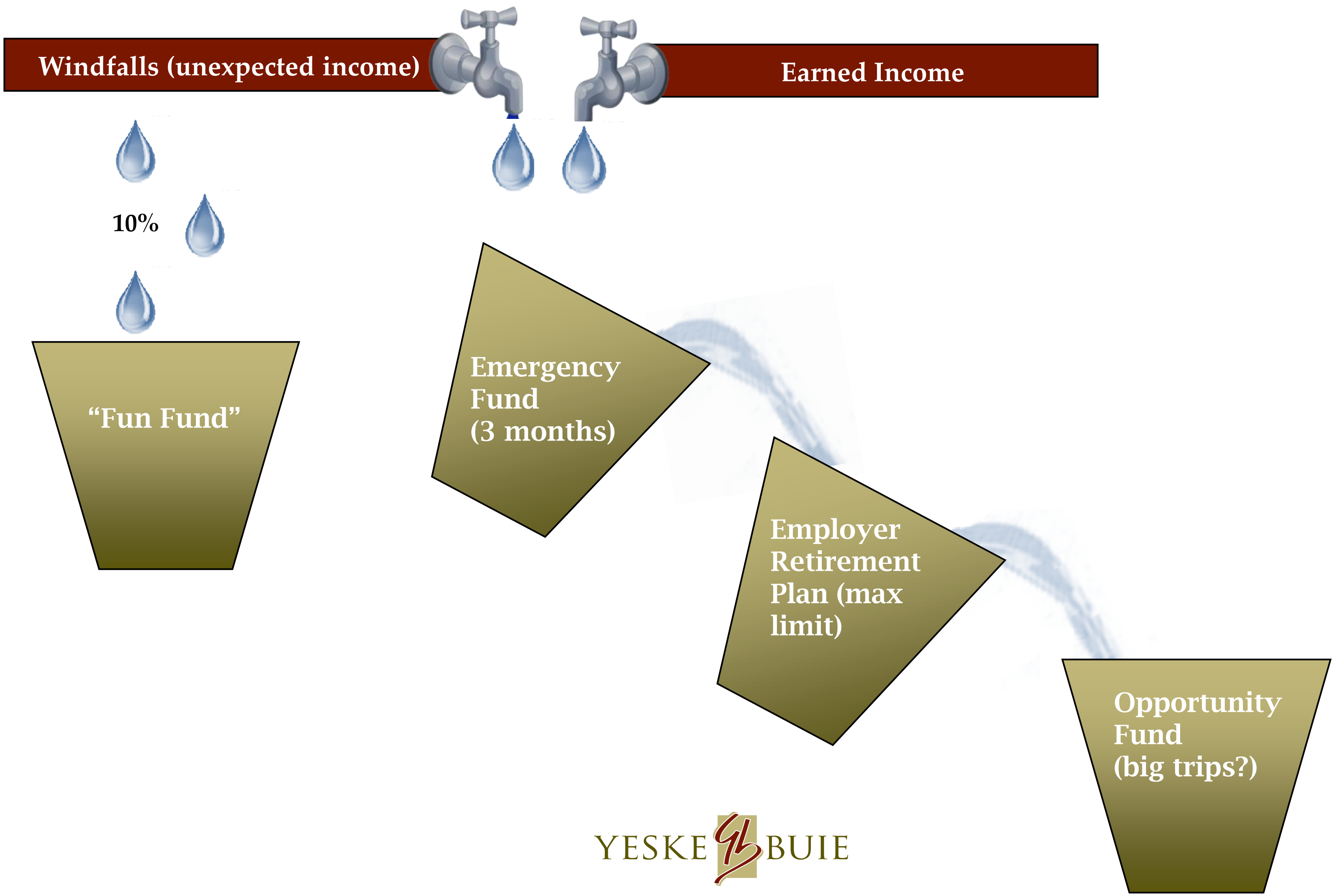
FP Policies - Applications

- All comprehensive financial planning engagements.
- Hourly or "one-time" financial planning engagements.
- Young people and others with little income and few assets for whom managing cash flow is the most important issue.

Cash Flow Policies

- I will save 10% of every paycheck.
- My savings will go first to my emergency fund until equal to 3 months worth of living expenses.
- Thereafter, my savings will go into my employer retirement plan to contribution limit.
- Any remaining savings will go into an after-tax "opportunity fund."
- Windfalls (bonuses) will be allocated 10% to a "fun fund" and 90% per the preceding policies.

Cash Flow Policies



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"Save More Tomorrow"

- System leverages the following biases:
  - Self-control restrictions easier to commit to in the future.
  - Loss-aversion: people hate to see their paycheck shrink.
  - Money illusion: people think about money in nominal terms.
  - Inertia.

The Strategic Perspective

- Policies are a good way to account for "Contingent Resources" for which the value, timing, and probability of occurrence are highly uncertain (e.g. inheritance, business sale, stock options, or bonus).
- Establishes in advance appropriate actions if contingent resource materializes.

Policy for Contingent Resource

- Any windfall from (name contingent resource) will be allocated as follows:
  - First, toward my granddaughter's college fund up to ½ the then projected 4 year cost.
  - Next, to my alma mater up to 10% of my then annual earned income.
  - Next, to a kitchen remodel up to 5% of the house's then appraised value.
  - Any remaining funds will be added to retirement savings.

Practical Impact of Policies

Highly Compliant

Non-Compliant

Practical Impact of Policies

Highly Compliant | Non-Compliant

Financial Planning Policies are not magic but they can shift behavior in a positive direction.

Safe-Withdrawal Rate Policies

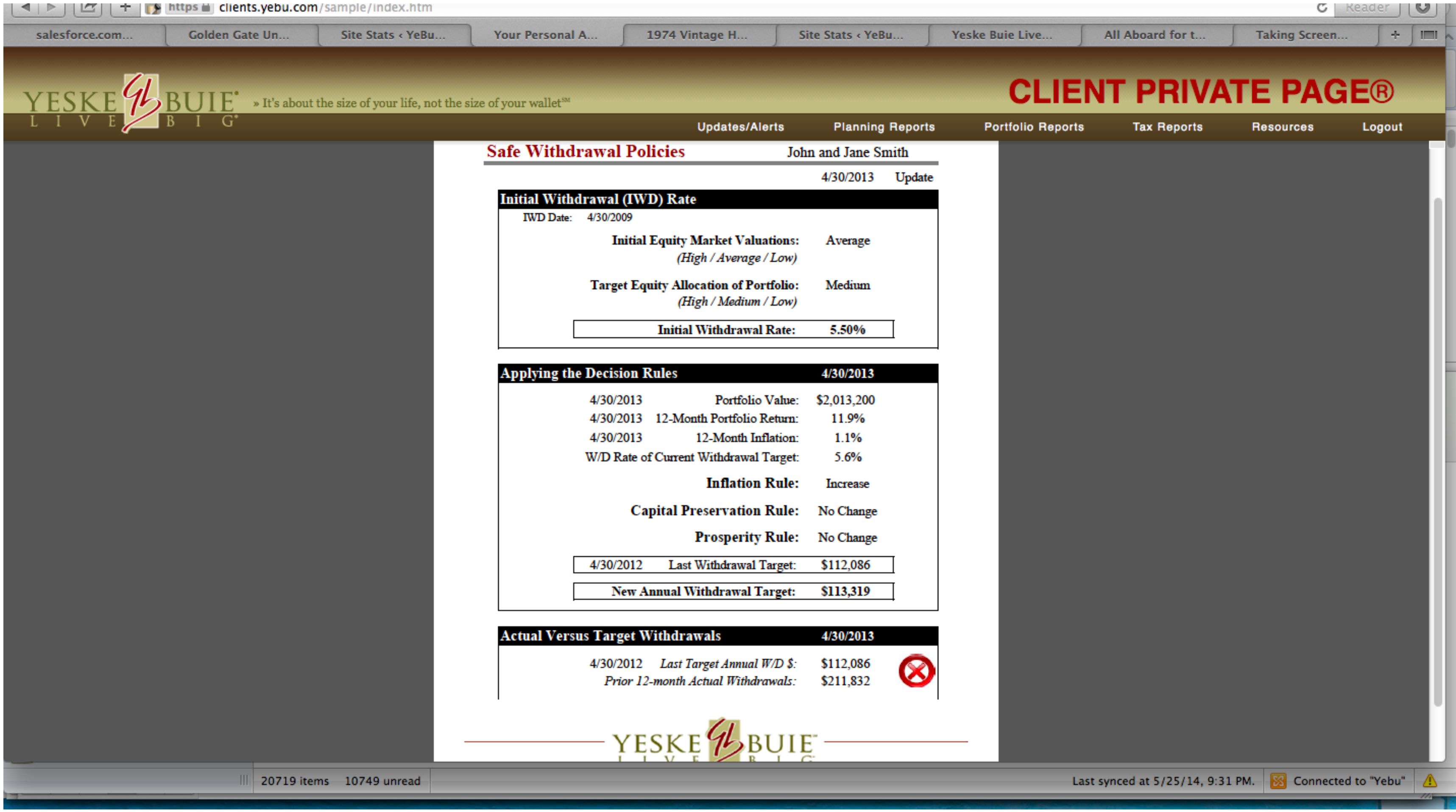
- **<u>Inflation rule:</u>** Target spending will be increased by the 12 month trailing CPI, except when the portfolio has a negative return and the current withdrawal rate exceeds the initial withdrawal rate.
- **<u>Capital Preservation Rule:</u>** If target spending as a % of portfolio is more than 20% larger than the initial withdrawal rate, target spending is reduced by 10%.
- **<u>Prosperity Rule:</u>** If target spending as a % of portfolio is more than 20% smaller than the initial withdrawal rate, target spending is increased by 10%.

Adapted from Guyton and Klinger (2006)

Principles of Choice Architecture

- Applying the principles to the Safe Withdrawal Rate policies:
  - Incentives
  - Understand Mapping
  - Defaults
  - Give Feedback
  - Expect Error
  - Structure Complex Choices

Incentives, Mapping, Defaults



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Give Feedback, Expect Error

Applying the Decision Rules		4/30/2013
4/30/2013	Portfolio Value:	$2,013,200
4/30/2013	12-Month Portfolio Return:	11.9%
4/30/2013	12-Month Inflation:	1.1%
	W/D Rate of Current Withdrawal Target:	5.6%
	Inflation Rule:	Increase
	Capital Preservation Rule:	No Change
	Prosperity Rule:	No Change
4/30/2012	Last Withdrawal Target:	$112,086
	New Annual Withdrawal Target:	**$113,319**

Actual Versus Target Withdrawals		4/30/2013
4/30/2012	*Last Target Annual W/D $:*	$112,086
	Prior 12-month Actual Withdrawals:	$211,832

Structure Complex Choices

"For the past 35 years, financial advisors have been telling me how to put money INTO my portfolio, no one until now has made it clear how I can take money OUT of my portfolio!"

Newly Retired Client

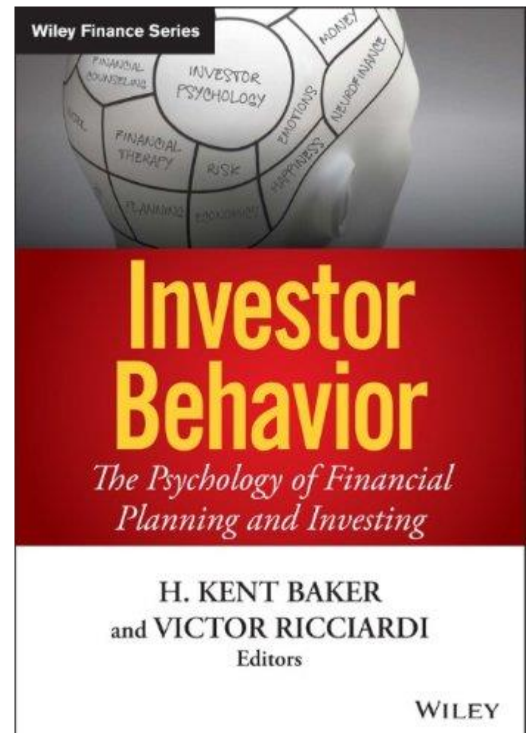
Conclusion

- The field of Behavioral Finance helps provide a deeper understanding of clients' cognitive biases but planners also need practical tools.
- Policy-Based Financial Planning offers a form of "Decision Architecture" that can help nudge clients in the direction of better decisions in the face of a changing world.

To find more on Policy-Based FP

"Policy-Based Financial Planning as Decision Architecture" Dec 2014

"Policy-Based Financial Planning: Decision Rules for a Changing World"



Questions?

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