

# Improving the Adviser-Client Relationship, Part 1

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**B**eing a successful adviser isn't just a matter of picking superior investments for your clients. Successful advisers also need to be world class at getting their clients to believe in and act on the advice that is dispensed. This doubles the difficulty of giving good advice. The adviser must create an appropriate recommendation, but then convince the client that the decision to accept and stick with the recommendation is in the client's best interest.

Behavioral finance has provided respectability to the common sense notion that individuals sometimes make decisions that are inconsistent with their well-being and these inconsistencies can occur in systematic ways. In some instances, this systemic behavior is driven by emotions that lead us astray, while in others, the problems are attributable to cognitive failures (that is, individuals make mistakes).

Behavioral finance has furthered our understanding of the ways in which individuals make mistakes when making decisions. With this knowledge, the adviser can see a more "accurate picture of the cognitive and emotional weaknesses of investors that relate to making investment decisions: their occasionally faulty assessment of their own interests and true wishes, the

relevant facts that they tend to ignore, and the limits of their ability to accept advice and to live with the decisions they make."<sup>1</sup>

We believe advisers who study this area and incorporate its insights into their practices will improve the outcomes for their clients by making and communicating useful recommendations in a way that increases the odds that the client will act upon and stick with them. This, in turn, will lead to high client retention and, hopefully, a better outcome for the client.

This column is the first in a two-part series in which we focus on the insights of behavioral finance that pertain to four areas (establishing the relationship, profiling the client, making recommendations, and performance evaluation/relationship renewal) of the adviser-client relationship.

Within each section, we describe some key findings from behavioral finance and make recommendations for advisers about how to incorporate these findings into their practices. We have not come close to covering every behavioral finding that has bearing on the adviser-client relationship. Instead we've focused on findings that (1) our experience suggests most frequently impede an effective adviser-client relationship and (2) those for which we have practical recommendations for advisers to use

## Establishing the Relationship

We believe the adviser-client relationship, as with all relationships, works best for everyone involved when the ground rules are established at the beginning. To establish sensible rules, it helps for the adviser to understand four tendencies exhibited by most people—tendencies that can influence virtually all subsequent interactions

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between adviser and client. At the beginning of the relationship, we suggest understanding the degree to which clients have these tendencies. Doing so allows the adviser to take them into account during the profiling, recommending, and evaluating/renewing stages of the relationship.

### Recommendation 1: Establish and Communicate an Understandable Corporate Investment Philosophy and Disciplined Process

Bohnet *et al* identify social risk as the product of situations in which decisions by other human beings are the primary source of uncertainty.<sup>2</sup> They find that individuals are less willing to take risk when the source of the risk is driven by the actions of another person, as opposed to the source of risk being pure chance. They refer to the tendency to make a special effort to avoid social risk as betrayal aversion.

In an advisory context, this means that individuals may become overly cautious in their willingness to accept and endorse investment recommendations made by the adviser. Understanding this tendency and addressing it when establishing the relationship can help clients overcome the aversion.

When presenting to institutional investors, it is important that the presentation include an extensive discussion of the firm's philosophy and process. Advisers presenting to individuals far too often take the "Trust me, I'm an intelligent, experienced professional" approach. This approach, which emphasizes the adviser as a person, can trigger the betrayal aversion tendency.

### Recommendation 2: Avoid Making Overconfident Statements to Clients

Overconfidence is one of the stronger findings of the behavioral finance literature. While much of that literature focuses on individuals making decisions for themselves or experts making decisions, we're concerned with overconfidence on the part of clients. There are two client types who may seek to use the services of an adviser, but who are subject to overconfidence.

- *I can do it, but don't have the time.* Clients of this type believe they are perfectly capable of managing their own investments. For example, Moore *et al* conducted what struck us as a

realistic trading simulation with MBA candidates at Northwestern University.<sup>3</sup> Nearly two-thirds of the students overestimated their actual past performance, despite being given regular updates about how they were doing relative to the market. When individuals like this choose to retain the services of an investment adviser, it is probably because they (a) realize they don't have time to devote to the task and/or (b) simply do not enjoy the task enough to justify allocating their own time to it. In either case, it is likely that they are overconfident in their own abilities and will use that inflated sense of their own skill as the standard against which they'll measure the performance of the adviser.

- *I can't do it, but you can.* These clients are different in that they recognize their own lack of the requisite skill and/or knowledge to manage money effectively. However, they have unrealistic expectations about what's possible in this arena and project onto the adviser a level of overconfidence.

Advisers who project competence through bold pronouncements about what they can accomplish may improve their initial attractiveness to potential clients, but failure to live up to those bold pronouncements will come back to haunt the advisers. Client confidence is earned over time by setting and meeting proper expectations, not with bold, overconfident statements in the beginning.

### Recommendation 3: Communicate Realistic Odds of Success

Another way to confront client overconfidence is to define success and set realistic expectations for achieving that success in the early stages of the relationship. The definition and expectation setting should be comprehensive and cover the investment plan, real dollar progress toward goals, portfolio return relative to risk, and services offered as part of the broad relationship.

### Recommendation 4: Be Clear About What You, as the Adviser, Do and Do Not Control

Illusion of control refers to the tendency for individuals to think they have more influence over events than they actually do. One manifestation of this illusion is to mischaracterize future events as having been determined by one's skill as opposed to by chance.

When thought about this way, the link to overconfidence becomes more apparent. Overconfidence can be caused by poor calibration on the part of the individual about the true odds of success. Poor calibration can be caused by individuals having an unrealistic perception regarding the level of control they exert over the events that affect them everyday.

Various factors are associated with an inappropriately heightened perception of control, even when experiments have been manipulated to produce random outcomes. These include:

- A greater sense of familiarity with a task
- Control over part of a task
- More time involved with the task
- A sense of superiority to others engaged in the same task

Think about the world of investing from the standpoint of a client who is hiring an adviser. The adviser is obviously familiar with investments, spends all day, everyday working with them, and makes representations that he is a top-notch professional (superior to not only the amateur do-it-yourselfers, but also to many of the other professionals who ply the same trade and compete for the same clients). Given these facts, it is no wonder that clients will sometimes gain an unrealistic perception of the level of the control advisers have over outcomes in investing.

The illusion of control can be mitigated to some extent with proper setting of expectations, describing the adviser's philosophy and process, and using an investment policy statement. Even with all this, clients may still need reminding that you, as the adviser, have little control over the

outcomes of your recommendations. You can help your clients avoid disappointment by being explicit upfront about where you do add value (for example, risk control, financial planning, account service, etc.) and why delivering that value is within your control.

### Recommendation 5: Make Clients Aware of What Can Go Wrong with Your Recommendations

The next three recommendations pertain to optimism. Individuals tend to be optimists. The optimist has at least three qualities that are relevant to the adviser-client relationship. Optimists tend to:

1. Overestimate their skills
2. Be more prone to suffer from illusions of control
3. Underestimate the odds that a bad event will affect them

Optimism interacts with overconfidence and illusion of control to make a bad situation worse, as each of the three reinforces the other.

Every recommendation of the adviser contains a degree of uncertainty. The recommendation may turn out well or poorly, based on how various assumptions that underlie it pan out and whether unanticipated events work in favor of or against the recommendation.

The client should be aware of the downside of the adviser's recommendations. By laying out the recommendation, the basis on which that recommendation was made, and the countervailing forces it may face, the client will likely become more appreciative of the work involved in preparing recommendations, as well as developing a more realistic sense for how capital markets work.

### Recommendation 6: Make Clients Aware of the Time Frame over Which Success of a Recommendation Should Be Measured

As part of this education process, attach a time frame for each recommendation to play out. Many advisers who work with

individuals suggest strategies expected to pay off successfully over a few years and find they must explain after a few weeks why the results aren't panning out. We think this often stems from the advisers' failure to communicate upfront that the road between recommendation and ultimate results is not linear.

### Recommendation 7: Take Special Care with Clients Prone to Optimism and Betrayal Aversion

There is a high-risk situation when the client is overly optimistic and then feels betrayed when the adviser does not meet those lofty expectations. We find that overly optimistic clients are often those who want to act the fastest without coming to a common understanding. It can be a challenge to slow them enough to provide

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the education and context necessary to set more realistic expectations.

**Profiling the Client.** In the profiling stage, the adviser seeks to develop a much deeper and more personal understanding of the client and the client's investing preferences. What makes the client tick? What are the nuances of his or her needs that provide color, flavor, and texture to universal goals such as retirement?

### Recommendation 8: Be Cautious About Risk Tolerance Assessments Performed During Periods of Extreme Market Movements

Projection bias refers to the tendency of individuals “to understand qualitatively the directions in which their tastes will change, but systematically underestimate the magnitudes of these changes. Hence, they tend to exaggerate the degree to which their future tastes will resemble their current tastes.”<sup>4</sup>

When advising individuals, a common practice is to assess the client's willingness and capacity to bear risk. This is a difficult task for many reasons, including the fact that an individual's willingness to take on risk is influenced by recent market performance.

Grable *et al* placed a financial risk tolerance survey online and asked respondents to take it while also answering a set of control questions that might reasonably be expected to influence risk taking (for example, age, income, education).<sup>5</sup> When analyzing what variables influenced risk tolerance, they found that price activity in the stock market over the previous week had a positive correlation with the risk assessment score.

Yao *et al* used the Federal Reserve Board's *Survey of Consumer Finances* data to perform a similar study.<sup>6</sup> Respondents were asked about their willingness to take on investment risk among a large number of other questions about their financial affairs. Their self-reported willingness to take on risk was correlated with market movements in the years preceding the survey, even after controlling for a set of relevant variables.

In light of these results, an assessment would ideally occur at multiple times, with each assessment taking place during a period when the market was exhibiting a different level of recent volatility.

When a multi-conversation assessment is not practical, we suggest scheduling the single conversation when the market is behaving in a neutral fashion. This also is frequently impractical.

In the event that the initial assessment takes place during a period of extreme market performance (note that this applies whether the volatility is on the upside or the downside), the adviser should do his or her best to get the client to think about periods when the market performance will be different from what their recent experience has been.

We have no illusions about the ease of this task. Its inherent difficulty leads to our recommendation of interpreting the assessment results with caution. To supplement these results, the adviser needs to maintain a frequent dialogue on the subject of risk and, over time, the adviser and the client will develop a better sense for the client's true level of risk tolerance.

### **Recommendation 9: Probe the Client About Risks They Haven't Experienced**

Our discussion of projection bias in the context of risk assessment focused on one aspect of risk (the client's willingness to endure the volatility that comes with stock market exposure). Advisers need to be concerned with more than just short-term volatility when performing a risk assessment at the beginning of a client relationship. When analyzing a broader set of risks, the adviser needs to be mindful of the availability heuristic (the tendency of individuals to make decisions based on evidence and considerations that are most easily accessible to them).

If individuals are subject to the availability heuristic, it isn't surprising that they are willing to take on more market risk if gains from recent market activity are fresh in their minds. For individuals who still carry the emotional scars of seeing their parents' or their own retirement nest eggs wiped out in the tech wreck of 2000–2002, the availability heuristic suggests that these clients will ascribe greater weight to capital preservation. The severe market downturn from October 2007 to February 2009 is an even more available example.

Which risks most concern a particular client? In general, risks that are more

“available” will be those with which the client has greater familiarity and those that are more salient or vivid. Factors that drive familiarity, salience, and vividness include: frequency of occurrence, whether the risk was personally experienced (or experienced by a close friend or relative), and how recent the experience was.

One task for the adviser is to have a discussion with the client about a broad range of risks and to assess the applicability of a given risk to the client. Examples beyond volatility include inflation risk, credit risk, and longevity risk. However, the adviser needs to be more than just a survey taker. The adviser needs to evaluate whether the client's expressed level of concern about each risk is driven by the “availability” of that risk.

### **Recommendation 10: Understand the Client's Past Experience Working with Advisers**

Clients can be subject to the availability heuristic with respect to relationship experiences, just as with risk and return experiences. This can create biases, strain the relationship, and hamper the success of the adviser. Past experiences, good or bad, may influence the clients' perception of an adviser's intent or actions. Prospective clients often seek out a new adviser because of a poor relationship experience with a past adviser. Understanding what worked, and more importantly, what didn't, will help the adviser set expectations, clearly communicate his or her process, and reduce the odds of disappointment down the road.

### **Recommendation 11: Prepare an Investment Policy Statement**

At some point in the relationship, the client will ask “How well am I doing?” The performance discussion is a hornets' nest that, when broken open, reveals a number of biases. The psychological literature suggests that one's objective achievements can matter less than how those accomplishments are perceived.

There are at least three subjective performance benchmarks that we find relevant to the adviser-client performance discussion.

1. *Performance compared to that experienced by others.* Individuals will sometimes talk about the performance of their investments with friends and family. It wouldn't surprise us if, the better the performance, the more they talk. If the clients hear these conversations, they'll naturally wonder how they are doing and use the performance bandied about from the chatter as the expectation. Why do the individuals latch on to the performance of others as a benchmark of performance? One explanation is that this kind of comparison is an example of the availability heuristic at work.
2. *Performance compared to the client's original expectations.* Many financial media outlets periodically survey individuals about their long-term rate-of-return forecasts for the U.S. stock market. Our sense is that their forecasts tend to be much higher than appropriate. This is consistent with the tendency towards optimism discussed earlier.
3. *Performance compared to what might have been.* A vivid example of this sort of benchmarking is provided by Medvec *et al*, who studied the behavior of Olympic medalists.<sup>7</sup> An analysis of the athletes' behavior on the medal stand indicates that silver medalists appeared to be less happy than bronze medalists. Objectively, the silver medalist was better off, but appeared to be less satisfied because they were thinking of the gold medal that got away, whereas the bronze medalists appeared to be happy that at least they received something for their years of toil.

The importance of agreeing to and documenting the goal of the adviser-client relationship, expectations of reaching the goal,

*Continued on page 37*

area—no one else gets the same results—the trusted transition adviser.

- Your business lines up with your personal purpose and vision of helping people acquire and protect their well-being.

### Seven Stages of Financial Transition Planning

1. **Discovery.** Includes identifying hard-wired communication styles, core beliefs, and values, and evaluating which life stage the client is in.
2. **Organize.** When life changes, money changes, and so does the paper work. One reason transition clients freeze and don't implement is because they feel disorganized.
3. **Explore.** What is possible now? Dream. Think about the new possibilities and use a system to test ideas and

combinations of goals.

4. **Review.** Check before implementing. This will accommodate the oscillating attention span. Sometimes, a client is with you, sometimes, he or she isn't. Sometimes, too much happens between meetings. Sometimes, he or she has discovered a new direction, and sometimes he or she hasn't been able to tell you about fears or misunderstandings.
5. **Implement.** It takes time to complete all of the investing, buying and selling, and finalizing commitments—the time it takes can tax the patience of the adviser.
6. **Rethink.** Clients are still in transition after implementation and they need a process to keep testing and rethinking. They need this time for some aspects to really sink in before they really get it.

7. **Wealth Management and Stewardship.** Both planner and client can move forward, reaping the rewards of the accumulation of years of good transition guidance.

Transition clients are different, but the same. Their transitions can be messy, confusing, and chaotic for the client and the adviser. Using a financial transition planning model can act as a guidance system, offering the planner a clear process and normalizing the emotional churn for the client. Yet the stages are dynamic, requiring both the planner and the client to be prepared to ride out the journey together.



### INVESTMENT RESEARCH Continued from page 31

and how progress will be measured cannot be overstated. A great tool to facilitate this is the investment policy statement (IPS). Creating and getting the client to agree to an IPS at the beginning of the relationship helps avoid surprises later.

In particular, performance expectations, benchmarks, measurement frequency, and gauges of success can be clearly documented before the emotions of the market or stories from others cloud comparisons. This is also an ideal time to highlight the unique needs of the client and discuss how comparisons to other clients would be ineffective and misleading.

The IPS should be revisited from time to time, especially if client expectations need to be reset in the wake of recent market gyrations. The IPS also serves as a place for documentation and agreement of the rationale for proposed changes to the plan that will help avoid comparison to what might have been. Too often, people view

the IPS process as a legal process only, when, in fact, it also serves as an emotional management document.

### Next Time

That's it for our recommendations pertaining to the establishment of the relationship and profiling the client. In a future column, we'll tackle the remaining two aspects of the adviser-client relationship.



### Endnotes

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