On-Demand Investment Performance: Behavioral Finance Considerations

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Riley Etheridge
Managing Director, Head of Client Segments and Advisor Development

Michael Liersch
Managing Director, Head of Behavioral Finance and Goals-Based Consulting

Steve Samuels
Managing Director, Client Segments and Advisor Development

In response to requests to enhance our online capabilities to provide more performance-related account information, performance reporting will be made available to clients with MyMerrill® accounts. In this brief note, behavioral finance considerations around how advisors and clients can best engage regarding on-demand access to account performance are discussed.

Evidence shows that investors can be their own worst enemy when it comes to reacting to markets – and to their portfolio performance. In fact, some research shows that U.S. equity investors forgo anywhere from two percentage points[1] to more than five percentage points[2] in annual returns due to poor investment decisions. And the phenomenon is not restricted to U.S. investors: a study examining equity investors in Taiwan uncovered similar costs of human behavior, suggesting that nearly four percentage points in returns are sacrificed per year.[3] In yet another study, the median investor in U.K. equity mutual funds misses out more modestly, with just over one percentage point in annual underperformance. To put these forgone returns in perspective, the median U.K. equity mutual fund investor – whose behavior appears to be least costly – reduced portfolio returns by 20% over the period of 1992 to 2009.[4] Imagine how much more portfolio value is diminished at two, four or five percent in lost annual returns.

In light of January 2016's market volatility, it may be time to evaluate what can be done to help prevent these diminished returns. In particular, for those who may regularly monitor investment performance online – there are three critical factors that can serve to mitigate behavioral tendencies that may be counterproductive:

- **Value of an advisor**
- **Investment Personality**
- **Self-control**

Online access to investment performance may motivate behavioral finance-related discussions that advisors can have with their clients

KEY IMPLICATIONS

Access to performance online may affect investment behavior, which can make it important to consider the following:

Value of an advisor

By working with clients to structure an ongoing, systematic approach to communication, advisors can proactively help clients keep account performance in context of their investment purpose, or goals.

Investment Personality

Evaluating clients' Investment Personalities – in particular, understanding their degree of adaptability to changing markets, desired level of portfolio protection, and interest in investment activity – can help identify how clients may react when performance reviews are not advisor-facilitated.

Self-control

Some clients desire at-will access to their investment performance, regardless of potential behavioral consequences. Although seemingly counterintuitive, having access may make these clients less, not more, likely to exhibit costly investment behavior.

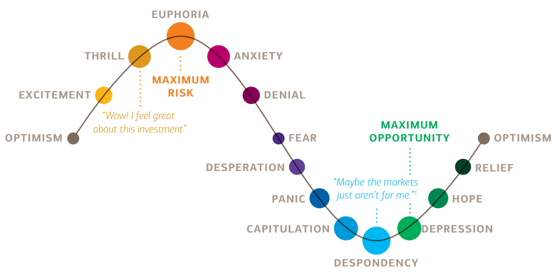
[1] Brad Barber and Terrance Odean, "Trading Is Hazardous to Your Wealth: The Common Stock Investment Performance of Individual Investors," Journal of Finance, Vol. 55, 2000 See also, Brad Barber and Terrance Odean, "Boys will Be Boys: Gender, Overconfidence, and Common Stock Investment," Quarterly Journal of Economics, Vol. 116, 2001.

[2] DALBAR, "Investors Can Manage Psyche to Capture Alpha," April 1, 2011.

[3] Brad Barber, Yi-Tsung Lee, Yu-Jane Liu and Terrance Odean, "Just How Much Do Individual Investors Lose by Trading?" The Review of Financial Studies, Vol. 22, No. 2, 2009.

[4] Andrew Clare and Nick Motson, "Do U.K. Retail Investors Buy at the Top and Sell at the Bottom?" September 2010.

The market-driven cycle of investor emotions



Source: Westcore Funds/Denver Investment Advisors LLC 1998

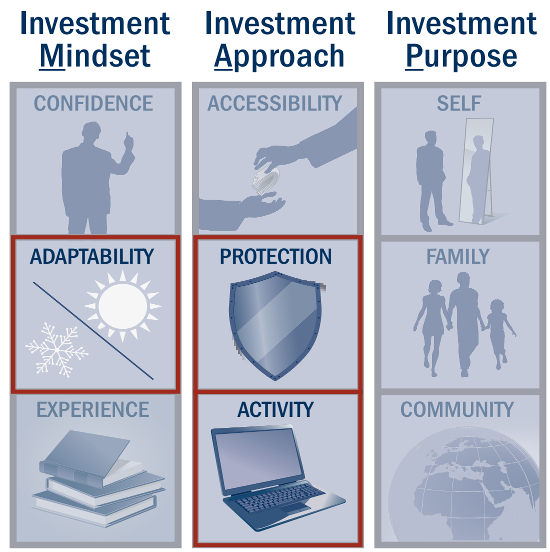
VALUE OF AN ADVISOR

Much of the evidence showing the cost of investor behavior involves self-directed individual investors who do not have the benefit of working with a dedicated advisor. Research shows that many of the best advisors collaborate with their clients to act not only as investment but *investor* managers.[5] Advisors have been shown to understand the importance of connecting with their clients during challenging market times to facilitate better investment decision-making, helping their clients to avoid costly mistakes.[6] That said, the ability for clients to have at-will access to their investment performance – without their advisor present – suggests that advisors may want to initiate conversations with clients about their unique behavioral tendencies. Such conversations can allow clients and their advisors to set up a systematic way of staying in regular contact about investment performance – which can help clients "stay the course" during their investment journey and pursue the outcomes they desire.[7]

INVESTMENT PERSONALITY

One way to initiate conversations with clients about the potential impact of non-advisor facilitated access to performance reporting: assess their Investment Personalities. By making clients' Investment Personalities the focal point of investment conversations, clients' tendency to evaluate investment performance out of context can be productively explored. For example, in the Investment Personality Assessment – available to existing and prospective Merrill Lynch clients today[8] – clients indicate whether they are fearful of market volatility (low "Adaptability"), are extremely averse to investment losses (high need for "Protection") or want to be in control of the investment process (high desire for "Activity"). Clients with these personality traits may tend to react to investment performance in a way that may compromise their investment returns. Discussing strategies to mitigate these risks – whether through establishing what is personally meaningful to them (e.g., assigning a purpose to particular investments), intentionally selecting investments with an element of protection (e.g., market linked investments, annuities) or simply scheduling regular communication with clients (e.g., monthly or quarterly calls) – can help clients keep the big picture in mind when reviewing their performance online.

Evaluating clients' Investment Personalities – specifically, their levels of Adaptability, Protection and Activity – can help advisors understand how on-demand access to performance might affect clients' behavior



SELF-CONTROL

It is important to recognize that some clients will continue to actively evaluate their performance, regardless of the behavioral risks presented to them. For these clients, the intuition might be to limit their exposure to performance so that they would be less likely to make impulsive decisions. However, like many aspects of human behavior, solutions to poor investment decisions can be counterintuitive. Evidence suggests that for those desiring to take a particular action (e.g., view investment performance), constant suppression of thought about the action, or suppression of the action itself, can actually deplete the ability to control oneself.[9] Ironically, then, giving clients more access can make them less likely to act because they are able to alleviate, or to address, their concern immediately, rather than waiting until they feel depleted and "out-of-control." There is evidence, too, that investors can implement their own self-control strategies (either intentionally or unintentionally). For example, investors tend to look significantly less at their investment performance during challenging markets – a behavior

5 Meir Statman, "How Important Is Asset Allocation?" Journal of Asset Management, Vol. 2, 2002. Working paper, City University London.
6 Philip Maymin and Gregg Fisher, "Preventing Emotional Investing: An Added Value of an Investment Advisor," Journal of Wealth Management, Vol. 13, No. 4, Spring 2011.
7 Michael Liersch, "What Is Behavioral Investing?" Merrill Lynch Wealth Management Institute, Fall 2014.
8 Michael Liersch and Anil Suri, "Innovations in Behavioral Finance: How to Assess Your Investment Personality," Merrill Lynch Wealth Management Institute, Fall 2014.
9 Roy Baumeister, Ellen Bratslavsky, Mark Muraven and Dianne Trice, "Ego Depletion: Is the Active Self a Limited Resource?" Journal of Personality and Social Psychology, Vol. 74, No., 5, May 1998.

researchers call the Ostrich Effect (reflecting the notion that ostriches are said to bury their heads in the sand in the face of danger).[10] Rather than rely on such an extreme self-control strategy, investors can instead work with their Advisor to create a goals-based approach, which can serve as a type of self-control strategy that empowers investors to evaluate performance in the context of their desired outcomes.

CONCLUSION

As Merrill Lynch continues along a path of industry-leading innovation, the focus remains on strengthening relationships with clients as we work with them to help achieve the outcomes that are most important to them in life. Online access to performance reporting via MyMerrill is consistent with this approach, as it enhances the potential value clients receive. To ensure that this value is fully realized, behavioral implications of at-will access to performance have been discussed in this brief note. One key action that can help mitigate behavioral risks: advisors and clients can have regular, structured conversations about the client's investment approach and the outcomes they may expect over time. The Investment Personality Assessment – which can help uncover clients' behavioral tendencies with respect to performance-based reactions – is one tool that can facilitate these conversations.

Key questions clients can ask their advisor:

How can the Investment Personality Assessment help me better understand the way I respond to changes in the market?

What are some of the ways I can use the assessment's findings as I make investment decisions?

How can I stay focused on my goals when markets turn volatile?

[10] For a thorough explanation of the Ostrich Effect, see Jason Zweig, "Should You Fear the Ostrich Effect?" The Wall Street Journal, September 13, 2008.

Riley Etheridge, Managing Director, Head of Client Segments and Advisor Development for Merrill Lynch Wealth Management, is central to the delivery of Merrill Lynch's operating model and client-focused strategy.

During his 30 years at Merrill Lynch, he has served as an Advisor, Director, and Regional Manager in addition to his current role.

His professional designations include CFA® (Chartered Financial Analyst®), CFP® (Certified Financial Planner™), and ChFC® (Chartered Financial Consultant). He is a 1983 graduate of Louisiana State University with a B.A. in History

Steve Samuels, Managing Director, Client Segments and Advisor Development, leads strategic integration and advisor Programs for Merrill Lynch Wealth Management. In this role, he works closely with segment heads, product teams, advisory councils to management, and complementary lines of business across the enterprise on the coordination and delivery of Merrill Lynch's client-focused strategy.

Prior to this role, Steve was responsible for advisor and field communications activities across Merrill Lynch Wealth Management and the Private Banking & Investment Group. Steve also served as the National Sales executive for U.S. Wealth Management. In this role he also ran the Global Practice Management consulting group with consultants deployed around the world to help advisors and teams optimize their practices through training and consultation.

Steve has an M.B.A. degree from New York University (Stern School of Business) and currently serves on the Dean's Advisory Board of the State University of New York at Albany Business School where he attended for his undergraduate degree. Steve and his wife Judy are proud parents of three children, Max, Rachel and Zoe.

Michael Liersch, head of Behavioral Finance and Goals-Based Consulting, is a member of the Client Segments and Advisor Development team at Merrill Lynch Wealth Management. He leads the behavioral finance initiative, which is focused on tailoring investment advice to meet the needs of a client's unique investment personality in the context of their investment goals.

Prior to joining Merrill Lynch, Michael led the behavioral finance initiative at Barclays Wealth for North and South America. He has also previously held the positions of Director of Research at Behavioral Research Associates, Consultant at Deloitte Consulting and Visiting Professor at New York University's Stern School of Business. Michael's research has been published in top psychology journals including Psychological Science and Journal of Marketing Research. His perspectives have been highlighted in investment media outlets including Bloomberg TV, CNBC, The Wall Street Journal, USA Today, On Wall Street and FundFire. Michael earned a Ph.D. from the University of California, San Diego in Cognitive Psychology. He also holds an A.B. in Economics from Harvard University.

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