

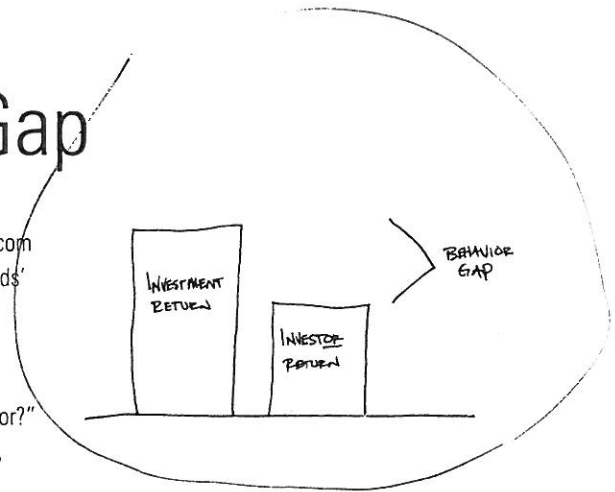
Closing the Gap



Jerry Kerns

Readers of our blog on MorningstarAdvisor.com have come to appreciate advisor Carl Richards' knack for asking basic, straightforward questions that lead to a deeper discussion about financial planning. Recently, in a post titled "What are your clients paying for?" he wrote, "Our value is the advice [we give], but clients pay us based on assets we manage. Does that cause a problem for anyone else?" The entry touched off an informative debate in the comments section about the nature of how advisors get paid. ("We are in partnership with our clients and only make money when they do," said an advisor, defending charging on AUM. Wrote another advisor, The hourly rate plan "has the fewest conflicts of interest.") It's an example of what makes Richards interesting. Instead of talking at readers, he'd rather listen to them. He's able to ask provocative questions because he has a genuine interest in hearing views other than his own. The advisors who comment on his blog posts seem to have the same interest. Richards' posts have become meeting places, where advisors are all too happy to share their thinking on the topics Richards raises.

Although he covers a range of subjects, Richards is most interested in investor behavior and why investors make decisions that are not in their self-interest. To Richards, the epitome of poor investor behavior is the fact that the return of the average mutual-fund investor is less than the return of the average mutual fund—something in which Morningstar has held a long interest. (See our Investor Return data point in our mutual-fund reports and research on asset flows.) In typical Richards fashion, he narrowed down the problem to its most basic level and sketched it, calling the difference the Behavior Gap. He started a blog with the same name dedicated to finding out why the Behavior



Gap occurs and what advisors and investors can do to shrink it.

Richards will now explore the topic in a regular column for *Morningstar Advisor* ("Our Job: Building Better Investors," Page 11), and you continue to meet up with him online at MorningstarAdvisor.com.

For our Spotlight this issue, we created what could be called a survivor's guide for the next decade (Page 32). No one can predict the next big challenge the economy will present, but we can create scenarios of some of the more likely events to get a better understanding of how they might affect investing. We came up with more than a dozen scenarios and asked Morningstar analysts what investors could do in each situation to protect their portfolios or to take advantage of an opportunity. Even if you don't act on any of our suggestions, it's an insightful look at some of the possibilities investors could experience in the coming years.

Our Job: Building Better Investors

By Carl Richards



A while back, I started a blog called Behavior Gap. It sprang from a statistic in the annual Dalbar report: The average investor's return is dramatically lower than the average mutual fund's return. It's not an exaggeration to say that this piece of information changed the way I do business—and it certainly changed what I think about the nature of a financial planner's job.

If it's true that real people pretty dramatically underperform the average investment, then maybe my job as a financial advisor is not so much about finding the best investment. Maybe it's about helping people become better investors.

Placing investors' over investments would be a dramatic shift for our industry. As advisors, we seem to be totally consumed with the idea that our job is to find the best investments. But what if the importance of finding the best investments pales in comparison with helping investors behave correctly? If that's the case—and I think it is—then the most important thing we can do is improve the way clients act. So maybe we're no longer in an arms race over who has the biggest computers and the best analysts who find the best investments. Maybe it's indeed true that if our clients owned a mediocre investment and behaved correctly, they would outperform most of their neighbors.

Think about this: The debates that so many advisors obsess over—say, whether to use actively or passively managed funds—only matter to the degree that they influence our clients' behavior. So maybe we shouldn't be asking whether we believe in passive or active

management. Instead, what if we viewed this question, and others like it, through the lens of behavior? It would mean that there's no right answer. There's no wrong answer. Instead, the "right" choice would be the one that you and your clients believe will positively influence their behavior.

A big part of that means staying true to our own philosophies. If I'm an advisor who believes in passive management, for example, I better be darn sure that I really believe it. Only when I really believe it will I be able to inspire the trust clients need in order to avoid the classic behavioral mistakes.

That may mean that not every client is going to fit into my belief system. And if a potential client falls outside of it, I'd be doing myself and that client a disservice to take him on: I'm not going to be able to provide the advice he needs at just the moment he needs it.

But the ones who do fit into my belief system will trust me. And that means that when they're required to behave correctly—even when it's hard—I'll have developed the trust to help them do it.

So many of our industry's tools and communication pieces aim to present a logical set of facts to try to convince people that they should act one way or another. But behaving correctly is, at the core, an emotional issue: Real people in the real world often behave in what might seem an irrational way. And you can't solve an emotional issue by throwing facts and figures at it.

Instead, you've got to figure out what tools will

make the greatest impact on behavior. And they're not always the ones that show up on a spreadsheet. For example, in many cases it's empirically true that adding alternative investments to a portfolio will reduce risk and increase returns. But if it also adds complexity and headline risk with which your client isn't comfortable, it's going to be difficult to inspire the client to stay the course when times are tough.

Here's why: We are genetically wired to get away from things that cause us pain. We're wired to want more things that create pleasure, safety, or security.

Everyone knows on a theoretical level that selling low and buying high is a bad idea, right? But when tough times come, we just want to get away from the pain. And throwing facts and figures at an emotional problem like that is like trying to put out a grease fire with water: It just makes it worse.

So we can educate clients until we're blue in the face. But in the end, all that matters is that they trust us. And the depth of that trust is a function of the quality of the time we spend together. If this is the case, does it change how you do business?

It did for me. ■■

Carl Richards believes that the world is a better place when people make smarter decisions about their money. That's just one of the big ideas he promotes at BehaviorGap.com, where Richards asks tough questions about financial planning and investor behavior. Richards puts his ideas to work in the real world through his firm, Prasada Capital Management.