INVESTMENTS & WEALTH MONITOR

A reprinted article from July/August 2021

Everything You Need to Know About X

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Falk (2020) addressed details about investors' goals and emphasized the importance of understanding, respecting, and improving decision-making about investing to increase the probability of reaching one's goals. Goals are funded contentment (aka your happy place).[1] Also included in the article was a clear definition of risk and how investments can be more or less predictable.

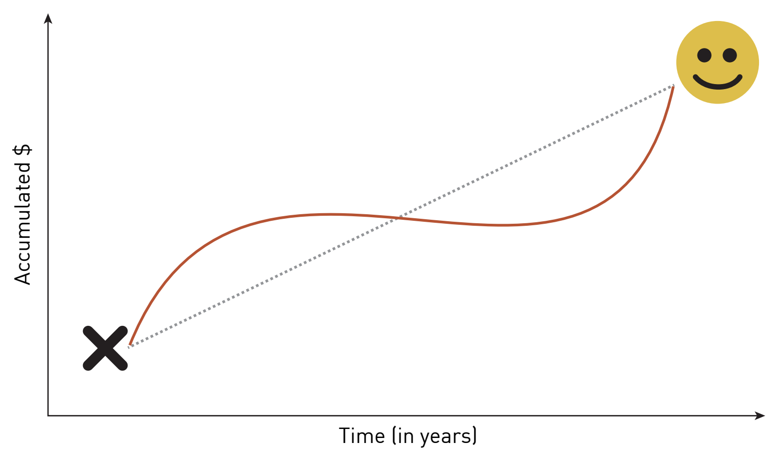
What was not included in Falk (2020) was much if any guidance regarding an investment portfolio. This was purposeful. Satisfaction can never be guaranteed. Then again, too much of the investment industry has embraced a policy portfolio of 60-percent equity and 40-percent debt. This does not mean that everybody always should hold the policy portfolio, or that it even makes sense in the current environment of negative interest rates (with roughly 75 percent of all debt, global bonds are trading at a negative real rate of return after inflation as of this writing).

Nevertheless, investors do need a starting portfolio that increases the probability of their contentment and doesn't disturb their sleep. From figure 1, this is X, and this article could be considered the prequel to Falk (2020) about how to position X.

Once again, we turn to the industry. The financial services industry is built primarily around helping people find their X. If fiduciary responsibility is being taken, an assessment of risk tolerance is necessary. Once a person's risk tolerance is assessed, the portfolio would be created. At this point, you may be feeling a bit unsettled. If not, you should, for the following reasons:

Figure 1

WHERE YOU ARE AND WHERE YOU WANT TO BE



- To what extent are risk tolerance measurements accurate and accurate over time? (They are not.)
- To what extent does a portfolio design fit the risk tolerance measurement? (We could be cynical here because a policy portfolio actually exists).[2]

RISK TOLERANCE

As discussed in Falk (2020), risk was defined as more things can happen than will. As redefined for financial services, risk meant falling short of one's goals or funded contentment. Does anyone really have any tolerance for that? No.

Most risk-tolerance assessments treat risk as the ability to accept volatility. This is wrong and not practical.[3] The industry compounds this error by treating the assessment as fitting some sort of fiduciary compliance standard. Put another way, it is a checkbox exercise with no real practical use.

If these wrong and impractical uses are not enough reason to stop using assessments, then respect the research that shows asking individuals how they would respond in an emotionally loaded, hot-state situation while they are in a calm, cold state does not work (Loewenstein 2005). The truth is these risk-tolerance assessments are not effective at doing what they are supposed to do: align the lowest variability portfolio with the pursuit of funding of the goal.

It is time the industry began using an effective, functional assessment tool. Below is a rough outline of what such a tool should look like. Think of two dimensions: one for funding capacity and the other for risk preference.

Funding capacity is a mathematical calculation; it borders on actuarial math. For example, how much savings do you currently have, how much will you be saving every year, how must your investments perform to satisfy your goal? That investment performance requirement is the dotted line in figure 1 (that forces the funding to satisfy the goal).[4]

Risk preference is a less-accurate measurement but no less important. This is about attitudes toward more things being possible than what will be experienced and how those possibilities make you feel. To avoid the trap of the classic questionnaire's hot-cold empathy gap, don't ask investors "if" questions about what they would do. Instead, ask questions about what they did when (e.g., they had big and little allocations to equities during past bull and bear markets). Better yet, don't ask them. Instead, review their past brokerage statements to see what they did. This approach may avoid any hindsight bias, poor memories, or ego puffery.

If past brokerage statements are insufficient or unavailable, use a behavioral questionnaire.[5] Our art focuses on questions about what we believe are the seven core biases with two questions for each, randomized in their order, delineating high to low affect (see sidebar). If the two answers don't align, a third question is generated automatically to break any ties between the high and low affect responses. All will receive between 14 and 21 questions with little to nothing to do with finance or money. Why are these questions not about finance? The assessment should never seem like a financial literacy test when we are trying to understand behavior.

With the funding capacity and the risk preference score, we can plot an accurate, functional risk tolerance easily on two dimensions. In fact, think of the funding capacity as a center point with the risk preference floating in and around this circle (to appreciate this score's inherent instability) around that point.

SEVEN CORE BIASES*

- Overconfidence
- Disposition bias (includes loss aversion)
- Regret aversion
- Status quo bias
- Availability bias
- Anchoring and adjustment bias
- Cognitive dissonance

** These seven core biases span across emotional errors (four), belief perseverance (two), and cognitive error (one). Again, the goal is not to test cognition but rather to test emotion.*

Billionaire investor and vice chairman of Berkshire Hathaway Charlie Munger famously said, "invert, always invert."

We should acknowledge a potential challenge with these two dimensions. They may not align very well with each other. More specifically, funding capacity might be very low for someone early in a career, and risk preference may be very low as well. Classically, the industry might bias an early-career investor toward stocks. However, the low risk preference could make that high allocation to stocks a challenging allocation for this investor, especially one who may want to sell during periods of stock market declines. As to how to deal with this lack of alignment, read on.

RISKY PORTFOLIOS

Understanding a person's risk tolerance may seem relatively straightforward now, even if there is a lack of alignment. However, how does anyone measure the riskiness of an asset class (e.g., stocks) or a portfolio of different asset classes (e.g., stocks and bonds)? Falk (2020) put forth an idea of a predictability measure. Regardless, we are still left with the chance that the performance, predictable or otherwise, will fall short of what is needed to fund contentment. Performance is best judged in terms of an investor making progress toward or reaching contentment—not in a vacuum and never in the eyes of your neighbors.[6]

So, predictability may be necessary but not sufficient. This question automatically bridges beyond the portfolio and toward clients' funding goals, including their risk tolerance. After all, shouldn't they all align? It is undeniable that they should all align. What is sufficient? And how might we understand what to do when there is a lack of alignment?

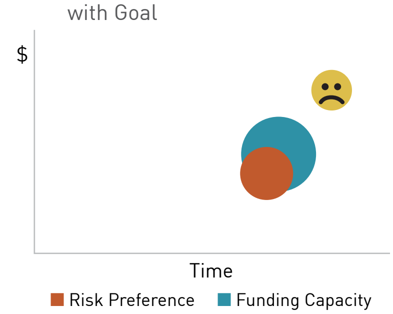
Earlier, we wrote about the two dimensions of risk tolerance. Now add the additional dimension of portfolio predictability to help visualize the connection between the risk tolerance and the required return (which warrantees the portfolio allocation and forces the savings to fund the contentment).

Risk preference would graph along with the funding capacity measure within a sphere. The sphere's size denotes the risk preference score's size, implying a greater or lesser effect on the core behavioral biases. For example, the portfolio predictability bubble (funding capacity) likely would tend to be larger due to the

Figure 2

SCENARIO 1: MISALIGNED

- Funding Capacity is aligned with Risk Preference
- Funding Capacity is not aligned with Goal

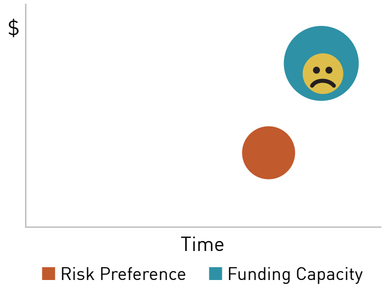


***Funding Capacity** (FC): size of circle changes with predictability of portfolio, and with less predictable portfolios, the larger the FC circle will be.*
***Risk Preference** (RP): Total aggregate affect will determine size of RP circle and a greater aggregate affect is represented by a smaller circle (harder to align with FC and goal).*
***Smiley Face** represents Funded Contentment (goals).*

Figure 3

SCENARIO 2: MISALIGNED

- Funding Capacity is misaligned with Risk Preference
- Funding Capacity is aligned with Goal

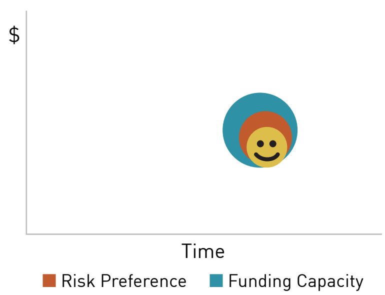


Funding Capacity (FC): size of circle changes with predictability of portfolio, and with less predictable portfolios, the larger the FC circle will be.
Risk Preference (RP): Total aggregate affect will determine size of RP circle and a greater aggregate affect is represented by a smaller circle (harder to align with FC and goal).
Smiley Face represents Funded Contentment (goals).

Figure 4

SCENARIO 3: ALIGNED

- Funding Capacity is aligned with Risk Preference
- Funding Capacity is aligned with Goal



Funding Capacity (FC): size of circle changes with predictability of portfolio, and with less predictable portfolios, the larger the FC circle will be.
Risk Preference (RP): Total aggregate affect will determine size of RP circle and a greater aggregate affect is represented by a smaller circle (harder to align with FC and goal).
Smiley Face represents Funded Contentment (goals).

greater variability of performance results (see figure 2). Think of a smaller bubble consisting solely of U.S. Treasuries, a bigger bubble representing the policy portfolio, and the biggest bubble if it were primarily a portfolio of equities. To what extent do the bubbles overlap? Don't forget that no matter how long a goal's time horizon seems to be, the long term is made up of a series of short runs.

The bubbles create a visualization of the alignment between one's stated goal, funding capacity, and risk preference. Should the bubbles between the variables not align, changes are necessary to reduce the potential failure of reaching one's goals.

A typical industry approach to hit the goal may be to take on more risk (less predictability) in the portfolio (see figure 3). After all, asking a client to save more may disrupt the current standard of living, so let's roll those dice. Unfortunately, this type of misalignment is one of the most challenging. The increased unpredictability of the allocation could cause the client to abandon the portfolio at exactly the most inopportune time, placing funded contentment at even greater risk.

The preferred approach would be a re-evaluation of the goal or savings element of the funding capacity to create alignment with risk preference and funding capacity (see figure 4). An alignment of the key factors with a 50 percent or greater overlap would make for a more predictable outcome and a higher probability of achieving funded contentment if only due to the smoother and more probable path that will arrive at the happy place.

EVERYTHING ABOUT X

Billionaire investor and vice chairman of Berkshire Hathaway Charlie Munger famously said, "invert, always invert."

Start with the funded contentment and work backward. Given the funding capacity, what investment return is required to make the funded contentment come true?

Can the required investment return be immunized?[4] If yes, you now know where X should be. After all, it makes sense to pursue the greatest probability of success with the least chance of failure; that is why immunization is the first question.

Suppose the required investment return is too high for immunization; it often is. In this case, the question shifts to whether it seems to be a stretch (not likely achievable) in the current investment markets, or whether the markets are reasonably capable of providing that required return.

If the required return is a stretch, the path to a better alignment has the following potential shifts:

- To what extent can the funded contentment be modified? For example, can it occur a few years later or could it be less costly?
- To what extent can the funding capacity be shifted? For example, can monthly savings be increased?
- Respect that risk preference is the single most challenging aspect to shift and the shift that most likely will not stick. That is why it is listed third and should not be counted upon as a viable shift or perhaps even be pursued. And over time, risk preferences frequently change. Although that would seem to indicate the need to engage more frequently with this behavioral aspect, that may not be necessary at all. If the investment portfolio is designed to emphasize predictability over return and investors stick to the three questions (from Falk 2020), when Mr. Market's bipolarity is acting up, the behavioral component is handled without adding complexity.

If the required return is reasonable, then the risky portfolio design is within reach. Based on 30 years of experience, our previous article shared thoughts on time horizons and more suitable equity allocations.

Why does X matter? It matters because if you start with alignment, a client will be able to make fewer and less difficult decisions. The bipolar nature of Mr. Market will not cause as much angst. In life, X often shows that "You

Are Here." Funded contentment is where you want to go. Let's connect those two moments once and for all to provide clients with the greatest chance of achieving their goals.

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ENDNOTES

1. The term "funded contentment" was coined by Brian Portnoy. See Portnoy (2018).
2. We could even be more cynical because the policy portfolio has a 40-percent-sized hole in it today given what's happening with real interest rates and bonds.
3. Volatility is motion and can be both positive and negative, and it is not very predictable. Moreover, positive volatility helps people, which means volatility is only half problematic apart from it not being very predictable.
4. As discussed in Falk (2020), the slope of that dotted line matters. For example, a steep slope is a high required rate of return. The dotted line never has anything to do with the current expected returns in the market. Investors always should first try to immunize their success if possible. Immunization looks like when very low-volatility investments (such as short-term U.S. Treasuries) or mature investments (such as U.S. Treasury zero-coupon bonds or Treasury STRIPS) can satisfy the required return and deliver the funded contentment on time.
5. The questionnaire is easier to standardize and leverages a practitioner's time versus the analysis of historical investment decisions (which also may have been influenced by the client's practitioner's biases).
6. See Cheney and Seyfarth (2008). This is where all baboon problems could be distilled down to one issue, other baboons. Can we admit we're all just baboons?

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