How to Use Behavioral Finance in Asset Management

by Barry Ritholtz, Chairman, CIO
Ritholtz Wealth Management

Part I: Managing Ourselves

Over the decades, I have consumed the entire canon of Behavioral Finance, from Ariely to Kahneman to Thaler to Shiller and back. The academic research on the topic is relevant, robust, and utterly fascinating. It continues to become more influential with each passing day.

What I have seen much less of are the ways to *implement* the lessons learned about human psychology in the day-to-day aspects of managing money for clients in a wealth management firm. I don't mean *theoretically*, but the actual block & tackling, day-to-day work of running a money management firm. If you work in money management, then a part of your job will involve some aspects of branding, finding clients, running their money, managing their expectations, communicating with them on a regular basis, reporting performance, building a set of goals, etc. In all of these areas, the knowledge accumulated from behavioral finance can be enormously helpful.

And yet, there is little in the way of advice along those lines.

I believe this is a huge oversight.

More than understanding the basic concepts, how can a practitioner take what we know about the ways cognitive errors impacts investors, and use these to design the fundamental building blocks of a wealth management firm?

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It is a worthwhile question. This week, I hope to answer it, rectifying an oversight by getting very specific and granular about how to apply behavioral economics across three different groups of people:

Us (as practitioners)

Our Clients (as investors)

The Public (as investors and potential clients)

These are what I believe to be best practices for using Behavioral Economics within a Registered Investment Advisory (RIA) firm — primarily across these three specific constituencies. In particular, we want to consider the a) decision-making process; b) the data set of information influencing people; and c) how to manage emotions across a variety of market conditions.

From narrowest to broadest, let's jump right in.

Us: Research & Analysis

I believe we as asset managers have an obligation to put into practice what we know about human cognition and psychology in our everyday work.

Thus, we begin by trying to lead by example. Several of the ways we do that is through enlightened self-awareness, and by showing the process behind our thinking. By that, I refer to: a) writing in public; b) explaining our thinking process; c) being pro-active about admitting and embracing errors; d) debunking nonsense in the media and online (especially issues identified by clients); e) recognizing our own cognitive biases, and taking concrete steps to avoid or at least minimize them. My unsubstantiated belief is that any asset managers who do this will be at a strategic advantage over those who do not.

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Let's look at just a few of the things we do to try to practice what we preach:

1. **Analyze & write in public**: We begin with our simple approach of being very public in all of our writing and analysis. This includes all of the firm's various writers: Me, Josh, Mike, Ben, Tony, Blair and Nick. Not only do we write in public, but we maintain a permanent archive of all prior writings.

I believe there are many benefits of sharing our thinking in a very public format, but let's just focus on these three:

1. We create a track record of our views, thereby avoiding hindsight bias;
2. We are intellectually harmonious in our commentary, maintaining a philosophy that is both recognizable and consistent;
3. Spurious and/or reckless commentary is immediately called out; we hold ourselves accountable for what we write when speaking to the broad investing public.

More than just creating a recognizable investing philosophy, all three of these hold ourselves out to the public as accountable. There is an ugly sub-genre of reckless and irresponsible fear-mongering, along with its greed-based corollary. Both tend to be short-term, as this hot button approach is unsustainable over longer periods of time.

By being so very public in our writings over longer periods of time, we want to create the standard for measured, responsible market commentary.

2. **Positive and Negative Weekly Summations**: Each week, with the help of our staff, I post at TBP a succinct summation of the week's events. The caveat is that it must contain a balance of positive and negative bullet points from the world of economics, corporate news, markets, and geopolitics.

This intellectual process *forces* you out of whatever market modality you are in: You cannot be a rampaging bull when you are assembling a list of negatives every week; nor can you be a full-on bear when the news flow has so much positivity in it. It also avoids allowing your own confirmation bias to creep into your view of the world.

It is harder than you might imagine.

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3. **Annual *Mea Culpas***: I learned this from Ray Dalio about a decade ago: every year I make a list of what I got wrong and what I learned from the experience.

I find doing this is incredibly freeing. You begin to realize that errors are common place, to be embraced, not hidden away. Second, acknowledging your mistakes is a great way to learn from them. Last, you get out of the headspace of the *resulting business* and into the mindset of a *process business*. It's a huge strategic advantage to understanding the difference between the two.

4. **Counterfactuals / inversions**: Finally, pulling a page from Charlie Munger at Berkshire Hathaway, we have all taught ourselves to invert. The counter-factual way of thinking avoids a variety of heuristic and psychological errors. It helps with debunking nonsense. It allows us to recognize how the element of chance and randomness plays into large complex systems like the economy and markets; it helps you to consider possible alternative outcomes to different situations. In terms of managing risk, it lets you consider extreme or unusual possibilities that might never have entered your mind without the counter-factual.

See Part II: How Behavioral Finance can help with clients

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Part II: How Behavioral Finance can help with clients
by Barry Ritholtz, Chairman, CIO Ritholtz Wealth Management

Yesterday, I laid out the ways we think about and use Behavioral Finance at RWM in the practice of running a wealth management firm. That discussion was about what we do to manage our own cognitive and behavioral issues.

Today, I want to focus more broadly — on how we have built a firm to use what we know from behavioral economics in the work we do with clients. What follows is an eclectic, incomplete list of examples from our practice. Nothing here is a secret — all of us have discussed these publicly. Collectively, they add up to better behavior from clients, with the highest likelihood of meeting financial goals.

RWM's clients experience a broad variety of these, ranging from modest nudges, gently shifting people towards better behavior, to others more robust and explicit behavioral controls. The goal of these are to prevent all of our natural instincts from interfering with our portfolios. Its not that people are stupid — our clients happen to be a very smart collection of accomplished and successful people. But the key word is ***people***, and all of us are subject to the same hard-wired traits that while great at making humans the dominant species on the planet, interfere with our success in the capital markets.

What follows are just a few of the ways we work to outsmart our own wetware:

1. **Asset Allocation/Diversification**: Let's start with the big one. We use an evidence based approach based on academic research and data. That means we are not alpha-chasing stock-pickers, as we know this is a poor probabilistic risk. Instead, our portfolios are broadly diversified, global, low cost, mostly indexed holdings. We have modest tilts within the portfolios and our international exposure mitigates home country bias.

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2. **Portfolios Names**: A modest nudge with an outsized impact. The traditional naming of accounts (Conservative, Moderate, Aggressive) rubs some people the wrong way (Aggressive? or "I am not a Conservative"). So instead, we named them based on how far various NASA missions travel: Mariner (inner solar system: Mars, Venus and Mercury), Pioneer (Jupiter), Voyager (Saturn, Uranus and Neptune, and beyond our solar system).

3. **Milestone Rewards**: The average holding period of a mutual fund is 3.3 years. Rather than let this "3-year itch" cause undue turnover, taxes, etc., at the 3 year mark *we lower clients' fees by 15 percent*. To qualify, they must have shown good behavior (e.g., no day-trading their accounts, or selling their EM because they heard something bad about Turkey).

4. **Financial Literacy Limitations**: Research shows financial literacy has a short shelf life. After about 6 months, it fades. So we constantly keep our clients informed about the things we know that matter — and those things we know do not — for the markets, the economy and their portfolios. We put together a quarterly conference call for all clients where I delve into those topics in (painful) detail. They get regular emailed updates with just our best commentary (including our podcasts and favorite other voices). All of our client facing advisors follow the 12/4/2 rule of regularly speaking updating clients, reviewing life changes, and performing a full revisit of their financial plans. *Speaking of which*:

5. **Financial Planning**: We build into our practice the idea that every client's financial plan is central to their long term success. Even before a prospect becomes a client, we are focusing on a few planning concepts: that money is a tool that can be used to accomplish specific goals; that the purpose of investing is part of a broader plan to achieve those specific goals; and lastly, that *good investing is supposed to be boring,* and this is not a competition or for entertainment purposes.

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6. **Communication/Debunking**: We spend a lot of time responding to client requests for information about things they read/heard/saw elsewhere. Many of our columns and blog posts, and much of our quarterly conference call comes directly from these client requests. We have examined the Hindenburg Omen, NYSE margin, economic conspiracy theories, buybacks, sentiment, single-factor indicators and so many others as the result of their questions. Helping people properly understand reality (to paraphrase Ray Dalio) is one of the most important aspects of our jobs.

7. **Goaltender**: There are plenty of tactical portfolios out there, trying to capture alpha. *Not ours.* Instead, we have created a portfolio designed to be an emotional release valve. Based on published quantitative research, was designed to: a) let investors leave their main pool of investment capital alone during periods of volatility and larger drawdowns; and b) allow cash withdrawals to occur from bonds that are (usually) rallying versus stocks that are (usually) selling at distressed prices.

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I do not think I am giving away any secrets when I share these things – even if we opened our kimonos completely and revealed all of our "secret" stack of technology, philosophy and portfolios.

Our real secret sauce? The combination of our culture + hardcore commitment to the philosophy we espouse — that's an unbeatable pairing for any firm to enjoy.

See Part III: How Behavioral Finance helps when we interact with the public

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Part III: How Behavioral Finance helps when we interact with the public
by Barry Ritholtz, Chairman, CIO Ritholtz Wealth Management

This is my third and final installment in our look at deploying what we have learned from behavioral economics in the everyday practice of financial planning and asset management.

Today, we look at how we interact with *the investing public* — and why. This includes investors, regulators, the media, academia, really, anyone interested in finance. It is clear to those who have studied the history of investing just how much behavior matters — the biggest source of "unforced errors" come from the many ways people allow their hard-wiring / wetware to lead them towards very questionable decision-making.

There is a huge pool of people who need some assistance in understanding how to manage their own money, whether or not they are in the tiny percentage (<1%) of readers who might eventually become RWM clients.

The ugly truth: there is an enormous contingency of players who *do not have your best interests at heart*. Whether they are trying to sell you a product, or get you to watch, listen or click on something, the giant bullshit industrial complex is working against you. And, they are expert at pushing the hot buttons hard-wired into you that is part of your evolutionary inheritance. Part of our jobs when dealing with the public is countering that machinery.

This is why we try to teach ***how to think*** (not *what to think*). That is where we start today:

1. **Thinking**: Most people have a fundamental misunderstanding about what money is, what purposes the markets serve, and what they are supposed to be doing in that space. Their beliefs are based on thinking that is imprecise and often inaccurate. Appeals to emotion are rampant in finance marketing, but we have behavioral tools to counter that.

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Markets do not exist so you can prove how smart you are, or for you to show your belief in (fill in the blank), or to provide cocktail party chatter. It is not a contest, at least not the sort of contest that gets portrayed on television. Markets are a place for companies that need capital to grow to meet the people who have that capital, and a willingness to put it at risk to obtain a return.

Once people learn *how to think*, once they develop their own analytical framework, they can see through the bullshit machinery on their own.

2. **Beta vs Alpha**: Beta is cheap and easy, Alpha is expensive and hard. Beta appeals to the intellect, alpha is emotional. Everybody has the ability to find beta; nearly no one has the ability to find alpha. Beta is a humble approach to markets, a more honest recognition of the limits of your talent and personality type. Alpha ignores the probabilities, assuming they will beat those odds to obtain the holy grail.

People who create alpha are exceedingly rare; people who can identify them in advance are rarer still. Why should any of us assume we are in either camp? Understanding this gives investors the greatest probability of succeeding.

3. **Media**: The way we use our platforms in the mass media is to provide interesting and intelligent commentary that avoids the sensational and emotional. We try to be a smart counter-weight to what else is out there. Watch Josh on Halftime Report — he is the voice of reason in a sea of emotions, getting people to think about slow money on a show that is about fast money (it's quite the trick). Listen to the discussions Mike and Ben have on Animal Spirits — they may be fun, but they focus on what matters and teach people about better investing (they also do a nice job debunking a lot of nonsense). Our blogs all consistently do the same.

My pet peeve has always been the ephemeral, meaningless focus of so much FinTV: "*Whats your favorite stock? Where will the Dow be in a year? When will the Fed next raise rates?*" These are questions you will never hear me ask on MIB. Instead, I use that platform to discuss finance in ways few others do. It has become a grad school level business and investing course taught by legends of investing and business.

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This is proof you don't have to engage in the sort of outrageous nonsense we see everyday to attract an audience or get people to click or maintain a large media presence.

4. **Evidence-Based**: Investing based on actual data leads to much better decision-making (and therefor results) rather than by myth or emotion. Debunking bad ideas, misleading memes, silly television tropes, and other assorted nonsense is an important and worthy goal of ours. Explaining how and why people make bad decisions can only lead to smarter investors. It is why we hosted the Evidence Based Investing Conferences, and why we always push back in public on so much nonsense. When the public sees this approach, they quickly realize how much nonsense everything else is.

5. **Cycles**: Markets are cyclical, recessions (outside of Australia) occur once a decade or so; drawdowns are a regular feature of equities, and crashes are inevitable. Once people *understand* these events are normal and natural, they are less likely to overreact or make bad emotional decisions due to fear or panic.

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I am now at my self-imposed 1000 word limit, so I will stop here. If you want to learn more about behavior and investing, see these posts, or WaPo or Bloomberg columns. Or contact us at the tab above.

-Barry Ritholtz

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