

CHUCK WIDGER AND DR. DANIEL CROSBY

Personal Benchmark

Integrating Behavioral Finance
and Investment Management

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Personal Benchmark

Integrating Behavioral Finance and Investment Management

Chuck Widger
Dr. Daniel Crosby

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Dedication

This book is dedicated to America's advisors.
Professionals who help investors achieve their goals.

Preface

The insight that inspired this book emerged in the spring of 2010 during an otherwise typical investment advisory discussion. My client, Rick, had investment needs. Like many investors, he wanted a conservative approach (low volatility) to managing his investments. Also like many investors, he simultaneously needed growth to increase his purchasing power. An inherent conflict. Thus, Rick called me to seek guidance on how to assemble a portfolio that would best meet his goals.

But Rick wasn't just any client. Rick was my longtime friend of more than 55 years. In the eighth grade, we played soccer together. In high school, we (along with our teammates) won the 1962 Pennsylvania State Championship. June 3, 1967, we entered Navy officer candidate school in Newport, Rhode Island together.

In 1970, I left active duty to join the finance industry. Rick went on to become a career Naval officer, rising to the rank of Captain in the Naval Supply Corp and earning a master's degree in computer science at the Navy's postgraduate school in Monterey, California along the way. He also prudently saved and invested his entire adult life.

Those of us who have the benefit of lifelong friendships know how special they are, especially at Rick's and my age. We shared a significant part of our youth together. Each of us was proud to serve our country. We each appreciate the career achievements of the other. And, importantly, we tease each other over minor missteps when we were young and a few misadventures we each have experienced as adults. There is an irreplaceable comfort in high quality, mutually respectful lifelong friendships.

Today, Rick and his lovely wife Dana have two children and three grandchildren. His personal goal is to provide for Dana on his death, and for his children and grandchildren on the death of the survivor.

Thus, when he turned to me in the spring of 2010 for investment advice, I was keenly aware of the discipline and sacrifice it took for him to assemble his portfolio. And I was intimately aware of the individuals who were trusting me for advice. So, as with any client, I took my advising role with Rick very seriously.

Rick knows from personal experience that markets are volatile. He also understands that at our age if he suffers a significant loss, he may not have time to recover. Thus, like many people, he prefers a conservative approach to managing his investments. Yet, his conservative bias is in conflict with another of his investment goals. Rick knows he must increase his purchasing power over time to maintain his standard of living. To increase purchasing power, investors must stay invested over reasonably long periods of time. Therein lies the rub: Rick is an action-oriented guy. Staying invested through good times and bad is at odds with his no-nonsense mentality of, "Don't just stand there, do something!" when things get rough. When volatility strikes, he (like many others), wants to reduce his volatility and chances of loss, even if that means reducing the chances for growth. In short, Rick's conservative (low volatility) approach was stymying the growth component his portfolio needed.

As I thought about Rick's investment goals and risk tolerance, I intuitively saw that by establishing specific goals (low volatility, growth) for each purpose, I could confidently recommend a tested Brinker Capital investment strategy that I believed had a high probability of achieving each goal. I knew in periods of market volatility, I could

point out the stability of the low volatility or safety allocation and note that, over time, the more volatile growth or accumulation allocation would compound and create more purchasing power. I now know what I had solved for Rick is the dilemma psychologists call “simultaneous risk preferences.”

A Strategy

With this broad investment policy in mind, two different Brinker Capital investment strategies were selected initially to implement it. Each strategy is from Brinker Capital's mutual fund asset allocation program known as Destinations. Brinker Capital has eight different investment programs, with each based on the same multi-asset class investment philosophy that seeks to reduce volatility, while maintaining the opportunity for appreciation. Rick's initial portfolio investment strategy is pictured in [Table P.1](#).

[Table P.1](#) Rick's Initial Portfolio Investment Strategy

Source: Brinker Capital, Inc. For illustrative purposes only.

	Safety	Accumulation
August, 2010	Destinations Defensive (70%)	Destinations Moderate (30%)

What I had intuitively done was use mental accounting, or buckets, to frame a portfolio investment strategy that both would create the investment experience Rick wanted and allow me to communicate with him in terms that he easily understands. Thanks to decades of research into human behavior we now know people naturally collect and simplify information through mental accounting. Framing information into discrete buckets allows for faster comprehension and more rapid decision making. This communication format creates an ongoing level of

understanding that enables the management of normal biases through his investment life cycle.

Following implementation of this strategy for Rick's portfolio, in the second half of 2010, investors in equities achieved very attractive returns. Our Destinations Moderate model, as part of the Accumulation allocation, was up +16 percent during this period (as of December 31, 2010).

With ten months of experience, Rick became comfortable with the performance of his portfolio investment strategy. In the spring of 2011, I suggested to Rick that allocating 70 percent in Destinations Defensive was much too conservative. He agreed. I then proposed, and he accepted, a change in his portfolio investment strategy.

We reallocated the 70 percent that was in Destinations Defensive: 35 percent to Destinations Conservative (a slightly less conservative strategy) and 35 percent to Crystal Strategy I Absolute Return, a global macro hedge strategy. His new reallocation is pictured in [Table P.2](#).

[Table P.2](#) Rick's New Portfolio Investment Strategy

Source: Brinker Capital, Inc. For illustrative purposes only.

	Safety	Tactical	Accumulation
May, 2011	Destinations Conservative (35%)	Crystal Strategy I (35%)	Destinations Moderate (30%)

By framing the portfolio investment strategy discussion and the performance discussion through the prism of mental accounts or buckets, Rick could easily see that:

- Using a Destinations Conservative strategy for his Safety bucket, a significant portion of his portfolio (35 percent) has the ability to remain stable during volatile

periods. Knowing that his portfolio's safety is established, he can manage and put into perspective the pain of the more volatile accumulation strategy.

- Using Crystal Strategy I for his Tactical bucket, he has the potential to gain downside protection in volatile markets and the opportunity for appreciation in rising markets.
- Using Destinations Moderate for his Accumulation bucket, he has the potential to protect and grow purchasing power to sustain his standard of living in the future.

Once the first 24 months of the investment advisory relationship had passed, Rick understood how to view his portfolio through the prism of these three mental accounts. Our discussions on portfolio performance now takes place during periodic reviews and not during periods of volatility.

During the initial period of the investment advisory relationship with Rick, I had also begun to focus on the continued failure of the advice industry (investment managers, sponsors, broker-dealers and financial advisors) to apply the principles of behavioral finance in the investment advisory process. I soon realized that this was a key to more successful investing.

A Behavioral View of Finance

Through the efforts of noted scholars like Richard Thaler, Amos Tversky and Nobel Prize winner Daniel Kahneman, behavioral finance has established itself as a social science with a body of principles which are useful in predicting human behavior. During the last 20 years, many investment management firms have developed high quality presentations on behavioral finance. However, these firms

neglected to develop investment offerings that integrate the principles of behavioral finance, even though individual investors continue to relate to their investment as human beings with behavioral biases, not just on the basis of return and risk (volatility).

For example, 30 years of data gathered by investment consulting firm Dalbar reveal that in periods of volatility, investors sell paper losses at bottoms and pile back in at market tops. This suggests that individual investors feel the pain of loss more than the pleasure of gain. As a result of this and numerous other behavioral tendencies or biases, actual investor performance materially underperformed commonly used indices for the 30-year period.

If, after the 2008–2009 Financial Crisis and Great Recession, former Federal Reserve Chairman Alan Greenspan (2014) can become “imbued with behavioral finance,” why shouldn't the investment advice delivery system? If behavioral finance is good enough to be included in the macroeconomic models that guide macroeconomic policy, surely it is appropriate to include behavioral finance in the investment advice delivery system that guides the development of individual investment strategies.

In his book *The Map and the Territory: Risk, Human Nature, and the Future of Forecasting* (2013), Greenspan recounts his epiphany. In reflecting on the 2008–2009 period, he notes that most analysts and forecasters, both public and private, agreed with *The Economist's* view expressed in December, 2006 that “market capitalism, the engine that runs most of the world economy, seems to be doing its job well.” He then asks and answers the question, “What went wrong?”. According to Greenspan (2009), what went wrong is that economic forecasters like himself held too narrow a definition of animal spirits. Animal spirits, as defined by Keynes (2011), is the “spontaneous urge to

action rather than inaction, not as the [rational] outcome of a weighted average of quantitative benefits multiplied by quantitative probabilities.” On reflection, animal spirits should include behavior biases or propensities because there are systematic patterns to how people behave in periods of extreme economic stress. These patterns can be measured and included in economic models which are used to guide economic policy (Greenspan 2009).

In my view, if behavioral finance is good enough for Greenspan and the macroeconomic models that guide national policy (Greenspan, 2009), it's good enough for the investment advice delivery system used to guide the development of individual investment strategies.

It is a central thesis of this book that embedding behavioral finance principles into an investment management offering is needed to resolve the performance shortfall driven in significant part by individual investor behavior. When principles of investment management and behavioral finance are combined in an investment offering, the advice delivery system will materially improve the investor experience. In turn, investors may enjoy an appropriate mix of return and risk, and, most importantly, intentionally manage their behavior biases.

Clues about how to embed such principles can be found in Richard Thaler and Cass Sunstein's book *Nudge: Improving Decisions About Health, Wealth, and Happiness* (2009). In it, the authors note that people struggle to make decisions in the midst of complex or stressful situations. They persuasively argue that in such situations, people's decision making should be guided (“nudged”). They nudge using choice architectures, processes, or systems that take into consideration people's behavioral tendencies and that promote optimal (more helpful, less hurtful) choices. For example, they explained, nations with opt-out organ donor

programs have more incidences of organ donation than nations with opt-*in* organ donor programs.

In the case of investment advisors, we are intimately aware that the number one source of stress is money (American Psychological Association 2012), and when this stress kicks in the quality of our thinking suffers. We forget the future, react (“Don't just stand there, do something!”), throw the plan out the window, and make what can be irrational comparisons to prior events. Having an investment advice delivery system that understands and anticipates these natural human reactions and tendencies is what investors need.

However, no delivery system has historically incorporated principles of behavioral finance or provided nudges and choice architectures that help investors voluntarily control their behavioral biases. Until now.

In later chapters, my co-author, Dr. Daniel Crosby, more deeply explains the concepts of behavioral finance that undergird Personal Benchmark, Brinker Capital's advisory model. Daniel has grouped 117 documented behavioral biases or tendencies exhibited by human beings into three categories of simple, safe, and sure.

In practice, we guide our clients to make allocations to safety, income, and tactical mental accounts. These allocations help clarify investors' personal goals, manage volatility, and harness the positive feelings linked to achieving personal goals. We still cannot predict short-term performance: No one knows what the market will do this month, or even this year. But over long periods of time, there is reasonable certainty that stocks will outperform bonds, and bonds will outperform cash.

The accumulation bucket in Rick's personal portfolio strategy recognizes this truth. By establishing a longer,

appropriate time horizon for the performance of this mental account (bucket), Rick has a reasonable level of certainty, or surety, that he will grow the purchasing power he needs to sustain his and Dana's lifestyles. The accumulation bucket also brings even greater personal meaning because it provides the opportunity to provide for their children and grandchildren on the death of the survivor.

Thus, as Rick's story shows, our focus on presenting a limited number of mental accounts to design the broad investment policy simplifies clients' basic investment policy choices, presenting a choice architecture that frames information in a positive way, encourages action, and helps clients stick to a plan. In other words, our approach helps nudge our clients toward investing strategies that are appropriate for them.

Perhaps more importantly, this choice architecture helps investors connect their investment strategies to the production of the purchasing power they need to finance the life experiences, relationships, and charitable giving that make life meaningful, fulfilling, and purposeful.

By attaching purpose (the “Why?”) to our investment strategies, we identify what matters to us personally. We establish our own “Why?,” making it almost effortless to do the right thing in our investing and in our lives. This makes us more productive and our lives more meaningful.

Simon Sinek illustrated the power of “Why?” using the Apple company as an example in his 2009 TEDx talk. He explained Apple answered the three key questions (“Why?,” “How?,” and “What?”) this way:

Why? “In everything we do, we believe in challenging the status quo.”

How? “By making our products beautifully designed and user friendly.”

What? “We just happen to make great computers.”

At Brinker Capital, our “Why?” is challenging the status quo, our “How?” is by offering purpose-driven investing to help avoid the “behavior gap trap” known as the *Dalbar Effect*. Our “What?” is that we just happen to make great investment products. The latest of these is the Personal Benchmark solution, which provides a simplified approach to help investors cut through the relentless financial information that bombards us daily. It was this kind of simplified framework that made sense to Rick in 2010 and continues to make sense with countless other clients today.

Personal Benchmark: A Tool for Advisors

The principles of behavioral finance were embedded or integrated in the investment advisory process I offered Rick. Today, Brinker Capital's Personal Benchmark offers an elegant (simple, yet sophisticated) solution that is easily communicated by advisors and intuitively grasped by investors. Embedded within the tool is a formal integration of the principles of behavioral finance and investment management. The integration is an advance in the theory of investing because it increases the explanatory and predictive power of investing theory by including plausible psychological premises.

Of course, we believe investment advisors will continue to play a critical role in this enhancement to the advice delivery system. Through their relationship skills and professional expertise, advisors develop an understanding of the investor's personal goals and risk tolerance and can

therefore guide the development of an investment strategy that will achieve the investor's personal goals. An investment offering that embeds the principles of behavioral finance empowers the advisor with important communication tools and discipline for managing behavioral biases. These tools are an important addition to the advisor's value proposition. By managing behavioral biases, advisors help investors avoid the “behavior gap trap” identified by Dalbar.

In numerous discussions with advisors, I have discovered that many advisors have clients with a mix of strategies, just like my friend Rick. Over the last six years, these advisors have put together investment portfolios that include individual strategies that separately provided safety, managed volatility and achieved growth or accumulation. Just as I intuitively set up individual strategies to satisfy the several separate purposes Rick had as an individual investor, many talented advisors, like Rob Burns, have done the same for their clients. Rob is a bright and service-oriented advisor from Exeter, New Hampshire. In discussions with Rob on his experience with Personal Benchmark, he noted he similarly had clients with whom he had developed portfolios with a “mishmash” of investment strategies. For Rob, Personal Benchmark is a solution that consolidates this “mishmash” into a single innovation providing both behavioral bias management tools and scalable practice management tools.

Glenn McKinney, a sophisticated advisor with offices in Tampa, Florida and San Diego, California echoes Rob's view. Glenn agrees that Personal Benchmark provides an easy-to-grasp, comprehensive solution that systematically incorporates several separate investment strategies, each with a different purpose. And, through the behavioral finance overlay, Personal Benchmark adds additional risk management alongside portfolio construction.

Personal Benchmark's bucket design combines several strategies into one individually managed unit. That single image paints a clear picture of each investor's life goal. All of the buckets are reported together 24/7 on Brinker Capital's website and on a quarterly basis through performance reports. The objective is to make information easy to use thereby making the advisor's practice more scalable. At heart we want the advisor and client to communicate comfortably using natural language and without tedious jargon.

Rob Burns indicates that when appropriate he will continue to guide existing clients to convert portfolios with a mix of strategies into the Personal Benchmark solution. He also notes that he will introduce prospects and new clients to this innovation. However, he notes that the media and the investment industry have conditioned (brainwashed?) much of the public to think about their investment portfolios in terms of performance against indices rather than performance that pursues and achieves personal objectives. Designing portfolios to beat indices is a significant cause of the behavior gap trap. Why? Because investors want the return but not the risk generated by the S&P 500 Index. When risk happens in bear markets like 2001-2002 and 2008-2009, investors bail and wait for the "all clear," piling in when markets recover prior peaks.

The tendency to measure personal performance against indices is a behavior bias. It is about keeping up with the Joneses. As Mary Mack, CEO of Wells Fargo Private Wealth Management, said at the Tiburon Conference in April of 2014, "investment strategies are no longer about keeping up with the Joneses; they are about keeping up with the purposes (purchasing power goals) of the plan." Indices have a role in investor portfolio strategies; their role is not to set the purpose of or be the plan. Rather, the proper role of indices is to provide a grasp of the context within which

the plan is operating (risk assets should be doing well, or non-risky assets are doing well) and to measure how well the individual managers are doing in performing their specific role in the investor's portfolio strategy.

As of this writing, more than 135 advisors have placed \$152 million in Personal Benchmark. We expect the assets under management to reach \$250 million by year-end 2014. Adoption by advisors and investors is taking place. *(Note: all forecasts are reasonably held at the time of this writing but are subject to change without notice by Brinker Capital, Inc.)*

Our goal in writing this book and in creating the Personal Benchmark solution is to change the investment advisory conversation and thereby help investors avoid the behavior gap trap. By embedding behavioral finance in an investment offering, which includes Brinker Capital's multi-asset class investment philosophy, we are confident we are adding a key element to the investment advisor's value proposition and at the same time leading the way to a better investment experience for investors.

Some Acknowledgments

It is said that “victory has one thousand fathers.” This book and Personal Benchmark are the result of the insights and efforts of many, many people over the last three years. First, my co-author, Dr. Daniel Crosby, has provided an expertise in human behavior and behavioral finance that has been invaluable in writing this book and in designing the investment offering. To our joint efforts he has brought a sharp intelligence with an engaging clarity in his writing and presentations.

Many at Brinker Capital also made significant contributions to our project. Brinker Capital's Investment Group stepped

up and contributed a coherent, well-written articulation of our firm's investment philosophy. Special thanks go to Amy Magnotta and Dan Williams from the firm's investment group. More than three years ago in a series of meetings, Amy first identified that what I was doing in my investment advisory discussions with Rick was using mental accounting. That was an a-ha! moment. The path to embedding behavioral finance in our investment management philosophy was opened up. Dan Williams did a first-class job in editing the chapter on Brinker Capital's investment philosophy. Bill Miller, Jeff Raupp, and Andy Rosenberger each made significant contributions to this chapter as well.

Ali McCarthy, Brinker Capital's National Marketing Director, has kept this project on track and has created excellent marketing materials that explain the concepts that are the foundation of Personal Benchmark. Avery Cook, Brinker Capital's Senior Product Strategist, did an excellent job in overseeing the technical design and manufacturing of Personal Benchmark.

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Critical to shaping the content of this book and the Personal Benchmark solution have been the insights, advice, and support of many advisors. It is simply not possible to develop a concept like Personal Benchmark without testing it with the advisors who will lead its adoption. So, a special thank you to Craig Beden, Darryl

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Introduction

Come this way, honored Odysseus, great glory of the Achaians, and stay your ship, so that you can listen here to our singing; for no one else has ever sailed past this place in his black ship until he has listened to the honey-sweet voice that issues from our lips; then goes on, well-pleased, knowing more than ever he did; for we know everything that the Argives and Trojans did and suffered in wide Troy through the gods' despite. Over all the generous earth we know everything that happens.

—The Sirens, Homer's *Odyssey*

Odysseus, Greek king of Ithaca, is best remembered for his arduous 10-year journey home after the Trojan War, as well as the Trojan Horse he used to gain surreptitious access to enemy fortifications. As the protagonist in Homer's epic poem “The Odyssey” and returning character in “The Iliad,” Odysseus is painted as a fierce warrior whose strength was matched only by his cunning. And while Odysseus may be best remembered as a warrior, perhaps his most important action on his decade-long sojourn was an act of restraint rather than brute force.

In Greek legend, Sirens were dangerous creatures that enticed sailors to come close with their beauty and enchanting music, only to lead them to shipwreck along a craggy shore. In addition to their beauty, these femmes fatale were also thought to be wellsprings of knowledge that could be harnessed for personal gain, if not for the unfortunate footnote that hearing their words led to certain death. Odysseus and his men, aware that they would soon be sailing through the Strait of the Sirens, sought to

capture this knowledge without succumbing to the Sirens' fatal wiles.

After consulting with Circes, Odysseus arrived at a solution; he would have his crew fill their ears with beeswax while he would have himself lashed to the mast of the ship. Thus, he would be provided access to the wisdom of the Sirens' song, but not be able to act in a way that would endanger his life. As expected, as Odysseus heard the song of the Sirens, he flailed and begged his men to be unfettered. But true to the original game plan, they ignored their leader's protestations until they were safely out of harm's way.

It is easy to paint ancient narratives like this as dusty and irrelevant to the hustle and bustle of modern life. However, Homer's story of Odysseus and the Sirens is remarkably telling when considering the Siren song of irrational behavior that shipwrecks so many investors. Like the epic hero, we are drawn to the promise of great returns and want to charge headlong into battle. Just as Odysseus was a man of strength and action, many investors have been successful based on lives of boldness and proactivity. But in Odysseus, we find an exemplar of the ways in which sometimes the most prudent action is restraint.

In *Personal Benchmark: Integrating Behavioral Finance and Investment Management*, we outline the ways in which a program of embedded behavioral finance, fueled by what matters most to you, can be your protection against the Siren song of irrational financial behavior. Along the way, you'll learn how to improve your investment experience, increase returns formerly sacrificed to misbehavior, and worry less about "The economy" as you become increasingly focused on "My economy." Welcome to a new way of investing, a new paradigm for conceptualizing

wealth, and a system of turning emotion from your portfolio's worst enemy into its best friend!

This new way is coming none too soon, given that for the 30-year period ending December 31, 2013 the average investor underperformed the S&P 500 Index by -7.42 percent annually. This figure comes from the 2014 update of Dalbar's 30-year study, which reported the average stock market investor's annualized return for this period was $+3.69$ percent, compared to $+11.11$ percent for the S&P 500 Index.

Don Phillips, Managing Director of Morningstar and one of the investment industry's most respected voices, takes aim at this pathetic outcome and used the term *Dalbar Effect* to describe the tendency to make irrational investment decisions to the detriment of performance. Phillips noted at the Tiburon conference in New York City on April 8, 2014, "The *Dalbar Effect* happens even though many investors have advisors. The *Dalbar Effect*, therefore, is a collective report card for the advice industry." Phillips, recognizing an opportunity for advisors, demands, "We gotta manage the behavior gap."

This book introduces a breakthrough solution to manage the behavior gap. This innovation is Personal Benchmark, an investment solution that embeds the principles of behavioral finance in Brinker Capital's multi-asset class investment philosophy.

Initially introduced in May 2013, Personal Benchmark is attracting a diverse and expanding group of advisors as an elegant (simple to grasp, yet sophisticated) solution for advisors to use in designing and communicating investment strategies that both create purchasing power and manage the behavioral and investment conflicts that surface throughout the investment advisory process. Advisors are recognizing Personal Benchmark as a scalable investment