Simple but Not Easy

Morningstar's Guide to Helping Investors
Overcome Behavioral Obstacles

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Draft for review and feedback

When the markets start dropping, do you get a tinge of fear—followed rapidly by calls from your clients? Do your clients feel envious when they hear that other people's investments are beating theirs? Or, even worse: Do your clients feel disengaged, believing that everything will be fine as they pursue their long-term goals?

For both investors and their advisors, investing is clearly more than a mathematical analysis of risk and return. It's a struggle with ourselves: to tune out irrelevant information, to have the strength to stick to the plan and to resist the urge to follow the herd (except, of course, when it knows better than we do). Facing this internal struggle, investors—and their advisors—are often told to avoid the emotional roller coaster and magically remove emotions and temptation from the picture. No problem, right?

We're All Human

Over the last decade, a different approach has started to emerge within behavioral science—one that accepts the fact that we're all simply human. We're all imperfect. We have a limited attention span and an unlimited capacity to screw things up.

Behavioral scientists study how our fundamental wiring as human beings drives our behavior and how that can undermine our potential to build wealth in the markets over time. Instead of denying our limitations, researchers are learning how we can work with (or around) our human nature to become more informed investors.

Where This Guide Comes In

This guide covers behavioral science and investing and how advisors can practically apply that research to help their clients and themselves avoid common pitfalls. We've pulled together research findings from our behavioral science team at Morningstar, along with lessons from other researchers, to walk you through many challenges advisors often face from assessing client needs and goals to keeping them on track when markets tumble.

You'll learn more about behavioral techniques to help coach investors and gain practical tools to bring those lessons into the real world.

A Long Tradition

As we've applied behavioral research ourselves at Morningstar, we've been struck by the similarities between behavioral research on investor behavior and a much older tradition in the investing world: the tradition of valuation-driven investing from industry giants like Ben Graham and Warren Buffett.

Morningstar was founded by valuation-driven investors, and the same tradition guides our investment management group. We've found that classic works like *The Intelligent Investor* focus heavily on the very behavioral obstacles that researchers now study, and many of the solutions that researchers now offer are likewise similar.

It's for that reason that this guide is titled "Simple but Not Easy"—it's a famous investing quote linked to Warren Buffett which explains how the basic logic of investing is simple, but our psychology and emotions trip us up. We'll draw parallels between behavioural science and the older tradition of valuation-driven investment, for which Morningstar is a proud standard-bearer in today's market.

One final note as you dig into the materials: Put yourself in the shoes of your clients. By approaching behavioral finance from the perspective of an individual investor (rather than an experienced financial professional), you can perhaps better understand, empathize with, and recognize how to best coach your clients to success.

Steve Wendel
Head of Behavioral Science
Morningstar, Inc.

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Appendix: Resources to Learn More

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A

Attracting and Educating Potential Clients

Learn more about behavioral science and investing, for yourself and your clients.

Why We Shoot Ourselves in the Foot

Which of these should investors do:

a. Buy low, sell high (i.e., make a profit)
b. Buy high, sell low (i.e., put your money in a big pile and burn it)

Got your answer to that one? Great, now let's try another one. Please imagine you see a story that's all over the news. It's about a hot company with an amazing hit product, like the next Apple or Tesla. Should investors:

a. Check out the company and potentially invest
b. Ignore the news and invest as before

We all know that "a" is the right answer to the first question. But we're likely to be conflicted about the second question. You know it's a trick, and that "b" is probably the right answer. But "a" feels natural because words like "all over," "hot," and "hit" are all positive, and they tell us that lots of other people like the company. We're naturally drawn to things that other people like and find valuable (behavioral scientists call that "social proof").

Unfortunately, investing isn't natural. If other people like an investment, the price goes up. If the price goes up, all things being equal, you're buying high—which is like putting money in a big pile and burning it. Yes, there are many nuances here, like the fact that other people might drive the price up even more after you buy it (aka the "greater fool" theory). But putting aside the nuances and our innate temptation to try and outsmart everyone else in the world, that's one small part of the crazy logic of investing.

Who Cares?

So, investing is a bit crazy. Why does that matter? It matters because if we do what feels natural, if we don't understand the crazy world of investing, we can lose our money. This doesn't mean that we might "miss out" on a hypothetical future gain we might have had. It could be much more serious than that—it may mean failing to reach our goals.

Investing is fascinating, and it's often exciting and fun. But we can't ignore the dark underside. Investments are always risky, and there's always the chance of losing out. But, one of the big factors that make investments risky is our own behavior as investors. In a study, investors who actively traded stocks in the market made mistakes again and again—and had returns that were one third lower than that of average return.[1] Even investors who have invested in mutual funds have similar challenges—losing up to 3.11% of returns on average (some are better, some are worse).

As Ben Graham ,said in *The Intelligent Investor*: "The investor's chief problem—and even his worst enemy—is likely to be himself." So, what actually happens?

Figure 1: The gap between what investments offer and what the average investor actually receives—largely because of mistakes of timing.[2]

Mind The Gap 2016

	10-Year					
	Asset Weighted Return %		Average Return %			
Group	Total	Investor	Total	Investor	Return Gap	Number of Funds
US Diversified Funds	7.10	5.84	6.58	4.96	–0.74	2,440
US Sector Funds	6.72	5.53	5.27	4.12	0.26	549
Intl Equity Funds	4.41	2.67	3.91	2.13	–1.24	966
Allocation	5.58	4.50	4.67	3.73	–0.17	1,058
Taxable Bond	4.87	3.26	4.08	2.61	–0.82	1,376
Municipal	3.87	2.31	3.63	2.10	–1.32	808
Alternative	1.07	–0.80	–1.50	–1.65	0.70	136
All Funds	5.73	4.35	4.88	3.44	–0.53	7,351

Source: Morningstar, Inc. Data Trailing Through 12/31/2015.

What We Do Wrong

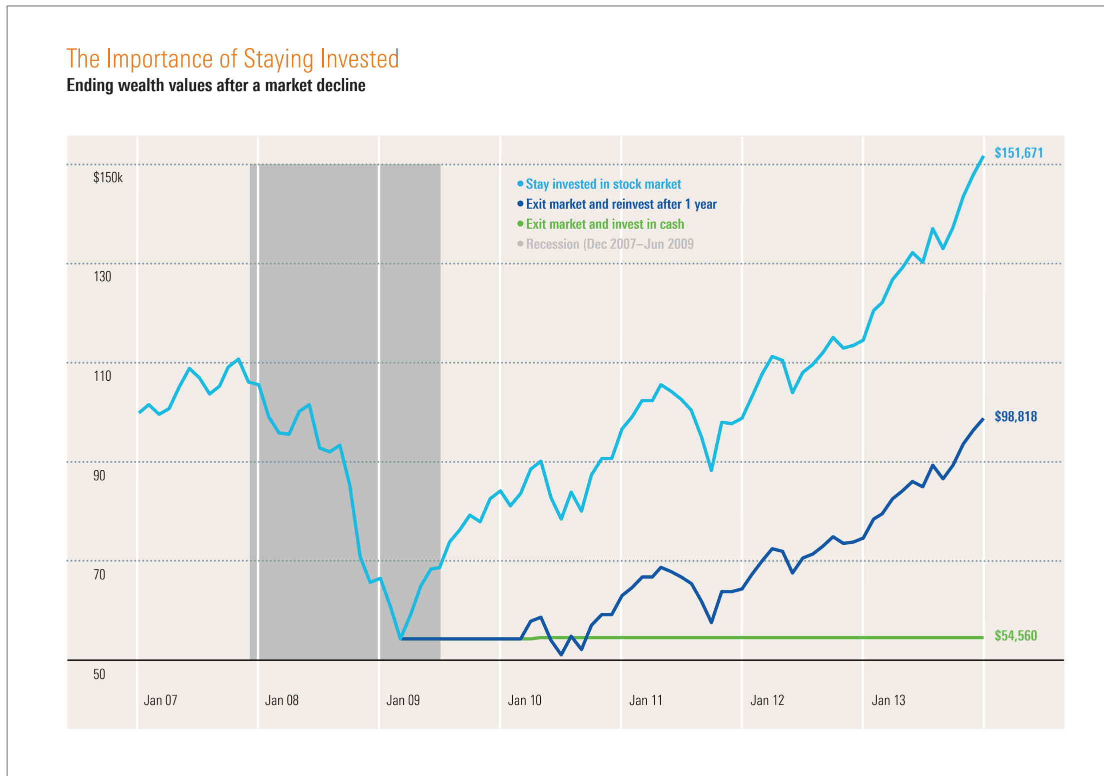
While there are many, many ways in which investors can run into trouble, three types of problems are very common:

- **Problem #1: Chasing returns.** If you've ever watched stations like CNBC or talked with friends about the stock market, you've probably felt the urge to invest in a new hot stock or sector. The problem is this: so does everyone else.

- **Problem #2: Exiting the market during downturns.** When the markets get jumpy, people ask themselves (and their advisors), "Is the market going to fall more, and should I get out of the market?" Unfortunately, it's impossible to tell whether a drop in the markets will continue, or whether it will rapidly turn around. In the extreme, Morningstar research shows that if investors pulled out of the market and missed the 10 best upswing days from 1992-2012, they'd have lost 45% of their returns.[3]

- **Problem #3: Picking inappropriate investments.** Investors are inundated with information about investments. It can be overwhelming, so we often go with what feels right. Unfortunately, for complex issues like asset allocation, diversification, and portfolio selection, the details matter, because they help drive long-term growth and determine whether we actually reach our goals.

Figure 2: Exiting during downturns can seriously impact long-term wealth.[4]



Dangerous Shortcuts

Investors face complex, multifaceted questions. Will markets fall, and for how long? Will these investments rise and fall together? Is the price reasonable? Answering these questions wisely requires a tremendous amount of information. It's more than one person can handle.

So, our minds take shortcuts, which make the task of investing feasible, but introduce mistakes that can end up costing us. Perhaps the simplest and most pernicious shortcut is to copy what other people are doing, but there are many others.

Forcing It To Be Simple

When faced with overwhelming complexity, our minds often avoid a decision altogether or simplify it to a level we can handle.

- Avoiding a decision means taking no action until we're forced to, which can be disastrous, for example, when millennials are deciding whether to start investing or not.
- We often simplify complex choices by focusing on a single piece of data. That's one reason investors appear to underappreciate the importance of investment fees—we focus instead on historical performance or other, more exciting attributes.

Researchers found that one of the most common "investing strategies" investors use when selecting options in their 401(k) is to choose "a little bit of everything."[5]

Rules of Thumb

Another way we simplify complex choices is to use simple rules of thumb to guide us. If there are 10 options, investors might put 10% of their investment in each one, even if one is already well diversified. Famously, Nobel Laurate and modern portfolio theory pioneer Harry Markowitz used that rule of thumb when he made his own selections. Our minds automatically take shortcuts behind the scenes.

If Only We Knew

Perhaps the most troubling aspect of using these shortcuts—also known as behavioral biases—is that we don't know it's happening. Even when we know, we can't just turn them off.

Why? They are part of the automatic part of our brain, outside of our conscious awareness. The answers they come up with "feel" right to us. We can't avoid using the shortcuts because our minds can't handle the underlying math that some investment decisions require.

So, logically knowing what to do isn't enough. As investors, we're really good at knowing the right thing to do and inconsistent about actually doing it. Thankfully, that's not the end of the story.

1. See Barber, Brad M., and Terrance Odean. "Trading Is Hazardous to Your Wealth: The Common Stock Investment Performance of Individual Investors." The Journal of Finance 55, no. 2 (April 1, 2000): 773–806. Their research focused on the boom years of the 1990s, in which a 33% decrease in returns correspond to 6.5 percentage points. Subsequent research has also shown large gaps, in the U.S. and internationally– see Barber, Brad M., and Terrance Odean, "The Behavior of Individual Investors." SSRN Scholarly Paper. Rochester, NY: Social Science Research Network, September 7, 2011.
2. Kinnel, Russell. "Why Investors Lag the Returns of their Funds." *Morningstar Advisor*, April 16, 2013.
3. Morningstar Investment Services LLC. "Fundamentals for Investors 2014." Morningstar white paper, 2004.
4. This chart is provided for illustrative purposes only and is not indicative of any specific investment. The image illustrates the value of a $100,000 investment in the stock market during the period 2007–2014, which included the global financial crisis and the recovery that followed. The value of the investment dropped to $54,381 by February 2009 (the trough date), following a severe market decline. All recoveries may not yield the same results. Returns and principal invested in stocks are not guaranteed. Stocks have been more volatile than bonds or cash. Holding a portfolio of securities for the long term does not ensure a profitable outcome and investing in securities always involves risk of loss. Recession data is from the National Bureau of Economic Research (NBER). The market is represented by the Ibbotson® Large Company Stock Index. Cash is represented by the 30-day U.S. Treasury bill. An investment cannot be made directly in an index. The data assumes reinvestment of income and does not account for taxes or transaction costs.
5. Benartzi, Shlomo, and Richard H. Thaler, "Heuristics and Biases in Retirement Savings Behavior", *The Journal of Economic Perspectives* 21, no.3 (2007): 81-104

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Investments in securities are subject to investment risk, including the possible loss of principal. Prices of securities may fluctuate from time to time and may even become valueless. Before making any investment decision, you should read and consider all the relevant investment products offering documents and information. You should seriously consider if the investment is suitable for you by referencing your own financial position, investment objectives, and risk profile before making any investment decision or by consulting with your advisor. There can be no assurance that any financial strategy will be successful.

Common Investor Biases and What to Do About Them

Many of us are wired to make mistakes in the market, with common errors (or "biases") like being overconfident in our ability to pick stocks, focusing unduly on recent returns, and underestimating the power of compound interest. The research on these biases is extensive and spans many decades of work. Here's a quick summary of the key lessons from this research, which you can use as a starting point for conversations with clients and for further learning.

If there's one overriding lesson in the research, it's this: We're hardwired for these biases, and the most common advice in the investment community—telling investors to just be smart and resist them—is woefully insufficient. Instead, we should look for clever ways to hopefully avoid or short-circuit these biases.

Overconfidence Bias

WHAT IS IT: Being overly optimistic about one's likelihood of success. For example, investors often falsely believe they can select investments better than others and can outperform the market.

HOW TO TACKLE IT: Educating investors about the prevalence of overconfidence appears to be effective. That means not telling an investor that she is being overconfident, but instead educating her about the fact that all investors tend to be overconfident. Note: If an investor is overconfident about having enough money for retirement, see the "present bias" entry for other interventions.

Confirmation Bias

WHAT IS IT: Subtly seeking out and paying more attention to information that supports one's viewpoint. For example, confirmation bias would be believing that a particular company or sector will do well in the future, and then "finding" information online that agrees.

HOW TO TACKLE IT: Ask the investor to list reasons that others might give against their viewpoint (i.e., to carefully think through an opposing viewpoint). Another technique is called "prospective hindsight," in which you ask investors to imagine a future in which they learn that they were wrong, then ask them to explain why that happened.

Recency Bias (Related: Representativeness Bias)

WHAT IS IT: Focusing unduly on recent events and using them to judge the future. For example, believing that an investment's recent stellar performance means it will do well in the future.

HOW TO TACKLE IT: Show the investor vivid, powerful examples of when buying after stellar performance led to disaster, like the run up to the 2008 bust. Statistics alone aren't enough; the more vivid and easy to remember the example, the better. In addition, you can arm investors with an alternative way to interpret past performance with easy-to-remember rules. For example, "when prices go up, the opportunity to profit usually goes down," or "the danger of losing money usually goes up as prices rise."

Disposition Effect

WHAT IS IT: Holding onto investments that have lost relative value for too long to avoid the regret of having made a bad decision, or selling stocks too early that gain in price. This is related to loss aversion: our overweighting and fear of losses relative to gains.

HOW TO TACKLE IT: Set guidelines for when to sell before investors are caught up in the emotions of regret and fear.

Present Bias

WHAT IS IT: Not taking future needs seriously enough and focusing on the present instead. For example, not putting aside enough for one's investments to have a comfortable retirement.

HOW TO TACKLE IT: As an advisor, you can ask investors to list each of their likely expenses in retirement, and prompt them for ones that are missing. For many investors, the amount they'll need is surprising, and it makes the future more real. Another technique is to try to make retirement more vivid and real for the individual with age-progressed images of their faces, detailed descriptions of where the investor would like to live, and so forth. In addition, you can ask clients to pre-commit to saving more when they receive their next raise or bonus.

Choice Paralysis

WHAT IS IT: Becoming overwhelmed with the complexity of a decision, and avoiding it or putting it off. For example, when investors are faced with a complex menu of 401(k) investments, some will become paralyzed by the daunting decision. Ironically, investors often ask for more complexity and a wealth of options, but often falter when actually confronted with them, which is known as the "paradox of choice."

HOW TO TACKLE IT: You have two main options as an advisor. You can try to remove the complexity altogether by reducing the number of options or data points about the investments. However, that can turn off your power-investors. Alternatively, you can make complexity easier to manage by providing a quick-and-easy summary for those who need it (with two simple "preferred options" to choose from, for example), and supplying the details in appendixes or online resources for those who want it.

There are dozens of such biases that researchers have identified, but these six cover many common scenarios and are a great place to start. Check the appendix for resources where you can learn more.

Three Ways to Do Better

How can you help investors overcome these challenges? The key is to remember that it's how we're wired. Everyone—no matter how smart you are.

We can't overcome these problems by force of will; instead, we have to remove our human frailties from the equation, or put tremendous time and energy into avoiding these mistakes.

Here are three basic strategies for avoiding these common mistakes.

1. Dedicate Your Entire Life to Investing (and Psychology)

Great valuation-driven investors (Buffett, Munger, Graham, etc.) show that this is possible. But these people not only dedicate their lives to it; they hire teams of others, gather extensive data, and buy specialized analytical software.

If you (and your clients) want to go down that route—great! But most individual investors just want to dabble, not live and breathe investing. Watching the news or reading the papers give individuals the illusion of special insight or information—but they'll usually be crushed by people who devote their lives to the process.

2. Outsource

Many investors realize the limitations they face and turn to third parties for help. In a poll of investors, roughly half of Americans who invest had consulted with professional advisors.[6]

That's because advisors are more likely to be the valuation-driven professionals described above. They're also more likely to study investor psychology (you're reading this guide, after all) and strategies to help their clients overcome behavioral challenges.

3. Keep It Simple and Use Autopilot

Our minds will take shortcuts, no matter what we do. One way to avoid this is to stop thinking and go with simple passive strategies. Many retirement plans do this—they help make saving and investing in appropriate vehicles automatic. That's what some online apps try to do as well.

This autopilot, though, contains two challenges. First, if investors overreact during market volatility and change or remove their investments, it's meaningless. Second, autopilots don't consider whether investors really need to re-engage—like when participants in a retirement plan change jobs.

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6. Saad, Lydia. "U.S. Investors Seek Advice for Some Things More Than Others." Gallup.com. Accessed April 25, 2016. The underlying poll is titled the "Wells Fargo / Gallup Investor and Retirement Optimism Index".

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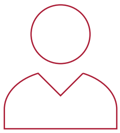
Our Investment Management Group's Approach

Nobody is immune from the curse of investment biases, not even the authors of this guide. Investing isn't easy. At Morningstar, our Investment Management group[7] (the people who dedicate their lives to the process) devised a set of investment principles to help stay on track. The principles combine valuation-driven investing with lessons from behavioral science.

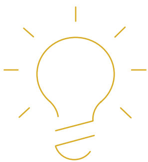
We thought we'd share them with you to explain one of the ways the Investment Management group applies this research in their own efforts. Hopefully this can also inform your own efforts to overcome behavioral obstacles and invest wisely.



We put investors first. We believe when a firm puts investors first, they win in the long term because their investors are more likely to win.

WHY IT MATTERS: Financial services companies that promote their own high-cost funds over cheaper alternatives or allow conflicts of interest to hijack their actions, for example, do not have investors' best interests in mind.

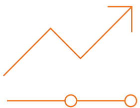
Our Investment Management group doesn't have any in-house funds, so we avoid this trap. We also employ behavioral research to reinforce our commitments and help ensure we're following through. We also align some of our portfolio managers' incentives with the long-term performance (after fees) that investors experience.



We're independent-minded. To deliver results, we think it's necessary to pursue our research conclusions, investing with conviction even when it means standing apart from the crowd.

WHY IT MATTERS: Herding is commonplace in investing. It generally delivers average results in normal times and can drive destructive booms and busts. Meeting your investment goals may often mean acting independently from the herd.

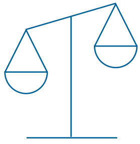
Our Investment Management group watches what other investors are doing in the market and checks to see if our investment decisions are too similar—if they are, we may need to course-correct.



We invest for the long term. Taking a patient, long-term view helps people ride out the market's ups and downs and take advantage of opportunities when they arise.

WHY IT MATTERS: Investors often overemphasize the importance of recent events, rushing into hot stocks when they're overpriced and fleeing from market downturns. Investors can fight this common error by focusing on long-term lessons and long-term performance.

Our Investment Management group concentrates on fundamental, long-term value drivers, selecting investments we believe we can and should hold for the long haul, then measuring how long we hold them in practice.

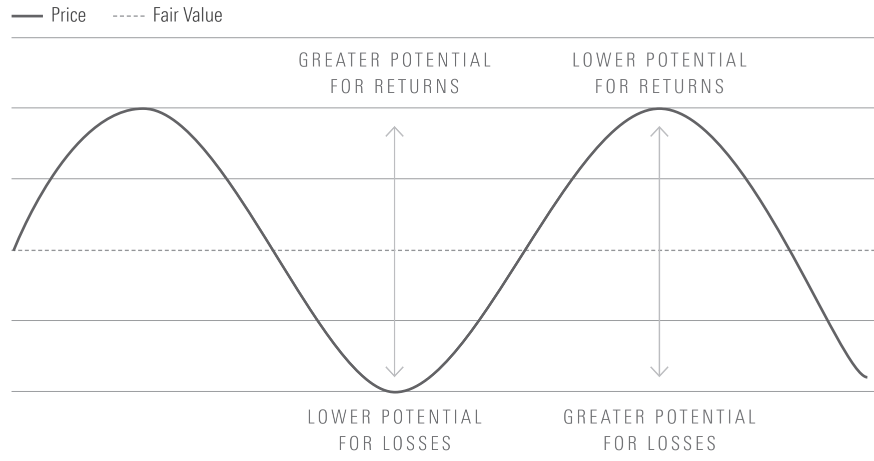


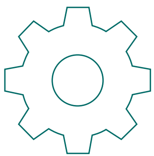
We're valuation-driven investors. Anchoring decisions to an investment's fair value — or what it's really worth — can lead to greater potential for returns.

WHY IT MATTERS: Our minds are hard-wired to find patterns in everything, but much of the market's daily volatility is just meaningless noise. Researchers have found that in the long term, the underlying value of a company, relative to its price, drives performance.[8]

Our Investment Management group assesses investments on the relationship between current price and intrinsic value, to help minimize the cognitive impact of short-term fads and noise. For example, instead of talking about a price going down (which can trigger herd behavior), we talk about expected returns going up.

Figure 3: An image we use at Morningstar to think about expected returns, and to reframe price volatility as a good thing.

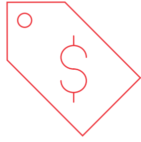




We take a fundamental approach. Powerful research is behind each decision we make, and we understand what drives each investment we select.

WHY IT MATTERS: Researchers find that investors base decisions on dangerous shortcuts: from the spelling of fund managers' names to whether friends have mentioned a particular company before. Investors use these meaningless characteristics to judge whether an investment is worthy and then concoct convincing stories about why these investments are good, and subtly seek out data that confirms those conclusions.

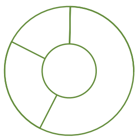
Our Investment Management group structures our analysis around the fundamental characteristics of each company, including its cash flow, balance sheet, and potential for a sustainable competitive advantage to keep our focus on facts that really matter.



We strive to minimize costs. Controlling costs helps investors build wealth by keeping more of what they earn.

WHY IT MATTERS: Investors face a barrage of information, and our minds tend to focus on one or two narrow characteristics. So, investment companies rarely highlight their fees to avoid investor scrutiny. But, while returns are volatile and uncertain, fees aren't; they will eat away at an investor's money.

Our Investment Management group targets funds for investments that have fees in the least-expensive quartile of their respective categories and purchases special lower-fee versions of funds where possible.



We build portfolios holistically. To help manage risk and deliver better returns, we combine investments with different underlying drivers into truly diversified portfolios.

WHY IT MATTERS: Our minds like compelling stories—stories about companies, strategies, and managers. These stories can help us tune out overwhelming details and make us more comfortable. Diversification and strategic asset allocation are rather boring by comparison.

Our Investment Management group embraces diversification. By taking the story out of the equation, we can create portfolios designed to lower risk for individual investors.

Morningstar's Investment Management group uses these principles to keep managed portfolios on track—to serve investors for the long term and overcome common behavioral obstacles along the way. While no approach is perfect, these guiding principles help the Morningstar investment team focus on consistent strategies that tend to deliver superior risk-adjusted returns long-term.

7. Morningstar's Investment Management group includes subsidiaries of Morningstar, Inc. that are authorized in the appropriate jurisdiction to provide consulting or advisory services in North America, Europe, Asia, Australia, and Africa.
8. Kinniry, F. M., Colleen M. Jaconetti, Michael A. DiJoseph, and Yan Zilbering. "Putting a Value on Your Value: Quantifying Vanguard Advisor's Alpha." The Vanguard Group (2014). Available at http://www.vanguard.com/pdf/ISGQVAA.pdf.

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It does not ensure a profit or protect against a loss.

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B

Assessing Client Needs

Resources for talking with clients about their overall financial picture and their financial "personality."

What to Expect

When individual investors start working with an advisor to chart their financial journey, it's often a long and personal relationship, and for the process to work, you should let them know what role they play in the planning process and what to expect from you.

The Advisor's Role

An advisor acts like a personal trainer: helping investors to develop a plan, form good habits, and coach them along when they struggle. Beyond working to understand investors' personal goals and improve their financial state, you must help your clients navigate the investment challenges they might face from a variety of circumstances, including downturns in the market to lifestyle or personal changes that affect their finances.

Relative to performance, you will be there to keep your clients updated on progress, adjust the plan when necessary, and coach every step of the way. In fact, according to a study by Vanguard[9], the coaching process is remarkably important—driving returns of up to 1.5% more for those who work with advisors vs. those who don't.

The Investor's Role

To help an advisor develop an effective plan, investors should be as transparent as possible. The relationship should be deep and honest. At the start, your clients are expected to have some difficult conversations with you, especially considering how personal and private financial health can be. They must be willing to open up about:

- Personal goals, and what that means for their finances.
- Willingness to take investment risks, or help you assess their risk tolerance.
- How long they hope to invest before reaching their goals, or their investing horizon.

The key to the whole relationship is honest, regular communication, and it's important for you to understand their expectations up front, including how frequently they want updates and their meeting preferences. Agreed-upon regular updates can help investors maintain the direction and discipline they need to invest effectively—and calm their anxiety about how volatility affects their long-term prospects and whether they're expected to act.

Morningstar's Role

Morningstar's Investment Management group's experienced team also supports you with materials that can help your clients develop financial proficiency, specialized market analyses, and portfolios[10]. Advisors turn to Morningstar and its Investment Management group for investment tools and independent research to help guide their recommendations, clearly communicate how to aim for better results, and help investors advance toward their goals.

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9. Bennyhoff, Donald G., and Francis M. Kinniry Jr. "Advisor's Alpha."Vanguard research paper. (2013). Available at https://personal.vanguard.com/pdf/icraa.pdf.
10. Morningstar® Managed Portfolios℠ are offered by the entities within Morningstar's Investment Management group, which includes subsidiaries of Morningstar, Inc. that are authorized in the appropriate jurisdiction to provide consulting or advisory services in North America, Europe, Asia, Australia, and Africa. In the United States, Morningstar Managed Portfolios are offered by Morningstar Investment Services LLC or Morningstar Investment Management LLC, both registered investment advisers, as part of various advisory services offered on a discretionary or non-discretionary basis.

A Holistic View

As you help your clients plan their investment strategy, it's natural to talk with them about their overall financial picture and long-term goals. As you know, it's more than just a nice conversation—it's part of a systematic approach to helping them meet those goals. Two key elements of holistic planning are goals-based investing and a "total wealth" approach.

Goals-Based Investing

It's all too common for investors to have a number of independent financial goals, but no real formal plan to achieve them. This problem is compounded when goals (such as retirement savings, college tuition, weddings, travel, or paying off loans) overlap or even conflict. For example, investors may have a vision for their lives in retirement and may think a 401(k) they started in their 20s will get them there, but don't understand how other goals can divert their journey.

Advisors can use goals-based planning to help clients prioritize goals and find the best way to reach them. Rather than simply investing for its own sake, goals-based investing gives them something concrete and meaningful to strive for. It helps them connect investments to what really matters: family, future experiences, and personal needs.

An advisor can use goals-based planning to help clients think about not only risk tolerance but also "risk capacity"—the amount of risk an investor should take to best meet goals.

Total Wealth Approach

As you know, your clients' investments, such as your 401(k) savings or brokerage accounts, represent only individual parts of their total wealth. A "total wealth" approach looks at the big picture: financial capital, human capital, pension wealth, housing wealth, partner's wealth, job, age, location, family situation, and other personal circumstances.

Using a comprehensive planning approach, you can help clients more accurately determine what they will need to save to meet goals and better plan for their future. For example, a tenured professor is less prone to experience a layoff and more likely to have guaranteed retirement income. A trader at a Wall Street firm or a professional football player are both more likely to lose their jobs at a relatively young age—and need to save and invest in other ways to compensate. The clearer the overall picture, the better you can collaborate with clients, help find potential problems, and build a holistic plan.

The information, data, analyses, and opinions presented herein do not constitute investment advice, are provided solely for informational purposes and therefore are not an offer to buy or sell a security. The entities within Morningstar's Investment Management group do not guarantee that the results of their advice, recommendations, or the objectives of portfolios invested in their strategies will be achieved or that negative returns can be avoided. Asset allocation and diversification are investment methods used to help manage risk. They do not ensure a profit or protect against a loss.

Investments in securities are subject to investment risk, including the possible loss of principal. Prices of securities may fluctuate from time to time and may even become valueless. Before making any investment decision, you should read and consider all the relevant investment products offering documents and information. You should seriously consider if the investment is suitable for you by referencing your own financial position, investment objectives, and risk profile before making any investment decision or by consulting with your advisor. There can be no assurance that any financial strategy will be successful.

Understanding the Total Financial Picture

This worksheet will help you and your advisor get a holistic view of your finances.

How It Works

We all know the simple cash-flow budgeting model: **Income-Expenses = Savings.**
Likewise, we know how to calculate net worth: **Assets-Liabilities = Net Worth.**
However, many people don't learn how to connect the two concepts in a way that helps them to see how their monthly savings (or debt accrual) adds or subtracts from their net worth over time.

> When we only deal with numbers on balance sheets, we see how we are spending, but we do not address why we make the choices we do.

To help you and your advisor see the bigger picture of your finances, you'll connect the concepts of economics with your underlying personal motivations. We do this with the Personal Economy Worksheet.

The key idea is to look beyond the numbers and understand how each person has their own "personal economy." The concept of a personal economy is based on how someone uses their resources to meet their needs.

There are three types of income-producing resources in your personal economy: land, labor, and capital. Taking stock of them will not only help calculate your net worth, but also show what resources you may be able to leverage to increase your income potential. On the other side, every expense or liability can be mapped to a human need. Some of these needs are obvious (a car meets a physical need) but others might be more subtle (the same car might meet some emotional needs as well).

A Better Way to Find Money to Save and Invest

When people want to increase saving, they often begin by trying to cut expenses. By first identifying the underlying needs each expense meets, you can better decide how to meet the same needs with less-expensive strategies.

For example, if someone is spending excessively on luxury clothing or personal products, removing this completely might threaten their needs for comfort, relaxation, and self-expression. Finding other outlets for these emotional needs is important, or the person won't stick to the plan.

How to Use the Personal Economy Worksheets

1. **First, map out what you know: income and expenses.** What do you spend money on each month, and where do you currently receive money? That's how money flows through your life.

2. **Second, think about why you earn that income, and why you spend money on those things.** What are the underlying resources and needs that drive each of them?

In terms of resources, map out what generates your income, and what do you have that could generate income in the future?

An easy way to categorize resources is to think about them in three areas: **labor** (your skills and your effort, which generate things like salaries, bonuses, and even spousal support), **land** (your house, separate rental properties, etc.), and **capital** (financial assets, cars, physical possessions, specialized tools and machinery).

In terms of needs, map out the benefits you get from your purchases, or the needs you are trying to fulfill. There are many systems for thinking about one's needs (like Maslow's Hierarchy), but a nice and nearly comprehensive one is to think about **survival**, **security**, **emotional wellness, esteem**, **self-actualization**, and **spiritual needs**.

Categorizing these needs is not a judgment of their worth. We're not separating items into "real needs" and "frivolous wants;" instead, we're accepting that there's probably a reason we spend money the way we do.

Resources and needs are what causes money to flow through your life. They aren't strange external forces; they are under your control.

3. **If you aren't meeting your financial goals, then we have two tools you can use.**
   a. You can find other strategies to meet your needs. For example, other things you can do or buy to provide shelter, happiness, etc. for you and your family. That might be meeting a need for entertainment by spending a week hiking with friends instead of going on an expensive cruise.

   b. You can find other ways to generate income from your resources. For example, renting out specialized tools and machinery, employing an underutilized skill at your current job or a new one, or, over time, switching to less-expensive cars or homes.

The next page has a sample worksheet, so you can see how it works.

Cash Flow

Income

Salary 1	$ ______
Salary 2	______
Child Support	______
Spousal Support	______
Bonuses	______
Commissions	______
Supplemental Work	______
Primary Residence	______
Rental Property	______
Savings Accounts	______
Brokerage Accounts	______
Other	______
IRA	______
Roth IRA	______
401(k)	______
Other	______
Home Furnishings	______
Personal Effects	______
Automobiles	______

Total Income $

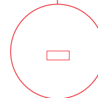
Now that you've done a standard cash flow, the next step is to think about how your assets connect to your day-to-day income. How are you using your resources to build up a store of income-generating assets that will support you after you stop working?

Expenses

Credit Cards	$ ______
Personal Loans	______
Auto Loans	______
Business Loans	______
Student Loans	______
Mortgage (Primary)	______
Mortgage (Rental(s))	______
Life Insurance	______
Auto Insurance	______
Home/Renter's Insurance	______
Mortgage Insurance	______
Health Insurance	______
Groceries	______
Rent	______
Utilities	______
Phone/Cable/Internet	______
Clothing	______
Child Care	______
Educational Expenses	______
Auto (maintenance, tax, etc)	______
Prescriptions and Copays	______
Pet Expenses	______
Entertainment	______
Restaurants/Bars	______
Subscriptions	______
Membership Fees	______
Gifts	______
Home Maintenance/Decor	______
Hobbies	______
Miscellaneous/Buffer	______

Total Expenses $

Similarly, your liabilities and expenses all trace back to your underlying needs. How can you reduce the day-to-day expenses you are generating while still meeting all of your needs?



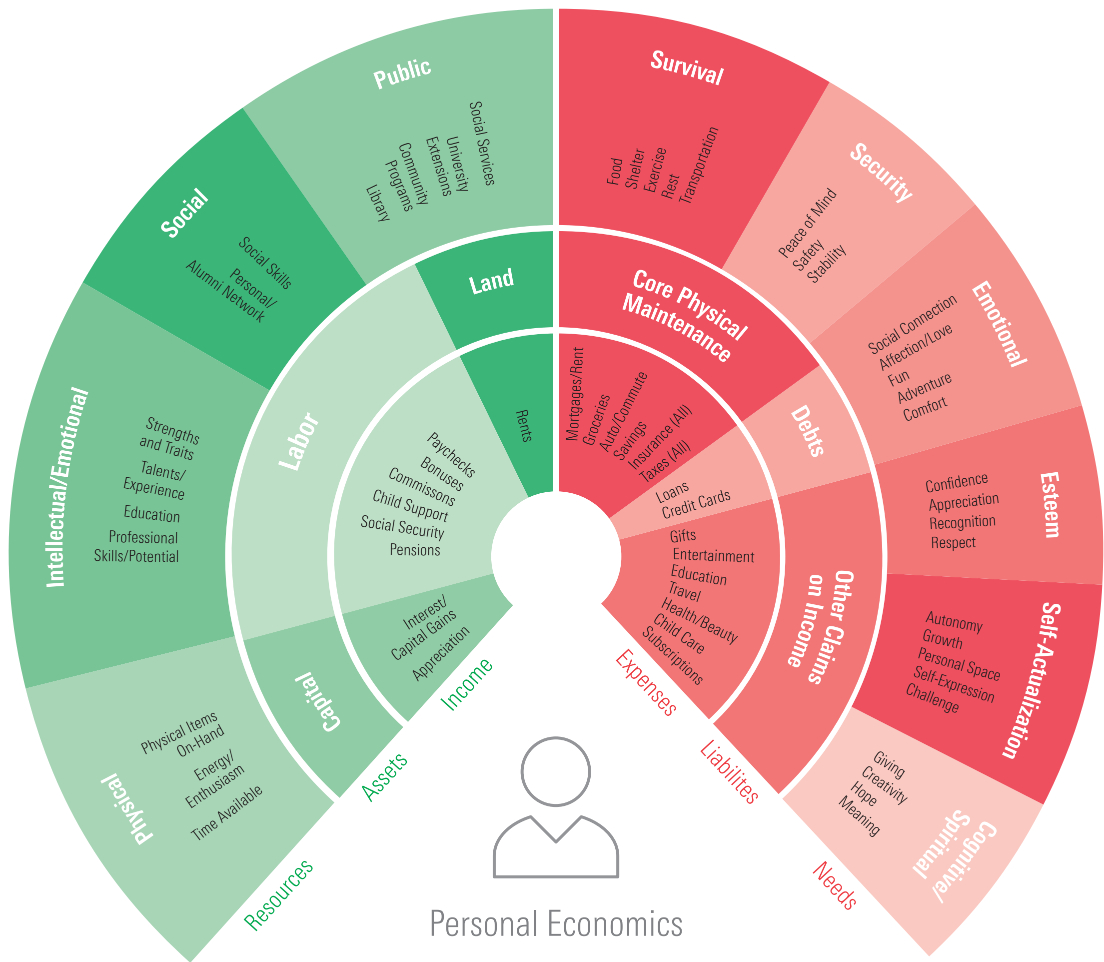
$

MONTHLY CHANGE IN NET WORTH

Your Personal Economy

These diagrams illustrate how the income and expenses we manage in our day-to-day life can be mapped to the resources and needs that produce them. For example, your degree, experience, and time all combine as skilled labor, which in turn creates a specific income stream. You are the asset, not your income. On the other side, your mortgage payment helps you meet your needs for security, safety, comfort, beauty, and connection with family and friends. Therefore, when you spend money, it's transformed into something else that serves a need.

Your Personal Economy



Assessing a Client's Financial Type

How It Works

Several psychological factors affect financial decision-making. The Financial Personality Matrix combines three of the most influential aspects into one easy-to-use framework.

With the Financial Personality Matrix, the answers to five simple questions can help you to understand your clients' underlying financial psychology. The results can help you provide personalized advice that targets each client's strengths and weaknesses and helps coach them toward healthier financial attitudes and behaviors over time.

FACTOR ONE: Time Perception

We all hate to wait, but some people actually experience time delays as being longer and more painful than others. A person's "mental time horizon" (as opposed to their financial time horizon) will have a large impact on how patient they are, and it can even predict whether they are at-risk for high debt/income ratios.

Impatient people feel time delays as more painful, and they have higher discount rates than their more-patient peers. Additionally, people who think farther into the future and picture the future using clear and detailed mental imagery tend to display more patient financial decisions.

FACTOR TWO: Locus of Control

Is your life determined by fate, a higher power, or chance? Do you believe that you create your own destiny? A person's locus (center) of control refers to their beliefs about how much control they have over their lives. A person with an external locus of control believes that forces outside themselves determine the course of their life. A person with an internal locus of control believes that he or she is responsible for creating their own destiny.

Locus of control has been shown to correlate with many behavioral factors, and it may even determine the emotional experience clients have when dealing with their money. Preliminary research at HelloWallet in 2015[11] showed that, regardless of income, people with an internal locus of control felt more peaceful and satisfied with their money, while those with an external locus of control had higher levels of anxiety and stress related to their finances.

FACTOR THREE: Emotional Drivers

The emotional meanings we associate with money can have a profound impact on our spending and saving choices. To some, the idea of great wealth inspires feelings of excitement, desire, and even lust. Others may find great wealth threatening to their way of life, and fear that they will become a target for the hostile envy or greed of others. Anxiety can lead people to hoard or hide wealth, and rob them of the ability to enjoy what they have. Beyond these extreme emotional responses is the feeling of peace and stability that can be achieved when one's financial life is in good order. Stability motives do not arise from fear, but from a balanced desire to maintain financial security while enjoying the pleasures of wealth in moderation.

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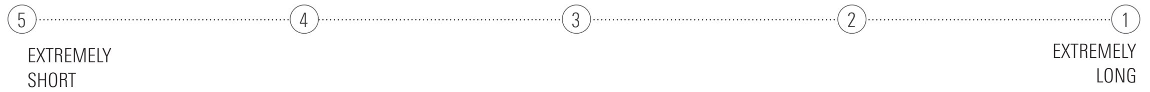
11. HelloWallet is a personal finance company that develops online applications to help people save for the future and manage their money. HelloWallet, 2015.

Your Financial Personality

Answer these five simple questions, and your advisor will help you understand your unique perspective on investing.

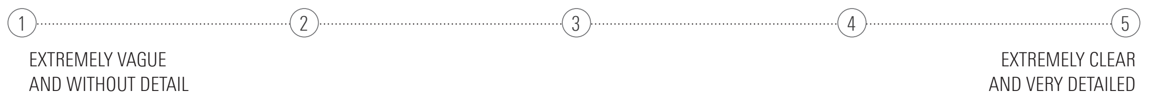
1. Please mark on the line below how long a 1-year wait feels to you?



EXTREMELY SHORT

EXTREMELY LONG

2. When you think of your life 10 years from now, how clear and detailed is your mental picture?



EXTREMELY VAGUE AND WITHOUT DETAIL

EXTREMELY CLEAR AND VERY DETAILED

3. How far ahead do you tend to think and plan?

1. Less than a month
2. 1-6 months
3. 6 months to a year
4. 1-5 years
5. 5-10 years
6. 10 years or more

4. Please mark the answer which is closest to your personal feelings about your financial life.

a. I create my own financial destiny.
b. My financial life is mostly in my control, but chance/God/other people play a small part.
c. I play a small role in my financial life, but chance/God/other people play a larger part.
d. I have little to no impact on my financial life.

5. Which of the following do you most strongly associate with wealth?

a. Opportunity, fun, freedom, excitement, luxury, etc.
b. Security (Peace of mind, safety, long-term stability)
c. Vulnerability (Being a target for fraud, scams, or the judgment of others)

Interpreting the Results (Scoring)

Mental Time Horizon

Question 1:
Score on a reverse scale of 5-1 (5 = Extremely short, 1 = Extremely Long) ________

Question 2:
Score on a scale of 1-5 (1 = Extremely vague and without detail, 5 = Extremely clear and detailed) ________

Question 3:
Score on a scale of 1-6 (1 = Less than a month, 6 = 10 + years) ________

Add up the total scores for questions 1-3. Answers will range from 3 to 16.
Scores between 3 and 8 = Short-Term focus. (Bottom half of the matrix)
Scores between 9 and 16 = Long-Term focus. (Top half of the matrix)

Locus of Control

Question 4:
If they answered (a) or (b), they have an Internal Locus of control. (Left-hand side of the matrix)
Answers (c) or (d) indicate an external locus of control. (right-hand side of the matrix)

The combination of time horizon and locus of control will place each client in one of the four quadrants. For example, someone with an external locus of control with a short-term focus would be in Quadrant D.

Emotional Motivation

Question 5:
Within the quadrant indicated by the answers above, circle the emotional subtype as follows:
If they answered A: Desire driven, B = Stability driven, C = Fear driven.

Financial Personality Matrix

LONG-TERM FOCUS

A

Long-Term Focus, Internal Locus of Control

People in this quadrant will tend toward good savings habits and long-term investment strategies. They will generally have a positive emotional experience with their money.

B

Long-Term Focus, External Locus of Control

May have higher financial anxiety. Watch for signs of passivity in financial decisions.

C

Short-Term Focus, Internal Locus of Control

May have generally positive feelings about their finances, a short-term mental focus is inherently problematic with respect to long-term planning. Look for ways to lengthen their view in small increments over time.

D

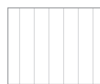
Short-Term Focus, External Locus of Control

This is the most at-risk type. The combination of short-term focus and external locus of control can result in high debt and high anxiety. Empower them by working toward small, manageable savings goals and building their financial skills over time.

SHORT-TERM FOCUS

INTERNAL CONTROL

EXTERNAL CONTROL



Desire Driven People with a desire-driven personality are excited by the pleasures, luxuries, and experiences that money can buy. They tend to equate material possessions with personal success, and so they enjoy and admire shows of wealth. People in this sub-type can be at risk for over-spending. It is important to help desire-motivated people identify ways they can enjoy themselves and gain esteem while keeping spending within their means.

Fear Driven People who are driven by fear can have high financial anxiety. They may anticipate worst-case scenarios or consistently ask 'what if?' While it is wise to be prepared for the unexpected, extremely fear-driven individuals can miss out on the enjoyment of their wealth. Help clients with this tendency by offering examples of how good planning and decision-making can reduce the risk of their worst-case scenarios coming to pass.

Stability Driven Those who did not score high on the fear or desire subscales are at lower risk for financial mismanagement arising from emotional motivations.

C

Analyzing and Planning

Extra tools to assist your analysis and planning efforts—like helping clients commit to an agreed-upon plan.

Letter to Your Future Self

How It Works

Commitments can be hard to keep. However, some promising research shows that we can help ourselves to follow through using what are known as commitment devices. When it comes to market volatility, we can have every intention to stay the course, yet we find ourselves abandoning our investment strategy when fear and panic set in.

To combat this natural tendency, your advisor can help you to write a letter to yourself. This letter is a simple promise, made when emotions are stable, to remember the commitment to hold steady. You can simply sign the prewritten letter below, or write a personalized version.

When the market takes a severe downturn, your advisor will email or hand you a copy of this letter as a reminder of your personal commitment.

The Personal Commitment Letter

To my future self,

I know you want to move your money right now. The market is going crazy. I am writing to remind you that even though it is tempting, what you really want to do is stay the course.

You have planned well, and you can handle the storm. Remember how you felt when you sat down with ______________________________ and talked about the reasons for choosing your strategy.

Ride it out.

Sincerely,

____

Date _______________

Investments in securities are subject to investment risk, including the possible loss of principal. Prices of securities may fluctuate from time to time and may even become valueless. Before making any investment decision, you should read and consider all the relevant investment products offering documents and information. You should seriously consider if the investment is suitable for you by referencing your own financial position, investment objectives, and risk profile before making any investment decision or by consulting with your advisor. There can be no assurance that any financial strategy will be successful.

D

Checking in and Responding to Requests

Tools to help you navigate ongoing interactions with clients once they are on a path.

Special Situations Guide

Conflicting Priorities Within Couples

Conflicts over money are consistently named as a primary reason for divorce. With this in mind, it's not hard to see how you as a financial advisor can be of great value to couples: by helping them to communicate more effectively about financial matters.

While some issues may be best resolved in the privacy of a marriage counselor's office, bear in mind that marriage counselors may just leave the financial one to professionals like you.

Every couple is different, and the issues that trigger conflict will be unique. However, there is some general advice that you can offer couples that may help them to make their arguments over money more productive and less destructive.

Focus on the Need, Not the Strategy

Financial conflicts are generally about behavior; what one party did or did not do with regards to money. However, according to conflict-management expert Dr. Marshal Rosenberg, everything we do is an attempt to meet a fundamental human need.[12] We all share the same set of needs, so while we may find ourselves baffled by our partner's behavior, we will be able to understand their needs. By learning to communicate about needs rather than behavior, couples can learn to devise strategies that meet the needs of both people.

For example, if one person is a spender and the other is a saver, each may associate money with different fundamental needs. The spender may see money as a means to experience fun, excitement, comfort, or pleasure. The saver may see money as a means to meet their need for safety, security, and peace of mind. The more the spender meets his or her need for fun, the more the saver feels their need for security threatened, and vice-versa. If this couple can learn to talk about the needs they each are meeting with their behavior (freedom vs. security), rather than the strategy (spending vs. saving), they may be able to find a strategy that satisfies both people.

Our fundamental needs are constant. The partial list of "Things Humans Need to Feel Satisfied" is not exhaustive but can serve as a starting ground for conversation.[13] Use this chart to help clients identify the need that they may be meeting with a particular financial behavior. Needs do not change, but strategies are flexible. Once the underlying need is identified, the person or couple can begin to think of other strategies that might meet the same need without violating the needs of the other person.

Handling Sudden Wealth

A client's core beliefs about money play a large role in how the person adapts to sudden wealth. When a person or family receives a large windfall, they are like immigrants arriving in a new land. There is a new culture to navigate, with new rules to learn, and even a new form of language.

Findings from cross-cultural psychology have identified three ways people respond: Avoidance, Assimilation, and Integration. Sudden wealth assessment worksheet will help you understand how a particular client may be responding to new-found wealth, and how to help them navigate the process. It covers ways for you to assess how people respond given their enduring beliefs about money and how they respond to money in the moment.

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12. More on Dr. Rosenberg's work, as well as books and tools for conflict management using his theory can be found at the Center for Nonviolent Communication, www.cnvc.org.
13. This excerpt is from Sarah Newcomb's book, *LOADED: Money, psychology, and how to get ahead without leaving your values behind*, Wiley, 2016.

Things Humans Need to Feel Satisfied (A Partial List)			
Survival	Food	Sex	Transportation
	Exercise	Shelter	Rest
Security	Peace	Stability	Safety
Emotional	Acceptance	Fun	Friendship
	Adventure	Intimacy	To Matter
	Affection	Love	Respect
	Appreciation	Nurturing (self or others)	Communication
	Belonging	Recognition	
Self-actualization	Challenge	Independence	Self-Expression
	Giving	Personal Space	Growth
Cognitive/spiritual	Awareness	Hope	Discovery
	Creativity	Meaning	Purpose

Sudden Wealth Assessment Worksheet

RISK FACTOR 1: Core Beliefs

Circle the number that reflects how much you agree or disagree with each statement

	Completely DISAGREE		Neither		Completely AGREE
I want people to know that I am wealthy.	1	2	3	4	5
Money corrupts people.	5	4	3	2	1
Wealth is a good indicator of success.	1	2	3	4	5
Having wealth will make me a target for scams, fraud, or loans.	5	4	3	2	1
I want to enjoy all the benefits and luxuries that wealth affords me.	1	2	3	4	5
I sometimes wish I did not have as much money as I do.	5	4	3	2	1

Results: Add up the circled numbers.

RISK FACTOR 2: Emotional Response

When you think about your wealth, how often do you experience the following emotions?

	Almost NEVER		Half the time		Almost ALWAYS
Anxiety					
Numbness					
Excitement					
Elation					
Peaceful					
Secure					

The Sudden Wealth Assessment Worksheet

The three strategies are not mutually exclusive. You may find your clients moving in and out of each strategy over time. Ideally, you will help them settle into a life where the parts of their past that they value most are well integrated with the parts of their new life that bring them joy and security.

Interpreting Core Beliefs

Based on your client's total, refer to the following sections:
(5-15) **Avoidance**, (16-19) **Integration** (20-30) **Assimilation**

Advising Avoiders:

People with one or more avoidance risk factors may need your help to adjust to their new situation. The things that help avoiders are the same things that help people with anxiety. Challenge avoiders to spend a bit more in order to see that the land of wealth may, in fact, be a safer place than they believe. Help them to feel secure by indulging their "What if?" scenarios and teaching them to see that even if some things go wrong, they can still be all right. Avoiders will often try to hide their wealth from friends, and even from their children. Help them to understand that their children need to learn how to manage large assets as early on as possible or they will not have the skills they need when their parents pass on.

Advising Assimilators:

Assimilators need to learn to enjoy the benefits of wealth while exercising moderation. By helping them to see how their net worth translates to a monthly/annual income stream, they may be able to learn the value of saving even as they adapt to a more luxurious lifestyle. Assimilators may hide their spending from you—they may be a challenge to coach, and ignore your warnings. Showing them examples of the cost of overspending/taking on too much risk may be useful motivators.

Advising Integrators:

The goal is that all clients who experience a large windfall will eventually integrate their new wealth into their lives in a healthy and balanced way. Overall, integrators will be the easiest to work with. They will be focused on how to maintain and protect their wealth for themselves and their legacy. Help them to go even further by including their children in their financial decisions so that they can be assured that the next generation will be well equipped to manage their wealth for years to come.

Interpreting Emotional Response

- **Fear:** People who report feeling Anxiety and/or Numbness more than half the time are likely experiencing a fear-based reaction to their wealth. This puts them at a higher risk for **avoidant** behaviors.
- **Desire:** Those who report feeling Excitement and/or Elation when they think about their wealth may be at higher risk for overspending. This puts them at higher risk for **assimilation**.
- **Stability:** People reporting feeling Peaceful and/or Secure more than half the time are likely to adapt well to their wealth without damaging emotional responses. They may **integrate** well without much coaching.

For more information, see Dr. James Grubman's book, Strangers in Paradise: How Families Adapt to Wealth Across Generations and the Sudden Money Institute.

Quick Response Table

What to do if...

You're getting to know to a new or potential client

- Review the Financial Type Assessment, and "Why we shoot ourselves in the foot."
- Use the Financial Type Assessment and Personal Economy Worksheet.
- Share the "What to Expect" information, and ask the client to commit to their choosen strategy.

Markets are dropping...and a client has called you, curious about how to respond

- Have client read "Why we shoot ourselves in the foot."
- Reiterate the core lessons of behavioral finance (and valuation driven investing): many people run away from falling markets, and because of that, it presents an opportunity for profit.

Markets are dropping...and a client has called you, panicked

- Have the client commit to (sign) their long-term strategy with the "Letter to your future self," and read "Why we shoot ourselves in the foot."
- Remind the client of their prior commitment to long-term investing, preferably with the signed commitment; in addition, remind the client of the general psychology of investing (not about them personally, but about all investors) in "Why we shoot ourselves in the foot."

Markets are dropping...And a client hasn't called, but you want to know whether to be proactive

- Get information and your response ready, but don't assume they are panicked—people close to the industry feel volatility much more, and faster, than people outside of the industry.

It's been too many months since you last spoke with a client

- Setup a regular check-in schedule with the "What to Expect" information.
- Show the work you're doing behind the scenes; unfortunately out of sight does mean out of mind. Send out a note asking about life events, and checking if goals and financial picture should be updated.

Your client passes away and a family member inherits the estate

- Prepare beforehand by including family members in the planning process; separately interview members without the primary contact there to assess goals and needs one on one
- See the "Special Situations Guide". After the condolence period, review plans and goals with the estateholder (to demonstrate depth of process the deceased went through).

Client inherits significant estate or receives financial windfall

- See the "Special Situations Guide"; beware of framing new wealth as a windfall—instead, focus on how to meet existing goals in an accelerated fashion.

E

Appendix: Resources to Learn More

Appendix: Resources to Learn More

Are you enticed by what you've read here and want to learn more about behavioral science and investor behavior—or the older, related, tradition of valuation-driven investing? There's a lot you can draw from, both to educate yourself and your clients. Here are a few suggestions to get started.

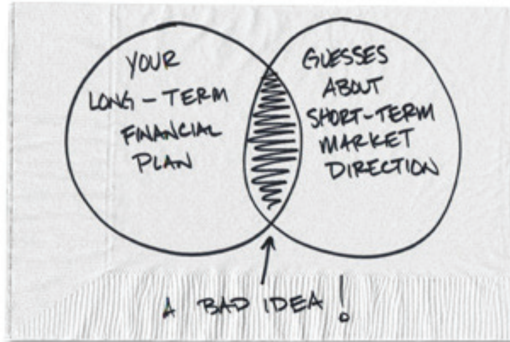

Figure 4: One of Carl Richards's simple, straightforward drawings about investor behavior (and the pitfalls therein)

On Behavioral Science and Investor Behavior

This guide is designed for practical use by advisors.
To learn more about the underlying research, check out:

- *Thinking, Fast and Slow*, by Daniel Kahneman
- *Nudge*, by Richard Thaler and Cass Sunstein
- *What Investors Really Want*, by Meir Statman
- *The Little Book of Behavioural Investing*, by James Montier
- *Investor Behavior: The Psychology of Financial Planning and Investing*, by H. Kent Baker and Victor Ricciardi

Carl Richards's sketches also nicely summarize many of the core challenges investors face; you can check them out in *Morningstar* magazine, on the *New York Times* site, or in his book, *The Behavior Gap*.

On valuation-driven investing

At its core, valuation-driven investing is simple: find the fair value of an investment, and only buy it if the price is sufficiently below that fair value to provide a margin of safety against error. Sell it if the price is significantly above the fair value of the investment.

But as valuation-driven investor Warren Buffett said: Investing is simple, but not easy. The investor biases discussed in this guide, including our overconfidence, our tendency to "find" evidence that confirms our views, and our undue focus on recent performance, and undermine our ability to make wise investment choices. It is exactly these challenges, and our mind's ability to trip us up, that valuation-driven investors seek to overcome.

To learn more about valuation-driven investing, see:

- *A Guide to Using Valuation-Driven Investing to Help Your Client*s, Morningstar
- *Seven Tips for Valuation-Driven Investing,* Morningstar
- *The Most Important Thing*, by Howard Marks
- *Margin of Safety*, by Seth Klarman
- *The Buffett Way/The Buffett Portfolio*, by Robert Hagstrom
- *Value Investing*, by James Montier
- *The Little Book of Common Sense Investing*, John C. Bogle

Ben Graham's 1949 book, *The Intelligent Investor*, is really the foundation of the approach, and it is still worth reading. It can be a bit intimidating for a non-technical investor though—but his light humor helps carry the reader through.

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