Toward a New Science of Private Client Psychology

BY CHARLOTTE BEYER

"There will come a time when you think everything is finished. That will be the beginning."
—from *Lonely on the Mountain* by Louis L'Amour

If Mohamed El-Erian of PIMCO is right, close to 40 percent of the financial services industry will disappear in the coming years. A recent article in the *Financial Times* described hedge funds as "a discredited industry in fundamental decline." Advisers who clung to their old scripts and lost clients will go out of business. Money managers, who were certain "it" wasn't different this time and lost nearly half of their clients' monies, will fade away—or be let go. Hedge funds that have no hope of coming back to their high-water mark will close the fund and, like a favorite sports team, "wait 'til next year." A beaten-down lot, these professionals are suddenly more humble, less sanguine, and more confused. A few professionals now openly voice their disdain for the private client business, claiming institutional entities are more manageable and less irrational. These managers may have been good at math, but they are woefully ignorant of private client psychology.

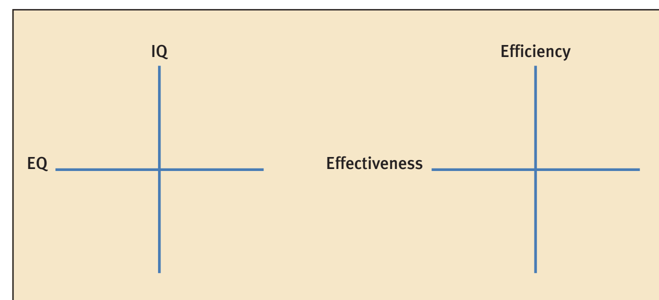
Finally, the wealth management industry is seeking a more relevant and useful science to draw on for the work it does with private clients. Two flaws in past research on investor psychology now seem obvious. First, academic research on investor behavior has been narrow, often using data from discount brokerage accounts. A self-directed retail customer has little in common with the high-net-worth client of a brokerage or investment counselor. Second, academic studies of "investor" behavior have relied on college students or even specific television shows to predict how investors (again, not necessarily anything like today's private client) will react, select, or behave in certain circumstances.

But the college student or do-it-yourself discount brokerage customer is not the "subject" the industry seeks to understand better. Across the table from the investment professional sits a private investor, the private client. The predominant sentiment of these investors is genuine fear and cynicism or disillusionment with "old" theories, tired advisers, and myopic money managers.[1] The options offered in the past were lackluster because the professional across the table seemed less skilled at building solutions and more likely to sell products or recommend complex instruments. Instead of focusing on outcomes for the client or setting goals for the private investor's portfolio, too many in the industry focused on marketing, growing assets, and hosting fancy client events. (Many of these activities are now buried in the time capsule of 2008.)

A new science of private client psychology would examine how trust and faith are at the core of the private client–adviser relationship. A client's level of trust and faith is critical for an adviser because it has a correlation of 1 with client retention. When client expectations match the client experience, the risk of losing that client is minimal. Thus, ensuring a successful and profitable private–client relationship depends on a solid understanding and implementation of client psychology. How exactly are trust and faith developed, and what are the quantitative and qualitative components of such a relationship?

IQ and EQ

One framework for understanding client psychology is to think of the investor–adviser relationship in terms of quadrants with IQ and EQ[2] labeled on a vertical and horizontal axis.



The vertical axis, IQ, represents the intelligence, knowledge, and expertise of the adviser. The horizontal axis is EQ, the emotional intelligence, empathy skills, and emotional maturity of the adviser. A private client whose adviser is in the upper right quadrant (high IQ and high EQ) might describe their adviser as follows: "She really 'gets' me, knows my needs and goals, serves me well, and genuinely cares about me meeting those goals" (high EQ). "She has delivered solid returns at a risk level I can live with, she impresses me with her knowledge of and experience with the markets, and the reports I get are clear and give me an excellent idea of how I'm doing" (high IQ).

A private client with an adviser in the lower left quadrant (low IQ and low EQ) might offer the following descriptors: "He has that 'voice' like the talking heads on CNBC, and he says the same thing over and over as if I am deaf or dumb or both. He really cannot know me, or he would not bore me with all the chatter. He seems more interested in being right with his strategy than discovering what I might need" (low EQ). "He kept telling me to 'stay the course' and did not

1. Institute for Private Investors survey, Family Performance Tracking® 2009

2. Daniel Goleman's *Emotional Intelligence* (1995) transformed everything from customer service to human resources testing.

discuss with me how I was feeling or whether I could stomach that course. He did not make one defensive move in my portfolio, so I did worse than the market! His excellent past track record didn't do him (or me) any good in 2008. He didn't even call to warn me about my December statement, which showed a huge 40 percent decline" (low IQ).

Another way to label the axes is with efficiency on the vertical axis and effectiveness on the horizontal axis. A happy client (upper right quadrant) might describe how timely and complete the reports are (efficient) and marvel at how consistent the communications are, always clearly capturing the key points in an executive summary and letting the appendix tell the rest (effective). In contrast, a frustrated client (lower left quadrant) might say: "We get this massive report each quarter that I don't even like wading through (ineffective), and if that were not enough, there is always a slightly different order to it and never a complete table of contents. How do I find one chart among eleven of them in an appendix without a listing of the charts (inefficient)?"

All of these descriptors measure the client's *experience*. When experience does not equate to expectations, the risk of losing that client increases enormously. Ultimately, clients' perception is the reality of their experience. The experience clients had with their advisers during 2008 will determine the tone of the relationship in the future. Advisers should keep in mind that the atmosphere at the client meeting hugely influences a client's decision to keep or terminate the firm, and retaining clients after a year like 2008 is critical to the survival of any firm.

The longer the period of time in which expectations align with experience, the more trusted the adviser—and the more loyal the client. But how can an adviser be sure the private investor's expectations are realistic and will equate to the experience? Two areas in particular are key: (1) technology and transparency and (2) empowering clients by giving them an opportunity to revisit and reset prior decisions and expectations. Indeed, from the client perspective these two categories are linked.

Technology and Transparency

Successful advisers have already adopted new technologies and strategies or methods that promote full transparency. These developments are transforming the investor–adviser relationship in four areas: clarity of reporting, risk-adjusted returns, fees, and measuring the quality of advice.

First, client reports are capturing what clients need to know even before they know they should ask for that data. Graphs, charts, and other visual aids can replace 10 pages of numbers. One-page executive summaries also quickly enable clients to understand how they are doing.

Second, investment firms are no longer reporting returns without citing risks. And risk is defined far more broadly than simply standard deviation. Risk includes liquidity risk, asset-liability modeling, and aspirational risk.[3] Giving a return number without the risk is now seen as buying a house without knowing what kind of neighborhood it is in.

Third, investors have learned to ask about fees and expect full disclosure. They often compare fees inside an online community. Just as the online service Zillow lets a homeowner see what home prices are in a neighborhood, so too are wealth management industry fee arrangements being exposed online.

Fourth, technology already has had an enormous impact on how advice is measured. Where might investors discover who did best in 2008 for their clients? Online! Online communities, databases, and master custodian reports have far more information than was available even two years ago. Advisers have discovered the power of simple graphics and how picking the appropriate benchmark makes all the difference. After all, how does a client know who's winning if no one is keeping score? The clearer and the more revealing the information given to clients is, the greater their sense of power. But power to do what?

Revisit and Reset

Investors need to be able to revisit prior decisions, outcomes, and expectations in light of new environments—such as a death in the family or market conditions—and, if necessary, reset their investment policies. Investors are reclaiming their own power to manage the decisions made "on their behalf." For advisers, outcomes and expectations first must be specifically defined, understood, and accepted and then must be clearly communicated. Both the client and the adviser need to accept that successful wealth management is a journey, not a destination.

Virtually all investment advisers wish their clients would take the time to become more educated about financial markets and their own investor personality. Advisers complain that high-net-worth clients shift their risk tolerance, change their return expectations, and fail to see the rationale for fees. Servicing often must include a heavy dose of investor education, a time-consuming undertaking. For the same reasons that no one reads the instruction manual, investors rarely wish to curl up with an asset allocation textbook. Moreover, few investment firms know how to teach, and even fewer admit that their clients may find their manner of teaching quite boring.

The Challenge of Investor Education

Great teachers know you cannot force-feed learning. A teacher is merely a catalyst; students need to want to learn.

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3. Ashvin Chhabra coins the term "aspirational risk" in "Beyond Markowitz: A Comprehensive Wealth Allocation Framework for Individual Investors," *The Journal of Wealth Management*, (2004).

ity and to focus on the interests of their clients. In practice, however, the opposite often has been true. In order to redress these deficiencies, such firms will need to focus on becoming more efficient, managing and pricing risk more effectively, and moving closer to their clients.

- More specifically, they will have to realize economies of scale, integrate their IT more closely with their business strategies, and outsource a higher proportion of their back-office activities. They will also have to rebalance their portfolios; develop "fine grain" pricing models that take account of different interest rates, fee structures, and abilities to pay; and concentrate on understanding how investors behave, segmenting them, and tailoring the services they offer accordingly.
- ***Solve their identity crisis.*** Finally, firms will have to change their business models to accommodate the trend toward greater specialization and the shift in the industry's revenue pools, as demand for products that help to create more transparency grows at the expense of demand for products that are opaque. Tomorrow's winners will be those companies that specialize, not those that try to do everything, and three specific areas of specialization are likely to emerge. Most firms will concentrate on becoming "beta transactors." A smaller number of firms will concentrate on providing advice, and a handful of "alpha seekers" will focus on generating high returns from high-risk investments.

Above all, the industry will have to become much better at understanding and addressing the needs of investors. More than 60 percent of the institutional and retail investors and intermediaries IBM surveyed believe that providers offer products that serve their own best interests, rather than those of their clients. What is even more disturbing is that many industry executives agree with them! Some 40 percent of respondents based in Europe, Middle East, Africa, and Asia–Pacific think that providers put their own interests first, and the figure rises to 49 percent among executives based in the Americas. So, it is hardly surprising that many investors and intermediaries no longer trust the industry.

Self-interest is not the only obstacle. Most providers do not even realize what investors actually want. When asked which financial services they thought would become more important over the next five years, industry executives put best-in-class offerings and one-stop shops at the top of the list. But when investors were asked which services they would be willing to pay a premium for, they ranked unbiased, high-quality advice and excellent service first. In fact, 79 percent of executives proved completely disconnected from their clients.

The most successful firms of the future will be those that focus on providing a first-rate service (as distinct from selling the best products) and those that concentrate on understanding how investors behave and tailor their services accordingly. For example, IBM's research shows that investors who rely heavily on their providers and who outsource as much as possible assign the highest value to customization and convenience in particular. And these investors are prepared to pay a substantial premium for such features. By contrast, investors who want a provider with minimal conflicts of interest place much greater emphasis on best-in-class offerings and excellent service. But although they are prepared to pay more for these features, they are less willing to do so than are other client segments.

The ability to serve specific investor clusters represents a major—and largely ignored—opportunity for the industry to make money. The investment management industry has long excelled at creating innovative products. Imagine what it could achieve if it used the same sort of discipline to understand its clients and fulfill their needs.

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In the aftermath of the current crisis and market drop, investors are seeking to be smarter and more prudent consumers of financial services. They, like the most respected advisers, appear to endorse three tenets: (1) an educated investor is a more prudent investor, (2) an educated adviser helps create a more informed consumer, who can then make better decisions, and (3) a series of self-discovery exercises for both prospective clients and their advisers can prevent an unhappy client–adviser relationship.[4]

The bold next step needed to support the development of new science of private client psychology is to engage the industry to fund research. Examining a large group of high-net-worth clients from a wide range of investment firms and advisory organizations will be pioneering work. This more robust study of actual behavior and attitudes will point the industry to a clearer path forward, better serving the private investor. Pursuing the goal of a more rewarding experience —for both investor and adviser—is well worth our efforts. We should not delay.

Charlotte Beyer is founder and CEO of the Institute for Private Investors.

4. Charlotte Beyer introduced the self-discovery exercise using quadrants of sophistication and control in "Understanding Private Client Characteristics," *Investment Counsel for Private Clients*, AIMR Conference Proceedings (1993). Available through www.cfapubs.org.