

Using Behavioral Investor Types to Build Better Relationships with Your Clients

by Michael M. Pompian, CFP®, CFA

Michael M. Pompian, CFP®, CFA, is the director of the Private Wealth Practice and a principal consultant at Hammond Associates, a St. Louis, Missouri-based investment consulting firm with over \$55 billion in assets under advisement. He can be reached at (314) 746-1600 or at mpompian@haifc.com.

Behavioral finance, which identifies and learns from the human psychological phenomena at work in financial markets and within individual investors, has taken a more prominent place in the financial advisory world since the bursting of the technology stock bubble in March 2000. Evidence of this fact is documented in my August 2007 research study titled “The Ultimate Know-Your-Customer Approach: Using Behavioral Finance to Retain and Acquire Wealth Clients.”¹ In that study, I surveyed 290 sophisticated financial advisors (identified as such by having at least one advanced designation, such as CFP®, CFA, or CPA) in 30 countries about their interest in and use of behavioral finance with their clients. The results were astounding: 93 percent of advisors believed that individual investors make irrational investment decisions, and 96 percent were successfully using behavioral finance to improve relationships with their clients.

Why is behavioral finance catching on? These advisors have figured out that acquiring clients is difficult and expensive, and losing them is easy—and contrary to popular belief, the primary reason financial advisors lose clients is not because of sub-

Executive Summary

- Since the bursting of the technology stock bubble in 2000, behavioral finance has taken a more prominent role in the financial media and, more importantly, in the minds of financial advisors globally.
- This paper is a continuation and refinement of a March 2005 *Journal of Financial Planning* article, “Incorporating Behavioral Finance into Your Practice.” It presents a framework for financial advisors to categorize their clients into four behavioral investor types, or BITs. BITs were designed for advisors to help them more easily apply behavioral finance to the everyday task of advising clients.
- The four behavioral investor types are Passive Preserver, Friendly Follower, Independent Individualist, and Active Accumulator.
- A description of each behavioral investor type is provided with examples of the cognitive and emotional biases associated with each BIT. Advice is given on how best to work with each behavioral investor type so that the advisor can build stronger client relationships.
- The paper then presents a diagnostic process called Behavioral Alpha™, a top-down methodology of classifying client investors into behavioral investor types based on their behavioral characteristics.
- The Behavioral Alpha approach begins by identifying investors as either *active* or *passive*. The next step is to administer a risk-tolerance questionnaire. After that, behavioral biases are isolated to determine a client’s behavioral investor type.

par investment results. Advisors acknowledge that the most common reason they lose clients is that they are unable to get inside the heads of their clients enough to build solid personal and financial relationships. Understanding how clients *actually* think and behave is a key ingredient in the recipe for success in acquiring and retaining clients. As such, behavioral finance is becoming a powerful force in the financial advisory field.

But some financial advisors are need-

lessly struggling with behavioral finance because they lack a systematic way to apply it to their client relationships. This paper intends to make the application of behavioral finance easier by building on key concepts outlined in my earlier March 2005 *Journal of Financial Planning* article, “Incorporating Behavioral Finance into Your Practice,”² and my 2006 book, *Behavioral Finance and Wealth Management*.³ In those two works, I outline a method of applying behavioral finance to private clients in a

way that I now refer to as “bottom-up.” This means that for an advisor to diagnose and treat behavioral biases, he or she must first test for all behavioral biases in the client, and then determine which ones a client has before being able to use bias information to create a customized investment plan. For example, in my book I describe 20 of the most common behavioral biases an advisor is likely to encounter, explain how to diagnose these biases, show how to identify behavioral investor types, and finally show how to plot this information on a chart to create the “best practical allocation” for the client. But some advisors may find this bottom-up approach too time-consuming or complex. So in this paper, I present a simpler, more efficient approach to bias identification that is “top-down”—a shortcut, if you will—that can make bias identification much easier. I call it Behavioral Alpha™.

The Behavioral Alpha approach is a multi-step diagnostic process that classifies clients into four behavioral investor types (BITs). Bias identification, which is done near the end of the process, is narrowed down for the advisor by giving the advisor clues as to which biases a client is likely to have based on the client’s BIT.

The word “alpha” is used for two reasons. For one thing, it means “first” or “the beginning.” Before an investment program is created for a client, financial advisors need to take inventory of a client’s behavior *first*—hence Behavioral Alpha. Second, the word has become synonymous with describing performance beyond expectations. By taking inventory of a client’s investing behavior before creating an investment plan, the result will likely be performance that exceeds both the expectations of the client and the advisor.

The paper begins with an introduction to the four behavioral investor types:

1. Passive Preservers
2. Friendly Followers
3. Independent Individualists
4. Active Accumulators

Next, a detailed description of each BIT is provided, including a simple diagnostic

for some of the behavioral biases and advice for dealing with each BIT. The paper concludes with a review of the Behavioral Alpha approach to identifying BITs, which starts by identifying active and passive investor traits and then uses traditional risk tolerance questionnaires to initially classify the client before identifying the client’s irrational biases to determine the client’s BIT.

Introduction to Behavioral Investor Types

Behavioral investor types were designed to help advisors make rapid yet insightful assessments of what type of investor they are dealing with before recommending an investment plan. The benefit of defining what type of investor an advisor is dealing with *up front* is that this will mitigate unwelcome surprises from the client wishing to change the portfolio allocation due to market turmoil. If an advisor can reduce traumatic episodes throughout the advisory process by delivering smoother, anticipated investment results due to an investment plan that is customized to the client’s behavioral make-up, the client relationship will be stronger. BITs, are not intended to be absolutes, but rather guideposts to use when making the journey with a client; dealing with irrational investor behavior is not an exact science. For example, an advisor may find that he or she has correctly classified a client as a certain BIT, but finds that the client also has traits (biases) of another.

Each BIT is characterized by a certain risk tolerance level and a primary type of bias—either cognitive (driven by faulty reasoning) or emotional (driven by impulses or feelings). One of the most important concepts advisors should keep in mind as they go through this section is that the least risk-tolerant BIT and the most risk-tolerant BIT are driven by *emotional* biases, while the two types in between these two extremes are mainly affected by *cognitive* biases. Emotional clients tend to be more difficult clients to work with. Advisors who can recognize the type of client before

making investment recommendations will be much better prepared to deal with irrational behavior when it arises.

Passive Preserver

Basic type: Passive

Risk tolerance level: Low

Primary bias: Emotional

Passive Preservers are, as the name implies, investors who place a great deal of emphasis on financial security and preserving wealth rather than taking risks to grow wealth. Many have gained wealth through inheritance or conservatively by working in a large company. Because they have gained wealth by not risking their own capital, Passive Preservers may not be financially sophisticated. Some Passive Preservers are “worriers” in that they obsess over short-term performance and are slow to make investment decisions because they dislike change. This is consistent with the way they have approached their professional lives, being careful not to take excessive risks. Some Passive Preservers who inherit wealth may have intense feelings of guilt or low self-esteem because they didn’t earn their money, and may have a fear of failure or lack of motivation.

Most Passive Preservers are focused on taking care of their family members and future generations, especially funding life-enhancing experiences such as education and home buying. Because the focus is on family and security, Passive Preserver biases tend to be emotional rather than cognitive. As age and wealth level increase, this BIT becomes more common. Although not always the case, many Passive Preservers enjoy the wealth management process—they like the idea of being catered to because of their financial status—and thus are generally good clients. Behavioral biases of Passive Preservers tend to be emotional, security-oriented biases such as endowment bias, loss aversion, status quo, and regret. They also exhibit cognitive biases such as anchoring and mental accounting.

Endowment bias. This emotional bias

occurs when a person assigns greater value to an object when he or she possesses it and is faced with its loss, than when he or she doesn't possess the object and has the potential to gain it. A classic example of endowment bias is a client who holds onto investments that were owned by previous generations, particularly concentrated equity positions or real estate that may have created the family's wealth to begin with, without justification for why these assets are retained.

Ask your client if they keep objects or investments because they already own them (through inheritance, for example), but wouldn't be interested in buying these objects or investments themselves. If so, they are likely to have endowment bias.

Loss aversion bias. Most Passive Preservers feel the pain of losses more than the pleasure of gains—the essence of loss aversion. This emotional bias prevents people from unloading unprofitable investments, even when they see no prospect of a turnaround. Some industry veterans have coined this “get-even-itis.” Holding losing investments in the hope that they get back to break-even has seriously negative consequences on portfolio returns when these investments stay in losing territory for extended periods.

A simple diagnostic for loss aversion bias: Provide your client a scenario in which they buy a security and it drops 25 percent with no foreseeable rebound. Ask if they are likely to hold it until it gets back to even or sell it and buy something with better prospects. If they hold on to the investment, they are likely to have loss aversion bias.

Status quo bias. This emotional bias predisposes people, when facing an array of choices, to elect whatever option keeps conditions the same. Passive Preservers often tell themselves “things have always been this way” and are more comfortable keeping things the same. Status quo bias is demonstrated by the investor who has been doing things a certain way for many years, and then hires a new financial advisor. The new advisor may propose practical

changes, only to find that the investor takes part of or none of the advice. It's not that the client doesn't need good advice—they are simply stuck in the status quo.

Regret aversion bias. People exhibiting this emotional bias avoid taking decisive actions because they fear that, in hindsight, whatever course they select will prove less than optimal. Regret aversion can cause investors to be too conservative in their investment choices. Having suffered losses in the past, they may shy away from making sensible new investments. This behavior can lead to long-term underperformance and can jeopardize investment goals.

Ask your client if they have made investments in the past that they regret—and if that regret affects current or future investment decisions.

Anchoring bias. This cognitive bias occurs when investors are influenced by purchase points or arbitrary price levels, and tend to cling to these numbers when facing questions like “should I buy or sell this investment?”

One of the most common examples of anchoring bias occurs during the implementation of a new asset allocation. For example, suppose a client comes to an advisor with 30 percent of their portfolio in a single stock and the advisor recommends diversification. Further suppose that the stock is down 25 percent from the high it reached five months ago (\$75 a share versus \$100 a share). For simplicity, assume that taxes on the sale are not an issue. Frequently, the client will resist the new allocation because they feel they must only sell the stock when its price rebounds to the \$100 a share it achieved five months ago. This is anchoring bias.

Mental accounting bias. The last Passive Preserver bias is mental accounting, a cognitive bias that occurs when people treat various sums of money differently based on where these sums are mentally categorized. Passive Preservers are risk averse and like to segregate their assets into safe “buckets.” A classic example of mental accounting is segregating college

money, money for retirement, and vacation money. If all of these assets are viewed as “safe money” sub-optimal returns are usually the result.

Advising passive preservers. After reviewing this section, readers might correctly conclude that Passive Preservers are difficult to advise because they are driven mainly by emotion. This is true; however, they are also greatly in need of good financial advice. Advisors should take the time to interpret behavioral signs provided to them by Passive Preserver clients. Passive Preservers need “big picture” advice and advisors shouldn't dwell on details like standard deviations and Sharpe ratios, or else they will lose the client's attention. Passive Preservers need to buy into their advisor's general philosophy first and then, once trust is gained, they will take action. After a period of time, Passive Preservers are likely to become an advisor's best clients because they value greatly the advisor's professional expertise and objectivity in helping make the right investment decisions.

Friendly Follower

Basic type: Passive

Risk tolerance level: Low to medium

Primary bias: Cognitive

Friendly Followers are passive investors who usually do not have their own ideas about investing. They often follow the lead of their friends and colleagues in investment decisions, and want to be in the latest, most popular investments without regard to a long-term plan. One of the key challenges of working with Friendly Followers is that they often overestimate their risk tolerance. Advisors need to be careful not to suggest too many “hot” investment ideas—Friendly Followers will likely want to do all of them. Some don't like, or even fear, the task of investing, and many put off making investment decisions without professional advice; the result is that they maintain, often by default, high cash balances. Friendly Followers generally comply with professional advice when they get it,

and they educate themselves financially, but can at times be difficult because they don't enjoy or have an aptitude for the investment process. Biases of Friendly Followers are cognitive: recency, hindsight, framing, cognitive dissonance, and ambiguity aversion.

Recency bias. This is a predisposition for people to more prominently recall and emphasize recent events or observations, and potentially extrapolate patterns where none exist. Recency bias ran rampant during the bull market period between 1995 and 1999 when many investors wrongly presumed that the market would continue its enormous gains forever. Friendly Followers often enter an asset class when prices are peaking, which can end badly with sharp price declines.

Hindsight bias. Friendly Followers, who often lack independent thought on investments, are susceptible to hindsight bias, which occurs when an investor perceives investment outcomes as if they were predictable—even if they weren't. An example of hindsight bias is the response by investors to the tech stock bubble when, initially, many viewed the market's performance as normal (not symptomatic of a bubble), only to later say, "Wasn't it obvious?!" when the market melted. (Ask your client if they thought the bursting of the 2000 technology stock bubble was predictable.) The result of hindsight bias is that it gives investors a false sense of security when making investment decisions, and thus excessive risk is taken.

Framing bias. This is the tendency of Friendly Followers to respond differently to various situations based on the context in which a choice is presented (framed). Investors often focus too restrictively on one or two aspects of a situation, excluding other considerations. The use of risk tolerance questionnaires provides a good example. Depending on how questions are asked, framing bias can cause investors to respond to risk tolerance questions in either an unduly conservative or risk-taking manner. For example, when questions are worded in the gain "frame," then

a risk-taking response is more likely. When questions are worded in the loss "frame," then risk-averse behavior is the likely response.

A simple diagnostic for framing bias is to pick one question from a typical risk tolerance questionnaire and re-phrase it to test if a client would answer the same question differently based on how it is asked. If they answer the question differently, they are likely subject to framing bias.

Cognitive dissonance bias. In psychology, cognitions represent attitudes, emotions, beliefs, or values. When multiple cognitions intersect—for example, a situation arises in which a person believes in something only to find out it is not true—they try to alleviate their discomfort by ignoring the truth and rationalizing their decision to ignore the truth. Friendly Followers who suffer from this bias may continue to invest in a security or fund they already own after it has gone down (average down), even when they know they should be judging the new investment with objectivity. A common phrase for this concept is "throwing good money after bad."

Ambiguity aversion bias. This is a difficult bias to explain; therefore, an example works best. Suppose a researcher asks Mr. Jones (or you ask your client) his prediction of the outcome of an ambiguous situation: whether a certain sports team will win its upcoming game. Suppose he estimates a 60 percent chance the team wins. Further suppose the researcher presents Mr. Jones with a 50 percent/50 percent slot machine, which offers no ambiguity, and then asks which bet is preferable. If Mr. Jones is ambiguity-averse, he will likely choose the slot machine, even if he feels confident about the team winning. Translating this idea to the investment world, even when investors feel skillful or knowledgeable, they may not be willing to stake claims on "ambiguous" investments like stocks, even when they believe they can predict these outcomes based on their own judgment.

Advising Friendly Followers. Advisors to Friendly Follower clients know that

Friendly Followers often overestimate their risk tolerance. Risky trend-following behavior occurs in part because Friendly Followers don't like situations of ambiguity. They also may convince themselves that they "knew it all along," which also increases risk-taking behavior. Advisors need to handle Friendly Followers with care because they are likely to say yes to advice that makes sense to them. Advisors need to guide them to take a hard look at behavioral tendencies to overestimate their risk tolerance. Because Friendly Follower biases are mainly cognitive, education on the benefits of portfolio diversification is usually the best course of action. Advisors should challenge Friendly Follower clients to be introspective and provide data-backed substantiation for recommendations. Offer education in clear, unambiguous ways so they have the chance to get it. If advisors take the time, this steady, educational approach will generate greater client loyalty and adherence to long-term investment plans.

Independent Individualist

Basic type: Active

Risk tolerance: Medium to high

Primary bias: Cognitive

An Independent Individualist is an active investor with medium-to-high risk tolerance who is strong-willed and an independent thinker. Independent Individualists are self-assured and "trust their gut" when making decisions; however, when they do research on their own, they may be susceptible to acting on the initial information rather than getting corroboration from other sources. Sometimes advisors find that an Independent Individualist client made an investment without consulting anyone. This can be problematic because, due to their independent mindset, these clients maintain the view they had when they made the investment, even when market conditions change. They often enjoy investing and are comfortable taking risks, yet often resist following a financial plan.

Recommended Web Sites

- Behavioral Alpha:
<http://www.behavioralalpha.com>
- Daniel Kahneman biography—Woodrow Wilson School of Public and International Affairs:
<http://www.princeton.edu/~kahneman/>
- Numerous research papers:
<http://faculty.haas.berkeley.edu/odean/Current%20Research.htm>
- Meir Statman biography—Santa Clara University:
<http://www.scu.edu/business/finance/faculty/statman.cfm>
- Institute of Behavioral Finance:
<http://www.ibfsa.co.za/>

Some Independent Individualists view investing as a way to make money to give themselves freedom. They can be good clients because they are usually busy people, although some will not accept financial advice. Others are obsessed with trying to beat the market and may hold concentrated portfolios. Of all behavioral investor types, Independent Individualists are the most likely to be contrarian, which can benefit them—and lead them to continue their contrarian practices. Independent Individualist biases are cognitive: conservatism, availability, confirmation, representativeness, and self-attribution.

Conservatism bias. This occurs when people cling to a prior view or forecast without acknowledging new information. Independent Individualists often do this, behaving inflexibly when presented with new information. For example, assume an investor buys a security based on an anticipated new product announcement. The company then announces that it is experiencing problems bringing the product to market. The investor may cling to the stock with the optimistic opinion that the problems will soon be resolved, and fail to sell on the negative announcement.

Availability bias. People often estimate

the probability of an outcome based on how prevalent that outcome is in their lives. People exhibiting this bias perceive easily recalled possibilities as more likely than those that are less prevalent. Ask your client to identify the “best” mutual funds. Most Independent Individualists would perform an Internet search and, most likely, find funds from firms that engage in heavy advertising. Investors subject to availability bias are influenced to pick funds from such companies, despite the fact that some of the best-performing funds advertise very little if at all.

Representativeness bias. This occurs as a result of a flawed perceptual framework when processing new information. To make new information easier to process, Independent Individualists project outcomes that resonate with their own pre-existing ideas. An Independent Individualist might view a particular stock, for example, as a value stock because it resembles an earlier value stock that was a successful investment—but the new investment is actually not a value stock. For example, a high-flying biotech stock with scant earnings or assets drops 25 percent after a negative product announcement. Some Independent Individualists may take this to be representative of a value stock because it is cheap; but biotech stocks don't typically have earnings, while traditional value stocks have had earnings in the past but are temporarily underperforming.

Self-attribution bias. This refers to the tendency to ascribe successes to innate talents while blaming failures on outside influences. For example, suppose an Independent Individualist makes an investment that goes up. The reason it went up is not due to random factors such as economic conditions or competitor failures, but rather to the investor's investment savvy. This is classic self-attribution bias.

Confirmation bias. This occurs when people observe, overvalue, or actively seek out information that confirms their claims, while ignoring or devaluing evidence that might discount their claims. Confirmation

bias can cause investors to only seek information that confirms their beliefs about an investment and not seek out information that may contradict their beliefs. This behavior can leave investors in the dark regarding the imminent decline of a stock.

Advising Independent Individualists. Independent Individualists can be difficult clients to advise, but they are usually grounded enough to listen to sound advice when it is presented in a way that respects their independent mindset. As we have learned, Independent Individualists are firm in their belief in themselves and their decisions, but can be blind to contrary thinking. As with Friendly Followers, education is essential to changing behavior of Independent Individualists; their biases are predominantly cognitive. A good approach is to have regular educational discussions during client meetings. This way, the advisor does not point out unique or recent failures, but rather educates regularly and can incorporate concepts that he or she feels are appropriate for the client.

Active Accumulator

Basic type: Active

Risk tolerance: High

Primary bias: Emotional and cognitive

The Active Accumulator is the most aggressive behavioral investor type. These clients are entrepreneurial and often the first generation to create wealth, and they are even more strong-willed and confident than Independent Individualists. At high wealth levels, Active Accumulators often have controlled the outcomes of non-investment activities and believe they can do the same with investing. This behavior can lead to overconfidence in investing activities. Left unadvised, Active Accumulators often have high portfolio turnover rates, putting a drag on investment performance. Active Accumulators seek risk in the hope of high return and are comfortable with volatility, although they don't like it. Active Accumulators are quick decision-makers but may chase higher risk investments than their friends. If successful, they

Tests for Active and Passive Investing Traits

1. Have you earned the majority of your wealth in your lifetime?
 - a. Yes
 - b. No
2. Have you risked your own capital in the creation of your wealth?
 - a. Yes
 - b. No
3. Which is stronger: your tolerance for risk to build wealth or the desire to preserve wealth?
 - a. Tolerance for risk to build wealth
 - b. Desire to preserve wealth
4. Would you prefer to maintain a degree of control over your investments or to delegate that responsibility to someone else?
 - a. Maintain control
 - b. Delegate
5. Do you have faith in your abilities as an investor?
 - a. Yes
 - b. No
6. If you had to pick one of two portfolios, which would it be?
 - a. 80 percent stocks/20 percent bonds
 - b. 40 percent stocks/60 percent bonds
7. Is your wealth goal intended to continue your current lifestyle or are you motivated to build wealth at the expense of current lifestyle?
 - a. Build wealth
 - b. Continue current lifestyle
8. In your work or personal life, are you generally a self-starter in that you seek to out what needs to be done and then do it, or do you prefer to take direction from someone else?
 - a. Self-starter
 - b. Take direction
9. Are you "income motivated" or are you willing to put your capital at risk to build wealth?
 - a. Put capital at risk
 - b. Income motivated
10. Do you believe in the concept of leverage or do you prefer to limit your amount of debt?
 - a. Believe in leverage
 - b. Limit debt

enjoy the thrill of making a good investment. Some Active Accumulators can be difficult to advise because they don't usually believe in basic investment principles such as diversification and asset allocation. They are often hands-on, wanting to be heavily involved in the investment decision-making process, although some readily admit they lack investment knowledge. Biases of Active Accumulators are overconfidence, self-control, optimism, and illusion of control.

Overconfidence bias. This is best described as unwarranted faith in one's own thoughts and abilities and contains both cognitive and emotional elements. Overconfidence manifests itself in investors' overestimation of the quality of

their judgment. Many Active Accumulators claim an above-average aptitude for selecting stocks; however, numerous studies have shown this to be a fallacy. For example, a study done by researchers Odean and Barber⁴ showed that after trading costs (but before taxes), the average investor underperformed the market by approximately 2 percent a year due to unwarranted belief in their ability to assess the correct value of investment securities.

Illusion of control bias. This cognitive bias occurs when people believe they can control, or at least influence, investment outcomes when, in fact, they cannot. Active Accumulators who are subject to illusion of control bias believe that the best way to manage an investment portfolio is

to constantly adjust it. For example, trading-oriented investors who accept high levels of risk believe themselves to possess more control over the outcome of their investments than they actually do because they are pulling the trigger on each decision.

To determine whether your client has control bias, ask if they have a tendency to want to pick their own numbers on a lottery ticket or want to be in control of the dice while playing a game of chance.

Self-control bias. This emotional bias is the tendency to consume today without saving for tomorrow. The primary concern for advisors with this bias is a client with a high risk tolerance coupled with high spending. For example, suppose you have an Active Accumulator client who prefers aggressive investments and has high current spending needs and suddenly the financial markets hit some severe turbulence. Just to meet expenses, this client may be forced to sell solid long-term investments that have declined in value due to current market conditions.

Optimism bias. Many overly optimistic investors believe that bad investments will not happen to them—they will only afflict others. Such an illusion can damage portfolios as people fail to acknowledge the potential for adverse consequences in the investment decisions they make. An example of this emotional bias occurs when employees allocate a high proportion of their 401(k) plan to their company's stock. Undue optimism leads these employees to perceive their own firm as being unlikely to suffer from economic misfortune.

Advice for active accumulators. Active Accumulators are the most difficult clients to advise. They like to control, or at least get deeply involved in, the details of investment decision-making. They are emotionally charged and optimistic that their investments will do well, even if that optimism is irrational. Some Active Accumulators need to be monitored for excess spending which, when out of control, can inhibit performance of a long-term portfolio. The best approach to dealing with

these clients is to take control of the situation. If advisors let the Active Accumulator client dictate the terms of the advisory engagement, they will always be at the mercy of the client's irrational decision-making and the result will likely be an unhappy client and an unhappy advisor. Advisors need to prove to the client that they have the ability to make wise, objective, long-term decisions and can communicate these results in an effective way. Advisors who can demonstrate the ability to take control of a situation will see their Active Accumulator clients fall into step and be easier to advise.

The Behavioral Alpha Process: A Top-Down Approach

Now that we have learned each behavioral investor type in detail, we will examine the diagnostic process for arriving at an individual BIT using the Behavioral Alpha



process. Recall that we use the term “alpha” because we are categorizing our clients by investor type before we embark on the design of an investment program. We start first with a diagnosis of passive or active traits.

Step 1: Interview client and identify active or passive traits. Most advisors begin the planning process with a client interview, which consists mainly of a question-and-answer session intended to gain an understanding of the objectives, constraints, and past investing practices of a client. Through this process an advisor

should also ascertain whether a client is an active or passive investor. In short, has the client in the past (or does the client now) wish to put his or her capital at risk to build wealth? Understanding the characteristics of active and passive investors is important because passive investors have tendencies toward certain investor biases, and active investors have tendencies toward different biases. The sidebar “Test for Active and Passive Investing Traits” provides questions to determine the active or passive nature of clients. A preponderance of “A” answers indicates an active investor

Figure 2: Decision Tree for Determining Behavioral Investor Types

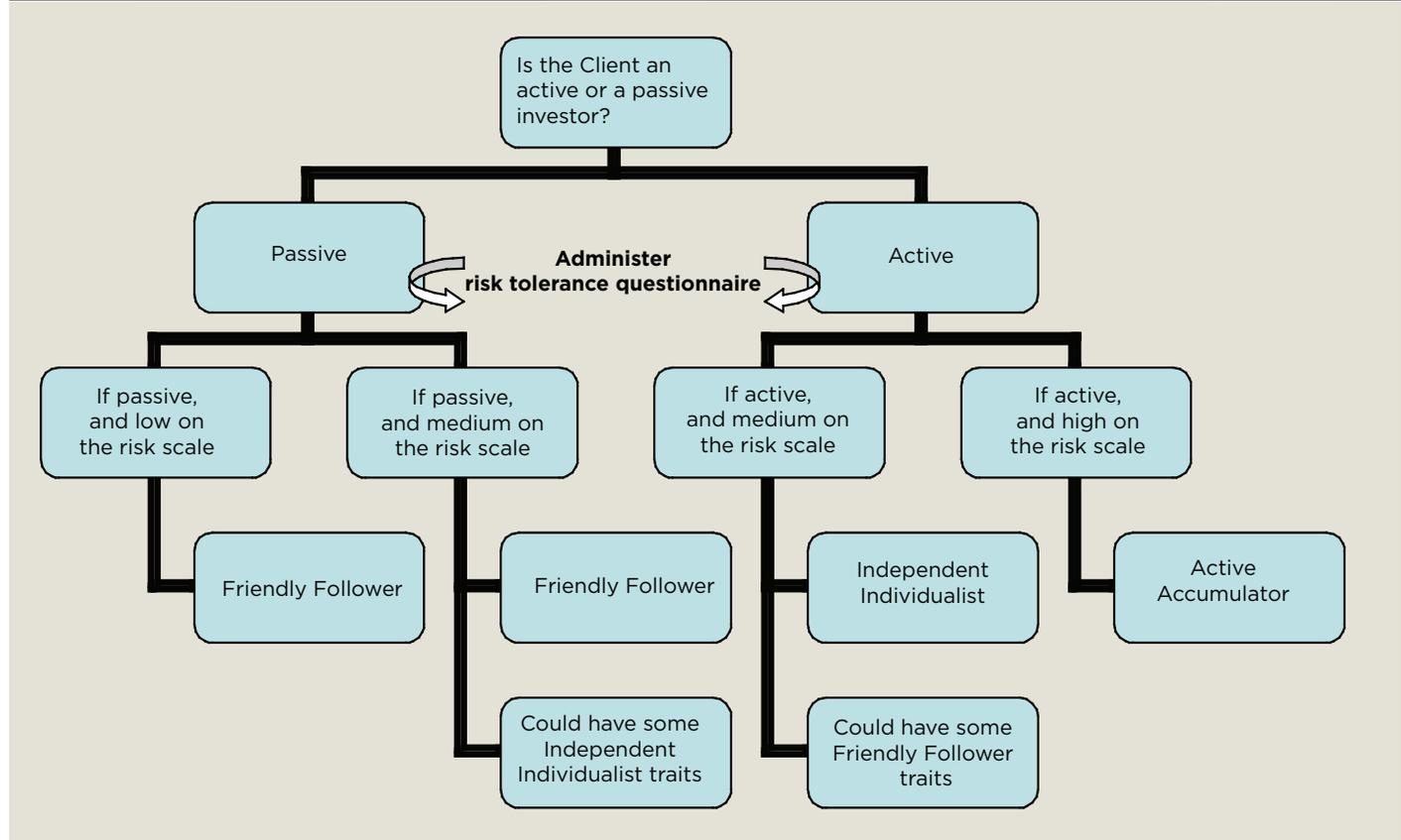


Figure 3: Biases Associated with Each Behavioral Investor Type

General Type	PASSIVE		ACTIVE	
	Low	Medium	Medium	High
Risk Tolerance	Low	Medium	Medium	High
Bias Types	Primarily Emotional	Primarily Cognitive	Primarily Cognitive	Primarily Cognitive
IPT	Passive Preserver	Friendly Follower	Independent Individualist	Active Accumulator
Biases	Endowment Loss Aversion Status Quo Anchoring Mental Accounting Regret	Ambiguity Aversion Hindsight Framing Cog. Dissonance Recency	Conservatism Availability Confirmation Representativeness Self Attribution	Overconfidence Self Control Optimism Illusion of Control

and “B” answers identify passive investors.

Step 2: Administer risk tolerance questionnaire. Once the advisor has classified the investor as active or passive, the next step is to administer a traditional risk tolerance questionnaire to begin the process of identifying whether a client falls into one of the four behavioral investor types. In the interest of keeping this article to a reasonable length, I have not included a risk tolerance questionnaire. The advisor’s task at this point is to determine where the client falls on the risk scale. This is shown in Figure 1.

The next step is to confirm the expectation that certain behavioral traits will result in certain behavioral investor types. If an investor is passive, and the risk tolerance questionnaire reveals a very low risk tolerance, the investor is likely to be a Passive Preserver. If the investor is passive and the questionnaire reveals a low to medium risk tolerance, the investor is likely to be a Friendly Follower. If an investor is active and has a medium to high risk tolerance, the investor is likely to be an Independent Individualist. Finally, if an investor is active and has a high risk tolerance, the investor is likely to be an Active Accumulator. This process is illustrated in the decision tree shown in Figure 2.

If, after going through this process, the advisor has narrowed the client down to one behavioral investor type, the next task is to confirm this BIT expectation by determining if the client has the biases associ-

ated with the expected BIT (as we learned earlier in the paper). This will confirm the BIT diagnosis. Figure 3 provides an overview of the characteristics of each behavioral investor type.

Conclusion

We have learned a top-down method of identifying a client’s behavioral investor type. By learning this process and applying it before creating an investment plan for a client, the client is more likely to be able to adhere to a plan that is custom designed for them and, when this happens, financial advisors build stronger relationships with their clients. The ultimate objective for this process is for advisors to get comfortable enough with the BIT process such that it becomes natural, almost second nature, and can be incorporated easily and efficiently into the advisory process. As a final note, advisors should realize that clients will have stronger or weaker forms of the behavioral investor types presented here based on the number and severity of the biases that are associated with each behavioral investor type. Some clients will have a reasonably rational approach to investing, displaying few biases and which have little impact on the investment process. Other clients will be highly biased and their irrational behavior will affect the investment process substantially. Advisors need to use their best judgment when assessing the potency of a client’s irrational behavior and

adjust their advice accordingly.



Endnotes

1. Michael M. Pompian, “The Ultimate Know-Your-Customer Approach: Using Behavioral Finance to Retain and Acquire Wealth Clients,” VRL KnowledgeBank, London, England, 2007: 73–83.
2. Michael M. Pompian and John M. Longo, “Incorporating Behavioral Finance Into Your Practice,” *Journal of Financial Planning* 18, 3: 58–63.
3. Michael M. Pompian, *Behavioral Finance and Wealth Management*, New Jersey: John Wiley and Sons, 2006.
4. Terrence Odean and Brad Barber, “Boys Will Be Boys: Gender, Overconfidence, and Common Stock Investment,” *Quarterly Journal of Economics* 116, 1 (February 2001): 261–292.
5. It is important to make a distinction between investing in a diversified portfolio and risking capital. Risking capital involves doing things like building companies (big or small), investing in speculative real estate using leverage, or working for oneself rather than for a large company.