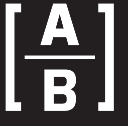

HOW TO GET CLIENTS TO TAKE ACTION NOW

When faced with a complicated or challenging decision for which we cannot find an immediate and satisfying answer, people use heuristics. Heuristics allow us to answer a simpler question instead.

People also inadvertently use natural biases (loss aversion, anchoring and proximity bias) when making decisions. These tendencies often disrupt rational decision making and prevent investors from taking action.

This guide explores how these kinds of dynamics interfere with good decision making and offers direction on managing the effects of heuristics and natural biases. The guide provides easy-to-follow examples of how to shift client assets into equities, active municipals and global bonds.

AB **ADVISOR INSTITUTE**SM

Ken Haman
Managing Director

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THE GUIDE INCLUDES THREE STRATEGY EXAMPLES THAT SCRIPT A SIX-STEP APPROACH FOR PRESENTING A COMPLICATED AND UNFAMILIAR SOLUTION.

HOW HUMANS MAKE DECISIONS

Investors often rely on simple and familiar solutions to complicated decisions. Understanding why and how this happens enables Financial Advisors to make more impactful recommendations.

HEURISTICS AND THEIR ROLE IN DECISION MAKING

The human brain is an amazing machine. The dynamic ways in which language, thoughts and emotions are deeply connected and how the brain perceives and reacts to information are widely studied. Daniel Kahneman won the Nobel Prize for delineating and describing the vulnerabilities of the central nervous system. In his book *Thinking, Fast and Slow*, he catalogs the natural heuristics that cloud investment decisions: “The technical definition of *heuristic* is a simple procedure that helps find adequate, though often imperfect, answers to difficult questions.”[1] We use heuristics when faced with a complicated or challenging decision for which we cannot find an immediate and satisfying answer. Our mind decides to answer a simpler question instead. Unfortunately, natural heuristics can befuddle investment decisions. By understanding the ways humans make decisions and how heuristics work, advisors can improve the quality of the recommendations they make to clients, and those recommendations may have greater influence. In this guide, we focus on how three heuristics (loss aversion, anchoring and proximity bias) influence financial decision making.

LOSS AVERSION COLORS OUR WORLD

The first few lines of Charles Dickens’ novel *A Tale of Two Cities* provides an example of how the human mind alters the information it receives according to built-in patterns. The famous lines “It was the best of times, it was the worst of times, it was the age of wisdom, it was the age of foolishness” are intended to present the emotional tension of the era in which the novel is set—the good and bad experiences of everyday life. This is where one of the peculiarities of human nature kicks in. Humans tend to experience the pain of losses significantly more than the pleasure of gains. This heuristic, loss aversion, has revealed that most of us require more than twice the upside of an investment for the positive feeling to equal the negative feeling experienced when we lose money.

In fact, loss aversion colors all of our experiences: we react to “worst of times” much more strongly than “best of times.” Imagine being told in advance that there will be some good times *and* some bad times on your vacation. How would you feel as you anticipated the trip? This tendency has significant implications for our work with existing and prospective clients.

With the loss aversion heuristic in mind, it becomes clear why investors often become negatively affected by news reports and market commentary. Rarely is *all* the news positive. Instead, investors are exposed to one or more issues of concern, which tends to get magnified and draw focus. As a result, in spite of attempts to provide useful information to help with decision making, client emotions can get activated as soon as a message includes anything negative.

1 Daniel Kahneman, *Thinking, Fast and Slow* (2011): 98

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ANCHORING SHIELDS US FROM PAIN

Another heuristic is anchoring. This is the normal tendency to vividly recall negative past experiences as a way to learn from the past and protect ourselves in the future. The anchoring bias can be difficult to see, but is easy to understand. If you have a traumatic or painful experience, such as an investment loss or accident, it registers deeply in the brain. This is a normal part of learning about the world and coping with danger. The challenge becomes that once we've had a painful experience, *we tend to see the possibility of that experience everywhere we look*. We create an anchor to past experiences and feel that the same experience is highly likely to happen in the future.

Anchoring leads investors to make the emotional conclusion that a previously experienced negative event is likely to happen again. When loss aversion is added to the equation, the past painful experience tends to be perceived with even more angst.

BABY BOOMERS AND THE GREAT CORRECTION

Observers of market behavior since the "Great Correction" of 2008–2009 have seen heuristics played out in two patterns: investors' aversion to re-risking and deploying assets into equities; and the increased frequency and magnitude of volatility as investors continue to react strongly to market movements, anticipating the painful event they "know" is likely to happen.

Loss aversion and anchoring, combined with the actual experience of investing in the past, have had a deep impact on the Baby Boomer generation. The oldest Baby Boomer turned 35 in 1981. During the 1980s and 1990s, 78 million Baby Boomers entered middle age and started investing. For the most part, they had a very positive and consistent experience with investing, enjoying bull markets in equities and fixed income.

Unfortunately, markets did not remain benign. Two major corrections within a single decade—one of them the largest in two generations—established a deep, negative anchor of disappointment and anxiety in many investors. This established a third heuristic, proximity bias, toward future corrections and a reluctance to reenter the markets and risk more losses.

These natural tendencies, combined with the elevated expectations of more than two decades of positive investment experiences, left a generation pessimistic and disappointed. In fact, the Pew Research Center has measured pessimism at the highest level ever seen within this group.[2]

This has profoundly impacted how Baby Boomers respond to messaging, with pessimism and skepticism about positive claims for the future. It's hard to believe that good things are likely to happen. In fact, it's easier to believe that bad things are likely in the future—that investors are surrounded by dangers that can still hurt them if they are not careful.

2 Pew Research Social & Demographic Trends, 2010

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MOTIVATING CLIENTS TO ACT

An elementary understanding of human behavior can be useful for developing a strategy that will motivate clients and help them overcome biases.

ACTIVATING THE THINKING PART OF THE BRAIN

Past negative expectations represent a challenge *and* an opportunity for the advisor who wants to work more effectively with any pessimistic investor. A closer look at how human beings make decisions will help clarify a strategy.

When making a decision to take action, an investor uses two parts of the brain: the rational part (the neo-cortex) and the emotional part (the brain stem). The neo-cortex uses information to understand whether or not something is a good idea; the brain stem and limbic system determine how you feel about the idea. When attempting to motivate a decision about investing, an investor needs to balance the *feelings* that motivate action with *clear thinking* that guides the decision.

The emotional part typically takes care of itself. As the Financial Advisor, your job is to activate the thinking, rational side. Your main tool for helping investors make good decisions is language. Your choice of words, and the illustrations you use to accompany those words, will determine how the investor becomes motivated. It's important to ensure that the investor understands the situation he is in and the likely impact of each investment. It's equally important to use appropriate language when describing a suitable investment. Our guidance is to avoid extreme terms and hyperbolic descriptions. Strike a balance between alerting your client to a potential problem and generating alarm or distress.

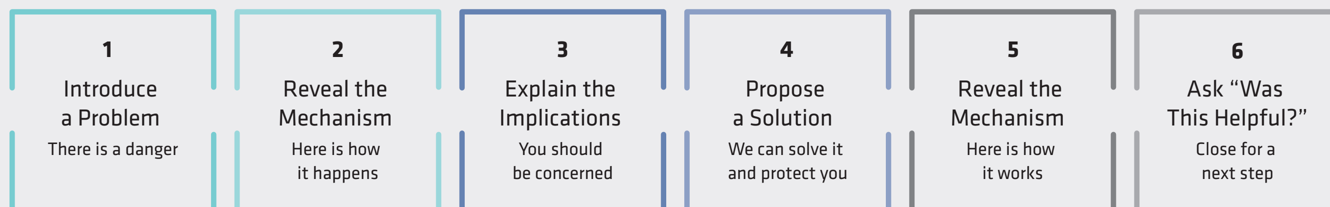
USING LANGUAGE AND INFORMATION TO MOTIVATE ACTION

There are six steps to moving a client from thinking about an idea to taking the action needed to implement the change. The first three steps are:

1. **Introduce a problem:** Start by introducing a problem that will potentially impact the investor—a "burning platform" problem that allows the story to achieve relevancy quickly.
2. **Reveal the mechanism:** Next, reveal the mechanism in the capital markets that creates this problem and why it's something to be concerned about.
3. **Explain the implications:** For the investor to respond to the message, he must understand how the problem happens and why it's something he should be personally concerned about.

Most advisors are familiar with the final three steps needed to get a client to take action, but these first three are often overlooked. If these first steps are accomplished successfully, the last three become less challenging. This guide provides step-by-step examples of how to take a client through these steps, with the ultimate goal of getting a client to move from the simple and familiar to the complicated and unfamiliar.

SIX STEPS TO MOTIVATE ACTION



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EXAMPLE #1: APPROACHING INVESTORS ABOUT EQUITIES

The following is an illustration of how to follow the six steps we've outlined and present the case for a reallocation into equities.

Given the ups and downs that come with investing in capital markets, it's not surprising that investors don't always make sound decisions. Rather than working against this powerful tendency, advisors are better off accepting it as human nature. They should frame their recommendations based on how investors *feel* about the world as well as how investors should *think* about investing. When approaching investors about equities, don't simply present the benefits of an asset class; speak to irrational fears.

STEP ONE: INTRODUCE A PROBLEM

Investors should be prepared for fixed income to offer lower-than-normal returns for some time. To improve returns and realize desired outcomes over time, investors will need to consider deploying assets into other asset classes—including equities. This comes with a challenge: volatility in the S&P 500 Index in recent years has been high. For risk-averse investors, this creates a negative motivation and a desire to avoid equities in favor of a less volatile investment. The result: investors are overweight fixed income and underweight equities.

STEP TWO: REVEAL THE MECHANISM

The second step is to pull apart the mechanism that causes the problem you've introduced: a combination of capital-markets dynamics (elevated volatility) and a particular concern or sensitivity of investors. Today, market conditions and investors' recent loss experiences are conflicting with older investors' increasing needs for income and sustained investment returns. Rationally, we can show that massive corrections like 2008 are very rare, just as massive leaps of return happen only occasionally. Over long periods, investors can be confident that they will most likely see a modest or good return on their investment punctuated by an occasional year of loss.

It's also helpful to reveal hidden aspects of the mechanism behind investments: observations over very long periods reveal that, on most days, markets move upward or downward in very small increments. Meaningful gains or losses take time to accrue. Occasionally, the markets lurch forward or backward. The big gains feel great, but the losses can activate a panic, pushing unprepared investors out of the markets. To truly understand the implications of these forward and backward lurches, it's helpful to examine what happens over time if you miss the best and worst days in the markets. This will reveal important dynamics about how the markets actually function.

STEP THREE: EXPLAIN THE IMPLICATIONS

The third step is to ensure that the investor understands the implications of the problem and how they will affect her personally. Motivation to respond to a recommendation can be inhibited by a type of emotional inertia, a reluctance to take any action. Advisors have frequently heard investors say, "Let's wait and see what happens" or "Let's wait until we see another big pullback before we invest."

Unfortunately, in the long term, such decisions can be devastating. An additional 1% of return each year over time substantially increases available spending in retirement. For the Baby Boomer generation, many of whom will live well into their 90s, this additional retirement funding is vital to sustain a desired lifestyle. This leads to the important implications of avoiding appropriate risk, which has led this investor to choose one of three unpleasant alternatives: (1) constrain the current lifestyle and save more toward retirement to make up for diminished returns over time; (2) constrain the retirement lifestyle by living on less during retirement; or (3) plan to spend less time in retirement.

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STEP FOUR: PROPOSE A SOLUTION

An advisor cannot simply propose that the investor choose equities as a solution; there are many different approaches to investing in equities. An effective solution needs to be specific and, to the extent possible, address at least some of the concerns the investor is likely to experience: "Can I count on this investment to deliver for me?" "Am I making the right decision with my money?" "What will happen to my investment if there is a big correction sometime soon?"

This means the advisor must select a strategy that uses mechanisms that address the investor's concerns. Rather than asking the investor to accommodate the requirements of equity investing ("In this part of your portfolio, you will need to tolerate substantial volatility from time to time"), it's more attractive to offer a strategy that uses specific methods to achieve desired investment outcomes without the experience of downside losses. This means selecting asset managers that have consistently delivered attractive performance while intentionally and consistently avoiding significant losses.

STEP FIVE: REVEAL THE MECHANISM

Now is the time to delve into the specific approaches of the strategy that you're recommending. In this case, we suggest showing the upside/downside capture ratios of various asset classes compared to our preferred strategy, along with illustrations of historical performance in various market conditions.

STEP SIX: ASK "WAS THIS HELPFUL?" AND CLOSE FOR A NEXT STEP

The final step is to close the conversation with a specific recommendation for action. Having presented an overview of how the preferred strategy compares to other asset classes (and even more familiar strategies) and having checked with the client that all of the information has been understood and digested, it's important to clearly recommend an action that will resolve the problem as presented in steps one through three.

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EXAMPLE #2: ACTIVE MANAGEMENT FOR MUNICIPAL BONDS

The following is an illustration of how to follow the six steps outlined and present the case for hiring an active bond manager.

Recent changes in tax rates have made municipal bond yields more attractive relative to taxable bonds. However, the muni market has undergone significant changes, including the demise of bond insurers and a decline in interest rates. In spite of these changes and with risks clearly elevated, investors still have hundreds of billions of dollars deployed in unmanaged bond portfolios. They need to understand the potential impact on their portfolios.

STEP ONE: INTRODUCE A PROBLEM

With interest rates near historic lows, yields are lower on newly issued bonds, which reduces annual income for fixed-income investors. When rates eventually start to rise, the impact will tend to reduce the value of existing bond portfolios—an issue that's more pronounced for longer-term bonds. Credit exposure within munis can offer the potential for enhanced income, but the need to address and respond to credit risk has only intensified.

STEP TWO: REVEAL THE MECHANISM

Aggressive monetary policy from the Federal Reserve and investor flight to Treasury bonds have pushed interest rates to near historic lows. And as a result of the financial crisis, municipal bond insurance has virtually disappeared, increasing the credit risk of municipal portfolios.

Prior to 2008, insured bonds represented, on average, more than 50% of issuance; today, they represent less than 6%.[3] This translates into a generally lower credit quality in the markets. As recently as 2007, the AAA-rated segment accounted for nearly 70% of the municipal market; today, it's only 13%.[4] This increased exposure to credit risk could more than offset the benefit of diversification in small, individually owned portfolios no longer protected by bond insurance.

STEP THREE: EXPLAIN THE IMPLICATIONS

The demise of insurance means that investors are much more exposed to the possibility of rating changes, which affect the price of a bond. About 75% of the market has had a credit rating revised in the last decade or so.[5] Not a default—because less than half of one percent of issuers default over time. But a rating change alone can impact bond prices.

For example, if a bond's credit rating is downgraded from A to BBB, a $1 million investment would lose almost $70,000, or 7%, from price depreciation alone. Remind the client that a bond's total return reflects not only its yield or income, but also its capital gain or loss. Also, locking into a bond or group of bonds in a passive portfolio could mean missing out on the higher yields that may be available as the shape of the yield curve, credit conditions or interest rates change.

Transaction costs can make a dent, too. The daily trading volume in the muni market is half of what it was just a few years ago. Net supply is down dramatically, as state and local governments cut back on new infrastructure initiatives. As a result, trading costs have risen across the board. If the client is trading in small volumes, it's possible to lose all of a year's income to trading costs—or even more. While smaller transactions have always been more costly than large trades, the difference has increased over the past few years.

3 *The Bond Buyer*, as of December 2014
4 *The Bond Buyer*, S&P and AB. Ratings are the measure of the quality and safety of a bond or portfolio, based on the issuer's financial condition as rated by Moody's Investors Service. AAA is highest (best) and D is lowest (worst).
5 *Distressed Debt Securities Newsletter*, Moody's Investors Service, US Federal Reserve Board and AB, as of December 2014

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STEP FOUR: PROPOSE A SOLUTION

There are many reasons why an active bond manager can be valuable to the private municipal investor today. There are more than 46,000 issues in the Barclays Municipal Bond Index alone—and thousands more that aren't even in the index. Each issue has its own features and levels of securitization, which can have a huge impact on its potential returns. For example, many municipal bonds have a call option, which allows the bond's issuer to buy it back—usually at a disadvantageous time for the investor.

Other aspects of a bond can affect the price, too, including put features, the issuer's creditworthiness and the bond's tax treatment. Researching the potential impact of these distinctions takes time, resources and expertise.

STEP FIVE: REVEAL THE MECHANISM

One way active managers can add value is by taking advantage of a phenomenon called roll—a tool not available to buy-and-hold bond investors. Roll is the natural price gain that a bond experiences as it ages, and competes with bonds with lower coupons. The ability to capture roll depends on the steepness of the yield curve: the steeper the curve, the more valuable roll becomes. Today's potential advantage is 1.5%, about 1.6 times the long-term average of 0.9%.[6]

Today the return from roll is likely to be greatest where the yield curve is steep, which is in the intermediate-maturity (five- to 10-year) range, and lowest where the yield curve is flat, in the long-maturity (20- to 30-year) range. Active managers can not only enhance potential returns by using strategies such as roll, but they can also reduce exposure to long-term munis, which are more vulnerable to rising rates. Active managers are also able to obtain institutional pricing, using the size of their orders to purchase bonds at wholesale prices and avoid the markups retail investors must pay.

Finally, because active managers can research the creditworthiness of specific bond issues, they can exploit the higher levels of return available in lower-quality bonds while managing the risks. This is critical, because in periods when the Federal Reserve has raised interest rates, lower-rated bonds have outperformed higher-rated bonds. And the extra income that these medium-grade and high-yield municipal bonds offer is still very high by historical standards.

STEP SIX: ASK "WAS THIS HELPFUL?" AND CLOSE FOR A NEXT STEP

Having helped the investor understand the mechanisms and implications of passive bond investing, and having educated her to appreciate the mechanisms and implications of active management, you can now check to see if the story has made sense to your client. If it has, you can then make a specific recommendation for an actively managed muni bond fund to replace her passive portfolio.

6 Municipal Market Data and AB, as of December 31, 2014; estimates for seven-year A-rated, noncallable municipal bonds

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EXAMPLE #3: GLOBALIZING BOND PORTFOLIOS

The following is an illustration of how to follow the six steps outlined and present the case for investing in global bonds.

Globalization has had a major impact on the composition of bond markets over the past three decades, but many bond investors' portfolios remain decidedly non-global. This has created vulnerabilities and potential unintended consequences, particularly in a rising-rate environment.

STEP ONE: INTRODUCE A PROBLEM

Fixed-income markets have become increasingly global, but many investors still show a lot of home-country bias in how they build their bond portfolios. This is particularly true for US investors: the core bond strategy for most US-based institutional fixed-income investors remains highly US-centric.

STEP TWO: REVEAL THE MECHANISM

Today, despite huge US deficits and massive debt issuance, US Treasuries are only about one-quarter of the global sovereign debt outstanding. By the end of 2012, more than half of the outstanding corporate credit had been issued outside the US. But many investors have been reluctant to invest globally, preferring to stick close to home with their core fixed-income investments. This concentration hasn't been helped by the global flight to quality, which led many investors to US Treasuries in the wake of the global financial crisis.

STEP THREE: EXPLAIN THE IMPLICATIONS

A US-only bond investor is affected by only one business cycle, one yield curve and a single monetary policy. This creates significant exposure to the potential for rising interest rates in the US. While we believe that the rising-rate cycle will be gradual, there will be an impact on US bond portfolios.

Home-country bias also limits an investor's opportunity set. At the end of 2014, the Barclays Global Aggregate Bond Index contained $43 trillion in outstanding debt and more than 16,000 issues. That's a much bigger universe than the Barclays US Aggregate Bond Index, with about $17.8 trillion in outstanding debt and 9,000 issues.[7] So, US-only bond investors are fishing in a much smaller pond for opportunities.

STEP FOUR: PROPOSE A SOLUTION

A global bond portfolio diversifies return patterns by giving investors exposure to many different countries, economic cycles, business cycles, monetary policies and yield curves. While these cycles may closely align over short time periods, they haven't been highly correlated over long periods. This creates a diversification advantage for global investors.

Active managers also have more room to enhance global bond returns, because the gap between the best-performing and worst-performing countries each year is sizable. For example, in 2014, the UK outperformed Japan by almost 12% and US Treasuries by 9%.[8] That's a major opportunity to add value by managing country exposures. Investors also preserved more capital during down periods by globalizing. Allocating assets away from the US into other countries provides more opportunity for an active manager to add value in a global portfolio, to use research to overweight countries that are likely to perform better, and to underweight countries that are likely to underperform.

One caveat to global investing is currency exposure. Currencies have historically been much more volatile than bonds, so an unhedged global bond portfolio can present unintended consequences. That's why unhedged global bonds have failed to fulfill the core objective.

Fortunately, hedging currency exposure sharply reduces the overall risk of a global bond portfolio without sacrificing return, putting hedged global bonds squarely in the core category. In terms of risk-adjusted returns, hedged global bonds have been the clear winner historically—better than an unhedged global bond portfolio or even a US core portfolio. In this context, global hedged is simply a better way to meet the core objective.

7 Barclays, as of December 2014
8 Barclays and AB, as of December 31, 2014

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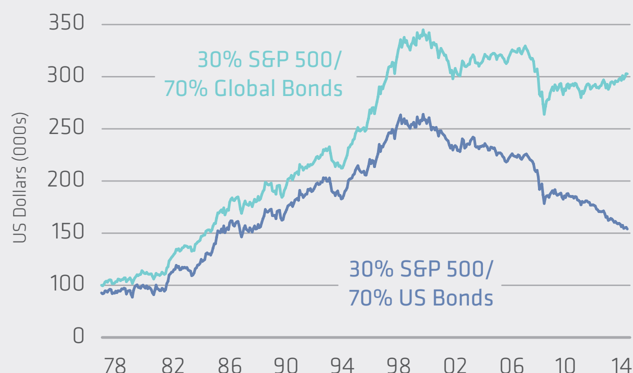
Growth of $100,000: 30/70 Stock/Bond Portfolio
with Inflation-Adjusted Withdrawals of 5%
HEDGED GLOBAL BONDS VERSUS US BONDS



Past performance does not guarantee future results.
Through December 31, 2014
Assumes a hypothetical investor is 65 years old and has accumulated a nest egg of $100,000 at the beginning of 1978. Five percent of the initial investment is deducted annually at the end of each month, adjusted for inflation. Allocation is invested in 30% stocks and 70% bonds. Stocks are represented by the S&P 500 Index. US bonds are represented by the Barclays US Treasury Index. Global bonds are represented by the Barclays Global Treasury Index hedged to USD (equal-weighted returns of the Barclays US, UK, Germany, Italy and Japan Treasury indices hedged to USD prior to 1987).
Source: Barclays, S&P and AB

STEP FIVE: REVEAL THE MECHANISM

Imagine a retiree who invested $100,000 in 1978 and has been taking an inflation-adjusted withdrawal of 5% annually. The dark blue line illustrates the growth of a portfolio in which the 70% portion of the 30/70 stock/bond allocation is invested in US core bonds. The teal line shows the growth of a portfolio in which the 70% portion is invested in hedged global bonds. The latter portfolio benefited from better risk mitigation during the inflationary environment of the late 1970s and early 1980s, as well as during the crash of 1987. The result over the full period shows almost double the accumulation versus the US-only allocation.

STEP SIX: ASK "WAS THIS HELPFUL?" AND CLOSE FOR A NEXT STEP

Having helped the investor understand the mechanisms and implications of a global bond portfolio, and having educated him to appreciate the mechanisms and implications of currency hedging, you can now check to see if the story has made sense to your client. If it has, you can then make a specific recommendation for a globally allocated, currency-hedged and actively managed bond fund to augment his existing portfolio.

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A WORD ABOUT RISK

Market Risk: The market values of the portfolio's holdings rise and fall from day to day, so investments may lose value. **Capitalization Size Risk (Small/Mid):** Small- and mid-cap stocks are often more volatile than large-cap stocks—smaller companies generally face higher risks due to their limited product lines, markets and financial resources. **Derivatives Risk:** Investing in derivative instruments such as options, futures, forwards or swaps can be riskier than investing in traditional investments, and derivatives may be more volatile, especially in a down market. **Leverage Risk:** Trying to enhance investment returns by borrowing money or using other leverage tools can magnify both gains and losses, resulting in greater volatility. **Short Sale Risk:** The risk that the portfolio will incur a loss by subsequently buying a security at a higher price than the price at which it sold the security short. The amount of such loss is theoretically unlimited. Short sale is a form of leverage. **Liquidity Risk:** The difficulty of purchasing or selling a security at an advantageous time or price. **Active Trading Risk:** A higher rate of portfolio turnover increases transaction costs, which may negatively affect portfolio returns and may also result in substantial short-term gains, which may result in adverse tax consequences for shareholders. **Management Risk:** There is no guarantee that a manager's investment and risk techniques will produce the intended results. **Foreign (Non-US) Risk (Including Emerging-Market Risk):** Investing in non-US securities may be more volatile because of political, regulatory, market and economic uncertainties associated with such securities. These risks are magnified in securities of emerging or developing markets. **Currency Risk:** If a non-US security's trading currency weakens versus the US dollar, its value may be negatively affected when translated back into US dollar terms. **Bond Ratings Definition:** A measure of the quality and safety of a bond or portfolio, based on the issuer's financial condition and not based on the financial condition of the fund itself. AAA is highest (best) and D is lowest (worst). Ratings are subject to change. Investment-grade securities are those rated BBB and above. If applicable, the Pre-Refunded category includes bonds that are secured by US government securities and therefore are deemed high-quality investment grade by the advisor. **S&P 500 Index** is a stock market index containing the stocks of 500 US large-cap corporations. Widely regarded as the best single gauge of the US equities market, the S&P 500 Index includes a representative sample of 500 leading companies in leading industries of the US economy. **Barclays Global Aggregate Bond Index** is a macro index of global government and corporate bond markets, and is composed of various indices calculated by Barclays, including the US Aggregate Index, the Pan-European Aggregate Index, the Global Treasury Index, the Asian-Pacific Aggregate Index, the Eurodollar Index and the US Investment-Grade 144A Index. **Barclays Municipal Bond Index** is an unmanaged index comprising a broad range of investment-grade municipal bonds having remaining maturities of greater than one year.

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