Finology Summit 2017 - The winds of change - key takeouts

Will Jackson | PortfolioConstruction Forum | 23 February 2017

Finology Summit 2017 featured international and local finology experts presenting their high conviction thesis on how the winds of change are affecting how investors think and behave with respect to money, and how we can better to relate with them.

Here are our key takeouts. Feel free to add your own!

THE WINDS OF CHANGE AND THE 4IR

– Graham Rich, Managing Partner & Dean, PortfolioConstruction Forum (Sydney)

> Synopsis
> Strong winds of change are blowing – we appear to be entering a new age of populist and economic nationalism. People are questioning long-held beliefs about money, investing and retirement, as improved longevity, new technologies and social media change the way we live and how we relate to others.

Graham Rich set the scene for Finology Summit 2017, by noting that the overarching Summit theme – "The Winds of Change" – relates just as powerfully to changes in society, as it does to the changes playing out in investment markets (the topic of the prior day's Markets Summit 2017 program). Rich wove the themes of intergenerational equity, social responsibility and technological innovation into his introduction, looking at the role technology has played in bringing cohorts together and in connecting people with money. "That's what, in a sense, Finology is about," Rich explained. "It's connecting people with money – not just for the sake of money, but in a way that means they have better financial wellbeing."

EMPATHY IS THE ESSENTIAL SKILL TO SURVIVE

– Michael Kitces, Partner & Director of Wealth Management, Pinnacle Advisory (Washington DC)

> Synopsis
> The compounding growth of computing power suggests it's only a matter of time before computers have the same brainpower as a human being. In fact, if Moore's Law – that computing power doubles every 18-24 months – continues to hold, the crossover point where computers are smarter than humans might not even be all that far away. Which has troubling implications for a wide range of knowledge-based professions, from doctors, to lawyers, to financial planners. Yet research shows that

> our brains are hard-wired to process information differently when received from human beings rather than computers. This implies the key trait for relating to investors will be the one skill that our brains are not programmed to receive from a computer - empathy.

Given the exponential growth of computing power, Michael Kitces showed that we are approaching the point at which machines will have more "brainpower" than people. In addition, mobile internet technology offers near-instantaneous access to almost all of human knowledge "in the palm of your hand".

However, Kitces argued that computers will aid rather than replace human advisers in the investment and financial advice process. Advisers will increasingly be pushed out of their traditional role as "gatekeepers of expert knowledge", but Kitces challenged delegates to consider how they will embrace new technology and where they may add value "beyond what the computer alone can do" - beyond simply bringing beta and alpha to portfolios, to adding he called "gamma".

Regarding the perceived threat of "robo" planners, Kitces noted that robos are the latest in a long line of technological innovations which have changed - but not eliminated - the role of human advisers. Indeed, completely automated robo advice services are only a small part of the market and tend to be restricted to asset allocation, Kitces showed. The most successful robo players, such as Vanguard and Personal Capital in the US, are those which use technology in combination with human advisers.

Kitces proposed that traditional planners should shift towards the role of "relationship worker" - that is, working collaboratively with clients to assess information, and to guide them towards desired goals. Finology skills, including "an ability to bring empathy to the table" will be crucial, he concluded.

THE ADVICE TIPPING POINT IS IMMINENT

- Stig Nybo, Global Head of Client Development, Capital Preferences (San Francisco)

> **Synopsis**
> Aging populations, low interest rates, and increased market complexity have financial wellbeing teetering on the edge. This is a global phenomenon with regulatory tailwinds, fee pressure, and unbridled experimentation around the delivery of advice. But the attack on advisors is not unique, it is simply next in a steady stream of disruption. Ironically, technology is both our poison and antidote.

Stig Nybo took a similar line to Kitces, arguing that technology represents an opportunity for financial advisers who are willing to modify their approach. According to Nybo, the big winners will be advisers who seek to better understand the goals and risk tolerances of their clients.

Nybo, who spent the past 30 years working in the US retirement sector, noted that the investment industry faces several challenges - from low savings rates and rising life expectancies, to a lack of financial literacy among the general public, and a culture of rampant lending and spending. Meanwhile, concerns over growing pension deficits have led governments to adopt a more interventionist stance in recent years. In the US, the Department of Labor Fiduciary Rule, which is scheduled to be phased in this year, will seek to raise standards within the field of retirement planning.

The problem of retirement provision is big and “emotionally charged”, Nybo said, adding that it is driving innovation in the so-called fintech sector. He predicted that 2017 will be "the year of the robo" and that such technologies will enable advisers to carry out their jobs more effectively.

However, advisers need to focus on better understanding the unique loss/risk tolerance profiles of their clients and to tailor their communications accordingly, Nybo argued. "If you are creating insight around your client, you are going to win, ultimately," Nybo added. "[But] if you are consuming insight, you are going to be on the receiving end."

PEOPLE KNOW WHAT TO DO TO CHANGE THEIR CIRCUMSTANCES. THEY JUST NEED TO DO IT! - Joanne Earl, Associate Professor, Flinders Business School, Flinders University (Adeliade)

Synopsis

People are bombarded with multi-media messages about the importance of changing behaviour across all facets of life. "Exercise more." "Eat less." "Plan ahead." "Buy low, sell high." But is it really all that easy? Can people easily change their behaviour and take action without support? What can be done to encourage people to act? The Theory of Planned Behaviour identifies elements that increase the likelihood of making changes - attitudes, the role of significant others and perceived control. When combined with implementation intentions, the theory of planned behaviour can help to promote real change and convert intentions into outcomes.

In her interactive, workshop-style session, Joanne Earl demonstrated how advisers can use the "Theory of Planned Behaviour" to support positive behavioural change in clients.

According to the theory, human intentions are driven by three factors:
1. Attitudes - the benefit an individual believes he may achieve through behavioural change;
2. Subjective norms - beliefs regarding how other people view particular behaviours; and,
3. Perceived behavioural control - the expected ease of achieving a behavioural change.

Earl explained that perceived behavioural control is key to achieving behavioural change, and that individuals often "switch off" when presented with too much information. She used the example of the 2006 documentary film "An Inconvenient Truth", which sought to provide education and inspire action on climate change, but which failed to provide practical steps that individuals could take.

Instead, Earl suggested, "smart goals" are an important tool in converting objectives into behaviour. For advisers, the key is to ensure clients make a strong commitment to an established goal, and that the goal is very specific. For example, if a client commits to set up a savings plan, there should be agreement on specifics such as what actions will be taken and when, how and where, she proposed.

BUY LOW, SELL HIGH SOUNDS SIMPLE BUT CLIENTS NEED A FRAMEWORK
– Douglas Isles, Investment Specialist, Platinum Asset Management (Sydney)

Synopsis

Despite increased awareness of behavioural finance, evidence confirms investors' poor timing with managed funds due to performance chasing. The world is probabilistic, but industry communication revolves around forecasts, opinions and outcomes, over-emphasising recent success. Markets present huge challenges – dealing with social pressures, processing information and timeframes. Clients benefit from understanding the investment journey. Most learn via anecdote and analogy – but key knowledge includes the range of outcomes and coping with feelings of loss aversion and FOMO. Having prepared responses to scenarios improves the chance of success. This framework is simply "Buy Low, Sell High".

Douglas Isles argued that cognitive biases continue to prevent individuals from following basic investment principles – and that financial advisers should seek to protect their clients from herd behaviour.

Isles proposed that human decision-making is heavily influenced by a "desire to be connected", given individuals feel the pain of social exclusion as acutely as physical discomfort. But while there may be "wisdom in crowds", investors face heightened risks when markets are driven by a consensus view.

In particular, Isles said, the framing of information plays a crucial role in investor perceptions. He described an experiment conducted by his firm in which they distributed equal numbers of positively- and negatively-framed questionnaires at 10 events they ran around Australia. The result? Respondents to the positively-framed survey predicted a markedly higher future market return.

Given the unpredictability of markets over the short term, investors must endeavour to remain rational by evaluating price movements against changes in the "real world". For advisers, the key is to speak with clients in a language they understand, Isles argued. "Accept that they struggle with social pressures, and that they struggle in dealing with information and time," he concluded.

AN INVESTMENT PHILOSOPHY IS CRITICAL
- Graham Rich, Managing Partner & Publisher, PortfolioConstruction Forum (Sydney)
- Tim Farrelly, Principal, farrelly's Investment Strategy (Sydney)

Synopsis

Investors are becoming more educated and enquiring. More and more they want to know WHY their adviser is making recommendations as well as what those recommendations are. This is critically important in times of market stress - the market is falling, why aren't we selling? Should we be buying? To get the best results for investors, advisers need to be able to bring take them on the journey. To do that a clear, communicable, logical and understandable Investment Philosophy is critical. If an investor understands their adviser's investment philosophy, bringing them along - particularly in times of market stress - will be dramatically easier.

In their combined workshop, Graham Rich and Tim Farrelly emphasised the importance of advisers having a robust, contemporary and defensible investment philosophy, and how such a framework may build client trust and satisfaction.

Rich told delegates that advisers who have a clear and communicable philosophy are better able to increase and demonstrate the value that they add. To illustrate the characteristics of a robust belief-set, Rich worked through the five founding principles of PortfolioConstruction Forum, which include a deep-seated conviction that high quality financial advice is underpinned by a defensible philosophy. "Without clarity around what your belief-set is for the giving of advice, the word 'quality' - I think - is suspect," he argued.

Farrelly noted the links between philosophy and Finology, arguing that a clear investment philosophy provides many benefits - including helping advisers gain client approval for investment ideas and reducing the chances of poor decision-making in times of stress.

In formulating a philosophy, Farrelly proposed that advisers base it around the central question: What am I trying to achieve for my clients?

Supplementary considerations included:
- What is risk?
- How important is risk profiling?
- Are markets efficient?
- Can I tell whether markets are cheap or expensive?
- What is my competitive advantage?

Other crucial decisions include whether advisers will seek to maximise client returns for a given level of risk tolerance, or the probability of meeting client goals. Adopting one approach over the other has a range of risk and portfolio construction implications, Farrelly noted.

FOCUS INVESTORS ON GOALS WITH A RETIREMENT SPENDING POLICY
– Tim Farrelly, Principal, farrelly's Investment Strategy (Sydney)

Synopsis
Most investors' capital is there for a purpose – generally, to generate sufficient cash flow to fund their desired retirement. In reality, most investors don't stress about returns, it's whether the returns will be sufficient to fund their goals. A robust, formal, written spending policy should describe how much confidence is required that funds will not be exhausted; how much can be spent each year; how that spending will be adjusted for changes to costs of living; and, how the spending plan will be reviewed each year to take account of changing circumstances. This way, we can help investors focus on what's really important – will they meet their goals?

In his second session of the day, Farrelly focused on the importance of a spending policy for clients who are drawing down their retirement savings.

He outlined a solution previously proposed by Michael Kitces, which calculates spending rates against the probability that retirement savings will be sufficient for the anticipated lifespan of the client. By adjusting spending and confidence levels at annual reviews, the approach can allow clients to spend more in the early years of retirement, when they are likely to be most active.

Such an approach potentially offers a "huge boost" to the advice process, Farrelly said, given that it benefits both clients and their advisers.

MINDSET/SKILLSET/TOOLSET – THE TRIFECTA FOR SUCCESS
– Troy Hendrickson, Duke CE

Synopsis
It is important to have both expertise and intellect to be successful in our roles. However, the key to being able to influence others is often underpinned by character attributes like credibility, trust and the ability to establish and maintain rapport. It's vital to have the right MINDSET, build the right SKILLSET and apply the right TOOLSET to maximise your connection and communication with investors.

In the final briefing of the day, Troy Hendrickson sought to bring together the threads of Finology Summit 2017, by describing how skillset, toolset and mindset were crucial factors for success.

Hendrickson examined the importance of listening and empathy in building relationships, and the frictions caused by the "intention-perception gap". While we judge ourselves on our intentions, it is important to remember that other people judge us according to their perceptions, he said.

On credibility, Hendrickson noted the importance of five factors:
1. Trustworthiness – reliability, competence and honesty;
2. Reputation;
3. Appearance – individuals tend to pass judgement quickly on others;
4. Consistency; and,
5. Knowledge.

"When it comes to the Finology concept, it's a matter of continually looking at: what [of our skillset, toolset and mindset] can we recalibrate and do a little bit differently?", Hendrickson concluded.

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