MULBERRY BOW

THE BOW BLOG

The Rider vs. The Elephant

June 2017

An old friend from Barclays days (seems so long ago, uh hum) was kind enough to give some of his time to a forum I run last week. If you haven't read any of the papers by Dr Greg Davies (Centapse) I wholeheartedly recommend them. Greg's insights into financial decision-making are second to none and while this blog is too brief to do them justice, I'd like to share some things I think you will might find very impactful on your/your clients' financial wellbeing.

Every decision we make has a rational aspect and an emotional one and Greg likens this to an intelligent rider on an instinctive but powerful elephant. The trouble is, when it comes to money, we naturally seek comfort and investing is inherently uncomfortable. For advisers with integrity there is an added problem, the world is uncertain. Therefore, by definition, 'telling it straight' undermines our client's comfort. In other words, we spook the elephant.

Clearly, we make thousands of little decisions every day and it makes sense to let our intuition steer us through most of them (no point building a complex model on the relative merits of a mocha over a flat white in Starbucks!) Even for more complex things, if we encounter them often we can reflect on what's important to us and train our intuition. The dangerous decisions are long-term, complex and unfamiliar. Such 'one-offs' (buying a house or transferring a pension) leave the rider not just challenged by complexity, but because they happen infrequently we cannot train the elephant.

How can we mitigate this difficulty and make better financial decisions? Well, there's good news and bad news. The good news is there are some strategies we can employ, and I touch on them below, but first the bad news - we are riddled with biases. What's more, being aware of them doesn't help much, but I'll take you through a few of them just the same – not least because it's fun thinking about times we've seen them manifest, in others anyway!

Loss Aversion – Why does losing 10% on an asset hurt more than making 10% feels good? Don't know, but it does
The Endowment Effect – A better known one, proved in lots of tests; if you wouldn't buy it again today, sell it!
Present Bias – We 'discount' our future selves i.e. choose pleasure today even if it means pain later (dessert anyone?!)
Crowd Bias – It's simply less painful to be wrong if you're not the only one, market 'bubbles' are a great example
Hindsight Bias – If it goes well we 'knew' it was the right thing to do, badly and we 'always felt a bit unsure of that one'
Attribution Bias – That successful decision was all down to my skill/knowledge vs. 'Nobody could've seen that coming'

So how can we cope with the huge value destruction that can undoubtedly result over our lifetime due to our elephant careering from one trap into the next, with the rider relegated to the role of coming up with *post hoc* rationalisations for emotionally-driven mistakes? There are three things we can do:

- ✓ Advice – A bit 'convenient' for a chartered financial planner I know, but a guide helping the rider read the elephant/spot potential problems in advance is critical (only works if the relationship is built on trust)
- ✓ A Financial Plan - A 'road map' for the rider gives context to decisions/calms the elephant during tricky times
- ✓ Break the Journey Down – Get a structure in place that sets out clear stages and takes on financial decision-making in 'bite-sized' quarterly or semi-annual 'chunks' instead of either 'obsess all the time' or 'ignore it'

Communication is key to all three. Your adviser needs to know what you want to achieve and then needs to shape the information you receive so it's both in line with those goals and presented in a clear/considered fashion. The elephant will get spooked otherwise. Imagine a valuation report with all 50 investments/lines on the front page sent out to you every month, with some red some black each time. Confusing? Scary? What if one month it's all red? Now imagine the same portfolio but the rolling three-year average is shown on the front page with the detail inside. Same portfolio, TOTALLY different emotional experience for the elephant and (probably) much more in line with your goals too.

Best of luck riders, I hope these insights help and if you need any help controlling that elephant give us a call!

Simon Bullock

Partner