THE HISTORY OF FINANCIAL PLANNING

The Transformation *of* Financial Services

E. DENBY BRANDON JR.
H. OLIVER WELCH

FOREWORD BY MARVIN W. TUTTLE JR.

Behavioral Finance

While asset allocation, asset management, and modern portfolio theory rely on probability formulas and mathematical models for their success, *behavioral finance*—which began gaining popularity in the late 1990s—turns the questions upside down. Rather than analyzing how portfolios perform, behavioral finance examines how *people* faced with money decisions perform. How tolerant are they of risk? How easy or challenging is it for them to make choices? And the big question: Which outcome is most likely to make a person happy?

Psychology was closely associated with early economic theory, including that of eighteenth-century writers Adam Smith and Jeremy Bentham. It later fell out of favor, to be replaced by theories that assumed people always act rationally with regard to money. A groundbreaking 1979 paper by two psychologists, Daniel Kahneman and Amos Tversky, shifted the discussion. In "Prospect Theory: An Analysis of Decision Under Risk," Kahneman and

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>
> —Daniel Kahneman

Tversky used the teachings of cognitive psychology to look at economic decision making—including the irrational variety.

In their prospect theory experiments, Kahneman and Tversky presented groups of subjects with this problem:

> *In addition to whatever you own, you have been given $1,000. You are now asked to choose between (A) a sure gain of $500 or (B) a 50 percent chance to gain $1,000 and a 50 percent chance to gain nothing.*

Another group was presented with this problem:

> *In addition to whatever you own, you have been given $2,000. You are now asked to choose between (A) a sure loss of $500 or (B) a 50 percent chance to lose $1,000 and a 50 percent chance to lose nothing.*

In the first group, 84 percent chose A. In the second group, 69 percent chose B. The two problems are identical in terms of net cash to the subject; however, the phrasing of the question causes the problems to be interpreted differently. "Put simply, your clients are far more distressed by prospective losses than they are made happy by equivalent gains," Kahneman said in a 2004 interview published in the *Journal of Financial Planning*.[17]

After Tversky's death in 1996, Kahneman collaborated with economist Richard Thaler on further research into "irrational" economic behavior. That work led to Kahneman's being awarded the 2002 Nobel Prize in economics. "The committee cited me for having integrated insights from psychological research into economic science," Kahneman wrote in his Nobel autobiography. "Although I do not wish to renounce any credit for my contribution, I should say that in my view the work of integration was actually done mostly by Thaler and the group of young economists that quickly began to form around him."[18]

Kahneman was a keynote speaker at FPA's 2004 convention. He observed, "All of us would be better investors if we just made fewer decisions."

Many planners found Kahneman's insights to be a welcome enhancement to their client services. Paula de Vos, CFP, of Synergist Wealth Advisors, LLC, in Carmel, California, told the *Journal of Financial Planning* that

> *planners provide value by being more dispassionate and objective, helping clients control some of their prevalent instinctive behaviors that can harm investment performance. Discussing behavioral finance with clients leaves them more open to having personal discussions and making the changes they need to succeed.*[19]