

GLOBAL INSTITUTIONAL CONSULTING

Making Group Decisions: Insights and Innovations in Behavioral Finance for Fiduciaries

Presented by:

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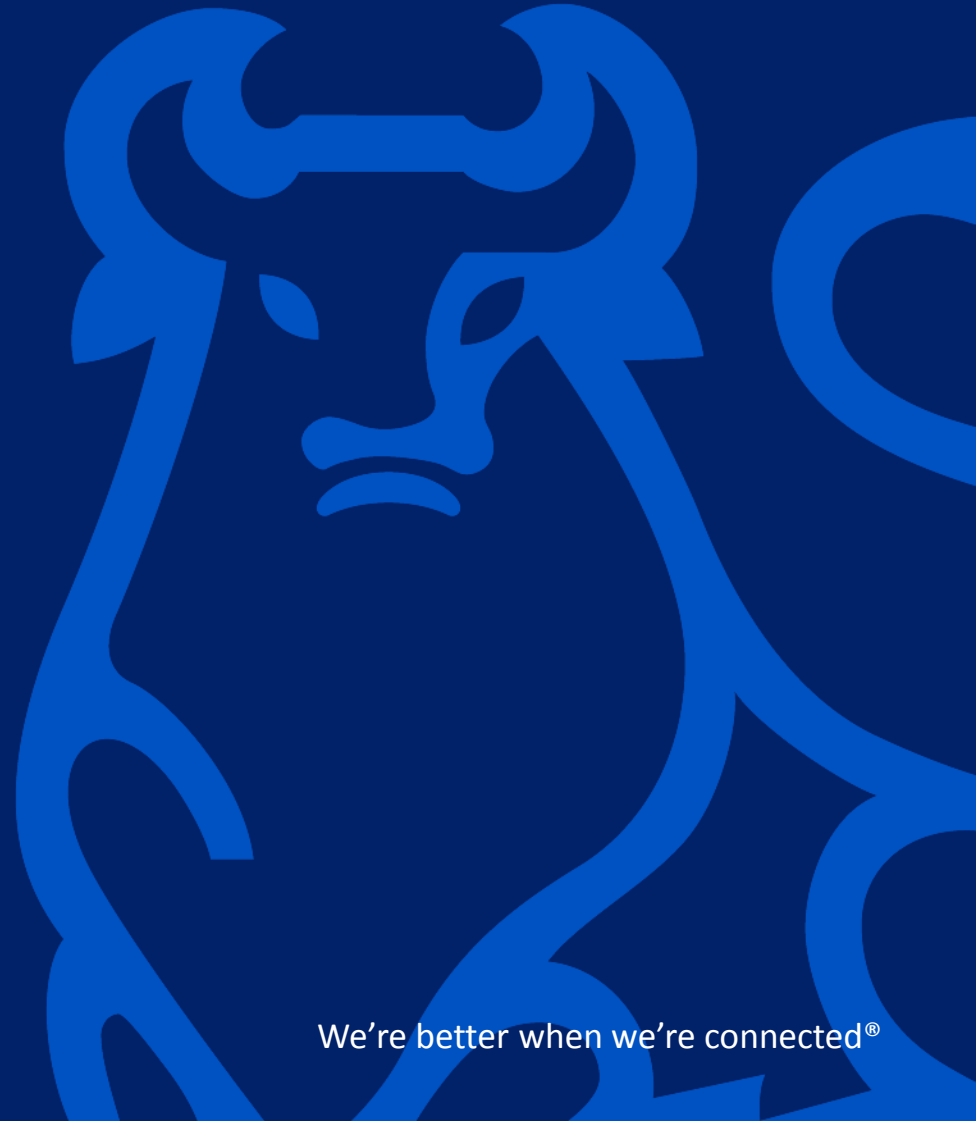
Michigan Community College Business Officers Association

Agenda

We will cover three main topics:

1. *What is behavioral finance?*
2. *How is behavioral finance meaningful to me?*
3. *How can behavioral finance impact my investment considerations?*

What is behavioral finance?



We're better when we're connected®

The cycle of market emotions

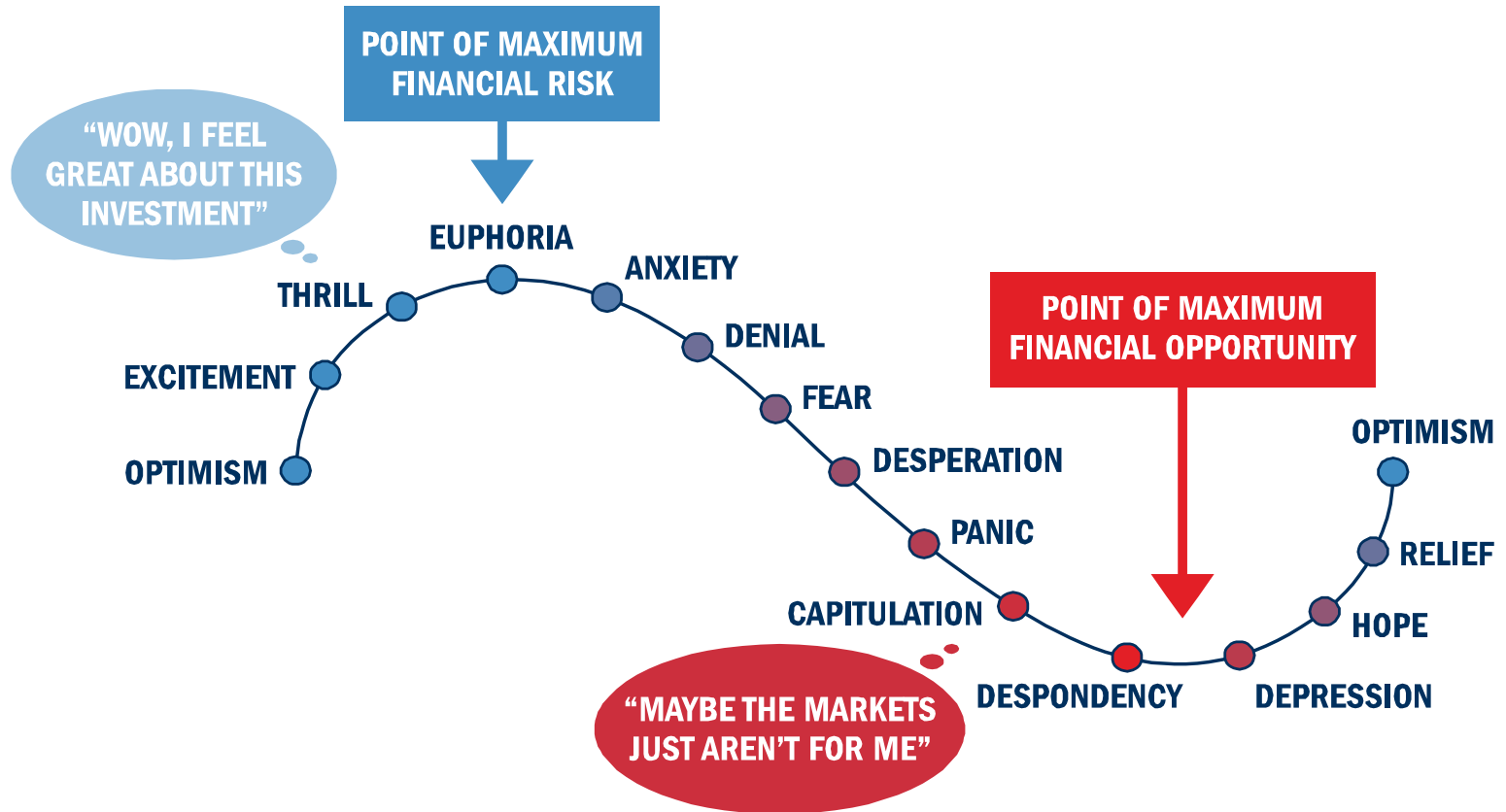
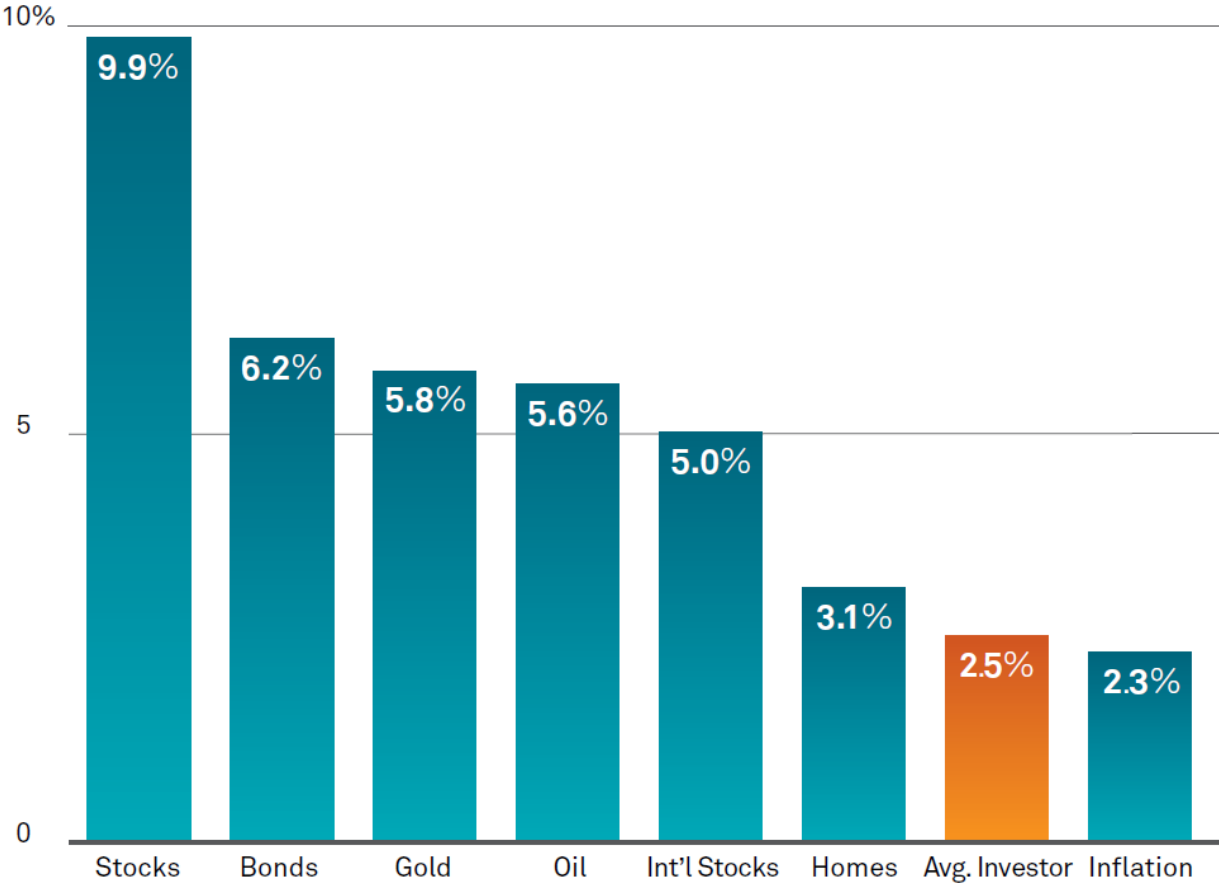


Chart source: Westcore Funds / Denver Investment Advisers LLC 1998

The average investor underperforms

Average Annual Returns Over the Past 20 Years, 1995–2014

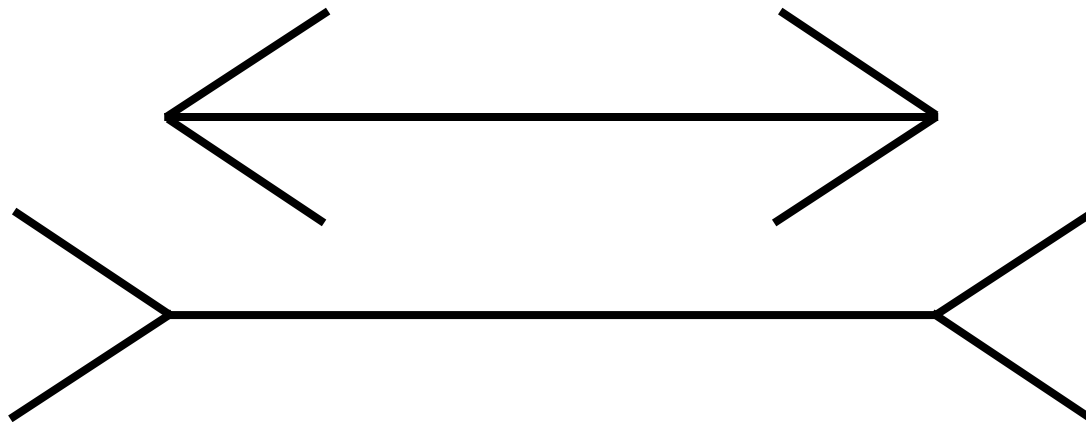


Source: BlackRock, Bloomberg, Informa Investment Solutions, Dalbar

Two lines of identical length



Can be made to appear different by changing perspective



Muller-Lyer illusion

Are you a risk taker?

Imagine that you bought \$6000 worth of stock from a now bankrupt company. There are two alternatives to recover money...

Would you choose A or B?

Alternative A

- Recover \$2000

Alternative B

- 1/3 chance \$6000 recovered
- 2/3 nothing recovered

92% go for A

Source: Wang, 1996

Different perspectives can change risky choice

Imagine that you bought \$6000 worth of stock from a now bankrupt company. There are two alternatives to recover money...

Would you choose A or B?

Alternative A

- Recover \$2000

Alternative B

- 1/3 chance \$6000 recovered
- 2/3 nothing recovered

92% go for A

Would you choose X or Y?

Alternative X

- Lose \$4000

Alternative Y

- 1/3 chance nothing lost
- 2/3 chance \$6000 lost

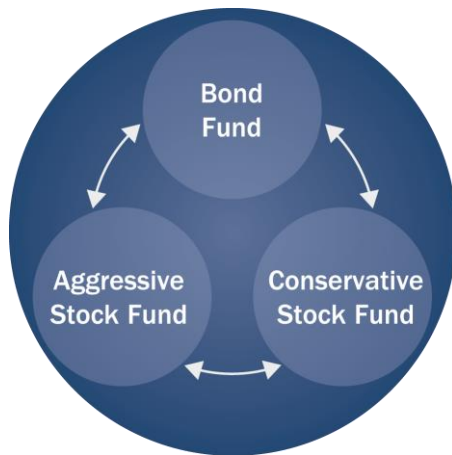
67% go for X

Source: Wang, 1996

What is behavioral finance?

Behavioral finance is the study of human behavior in a financial context, and acknowledges that the human side of investing is critical to investment success.

Traditional Finance

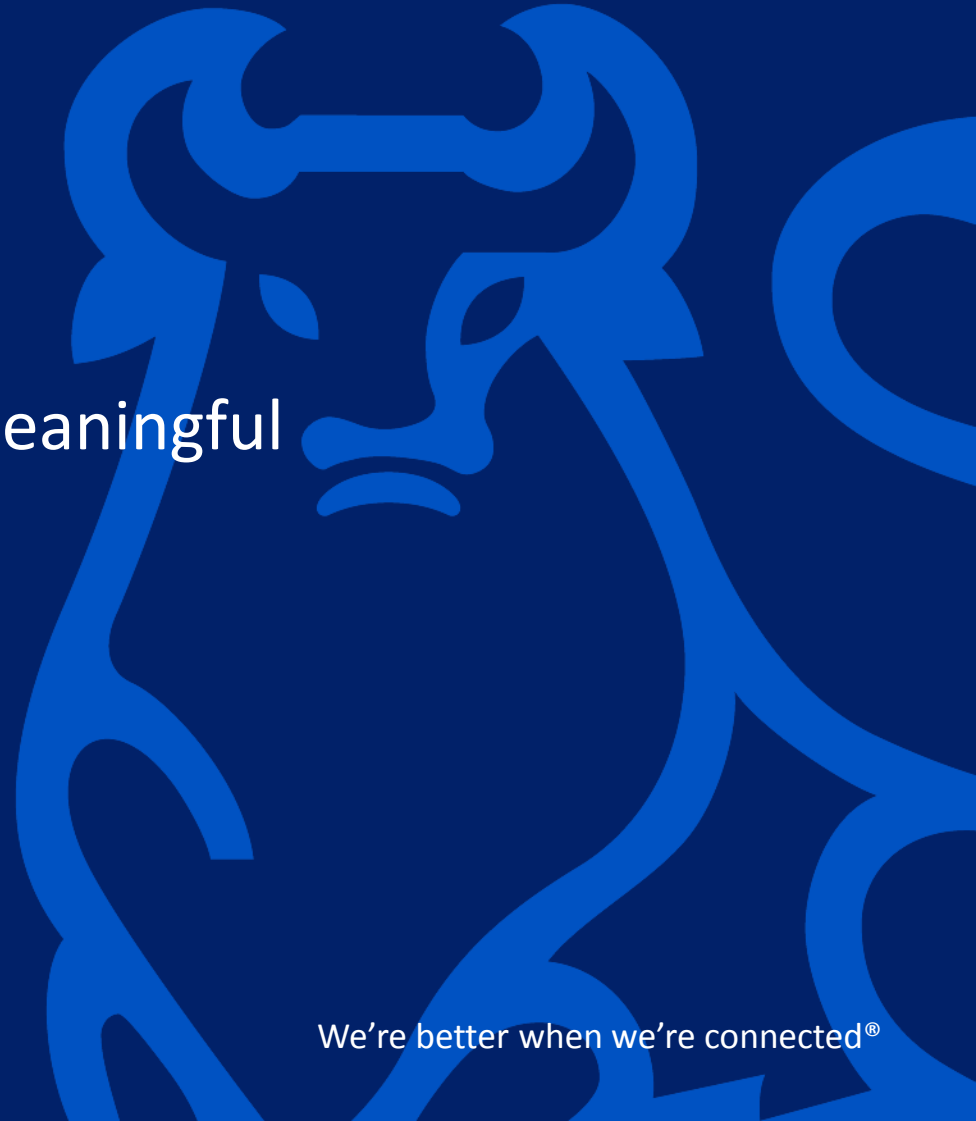


Behavioral Finance



How is behavioral finance meaningful
to me?

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What is your Investment Personality?

Investment Mindset

> My unique mindset about investing that reflects who I am.

Investment Approach

> The most important elements of my investment journey that help define the right investment approach for me.

Investment Purpose

> The people and purpose I am investing for.

Example: What is your Mindset toward risk?

Forced decision between *Choices 1 and 2...*



Choice 1: Receive \$20 in cash

OR



Choice 2: Flip a coin

- If heads, you receive \$0
- If tails, you receive \$100

Example: What is your Mindset toward risk?

Forced decision between *Choices 1 and 2...*



Choice 1: Receive \$1,000,000 in cash

OR

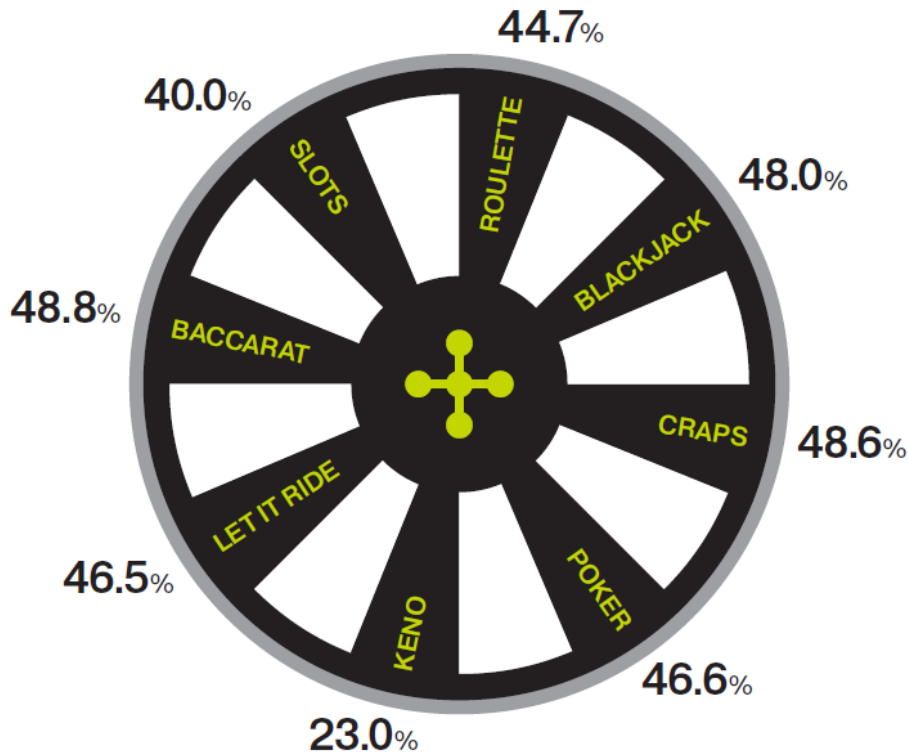


Choice 2: Flip a coin

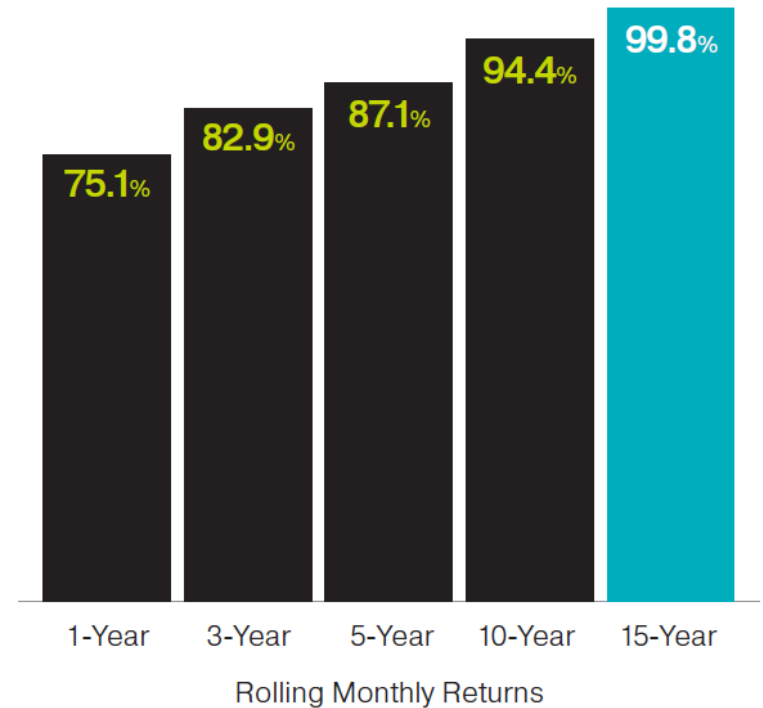
- If heads, you receive \$0
- If tails, you receive \$5,000,000

Is the market really like a casino?

Odds of Winning at Various Casino Games



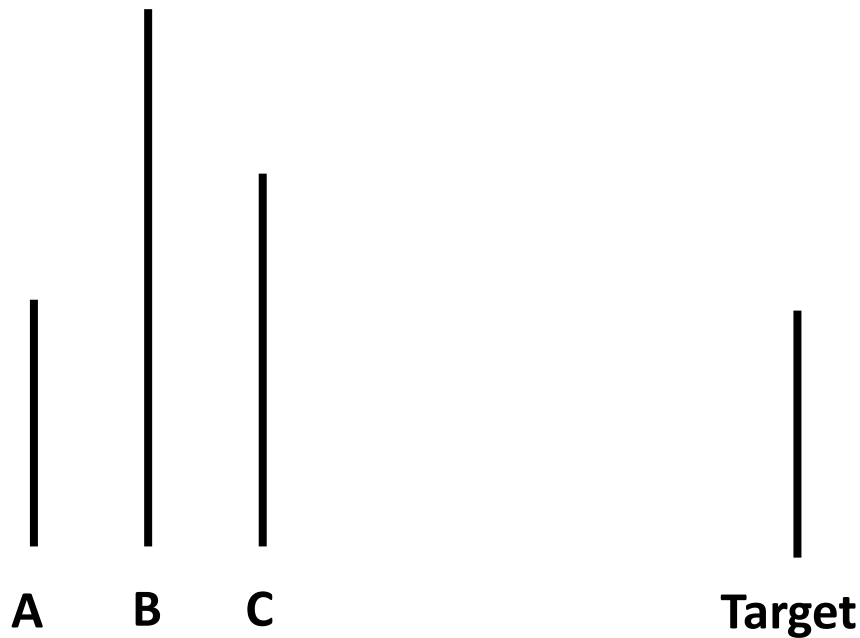
Percentage of Years U.S. Stocks Posted Positive Returns Over Rolling Periods (1926–2014)



Source: Morningstar Direct

Group decision making: Asch Experiment

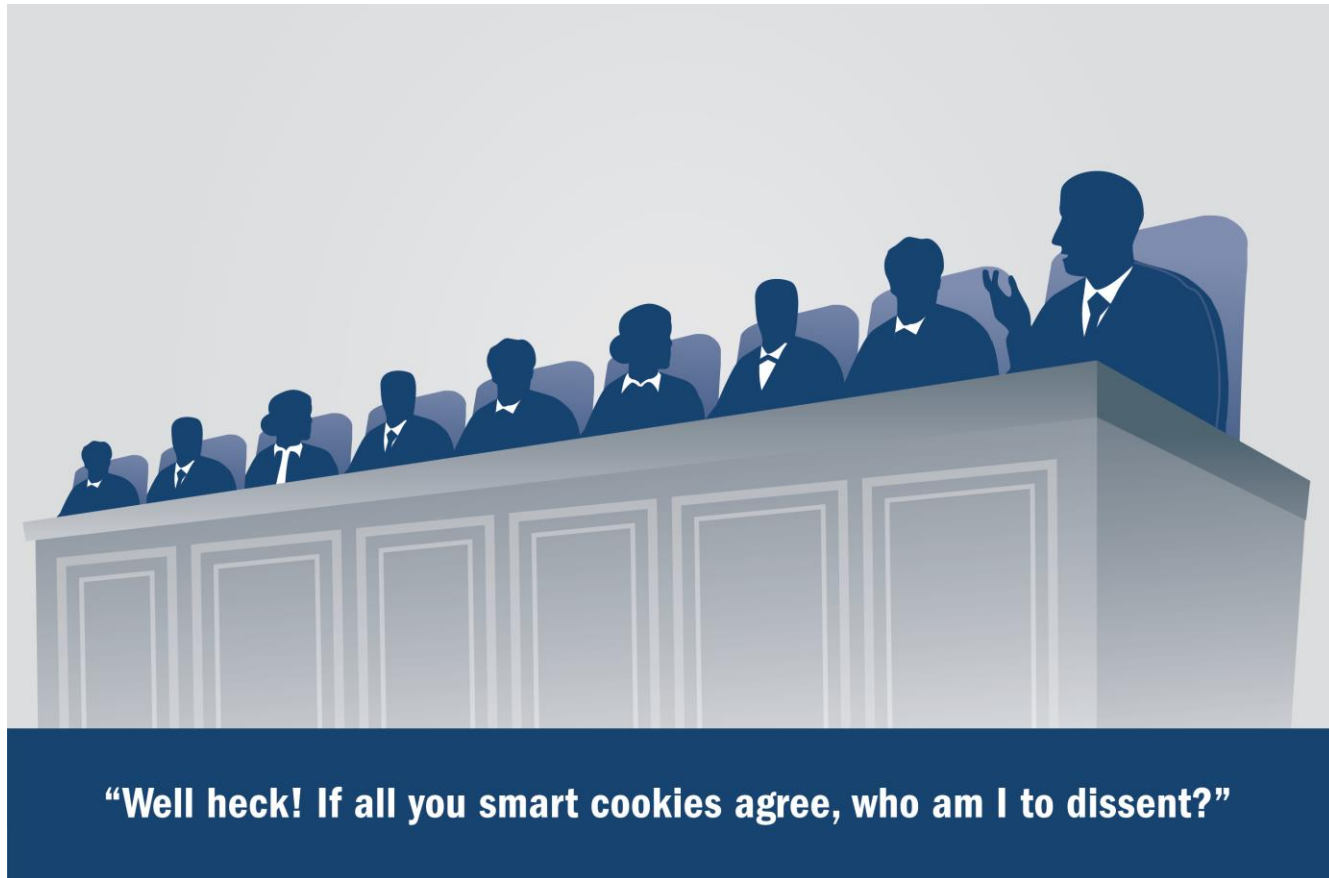
- Participant is brought into a room with other people
- In sequence, each person judges line lengths: *which is most similar to the target... A, B, or C?*



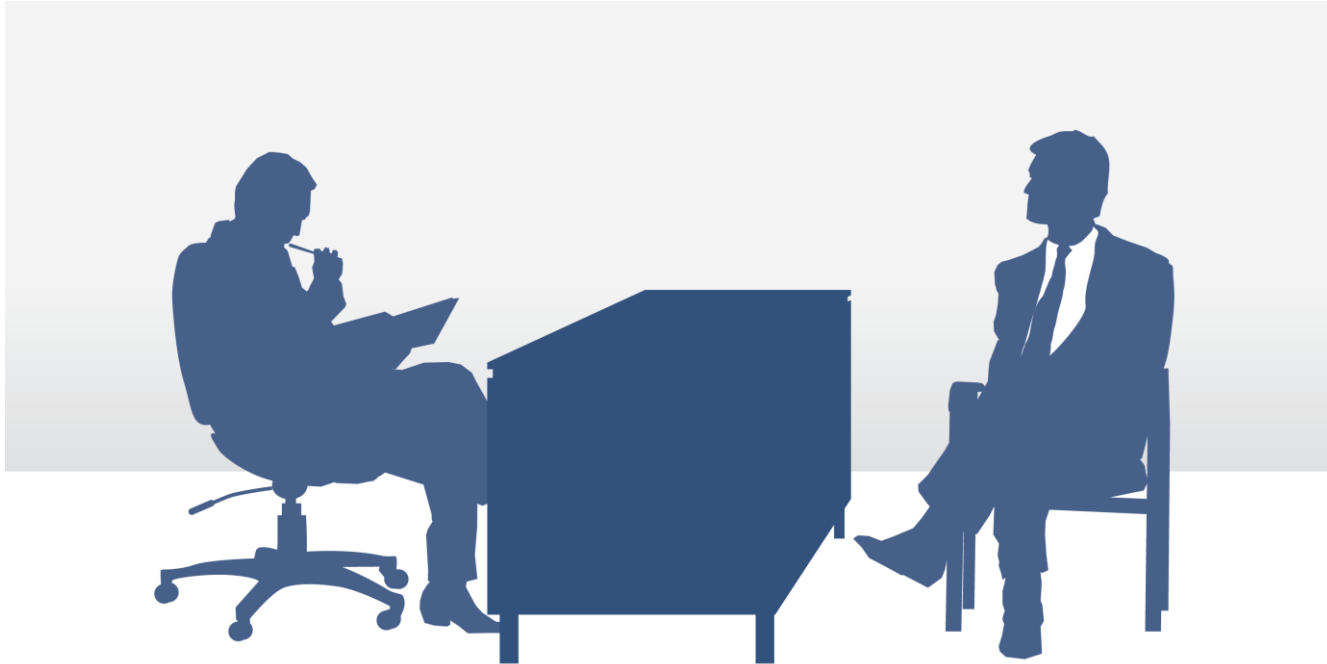
Information sharing



Information sharing



Information sharing



“I’d like your honest, unbiased and possibly career-ending opinion on something.”

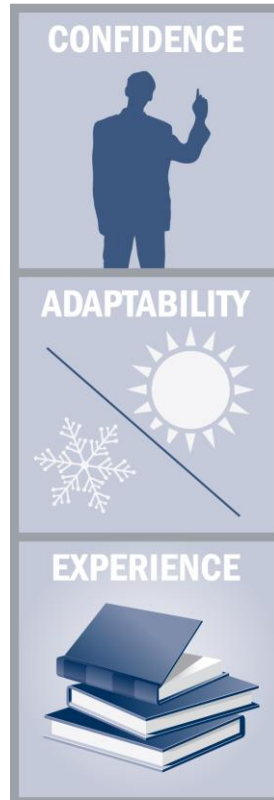
How can behavioral finance impact
my investment considerations?

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Understanding your own Investment Personality

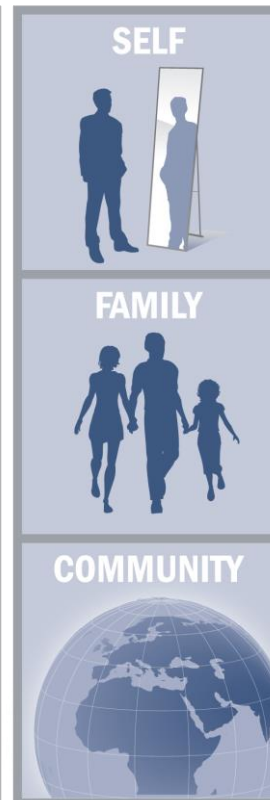
Investment Mindset



Investment Approach



Investment Purpose



Investment Personality whitepaper & questionnaire

SPRING 2012

Innovations in Behavioral Finance: How to Assess Your Investment Personality

Merrill Lynch
 Wealth Management
 Bank of America Corporation

WEALTH MANAGEMENT INSTITUTE WHITEPAPER

MICHAEL LIERSCH, Director
ANIL SURI, CIO, Multi-Asset Class Modeled Solutions

How can an investor avoid costly reactions to the ups and downs in financial markets? Behavioral finance suggests a solution: An investor can embrace—rather than reject—personal and emotional needs. By better understanding the makeup of her unique Investment Personality, an investor can enhance the opportunity to make decisions that are right for her.

Are you a bull or a bear? Not sure? Well, you are not alone. Individual investors' six-month forward-looking view on markets started 2011 on an optimistic note, with 56% of investors identifying themselves as bulls and only 18% as bears.¹ However, sentiment quickly turned negative, with bears dominating bulls by mid-March, corresponding with the Japanese earthquake, tsunami and subsequent Fukushima nuclear power plant crisis. From that point on, bull/bear dominance flipped not once or twice, but nine more times through the end of 2011 (see Figure 1).

Figure 1: Bull/Bear market sentiment—American investors' view on future stock market performance in 2011 (6-month forward-looking view).

Source: The American Association of Individual Investors (AAII), Dec. 2011

Importantly, bullish or bearish sentiment can define an investor's strategy: Bears may attempt to profit from falling markets, whereas bulls may attempt to benefit from rising markets.² Without a clear forward-looking view, what is an investor to do? Behavioral finance, the study of how investors make real investment decisions, can help. Rather than focus on markets, the investor can shift focus to an alternative that is much more in her control—investing according to her personality and goals.

KEY IMPLICATIONS

Understanding one's Investment Personality—the investor's Mindset toward risk, her Approach to building an investment strategy and her Purpose for investing—can help the investor and her Financial Advisor tailor a unique, and comprehensive, financial strategy best suited to achieving her goals.

- Investment Mindset**
The investor's comfort with, and willingness to take, investment risk.
- Investment Approach**
The elements, or solutions, that can be included in an investment strategy to help the investor stay invested.
- Investment Purpose**
The reasons that the investor is investing, and whom she would like to benefit from her investment dollars.

By making the investor—rather than markets or investments—the focal point of the investment conversation, the Financial Advisor and the investor may be able to enhance investment outcomes.

¹The most recent AII numbers are taken from the American Association of Individual Investors (AAII) weekly sentiment survey of individual investors.

²Jason Zuehl, "It's Looks Like a Bear," The Wall Street Journal, October 8, 2011.

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My Investment Personality

Your Merrill Lynch Financial Advisor will work with you to help you make investment-related decisions tailored to your unique goals and needs. To create a starting point for a conversation about who you are as an investor and what is important to you, please answer the following questions to the best of your ability. There are no right or wrong answers to any of the questions, no math to solve—just answers that can help us to better understand you.

Questionnaire

	Strongly Disagree	Disagree	Agree	Strongly Agree
1. I believe that I have a lot of investment experience.	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
2. I feel that I may be able to adjust my lifestyle and spending to accommodate changes in the value of my investments.	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
3. I feel that I may have an unforeseen need for a large amount of money in the future.	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
4. It is my perspective that the historical benefits of taking investment risk may continue into the future.	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
5. I believe my own financial house should be in order before investing for—or giving money to—family members or the community at large.	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
6. My family is the most important part of my life.	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
7. I want to personally make regular changes to my investment approach in an attempt to improve investment returns.	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
8. I have no interest in leaving behind a substantial sum of money to a charity or a nonprofit.	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
9. I spend very little time worrying about losing my principal (or original investment).	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
10. I feel most comfortable believing that my investment yield, dividend or return will reliably cover my lifestyle.	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
11. I feel that I should financially support my children, parents or significant other.	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
12. Following market news and reading investment-related publications or books is something that I do on a regular basis.	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
13. I understand that investments can lose money.	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
14. I believe that I am investing enough for my future and have very little concern that I may outlive the money I have accumulated.	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>

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