

Seeking Differentiation in Wealth Management

By Helen Yang

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Financial services have been increasingly commoditized. With low-cost ETFs, free trades, and free financial planning apps, the traditional wealth management service can no longer justify a 1% advisory fee. Financial advisors feel tremendous pressure to differentiate but don't know how.

To find a solution, we need to first examine the root cause of the problem. The traditional cookie cutter service is based on the classical financial theory, which assumes that investors are rational and the markets are efficient. When clients panic in a market turmoil, advisors, who are not equipped to have a real conversation, can only say, "if you look at the 30-year time horizon, equity outperforms bonds and inflation." While it may be true, it is not helpful. Many investors don't have a 30-year investment horizon. And even if they do, they still need to understand why staying put makes sense even when volatility is high.

To fundamentally transform this practice, we need a new theory that can explain market cycles and investor emotions.

When I was at MIT, I was intrigued by the Adaptive Market Theory by Dr. Andrew Lo that reconciles behavioral finance with efficient markets. I worked closely with Dr. Lo and we shared the Harry Markowitz Award in 2011.

The Adaptive Market Theory states that investors are subject to cognitive and emotional biases that are deeply rooted in our survival instinct, that the markets are mostly efficient but not always, and the relationship between risk and return changes all the time.

It looks promising, but how can we apply it in a way that is easy to use and easy to understand?

It starts with getting to know clients well using behavioral finance. People talk a lot about behavioral finance but don't know how to use it in practice. A good way to do it is to break it down into a set of behavioral factors, each of which can be individually assessed for maximum flexibility.

During client onboarding, understanding the client's investor type (passive investor, trend follower, contrarian, etc.) can help determine if a client may be a good fit. Learning about loss aversion, a common behavioral bias, can help clients keep their emotions in perspective.

Over time, advisors can build up the client's behavioral profile, all of which can then be rolled into a Behavioral Risk Index, a single number to indicate how likely the client is subject to irrational responses, so advisors can prioritize

Common Investor Types



Adapted from research by Dr. Andrew Lo from MIT.

during market turmoil.

But we cannot talk about behavior in a vacuum. Advisors need to show real insights in investments to build credibility.

To effectively tell the long-term story, we need to look at the risk over the short-terms, medium-terms, and long-terms. This richness can't be captured by a single risk number—it simply doesn't make sense to insist that the portfolio's risk stays the same at the height of the market turmoil. The right story is that the portfolio risk may indeed be very high in the short term, but it is still aligned with the investor's risk tolerance in the medium term (3 to 5 years).

Combining behavioral finance with innovative risk visualizations, advisors can now deliver deeper conversations and truly personalized services. This is a new way to deliver wealth management, the differentiation that the industry has been looking for. ■

Helen Yang, CFA, is the founder and CEO of Andes Wealth Technologies, and a co-winner of the 2011 Harry Markowitz Award.

Learn more at www.andeswealth.com.

