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Policy-Based Financial Planning as Decision Architecture

presented to the

Phoenix Symposium

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presented by

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LIVE BIG™

Agenda

- Thinking Fast and Slow
- Behavioral Biases in the Context of Financial Planning
- Nudges
- Principles of Choice Architecture
- Policy-Based Financial Planning as "Decision Architecture"
- Examples and Case Studies

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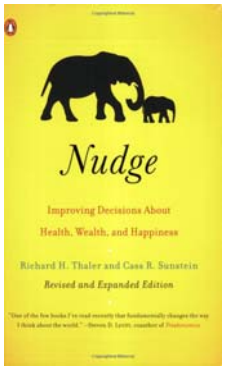
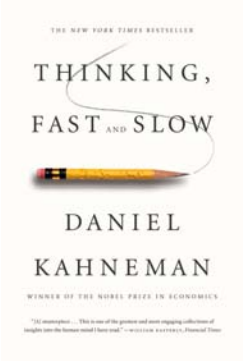
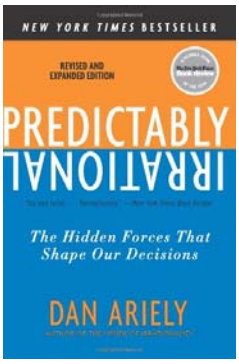
Thinking Fast and Slow

Decision-making in a "behavioral" world: a few resources.







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Thinking Fast and Slow

Two systems for interacting with the world:	
Automatic System	Reflective System
System 1	System 2
Human	Econ
Bureaucracy of Habits	Beginner's Mind
Fast	Slow

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Thinking Fast and Slow

- The automatic system allows for fast decision making.
- Time and repetition move functions from the reflective to the automatic.
  (this is why younger drivers are more accident-prone, they're using their reflective system so reaction times are slower)

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Thinking Fast and Slow

- The Automatic System is fast because it uses short-cuts (heuristics) which can lead to biases:
  - Anchoring
  - Availability
  - Representativeness
  - Loss Aversion
  - Overconfidence
  - Mental Accounting

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Behavioral Biases in the Context of Financial Planning

- Availability Heuristic
  - Clients are biased by information that is easier to recall.
  - A client's willingness to buy life or disability insurance will be influenced by whether or not they know someone who became disabled or died prematurely.
  - Likewise their willingness to plan for a long retirement or update their estate plan.

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Behavioral Biases in the Context of Financial Planning

- Representativeness
  - Clients will see or anticipate patterns that don't exist.
  - Trading based on presidential elections.
  - Fukushima and the retired nuclear engineer: answering the wrong question.

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Behavioral Biases in the Context of Financial Planning

- Optimism, Overconfidence, Loss Aversion, and Anchoring
  - Overconfidence led employees of tech companies to hold too much in employer stock during the tech boom against their financial planner's advice.
  - Loss Aversion and Anchoring caused them to continue holding the stock after it plunged when the tech bubble burst.

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Nudges

- You can't fight a client's Bureaucracy of Habits ("habits eat change") but you can enlist those habits to effect desired changes (Heller and Surrenda).
- Likewise, you can use Behavioral Biases to structure choices in a way that "nudge" decision makers toward better outcomes (Thaler and Sunstein).

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Nudges

- *"People will need nudges for decisions*
- *that are difficult and rare*
- *for which they do not get prompt feedback, and*
- *when they have trouble translating aspects of the situation into terms they can easily understand."*

Thaler and Sunstein, 2008

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Nudges

"Give people an easy off ramp"

Daniel Pink

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The Power of the Nudge

- Germany and Austria
  - Cultural Similarity Index = 0.846*
- Organ Donation Rate
  - Austria = 99%
  - Germany = 12%
- System for Electing
  - Austria = opt out
  - Germany = opt in

YESKE BUIE *European Social Survey

Principles of Choice Architecture

- Incentives
- Understand Mapping
- Defaults
- Give Feedback
- Expect Error
- Structure Complex Choices

YESKE BUIE Thaler and Sunstein, 2008

Policy-Based Financial Planning

- Hallman and Rosenbloom (1975)
- Turn of the 21st Century turmoil.
- Yeske and Buie (2006)
- Compact decision rules that allow for rapid decision-making.
- A form of Decision Architecture to keep clients committed to a consistent course in a rapidly changing world.

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What Policies Are Not

- Beliefs or Values
- Action Items
- Implementation
- Observations
- Goals and Aspirations

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Policies vs. Values, Beliefs, Observations, Goals, Action Items

- **Belief**: Too much inheritance blunts ambition.
- **Goal**: To provide for spouse without leaving too much money to our grown kids.
- **Policy**: We will own life insurance for our survivor needs only, establishing charities as contingent beneficiaries.
- **Action Item**: Buy term insurance based on capital needs analysis; coordinate beneficiary designations; monitor regularly.

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Policies vs. Values, Beliefs, Observations, Goals, Action Items

- **Belief**: Preschool enrichment programs greatly enhance lifetime educational success.
- **Goal**: To devote a sustainable portion of my annual income to supporting preschool enrichment programs.
- **Policy**:
  i.) I will focus my charitable giving exclusively on preschool enrichment programs and
  ii.) I will annually donate to such organizations an amount not to exceed 10% of the annual safe-withdrawal spending target for my portfolio.

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Two-Part Test

- **Is it a policy?**
- **Is it a good policy?**

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Is It a Policy?

- Does the policy return new answers as external circumstances change?
  (if not, it's probably a belief, observation, goal, or action item)

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Is It a Good Policy?

- Dual Characteristics:
  - Broad enough to encompass any novel event that might arise.
  - Specific enough so that we are never in doubt as to what actions are required.

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Debt Policy Example

- We will use credit cards for convenience only for purchases that are part of the monthly budget.
- For purchases equal to 10% or less of annual after-tax earnings, we will set aside funds monthly until needed sum is accumulated.
- For purchases equal to more than 10% of annual after-tax earnings, we will use amortized debt.

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Roth Conversion Policies

- We will convert IRA assets to Roth whenever we can do so at a 15% or lower federal tax rate.
- We will only convert IRA assets to Roth when we have after-tax assets with which to pay the tax. Or . . .
- We will only convert IRA assets to Roth up to the degree that estate taxes will be payable.

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Financial Planning Policies The Six-Step Process

- Step 1: Discovery
- Uncover client's history, beliefs, values, and goals.
- Identify "**bureaucracy of habits**" or **behavioral biases**.
- Good discovery helps ensure that clients see their personal goals and values reflected in policies, encouraging them to embrace and act on them.

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Financial Planning Policies
The Six-Step Process

- Step 2: Identify Planning Area and Related Principles
  - What Planning Area(s) are the Policies going to need to address based on the client' s circumstances?
  - What are the Best Practices in that/those Planning Area(s)?
  - Evidence-Based Best Practices *(see Buie and Yeske, 2011)*.

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Financial Planning Policies
The Six-Step Process

- Step 3: Combine Client Goals and Values with Planning Principles
  - Draft statements that you believe reflect the client goals, values and attitudes, and the relevant planning principles.
  - Make sure the policy reflects everything you learned during the discovery process.
  - Use the client's own words where possible.

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Financial Planning Policies
The Six-Step Process

- Step 4: Test Policies and Develop Specific Recommendations
  - Is it a policy?
    - Does policy return new answers as external circumstances change?
  - Is it a good policy? (scenario planning)
    - General enough to encompass a wide range of circumstances.
    - Specific enough to leave one in no doubt as to the actions to be taken.

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Financial Planning Policies
The Six-Step Process

- Step 5: Test Policies with Client
  - Formalize for discussion with client.
  - Does the wording resonate with them?
  - Do clients see their goals and values reflected in the Policies?
  - Interactive process / wordsmith.

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Financial Planning Policies The Six-Step Process

- Step 6: Periodic Review and Update
  - Policies change based on ***structural*** or ***fundamental*** changes, ***not cyclical*** changes.
    - Laws and Regulations.
    - Best Practices (evolving, evidence-based).
    - Change in Client Values or Goals or Structural Circumstances.
      - An interior shift that has changed the exterior goals
      - An exterior change that has changed the structural circumstances

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FP Policies - Applications

- All comprehensive financial planning engagements.
- Hourly or "one-time" financial planning engagements.
- Young people and others with little income and few assets for whom managing cash flow is the most important issue.

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Cash Flow Policies

- I will save 10% of every paycheck.
- My savings will go first to my emergency fund until equal to 3 months worth of living expenses.
- Thereafter, my savings will go into my employer retirement plan to contribution limit.
- Any remaining savings will go into an after-tax "opportunity fund."
- Windfalls (bonuses) will be allocated 10% to a "fun fund" and 90% per the preceding policies.

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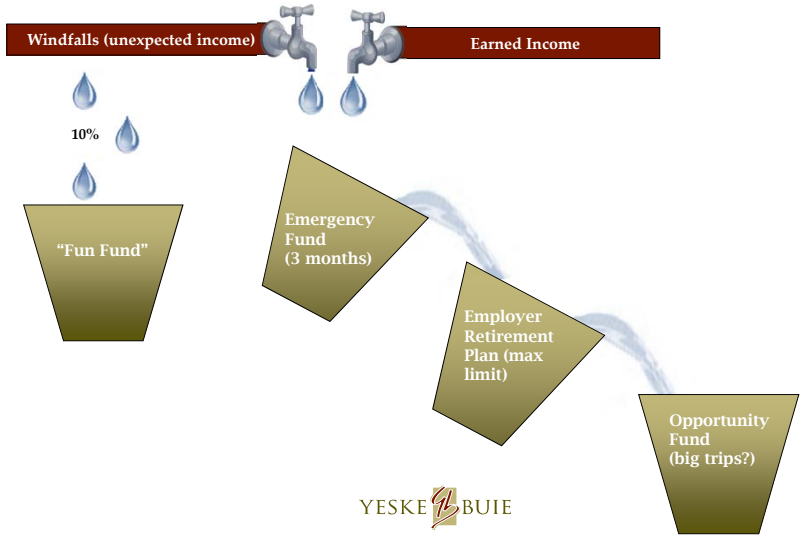
Cash Flow Policies



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"Save More Tomorrow"

- System leverages the following biases:
  - Self-control restrictions easier to commit to in the future.
  - Loss-aversion: people hate to see their paycheck shrink.
  - Money illusion: people think about money in nominal terms.
  - Inertia.

YESKE BUIE Thaler and Bernatzi

The Strategic Perspective

- Policies are a good way to account for "Contingent Resources" for which the value, timing, and probability of occurrence are highly uncertain (e.g. inheritance, business sale, stock options, or bonus).
- Establishes in advance appropriate actions if contingent resource materializes.

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Policy for Contingent Resource

- Any windfall from (name contingent resource) will be allocated as follows:
  - First, toward my granddaughter's college fund up to ½ the then projected 4 year cost.
  - Next, to my alma mater up to 10% of my then annual earned income.
  - Next, to a kitchen remodel up to 5% of the house's then appraised value.
  - Any remaining funds will be added to retirement savings.

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Practical Impact of Policies

Highly Compliant

Non-Compliant

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Practical Impact of Policies

Highly Compliant

Non-Compliant

Financial Planning Policies are not magic but they can shift behavior in a positive direction.

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Safe-Withdrawal Rate Policies

- **Inflation rule:** Target spending will be increased by the 12 month trailing CPI, except when the portfolio has a negative return and the current withdrawal rate exceeds the initial withdrawal rate.
- **Capital Preservation Rule:** If target spending as a % of portfolio is more than 20% larger than the initial withdrawal rate, target spending is reduced by 10%.
- **Prosperity Rule:** If target spending as a % of portfolio is more than 20% smaller than the initial withdrawal rate, target spending is increased by 10%.

Adapted from Guyton and Klinger (2006)

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Principles of Choice Architecture

- Applying the principles to the Safe Withdrawal Rate policies:
  - Incentives
  - Understand Mapping
  - Defaults
  - Give Feedback
  - Expect Error
  - Structure Complex Choices

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Incentives, Mapping, Defaults

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Give Feedback, Expect Error

Applying the Decision Rules		4/30/2013
4/30/2013	Portfolio Value:	$2,013,200
4/30/2013	12-Month Portfolio Return:	11.9%
4/30/2013	12-Month Inflation:	1.1%
	W/D Rate of Current Withdrawal Target:	5.6%
	Inflation Rule:	Increase
	Capital Preservation Rule:	No Change
	Prosperity Rule:	No Change
4/30/2012	Last Withdrawal Target:	$112,086
	New Annual Withdrawal Target:	**$113,319**

Actual Versus Target Withdrawals		4/30/2013
4/30/2012	*Last Target Annual W/D $:*	$112,086
	Prior 12-month Actual Withdrawals:	$211,832

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Structure Complex Choices

"For the past 35 years, financial advisors have been telling me how to put money INTO my portfolio, no one until now has made it clear how I can take money OUT of my portfolio!"

Newly Retired Client

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Conclusion

- The field of Behavioral Finance helps provide a deeper understanding of clients' cognitive biases but planners also need practical tools.
- Policy-Based Financial Planning offers a form of "Decision Architecture" that can help nudge clients in the direction of better decisions in the face of a changing world.

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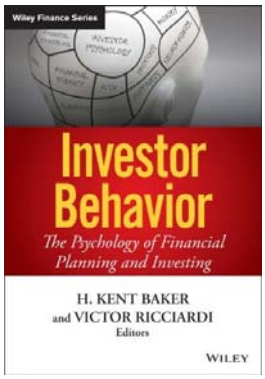
To find more on Policy-Based FP

"Policy-Based Financial Planning as Decision Architecture" Dec 2014

"Policy-Based Financial Planning: Decision Rules for a Changing World"



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Questions?

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