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What Kind of Investor Are You?

The answer isn't as simple as you think, but knowing it can boost your portfolio performance.

BY ROBERT FRICK

The investment profession's holy grail is a formula for figuring out how clients will react to market gyrations. If you've ever used a financial planner or broker, you probably were asked to fill out a questionnaire, especially one designed to pinpoint your risk tolerance. Answer the questions and planners typecast you.

The idea is that if they know what motivates you financially, they can tailor a portfolio to suit your risk tolerance.

Most of these questionnaires don't work, or at least not well. (At the end of this column is a link to a test that I believe works very well.) As one financial planner told me, the tests rarely worked because of the "Mike Tyson" problem. The former heavyweight champ is credited with saying, "Everybody has a plan until they get punched in the face."

So when the market crashed in 2008, even many investors who scored on those tests as loving volatility sold stocks at the bottom and lost their shirts. Likewise, investors who score as cautious still pile in at the top of the market and lose *their* shirts when the bubble pops.

Unlocking Investor Behavior

I have to admit I was once enamored with slicing and dicing investors by archetypes. But eventually I realized, as many planners have, that these systems are incomplete, ineffective or just plain silly. Dozens of other descriptions of investors are based on everything from pop psychology to Buddhism. Then in the past 15 years, the field of behavioral finance unlocked much of the basic wiring for our financial decision-making. Given most investors don't even earn the market rate of return because their biases lead them to make bad decisions, finding the key to influence their behavior is important work.

I recently came across a behavioral-science company that devises solutions in different areas and has designed an eye-opening system that may be a key to understanding investor behavior.

Its president, Hugh Massie, started a financial services business in the 1990s and observed, "It doesn't matter whether a client is wealthy or not. They behave a certain way when things are going well, but under pressure their behavior changes."

Since then he's worked with psychologists and behaviorists to develop a system that accounts for our biases—things such as following the herd or having an unreasonable fear of losses. Using the firm's proprietary questionnaires, he can predict an individual's likely behavior during market ups and downs.

I took the questionnaire. It forces you to make difficult decisions regarding trade-offs to simulate thinking under pressure. But of all the questionnaires I've taken—and I've taken at least a dozen—it described me the best. (I like new challenges and am flexible, but I may not see dangers and juggle too many tasks.) What's more, it nailed my risk tolerance and the kind of portfolio I have and am comfortable with, *without ever asking me about risk and investing*. That's pretty ingenious.

Key Characteristics

The DNA Behavior system is designed to help financial professionals identify the right portfolios for clients and communicate with them in tailored ways to help them better weather market volatility. For example, when the market deals us a Mike-Tyson-punch-in-the-face test, some people need reassurance, while others need reining in because they see too many bargains and want to rush in and buy with abandon. At its simplest level, the test breaks people down into four groups. See if any of these groups ring true for you or someone you know.

Goal-setting. Much more goal-driven than average, these people will take risks. Communicating with them is "about their goals and the bottom line," Massie says. They tend to look at the big picture in a consolidated way, which can be a problem because they're not as good with details. One danger for goal-setters is they tend to justify losers in their portfolios if the overall result is okay, and trade their accounts too much. The best way to keep them from making bad decisions is to have them focus on making progress toward their overall goals.

Lifestyle. These folks want to maintain their lifestyle and are aware of what other people have and do. They tend to follow the herd and make instinctive decisions with no research. When the market goes down, they need to know "their world isn't getting rocked," Massie says. They tend to spend too much, which can make them a tough client to deal with. In times of trouble, getting through to them involves using graphics in a relaxed environment to illustrate their options.

Information. Besides saving a lot of money, these individuals engage in behavior known as "mental accounting." This means they tend to sequester money into different accounts—for retirement, vacations, a car fund and so on. They're more inclined than others to follow patterns and benchmarks, and they can be rigid in their thinking when changes need to be made. These folks need facts, details and transparency to change their views.

Stability. We are all loss-averse to some degree—behavioral studies show we feel the pain of loss more than twice as much as the pleasure of an equal-size gain. But stability people are hyper-sensitive to losses. They also are afraid of making decisions for fear of making wrong ones. When losses occur, they need a calm atmosphere and space to discuss their feelings to avoid making rash decisions.

TRY IT YOURSELF

DNA Behavior has set up the test exclusively for *Personal Finance* subscribers. To take the test, type this into your browser: www.dnabehavior.biz/Account/RegisterByGroup/Investment%20Daily/22