

FTwealth

March 27 2009

www.ft.com/ftwealth

INVESTMENT

MANAGING RISK

Bold move: Daniel Kahneman, left, and Andrew Rosenfield, have found a new way of presenting questions of risk to the ultra-wealthy



What risk aversion?

The realisation that investors prefer avoiding loss to acquiring gains has led Guggenheim Investment Advisors to divide wealth into separate 'conservative' and 'bold' portfolios. By Lauren Foster

HOW MUCH money are you willing to put at risk of loss in the quest for incremental gain?

For Daniel Kahneman, Nobel laureate and emeritus professor of psychology at Princeton, and Andrew Rosenfield, chief executive of Guggenheim Investment Advisors, this question is central to managing money for the ultra-wealthy. After all, understanding how risk is framed can affect how clients deal with that risk.

"There has been a tendency in the management of wealth to create the impression that you can seek gains that are disconnected somehow to the potential loss that that strategy entails," Rosenfield says. "Often people say: 'I want to make 12 per cent' or 'I want to make 9 per cent'. That has to be connected in some way to the question: 'How much money are you willing to put at risk of loss over some period of time?'"

That may sound like common sense but, as the global financial crisis has shown, many people lost sight of risk during the bull market – particularly when it came to highly levered or illiquid investments.

And while risk has always been a routine part of discussions between advisers and clients, Rosenfield says advisers generally did not focus on separating losses from gains or delving into whether a client was more inclined to loss aversion (losing money) or gain regret (not capturing all the upside when markets are exuberant).

"They didn't ask [about risk] in the frame of separating losses from gains... they didn't have a regret-focused system," he says. "I think it's routine to talk about risk but to talk about risk in a rather antiquated, old fashioned way: 'Are you risk neutral? Are you risk averse?' That turns out not to be not deep enough.... We don't really know what the question means and what the answer means. If you ask someone if they are risk averse, people might say 'yes'. What does that mean?"

Guggenheim's approach to helping clients understand risk – think of it as behavioural

wealth management – stems from Kahneman's work on "Prospect Theory". What Kahneman and his fellow psychologist Amos Tversky found was that people become far more distressed by losses than they become happy by similar gains. This suggests people tend to be risk-averse when faced with sure gains, and risk-takers when faced with an equal prospect of losses.

Kahneman, who received the 2002 Nobel Prize in economics for his work on this subject, explains: "If you have a choice between getting £900 for sure or a gamble with 90 per cent chance of making £1,000, almost everyone will take the £900 for sure. But if you force people to choose between losing £900 for sure and a gamble in which they have a 90 per cent chance to lose £1,000 and a 10 per cent chance to lose nothing, then everyone prefers the gamble."

In both scenarios, the expectation is the same – £900 – but by framing the example as avoiding a loss one gets a different reaction than pursuing a gain, so the implication of Prospect Theory is that people have "loss aversion". Simply put, investors tend to strongly prefer avoiding

losses over acquiring gains.

So how does one put this into practice when managing money?

"When you meet someone who wants their wealth managed – whether it's a wealthy individual or a foundation or endowment – they have two goals in their mind," says Rosenfield. "First, they want to lose no money, and, second, they want to make a lot more. And those two things are really disharmonious, they are in rivalry, so you have to figure out how to try to achieve one with attention to the other."

Chicago-based Guggenheim, which has more than \$50bn under management or supervision for endowments, pensions and wealthy families, does not use phrases such as risk averse, risk neutral and risk preferred. Rather, its wealth management business is predicated on balancing loss aversion and gain regret.

Instead of offering clients a selection of portfolios based on their risk appetite, Rosenfield and Kahneman, who joined the independent wealth manager in 2005 as a senior adviser, drew on the work of Richard Thaler, a professor at the University of Chicago and one of the leading figures in the emerging field of behavioural finance. In 1980, he coined a concept known as "mental accounting", which attempts to describe the process whereby people code, categorise and evaluate eco-

nomics outcomes.

They thought: why not separate clients' assets into two portfolios, one conservative, the other bold?

"Connecting the risk of loss with the expectation of gain is a remarkably candid thing to do in this business but I think people find it very valuable," says Rosenfield. "We took an idea that was really Dick Thaler's to make that even more salient. We said: 'Why don't we have two portfolios because then

you can really address the questions with precision?'"

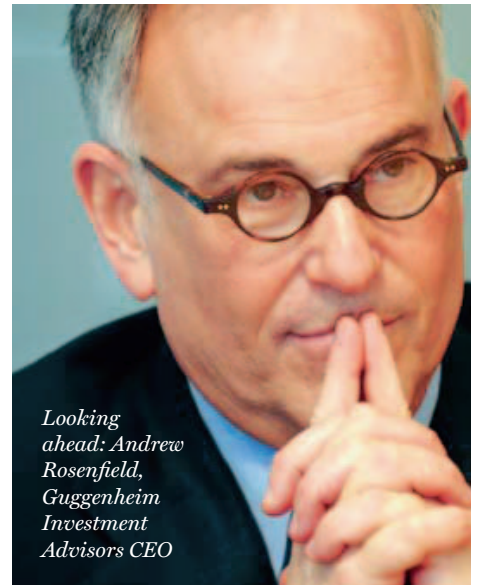
"So if you have a component of your wealth that you want to think of as your conservative component,

and a component that you want to think of as much bolder and gain-seeking, you can separate those, either mentally, as Dick had written about, or, in our case, literally, into separate portfolios that are then invested differently, with different goals, different loss exposures, different return expectations, and move your assets more to one than the other."

Rosenfield says that when Guggenheim started applying this approach, Kahneman's "gut instinct" was that people would want to be 90 per cent in the conservative

portfolio and 10 per cent in the bold. "And that's turned out to be almost exactly correct," Rosenfield says, because people want "a combination of a sure thing and a long shot".

Since the terms



Looking ahead: Andrew Rosenfield, Guggenheim Investment Advisors CEO

People tend to be risk-averse when faced with sure gains, and risk-takers when faced with an equal prospect of losses

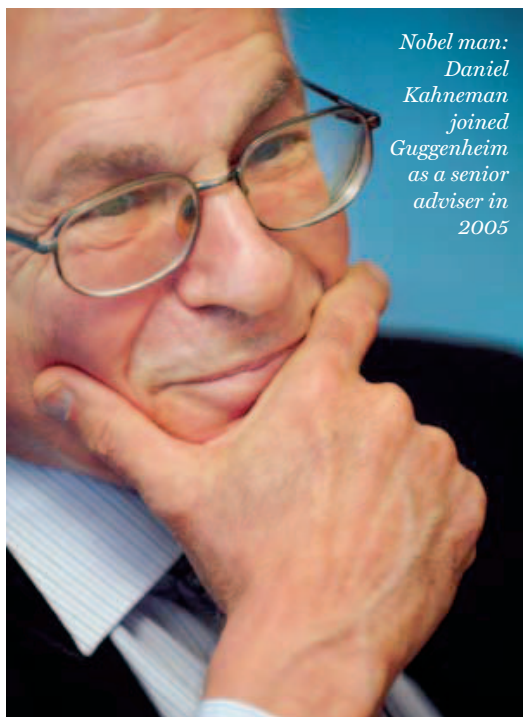
"conservative" and "bold" mean different things to different clients, there is great variation under these portfolio umbrellas.

"There are really multiple decisions being made," says Kahneman.

"One is how much you will allocate to the conservative portfolio and how much to the bold. And then how conservative you want your conservative portfolio to be and how bold you want your bold portfolio to be, and there is variation on all three aspects."

How a client makes those decisions is based on a risk assessment process Guggenheim calls "riskometry".

"Riskometry is basically a structured conversation with the client," says Kahneman, who helped develop the approach. "I think of it as figuring out the conditions under which the client may regret their choices. This is educational, as such: anticipating your own regret and anticipating your circumstances under which you would be tempted to change your mind. That's educational and it's also valuable because people who discover that they are regret prone would be led to be more conservative and that is an essential part of the process." ■



Nobel man: Daniel Kahneman joined Guggenheim as a senior adviser in 2005

'There has been a tendency to create the impression that you can seek gains that are disconnected to the potential loss that the strategy entails'