UNDERSTANDING GREAT INVESTORS

THE COMPETENCIES OF INVESTING SUCCESS

A DATAPOINTS WHITE PAPER

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EXECUTIVE SUMMARY

As technology continues to automate much of the technical mechanics of investment management, the financial services industry is slowly realizing that investor behaviors can have a larger (favorable) impact on investment outcomes than seeking investment alpha, and thus there is significant value in a behavioral approach to working with clients. Using behavioral assessments, advisors can understand the wide array of factors that can help predict their clients' future behaviors and guide them towards better investing and other financial-related behaviors.

To do this successfully, advisors and clients need a comprehensive understanding of the key behaviors that relate to sound investing decisions. Specifically, understanding the framework for good investing behaviors is a first step. Understanding risk preference of investors is only one piece of the puzzle when it comes to anticipating how individuals might behave in the future. Instead, considering a more comprehensive assessment of psychological risk tolerance, one that includes not only preference but also confidence, judgment, personality, and composure, can more accurately anticipate what we might do in the future, and thus be used to guide better behaviors.

This report outlines the findings of a survey conducted with investors who are emerging and/or mass affluent, that span Generation X, Y, and Millennial groups, with the purpose of understanding attitudes, experiences, behaviors, and satisfaction related to investing and financial management. Part of this research examined how a new methodology developed by DataPoints for assessing psychological risk tolerance, the Investor Profile, can give advisors and clients a more accurate understanding of their investor-related behaviors. As part of this research, we examined other critical areas including early experiences related to investing, their perceptions of financial services, and critical financial behaviors such as savings rates and selling during a downturn or bottom.

KEY FINDINGS

- **Five unique investor characteristics** can be used to understand **psychological risk tolerance** and to **guide better investor decision-making.**

- While approximately 50% of respondents were taught to save for the future, **less than 20% of respondents were taught good investing behaviors or how to invest while growing up**, leaving ample room for education and coaching.

- **Investors believe financial advisors can add value**, particularly in investing/investment management and retirement planning.

- **Investors generally understand the meaning of a "fiduciary,"** but are skeptical in their opinion about financial services in general.

- Investors scoring **high** on DataPoints' **Investor Profile** assessment save approximately **156% more each month** as compared to their low-scoring counterparts and are **more likely to put money into the market** when the market declines than their low-profile counterparts.

Going beyond preferences to

UNDERSTAND WHAT MAKES A GREAT INVESTOR

What makes a great investor? Can we use those characteristics to help us make better investing decisions in the future? What is the best way to measure how investors will react in the future?

Self-assessments are sometimes considered to be inaccurate when it comes to anticipating what we might do. Why? Because typically self-assessments involve one or two questions, or ask a combination of different types of characteristics, or are not well-designed. A sound measure of investor-related characteristics is both reliable (that is, it provides the same measurement over and over again) and valid (that is, it measures what it says it measures).

Many traditional measures of psychological risk tolerance focus on situational judgment questions, or questions that focus solely on what we *might* do or *might* want to do given a certain situation. These questions, particularly when they have to do with hypotheticals that have never been encountered, may not be the best predictors of what we might actually do in the future when the “bullets are live,” so to speak.

Finally, whereas most risk tolerance assessments focus on preferences for risk, we know from published research that many other factors affect how well we react and make decisions in relation to our investments. Indeed, risk preference is only one piece of the puzzle. DataPoints has found that several other behavioral and personality-based characteristics affect investor-related decision making.

CONSIDER THIS INVESTORS

As you read the report, consider your own attitudes, behaviors, and habits when it comes to investing.

Look for ways in which you exhibit the same behaviors as those who might be considered “good investors.”

Use the reference section to dive into the research on investing and investing-related behaviors.

CONSIDER THIS ADVISORS

As you review the results in the report, consider how your prospective/current clients learn about and behave related to investments.

Watch for ways in which your firm could better serve clients through a focus on investing-related behaviors.

Note the section on *perceptions* of financial services: how would your firm stack up to skeptical prospective clients.

A BETTER APPROACH: THE INVESTOR PROFILE

Is there a better way to understand how we will react to changing market conditions, increased volatility and uncertainty? DataPoints has created a reliable and valid assessment that examines past experiences and behaviors in addition to preferences and personality to comprehensively assess what the financial services industry generically refers to as "risk tolerance."

How can we determine what individual characteristics impact good investment decision-making? If we consider investment management to be one of the important jobs that our clients must perform (with the advisor's guidance of course), then we can break down the types of characteristics or competencies that are required for doing that job well. Through the research that underpins the Investor Profile, DataPoints identified five key factors that make up *psychological risk tolerance* and differentiate investors in terms of outcomes. These five competencies include Investor Confidence, Risk Preference, Volatility Composure, Investor Judgment, and Risk Personality.

THE 5 FACTORS OF THE INVESTOR PROFILE

1. INVESTOR CONFIDENCE
Self-efficacy, self-esteem in investing and comfort with investing-related topics and discussions

2. RISK PREFERENCE
General preference for and experience with different levels of investment risk

3. VOLATILITY COMPOSURE
Ability to emotionally manage declines in values of investments or in the market in general

4. INVESTOR JUDGMENT
Knowledge of and judgment related to investing

5. RISK PERSONALITY
General risk-taking propensity and comfort with some level of uncertainty

Taken together, these five factors provide a *predictor* of future behaviors that can be used to both (i) create asset allocations for the client based on his or her score, and (ii) improve investor-related decision-making by focusing educational and mentoring opportunities on the factors that could be enhanced to improve investing-related outcomes.

DataPoints partnered with the Financial Planning Performance Lab to map scores from the Investor Profile to how other investors have been allocated by advisors. This provides a starting point for allocation discussions. And, we can also use this information to better understand the "why" behind findings related to perceptions, attitudes, and behaviors. Finally, and perhaps most importantly, as advisors and individual investors, we can work to improve how we manage our investing behaviors in the future by identifying and focusing on the specific areas where we may score low.

BACKGROUND

Investing in equities (i.e., the stock market) can be a critical element of growing financial assets during a lifetime. Over a long-term time horizon, money invested can grow at rates beyond more conservative types of investments. The benefits of investing in equities for the long-term include the ability to achieve a higher rate of return, a critical advantage given that other significant long-term costs such as education and healthcare continue to rise at rates exceeding inflation. The cost of this benefit is increased volatility and risk.

Despite the potential upside of investing in stocks, not everyone is open to the idea of buying into equities markets. For example, only one out of three Millennials is investing in the stock market. A study in 2017 indicated that 61% of adults felt that investing was "scary," with Millennials indicating being more scared than their older-generation counterparts.

These factors have led to an all-to-common situation where it is critical to serve the client's long-term best interest by investing heavily in equities, but where the individual client may not be willing or able to shoulder the psychological burdens that can come with holding more volatile and risky financial assets. This mismatch can lead to bad client outcomes: think about the result when the advisor prevails upon a high equity allocation in the portfolio during a market boom-time, only to be forced to lock in losses during a down-turn because the client in reality was not psychologically prepared for the inevitable volatility.

And the choices related to how to invest are also complex, from do-it-yourself options using robo-advisors to working with full-service financial services professionals. If you choose to get help from a professional, there are additional options to consider: commission-based asset manager or fee-only financial planner? And the marketing around these various service options make information discovery and final decision more difficult, not less.

THE INVESTOR PROFILE

As part of the research and development of a holistic assessment of psychological risk tolerance, the Investor Profile, DataPoints surveyed a sample of investors to answer several related questions:

- What types of **influences** did **parents/caregivers** provide related to financial and investment management?

- **How satisfied are investors** with their current and future financial situations? Does their psychological risk tolerance relate to satisfaction?

- How do investors **view the financial services industry?**

- In what areas of financial management are **advisors viewed as most valuable?** And where are they being used?

- How do **investors behave in down markets?** Does their behavior depend on their unique characteristics?

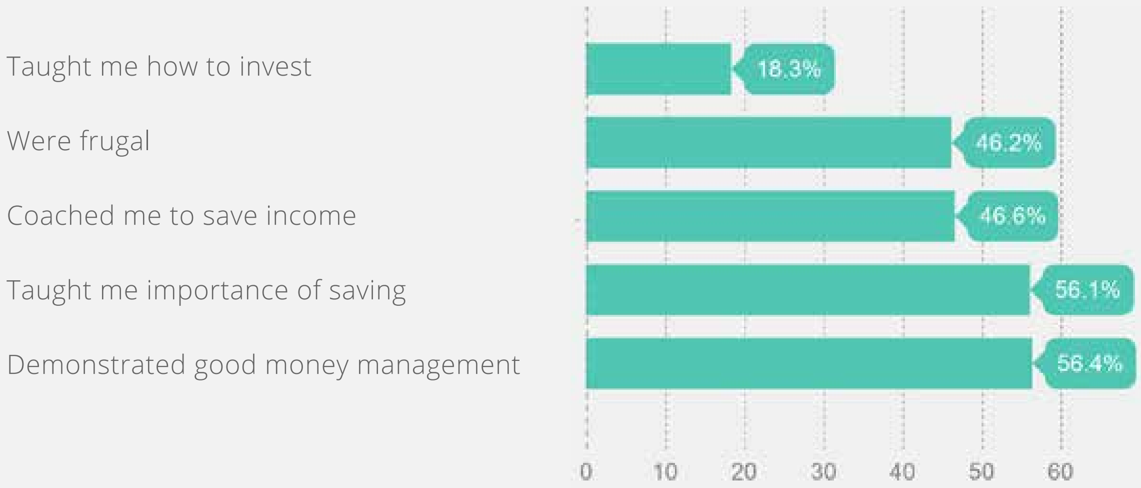
Investors and the influences of

PARENTS ON MONEY MANAGEMENT

When we think about how investment decisions are made, what are our early influences? Who teaches us how to invest? Approximately 50% of the respondents saw their parents being frugal or were taught money management skills while growing up, less than one-fifth of respondents indicated that their parents taught them how to invest. And it's not certain even within that 18% that those investing skills were the right ones.

This also means that knowledge about investing must come from somewhere. If not self-taught or if it wasn't a focus within one's academic career, individual investors will turn elsewhere, even if their teacher (e.g., the media, a friend, social media) isn't the most qualified. Working with a competent fiduciary advisor, one that is making decisions and giving advice in the best interest of the client, can be another valuable resource in building knowledge and expertise in investing.

FIGURE 1.
PERCENTAGE AGREEMENT: PARENTAL INFLUENCES



When we separate groups by psychological risk tolerance, we see that those who scored high on the Investor Profile assessment also tended to learn more about money management and had good role models compared to their low scoring peers. As an example, nearly 12% of the low scoring Investor Profile group reported receiving investing guidance from their parents, while 23% of high scoring investors received such instruction.

In general, those with high scores on the Investor Profile reporting having higher levels of parental guidance related to money management than their peers, particularly around savings behaviors. This is important because our data indicates that savings behaviors tend to have an over-size impact on overall long-term financial success, especially so during the early years of accumulation.

FIGURE 2.
PERCENTAGE AGREEMENT BY INVESTOR PROFILE (IP) GROUP

CONSIDER THIS INVESTORS

Didn't get great investing advice at home? You're not alone—less than 20% of investors received guidance from their parents about how to invest.

Set aside time each week to build investing knowledge. Those who are adept at building/sustaining wealth spend more time studying/reading than their under-accumulating peers.

Identify reputable resources for investing knowledge.

Considering advice? Look for a fiduciary financial advisor—one who wants you to grow in your financial and investing-related knowledge.

CONSIDER THIS ADVISORS

Make investing knowledge a key component of how you provide value to clients.

Set up an educational series on your blog/website for investors.

Create a library of investing-related resources to share with clients.

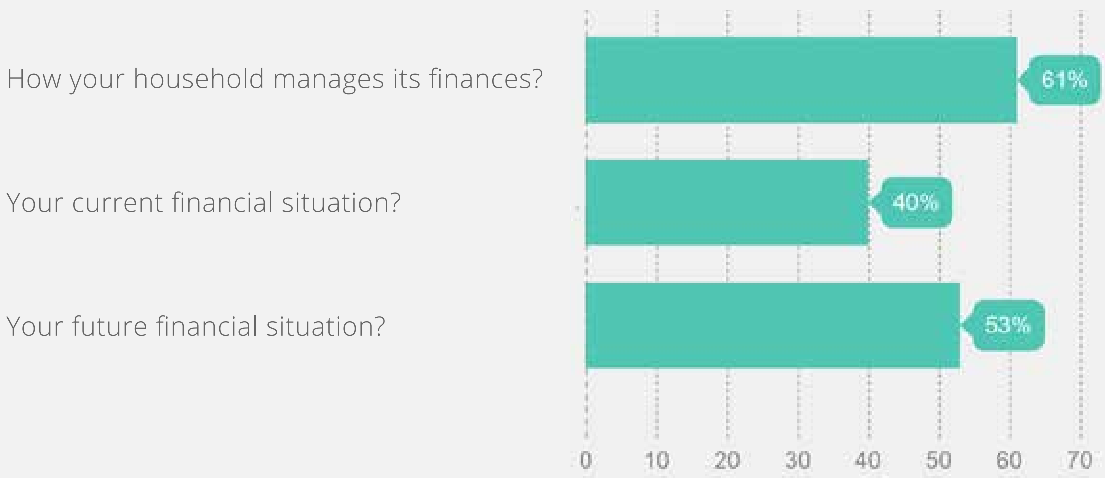
Use assessments to identify which clients could benefit most from investing knowledge and education, and target your educational/coaching efforts to those clients.

Satisfaction:

HOW DO WE FEEL ABOUT OUR FINANCIAL LIVES?

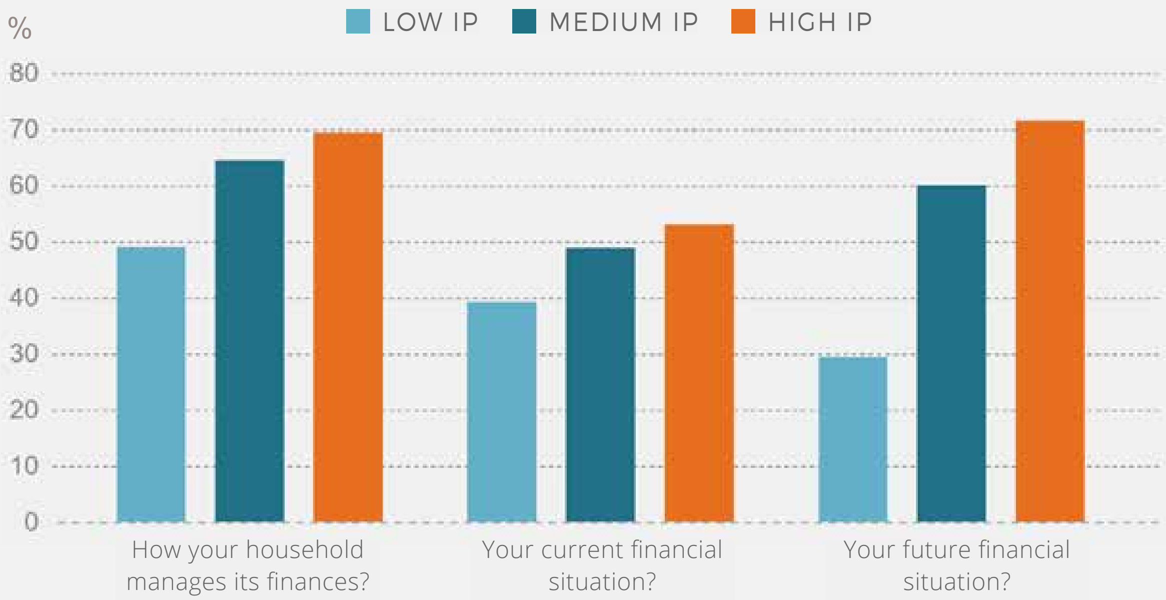
Overall, investors in our survey were satisfied with how their households manage their finances (61% said agree or strongly agree), and more than 50% said they were satisfied with their future financial situation. But while they may be somewhat satisfied with how they manage their finances, they appear to be less satisfied with the outcome of those management skills today. Only 40% agreed that they were satisfied with their current situation, leaving room for improvement in this area.

FIGURE 3.
PERCENTAGE AGREEMENT: FINANCIAL SATISFACTION



Overall those with a higher Investor Profile score were more satisfied with their current and future financial situations, and more satisfied with how their household managed finances, than were their medium- or low-scoring peers.

FIGURE 4.
PERCENTAGE OF AGREEMENT BY INVESTOR PROFILE (IP) GROUP



CONSIDER THIS INVESTORS

If you're not happy with your financial situation today, or its future outlook, first consider which aspects are most troubling.

Identify resources to help and to address each specific concern. In some cases, this may be an app or even a simple spreadsheet. For other areas of financial management, consider seeking the advice of a fiduciary financial professional.

Some of the concern about your satisfaction may be due to how you're managing finances today. Identify behaviors you need to start doing (or stop doing) and set about working on each one.

CONSIDER THIS ADVISORS

Make measuring satisfaction a part of your practice. Use the results to pinpoint where your practice can improve and which clients need additional follow-up.

Know that each client enters into a relationship with you with a certain amount of satisfaction about her current and future outlook. Assess this from the get-go and measure it along the way to ensure you are working to help your client improve in this area.

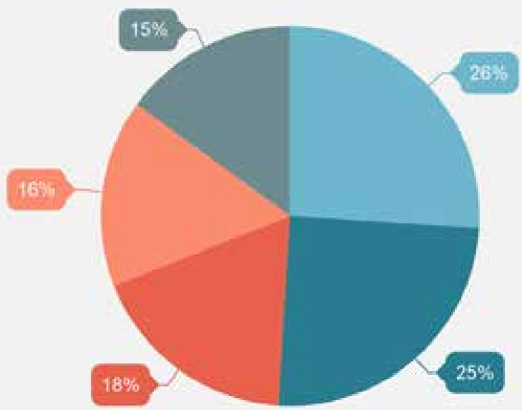
Identify your clients' strengths and areas where he could improve. Gaining knowledge and skills in areas that may be new or challenging will help improve his or her overall satisfaction.

What we view as

OUR FINANCIAL PLANNING CHALLENGES

We asked respondents to choose the financial task they found most challenge out of five different options. Over one-fourth of the sample selected "adhering to a budget" while another 25% agreed that working with others to manage finances was the most challenging. The remaining three (concentrating on detailed matter, remaining calm during volatile markets, and taking ownership of negative outcomes) were selected by just under 50% of the sample (18%, 16%, and 15%, respectively).

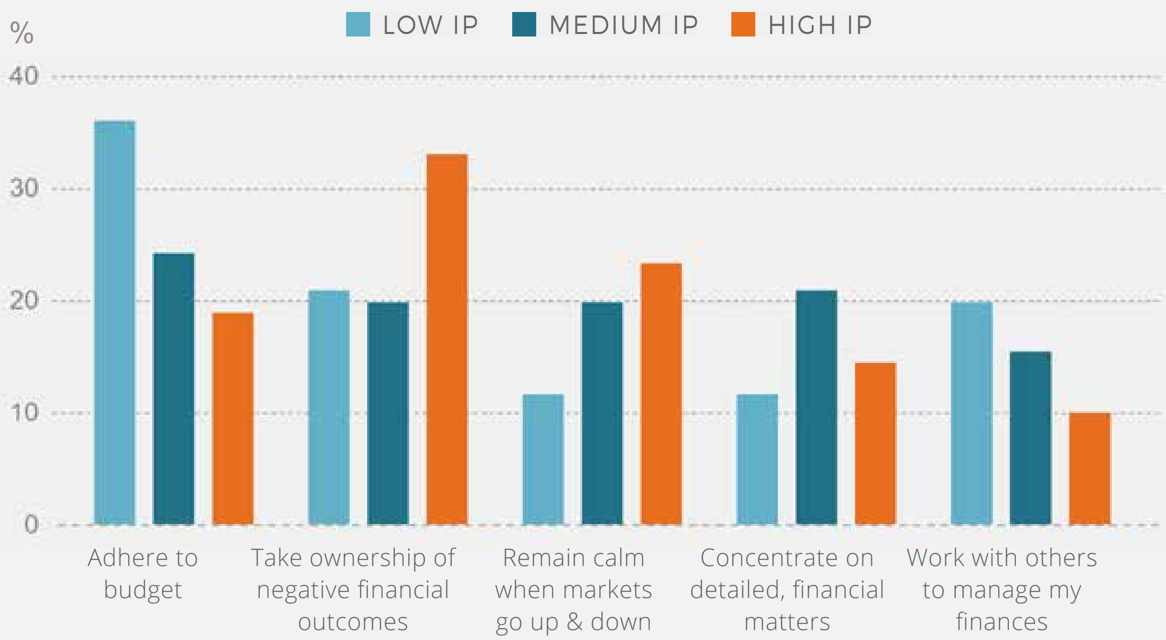
FIGURE 5.
CHALLENGING FINANCIAL BEHAVIORS



WHAT DO YOU FIND THE MOST DIFFICULT TO DO CONSISTENTLY?

- Adhere to budget
- Work with others to manage my finances
- Concentrate on detailed, financial matters
- Remain calm when markets go up & down
- Take ownership of negative financial outcomes

FIGURE 6. CHALLENGING FINANCIAL BEHAVIORS BY INVESTOR PROFILE (IP) GROUP



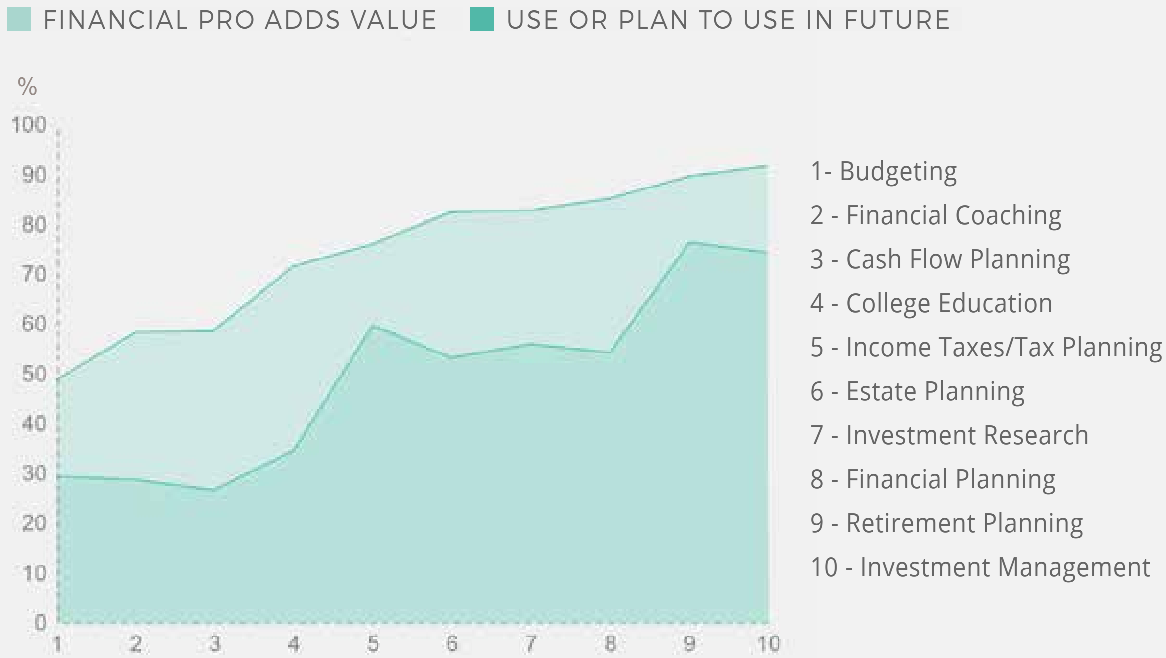
When we compare individuals within each of the investing groups, we see that those who scored low on the Investor Profile rated "adhering to budgets" as their struggle area much more often than their high scoring peers. Those who scored high on the Investor Profile tended to rate "working with others to manage my finances" as more challenging than other groups. This latter finding is consistent with the idea that individuals who are competent at managing their finances are also more challenging to work with.

Clients with higher Investor Profile scores may be more challenging to work with, a finding that mirrors findings related to clients with higher *wealth potential,* or better overall financial behaviors. Those with lower risk tolerance found it harder to adhere to budgets. It's critical to ensure that the basics of financial management, like budgeting and goal setting, are achieved first, particularly for those who are still building wealth.

Utilization and perceptions of

VALUE FROM FINANCIAL PROFESSIONALS

FIGURE 7. FINANCIAL PROFESSIONALS:
INVESTORS' PERCEPTIONS OF VALUE VERSUS UTILIZATION



If less than 20% of respondents learn how to invest on their own, and only 40% are satisfied with their current financial situation, perhaps involving a financial professional could help. We asked respondents to share with us their perceptions of the value that a financial professional could bring to several different aspects of financial management. Additionally, we asked them to share with us their current usage or plans to use such professionals.

The results demonstrated that the perceived value for financial professionals is still highest in the technical areas of investment management and research, despite the continued proliferation of self-directed options for investors. More than 90% of the sample indicated that financial professionals were valuable related to investment management, and nearly three-fourths of the sample said they use or plan to use a professional for this area. Retirement planning was a close second with just under 90% of the sample indicating that financial professionals add value to this aspect of financial management, and over 75% of the sample indicated using or planning to use a financial professional for this area in the future.

Interestingly, respondents in our sample did not view financial professionals as adding as much value in the areas that might be considered the "basics" of financial management, such as budgeting and cash-flow planning. Unfortunately, this continued misperception about the value of financial professionals in these critical fundamental areas may be why so many Americans—even those with above-average incomes—continue to live paycheck to paycheck.

FIGURE 8. BY LOW INVESTOR PROFILE (IP) GROUP

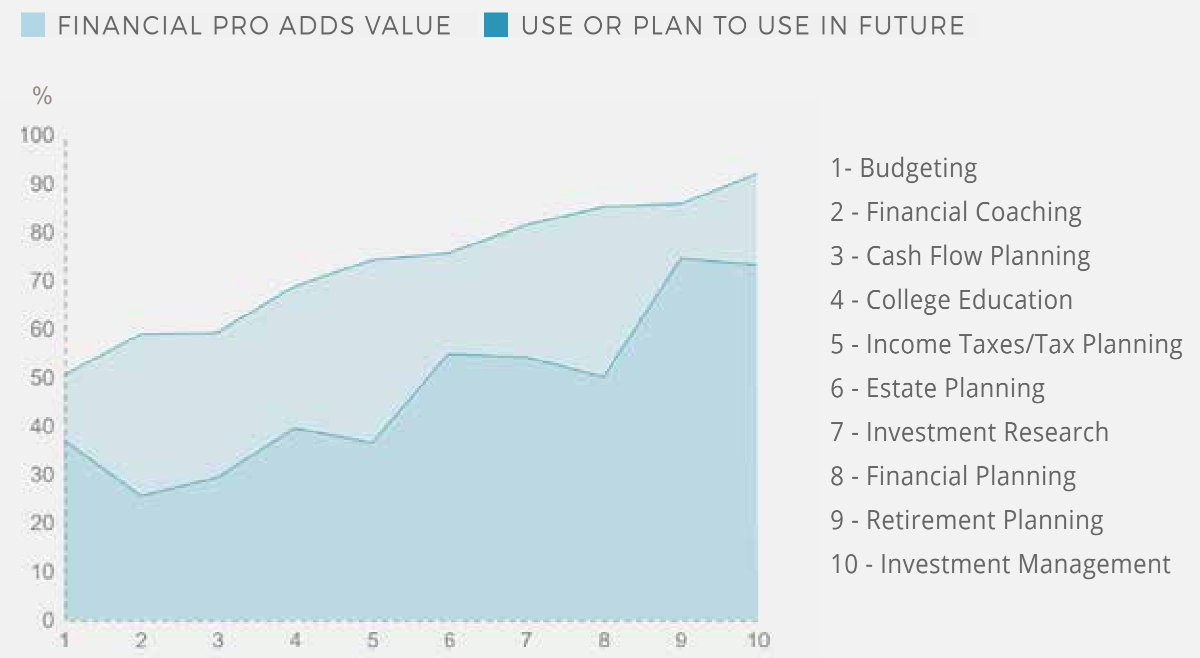


FIGURE 9. BY MEDIUM INVESTOR PROFILE (IP) GROUP

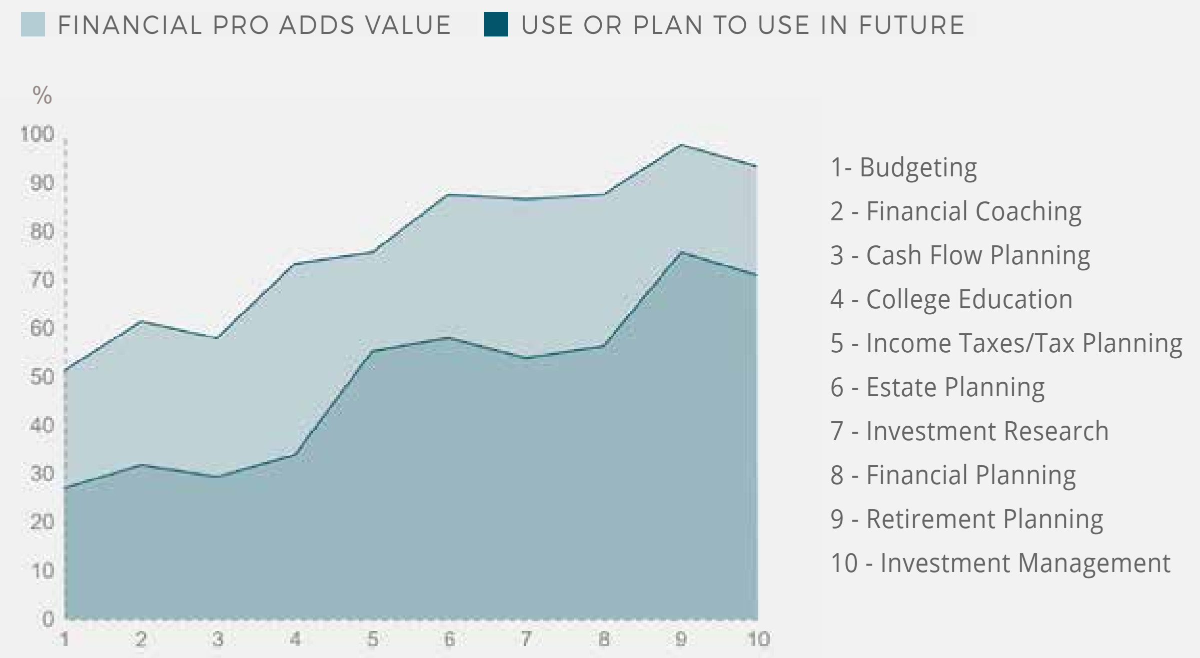
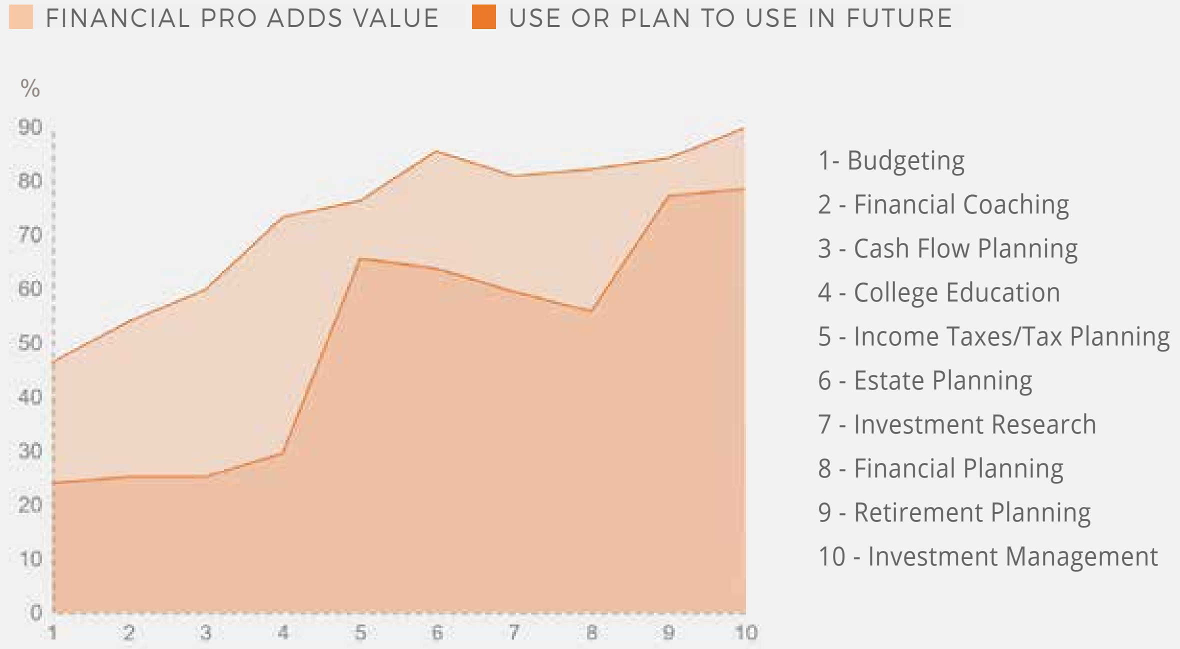


FIGURE 10. BY HIGH INVESTOR PROFILE (IP) GROUP



CONSIDER THIS INDIVIDUAL INVESTORS

Understand your options when it comes to financial advice, including whether the advisor has potential conflicts of interest.

Recognize that advisors who operate under a fuduciary standard have a duty to provide you advice that is in your best interest, irrespective of what may be in his/her best interest.

Ask anyone offering you financial advice this question: have you signed a fiduciary oath?

CONSIDER THIS ADVISORS

The majority of invesors in our sample know that fiduciaries must act in a client's best interest. If you are fiduciary, ensure your marketing and outreach efforts include this in your messaging.

Provide links/educational resources on your website to help prospective clients learn more about what the fiduciary standard means to them.

Is financial services

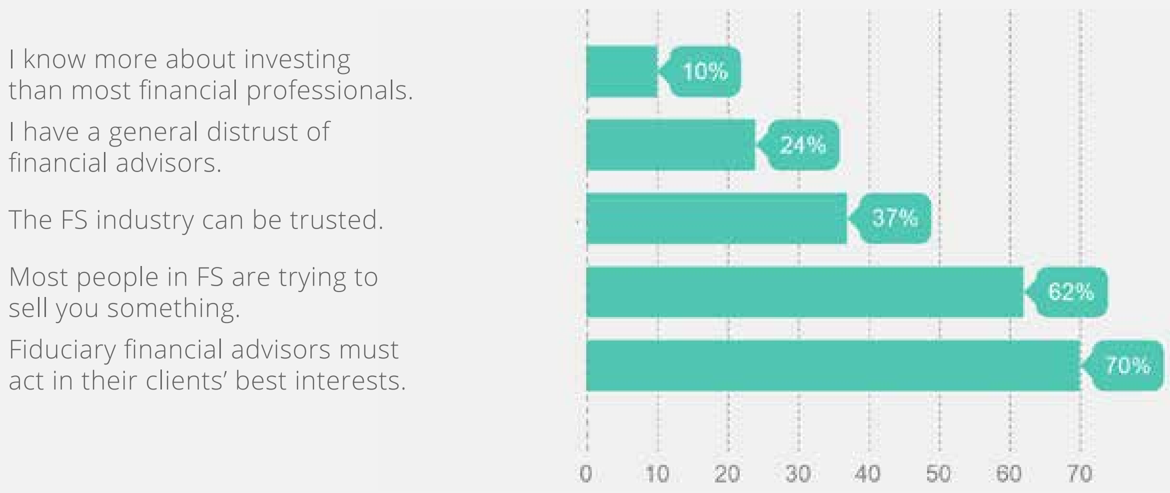
ACTING IN OUR BEST INTEREST?

We see a similar pattern in perceptions about advisors when we asked our sample several statements about the financial services industry and financial advisors specifically.

First, only 10% of the sample agreed that they know more about investing than those in the financial services industry. This is consistent with findings related to “perceptions of value” of financial professionals in the areas of investment management and investment research.

Despite the view that advisors know more about investing, trust in advisors and the industry has a bit farther to go. First, just under 25% of respondents indicated they have a general distrust of advisors, but over 60% of respondents disagreed that the financial services industry can be trusted. Over 60% agreed that those working in the financial services industry are trying to “sell you something.” Finally, 70% of the sample indicated that fiduciary advisors were acting in their clients’ best interests.

FIGURE 11. PERCENTAGE AGREEMENT:
ATTITUDES ABOUT FINANCIAL SERVICES

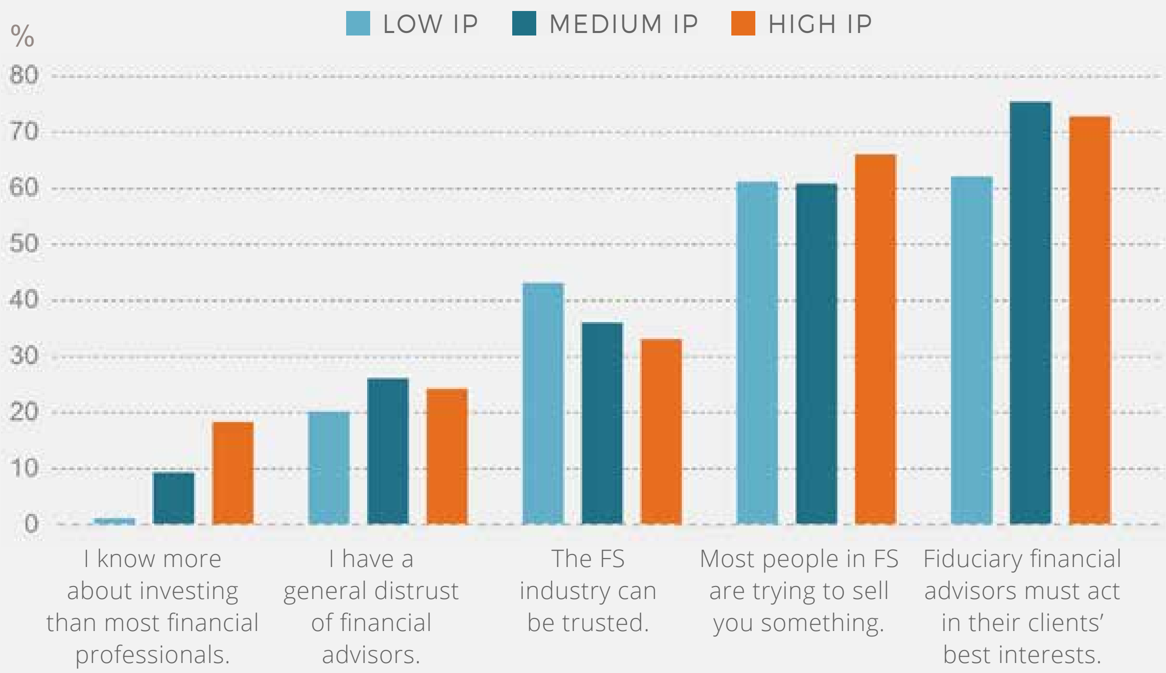


ATTITUDES AND PERCEPTIONS BY INVESTOR PROFILE GROUPS

How do investing-related competencies differentiate attitudes and knowledge about financial services and advisors, specifically? We see a few clear differences between the low and high Investor Profile groups in terms of their attitudes. First, whereas nearly one-fifth of the high Investor Profile group agreed that they know more about investing than professionals, only 1% of the low Investor Profile group agreed. Over 40% of the low Investor Profile group agreed that the industry in general can be trusted, whereas about one-third of the high Investor Profile group agreed. Finally, nearly three-fourths of the medium and high Investor Profile groups agreed with the statement that fiduciary financial advisors must act in their clients' best interests, whereas just over 60% of the low Investor Profile agreed.

These findings taken together indicate a clear difference in both attitudes and knowledge that can be understood through differentiation by investor-related competencies. In other words, investors may have differing perceptions of the industry and advisors specifically depending on their own investing-related characteristics.

FIGURE 12.
PERCENTAGE AGREEMENT BY INVESTOR PROFILE (IP) GROUP



What we do

WHEN MAKING INVESTING DECISIONS

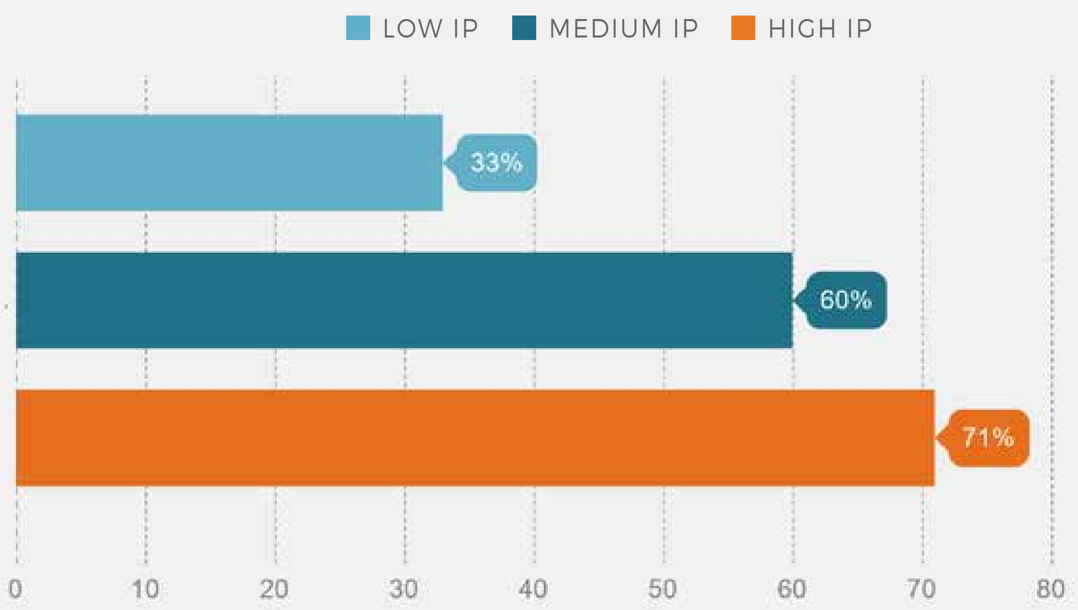
SHOULD WE INVEST?

Approximately 55% of the sample agreed that most people should invest some money in the stock market. This finding is somewhat consistent with the findings related to “fear” or apprehension of stock market investing.

The majority of those with a higher Investor Profile score also indicated a higher-level agreement with the concept that most people should invest some money in the stock market. Whereas nearly 55% of our sample agreed with this statement, 70% of the high Investor Profile group agreed. Only one-third of the low Investor Profile group agreed with this statement, indicating that this group may be afraid of investing, and that measuring investing-related competencies can help differentiate prospects and clients related to attitudes about investing.

FIGURE 13.
PERCENTAGE AGREEMENT BY INVESTOR PROFILE (IP) GROUP

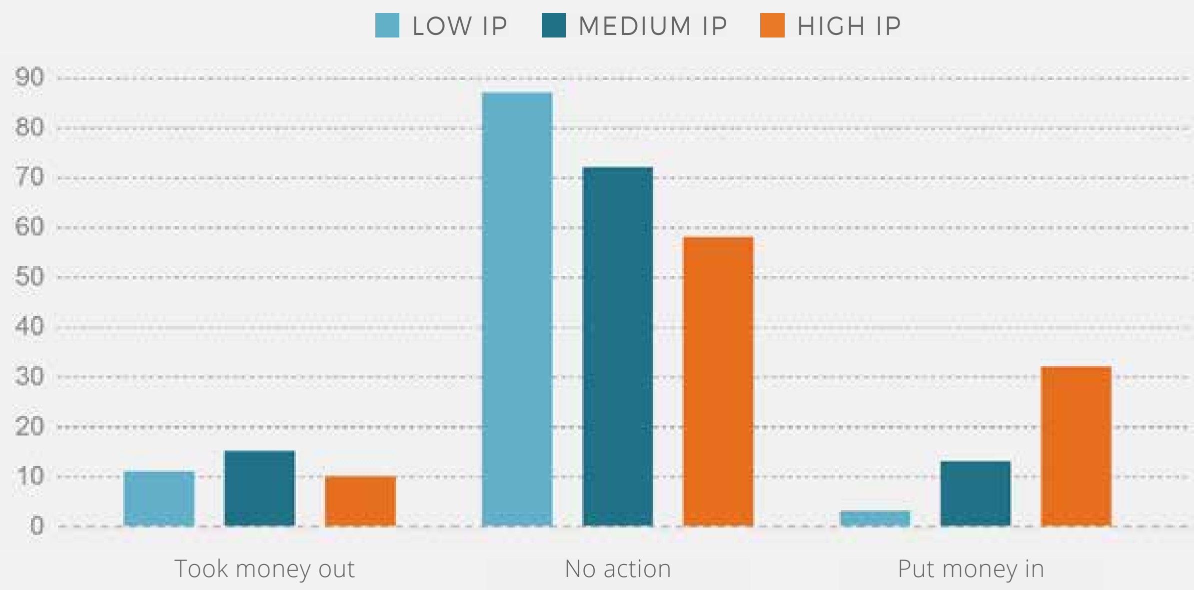
“MOST PEOPLE SHOULD INVEST THEIR MONEY IN THE STOCK MARKET”



ACTION DURING A DOWNTURN AND OVERALL SAVINGS BEHAVIORS

One of the more critical implications for examining behavioral patterns is their ability to predict outcomes that are critical to financial success. We find that Investor Profile groups differ significantly in two key outcome areas: (1) investment related behaviors during downturns in the market, and (2) monthly savings rates. Specifically, those investors who scored high on the Investor Profile were more likely than their low-profile peers to put money into the market during a significant downturn and save approximately 156% more each month as their low-profile counterparts. Given that both groups are similar in age, these two significant differences can make or break future financial success.

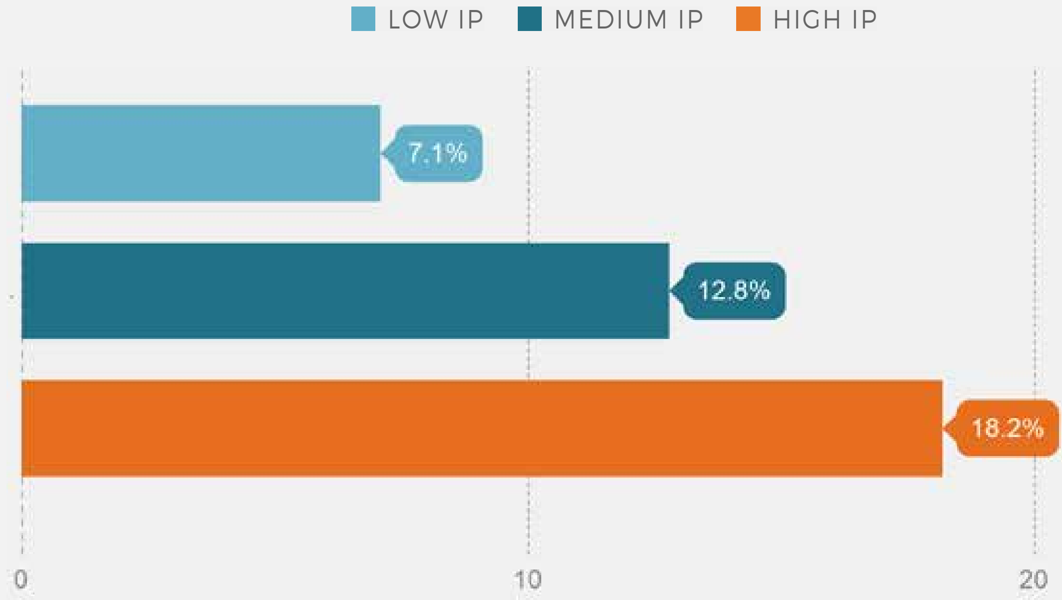
FIGURE 14. INVESTOR BEHAVIOR DURING LAST SIGNIFICANT DOWNTURN IN MARKET BY INVESTOR PROFILE (IP) GROUP



WHAT IS VOLATILITY COMPOSURE?

We define volatility composure as a combination of past experiences and behavioral patterns that describe how an investor typically reacts to changes in the market value of his or her investments as well as overall changes in the value of the stock market. How will the individual behave—as opposed to how they think they will behave—when the stock market goes haywire? How will the individual investor respond emotionally, and how do those emotions impact his or her behavior? During times of market volatility, investors that possess high volatility composure are more inclined to ignore market news and maintain their position regardless of what is transpiring day to day, while those investors that are low on volatility composure are more inclined to actively seek information (e.g., calling their advisor or

FIGURE 15. MONTHLY SAVINGS RATE BY INVESTOR PROFILE (IP) GROUP



checking the market frequently) and to take action (i.e., trading)—action that might not be consistent with their long-term financial goals.

Some of the behavioral components that determine volatility composure include an ability to stick to a long-term plan (i.e., a form of discipline), remaining calm even in chaotic situations (another form of discipline), and avoiding excessive worry when an element of their financial life feels uncertain. In our research volatility composure is positively related to traditional measures of "risk tolerance" (e.g., Grable & Lytton's 1999 measure of risk tolerance), and is negatively related to how we view financial loss (i.e., so-called "personalization of loss"). But we also find that volatility composure is a separate and distinct component from other aspects of an individual's experiences and personality that might influence investor behavior (e.g., judgment, risk personality, preferences). For example, volatility composure is a different animal than preferences for certain types of investments. You might love a good penny stock but at the same time have very little composure to watch it go close to zero. Likewise, volatility composure is not the same as judgment; you may be extremely composed but at the same time be overly focused on short-term gains and losses.

Instead of focusing on specific cognitive/behavioral biases, our Investor Profile tool employs a broader behavioral approach, an approach that lends itself to guidance from the advisor to help the client improve critical behaviors over the long-term. As the Vanguard "Advisor's Alpha" study asserts, the behavioral-guidance side of investment management can add significantly to annual portfolio returns. In other words, the guidance of a trusted advisor can help investors make better decisions and engage in better behaviors with respect to their investments. By understanding how we typically behave when the markets become choppy, we can create a plan of attack to neutralize and ultimately improve those behaviors.

Using science to

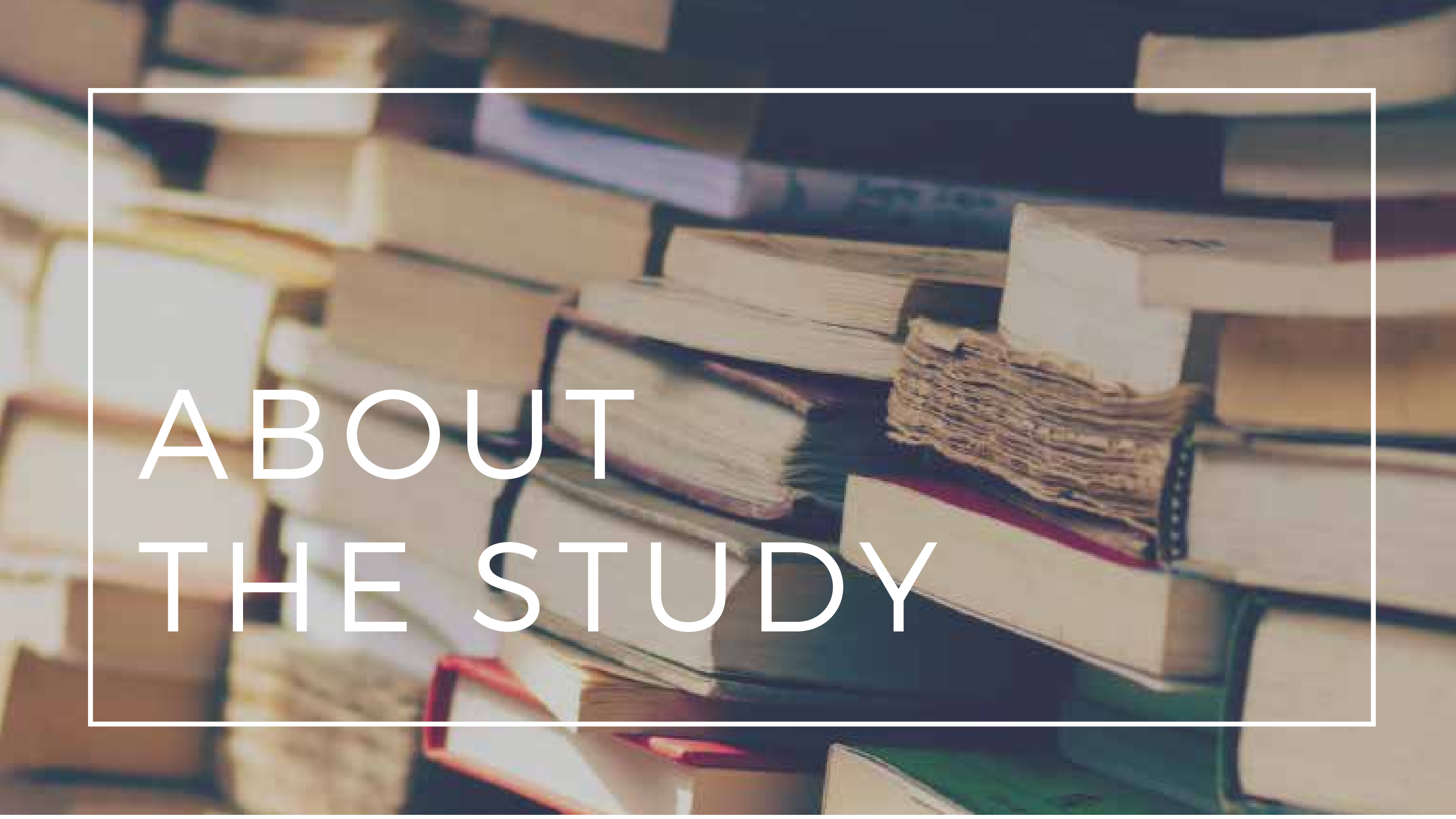
GUIDE BETTER INVESTING BEHAVIORS

Investing is critical to long-term financial success, but investors rarely receive sufficient guidance from parents and continue to have some skepticism of the financial services industry. Likewise, there is still a fear of investing in some segments of the investor population.

To improve investing decision-making, it's important to first understand an investor's pattern of behaviors, experiences, attitudes, and preferences that contribute to the psychological ability to invest, often referred to psychological risk tolerance. Instead of focusing on demographic characteristics of clients, such as age, gender, and marital status, identifying these psychological and behavioral patterns can serve two important functions: 1) it allows the advisor to better understand the types of attitudes and behaviors they can expect from their clients, and 2) it gives the advisor a framework from which to guide better investing behaviors.

What types of guidance should advisors be giving when it comes to better investing behaviors? DataPoints' five-factor framework helps advisors provide personalized counsel to their clients in order to help their clients become better investors. Using behavioral science, we can identify the key behaviors and experiences that lead to good investing behaviors. Advisors can then use these investor profile factors to guide and advise their clients—helping to empower them to make better long-term investing decisions by improving their composure, to build confidence in investing through coaching and mentoring, and to understand why taking on some amount of investment risk will allow their money to grow at a higher rate over the long-term.

Taking risks allows investors a greater opportunity to increase wealth over time and plan for a future retirement. While investing advice must take into account the client's ability to invest for the long-term, we argue behaviors (which ultimately lead to outcomes) can change and, as in Vanguard's Advisor's Alpha research, advisors are in a unique position to guide investors towards better overall behaviors and to therefore reap the full benefits of a long-term investment strategy.



ABOUT THE STUDY

DataPoints used a crowdsourcing site to conduct its latest survey. We required that respondents be at least 25 years old, have at least $25,000 in annual household income in the previous year, and be responsible or jointly responsible for financial decisions in their households. A total of 268 individuals participated in the survey. While there are significant differences between the Investor Profile groups in terms of net worth, research has shown that the Investor Profile overall score is related to investor-related outcomes regardless of age, income, or net worth.

59% FEMALE

41% MALE

62% BACHELOR'S DEGREE OR HIGHER

53% MARRIED OR REMARRIED

25% WORK WITH A FINANCIAL PROFESSIONAL

38% USE A SPEND-TRACKING TOOL (MINT, YNAB)

63% HAVE LIFE INSURANCE

77% OWN FINANCIAL INVESTMENTS

FIGURE 16. NET WORTH GROUPS REPRESENTED IN STUDY

- Less than $100,000 (56.6%)
- $100,000 to $999,999 (40.2%)
- $1 million or more (4.1%)

	Investor Profile Group			
	All	Low	Medium	High
Age	38.5	39.0	39.7	36.7
Income*	$68.5	$56.0	$70.0	$76.0
Net Worth*	$77.5	$17.5	$87.0	$136.0

*Median. Dollars in thousands.

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ABOUT THE INVESTOR PROFILE

The Investor Profile assessment from DataPoints provides advisors and their clients with a comprehensive picture of client psychology, behaviors, and personality in investment-related decisions and market volatility. With its unique focus on behavioral patterns, preferences, and attitudes, the Investor Profile is the scientific answer to understanding the psychological risk tolerance of clients, thereby anticipating (and guiding) future actions. The factors of the Investor Profile are featured in the book *The Next Millionaire Next Door.*

ABOUT DATAPOINTS

DataPoints provides behavioral science tools to enable advisors to impact client financial success. Using more than 40 years of behavioral, consumer, and demographic data and findings that shaped the best-selling book, *The Millionaire Next Door,* DataPoints enables advisors to assess and change client financial behaviors.

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