

tBf The Boston Foundation
Philanthropic Advisor
 A GUIDE TO CHARITABLE GIVING FOR PROFESSIONAL ADVISORS

Understanding Behavioral Finance When Advising Clients

[Randy Hustvedt](#)

Principal

[Federal Street Advisors](#)

[Beth Milkovits](#)

Director of Development

[The Boston Foundation](#)



Randy Hustvedt (left) and Beth Milkovits.

As students of behavioral finance, we would argue that “Behavioral Finance” is really not finance at all—rather, it is a healthy dose of psychology, a tad of sociology, and a pinch of economics. But, call it what you like—it is the study of how social, cognitive, genetic and emotional factors influence the decisions we make every day. This study not only applies to economic decisions but also to health and lifestyle decisions. In a nutshell, the idea is simple: most humans, except for the rarified few (we can’t help but think of Warren Buffett in this category), engage in a number of behavioral patterns that are seemingly irrational. While stories about irrational behavior may be amusing, we would rather focus on the positive aspects of this field of study. As a result of our studies in this topic, we better understand ourselves, our clients and our donors. By studying why people are hard-wired to make classic investing mistakes, we are, at times, able to “save them from themselves” as clients sometimes ask us to do.

The single most important role of an advisor is often managing a client’s behavior, not his or her portfolio. Nick Murray in his recent newsletter writes: “The essence of personal investment advisory is the management of the proclivity to panic. For many of us, the essence of long-term, real-life investment success will turn out to be the suppression of our own impulse to panic. This leads directly to the conclusion that, if we doubt our own capacity single-handedly to overcome our deep susceptibility to panic, the highest and best function of our financial advisor isn’t to forecast the markets—something neither she nor anyone else can consistently do—but simply to talk us in off the ledge.”

In order to understand Behavioral Finance, it is important first to understand the Efficient Market Hypothesis (EMH). According to the EMH, major financial markets reflect

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all relevant information at a given time. The underlying assumptions of the EMH are that investors are rational, although there will be independent deviations from rationality. According to the EMH, these deviations will either cancel each other out, or a group of rational investors will take advantage of the situation. Either way the market will remain in balance. Therefore, as the old joke goes, there could never be a real \$100 bill on the sidewalk. According to the EMH economist, surely, if the bill were real, someone else would have picked it up already.

The debate over whether or not the markets are efficient continues, and we have no intention of ending, let alone entertaining, that debate in this article. As hard as it might be for those of us schooled for years in the EMH, incontestable evidence exists, both in the lab and in our offices, that people are indeed prone to making irrational decisions when it comes to some of the most important issues in their lives—be it what to eat, how much to exercise, when to sell a stock, how to evaluate a charity and whom to choose as a life partner.

As Terry Burnham, has said “We have brains that worked well to solve ancestral problems. Difficulties arise, however, when we take those ancestral instincts to unnatural environments. And there is no more unnatural environment for a human brain than a financial market.” In modern financial markets and perhaps philanthropy to some degree, we are indeed fish out of water. We hope that by being aware of these biases and tendencies, we can correct them in ourselves and in our clients. In her recent article in *Investment Advisor* called *The Upside of Irrationality*, commentator Olivia Mellan stated that our “irrational” behaviors “...are neither random nor senseless: they are systematic and predictable.”

Students of behavioral finance are already familiar with the heuristics (rule of thumb) and cognitive biases often cited that are the core of the field. (For a complete listing, see http://en.wikipedia.org/wiki/Behavioral_economics, or pick up one of the many books on our reading list [here](#).)

Prospect theory is one of the main theories of behavioral finance. The theory posits that people are much more distressed by losses than they are happy about gains. This may be best illustrated with an example. A study was done at Cornell University that we recreated in a recent seminar given at the Boston Foundation with some of the best and brightest advisors in the Boston area attending. We asked participants to bet on a coin toss. If the participant loses, she pays \$100. Participants were asked how much money they would have to potentially win in order to compete. In other words, how much would they need to win in order to risk losing \$100? The study showed that people generally need between \$200 and \$250 to risk losing \$100. This explains the numerous phone calls we received in 2008 as the market was crashing, but the few calls in 2009 as it was rallying. People focus on losses, and it causes them great pain!

This natural aversion to loss is what caused so many people to cash out in 2008. By understanding this tendency and using another technique we'll discuss later on, some financial advisors were able to keep a lot of clients invested in stocks despite their fear. Clients who stayed invested greatly benefited, even with the 2008 crash. However not all investors could quell their panic enough to stay invested in the stock market, which explains the massive in-flows into bond funds. The amount Americans put into savings accounts and money markets increased 18% between October 2007 and March 2009.

Framing is another heuristic we often see in ourselves and in our respective clients. Framing dependence states that how a question or problem is described has an effect on how people will answer or react. One classic example is to think about buying a lamp for \$100. If you hear the same lamp is on sale 5 blocks away for \$75, would you drive the 5 blocks to save \$25? Most of us would say yes. Alternatively, after you spent an hour

negotiating a car purchase for \$25,000, would you drive 5 blocks for the same car on sale for \$24,475? This scenario also saves you \$25; however few people would bother to save \$25 on a \$25,000 purchase. Rationally speaking, \$25 is \$25. If you would choose save \$25 on the lamp, you would choose to save \$25 on the car. But often we are not rational thinkers.

In our professional careers, we see framing all the time and try to use it in a productive way. For example, you can say to a client: if you follow this strategy, you have a 90% chance of hitting your retirement goals. Clients react positively to this statement. However if you say instead: if you follow this strategy, you have a 10% chance of failure; or, one of out 10 people who followed this strategy went bankrupt, then the response is less favorable. We have learned to try to control framing by reframing the question not just in space but in time. A 20% drop in a client's portfolio in 2008 is awful, but look at the performance over the past 2, 3 and 5 years, and your client's outlook may improve.

Anchoring is another heuristic we find to be prevalent among our client base. With anchoring, a person focuses on one piece of information when making a decision. This piece of information may or may not be relevant to the situation. For example, ask yourself the following: Mary is 31, single outspoken and very bright. She majored in philosophy. As a student, she was deeply concerned with issues surrounding equality and discrimination. Is it more likely that (1) Mary is a bank clerk or (2) she is a bank clerk and active in the feminist movement? Stop reading and answer whether you think number 1 or number 2 is more likely.

Most people pick number 2 but the correct answer has to be number 1. Number 2 is a subset of number 1 and therefore has a much smaller likelihood of occurring. This example shows how much we are influenced by irrelevant facts, such as that Mary was concerned with equality in college. While this fact alone is not irrelevant to Mary, it is irrelevant to our question, yet it affects our answer. Advisors see this in their work when people focus on the price of a stock at the time it was purchased, and refuse to sell the stock until it reaches that price again. The stock's value is totally irrelevant (think Enron at \$90 and the numerous people who rode it all the way down!) but people "anchor" on the price.

This phenomenon occurs in philanthropy as well when donors evaluate nonprofit organizations and programs. Spending on overhead has become a very important consideration when choosing which organizations to support. Although cost of overhead as a percentage of a nonprofit organization's overall spending is an important factor, it does not tell the whole story. Anchoring on overhead percentage can lead a donor against supporting an organization when comparing only overhead expenses. However not all organizations are the same and overhead costs often depend on the mission of the nonprofit. It is important to base decisions on more than one fact – therefore it is important to recognize that our decisions are often based on one, possibly irrelevant, fact.

Another heuristic is called **mental accounting**. We all put money into different mental buckets. Some experts believe that this is one reason lottery winners usually spend their winnings within a few years of winning and end up the same or worse off than before. Lottery winnings (or inheritances, which are far more prevalent) are somehow considered to be different from earned income. Advisors can embrace this bias and use it to their clients' advantage. For example, in 2008 some advisors encouraged clients who were convinced that the world was coming to an end, to put aside enough cash and bonds for a few years of living expenses and stop thinking about their stock portfolios. It worked for some, enabling them to stop focusing on their fear of loss. The clients were

better positioned to benefit from one of the largest market rallies this country has ever seen.

In some respects, a Donor Advised Fund is nothing more than a fancy word for a “charitable bucket.” When clients separated out their charitable dollars, it made it easier for them to continue to give. However, as we know, there is no legal requirement that annual grants be made from a Donor Advised Fund. Since studies also show that giving, and not increased wealth, is a large contributor to one’s happiness, this has a dual benefit.

Finally, we will look at **overconfidence**. When asking a room of people to respond by a show of hands how many of them consider themselves to be above average drivers, usually at least 80% of the people raise their hands. Academics have run studies in which students were asked to rate their own ability to “get along with others.” A statistically insignificant number — less than 1% — rated themselves as below average. Furthermore, 60% rated themselves in the top 10%, and one-fourth of respondents rated themselves in the top 1%. Overconfidence actually leads to increased trading in investing. Because of transaction costs, even if an investor chooses correctly most of the time, any gains are eaten away by costs associated with trading. Again, overconfidence no doubt helped us survive the dark ages, but it is a dangerous tendency when it comes to investing. It is astounding how many people think that they can be better investors than trained money managers, especially when it comes to market timing, something even the most astute investors like Buffet say they cannot do.

Summary:

Behavioral finance is important to charitable giving for a few reasons. First of all, charitable giving is a choice about money. The process is the same for people making decisions about how to invest in the market or how to invest in their community. Philanthropy is social. According to Jonah Lehrer, giving money is not only a rational decision, it is influenced by social machinery of the brain.

The study of behavioral finance also calls into question the way the current system assumes people make decisions. For instance the EMH assumes everybody is optimizing their choices, which means that they are making choices that grow their bank account balances. However, as we have seen, often people are making choices based on other factors, and sometimes the factors are intangible.

We are social creatures. Sometimes having the highest bank account balance is not what makes us happiest. In fact many studies have been done showing that people who bought dinner or gifts for friends and family, or who gave money away to charity, were happier than those who did not. It is important that advisors speak with clients about their financial goals. Clearly, as we have seen much too often, the biggest bank account does not necessarily equal happiest clients.

Studying this field can be helpful to advisors in reining in some of our own tendencies, as well as in understanding our clients. We can use behavioral finance to find ways to work with clients in difficult times and to hopefully make them better and more patient investors. After all, as Jeremy Siegel so memorably said in the third edition of his classic book *Stocks for the Long Run*, “Fear has a greater grasp on human action than does the impressive weight of historical evidence.”

We encourage those of you with an interest in this topic to review our reading list ([click here](#)) and to incorporate these findings into understanding yourselves and your clients. As Terry Burnham said, “Because our instincts are exactly out of sync with financial opportunity, markets can be mean. However, it is the very irrationality of markets that provides the opportunities to make sweet profits. Financial success is based on using

emotional intelligence to shackle the lizard brain. Fortunately emotional intelligence can be increased by diligence, introspection, and discipline. Therefore, any investor willing to work to understand and tame the lizard brain can transform mean markets into money and satisfaction.”

The Roth IRA Conversion and Charitable Giving

[Michael D. Hough](#)

Director

[WTAS LLC](#)

By now most people have learned about the opportunity to convert their traditional IRA to a Roth IRA during 2010. A Roth IRA is advantageous because all earnings inside the Roth are free from income tax, even when distributed, whereas income earned inside a traditional IRA is taxable as ordinary income when distributed. The price of a Roth IRA conversion is that ordinary income taxes must be paid up front on the amount converted in excess of tax basis.

A Roth IRA has other attractive features compared to a traditional IRA. Minimum distributions are not required from a Roth during the original owner's life, and may be stretched over the life expectancy of a beneficiary, thus extending the income exemption benefit. The Roth IRA account is still subject to estate taxes, but solves the major estate/income tax inefficiency inherent in traditional IRA's because distributions to Roth beneficiaries do not create taxable income (known as income in respect of a decedent, or "IRD").

Those who pursue a Roth should think seriously in the year of conversion about their lifetime charitable objectives. The Roth conversion is a significant ordinary income event and, if large enough, may be subject to combined federal and state income taxes in excess of forty percent. A donor who times charitable giving in the Roth conversion year will optimize the tax benefit of the deduction both because of the higher Adjusted Gross Income limit and because the donation will offset the highest taxed income first.

To get an extra income tax benefit from charitable giving, a taxpayer can offset Roth conversion income by donating appreciated securities held for more than one year. This technique will shelter ordinary income without triggering any capital gains tax on the fair market value of the securities donated.

While charitable giving in the Roth conversion year makes great tax sense, lining up a charity right away might be difficult. A Donor Advised Fund can help those who have lifetime charitable plans and can use the deduction in 2010 for those who would prefer to wait until a later time to grant the assets to one or more charities.

Despite the advantages, the Roth IRA conversion is not for everyone. Those considering a Roth conversion should keep in mind other important factors, including current versus future tax rates, potential changes in state residency, life expectancy, the alternative minimum tax, and charitable intentions. In particular, individuals with taxable estates who plan on donating assets when they die may want to skip the Roth conversion altogether and earmark their IRAs for charity. (We are assuming here that the estate tax will re-appear in some form after 2010.)

An individual who anticipates donating a fixed percentage of his or her estate at death may leave more assets to other beneficiaries by not converting a traditional IRA and paying less income tax during life. The analysis is similar to why donating appreciated securities during life is tax efficient. A taxpayer who donates appreciated securities pays zero capital gains tax on the appreciation while getting a fair market value deduction, and thus is left with more assets than if he sells securities, pays the tax, and donates cash. Similarly, a donor who does not convert to a Roth but instead donates the

traditional IRA at death pays less ordinary income tax during life, pays zero income taxes on the value of the account donated at death, and leaves a larger estate net of taxes. Additionally, the assets that pass to non-charitable beneficiaries will be more tax efficient because they likely won't create IRD like a traditional IRA.

The mechanics of donating an IRA account are as simple as changing the beneficiary designation to a qualified charity, which usually requires completion of a simple form provided by the custodian. If the assets are intended for multiple charities then naming a Donor Advised Fund may simplify the distribution logistics. A Donor Advised Fund can also be useful for donors who want to create a lasting legacy and integrate heirs in future giving.

For those who have already converted their IRA and now have second thoughts, it is not too late to go back. A taxpayer is permitted to re-characterize a rollover by making a trustee-to-trustee transfer from the Roth to a traditional IRA before filing his or her 2010 tax return. In all events, the Roth IRA analysis is complicated, and those considering the conversion should consult a tax professional before making a final decision.

Top Ten Suggestions on How to Motivate Clients to Practice Philanthropic Planning

[Scott E. Squillace](#)

Principal and Founder

[Squillace & Associates, P.C.](#)



Since opening our practice, we have done a considerable amount of work with clients around philanthropic planning. For us, it fits naturally with who we are and what we want to do personally and professionally. Since much of our work has been during the throws of the Great Recession, it has been surprising for us to learn that many advisors are struggling with getting clients to consider including philanthropy in their plans. While many clients were indeed 'frozen' in late 2008 and early 2009, we found considerable acceptance with the notion of incorporating philanthropy in their plans even during this difficult period. In fact, over seventy percent of our clients have done some form of philanthropic planning – mostly in the form of testamentary gifts. We recently calculated what the value of all of those gifts would be if they were to have been accelerated on January 15, 2010 – and the total was surprising, even to us: \$33,472,000.00! Needless to say, it was encouraging to feel that we had facilitated in some way such meaningful giving.

So, the question we now get from other advisors is: How do we do it? While none of this is terribly sophisticated, we have come up with the following 'Top Ten' Suggestions for Advisors to Motivate their Clients to Practice Philanthropic Planning.

1. Ask your clients about it.
2. Make the discussion about them (not the charity): current income tax saving or teaching the next generation about philanthropy can be compelling.
3. Introduce easy to understand concepts. For example, with high-wage earners or people who enjoy large bonuses, discuss the 'flex spending account' for charitable giving (Donor Advised Fund).
4. Take the obvious road blocks off the table: of course there's not enough for your family/loved ones – but think about the one major liquidity event – maybe you could 'sweep something off the top'?
5. How about getting Uncle Sam to 'match your gift'? (X % of IRA/401(k) assets has that effect.)
6. Try a formula approach – if the total value of my gross estate exceeds (pick it) (\$3.5 million) – then 5% of everything above \$3.5 million could be used for philanthropy.
7. Help them understand what's in it for them. For example, another way to diversify a retirement income stream is to set up a charitable remainder trust for (steady income source).
8. Look for the opportunities: highly appreciated assets are ripe resources for these techniques to eliminate capital gains tax.

9. Remind small business owners to think about it BEFORE the exit strategy is put in place.
10. Again, ask about it. Don't be afraid to raise the issue and just LISTEN.

Friends of the Foundation: Professional Advisors Give Back to the Community

The Boston Foundation would like to recognize the following named attorneys, investment advisors, financial planners and accountants who helped to facilitate at least one new fund or planned gift to the Boston Foundation between July 1, 2009 and June 1, 2010.

Does Your Name Belong Here?

Please let us know if your name should be added to the list of Friends of the Boston Foundation in future issues of this publication. Simply let us know that your client is including the Boston Foundation with a current or future gift. Your client may remain anonymous if desired.

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June 7520 Rate Down to 3.2% - For purposes of determining the present value of an annuity, an interest for life or a term of years, or a remainder or a reversionary interest, [Revenue Ruling 2010-15](#) indicates the applicable federal rate under section 7520 for June 2010 is 3.2%; up 0.2% from the May rate of 3.4% and unchanged from the April rate of 3.2%. [Rev. Rul. 2010-15](#); [2010-23 IRB 1](#).

IRS Releases Pub. 946, How to Depreciate Property - The IRS has released [Publication 946](#), How to Depreciate Property, for use in preparing 2009 returns. Of particular interest to charitable gift planners is an example of the interplay between the [Section 179 business deduction](#), taken in lieu of depreciating property, and the income tax charitable deduction for corporations.

ACGA Issues New Suggested Gift Annuity Rates - The [American Council on Gift Annuities](#) board of directors held its semi-annual meeting on April 28, 2010. At the meeting the Rates Committee recommended a new schedule of gift annuity rates effective July 1, 2010.

For more information go to the [Planned Giving Design Center](#), and then "News Stories."

About the Boston Foundation

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[The Boston Foundation](#), Greater Boston's community foundation, is one of the oldest and largest community foundations in the nation, with assets of \$682 million. In Fiscal Year 2009, the Foundation and its donors made over \$95 million in grants to nonprofit organizations and received gifts of over \$81 million. The Foundation is made up of some 900 separate charitable funds established by donors either for the general benefit of the community or for special purposes. The Boston Foundation also serves as a major civic leader, provider of information, convener, and sponsor of special initiatives designed to address the community's and region's most pressing challenges. For more information about the Boston Foundation, visit [our website](#) or call 617-338-1700.

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For more information on the Boston Foundation and how we work with advisors and their clients, contact Beth Milkovits, Director of Development, at 617-338-1218 or beth.milkovits@tbf.org.

For more information about the Fund for the 21st Century, contact George Wilson at 617-338-1626 or george.wilson@tbf.org.

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