WEALTH MATTERS

Aligning Your Investments With What Motivates You

By PAUL SULLIVAN

ALPHA. Beta. Gamma. Phi. The letters could be the name of a college honor society or maybe a fraternity or sorority. But in finance, they represent the progression of thinking about investments and how to judge them. Phi is the newest one.

Alpha measures an investment's performance against a market index. If the Standard & Poor's 500-stock index is up 10 percent and a mutual fund is up 15 percent, for example, that 5 percentage point difference is alpha.

Beta is the return of any given market. And charting beta is what a passive index fund does. Comparing different indexes' beta — say domestic equities and international bonds — helps investors in deciding how to allocate their investments.

Gamma, introduced in 2013 by Morningstar, the investment research firm, is used to assess the impact on returns of more intelligent financial planning decisions.

For individuals, high gamma is generally achieved by seeking advice from a qualified investment professional. But not always. The original Morningstar paper on gamma discussed the need for intelligent decisions across five areas, including tax management and withdrawal strategies.

What phi aims to add is a way for investors to quantify how their motivations — or those of the people managing their money — will affect long-term investment returns.

Suzanne Duncan, global head of State Street's Center for Applied Research, who led the team that surveyed and studied about 7,000 individuals and investments professionals over 18 months, said their research began by looking at the role incentives play in making investment decisions. But, she said, it quickly shifted to examining what motivated a person to invest — or not — in the first place.

"We understood quite quickly and clearly that most individuals and professionals are working with a market-based motive," said Ms. Duncan, who conducted the study in conjunction with the CFA Institute, which administers the chartered financial analyst designation. "It can manifest itself in a passion for markets with individual investors. But for most, it's a fear of markets."

And both of these motivations, the study found, can hurt long-term returns.

To score high on phi, Ms. Duncan said, people need to have a deeper sense of purpose in what they are doing, whatever the job. "It's not about outperforming markets or peers, and it's not an asset-gathering measure of performance," she said. "The performance has to be defined as sustainable and with a deeper sense of purpose."

She noted that in the research, financial services professionals had low phi scores, ranking 12th out of 14 industries. Phi is "a unicorn in our industry," she said. "However, it's not a unicorn in other industries."

Ms. Duncan cited companies like Whole Foods Market, Southwest Airlines and Disney for instilling a high sense of passion, or phi, in their employees.

The implications for this study, which will be released next week, are broad for people who invest their own money, people who select advisers and rely on their guidance, and investment professionals — as well as the managers who motivate and manage them.

People's phi scores are determined by questions about their purpose, habits and the incentives around what they do. (To test phi, there are online tests for financial professionals — and for individual investors.)

Qualities that you might think are desirable are not, when it comes to phi. For example, answering that you have a passion for the markets or that you like your job because you work with smart people will not raise your phi score. Both responses seem good at first, but there is the risk that there is no greater purpose in what you are doing.

"It's very interesting because it talks to a very needed culture shift to our industry," said Rebecca Fender, head of the future of finance initiative at the CFA Institute. "Phi takes this heretofore very unquantifiable subject and puts some numbers around it so we can have a more meaningful conversation with the industry."

While the study found that wealth was not a differentiator for phi scores, there were generational differences. Millennials scored high on the test and, more generally, as people got older, their phi scores increased.

When it came to the types of investors who score high on the phi test, Ms. Duncan was careful not to overgeneralize. But she said the research found that people who invested with a socially responsible mind-set scored better. Their dual goal of seeking profit but doing so to achieve some social benefit naturally gives them a purpose beyond returns.

But what about those who invest more broadly or do so to maximize their gains? It's not easy to change them.

Individuals seeking to improve their phi have to move their focus beyond competing with their neighbors and looking toward a specific goal. Ms. Duncan said there were three areas where they should focus — their purpose, habits and incentives.

In terms of purpose, individuals need to ask soul-searching questions about what they want their life to be. With investing, the investment goal ranks below the purpose of those investments — what they might use the money for in the future and not the sheer amount in the portfolio.

To stay on the path to that purpose, investors need to change habits that distract from it.

"In the case of individual investors, the cue is this market motive," Ms. Duncan said. "They need to replace the market motive with the purpose motive, which is phi."

"Those with high phi will have sustainable performance to a much greater degree," she added. "The purpose motive breaks the bad habit" of following the markets.

The incentives to get people to shift their purpose and break bad habits, she said, are taken from nudge theory, a term coined by the economist Richard Thaler and Cass Sunstein, a legal scholar. The idea is to persuade someone to adopt better behavior, like automatically signing people up for retirement plans or getting them to agree to increase their contribution rate to the plans when they get a raise.

For investment professionals, Ms. Duncan said, the way to increase phi is to change motivation that is often tied to compensation. The study discusses four ways of doing this, including laying out a compelling vision for the future, challenging investment professionals' assumptions and discussing their values and beliefs.

At its simplest, this could mean changing annual bonuses so they are paid out over several years, with a greater reward if the performance is sustainable.

The study showed that changes that increased phi had a meaningful impact on a person's investment strategy.

Every one-point increase in people's orientation toward investment goals with a purpose — and the scale is 0 to 3 — equated to 42 percent greater odds that the investors know what they are paying in fees, 37 percent greater odds that investors are not rejecting their financial adviser, 38 percent greater odds that the people consider investing in socially responsible investments and 79 percent greater odds that investors will trade less frequently, the research found.

For investment professionals, that same one-point increase resulted in a 21 percent greater likelihood of excelling at long-term goals and 37 percent greater chance of scoring higher on client satisfaction.

"This is intended to start a thought process of leaders in the industry," Ms. Fender said. "Culture can't be changed overnight. It's essential to reconnect the investment profession with its stated purpose of improving society."

And for those seeking an adviser, administering a phi test would surely help. As a group, wealth managers have higher phi than others in financial services. One reason is they are more connected with the people they serve.

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Suzanne Duncan, global head of State Street's Center for Applied Research, led a team that started by looking at incentives in investment decisions, but switched to studying motivation.