

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

Understanding Behavioral Finance When Advising Clients

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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.”

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High Impact Philanthropy - What is it and how can a community foundation help you do it?

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Jennifer Christian Murtie and
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Much has been written in recent years about a trend in philanthropy to seek greater impact and more measurable results. Most experts believe this trend is not only here to stay; it is transforming how donors (both individuals and foundations) approach their charitable giving. Organizations like the Center for High Impact Philanthropy at the University of Pennsylvania and FSG Social Impact Advisors, along with numerous blogs and books like *High Impact Philanthropy: How Donors, Boards, and Nonprofit Organizations Can Transform Communities*, by Kay Sprinkel Grace and Alan Wendroff, and *Forces for Good: The Six Practices of High-Impact Nonprofits*, by Leslie Crutchfield and Heather McLeod Grant, are bringing the concept of high impact philanthropy to a broader audience.

So what exactly is "high impact philanthropy" and what is the buzz all about? The Center for High Impact Philanthropy defines it as "the practice of making charitable contributions with the intention of maximizing social good. The aim is to make the biggest difference possible given the amount of capital invested." As a donor, how can you have the greatest impact on positive social change? How can you make your money stretch further? How do you select organizations that have measurable results? How do you know if you are having an impact? These questions and many others have become increasingly important to philanthropists. Since the market turmoil of 2008, many donors have fewer dollars and therefore have been forced to be more strategic with their philanthropy. Most experts believe this is a positive shift for the philanthropic sector.

Personal Involvement is Key

Foundations and individual donors have always strived to have an impact on social change, but this new approach is different in that donors are focused on personal involvement and long term change – and are more cognizant of the charitable organization's strategy. Finding charities that work directly with the people they serve is becoming an increasingly popular funding strategy. Not only do your charitable dollars address a particular issue, they support an organization that has local people on staff, a long history of success in the region, and an information base that gives them an advantage in solving social problems.

You Don't Need Millions to Have High Impact

It is important to remember that you do not need a large fortune to have a high impact; rather, you need commitment, energy, and time to be actively involved. Creativity goes a long way, and partnering with the right organizations, people, and institutions can create lasting social change. By definition, high impact philanthropy does not necessarily mean impacting the greatest number of people. Nor does it mean shifting emphasis to projects that can easily count immediate results (e.g., the most people served). Rather, the focus is on longer-term, more significant and longer lasting impact, even though it may be more difficult to measure. High impact philanthropy works to permanently improve the circumstances of individuals and/or communities, using effective organizations that have the right strategies.

A New Breed of Hands-On Philanthropists

No one exemplifies this new approach to philanthropy better than the shared clients of the Boston Foundation and Federal Street Advisors, Jim and Karen Ansara. We are humbled by the Ansaras' commitment, passion, and capacity to implement high impact philanthropy and create positive change through their efforts.

The Ansara Family Fund is a Donor Advised Fund at the Boston Foundation, which is Greater Boston's community foundation. The focus of the fund is on eradicating global poverty in Latin America and Central Asia. The Ansara family annually makes 20-30 grants totaling \$500,000-\$700,000. This year, with the help of the Boston Foundation, Jim and Karen took their philanthropy to a whole new level. They asked the Boston Foundation to create The Haiti Relief and Reconstruction Fund ("HRRF") in response to the earthquake of January 12, 2010.

In order to build the fund, the Ansaras leveraged their money by pledging to match donor contributions dollar for dollar up to \$1 million. They managed to raise \$1 million in less than a month, creating a \$2 million fund in only a few weeks. Over the course of the next five years, the Fund will devote up to 25 percent of its resources to immediate disaster relief, and the balance to innovative projects and organizations helping Haiti rebuild livelihoods, reconstruct infrastructure, and promote human rights so that Haitians can have a voice in shaping their own futures. Another priority for the Ansaras is to support the healing and strengthening of Boston's Haitian community in the aftermath of this disaster, as well to support the Boston Foundation in convening leaders of the local Haitian community to address long term reconstruction issues.

Focus on a Specific Need

What makes the Ansaras' philanthropy high impact is that they have focused on a specific need and selected organizations like Partners in Health, whose mission aligns with their philanthropic strategy. Even more important, they have made a long-term and personal commitment to the cause. Seventy-five percent of the Ansaras' fund will go to long term rebuilding efforts, and they are actively involved not only with their money but also with their time.

Strategic Advisors Help Maximize the Impact

The Boston Foundation has facilitated and enhanced the Ansaras' efforts through the structure and administration of the Ansara Family Fund, while Federal Street Advisors has carefully aligned the Fund's investment strategy with the Ansaras' values and goals. The Boston Foundation helped the Ansaras entrust a Donor Advised Fund, and now provides grantmaking advice and support, and helps raise awareness about the Fund. Because the Boston Foundation handles many of the fund's administrative burdens, Jim Ansara is free to spend one week a month building clinics and helping doctors in Haiti. He keeps a blog of his work, providing current and relevant updates to supporters of the

Fund. Karen spends her time fundraising and raising awareness about international poverty issues.

Community Foundations Give Small Family Funds Access to Top Level Resources

A majority of Ansara Family Fund grantmaking decisions are made at a semi-annual meeting. In preparation for the meetings, the Boston Foundation's Philanthropic and Donor Services staff responds to inquiries from nonprofit organizations, review proposals, manage grantee communication and oversee the grantmaking budget for the Ansara Family Fund. The Boston Foundation's staff also performs due diligence to ensure that grantees are qualified nonprofit organizations that are exempt from federal income taxes under Section 501(c)(3) of the Internal Revenue code. (Grants to non-U.S.-based and non-501(c)(3) organizations located outside of the U.S. are made through an intermediary organization such as CAF America.)

For The Haiti Relief and Reconstruction Fund (HRRF) in particular, the Boston Foundation administers all aspects of this fund, including:

- processing more than 1,200 gifts of cash, checks, credit cards and securities
- processing grants
- convening forums for the Greater Boston and Haitian American community
- managing inquiries from donors, press, civic leaders and nonprofit organizations
- convening a grants committee and advisory council to advise grantmaking over \$1,000,000
- organizing fundraising and donor reception events
- organizing meetings with civic and nonprofit leaders around development plans in Haiti and support for the Boston community

In the coming months, the Boston Foundation will be reviewing proposals to the HRRF from organizations seeking funding and will be conducting due diligence on all applicants. With an application deadline of April 23, HRRF received more than 80 inquiries from nonprofit organizations. The partnership between the Boston Foundation and the Ansaras has led to a very successful high impact fund that is focused on meeting the long term needs of the Haitian people.

A New Investment Mentality in Philanthropy

The Boston Foundation and Federal Street Advisors are increasingly working with donors to foster a new "investment mentality" in charitable giving, both by measuring "returns" from those investments in terms of impact, as well as by supporting sustainable and socially focused investment strategies in client portfolios. Foundations call this new approach "mission related investing" and with the help of their investment advisors they are finding innovative market-rate investment opportunities. Whether a donor is interested in human rights, the environment, or community development, there are ways to use their 'investable' assets to further social priorities.

The Ansaras' Leadership Continues to Inspire

The Ansaras' commitment to tackling poverty has been written about in The Boston Globe several times, as well as The Wall Street Journal. The Journal's recent article states: "With less to give, donors want to be certain that what they do give goes as far as possible, and many are deciding that means helping people improve their lives and their prospects, not just relieving their immediate suffering." Jim and Karen Ansara

make us proud to be their partners. They set a high standard for all of us, showing us how we can have the biggest impact with the resources we do have.

Karen Ansara quite eloquently states:

"In today's busy modern world it is so easy to lose focus when it comes to what's important. Haiti seems to have already disappeared from the headlines, even though the real work of fighting cholera, typhoid, and infection — and rebuilding an entire society — has just begun. That's why we must raise this money now, before Haiti's trauma becomes a mere memory to the outside world, while there is still so much to be done."

The Ansaras are leading by example, and we believe their model of philanthropy can be replicated and used by others to fulfill their own philanthropic vision. We at the Boston Foundation and Federal Street Advisors feel privileged to be two of the partners the Ansaras work with to help them further their philanthropic mission.

Where and How to Get Started

There are more than 700 community foundations nationally, and like the Boston Foundation, they offer many ways to help donors meet their charitable giving interests and goals. Their grantmaking experience and vast knowledge of local issues make community foundations natural partners for individuals and families interested in high impact philanthropy.

Regardless of your philanthropic budget, you can have a greater social impact with your philanthropy through research, networking, creating an organized process, and selecting effective organizations. Whether your passion is to support your community, your town, your state, your country or, with great ambition, our world, you can make an even greater difference. The Ansaras are leading by example and we believe their model of philanthropy can be replicated and used by others to find their own philanthropic vision.

Aligning your investment portfolio with your giving

Emily Bannister, Senior Research Analyst, Federal Street Advisors

We at Federal Street Advisors believe that foundations and individuals should invest their portfolios for maximum return at an acceptable level of risk. Fortunately, this objective is not incompatible with mission related investing (MRI). We have seen evidence that focusing on environmental, social and governance (ESG) factors does not necessarily result in lower performance. The FTSE KLD 400 Social Index, for example, uses these factors to create an index of U.S. equities. It has outperformed the S&P 500 index for the full common time period from May 1990 through March 2010, returning 9.7% annualized versus 8.8% annualized for the S&P 500.

Including MRI in the investment portfolio can amplify a high impact philanthropy strategy since it allows clients to leverage their invested assets to make an even greater difference than they are already making with their grants.

Mission Related Investing (MRI) Requires an Additional Layer of Due Diligence

It is possible to achieve outperformance with a mission focus. But just like any other investment style, there are good managers and bad managers; our job is to find the exceptional opportunities. When we research MRI managers, we hold them to the same standards by which we evaluate all managers. We recommend only managers that offer outstanding risk/reward profiles. Our research team uses qualitative and quantitative tools to assess whether we believe that managers who have done well relative to peers and benchmarks in the past have the process and team in place to outperform in the future.

With MRI managers, however, we have an additional layer of due diligence to perform.

We evaluate their approach to integrating ESG issues into the process, as well as the independence and sources of ESG data. We also look at the resources they offer in terms of proxy voting, thought leadership, and shareholder advocacy.

MRI Can be Broad or Highly Targeted

For some clients, a broad focus on sustainable investing aligns with their philanthropy, since their goals cover a number of issue areas. For other clients, the mission is more defined. In these cases, we have successfully found equity, fixed income, private*equity, and hedge*fund solutions that target specific issues.

One key aspect that differentiates high impact philanthropy from general charitable giving is the goal of *measuring* impact. While there is no standardized reporting yet in this area, we work with managers who highlight the tangible results of their advocacy efforts, and report the percentage of their portfolio invested in companies working on issue-specific solutions.

Looking to the Future

It is important to find ways to integrate mission related investing (MRI) into client portfolios, allowing them to align their investments with their high impact giving. As this market grows, we see new strategies being developed all the time – and some of these will turn into exceptional new investment opportunities for clients.

About the Authors: Jennifer S. Christian Murtie and Ruben Orduña

Jennifer Christian Murtie

Director of Foundation Services

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Jen Christian Murtie started at Federal Street Advisors in 2004 and serves as Director of Foundation Services. Her primary role is to provide assistance, support and service to foundation and nonprofit clients. In this capacity, she partners with clients on specific projects, such as conferences, in which they want to connect their investment strategies with their ongoing program initiatives. In 2009, Jen was nominated as an outstanding leader by the Family Wealth Alliance for their 40minus Leadership Summit. Prior to joining Federal Street, Jen spent six years working at The Moriah Fund in Washington D.C. She served as the Fund's Administrative Director, where she oversaw the day-to-day operations of the organization as well as worked with the program staff on grantmaking initiatives. In the fall of 2007 she took a six-week paid sabbatical from Federal Street Advisors to work on a clean water project in Ghana. She is also the winner of the 2007 Silverman Business Plan Competition with her business proposal to create an ecotourism consulting company focused on economic development in Africa. Her past experience gives Jen the ability to understand the unique needs of foundations and their goals of aligning their investment decisions with their mission. Jen received her BA in sociology and international relations from Houghton College and her MBA from the Simmons School of Management. She serves on the Professional Advisors Network for the Boston Foundation and helps lead the YAO Boston Chapter for Opportunity International.



Ruben D. Orduña

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Ruben Orduña is the Vice President for Development at the Boston Foundation where he manages and directs the Foundation's new business development efforts, which include professional advisor relations, new donor cultivation, and solicitation of outright and planned gifts. Since becoming Vice President in 2003, the Foundation has increased its annual giving 100%, reaching a record annual amount of more than \$75 million. Before his current position, he served as the Department's Director of Development. Ruben was the first Executive Director of the Crossroads Community Foundation – a five-year-old community foundation serving the Metrowest Region. Ruben also worked at the Council on Foundations as the Director of Community Foundation Services where he managed all services and programs for community foundation members. Ruben is a graduate of Occidental College in Los Angeles and received his MBA from the University of Maryland.



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