WHEN MORE IS LESS
– rethinking financial health

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Financial advisors play an important role in guiding clients on the path to financial health. In a recent paper, we argue that people need both economic stability and emotional well-being to be financially healthy, and utilising two simple principles from psychology can contribute to both factors.

Advisors can use this information to assess how healthy their clients are by adding two simple ideas to on-boarding interviews and check-in conversations. By helping clients think further into the future and feel more personally empowered in their financial lives, advisors can foster positive changes in clients' economic behaviours and emotional well-being over time.

Every advisor has met them: the clients who will never outlive their money yet are so afraid of not having enough that they cannot buy a gift for their grandchild without anxiety. A standard financial algorithm would classify these clients as being in excellent financial health, since they possess enough material wealth to withstand any reasonable economic shock—yet their quality of life is quite low. They do not have peace of mind.

Traditional definitions of ***financial wellness*** focus on the economic aspects of a person's life. This is essential, of course, but it neglects how a person feels about their financial circumstances. A finance-only definition of well-being assumes that emotional well-being will automatically follow economic stability—our research at Morningstar shows otherwise.

Throughout 2016, Morningstar conducted several focus groups with financial advisors to learn about the types of financial ill-health they encounter in their day-to-day practices. In every session, similar themes emerged. There are the clients who fear not having enough, despite every indication to the contrary. There are those who are so fearful of making a wrong choice that they refuse to make any, leaving their wealth to slowly erode in cash accounts. Other clients, in contrast, spend too freely, choosing blissful ignorance about the damage done to their bottom line.

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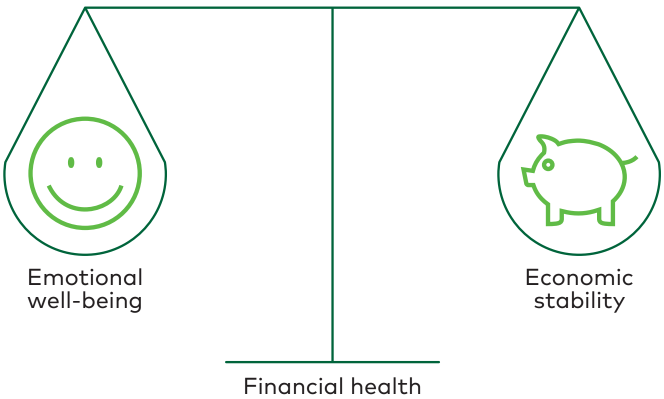
The lesson from these interviews was clear: Our current measures of financial well-being are flawed. If we ignore the emotional aspects of clients' financial lives, we do them a great disservice. The fearful penny-pincher may be wealthy, but they are not well. Likewise, the blissful spendthrift may be joyful, but the instability of their economic state could easily lead to ruin. Financial wellness, then must be defined in a way that includes economic and emotional health.

Based on these interviews, Morningstar has developed a simple model of financial health that incorporates both the economic and the emotional aspects of well-being. According to this model, a person who isn't both economically sound and emotionally well, is not financially healthy. Advisors can use this framework to quickly identify the specific aspects of a client's financial health that need to be addressed, and use this information to guide them toward greater well-being.



To put this model to practical use, we need to know what factors drive economic stability and emotional well-being so that advisors can work directly with the source of each dimension of financial health. The paper outlines two simple components of psychology that are associated with economic stability and emotional well-being. This information will help advisors target the specific area(s) where their clients need the most support and use simple tools to improve the client's underlying financial psychology.

Economic stability: Time is money (but not like you think)
What factors motivate better cash-management, debt-reduction, and savings behaviors? In a survey of several hundred US residents, we found that a person's perspective on time was far more influential than income, age, education, or gender when it came personal finances. Our results showed that people who think further into the future tend to save more frequently and build larger savings balances in retirement and nonretirement accounts.

Compared with those with time horizons of less than a year, people with full financial life plans had, on average, 20 times more money saved. Even looking ahead by just a few years increased savings fourfold. Regression analysis showed that the effect of time horizon on retirement savings was significant even when we controlled for age, income, gender, education, and the number of dependents, and the size of the standardized effect size was greater than that of the demographic variables. In other words, life circumstances matter some, but perspective matters more.

Our analyses showed time horizon had a significantly greater impact on economic behaviors than income. Yes, a person must have income that is adequate to their needs if they are going to be able to save. Our study suggests, however, that regardless of paycheck size, having a future-oriented mindset can make the difference between allowing expenses to crowd out one's income or finding ways to save money.

Mental time horizon was correlated with more than just savings behavior; it had the same effect in reported cash and debt-management. This suggests that people who think ahead are more likely to keep track of spending, pay their bills on time, and carry low or zero balances on their credit cards. These effects also remained significant when controlling for demographic factors.

The difficult truth is that our brains are hard-wired to give more weight to immediate needs, and to discount the future. Some people naturally think further ahead than others, and our mental time horizon does tend to extend with age. Still, most people don't think nearly far enough ahead to naturally motivate the kind of saving that will adequately prepare them for retirement. The shorter a person's mental time horizon, the more they will find long-term saving to be a challenging and painful task. The good news is we can train our thoughts and form new habits over time.

As an advisor, you are in an excellent position to help clients improve their mental time horizon. On boarding interviews offer an ideal opportunity to determine a client's current mental time horizon, and periodic check-ins provide the platform for moving their vision outward over time. Since it fits easily into conversations about financial goals, this process can be very simple and natural.

Additionally in our research, we saw that the clarity of a person's mental picture had a large impact on behavior—almost as much as time horizon. The combination of thinking further ahead and thinking with clarity, is a powerful mental trick to drive better savings behaviors.

While it may seem simplistic, this one mental factor can affect thousands of tiny daily decisions, and it may be the difference between a timely, secure retirement and a delayed, precarious one.

Helping clients to extend their mental time horizons could dramatically change their financial behaviors, but the habit of thinking ahead will take time to build. In our paper, we offer a few tips and tools to help in the process.

Emotional well-being: empowerment is the key

According to the American Psychological Association, year over year, money is the number one source of stress in U.S. households, regardless of the economic climate. Given that stress leads to health problems, lost productivity, relationship problems, and an overall loss in quality of life, it's clear that the emotional aspects of a person's financial life are a critical part of their overall financial health.

Ideally, economic stability would naturally couple with emotional well-being, since the ability to withstand shocks should foster a sense of peace and satisfaction. However, advisors know first-hand that emotional satisfaction and financial wealth aren't always linked.

This area of financial health is not well studied and there are few—if any—existing measures. Emotional and attitudinal factors present an opportunity for advisors to coach their clients in a very meaningful way. By identifying specific patterns of thought that may sabotage a client's overall financial health, an advisor can help guide clients into making better financial decisions and increase their satisfaction and peace of mind.

In our study, we found that—across all income groups—people who feel empowered in their financial lives experienced more joy, peace, satisfaction, and pride in their financial lives. Like time horizon, this effect remained significant when controlling for age, income, education, and gender. The standardized effect size of empowerment on emotional wellbeing was more than twice as large as that of income. The lesson here is fascinating: A sense of personal power—not money itself—may be the key to emotional well-being in our financial lives.

In our study, we did not measure how much control a person actually had in their financial lives, but how much they believed they had. It is the feeling of power, not necessarily the exercise of it, that we found was linked to emotional well-being. Therefore, the solution to feeling disempowered doesn't necessarily lie in behaving differently, but in a person's belief that they can shape their financial future.
A person's belief about power in their lives, financially or otherwise, may be harder to change than their time horizon. Still, in our paper we detail some tools you can use to help willing clients move toward empowerment and improve their emotional well-being. ■

For the full Morningstar paper visit: http://images.mscomm.morningstar.com/Web/MorningstarInc/%7bb87a29d4-9264-4e6f-a5d7-5e65f8714f92%7d_US_ADV_MoreLess_Whitepaper_Final.pdf