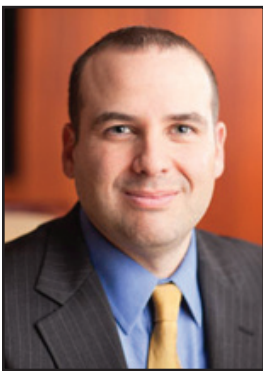


Investment Insight

August 19, 2009

The Beginning of the End to the Great Recession: Handling Client Emotions & Instilling Investor Confidence



A conversation with:
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Private Client Portfolio Manager

Highlights:

- The reactions and emotions of clients really ran the spectrum for us; we saw every different type of behavior. All of the classical behavioral investor concepts and theoretical constructs came into play because it was an incredibly stressful time.
- We used a probability matrix to understand how close we were to a recession, how deep we thought that recession would go, how high we thought the volatility could get in the markets, and the responses to all of that. As the probability of that recession and the depth of that recession increased, our strategic endeavor was to raise cash to protect portfolios from losing capital over that period of time.
- When you think about the emotional investors, you cannot just present facts and make them understand what you want to do, you really have to tie that to something in their lives. You want to somehow bring about an emotional response to what you are saying and by doing that, you are bringing them to a level of understanding which explains what the recession and declines actually mean to them personally.
- We are entering recovery mode which, for us, means switching from the no buying and raising cash mode to a buying mode. We have made the switch and communicated that and it has been taking place over the last few months as we continue to execute our plan. Now, we are dealing with a different set of emotions and thought processes on the back end of that.

The following discussion is moderated by Gloria Fontanetta, Marketing Manager of Rochdale Investment Management. The below is a transcription from Rochdale's August 19, 2009 Advisor Forum Conference Call.

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Q: Paul, I'm sure you received a tremendous amount of phone calls when the market started to go south in 2007 and especially in 2008, and into 2009. Can you describe some of those experiences and what types of concerns clients were conveying to you? I know you probably experienced many different reactions since there are all different types of investors and clients out there.

A: A tremendous amount of phone calls does not even do it justice. I think that communication was probably the most important thing we could have done through that period of time and we tried to do as much as we could for our clients.

The reactions and emotions of clients really ran the spectrum for us; we saw every different type of behavior. All of the classical behavioral investor concepts and theoretical constructs came into play because it was an incredibly stressful time, as everyone knows now looking back on it. It was an incredibly stressful environment across the markets, economy, credit markets, and housing markets. So everything really was coming together there.

Now that we can step back from it a little bit, it is an interesting period of time for understanding investor psychology, emotions, and how those interplayed in the decision making processes during that time. So it is really an interesting period in history and we learned some very valuable information on how people react.

Q: I know there have been some behavioral studies done in the past about the different types of investors. Can you go into a little more detail about them, beginning with the emotional investor?

A: Sure. You know, when we think about investors from a psychological, behavioral point of view, the evidence really points to two different types. We have the emotional type and then we have the type of investor that is more thoughtful. So, from all the readings we have done and the studies that we have looked at, I have tried to formulate some conclusions about these two categories of investors.

Let's begin with the emotional investor. You have these relatively conservative emotional investors and you have aggressive emotional investors. Both of them are operating from a similar place and they come with their own sets of biases, how they view information, how they take in information, and how they respond to different situations.

Now let's look at the first type of emotional investor, the conservative investor. These are people that are just inherently nervous about their money and about what is happening to their money. Many times, you find its people that have inherited money, won the lottery, or some type of windfall profitability and they tend to then have a different connection to the money. They did not have to risk a lot

getting where they are, so they are extremely afraid of losing it.

Regardless of how they acquired it, they do display characteristics that all of us advisors and portfolio managers and others in this business tend to see but maybe we don't label and/or do not understand exactly how to deal with it. I certainly have a few clients that fit that description. These people have loss aversion and do not get very happy about taking gains, but they really feel terrible about taking losses. The tendency is to not sell anything until it goes out of business and something is forced to happen.

You know, they also have this tendency to become married to their holdings. They view something that they have had over some period of time as having greater value than something that they might buy today and, therefore, they will hold on a little bit longer than maybe they should. They are also people that get fairly anchored in prices so they look back on what a price was, where the stock had traded, what its high point was, and they feel like it has got to get back there.

The most difficult aspect to understand is the regret that accompanies these investors and their decisions. They often look back and say, I should have done this, I could have done that, or I do not want to take action because I might make a mistake.

That is one of the types of emotional investors and probably the one that we saw the most in the early stages of the bear market.

The other type of emotional investor we found is this aggressive emotional investor. These are the people that are very optimistic. They feel like they want to exert control over their investment. They do not think things can happen to them, especially bad things, and they do not think they can make bad decisions.

We see this a lot with executives. We had so many corporate executives who did not have their company stock with us but had company stock and refused to sell it because they view it as less risky than everything else that is out there. They tend to get attached to it and feel that that level of control is there and, therefore, they do not have to worry about losses. Quite a bit of decline can occur when you have that bias.

So it is an interesting difference with both investors acting out of emotion, but with different parts of their emotional side.

Q: Can you tell us a little bit about the cognitive or thoughtful investor?

A: Sure. The thoughtful investors are the people that think first and emote later. They kind of fall into similar groups. There is one group that tends to follow what other people

are thinking and I think that is a construct that has been out there for a long time and I hear about it quite often. “My neighbor told me to do this,” “my cousin told me that this was a good idea” and, therefore, they invest based on information they hear from what other people are doing.

They often get into riskier portfolios or riskier investments than they should be in or have the ability or the willingness to be in because they do not quite understand what they are actually following along with since it is what the “other people” are doing.

It is a very difficult situation to be in at the start of a recession because if you are over-aggressive, you end up not thinking and acting on emotions.

To continue along the line there, the biases that they exhibit are what tends to happen when you are following something or someone else, you tend to follow a trend. So when you look at what happens in a bull market, which is what we had in 2003, 2004, 2005, 2006, and even for most of 2007, it was positive. Housing markets were positive, the economy was positive, lots of leverage, markets were going up, and international markets were going up as well.

You see this “following” tendency quite often and this not only happens to individual investors, but it also applies to the psychology of advisors as well as hedge fund investors.

They would overemphasize the recent past overlooking at a longer history. So when you think about it, these are people that would have looked at a bull market and invested relatively aggressive through that period of time. They would have overloaded in international way more than they should have, while not truly understanding what the risks actually were, and they would just focus on what returns they were producing and think that those returns can continue forever. So this was, again, particularly difficult for those individuals as the economy started to change.

The other part of it, which is another thing that we see a lot and I think a lot of advisors on the call would understand, these investors tend to look backward a great deal. A lot of hindsight occurs when you are in the moment today and you look back and say, “it was obvious that housing was going to collapse and that the market was going to go down 40% in 2008 and then have a correction in 2009.”

Thoughtful investors tend to assume that those were predictable events and forget about the day before Lehman Brothers went out of business. You do not know they are going to go out of business, you do not know what the response will be, you are not absolutely certain about any of this. This can also impact their investments as they are tending to look backward and assume there is predictability there and they become overconfident in what they are going to buy.

The other part of that, the other bias that we can identify on the cognitive or thoughtful investor is really the independent thinker. Everyone has those clients, the clients that come in and tell you what they want to invest in. They have definite opinions on all the stocks, asset classes, and what they should be doing at different points in time. At times, it can be great. Other times, the sheer weight of what they want to do will force an investment manager to put them into what they want.

What needs to be recognized is that they are often working with some information but it is not complete information. Studies have shown that one of the biases they possess is that they do not assimilate new information into their thought process. They often have a definite idea in their head and they know they want to move forward, but as new information comes in, and if it is contrary to what they want to do, the tendency is to ignore it and only focus on the old frameworks.

Once again, this is especially difficult in a rapidly changing environment with new information coming in daily for that investor to cope with while understanding what is actually occurring.

So the investor tends to fit all the investments into the same mold or likeness so they look at what a stock was and then they assume that it has to stay that way. Let’s take Citibank as an example. I have received so many calls asking about buying Citibank because it had a 7% yield. The price had come down from 60 to 30, the yield had doubled, and was a value stock.

This is a very common misconception because people believe it is a value stock forever, not recognizing that it actually turns into a much more aggressive stock at some point.

Q: Well, you obviously had your hands full the past year and a half with all these conversations and with all these different kinds of investors. It was clear at that point that the firm needed to come up with some type of plan. What did Rochdale actually do and what was our goal?

A: We used a probability matrix to understand how close we were to a recession, how deep we thought that recession would go, how high we thought the volatility could get in the markets, and the responses to all of that. As the probability of that recession and the depth of that recession increased, our strategic endeavor was to raise cash to protect portfolios from losing capital over that period of time.

So as that probability is rising, you’re making a decision at that point in time whether or not you can be invested in the market and if so, what parts of the market? I believe we have said this quite a bit, but we raised substantial cash throughout all of our equity portfolios for almost all of our clients if they would let us. That is what we were generally

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recommending people do during that period of time. As we obtained new information, we would try to assimilate it and talk about it.

Q: Once we came up with this plan of action, how did you actually apply behavioral theory and advise these different types of investors of our plan, while simultaneously making them feel comfortable with these decisions?

A: That was probably the most difficult part of what we were trying to do over that period of time. Educating our investors and our advisors on what the best courses of action was proved to be quite challenging. For each of these types of investors you have to take a little bit of a different approach.

Those clients and advisors we could identify were really driven by the factual thinking evidence of what was going on, really driven by their thought processes.

It is very important to have facts and educate everyone in order to produce a result, and that is an important takeaway. For the cognitive or thoughtful investors, they want to know that we know what is going on, that we have evidence lined up, and that we have factual reasons to support our probability that the recession was rising.

It was a process of informing and it took some time to put that information forward. However, that is probably the most important way of changing those investors and removing some of their biases and actually helping them through a difficult period of time. They need to understand what is going on at all times. From an action plan point of view, I think some of the steps you take when you are dealing with those types of investors are that you have all your facts and that you are going to take action to make your plan complete.

Clients are not always ready to take an immediate action, picture the company executive that is holding on to their stock positions, so a lot of what you will do here is introduce hedging techniques. You want to introduce sell disciplines, reasons to sell that do not force a decision immediately but lets the investor have a reasonable amount of time to understand what is going on, and that also puts in some protection for them.

When you think about the emotional investors, you cannot just present facts and make them understand what you want to do, you really have to tie that to something in their lives. You want to somehow bring about an emotional response to what you are saying and by doing that, you are bringing them to a level of understanding which explains what the recession and declines actually mean to them personally. Will their lifestyle change? Will their inheritance change? Will their spending habits have to change? Those are the types of things they want to hear. They want to know how that bigger picture is going to impact them on a personal level and then you can make those same types of decisions.

Now with these clients I think you are a little faster to implement sales processes. Once they get over their initial emotions, they are willing to move along with the plan. It is the same approach you need to use for the conservative investors; you have to use limits and stop outs and all of these techniques. For the aggressive investors you can use that hedging technique because they are not ready to sell. They want to wait and see if they cannot get something out of it so you want to protect them without triggering an immediate action. For the ones that are more conservative, you could actually trigger an immediate action.

However, they are still one in the same. They are very similar in that they are doing the same thing which is trying to protect the downside. You want to help people through that learning curve and it became a lot easier after the first couple of legs of the decline and the information came in. At some point everyone gets on the same page.

Q: Well, a lot of things have obviously started to change the past couple of months and now that we see a recovery in sight, what are we doing now as a firm? What kind of changes are we making?

A: We are switching our thought process and communications from recession and worry about the recession to what is the nature of the recovery.

Clearly, all the evidence is showing us that we are in recovery mode, but questions still linger. What is the nature of this recovery? How do you deal with this recovery? What's the proper portfolio positioning for any type of investor with all types of risk tolerances?

We believe the recovery will not be robust. We are using the term square root recovery which has now become a pretty common phrase, but this is just the expectation that growth will not be above average. It will be slightly below average in terms of U.S. GDP growth.

The reasons for that include unemployment, consumer spending, the availability of credit, and all the things that we already know about that were extremely negative in 2008. There are some of those that are still with us and I think anyone on this call could come up with 10 other things that they think would be a problem for us as we move forward.

However, we are still entering that recovery mode, which for us means switching from a no buying and raising cash mode to a buying mode. We have made the switch and communicated that and it has been happening over the last few months as we continue executing our plan. Now, we are dealing with a different set of emotions and thought processes on the back end of that.

Q: Over the past year and a half I am sure many clients have reevaluated and since modified their investment outlook.

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Can you talk a little bit about how their outlooks have changed and how you are instilling confidence in them now that we are buying again?

A: Let's revisit the conservative and aggressive emotional investors. Bringing it back into that framework of the behavioral discussion that we are having here, the conservative emotional investor is now too conservative. As anyone can imagine, they have reacted emotionally. I mentioned already that they anchor themselves in prior pricing and they have biases to holding losses versus gains. Now we have passed that point in time and these clients have recognized in many cases that they are more conservative than they have been in the past, and they do not want to invest in any securities.

For those individuals, and I am going to go back to the same type of design we had last year, you have to present new information and link that to their personal life. So if you stay ultraconservative, how is that going to impact your life, your kids' inheritance, and all of these emotional pieces of their lives?

You want to draw the same picture you would think about in a decline. I will give you an example; the investor who lost a lot of money but still takes a lot of money out of their portfolio. They want to continue to take money out of their portfolio, but it cannot be all in cash because that is a sure way of losing it.

They have to start thinking about how they can get more income and further extend the life of their portfolio? If they do not do it, what is going to happen to all of those things they do every day? Once again, they have been too conservative and if they are tending to be too conservative you want to try to move them forward.

One thing we have found that helps here is a slower entrance into the market. We want to try to slow down as we are buying by buying smaller portions over a longer period of time. That is one way of handling that if we can get past some of those bigger emotional issues.

The aggressive emotional investor wants to take out the old playbook again, the one we keep referring to as the wrong playbook, which is as you come out of a recession you should buy everything that is aggressive, growth, going to leverage the consumer and all of these very high beta, high growth type investments. The normal path of recovery after a recession is above average, so you would want to be invested in all of these aggressive investments. However, we do not know if that really is the case with this recession as we have a much higher probability that a slower growth trajectory may happen, which does not favor high beta or high growth type of investments.

Again, you are trying to remind those people of what happened last time we were too aggressive, how that made them feel, and how it impacted their lives. Then you are trying to reorient the asset allocation to control that a little bit better, something that tends to satisfy the aggressiveness in them, which may be a slightly faster investment pace in the right asset allocation. That is on the emotional side of it.

The followers, the ones who took the advice of their neighbor or cousin and followed that investment, which I mentioned tended to be overly aggressive, now tend to be overly conservative because they are extrapolating the decline into worse declines or into another recession.

It is the same solution; you just have to present the facts to these investors and this is where a lot of what we do comes into play. We have a lot of factual information in all of our presentations, and for these clients we tend to delve into those facts and go through real numbers.

For emotional clients we tend to look at the big picture. It is the same technique and the same implementation strategy. It may be a little bit slower and you have to make sure that they truly understand why they can have a little bit more risk in the portfolio or why they can have a reasonable level of risk.

For the independent thinker, they are going back to the old playbook, like that aggressive emotional investor. They just have an old framework that worked, and if it worked there would be no need to fix it. Educating these types of clients really helps them to understand why consumer spending probably is not going to be as high as it was three to five years ago. Consumers do not have access to capital, they have to save, they are under-employed, or even unemployed. They are worried about those things.

You have to present that evidence to get that understanding across. These are obviously broad strokes of defining people because people can't be defined in buckets, but I am finding this across so many conversations that we are having with clients and that is why I thought this was good information. We do see these trends and patterns emerging in how people interact.

Q: As most of you on this call know, we partner with many financial advisors. Are there things that our partner advisors currently do or something they can do to make this whole process run smoother and more seamless?

A: Well, I love working with our advisors and I love the fact that we choose to work with advisors because they really do know the clients best. They spend more time with the clients and, in most cases, have known them over a number of years.

Sometimes they are new, but they typically come through

referrals where they know friends, family, or neighbors where they live. This detailed information is extraordinarily helpful in identifying what the basis for the investment decisions are for that particular client.

Do they tend to be emotional in their decision-making? Is that the trend that they have seen and is that how they interact with them in the past? Are they people that need a lot of information, need to sit down and think it through and do not make quick decisions?

I think the advisors really have that insight because in the process of acquiring them as clients they understand more of their driving forces. The advisors can sit and help identify the client and that is invaluable information in personalizing an approach to making the investments.

You need that feedback and that information to effectively implement the buy strategy, sell strategy, and to understand what the driving forces are and how to react to that and the ebbs and flows of the market.

So our advisors go through an invaluable process which gives us a lot of information which is helpful beyond just the asset allocation or how much cash flow they need. They can really help us identify some of the deeper drivers of their decision.

Q: Throughout the year there have been a lot of government and Fed actions or policies that took place. Were there any in particular that clients had an issue with? Did they call you after these policies were implemented asking for better answers and explanations?

A: We had calls about everything on policy actions and government actions and I think that plays into this as well. You know, you can identify some of the same emotional processes in how people handle news and how they read into it, how they feel the government is acting either on their behalf or against them.

Every single plan that came through was a pretty big deal. Everyone has a different take on what that will mean as we move forward from here. We clearly have an opinion on those programs, but we are not going to see the results of

those programs in the near-term. But absolutely, there have been very controversial programs like bailing out companies like GM, Citibank, etc. The stimulus packages were relatively controversial in terms of our clients and their reaction to it too.

Our job is to understand what the impacts of these actions will be on the investment strategy, and in an effective way, assimilate that information into the strategy while dealing with both emotions and thoughts. We must understand its impact and put a probability around how that will impact the economy and nature of the investments.

If it is a very high probability and a high impact, we need to plan a strategy around it. If it is a low probability and a low impact, perhaps we do not. We have to keep it in our mind though, but it is not going to be a factor that drives our strategy.

So that information we want our advisors to takeaway is that we want them to be informed so that they can deal with all of these different types of answers as well and give the information they need.

Q: Paul, is there anything you want to add or summarize? Any last thoughts?

A: I really do appreciate the time today and if I were going to just give a couple of thoughts on an action plan, it is very helpful for advisors who are working with us to identify or help us identify the types of clients they have and how they are feeling.

Are they acting emotionally or are they acting more out of their thought process? Also, help us to understand what they need to then talk to those clients about, keep those clients happy, keep them comfortable, keep them understanding, and really make a much better experience for them all the way around.

So we ask all of our advisors if they can communicate these points and think about their clients in these different ways with these different frameworks so that we can help them in answering questions and advising them.

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