

INVESTMENTS & WEALTH RESEARCH

FOCUS RESEARCH SERIES

ISSUE 4
2019

THE ROLE OF BEHAVIORAL FINANCE IN ADVISING CLIENTS

By Asher Cheses, Research Analyst, High-Net-Worth, Cerulli Associates

Demographic and market trends will increase the need to educate clients about how behavioral biases can impact their investment decisions. This issue of *Investments & Wealth Research* provides practical guidance about how advisors can better understand and manage their clients' and their own behavioral biases and suggests best practices to help advisors strengthen relationships and potentially achieve better investment outcomes for their clients.

METHODOLOGY

Charles Schwab Investment Management in collaboration with the Investments & Wealth Institute® retained Cerulli Associates, a leading independent market research and consulting firm, to learn how advisors view and use behavioral finance when working with clients. In July 2019, Cerulli Associates conducted a survey of more than 300 financial advisors. Respondents were members of Investments & Wealth Institute and diversified among business models, including wirehouse, registered investment advisor (RIA), and national and regional broker-dealers. Key findings

from the survey, BeFi Barometer 2019, are discussed here.

KEY POINTS

- Awareness of behavioral finance is becoming more widespread, but advisors are more likely to incorporate its principles into their everyday communication with clients rather than within the context of their portfolio construction processes.
- According to the survey, the most common behavioral biases impacting clients are recency bias, loss aversion, and confirmation bias; advisors rank loss aversion and overconfidence as the most prevalent biases impacting their own investment decisions.
- Advisors cite strengthening trust with clients, improving investment decisions, and better managing of client expectations as the greatest benefits of incorporating behavioral finance into their practices.
- Advisors recognize the value of behavioral finance, but many find it challenging to apply concepts in everyday practice. Advisors cite difficulty translating theory into

implementation, and a lack of software and tools, as the primary reasons preventing adoption.

In the midst of the longest market expansion in U.S. history, advisors need to be hyper-focused on keeping clients' emotions in check as increased volatility and lower returns appear on the horizon. In this environment, an advisor's role is to help clients maintain focus on their long-term goals and tune out the noise of short-term market swings. Furthermore, as the landscape becomes more competitive, advisors will need to differentiate their services and provide an enhanced client experience. A deeper understanding of behavioral finance can benefit many aspects of an advisor's day-to-day job, including more effectively communicating with clients, managing client expectations, and clearly identifying goals. Understanding the different ways behavioral tendencies can impact investors can help advisors better serve clients over the long term and is fundamental to building a successful wealth management practice.

Investments & Wealth Research is offered exclusively to Investments & Wealth Institute® members. This article was created by and published in partnership with Cerulli Associates and Charles Schwab Investment Management.



As the field of behavioral finance has permeated the financial services industry, more advisors have looked to integrate it into their practices. According to the BeFi Barometer 2019 survey, nearly three-quarters (70 percent) of surveyed advisors indicate that they incorporate behavioral finance within the context of client communications and interactions, compared to 58 percent of advisors who incorporate behavioral finance in the portfolio construction process (see figure 1). Although it's apparent that advisors understand the importance of behavioral finance, many struggle when implementing concepts into the portfolio construction process. To maximize the impact of their efforts, advisors should take a more proactive approach to incorporating behavioral finance practices throughout their client service and portfolio construction processes.

Advisors recognize that integrating behavioral finance into their practices can help them deepen client relationships and ultimately increase client retention. According to advisors, incorporating behavioral finance offers multiple benefits

when working with clients, including strengthening trust (50 percent), improving their investment decisions and prioritizing goals (49 percent), and better managing expectations (46 percent) (see figure 2). Furthermore, advisors potentially can help clients achieve better investment outcomes and stay invested during periods of volatility by applying behavioral finance principles, including strategic asset allocation.

UNCOVERING BEHAVIORAL BIASES

In the BeFi Barometer 2019 study, Cerulli Associates surveyed more than 300 advisors to better understand the most prevalent biases impacting their clients' investment decisions. The list of potential behavioral biases is extensive, but Cerulli Associates found that the five most prominent behavioral biases among clients are: recency bias (35 percent), loss aversion (26 percent), confirmation bias (25 percent), familiarity/home bias (24 percent), and anchoring bias (24 percent) (see figure 3). Developing a greater understanding of these biases and having the appropriate guardrails in place

will better position advisors to help clients avoid emotional decisions that may not be in their best interest. The following is an overview of the most common biases that impact clients' investment decisions.

RECENCY BIAS

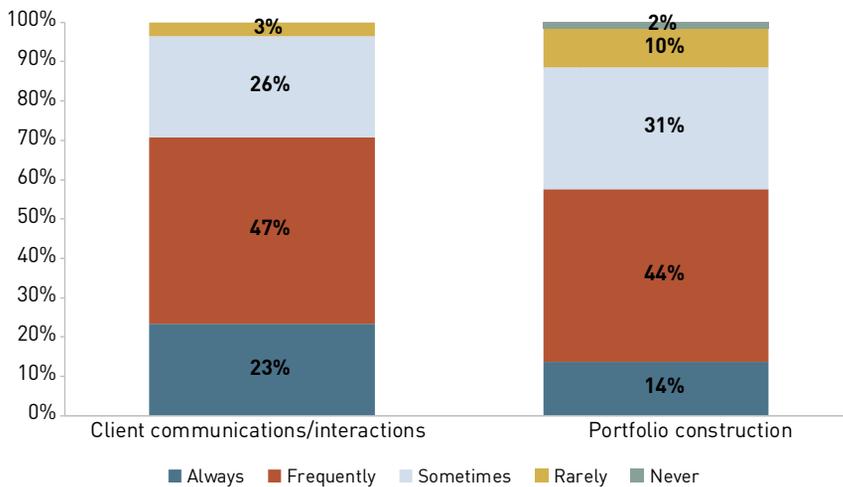
Recency bias—the tendency to be influenced easily by recent news, events, or experiences—was listed as the most common bias among clients. When clients overweight the importance of recent or memorable events, they are more likely to chase performance rather than make strategic investment decisions that may be better suited to them. Expecting future results to be a continuation of recent market trends often leads to irrational decision-making. Recency bias can cause clients to buy and sell securities at the worst possible times (i.e., buy high and sell low)—for example, buying the hottest investment trends or selling securities immediately after a market downturn.

The 2008 financial crisis still resonates with many clients, but the prolonged recovery has conditioned many investors to become accustomed to rising asset prices. Clients tend to believe that strong market performance is bound to continue for the foreseeable future. However, stock prices can go up or down at any point, and expecting a continued bull market likely will lead to disappointing results and outcomes. Advisors can play an important role in guiding clients by helping them take a step back and make more informed investment decisions in the context of long-term macro trends and portfolio objectives. Furthermore, advisors can help clients identify unrealistic expectations before a market downturn takes place and maintain long-term views by adhering to a prudent financial plan.

LOSS AVERSION

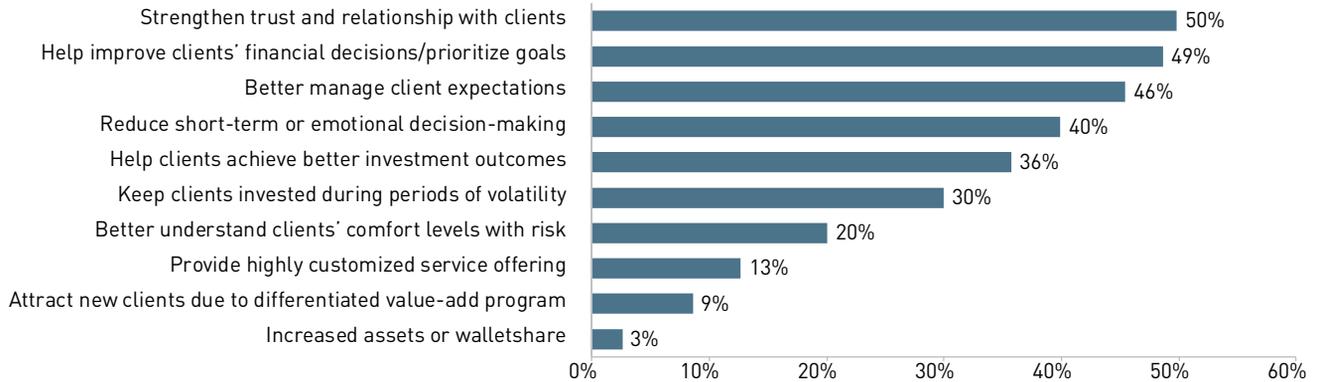
Loss aversion is the tendency to prefer avoiding losses over achieving equivalent gains, and it often causes clients to accept

FIGURE 1
BEHAVIORAL ADVICE IMPLEMENTATION, 2019



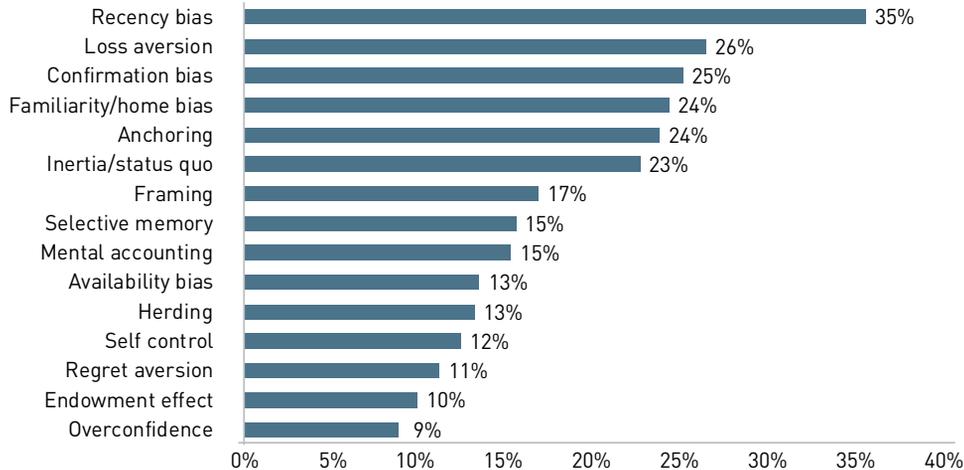
Analyst Note: Advisors were asked how often they incorporate behavioral finance into their advisory practice with respect to client communications and portfolio construction.
Sources: Cerulli Associates, in partnership with Investments & Wealth Institute (formerly IMCA)

FIGURE 2

GREATEST BENEFITS TO ADVISORS OF INCORPORATING BEHAVIORAL FINANCE, 2019

Analyst Note: Advisors were asked, "What are the greatest benefits of incorporating behavioral finance into your practice?" Respondents were allowed to select more than one response.
Sources: Cerulli Associates, in partnership with Investments & Wealth Institute (formerly IMCA)

FIGURE 3

MOST SIGNIFICANT BEHAVIORAL BIASES AFFECTING CLIENTS' INVESTMENT DECISIONS, 2019

Analyst Note: Advisors were asked, "To what degree do you believe the following biases may be affecting your clients' investment decision making?"
Sources: Cerulli Associates, in partnership with Investments & Wealth Institute (formerly IMCA)

less (or more) risk than they can tolerate. Loss aversion can have significant repercussions on clients' investment behavior and even can lead clients to act irrationally risky or risk-averse at times. For example, a client who was distressed after a significant market decline (such as that experienced during 2008–2009) and decided to liquidate holdings inevitably

would have missed out on the subsequent market recovery. Conversely, a client may hold onto a risky or losing investment for too long simply to avoid realizing the loss.

Loss aversion is often consistent with clients' level and source of wealth. For example, advisors who focus on mass-affluent clients (those with less than

\$500,000 in investable assets) are more likely to indicate that their clients are subject to loss aversion, and advisors who focus on high-net-worth (HNW) clients (those with more than \$5 million in investable assets) are less likely, at 41 percent and 16 percent, respectively. Loss aversion is best overcome by reminding clients to keep an eye on their

long-term goals instead of daily market performance. Advisors should encourage clients to refrain from checking their portfolios too frequently, which often can lead to emotionally driven investment decisions. In addition, advisors can proactively identify potentially susceptible clients and reach out during uncertain market environments. Advisors must look to reiterate their commitments to clients' long-term goals and bring risks to clients' attention before they cause emotional reactions.

CONFIRMATION BIAS

Confirmation bias is best explained as the tendency to seek information that reinforces one's pre-existing beliefs while ignoring contradictory information. Many clients have preconceived notions regarding certain investments they own; as a result, they overweight evidence that supports those pre-existing beliefs while discounting important information that opposes them. For example, a client who has a concentrated holding in a particular stock or sector may seek only good news and ignore bad news regarding these investments. As advisors, it's important to provide clients with additional information that they may have ignored otherwise in order to provide a complete and accurate picture. Likewise, advisors must be aware of this bias and seek out multiple viewpoints and opinions that oppose their clients' long-held views when making investment decisions.

FAMILIARITY/HOME BIAS

Familiarity bias is an example of a cognitive shortcut in which people tend to make decisions based on their own or familiar experiences. Clients can exhibit familiarity bias in many ways, including concentrated exposure to an employer's stock or a preference to invest in U.S.-domiciled companies (i.e., home bias). Familiarity bias often leads to portfolios that are weighted heavily toward domestic companies, exposing clients to potential risks due to a lack of portfolio diversification. Advisors should caution against such concentrated portfolios, especially among wealthier clients, and look to diversify portfolios more effectively. According to the survey results, familiarity bias is prevalent among HNW clients; nearly one-quarter (23 percent) of advisors whose core market is HNW indicate their clients are significantly affected by familiarity or home bias. Particularly among these clients, advisors need to explain the benefits of greater diversification across a wider range of asset classes and geographies.

ANCHORING BIAS

Anchoring bias involves the tendency to focus on a specific reference point when making investment decisions. This bias can lead to issues related to clients' investment decisions, because many tend to associate the initial value of or price paid for their portfolio as an anchor or "rule of thumb." For example, clients tend

to focus on a price they initially paid for the position even though that value does not correlate to the stock's fundamentals. In addition, anchoring may occur when a client becomes too reliant on a single benchmark, such as the S&P 500, which may not be the most appropriate measure given their risk tolerance.

A potential solution to mitigate anchoring bias is to associate the client's individual portfolio or strategy with a future goal rather than a past price or an arbitrary benchmark. For example, advisors can explain why a particular strategy fits into the overall asset allocation, and as a result, shift the buy-sell decisions to focus on how this strategy can help achieve the client's goals rather than whether or not the fund underperformed relative to its benchmark in a given month. In addition, advisors should avoid overemphasizing specific reference points and instead use diversified benchmarks that are closer to clients' personal risk-return profile.

GENERATIONAL BIASES

Advisors also need to be cognizant of the variations of biases across different client types and age groups. According to surveyed advisors, loss aversion is most prevalent among baby boomers' (75 percent) and silent generation (71 percent) clients, and recency bias is most common among Generation X clients (64 percent) (see table 1).

TABLE 1
MOST COMMON GENERATIONAL BIASES, 2019

Millennials (<38)	Generation X (38–53)	Baby Boomers (54–72)	Silent Generation (73+)
Framing	Recency bias	Anchoring	Familiarity/home bias
Herding	Mental accounting	Loss aversion	Loss aversion
Confirmation bias	Confirmation bias	Overconfidence	Selective memory
Self control	Self control	Confirmation bias	Anchoring
Availability bias	Regret aversion	Mental accounting	Framing

Analyst Note: Advisors were asked, "Across different age tiers, which of your clients are most vulnerable to the following behavioral biases?" Respondents were allowed to select more than one response.

Sources: Cerulli Associates, in partnership with the Investments & Wealth Institute (formerly IMCA)

Meanwhile, the most common behavioral biases among millennial clients are framing (54 percent) and herding (46 percent). Understanding the different preferences and attitudes of each generation and addressing their unique biases accordingly can lead to stronger client relationships and potentially more optimal investment results. For example, millennials who fall prey to herding bias—meaning they gravitate to the latest investment trends for fear of missing out—could benefit from understanding the risks that come with following the crowd and investing in potential bubbles.

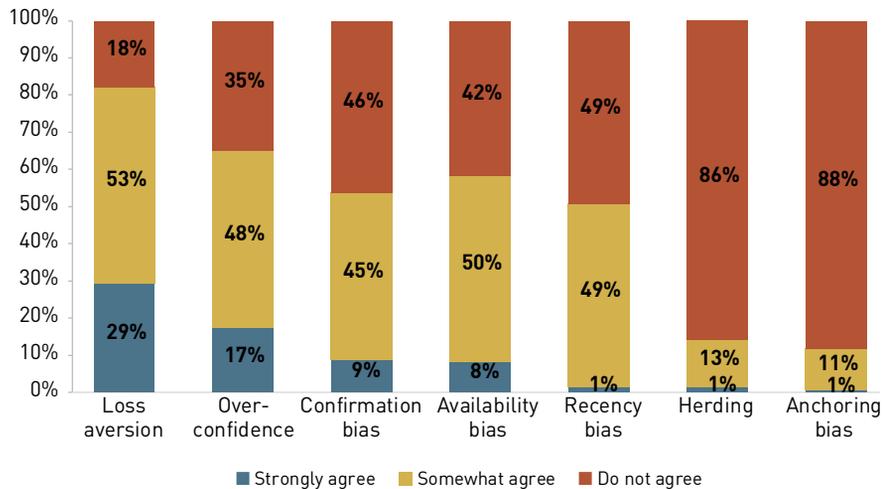
ADVISORS NEED TO BE MINDFUL OF THEIR OWN BIASES

It's important to understand clients' behavioral biases, but it's equally important for advisors to be aware of how their own biases can impact investment decisions. Advisors rated loss aversion, or the tendency to prefer avoiding losses over achieving equivalent gains, as the most significant bias (29 percent) affecting their investment decisions, followed by overconfidence bias—overestimating one's own abilities (see figure 4). When asked whether or not advisors' own portfolio management skills can help their clients outperform the market, 17 percent of surveyed advisors "strongly agreed" and another 48 percent "somewhat agreed." Seemingly, many advisors overestimate their own portfolio management skills and would be better served by having a clear and disciplined investment process that helps prevent the consequences of overconfidence, including excessive trading or improper management of risk. Although advisors may recognize and be aware of these biases, more can be done to manage their own internal behaviors to help improve investment outcomes for their clients.

MOST EFFECTIVE METHODS TO MITIGATE BEHAVIORAL BIASES

Advisors can't completely offset their own or their clients' biases, but they can adopt specific techniques to reduce the impacts of various biases. The following techniques

FIGURE 4
ADVISORS' BEHAVIORAL BIASES, 2019



Analyst Note: Advisors were asked to indicate the degree to which the following biases affect their own investment decisions.

Sources: Cerulli Associates, in partnership with the Investments & Wealth Institute (formerly IMCA)

can help reduce the negative impact that biases have on investment outcomes.

Long-term view: When asked about the most effective methods to help clients avoid behavioral biases, nearly two-thirds of advisors (62 percent) said that helping clients take a long-term view is a "very effective" strategy (see figure 5). Particularly in periods of volatility, reminding clients of their investment goals and ensuring they adhere to a sensible financial plan can help them reduce emotional reactions and avoid making poor investment decisions.

Systematic process: More than half (52 percent) of advisors cite implementing a systematic process as a "very effective" mitigation technique. Implementing a systematic approach (e.g., automatic rebalancing) can help reduce the impact emotions have on investment decisions. Setting up guidelines and parameters for managing one's portfolio can help take emotional decision-making out of the process to avoid biases such as overconfidence, loss aversion, and herding.

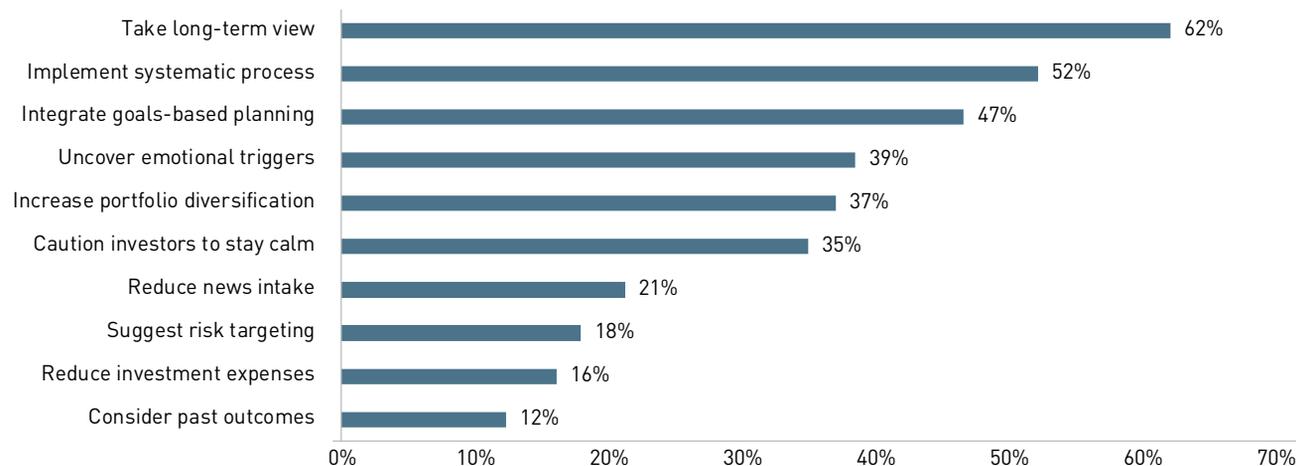
Goals-based planning: Nearly half (47 percent) of advisors cite implementing a goals-based planning approach as a "very effective" strategy for mitigating bias. By separating clients' wealth into different accounts, advisors are able to assist clients to better measure their progress toward certain goals (e.g., saving for retirement, purchasing a home), which subsequently can reduce the likelihood they will overreact to a drastic market move.

ADDRESSING THE 'BEHAVIORAL GAP' DURING PORTFOLIO CONSTRUCTION

Advances in behavioral finance have provided insights into the ways investors make decisions, but there is a greater need for advisors to factor these biases into their portfolio construction processes. Advisors should account for their clients' biases when determining the asset allocation to ensure that clients stay invested and meet their objectives over the long term. Advisors who accurately recognize their clients' risk profiles during the portfolio construction process will be more prepared to deal with biases

FIGURE 5

MOST EFFECTIVE BEHAVIORAL BIAS MITIGATION TECHNIQUES, 2019



Analyst Note: Advisors were asked: "Which of the following techniques have proven to be most effective when working with your clients to help them reach their long-term goals?" Respondents were allowed to select more than one response.

Sources: Cerulli Associates, in partnership with Investments & Wealth Institute (formerly IMCA)

as they arise. However, finding the balance between adhering to a client's comfort level with risk (i.e., risk preference) versus the ability to take risk (i.e., risk capacity) is a significant challenge. Cerulli Associates surveyed advisors to understand how they typically handle a misalignment between their clients' preferences and capacity to take risk and found that more than one-quarter (27 percent) of advisors typically adjust to or accommodate their clients' risk preferences but only 16 percent seek to increase clients' comfort levels with risk. Advisors often allow their clients' risk preferences or behavioral biases to dictate the asset allocation decisions; however, this can lead to suboptimal investment outcomes.

Ultimately, the goal for an advisor should be to find a balance between moderating a client's behavioral biases and choosing an optimal portfolio based

on the client's individual comfort level. Cerulli Associates found that just more than half (51 percent) of advisors typically compromise and create a modified asset allocation based on a combination of both factors (e.g., risk preference and capacity). The ability to adjust a client's portfolio ultimately depends on the situation and age of the client. Advisors may be more flexible when dealing with clients who have higher levels of wealth, and they may seek to moderate (reduce or eliminate) biases at lower wealth levels where sufficient risk may be necessary to achieve financial needs.

Advisors with a core market of HNW clients (12 percent) are least likely to moderate client biases (i.e., increase clients' comfort level with risk) because these investors typically have sufficient assets to accept a higher or lower risk level without jeopardizing their financial well-being.

Before recommending an investment plan, advisors should gain a deeper understanding of clients' risk tolerances and behavioral tendencies. Advisors need to be mindful that their clients' risk preferences are strongly correlated with their behavioral biases (e.g., loss aversion). Adjusting a client's portfolio to help mitigate the negative impacts of biases can help achieve better investment results over the long term. For example, advisors can incorporate certain risk-targeting strategies that aim to mitigate losses during times of market volatility. In addition, advisors can construct more-effective client portfolios by minimizing investment expenses and leveraging tax-efficient strategies with low turnover. Incorporating these elements into the portfolio construction process can help keep clients invested throughout market cycles and achieve more-optimal investment outcomes.

CONCLUSION

Advisors are well aware of the benefits of incorporating behavioral finance into their practices (see figure 2), but many believe they lack the tools and applications necessary to employ those tactics with clients on a regular basis. Nearly two-thirds (65 percent) of advisors cite difficulty translating theory into implementation as the primary reason for not incorporating behavioral finance into their practices, and more than half (54 percent) cite a lack of software or tools. Although general education is important, there is a greater need for structured support and guidelines for advisors, particularly in terms of managing these biases throughout the portfolio construction process.

Both advisors and clients are prone to behavioral biases that can impact their investment decisions. By gaining a stronger understanding of these biases and recognizing when they are most likely to impact one's own investment decisions, advisors can minimize regretful decision-making. The following five best practices can help advisors apply behavioral finance tactics more effectively in their practices.

Invest in education. Education is a critical element to help clients understand their biases, but there is a greater need for structured support and guidance.

Proactively communicate with clients about their biases. Identify clients who are prone to certain biases

(e.g., loss aversion, recency bias) and discuss emotional tendencies before they occur.

Construct goal-based strategic portfolios. Clients are more likely to stay on track with a diversified investment plan that connects to their specific goals over the long term.

Be mindful of internal biases. Advisors need to be aware of their own biases (e.g., overconfidence) in order to improve the investment decisions they make on behalf of clients.

Create automatic and systematic processes. Take emotions out of investment decision-making by automating the process (e.g., automatic rebalancing). ●



Investment
Management

Contact Asher Cheses at acheses@cerulli.com.

INVESTMENTS & WEALTH INSTITUTE® is a registered mark of Investment Management Consultants Association Inc. doing business as Investments & Wealth Institute. CIMA®, CERTIFIED INVESTMENT MANAGEMENT ANALYST®, CIMC®, CPWA®, CERTIFIED PRIVATE WEALTH ADVISOR®, RMA®, and RETIREMENT MANAGEMENT ADVISOR® are registered certification marks of Investment Management Consultants Association Inc. doing business as Investments & Wealth Institute. Investments & Wealth Institute does not discriminate in educational opportunities or any other characteristic protected by law.

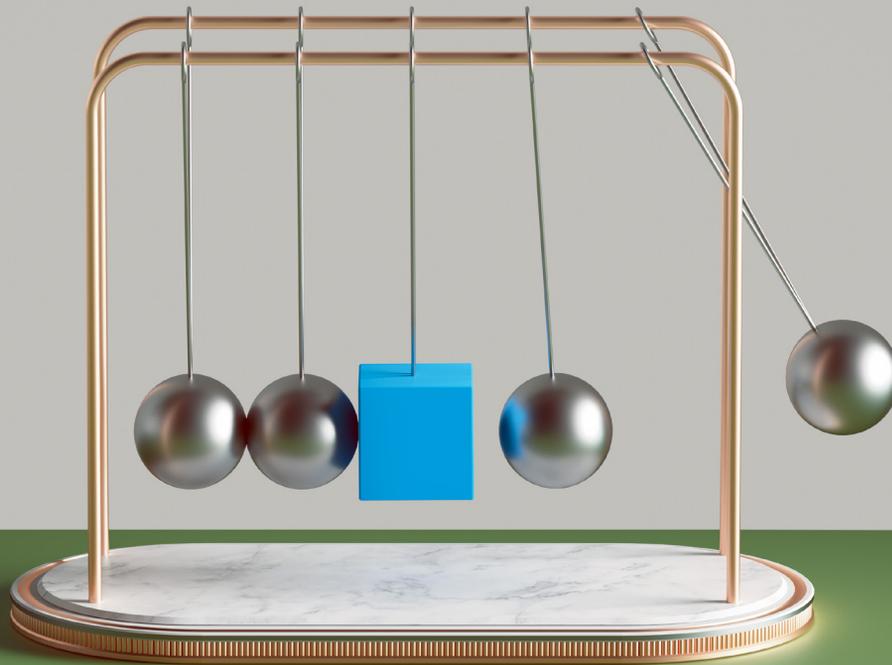
Charles Schwab Investment Management, Cerulli Associates, and Investments & Wealth Institute are unaffiliated entities.

Befi Barometer 2019 is a survey of 301 financial advisors conducted by Cerulli Associates in July 2019. All data is self-reported by survey participants and is not verified or validated.

©2019 Investments & Wealth Institute®. Reprint only with the permission of Investments & Wealth Institute. All rights reserved.

Published by Investments & Wealth Institute, 5619 DTC Parkway, Suite 500 | Greenwood Village, CO 80111 | www.investmentsandwealth.org

0919-9374



Low-cost core investment products and solutions from Schwab. What a welcome alternative.

When it comes to customer service, most firms just go through the motions. Not Charles Schwab Investment Management. In addition to offering core foundational products including some of the lowest-cost market cap index mutual funds and ETFs in the industry, we strive to provide advisors and their clients, regardless of investment size, the attention, education, and resources they need. **Visit schwabfunds.com/welcome-alternative.**

Schwab Funds. Schwab ETFs.

[Index](#) | [Active](#) | [Multi-Asset](#) | [Strategic Beta](#)

charles
SCHWAB

Investment
Management

Investors should consider carefully information contained in the prospectus or, if available, the summary prospectus, including investment objectives, risks, charges, and expenses. You can obtain a prospectus or, if available, a summary prospectus by visiting schwabfunds.com. Please read it carefully before investing. Charles Schwab Investment Management, Inc. (CSIM) is the investment advisor for Schwab Funds, Laudus Funds, and Schwab ETFs. Schwab Funds and Laudus Funds are distributed by Charles Schwab & Co., Inc. (Schwab), Member SIPC. Schwab ETFs are distributed by SEI Investments Distribution Co. (SIDCO). CSIM and Schwab are separate but affiliated companies and subsidiaries of The Charles Schwab Corporation, and are not affiliated with SIDCO. 0919-9VRK