AN AMERICAN PORTFOLIOS' GUIDE

AMERICAN PORTFOLIOS

Modifying Investor Behavior: How Advisors Can Protect Clients From Their Worst Instincts

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BEHAVIORAL FINANCE RESTS on the disarming notion that rational man does not exist. It's an unsettling idea since rational behavior is a bedrock premise underlying traditional economic and finance theory.

The study of human behavior in the investment decision-making process goes back to the turn of the 20th century with the publication of *"Psychology of the Stock Market"* by G.C. Selden in 1912, though it is generally regarded that behavioral finance science traces its founding to the release of *"Prospect Theory: A Study of Decision Making Under Risk"* by Daniel Kahneman and Amos Tversky in 1979.

Since then, the inquiry into how investors make decisions in the real world has grown into a robust, highly respected economic discipline. It is now broadly accepted that investors frequently make decisions that run counter to their best financial interests. Years of behavioral research, it seems, confirms what Benjamin Graham observed long ago: "The investor's chief problem – and even his worst enemy – is likely to be himself."

This unfortunate reality is regularly spotlighted with the annual release of Dalbar's "Quantitative Analysis of Investor Behavior." As with past years, the 2017 study showed some frightening conclusions about the cost of bad investor behaviors:

- The average annualized return for the average equity mutual fund owner was 6.18 percentage points below that of the S&P 500 Index over a 30-year period. The gap for the 10-year and 20-year periods was only somewhat less distressing at 3.31 percentage points and 2.89 percentage points, respectively.[1]

- Meanwhile, the holding period for equity mutual funds declined from 4.1 years to 3.8 years between 2015 and 2016.[2]

In this white paper, *Modifying Investor Behavior: How Advisors Can Protect Clients From Their Worst Instincts,* we explore strategies that advisors can use to help clients avoid falling victim to the inherent biases and emotions that can lead to poor investment decisions.

BEHAVIORAL RISKS:
SETTING THE TABLE

The human brain evolved in a myriad of ways to ensure our survival. The basic fight or flight response was ideally suited for a primitive form of danger that took the form of an approaching animal or a threatening sound.

Herding, or following the crowd, was another survival mechanism for our early ancestors since safety was found in numbers. Humans also developed a familiarity bias as a protection from the unknown, be it the unrecognized visitor or unexplored territory.

These survival mechanisms are ill-suited for a modern investment setting. Selling (flight) at the first sign of market distress, buying what everyone else is, and limiting investment exposure to home markets are just some examples of how evolution has disadvantaged the present-day investor.

The list of behavioral biases can run quite long. However, they can be categorized into two general groups:

- **Cognitive Biases:** These biases are rooted in faulty information processing or memory errors. Examples include "Anchoring," "Selective Memory," and "Herding."

- **Emotional Biases:** These biases are psychological in nature and stem from instinctual responses. Examples include "Fear and Greed," "Regret," "Risk Aversion," and "Overconfidence."

The distinction is critical because finding an effective response is predicated on properly identifying the nature of the bias behavior. For instance, a client who suddenly calls an advisor to "sell everything" is likely experiencing an emotional response to something going on in the market, e.g., a flash crash. Responding to this fear with information, e.g., a chart showing the average recovery period from stock market declines, will fall on deaf ears. Empathy and calming would be a much more appropriate response to this anxious client.

Thus, the prerequisite for successfully addressing investor biases is a clear understanding of the bias being exhibited.

THREE ESSENTIAL STRATEGIES TO PROTECT CLIENTS FROM THEMSELVES

STRATEGY ONE: KNOW THY CLIENT

The principle of "know your client" is essential to providing suitable investment advice. Standard questions about investment experience, risk tolerance, and investment time horizon, however, don't go far enough. From a behavioral investing perspective, advisors need to dive deeper if they are to get a better appreciation of a client's unique behavioral risk personality. This can be done in two ways.

The first is gain better insight into a client's personal behavioral make-up. New client interviews should always include open-ended questions whose answers can provide a sense of the influences on their investment decisions, such as:

What actions did you take with your investments during the 2008 credit crisis?

What was the worst investment decision you made? Why did it happen?

What do you expect the market to return in the next year? Next 5 years?

How often do you check your investment accounts?

What were the last three investments you made? Why?

Do you find saving enough difficult?

Be sure to give the client plenty of room to answer. The priority for the advisor is to listen to what the client has to say.

The second way is by generational categorization. Consider the distinct experiences of, and impact on, the different generations that advisors serve.

THE SILENT GENERATION
(aka The Greatest Generation)

EVENTS:

The Great Depression

World War II

IMPACT:

Frugal spenders

Stock market trepidation

BABY BOOMERS

EVENTS:

Post WW II economic boom

Oil embargo

High inflation

IMPACT:

Conspicuous consumers

Avid stock market investors

GEN X

EVENTS:

1987 crash

Late-1980s recession just as careers were getting started

Dotcom crash

IMPACT:

Value work-life balance

Entrepreneurial

Skeptical

MILLENNIALS

EVENTS:

9/11

The Great Recession

IMPACT:

Distrustful of institutions

Fear of equity investments

Techno savvy

A recent survey by Legg Mason underscores how these contrasting experiences can lead to different investing personalities. For instance, 52 percent of Millennials describe their risk tolerance as "very conservative," considerably higher than Gen X (30 percent) and Baby Boomers (29 percent). At the other end of the risk spectrum, only 8 percent of Millennials viewed their risk tolerance as "somewhat aggressive," while 22 percent of Gen Xers and 24 percent of Baby Boomers describe themselves as "somewhat aggressive."[3]

By piecing together a comprehensive behavioral profile for each client, advisors can more readily anticipate a particular client's behavioral biases and lay the groundwork to mitigate them.

DESCRIBES THEIR RISK TOLERANCE AS
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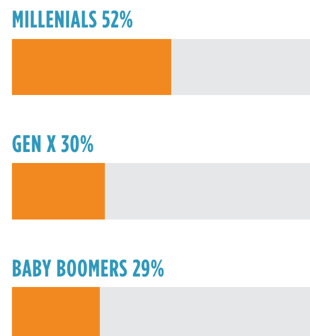

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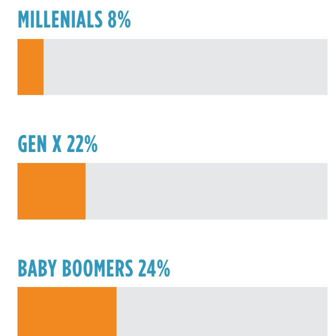
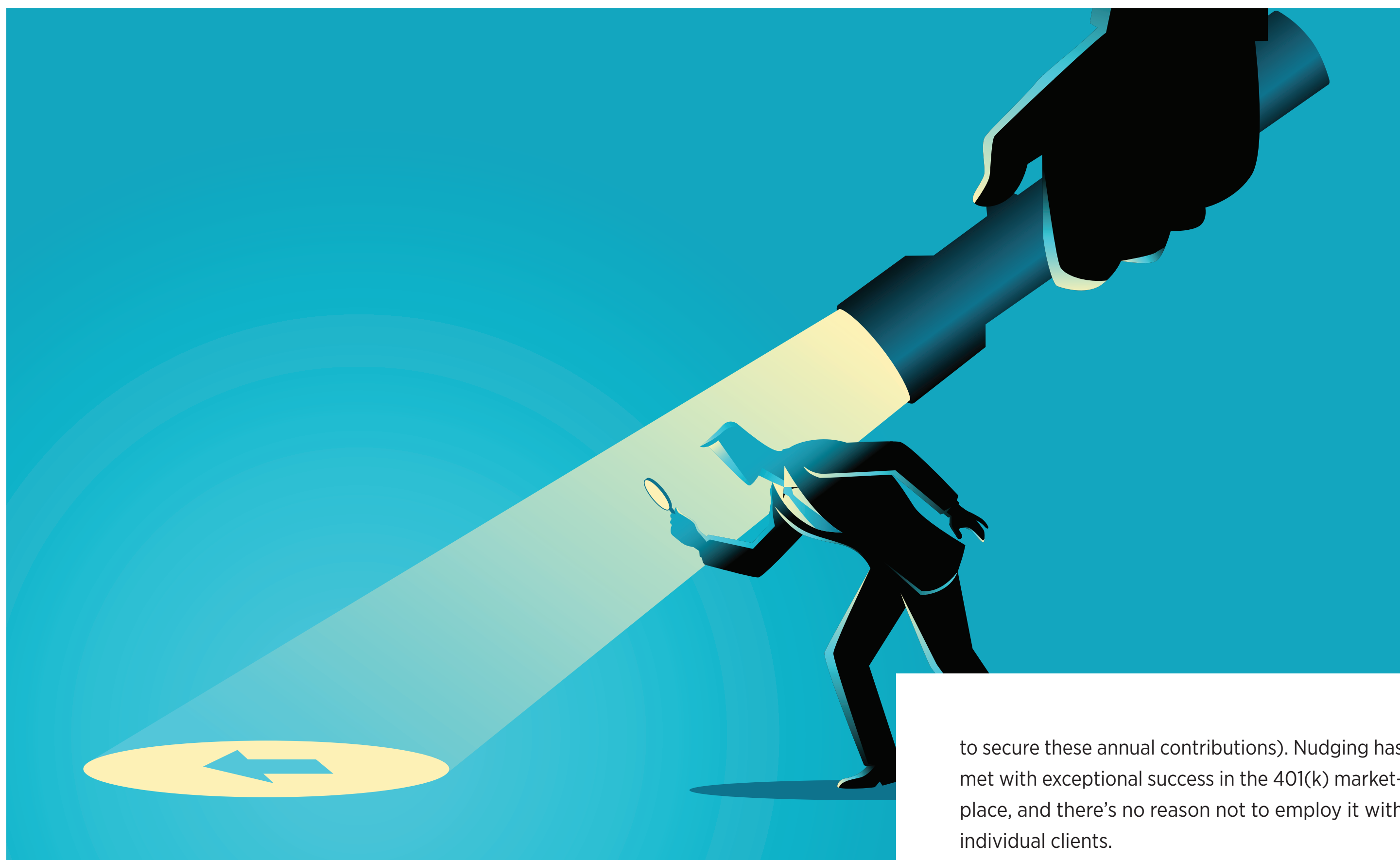




STRATEGY TWO: CONSIDER NEW APPROACHES

As the person closest to the client, the advisor will be in the best position to tailor his or her approach to each client. Nevertheless, here are some ideas for managing some of the investor behaviors that advisors confront.

Stop Benchmarking to the Index

Individuals invest in order to accomplish financial goals. Client reviews ought to stress the status and progress toward achieving those goals, rather than focusing on how individual money managers have performed versus some comparative index. This will help clients to maintain a long-term view and dampen the urge to chase performance.

This also lays the groundwork to manage overreactions to market corrections. Since fear is an emotional response, discussing the history of market rebounds with graphs will be of little help. Instead, fearful clients should be comforted with rerunning financial projections that reconfirm they remain on track to reach their goals.

Expectation Setting

Client expectations can be misguided due to "anchoring" or an insufficient knowledge base. To combat misplaced expectations, advisors may want to expand the number of education-focused client meetings and the educational content on their websites. Education, best done in calmer times, finds its greatest impact in continual reinforcement. Additionally, consider how to present outcomes in terms of probabilities and ranges. "Past performance is not necessarily..." or "the historical return on stocks is 8 percent" are less than helpful.

Nudging

Did you know that nearly 40 percent of IRA owners waited until the last three weeks of tax filing season to make prior-year contributions, missing out on 15 months of potential growth?[4]

If you have clients that have a difficult time saving, or put it off until the last moment, consider enrolling them in an automatic savings plan. It may strike the advisor or client as a bit pedestrian, but it may be an ideal way to fund an IRA or HSA (while also saving advisors the hassle of repeated follow-up to secure these annual contributions). Nudging has met with exceptional success in the 401(k) marketplace, and there's no reason not to employ it with individual clients.

Be Creative

There is limited evidence of the efficacy of the tactics used to address behavioral biases. While more reliable answers may come with future research, advisors should be open to their own creative ideas in designing relevant responses to harmful client behaviors. For example,

- Rather than making a rational case to counter a client's fear instinct to sell stocks (or automatically implementing the client's wishes), propose a tweak to the allocation to address his or her fears, or perhaps suggest moving some of that equity exposure into a variable annuity to comfort the client with the downside protection he or she is clearly seeking.

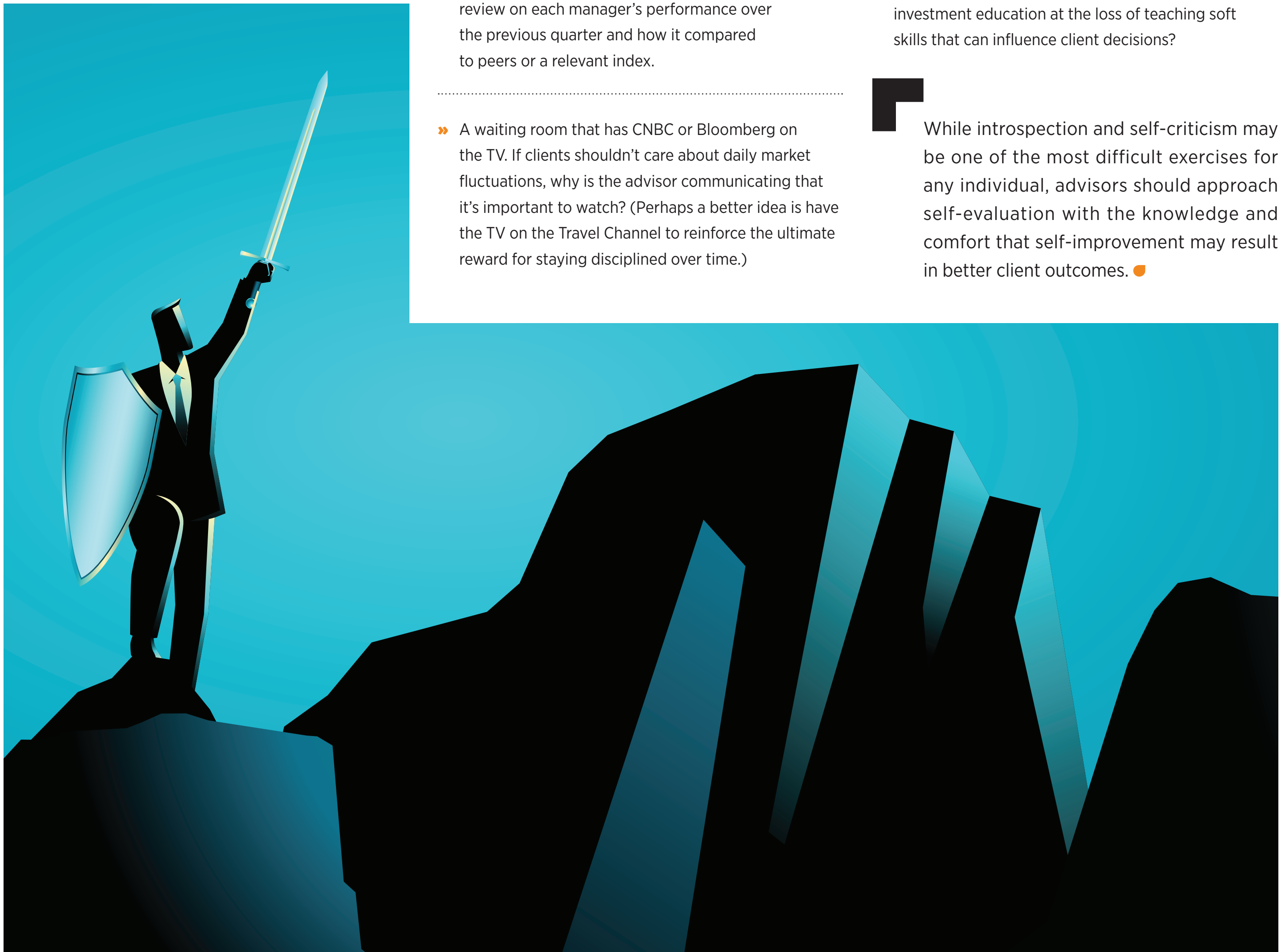
- If you have clients easily distracted by "hot funds" or the latest investment fad, consider opening a separate "play" account that will scratch this particular itch, leaving the serious money to be managed properly.

- If Millennial clients balk at recommended equity exposure, present socially responsible funds since they satisfy that generation's desire for positive impact, and potentially overcome their institutional mistrust.

STRATEGY THREE: ADVISOR, HEAL THYSELF

Leaders must set the example for the people they wish to lead. Advisors are the financial leaders of their clients, and as such, they must practice what they preach and avoid sending conflicting signals to their clients.

In a survey conducted by the CFA Institute, investment professionals were asked to identify which habits of their peers were most harmful to clients. The two top bad habits were "Chasing performance" (36 percent) and "Focusing on short-term metrics at the expense of long-term value" (35 percent). "Measuring performance against market-weighted benchmarks versus achieving client goals" was identified by 20 percent of respondents as the most harmful habit of investment professionals.[5]



The behaviors identified above are obvious instances where an advisor may be engaging in a practice that contradicts the advice he or she is giving to clients. Sometimes the conflicting signals are more subtle.

Consider some examples of how clients may receive mixed messages:

- The advisor who counsels clients not to be distracted by "shiny new investment ideas or fads," yet posts a blog entry on the "top investment opportunities in the new year."
- The advisor who cautions against performance chasing, but promotes the performance record of a newly added money manager or fund.
- The advisor who counsels clients to remain focused on progress toward a goal, but spends the bulk of the quarterly client review on each manager's performance over the previous quarter and how it compared to peers or a relevant index.
- A waiting room that has CNBC or Bloomberg on the TV. If clients shouldn't care about daily market fluctuations, why is the advisor communicating that it's important to watch? (Perhaps a better idea is have the TV on the Travel Channel to reinforce the ultimate reward for staying disciplined over time.)

It's crucial that advisors understand that they, too, are human, and subject to the same biases and emotions as their clients. If an advisor is to succeed at changing their clients' worst behaviors, a necessary precondition is that advisors reflect honestly on how their actions and messaging may betray the advice they are giving their clients.

Advisors should examine not only how their personal biases may seep into their interactions with clients, but also how they may manifest themselves at a corporate level, including:

- Client communications: Is their focus on markets, at the expense of information and education on goal planning and smarter financial behaviors?
- Compensation structure: Are rewards aligned with client interests?
- Training programs: Are they geared toward technical investment education at the loss of teaching soft skills that can influence client decisions?

While introspection and self-criticism may be one of the most difficult exercises for any individual, advisors should approach self-evaluation with the knowledge and comfort that self-improvement may result in better client outcomes.

SOURCES

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