Addressing behavioral finance with your clients

Beth Braverman, 03/19/2020

Most advisors have been in this situation: You meet with a client who listens carefully to your advice, clearly understanding and agreeing with everything you're saying during the conversation. Then, they go out and do the opposite of what you've discussed.

Clients often make financial decisions that aren't in their own self-interest, even when they logically know that doing so could have adverse consequences. Thanks to the growing awareness of behavioral finance—the study of psychology and biases behind money decisions—it's become easier to understand why people make certain choices in the heat of the moment. Even more importantly, you can learn how to potentially correct for them.

Advisors have started to realize that understanding behavioral finance and incorporating some of its lessons can improve both their client relationships and help tailor the construction of their clients' portfolios. Seven in 10 advisors say that they consider behavioral finance when communicating with clients, and nearly six in 10 say it plays a role in portfolio construction.[1]

"It's about deconstructing the customer journey to look at every single touchpoint in the customer experience at which the customer can make a choice," says Renée Richardson Gosline, PhD, a senior lecturer and principal research scientist at Massachusetts Institute of Technology. "At each of those, consider the contextual, the psychological, and social influences that can shape that choice."

Here are some important behavioral finance concepts—as well as tips for incorporating them into your client interactions.

The idea: We have short memories

The tendency to put a greater emphasis on the latest events is known as recency bias, and it's among the most common biases that advisors see in their clients.[1] After a bull market like the one we've seen over the past decade, some investors may feel less concerned about the risks of a market downturn. Conversely, investors who have' experienced a recent loss might be overly hesitant to take risks.

Put it into your practice: Create a long-term financial plan with your clients and emphasize the importance of sticking to it, regardless of swings in the market.

"You want to prepare someone ahead of time to be psychologically aware of the fact that [pullbacks are] going to happen," says Nicholas Yrizarry, president and CEO of Align Wealth Advisors and a Behavioral Financial Advisor. "Otherwise," he says, "it's human nature for clients to panic and want to bail."

The idea: Go for goals, not returns

People often engage in mental accounting, thinking about money in categorical ways (like "money I can afford to lose" or "money for retirement") before actually making decisions with it. While there are drawbacks to mental accounting (money is fungible, after all), investors can also take advantage of the human tendency to think differently about money allocated for different purposes. Research shows that goals-based financial planning can lead to a 15% increase in wealth when combined with an optimal savings strategy.[2]

Put it into practice: True goals-based planning requires more than just separately labeled accounts. Discussing the values behind each financial goal, and the rationale for the investment strategy to achieve it, can help investors buy into the approach.

That said, Gosline suggests considering anchoring biases that could be activated when using specific numbers or deadlines in communications. "If clients feel they aren't getting to their goal as quickly as they should, things can start to feel out of reach," she says.

The idea: Make it easy

Economists agree that auto-enrollment in plans by employers increases 401(k) participation rates.[3] In behavioral finance terms, auto-enrollment is considered a "nudge," an action that influences people to do so something they might otherwise not do (even if they want to).

In this case, auto-enrollment makes people much less likely to opt out of a 401(k) plan than they are to opt into it in the first place. "When we talk about making things easier, we're not talking about reducing choice or control; rather, we're talking about reducing the distracting cognitive effort that it takes to get to your goal while increasing a sense of earned achievement," Gosline says.

Put it into practice: Once you and a client have agreed on a plan, "nudge" them to make it as automatic as possible. That may mean helping them set up auto-deposits for retirement or college savings or calling and emailing to remind them to do it themselves.

The idea: Money stories matter

Everyone has a "money story," typically rooted in the way they felt (and learned from their parents) about money in their youth. These stories lead to deep-rooted, often subconscious beliefs about money that prevent people from making rational decisions about their money. Someone who grew up in a home where money was scarce, for example, may feel uncomfortable spending and enjoying their money, even if they're financially secure. Money stories can create emotional biases.

Put it into practice: When you meet with new clients, ask them to share their "money story." This will help both of you understand their approach to money—and spark a conversation about how to change that story, if necessary."Trying to understand your client's financial psychology is really important," says Brad Klontz, Psy. D., co-founder of the Financial Psychology Institute. "Beyond the cognitive biases that we all have to learn about individual psychology and history around money."

Beware your own biases

You're just as human as your clients, and also susceptible to behavioral biases. Recognizing these biases in yourself can help you counter their influence. It may also help you connect with your clients.

The two most common behavioral biases among advisors, according to a recent study? Loss aversion and overconfidence.[1]

> *Loss aversion:* This is the tendency to "feel" the pain of a loss to a greater degree than the delight of a gain. As a result, we may prioritize the avoidance of loss to a sometimes irrational level. If you need to sell an investment, for example, this might lead you to a preference to choose one that's gained 10% rather than one that's lost 10% because the latter would require you to lock in a loss. If the losing asset is poised to continue declining, however, selling now might be the better move.
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> *Overconfidence:* There's a benefit to feeling certain in your convictions when you're advising others on their money decisions. But when that certainty becomes overconfidence, you may create blind spots around certain market risks. Just as dangerous, overconfidence may affect your ability to take seriously the concerns of a client with differing views.

"People are smart, and they can easily glean when an advisor's biases may not serve them," Gosline says. "If they feel a lack of trust or worry about harmful effects to their financial health, they'll go elsewhere."

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Sources:

[1] "BeFi Barometer," Charles Schwab Investment Management, 2019. (Found here.)

[2] "The Value of Goals-Based Financial Planning," Financial Planning Association, May 2015. (Found here.)

[3] "Automatic enrollment: The power of the default," Vanguard Research, February 2018. (Found here.)

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