What behavioral finance can teach us about markets — and ourselves

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Behavioral finance — a body of work combining psychology, economics and other social sciences — has upended the way we think about people and money. Where we once assumed that men and women are purely rational decision makers, we now realize that people are rational some of the time but also emotional, biased and often seemingly irrational when making money-related decisions. Omar Aguilar, Senior Vice President and Chief Investment Officer, Equities and Multi-Asset Strategies, at Charles Schwab Investment Management, analyzes global equity markets through a behavioral finance lens. In a recent discussion with Evan Cooper, Executive Editor of InvestmentNews Content Strategy Studio, he shared some thoughts on the rational and irrational elements in human investment behavior — and ways advisers can help bridge the gap.

INVESTMENTNEWS: Let's begin with some basics. What are the core principles of behavioral finance?

OMAR AGUILAR: This whole field came into being because conventional economic theory with its math, models and equations could not explain what happens in real life. So it's appropriate that the first principle of behavioral finance is that we're human; we're not machines carrying out algorithms. Second, and closely related, is that because we're human, we have biases. We're wired that way, and our biases have enabled us to survive as a species, even if they sometimes lead to less-than-optimal solutions. Finally, there is a significant degree of dispersion in how people react to different events, partly due to our innate biases and partly due to social pressure and circumstance.

IN: What decisions do people make that reveal these biases?

OA: All of them. It's actually irrational to think that people will always make rational decisions. Again, traditional economic theory assumes market efficiency and that every individual is making rational investment decisions. If that's the case, and if people are making rational decisions constantly, then markets become efficient. If an individual doesn't make a rational decision, the market is supposed to correct it instantly and say, "You were wrong." But the market doesn't know what an individual's objectives are, the costs associated with achieving those objectives, and hence the lack of information may be at odds with the theory of efficient markets. In other words, an individual's investment decision could be irrational, but right for the individual utility function. By the same token, you could make a decision that's perfectly rational and in your best economic interest, but it might keep you awake at night. So if it's a rational decision that maximizes your wealth but doesn't let you sleep, you'll probably be biased towards irrational decisions. For advisers, the challenge is trying to understand client biases, getting clients to understand them, and then encouraging actions that will be in a client's best interests.

IN: Many veteran advisers probably would say they don't need behavioral finance to know that their clients often make irrational decisions. How can a formal understanding of the area help advisers better serve clients?

OA: Making the connection between the client's investment objectives and emotional tendencies is what makes a long-term relationship succeed. At Charles Schwab Investment Management, we have a defined process that can help advisers do that. We help them understand a client's investment objectives in the pure economic sense, using financial planning tools to create a rational solution. That's the traditional part, which — of course — only solves part of the problem.

For the emotional side, we encourage advisers to get into deeper discussions with clients to understand their needs as well as the trade-offs clients and the adviser may have to make to reach the long-term goal. Getting there isn't based on just one decision, it's a journey. So advisers should understand if their recommended investment solutions will satisfy the emotional and human aspects of their clients. The best thing that can happen for an adviser is to make good recommendations that meet client needs, so that the client sticks with those recommendations in a plan that lasts a long time.

IN: What should advisers do to nudge clients in the right direction?

OA: There aren't any nudges or tricks. Advisers have to understand each one of the client's biases and incorporate them into their solutions. That is what's critical for a successful, long lasting relationship with their clients. As we describe it to our advisers and clients, there are two types of human biases: emotional and cognitive, and they are very different. Some people tend to have biases that are more emotional in nature, others more cognitive. As a result, even individuals who on paper look the same in terms of wealth, generation or education may react very differently to the same economic conditions or even communications.

For clients whose biases tend to be emotional in nature, we encourage financial advisers to create a clear and disciplined strategy for addressing uncertainties that may generate emotional reactions, for example changes in volatility or market corrections. Most importantly, we help advisers identify a communication strategy that focuses on their clients' emotional traits. Clients are not going to change very easily because emotional biases never change. Emotional biases can be mitigated and controlled, but they rarely change.

Cognitive biases are easier to deal with as they tend to be driven by evidence or are social in nature, for example feeling left out of a bull market. Advisers can provide clients with information explaining their biases and how they can actually use them to work in their favor. This gives clients a better sense of solid evidence that will help them achieve their long term goals.

IN: What about an adviser's own biases? How can those be countered?

OA: That's a question we get all the time, and I always offer the following analogy. Imagine you're on a plane and it suddenly hits turbulence. No matter who you are — a passenger, the pilot or a crew member — a reaction is expected because we are human. If you're the pilot or a flight attendant, the cognitive part of your brain kicks in almost immediately and calms you down. But if you don't travel that often or if you hate flying, it will take a while for the rational part of your human brain to override the emotional part. Both the trained and the untrained flyers have the same emotional reactions, it's just that trained professionals can switch mental gears more smoothly.

In the same way, financial advisers have the training and experience to help them overcome their own biases. But don't be mistaken; advisers have biases just like anyone else, and those biases don't go away. Advisers need to understand their own biases and how to manage them.

For example, if the market takes a dive, some advisers' gut reaction based on experience would be that everything will be okay like it was in the past, in other words this is just turbulence. They would immediately reach out to clients and reassure them. Other advisers will first do research around similar historical market scenarios and then call clients armed with data to show how markets recovered under similar circumstances. In the first case, advisers are relying on their own emotional and experience bias to stay calm. In the second case, advisers gather information so their cognitive brain can override their emotional brain.

IN: Should advisers admit their biases to clients?

OA: I think they should. Being upfront about it makes you more human. But advisers also should explain that they have the training and experience to help understand their own biases, as well as the tools and equipment to help clients handle different market conditions when emotions can be overwhelming.

IN: Are there certain patterns of client biases, based perhaps on age or gender?

OA: Absolutely. In addition to psychology and economics, society plays a role in triggering and reinforcing cognitive biases. We've done a lot of work on generational differences, and there are several biases based on those differences. For example, the generation that lived through the Great Depression was very risk averse even after they realized that things were getting better.

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As kids, baby boomers had to fight to get a seat in school because there were too many of them and not enough schools or chairs. They were always elbowing each other to get attention, which shaped and reinforced their risk taking nature.

Millennials on the other hand grew up in the middle of several economic recessions and stock market collapses since the late nineties. Therefore, they tend to be more risk averse than other generations and less trustworthy of capital markets in general than other generations at their age. They also have more school loans than any previous generation. Their risk aversion is likely to carry through as they age.

IN: Does the rise of robo advice, where things are more or less on autopilot, mean that behavioral finance issues will become less important in the future?

OA: Robo advisers are great because they provide financial recommendations for people who may not otherwise have access. But we believe the human touch is necessary too and shouldn't be lost. The client-adviser relationship is just as important as the investment solution itself, whether the solution comes through traditional methods or a machine. The ability to merge investment solutions with an understanding of clients' social and behavioral preferences can help advisers deliver more optimal investment solutions and build stronger long-term relationships.

IN: Why is Charles Schwab Investment Management so interested in behavioral finance?

OA: Our mission is to create solutions for clients that are in their best interest. So, understanding what makes investors tick is very important, especially if you look at products and solutions through the eyes of clients, which is what we always try to do.

Understanding the client means not just trying to make a good asset-allocation decision. It also means trying to understand how an asset allocation is going to affect the life of a particular human being.

We also recognize that markets contain a lot of information that reflects inefficiencies created by human behavior. Sometimes people refer to this as "soft data." We strive to understand behavioral aspects that may be moving markets so that we can reconcile that with the "hard data" and hence can provide appropriate guidance to advisers and clients about how to navigate market conditions.

IN: For advisers who want to know more about behavioral finance, what does Charles Schwab Investment Management offer?

OA: We have a behavioral finance program called Biagnostics™ to help advisers understand and address their clients' biases. It also helps them better understand behavioral science and the ways it can benefit their practices and their clients.

And since we look at markets and investing through a behavioral finance lens, we provide insights that differ from what clients might read or hear from the media. This unique perspective can be helpful to advisers when trying to explain market moves to their clients.

When you asked about why we are interested in behavioral finance, I think it all boils down to caring about people. There are a lot of things you can do today without human interaction — including investing. But we also understand that investment decision-making is a function of recognizing that we're all human and that we must adapt to our own irrationality. Advisers play a key role in that process. ■

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