The Role of Behavioral Finance in Advising Clients

With the prospect of increased market volatility, advisors must do more to incorporate behavioral finance into their practice to help mitigate biases.
Executive Summary

Demographic and market trends will increase the need to educate clients on how behavioral biases can impact their investment decisions. This white paper provides practical guidance on 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 the Investments & Wealth Institute® and diversified among business models, including wirehouse, registered investment advisor (RIA), and national/regional broker dealers. Key findings from the survey, BeFi Barometer 2019, are discussed in this white paper.

KEY POINTS

- Though awareness of behavioral finance is becoming more widespread, 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, while 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 client expectations as the greatest benefits of incorporating behavioral finance into their practice.

- While advisors recognize the value of behavioral finance, many find it challenging to apply concepts in everyday practice. Advisors cite difficulty translating theory into implementation, and a lack of software/tools as the primary reasons preventing adoption.
In the midst of what has now been the longest market expansion on record in the U.S., advisors need to be hyper-focused on keeping their clients’ emotions in check with the prospect of increased volatility and lower returns on the horizon. In this type of environment, an advisor’s role is to help clients maintain a focus on their long-term goals, and to help them 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 help many aspects of an advisor’s day-to-day job, including more effectively communicating with clients, managing their expectations, and clearly identifying goals. Understanding the different ways behavioral tendencies can impact investors is a fundamental aspect to building a successful wealth management practice and can help advisors better serve their clients over the long term.

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%) of surveyed advisors indicate that they incorporate behavioral finance within the context of client communications/interactions, compared to 58% of advisors who incorporate behavioral finance in the portfolio construction process (see Exhibit 1). While 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 practice 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%), improving their investment decisions/prioritizing goals (49%), and better managing expectations (46%) (see Exhibit 5). Furthermore, advisors can potentially 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 surveyed more than 300 advisors to better understand the most prevalent biases impacting their clients’ investment decisions. While the list of potential behavioral biases is extensive, Cerulli found that the five most prominent behavioral biases among clients are recency bias (35%), loss aversion (26%), confirmation bias (25%), familiarity/home bias (24%), and anchoring bias (24%) (see Exhibit 2). 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 easily influenced by recent news, events, or experiences—was listed as the most common bias among clients. When clients overweight the importance of recent/memorable events, they are more likely to performance chase rather than make strategic investments that may be better suited for them. Simply 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.
While the experience of the 2008 financial crisis still resonates with many clients, the prolonged recovery has conditioned many investors to become accustomed to rising asset prices. Clients tend to believe that the strong market performance is bound to continue for the foreseeable future. However, as history would suggest, regardless of the economic environment, stock prices can go up or down at any point and expecting a continued bull market will likely 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 less (or more) risk than they can tolerate. Loss aversion can have significant repercussions on clients’ investment behavior and can even lead clients to act irrationally risky and/or risk-averse at times. For example, a client who was distressed after a significant market decline (like that experienced in 2008–2009) and decided to liquidate their holdings would have inevitably missed out on the subsequent market recovery. Conversely, a client may hold on to a risky or losing investment for too long simply to avoid realizing the loss in their portfolio.

Loss aversion is often consistent with clients’ level and source of wealth. For example, advisors who focus on mass-affluent clients (less than $500,000 in investable assets) are more likely to indicate that their clients are subject to loss aversion, compared to high-net-worth (HNW)-focused advisors with a core market of investors with $5 million or more, at 41% and 16%, 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 their clients to refrain from checking their portfolios too frequently, which can often lead to emotionally driven investment decisions. In addition, advisors can look to proactively identify potentially susceptible clients and reach out during uncertain market environments. Advisors must look to reiterate their commitment to their clients’ long-term goals and bring risks to their clients’ attention before they cause an emotional reaction.

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 otherwise ignored 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 their own 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 heavily weighted 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 their portfolios more effectively. According to the survey results, familiarity bias is prevalent among HNW clients; nearly one-quarter (23%) of advisors with a core market greater than $5 million, indicate their clients are significantly affected by familiarity/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, as 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 the price they initially paid for a position even though that value does not correlate to the fundamentals of the stock. 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 goal in the future, rather than a price in the past or an arbitrary benchmark. For example, advisors can explain why a particular strategy fits into their 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.

### EXHIBIT 3

**MOST COMMON GENERATIONAL BIASES, 2019**

<table>
<thead>
<tr>
<th>Millennials (&lt;38)</th>
<th>Generation X (38-53)</th>
<th>Baby Boomers (54-72)</th>
<th>Silent Generation (73+)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Framing</td>
<td>Recency bias</td>
<td>Anchoring</td>
<td>Familiarity/home bias</td>
</tr>
<tr>
<td>Herding</td>
<td>Mental accounting</td>
<td>Loss aversion</td>
<td>Loss aversion</td>
</tr>
<tr>
<td>Confirmation bias</td>
<td>Confirmation bias</td>
<td>Overconfidence</td>
<td>Selective memory</td>
</tr>
<tr>
<td>Self control</td>
<td>Self control</td>
<td>Confirmation bias</td>
<td>Anchoring</td>
</tr>
<tr>
<td>Availability bias</td>
<td>Regret aversion</td>
<td>Mental accounting</td>
<td>Framing</td>
</tr>
</tbody>
</table>

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

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.

**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%) and Silent Generation (71%) clients, while recency bias is most common among Generation X clients (64%). Meanwhile, the most common behavioral biases among Millennial clients are framing (54%) and herding bias (46%). 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**

While it's important to understand clients' behavioral biases, 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%) affecting their investment decisions, followed by overconfidence bias—overestimating one's own abilities. When asked whether or not advisors' own portfolio management skills can help their clients outperform the market, 17% of surveyed advisors “strongly agreed,” while another 48% “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, there is more that can be done to manage their own internal behaviors to help improve investment outcomes for their clients.
Most Effective Methods to Mitigate Behavioral Biases

While advisors can’t completely offset their own or their clients’ biases, there are specific techniques they can adopt to reduce the impacts of various biases. The following techniques can help reduce the negative impact that biases have on investment outcomes.

Long-Term View: In asking advisors what the most effective methods are to help clients avoid the impact of behavioral biases, nearly two-thirds (62%) cite helping clients take a long-term view as a “very effective” strategy (see Exhibit 4). 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%) 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%) 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 can subsequently reduce the likelihood they will overreact to a drastic market move.

Addressing the “Behavioral Gap” During Portfolio Construction

While advances in behavioral finance have provided insights into the ways investors make decisions, there is a greater need for advisors to factor these biases into their portfolio construction processes. Advisors should look to account for their clients’ biases when determining their asset allocation to ensure that they stay invested and meet their objectives over the long term. Advisors who accurately recognize the risk profiles of their clients during the portfolio construction process will be more prepared to deal with biases as they arise. However, finding the balance between adhering to clients’ comfort level with risk (i.e., risk preference), versus their ability to take risk (i.e., risk capacity), is a significant challenge. Cerulli 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%) of advisors typically adjust to or accommodate their clients’ risk preferences, while only 16% seek to increase clients’ comfort level with risk. Advisors often allow their clients’ risk preferences/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 their individual comfort level. Cerulli found that just more than half (51%) of advisors typically compromise and create a modified asset allocation based on a combination of both factors (e.g., risk preference and capacity). While 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 at higher levels of wealth, and seek to moderate (reduce/eliminate) biases at lower wealth levels where sufficient risk may be necessary to achieve financial needs.

EXHIBIT 4

MOST EFFECTIVE BEHAVIORAL BIAS MITIGATION TECHNIQUES, 2019

<table>
<thead>
<tr>
<th>Technique</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Take long-term view</td>
<td>62%</td>
</tr>
<tr>
<td>Implement systematic process</td>
<td>52%</td>
</tr>
<tr>
<td>Integrate goals-based planning</td>
<td>47%</td>
</tr>
<tr>
<td>Uncover emotional triggers</td>
<td>39%</td>
</tr>
<tr>
<td>Increase portfolio diversification</td>
<td>37%</td>
</tr>
<tr>
<td>Caution investors to stay calm</td>
<td>35%</td>
</tr>
<tr>
<td>Reduce news intake</td>
<td>21%</td>
</tr>
<tr>
<td>Suggest risk targeting</td>
<td>18%</td>
</tr>
<tr>
<td>Reduce investment expenses</td>
<td>16%</td>
</tr>
<tr>
<td>Consider past outcomes</td>
<td>12%</td>
</tr>
</tbody>
</table>

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

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?”
Accordingly, advisors with a core market of HNW clients ($5 million or more in investable assets) are least likely to moderate (increase clients’ comfort level with risk) clients’ biases (12%), as 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 look to gain a deeper understanding of clients’ risk tolerances and behavioral tendencies. Advisors need to be mindful of the fact that their clients’ preference for risk is heavily 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 within an investor’s portfolio 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 enable advisors to more effectively keep clients invested throughout market cycles and achieve more optimal investment outcomes.

**Conclusion**

While advisors are well aware of the benefits of incorporating behavioral finance into their practices (see Exhibit 5), many believe they lack the tools and applications necessary to employ those tactics with clients on a regular basis. Nearly two-thirds (65%) of advisors cite difficulty translating theory into implementation as the primary reason for not incorporating behavioral finance into their practice, while more than half (54%) indicate a lack of software/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.
Charles Schwab Investment Management is not affiliated with Cerulli Associates or Investments & Wealth Institute.

BeFi Barometer 2019 is a survey of 301 financial advisors to learn how advisors view and use behavioral finance when working with clients. Conducted by Cerulli Associates in July 2019. Respondents were members of the Investments & Wealth Institute® and diversified among business models, including wirehouse, registered investment advisor (RIA), and national/regional broker dealers. All data is self-reported by survey participants and is not verified or validated.

(0919-9N14) MKT108281-00 (09/19)