

Behavioral finance: Six principles that fuel your clients' fears

*A practical guide to understanding – and acting on –
the key factors that govern your clients' thinking*



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Executive Summary

A central underpinning of classical economic — and investing — theory is that people act rationally to secure outcomes in their best interest.

Starting in the mid-1990s, however, research by psychologists and other social scientists has shown that rationality doesn't always rule. Perhaps because the human brain has difficulty accurately assessing risk and probabilities and because emotions powerfully affect our thinking, people are often irrational in their economic and investing decision-making, usually in specific and predictable ways. Behavioral economics and behavioral finance are the terms used to describe the study and analysis of these newer ways of explaining our financial and economic interactions.

This white paper is intended to illuminate six of the most powerful behavioral finance insights. Specifically, it will explain how advisers can practically understand and deal with the underlying motivations of clients and prospects, and suggest how behavioral finance insights can help secure better investing outcomes.

Six Behavioral Finance Insights

While researchers are continually adding to our knowledge in this field, six established tenets of behavioral finance will add greatly to an understanding of investors. The six are: Loss aversion, anchoring, familiarity bias, mental accounting, the gambler's fallacy, and herd behavior. Let's examine each, discuss implications for advisers and their clients, and the action steps an adviser can take to improve outcomes.

1 LOSS AVERSION

One of the first and most compelling insights of behavioral finance and economics is that a loss produces pain greater than the pleasure of a win. In fact, one of the fathers of behavioral finance – the Nobel-Prize winner Daniel Kahnemann – found that a loss hurts 2.25 times more than an equivalent gain. In other words, an investor would have to see a gain of \$2.25 on an investment of \$1 in order to make up for the emotional cost of losing that dollar.

For advisers, this finding has several implications. First, is that most tools used to measure or assess risk tolerance should not be taken as gospel. People no doubt honestly respond to questions asked in risk tolerance questionnaires, but experience demonstrates that they act and feel quite differently when an actual market downturn occurs and the value of their holdings decline. As we'll see when we look at anchoring, loss aversion can lead to investing behavior that is sometimes irrationally risky and at other times irrationally risk averse. When investors are shaken by a dramatic market decline, for instance, they may become so frightened that they decide to sell all or most of their holdings. Of course, this may occur at the nadir of a decline, meaning that the sellers miss out on the inevitable recovery in valuations. At other times or in other situations, they may be so frightened of loss that they hold onto investments that they deem safe, even if buying seemingly "riskier" investments would be less risky.

WAYS FOR ADVISERS TO ADDRESS LOSS AVERSION: First, use every client contact opportunity to reiterate your commitment to your client's long-term financial health and meeting their goals. Next, tell clients that as part of your responsibility as their adviser, you have an obligation to bring risks to their attention that they may consider unpleasant. One ever-present risk is that of a market downturn. For many investors, of course, the experiences of the dot com bubble and the 2008 market slump still resonate. But memories of those experiences are fading, and the recovery of the last five years has conditioned many equity investors to rising stock prices. Clients must be continually reminded, however, that stock prices can go down, as well as up, regardless of positive economic forecasts or the projections of market prognosticators.

One way to initiate a client conversation about loss would be to say, "Let's suppose we saw prices start to fall – not just those one- or two-day events we've seen after which prices rebound – but maybe a big one-day decline that keeps on going. Let's talk about how you would feel about the impact of such a decline on reaching your financial goals. In fact, what would you feel like right now if your portfolio was worth 10% less tomorrow? Could you live with the very real pain (you can mention the 2.25/1 ratio) of loss? What aspects of your long-term goals — maybe solid retirement income or a legacy — are so important to you that you wouldn't want market events to jeopardize them? Would you be willing to take some steps now that might cut into present gains to position your portfolio for possible losses?"

The honest answers to these questions can prepare clients for what may come as well as afford advisers an opportunity to explain various investment products and strategies that can help mitigate loss. A discussion of loss and its impact also helps focus investors on their long-term goals and away from current performance. When investors are on track to meet those goals, any short-term declines are more likely to be seen as an expected hiccup rather than as a catastrophe.

ANCHORING

Also known as focalism, anchoring involves the human tendency to focus on one piece of information — usually the first piece offered — when making a decision. Because of this tendency, and because people have difficulty in assessing probabilities, many of the assumptions investors make about securities prices and the direction of those prices can be flawed.

For example, let's say XYZ shares have been trading in a \$30-\$35 range for a few months. An investor who becomes aware of the stock during that time period and is thinking of buying it may come to believe that XYZ is a "\$32 stock" as a result of the anchoring phenomenon. If the stock then drops to \$27 a share, anchoring is likely to lead the potential buyer to believe that the stock is a bargain. Of course, it's just as rational, or irrational, to believe that XYZ was *really* a \$27 stock all along — if such a thing even exists — but had been unrealistically trading in the low \$30s for a while.

Anchoring also can lead to longer-term portfolio problems for investors, who often tend to position the price they paid for a security as an anchor. If those XYZ shares were purchased at \$32 a share, for example, that price would become the investor's anchor. The investor would be very reluctant to sell the shares at \$27 since, in his or her mind, the stock is "worth" \$32 a share.

WAYS FOR ADVISERS TO ADDRESS ANCHORING: The key to avoiding problems with anchoring is to tie the purchase of securities to a purpose. For example, if a stock is purchased for its dividends, remind clients that a stock price decline does not affect the dividend-paying ability of the issuer. Moreover, the stock continues to perform its intended portfolio purpose. Similarly, in the case of mutual funds bought to execute an asset allocation plan, decisions to buy or sell become more about updating positions to bring allocations in line with plan goals and less about having to sell securities that the investor might otherwise think of as being "temporarily" away from their "real" values.

Another way to get around the anchoring tendency is to set pre-determined buy and sell targets. By jointly determining pre-set selling price targets (both above and below the purchase price) at the time of purchase, the investor effectively has made the sell decision early and automatically, thereby weakening the influence of anchoring and resultant mistakes caused by selling winners too quickly and losers too slowly.

**As their adviser,
you have an
obligation to bring
risks to their
attention that
they may consider
unpleasant.**

FAMILIARITY BIAS

It is a human tendency — or *heuristic*, to use the psychological term to describe our rule-of-thumb way of making judgments — to come to certain decisions quickly based on experience. When confronting a new situation or set of facts, our minds race to find similarities to past events and then come up with a conclusion or assessment of the current situation. All too often, however, this familiarity bias can lead us astray.

When investing, we exhibit familiarity bias in several ways. One is the way U.S. issues dominate our holdings. In addition to all the rational reasons for buying or not buying a particular security, Americans tend to overweight U.S. issues in their portfolios simply because we are familiar with them. (Foreign investors, by the way, also invest more heavily in domestic securities, but because their home markets are much smaller than ours, they invest internationally more than Americans do simply out of necessity.)

Second, many investors tend to favor equities over fixed-income securities or energy stocks over technology stocks, for example, largely because they are comfortable with their current choices and find unfamiliar investments unsettling.

Advisers are unlikely to persuade an investor that gambler fantasy market predictions are irrational simply by providing a lesson in statistics.

WAYS FOR ADVISERS TO ADDRESS FAMILIARITY BIAS: Advisers should use the power of metaphors and stories to help their clients become familiar and more comfortable with different types of investments. Fixed-income investors anxious about the risks of equities, should be told about quality dividend-paying stocks, which can be explained as being very bond-like in their return patterns. Similarly, growth stock investors who are comfortable assuming investment risk may wish to learn more about certain high-yield and distressed debt investments, which can exhibit growth-stock like volatility.

To help make foreign companies more familiar, advisers should remind clients that many American household brands — Q-Tips, Dial Soap and Lean Cuisine to name just three — are owned by non-U.S. companies, in this case Unilever (U.K.), Henkel (Germany) and Nestle (Switzerland). Moreover, many large U.S. companies are more like their foreign counterparts — GE and Siemens (Germany) in electrical generation, for example, Boeing and Airbus (a European consortium) in aviation, ExxonMobil and Shell (British/Dutch) in energy — than they are like their smaller U.S. rivals. Investors should be reminded too that U.S. institutional investors largely ignore borders among developed countries when investing.

MENTAL ACCOUNTING

Richard Thaler, a pioneer in the field of behavioral finance, describes mental accounting as the cognitive operations we use to organize, evaluate and keep track of financial activities. In essence, we think about money in a compartmentalized way, which affects how we behave.

Take someone who earns a salary and a bonus. Instead of thinking of the two as merely the constituents of annual income (one pot of dollars), many people tend to think of the salary component as one pot from which they pay for rent, food, auto bills and other expenses, while the bonus pot goes for trips, splurges or lump-sum savings. Essentially, because of our tendency to engage in mental accounting, we think of a dollar as being different (more valuable, easier to risk, etc.) in one context than in another.

Our mental accounting processes can have positive and negative consequences. For example, the requirement to make a regular contribution to a voluntary savings plan — the basis of the old Holiday Clubs at banks through which people could save for gift-giving season — leverages our capacity to often prefer a mental “box” for savings. The same principal, however, boomerangs when we over-withhold taxes. While the government gets to use our money without paying us for it, many people prefer receiving a refund from the government — which seems like a gift — than sending the IRS a check for any shortfall.

WAYS FOR ADVISERS TO ADDRESS MENTAL ACCOUNTING: Advisers can help their clients think about all their money more rationally, which will help in investment thinking as well. If a client is paying credit card interest at 18 percent or more, for instance, eliminating that debt by tapping money in a checking account or a money market fund earning 0.2 percent can represent a return of more than 17 percent. Helping clients clarify how they allocate and think about “safe” money as opposed to money they feel they can risk through investing also can lead to more effective advice-giving by advisers.

For clients who love the excitement of trading, even if it may be antithetical to reaching long-range financial goals, advisers may consider allocating a small, designated portion of the portfolio to trading. If the client feels satisfied by thinking of speculation as being confined to a “box,” the adviser will have employed mental accounting principles successfully.

GAMBLER’S FALLACY

Let’s say you’re doing a coin toss and you come up with heads six times in a row. It’s more likely that you’ll get fewer heads the longer you keep going, right? If your clients believe that, they are succumbing to the gambler’s fallacy, also known as the Monte Carlo fallacy.

The fallacy is that a past pattern somehow influences future odds. Because humans have difficulty understanding the mathematics of probability, we are prone to seeing patterns in random events and then, after presuming a pattern, assuming that it cannot continue. Those who think “this stock is down so much it’s bound to go up” are expressing the fallacy.

WAYS FOR ADVISERS TO ADDRESS GAMBLER’S FALLACY: Advisers are unlikely to persuade an investor that gambler fantasy market predictions are irrational simply by providing a lesson in statistics. Better to constantly remind clients that every day is a new day in the markets and that pricing direction in the short run is largely random. Also effective is keeping investors focused on long-term investing and discussing how they are making progress toward their goals. Those are the best ways to keep short-term market fluctuations from derailing their plans.

As in the mental accounting example, if clients cannot resist playing hunches on the market and falling victim to the gambler’s fallacy, it may be prudent to set aside a small portion of a portfolio for speculation.

HERD BEHAVIOR

Wherever and whenever there are markets, there is herd behavior. From the South Sea bubble in 1720 to the dot com bubble in the final years of the last century, many investors can't help but be swept up in the euphoria of a bubble.

Of course, few investors recognize a bubble as it is occurring. Most times, a speculative bubble starts off rationally. In the case of the dot com bubble, for instance, the Internet really was a development that would change the way we live and do business, and many new companies were capitalizing on the growth. The general upswing in share prices moves into bubble territory when social pressure mounts to join what seems to be winning behavior — “everybody’s doing it and making money, so it must be right.” Rising stock prices take on a life of their own, leading to wildly excessive valuations, and ultimately a collapse in prices when everyone collectively wakes up and realizes the euphoria wasn’t reality.

Bubbles are the extreme example of herd behavior. Many investors join mini herds and demand the latest hot stock or hot mutual fund. When prices break, other investors will join a herd of sellers. Obviously, herd buying or selling can be injurious to financial health.

WAYS FOR ADVISERS TO ADDRESS HERD BEHAVIOR: The best way for advisers to help clients steer clear of the herd is to educate and remind them that understanding valuations, and paying and receiving a reasonable price for a security based on value, are the most likely routes to success as an investor over the long run. Determining a fair multiple on a stock before buying or selling can help strengthen investors’ resolve and fortitude when running with the herd is enticing.

Finally, tell clients that if ever several of their friends are buying or talking about a security, they should alert you before making any buying decisions so that you can do special research for them. Hopefully, you will find sufficient reasons to keep them from riding with the herd.

Conclusion

Long before academicians uncovered and researched the tenets of behavioral finance, advisers were aware that investors do not always behave rationally. Today, armed with insights about how and why investors actually make decisions, advisers can help their clients make better choices that lead to long-term investment success.

Having an investment and/or financial plan that has clear goals and ways to measure movement toward those goals helps investors focus on the long run, making them less susceptible to many of the irrationalities behavioral finance experts have uncovered.

The good news is that investors often will recognize their irrational behavior when explained in a non-threatening or antagonistic way, and will appreciate an adviser's efforts to keeping them focused.

About This White Paper

This white paper was co-developed by Cadaret, Grant & Co., Inc. and *InvestmentNews* Research in May 2015.



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