Challenges in Financial Advising From the Scope of Behavioral Finance

July 13th, 2011

Dear Friends,

In today's world, especially after the recent financial meltdown, understanding the human emotions and sentiments before investing money is capturing interests of researchers and advisers. We too continue our long love with Behavioral Finance and present you some interesting findings by researchers in this area. Before we discuss the topics in detail here is a brief introduction on Behavioral Finance.

'Behavioral Finance combines the psychological characteristics with traditional finance principles in evaluating an investment. Behavioral finance focuses on the cognitive and emotional aspects of the investment decision-making process.'

At the start we discuss *Intuitive* and *Reflective* minds. Following up are discussions on *Investor Paralysis*, *Lack of Investor Discipline* and *Loss of Trust* by Shlomo Benartzi, Ph.D, UCLA Anderson School of Management and some other researchers. We conclude by providing some interesting solutions to overcome the 3 mentioned behavioral finance challenges and why they should be understood by financial advisers and clients.

Intuitive and Reflective Minds:

Intuitive mind is the one which forms quick judgment with great ease, less effort and with no conscious input. Often it can lead to wise decisions but it could also lead to irrational or poor decisions, which could be a big issue if these are financial decisions.

Reflective mind is the one which is slow, analytical and requires conscious effort. It leads to more thoughtful and rational decisions. Financial Adviser's role is to understand the reflective mind of clients and help them to reduce the mistakes caused by intuitive mind.

Investor Paralysis:

The psychological fallout of the '08-'09 financial crisis was very profound. Huge amounts of cash were left idle for a long time as investors thought that the market was still bearish. Financial Advisers themselves can become a subject to this behavior known as ***Investor Paralysis.***

> "People are even more averse to the prospect of future losses when they have experienced loss in the recent past, as most people did during the 2008 financial crisis."
>
> Richard Thaler,
> University of Chicago,
> Graduate School of Business

A solution to Investor Paralysis is 'Invest More Tomorrow' program which relies on overcoming loss aversion and procrastination.

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Lack of Investor Discipline:

From years it has been noted that investors buy high and sell low. They also often buy the wrong stocks, sell the wrong stocks and, in normal times, do far too much buying and selling. A winning stock offers the opportunity to sell, and lock in a gain and hence the investors do so to experience the pleasure of that gain. This is a positive investing episode. A losing stock involves the prospect of incurring a loss. Investors hold on to such stocks in an attempt to avoid a negative investing episode *(Source: Barberis, Xiong, 2010).* This is not because people are stupid, they are just humans.

A study of 66,465 individual investors over a six-year period in the United States found that the average investor turned over 75 percent of his/her portfolio each year. Due to transaction costs associated net performance was reduced by 3.7%. *(Source: Barber and Odean, 2000; Daniel et al., 1998).*

> "The evidence that investor emotions are influencing prices of securities is becoming overwhelming."
>
> Kent Daniel, Graduate School of Business, Columbia University

People buy stocks on a simple rule of thumb, or heuristic: Follow the news i.e. Buy the stocks if the company is in news. This is the intuitive mind taking the easy way to making a choice, but the reflective mind might reject the choice wanting a more rational decision. Stock markets often move in response to many factors unrelated to true value. For example a soccer mania country's stock market gets affected if the national team loses a big trophy *(Source:Edmans et al., 2007)* .

Thus we see that investors lack discipline in making sound investment choices and have their emotions, peers and intuitive mind take decisions. The challenge for behavioral finance is to find ways to help people not go with the crowd, and not be susceptible to the errors of the intuitive mind. We discuss later the Ulysses Strategy as a recommended solution.

Regaining and Maintaining Trust:

Apart from Investor Paralysis, the recent financial meltdown has also had a huge impact on the bond of trust between financial advisers and their clients. According to a survey by Chicago Booth/Kellogg School Financial Trust Index, at the beginning of 2009 only 34 percent of Americans expressed trust in financial institutions. Thus rebuilding trust is of top priority for financial advisors & institutions, even if their strategies did not lead directly to clients' losses (Gounaris and Prout, 2009).

The bruised psychological state of investors has been likened to the feelings of betrayal following the discovery of a partner's affair.

Demonstrating empathy and competence is the key to regain and maintain the trust.

> "Active demonstrations of professional competence and personal empathy have been identified as key to building and maintaining trust."
>
> Noah Goldstein, UCLA Anderson School of Management

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Researchers' advice and what we at BFM strive to practice!

1) A potential solution to **Investor Paralysis** can be solved using 'Invest More Tomorrow' Strategy. This strategy works on the lines of **'Save More Tomorrow (SMarT)'** program. There are two parts to the Invest More Tomorrow strategy: first, overcoming the fear of seeing the value of the portfolio decline, or loss aversion; and second, overcoming the strong tendency to put off until tomorrow what one should be doing today, or procrastination.

Overcoming Loss Aversion: Instead of investing all the cash at one go in the market, the investor can invest periodically. The advantage here is that if market falls, the investor sees an opportunity to buy cheap with the next purchase. In other words we can say intuitive mind does not react negatively because the reflective mind turns the downfall into an opportunity.

Overcoming Procrastination: 'SMarT' worked by asking people to commit to increase their contribution/saving rate in advance. In a similar way, Invest More Tomorrow involves clients to pre-commit going into the market in the future at a specific time chosen by the investor themselves. Pre-commitment is the important psychological element here as it results into a question of *what* to buy at that point rather than *whether* to buy at that point.

We can summarize the Invest More Tomorrow into the following 3 steps:

(Source: Shlomo Benartzi, Ph.D, Chief Behavioral Economist, Allianz Global Investors)

2) To overcome **Lack of investor discipline** one solution is **The Ulysses Strategy**. The phrase "Ulysses contract" refers to a decision made in the present to bind oneself to a particular course of action in the future.

In this strategy the clients are advised to engage their reflective mind to pre-commit to a rational investment strategy. Pre-commitment to a rational investment plan is important; otherwise the intuitive mind might trigger irrational investment responses later when market conditions tempt them to follow the herd. Also a memorandum is signed. This memorandum is not binding, in the sense of a

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legal contract but it helps clients to stick with the plan when changes in market conditions tempt them to go with the herd.

1
- Help clients understand the impulsive nature of investment decisions.

2
- Discuss what action would be taken when, for example: index 30% down.

3
- Sign a commitment memorandum, with both client and advisors.

(Source: Shlomo Benartzi, Ph.D, Chief Behavioral Economist, Allianz Global Investors)

3) A 2010 Golin/Harris survey revealed that the most effective action to restore broken trust is to be "open and honest." To regain or maintain trust demonstrating competence and empathy is important.

When performance exceeds expectations, it is human tendency to proclaim full credit but during downfall the tendency is to blame luck and other external factors. However, this is unwise to do. **Admitting luck** at the good times portrays honesty to the shareholders. Warren Buffet himself is a student of this belief.

Talk about the downside before presenting the upside. By talking about the downside first, the financial advisor is displaying honesty that generates a greater willingness in the listener to trust what is then said about the upside.

Apart from making investment decisions for clients putting value on the human side of business has been described as "relational intelligence".

Clients portray embarrassment i.e. even if they do not understand a strategy perfectly they will not admit it openly. So instead of asking questions like: "Is there anything about our strategy you don't understand one should ask "Is there anything about our strategy that I can clarify?

Competence
- Admit Luck.
- Discuss downside before upside.

Empathy
- Have frequent contact with clients, especially in difficult times.
- Allay embarrassment.
- Seek feedback.

Source: Shlomo Benartzi, Ph.D, Chief Behavioral Economist, Allianz Global Investors)

Overall we advice that pre-committing to a strategy reaps future benefits. A good analogy for the discussion can be with someone who wants to start going to the gym but keeps delaying: **"I'll start that exercise program next week, I promise!** But it never happens. So do not make the same mistake with your investments!

We at BFM understand investors look beyond financial advice and we are here to give you a whole new investment experience!

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