IMPROVING INVESTOR BEHAVIOR

FIVE COMMON MISTAKES

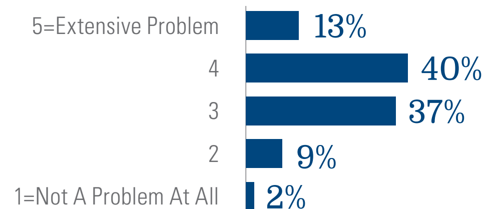
From anchoring to overreaction, why behavioral finance mistakes matter—and how you can help your clients address them.

We like to think of ourselves as rational people, but our actions often indicate otherwise. Despite education, training, and experience, investors still make financial decisions that go against their best interests. Fortunately, academics, psychologists, and other experts have spent the past few decades exploring these issues, resulting in the emerging field of behavioral finance. But despite its growing popularity, it's still relatively underutilized by many financial professionals: Only 40% of advisors say they have an excellent or very good understanding of the field, and roughly 20% of advisors admit to having little knowledge of behavioral finance issues, according to a recent survey by LPL Financial and WealthManagement.com.[1]

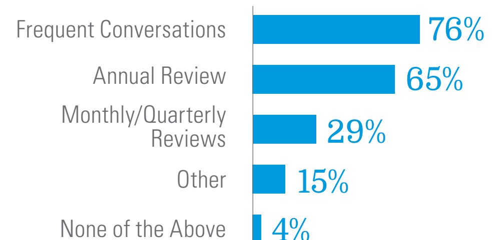
That lack of knowledge does both clients and advisors a disservice. "The more we understand about how people make decisions, the better we can understand ourselves and our clients," said Matt Taddei, president and co-founder of Taddei, Ludwig & Associates, an independent wealth management firm in San Rafael, California.

Advisors can learn more about emotionally motivated errors because clients tend to make the same behavioral mistakes again and again. We've selected five of the most common mistakes clients are likely to make and offer illustrations of how these mistakes manifest themselves in real-life situations. With a stronger understanding of behavioral finance, advisors will be in a better position to equip their clients with the tools and strategies that enable them to avoid these mistakes. For each common mistake, we offer advisors concrete and actionable advice to help their clients change their behavior.

How big of a problem do you consider behavioral finance issues?



How do you educate your clients so they can make sound financial decisions?



Source: "Behavioral Finance Study," a survey of 230 advisors, LPL Financial/WealthManagement.com, Sept. 23, 2014.

[1] "Behavioral Finance Study," a survey of 230 financial advisors, LPL Financial/WealthManagement.com, Sept. 23, 2014.

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1. Overreaction/availability bias

What is it? In financial terms, overreaction is the tendency to react in the right direction—but excessively so. Example: An investor who pulls all of their money out of the stock market at the first sign of bad news. "It's like the investing equivalent of a person who gets upset by a small thing and loses their temper completely," said Hersh Shefrin, a professor of finance at Santa Clara University's Leavey School of Business and author of *Beyond Greed and Fear: Understanding Behavioral Finance and the Psychology of Investing.*

Overreaction is often related to availability bias, which is the habit of overweighting easily available information. Taddei said it can be something as small as a client seeing a dip in the account balance on their monthly statement. "If the client is prone to overreaction, something small like that can cause them to question their entire investment strategy," he said.

Availability bias makes the situation worse, since the client will likely put too much weight on information that's new or easily available, rather than taking a step back and looking at the bigger picture. "Both of these biases tend to lead to mispricing in the market," Shefrin pointed out. "People assume that stocks that have done really well will continue to do so for a long time, and vice versa."

What can I do? To counteract these potentially damaging biases, remember the situation is one in which the client has information that's correct but incomplete. "In these cases, your job is to add in the missing pieces," Shefrin said.

Start by acknowledging what the client is getting right and avoid focusing on what's wrong. If they feel shot down, they're less likely to listen. Instead, your priority should be making them feel receptive to—but not overwhelmed by— additional data. Validate their instinct to react in the correct direction and then flesh out the picture by providing additional information. This puts everything into a larger context, which can help mitigate the tendency to react too strongly.

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> — *Matt Taddei, president and co-founder of Taddei, Ludwig & Associates*

2. Focusing on short-term performance

What is it? Your clients likely came to you for a financial plan to help them meet their long-term goals. But that long-term focus doesn't necessarily mean they aren't also looking at short-term performance. That's because human beings tend to overweight the importance of whatever's going on *right now.* Simply put, we're wired to be short-term thinkers, and overcoming that tendency is a difficult—but not impossible—task.

When it comes to investing, clients may feel the pain of a loss in the moment more acutely than they'll appreciate a gain over time. That's not surprising, as Shefrin said, "When you lose, it hurts today." Of course, common sense reminds us financial markets tend to reward patience. But it can be hard for clients to truly believe in a reward that's years in the future.

This behavioral bias is compounded by the fact our media consumption now means we're bombarded with messages about short-term developments in the financial markets. "News spreads through the Internet so quickly, it feels like things can turn on

a dime," said Paul Mann, an advisor with Gilbert, Arizona-based Empire Wealth Management. "Clients come to you in a panic about something they just read, feeling as though they need to take immediate action or they'll lose out."

What can I do? If the client is thinking short-term, the advisor's job is to get them back in a long-term frame of mind. That job is easier if you've already worked with the client to build a comprehensive financial plan. "Bring it back to the financial plan, which is the foundation for everything else," Taddei recommended. Ask clients if their long-term goals or time horizon have changed. If not, remind them of the reasons they're allocated the way they are.

Some advisors feel inclined to throw data at clients who are nervous about short-term losses, assuming charts and spreadsheets will help broaden their focus. In reality, a face-to-face expression of reassurance is much more likely to be effective than a binder full of charts. "It's like when you're on a flight and you get nervous because there's some sudden turbulence," Taddei said. "When the pilot comes on and tells you that he's got it under control, it's immensely reassuring just to hear his voice. It's the same thing with advisors and clients. Seeing you and hearing you renews their trust in you, and helps them remember that you've got the situation in hand."

Storytelling is another effective tool for assuaging clients' anxieties about short-term performance. Shefrin recommends advisors use anecdotes—even if they're hypothetical. For example, an advisor may tell a story about how an investor overcame a temporary downturn by sticking with their long-term investing strategy and not making short-sighted changes. "Stories are much more likely to be remembered than facts or statistics," he said. "You want to make sure you're giving the client something that will stay in their mind long after the meeting is over."

FOCUS ON THE INVESTOR

Which of your clients are most vulnerable to common behavioral mistakes?

In our survey[2] of more than 200 advisors, we discovered some clients are more likely to fall into common behavioral traps—whether anchoring or following the herd. Here's what we found:

Older clients (41%) are more likely than younger clients (12%) to make **anchoring** mistakes.

Middle-aged clients are most likely to **follow the herd** when it comes to making investment decisions.

Men (47%) are more likely than women (9%) to make mistakes based on **overconfidence**.

Less affluent clients (30%) are more likely than wealthy clients (12%) to act on **incomplete information**.

[2] Source: "Behavioral Finance Study," a survey of 230 financial advisors LPL Financial/WealthManagement.com, Sept. 23, 2014.

3. Following the herd

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What is it? Warren Buffet made his billions by blazing his own trail. And while most investors would like to follow the same path as the Oracle of Omaha, the truth is the average investor is more likely to simply follow other investors. If there's a sudden rush into high-flying tech stocks, then an investor with herd habits is going to want to follow suit—even if those stocks are clearly overpriced. That's what happened in the late '90s and early 2000s, as the dot-com bubble expanded and eventually popped when it became clear many firms' high stock prices weren't supported by solid fundamentals.

Herd behavior can lead to all sorts of unfortunate consequences, most disastrously when an investor buys when the market is high and then sells in a panic when things start to go the other direction. Paul Mann recalls a client who came to his firm after suffering major losses in the Great Recession. The client had held fast and rode the tanking market all the way down. But he panicked and ended up selling it all off within a week of when the market bottomed out. "By following the herd, he locked in his losses," Mann said.

What can I do? People follow the herd because going along with everyone else gives them a sense of security—even if, in reality, herd behavior is exactly the opposite of safe investing. In order to counteract the behavior, advisors have to address its root cause and find another way to make clients feel safe in their investments.

For example, a client might be afraid to buck trends because they don't want to appear foolish or left out. Point that out to the client, and also show them the results of past investment trends—whether tech stocks or the housing bubble—that didn't always pan out for investors.

Meanwhile, Aaron Brask, founder of Jupiter, Florida-based wealth management firm Aaron Brask Capital, has found that clients respond well to analogies from other areas of their lives. "Remind them that it's not just a question of whether it's a good stock to own but also if it's valued correctly," he said. "You'd never buy a car or a house without asking yourself that second question, but often with stocks people behave as though the price doesn't matter."

4. Confirmation bias

What is it? When you have a strongly held belief, it's easy to see validation everywhere. This habit of noticing information that affirms your beliefs and opinions while also ignoring or denying contradictory information is known as confirmation bias. It's powerful in part because it's reassuring: "Once you're comfortable with an idea, you feel better when you hear information that tells you you're right," Shefrin explained.

While confirmation bias plays a role in everything from politics to medical diagnosis, it can be especially damaging when it comes to making financial decisions. That's because people in the grips of confirmation bias truly believe that they're making an informed decision—and they don't realize the information they're basing their choices on has been skewed by their own preconceptions. For example, a client who's

particularly convinced that a certain investment is a good buy will pay attention to the facts that support such a belief (such as strong recent performance) while glossing over other information (such as a high price-to-earnings ratio).

What can I do? This behavior is one of the hardest to break, in part because most people don't even realize they're doing it. "People tend to be more stubborn and close-minded than they think they are," Shefrin said.

As with overreaction, the advisor needs to find a way to affirm what's correct about the client's beliefs while also providing additional information that gives a more complete picture. However, you're not likely to get good results by just telling a client she's wrong. If a client is deadset on a particular point of view, try asking her to engage in a bit of play-acting: Pretend you're in a debate, and ask her to take the opposing side. You can even give the client homework, asking her to research the position contradicting the belief she currently holds. Even if doing so doesn't change her thinking completely, it will still encourage her to be a bit more objective in evaluating new information.

5. Anchoring

What is it? Just as we interpret information through the lens of our prior experiences and beliefs, people also have a tendency to base their decision-making on individual numbers, such as a stock price. This is called anchoring. For example, when investors fall prey to anchoring, they may decide that a stock "should" attain a certain price before they'll consider selling it. Anchoring is especially common when people are dealing with concepts they find confusing. Settling on a reference point makes them feel comfortable and secure, even if it may actually cause harm in the long term.

These benchmarks are often arbitrary in nature and can result in investors making decisions that work against their own best interest—for example, holding on to a tanking stock for longer than they would otherwise. "Think of it as a weight that pulls your judgment in a particular direction," Shefrin explained.

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LPL knows continuing education is a critical way for advisors to deliver the best possible service to their clients. That's why we work to foster an environment promoting high-quality continuing education programs for advisors. Whether it's learning about specialized financial products or understanding new teachings about the psychology of investing, continuing education is a powerful tool for advisors.

That focus on education can also help strengthen relationships between advisors and their clients.

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Anchoring can work in the opposite direction, too, such as when some investors dealing with the 2008 recession had a difficult time believing the outlook would be much better five years down the road. Some of those investors pulled out of the market entirely, in part because they'd anchored to a reference point that made them feel as though things would never improve. By doing so, they missed out on the significant market rally of the past few years.

What can I do? As with many of the biases discussed here, the best way to counteract anchoring is to point out it's happening. If a client is fixated on a particular benchmark—say, refusing to sell an investment property until she can recoup the $350,000 they originally paid for it—call their attention to that fact. Then encourage them to stretch a bit outside their comfort zone, perhaps by asking if they'd be comfortable selling at $340,000 or $330,000 instead. Ask the client to consider the opportunity cost of waiting until the property hits $350,000. If they sold now for, say, $330,000 and put that money to work in their portfolio, there's a chance the value of that asset could far exceed the $350,000 for which the client was originally holding out.

When faced with clients who are holding on to a stock too long due to anchoring, Taddei has found success using a simple thought experiment. "I ask them, if you didn't already own this, would you buy it today at its current price? Often they'll say no," he said. Reframing the conversation to be about the future rather than the past can help clients move away from basing decisions on past performance rather than current realities.

"Meeting regularly with clients, sending out newsletters, hosting client events—all these things help affirm your experience and expertise."

— Paul Mann, advisor with Empire Wealth Management

The bottom line

While we may never be able to eliminate our emotionally-driven tendencies to make decisions against our best interest, gaining a better understanding of behavioral finance can go a long way toward mitigating their negative effects.

Advisors should reach out proactively if they notice clients exhibiting any of these behaviors. Doing so can help prevent crises—and even strengthen an advisor's relationship with their clients. After all, those relationships are the best weapon in the fight against behavioral errors. "Building trust with clients can go a long way toward combating any of these biases," Mann said. "Meeting regularly with clients, sending out newsletters, hosting client events—all these things help affirm your experience and expertise. That way when a client has a moment of fear and anxiety where they might succumb to one of these biases, you can help override those negative emotions." ■

This material was prepared by WealthManagement.com.

LPL Financial, WealthManagement.com, Taddei, Ludwig & Associates, Santa Clara University, and Empire Wealth Management are not affiliated entities.

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