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Annuities

Behavioral financial advice

The backbone of financial planning

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Behavioral financial advice: the backbone of financial planning

If the pandemic has taught us anything, it's that preparing for the certainty of uncertainty is more than a sound financial planning strategy: it's essential. One of the best ways for financial professionals to prepare their clients for the certainty of uncertainty is through behavioral financial advice.

While most financial professionals function as money managers for their clients, enhancing technical financial expertise with behavioral financial advice positions a financial professional as a trusted resource who meets the needs of today's investor. By applying the concepts of behavioral advice, financial professionals can deepen relationships with clients, deliver more values-based financial and professional advice, and shift the focus from products to the most important factor in portfolio growth — the spending and saving behavior of their clients.

Behavioral financial advice does not replace financial planning

It simply increases the effectiveness of the financial plan by improving decision-making behavior, especially under pressure. Through the integration of traditional financial theories, psychology and neuroscience, behavioral financial advice provides a holistic and stable approach to building and maintaining wealth, one that helps both financial professionals and clients mitigate biases and intervene on irrational behaviors — often stimulated by extreme emotions — that can hijack the performance of a financial plan.

Underperforming financial plans are more common than you might expect.

Based on data from the 2023 DALBAR report, average equity fund investors have underperformed their indexes across time horizons ranging from one to 30 years, by varying margins — some quite significant.[1] While the degree of underperformance varies, investors fall short with remarkable consistency. And the only explanation for this consistent underperformance? Bad investor behavior — people buying and selling at the wrong time.

It's easy to imagine how unchecked emotions can derail a wise financial plan, or any plan for that matter. However, less obvious are the biases that also undermine investor decision making. Biases are irrational assumptions or beliefs that warp the ability to rely on facts and evidence. In addition, when a bias is activated, people have a tendency to ignore any evidence that does not validate their assumptions. This means when a bias is driving a particular decision, it can be challenging to persuade an investor to consider alternatives even when well-researched facts discredit the bias.

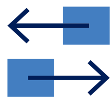
For financial professionals to intervene and try to overcome a bias, they need to better understand client biases.

Biases can be categorized as cognitive or emotional based on whether they relate more to errors in memory, information processing and reasoning (cognitive) or fear, greed and social influences (emotional). Some common biases that influence investor behavior include anchoring, hindsight and confirmation bias on the cognitive side, and loss aversion, overconfidence, and herding mentality on the emotional side.[2] It's not hard to see how these reasoning and processing errors, as well as emotional drivers, can lead investors to chase trends or buy and sell at inopportune times.

Common biases that impact investing decisions:

Cognitive biases

Anchoring bias can lead an investor to base decisions too heavily on just one piece of initial information and disregard important details.

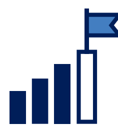


Hindsight bias can make past events appear to have been more predictable than they actually were. This can stoke client overconfidence in their ability to predict future market performance.

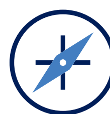
Confirmation bias leads investors to look for information that supports their pre-existing views — and disregard evidence that contradicts their position.

Emotional biases

Loss aversion is the tendency of an investor to fear losses more than they value potential gains. It can spur investors to sell winning investments early to avoid even the slightest risk of future loss.



Overconfidence can lead clients to overestimate their own expertise and predictive abilities, which can incite excessive trading or risk-taking beyond what may be prudent.



Herding mentality is a tendency to follow trends and investing fads based solely on the actions of others. It can cause a client to disregard their own knowledge, values and investing goals.

By understanding the biases and emotions that compromise an investor's decision-making ability, financial professionals are better equipped to offer clients behavioral techniques that support rational decision making. One such tool for calming emotional reactions and illuminating cognitive biases is the "Four Rs" named for the four elements of process: recognize, reflect, reframe and respond. Using this four-step technique helps individuals interrupt autopilot reactions that arise from emotional or cognitive triggers and actively choose a thoughtful response. **Both financial professionals and clients will benefit from using the Four Rs on a regular basis.**

Using the Four Rs for rational decision making

Recognize

Freeze. Stop what you're doing to ask yourself: "In this moment, how am I feeling? What am I thinking? What am I doing?" This exercise promotes a present-moment awareness of self. By taking a reality check like this several times throughout the day, you can recognize how your feelings and thoughts are directing your actions on a moment-by-moment basis. Frequent use of this first step will help increase self-awareness.

Reframe

As the reflection process activates the prefrontal cortex — the logical part of your brain — you begin to reframe your situation and account for any biases or unhelpful emotions. The brain then evaluates the advantages and disadvantages of different responses in relation to your values and goals. After weighing options and tradeoffs, you are ready to make a decision.

Reflect

After recognizing your cognitive, emotional and physical state, stop and reflect. View your present situation from 50,000 feet. As you reflect on the bigger picture — your values and your goals along with possible cognitive biases — you begin to calm down and think more clearly. Reflection provides the clarity and perspective needed for reframing.

Respond

With a cooler head and your options evaluated, you are ready to respond. Using the Four Rs empowers you (and your clients) to choose a response or make a decision that's consistent with your goals, values and beliefs, while avoiding emotional or bias-based reactions that frequently result in negative consequences.

The Four Rs technique is just one of many behavioral financial advice tools and strategies that financial professionals can leverage to help clients prepare for the certainty of uncertainty. The **Values Card Exercise** is another. Values Cards provide an interactive way to explore and identify what matters most. By sorting through 52 different values, financial professionals and clients are prompted to define their top five values. Once values are clarified, they provide the north star for decision making and goal setting — they are the behavioral financial advice backbone to support the financial planning process.

To assist your clients in determining their values, try our digital Values Card Exercise on our website: **www.smartriskcontrol.com/reveal-client-core-values**

[1] DALBAR, Inc., 2023 Quantitative Analysis of Investor Behavior Report, 2023.
[2] Corporate Finance Institute, Behavioral Finance, June 13, 2023.

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