# 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 advisors to prepare their clients for the certainty of uncertainty is through behavioral financial advice.

While most advisors function as money managers for their clients, enhancing technical financial expertise with behavioral financial advice positions an advisor as a trusted resource who meets the needs of today's investor. By applying the concepts of behavioral advice, advisors 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 advisors 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 26th annual DALBAR report, average equity fund investors have underperformed their index by a significant margin for 25 years in a row.[1] It's not just on a 20-year basis. It's on a one-year, a three-year, a five-year, a 10-year, a 20-year, and a 30-year basis. So the consistency and the degree of underperformance are significant. 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 advisors to intervene and try to overcome a bias, they need to better understand client biases. According to the BeFi Barometer 2020, the second edition of the survey commissioned by Charles Schwab Investment Management, Inc. (CSIM) in collaboration with the Investments & Wealth Institute and Cerulli Associates, the five most prominent behavioral biases among clients are recency bias, loss aversion, familiarity/home bias, framing, and mental accounting.[2] Following is a brief explanation of each.

## Common biases that impact investing decisions:

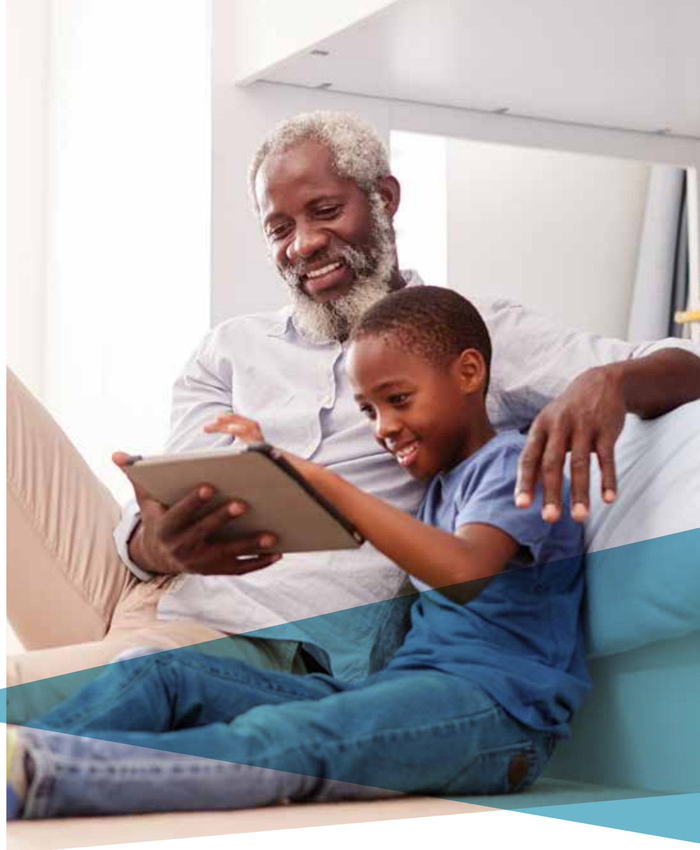
**RECENCY BIAS** is the tendency to be easily influenced by recent news, events, or experiences. It can cause investors to chase trends or buy/sell at inopportune times.

**LOSS AVERSION** is the preference for avoiding losses more than achieving equivalent gains, often causing investors to accept less risk than prudent.

**FAMILIARITY/HOME BIAS** is the tendency to prefer familiar or well-known investments, such as the investor's employer and domestic companies, over lesser-known and international securities. This bias can leave an investor's portfolio lacking diversification.

**FRAMING** means that how a situation or idea is framed influences how it is perceived. People tend to be risk averse when a problem is presented as a gain and risk seeking when the same problem is framed as a loss.

**MENTAL ACCOUNTING** is the set of cognitive operations used by individuals and households to organize, evaluate, and keep track of financial activities.



By understanding the biases and emotions that compromise an investor's decision-making ability, advisors 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 advisors and clients will benefit from using the Four Rs on a regular basis.**

## USING THE FOUR Rs FOR RATIONAL DECISION MAKING

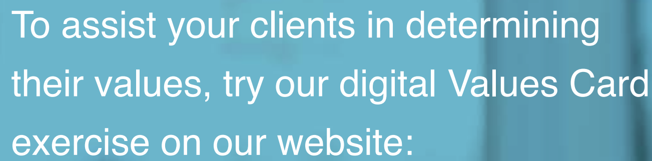
**RECOGNIZE.** Freeze. Stop what you're doing to ask yourself: "In this moment, how am I feeling? What am I thinking? What am I doing?" This exercise promotes a present-moment awareness of self. By taking a reality check like this several times throughout the day, you can recognize how your feelings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

**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.

**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.

**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 advisors 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, advisors 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:
**smartriskcontrol.com/reveal-client-core-values**

SOURCES:
[1]DALBAR, Inc., *Quantitative Analysis of Investor Behavior*, 2020.
[2]Cerulli Associates, *BeFi Barometer 2020*.

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