

# What is Behavioral Finance, Really?



Why do even experienced investors mistakenly neglect careful risk management, invest in unsound financial business models, and buy too late and sell too soon? The answer is simple: Investors are human.

We aren't always rational, we have limits to our self-control and are affected by our culture, emotions, social norms, the media, and cognitive factors. The attempt to understand our complex nature and how it influences financial decision making is at the core of behavioral finance.

## **Behavioral Finance History**

Although using behavioral factors to explain individual and collective choice was not new in the 1980s, the work of psychologists Daniel Kahneman and Amos Tversky, and economists Robert J. Shiller and Richard Thaler formalized the field of Behavioral Economics. The founders used experiments and research to, as Shiller wrote, “distance ourselves from the presumption that financial markets always work well and that price changes always reflect genuine information.”

## **How Advisors Can Help Mitigate Behavioral Biases**

Behavioral finance uses Behavioral Economics to try to reckon with deviations from rational behavior and expectations. Its purpose is to build on traditional rationality and in turn create a better understanding of financial behavior. Some common biases include:

- Mental accounting – the concept that people treat money differently based on where it came from and how they think it should be used
- Loss aversion – avoiding losses rather than seeking gains

- Overconfidence – the tendency to think we know or can control more than we actually do or can
- Anchoring bias – placing too much value on an initial piece of information
- Herd behavior – following others rather than making individual decisions based on financial data

Identifying and understanding a client's biases and emotions is key to creating a sophisticated and personal response to them. According to a Vanguard survey, the emotional value that an advisor creates through behavioral coaching makes up about 45% of the total perceived value of an advisor-client relationship.

This value will likely increase as we enter 2023 after a punishing year. We're facing factors including interest-rate tightening, recession fears and the Russia-Ukraine war. With so much uncertainty about the new year, long-term trends and norms are expected to shift. This presents an opportunity for advisors who understand behavioral finance biases to differentiate their services in today's competitive environment in ways that support and develop client-advisor relationships.

## **Behavioral Finance Techniques**

Based on the BeFi Barometer 2021 survey of over 300 financial advisors, behavioral biases are on the rise, but the study shows success in leveraging behavioral finance principles. Some of the most effective mitigation techniques include:

- **Taking a long-term view:** Remind clients of their investment goals and ensure they stay in lock-step with a sensible financial plan
- **Implementing goals-based planning:** Help clients expand and prioritize their goals and the plan to fund them, rather than a retirement-only plan
- **Integrating a systematic approach:** Auto Rebalancing along with goals-based planning help reduce emotional decision making

Advisors who incorporate behavioral finance key elements benefit from better outcomes, including:

- Deepened trust with clients and increased retention
- Keeping clients invested during periods of volatility

- Circumventing emotional decision making
- Improved financial decisions

While there are notable benefits to incorporating behavioral finance principles, many advisors have difficulty translating behavioral theory into practical application.

## **Behavioral Finance Tools**

Investment advisors can add significant value to their clients with solutions that combine best-in-class advisor tech with behavioral finance. The result is goals-based investing that accounts for a client's individual motivations and risk tolerance, while minimizing vulnerability to factors like market volatility. Aligning a client's mental accounts with asset allocation and their tendency towards ambition increases the likelihood of client satisfaction with their financial plan, and consequently their advisor.

Advisors can use Behavioral Finance tech to play to their greatest strength: creating enduring client relationships and better outcomes.

**Want to learn how you can provide incredible value to your clients through behavioral coaching and applied behavioral finance techniques? Start here with Orion's Chief Behavioral Officer, Dr. Daniel Crosby's, covering the drivers of human behavior and how to keep clients invested.**

0049-OAT-1/9/2023