Understanding

Behavioral Aspects of Financial Planning and Investing

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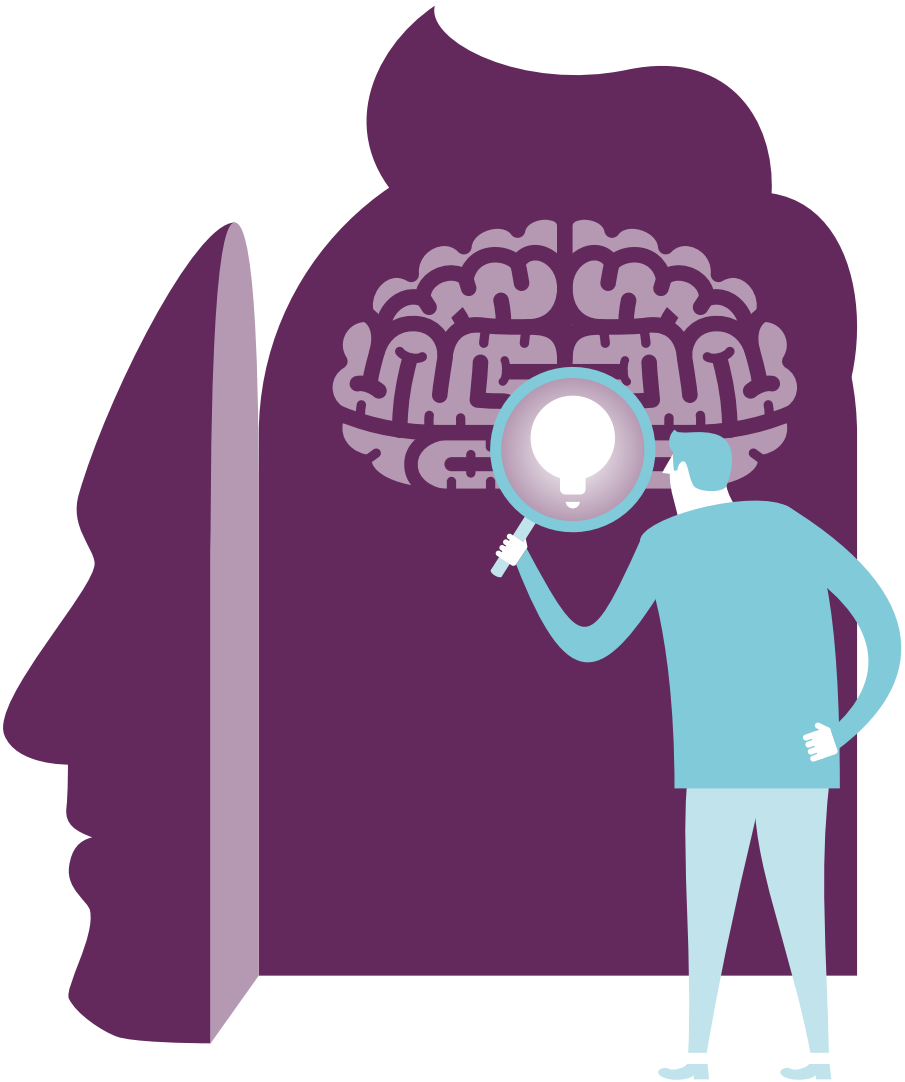

People often view financial planning and investing as overwhelming, intimidating, and scary, especially if they must tackle these tasks on their own. They are fearful of making costly mistakes that could influence both their present and future financial well-being. Their trepidation often stems from a lack of background, education, or experience to help them adequately cope with the financial side of living. In reality, the world of financial planning and investing can be highly complex and difficult. What should investors do?

Investors sometimes find themselves in a similar position as Alice in Lewis Carroll's *Alice's Adventures in Wonderland* who, when coming to a fork in the road, asks the Cheshire Cat:

> **Alice:** "Would you tell me, please, which way I ought to go from here?"
> **Cat:** "That depends a good deal on where you want to get to."
> **Alice:** "I don't much care where."
> **Cat:** "Then it doesn't matter which way you go."

Unlike Alice, investors should make decisions based on their goals and then determine the appropriate path to get

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there. As Altfest (2014) notes, advisers should assist individuals in developing a financial plan that incorporates a client's values, needs, and wants in order to reach their financial goals.

Assuming investors have well-defined goals, they can take one of two major paths to achieve them. One is to acquire the knowledge needed to do one's own financial planning and investing. According to Benjamin Franklin, "An investment in knowledge pays the best interest." Nothing is likely to pay off more than gaining a financial education and engaging in the necessary research, study, and analysis before making any investment decisions. Otherwise, the result could be regrettable investment decisions. As Finke and Huston (2014) conclude, "Financial literacy in the United States is surprisingly low, and certainly too low to expect that consumers can make effective financial decisions with many of the most complex product markets."

Another is to use the services of an investment professional such as a financial planner or adviser who already has the requisite knowledge, skills, and abilities to carry out these important tasks. Both options involve trade-offs, but each offers the potential for long-term success.

Successful financial planning and investing are much more than crunching numbers, listening to popular opinion, and understanding the latest market trends. As much as people need to know about financial markets and investments, they also need to know about themselves. A large part of investing involves investor behavior. Emotional processes, mental mistakes, and individual personality traits complicate investment decisions. As Ben Graham, the father of value investing, once noted: "Individuals who cannot master their emotions are ill-suited to profit from the investment process."

Despite this sage advice, investors often allow the greed and fear of others to affect their decisions and react with blind emotion instead of calculated reason. In fact, emotions can help explain asset pricing bubbles and related market behavior.[1] According to the old investment adage, investors can make money as a bull or a bear but not as a pig. In short, investors need to understand the psychology of financial planning and investing.

Investor behavior often deviates from logic and reason. From the financial planner's perspective, such factors increase the difficulty of comprehending clients' judgments. Yeske and Buie (2014) state that "Financial planning clients are as prone to behavioral bias as anyone and advisers must work to mitigate these tendencies." Consequently, appropriate financial planning policies can play a powerful role in keeping clients committed to a consistent and disciplined course of action and in avoiding such biases. Ignoring or failing to grasp this concept can have a detrimental influence on investment performance.

> "Investing isn't about beating others at their game. It's about controlling yourself at your own game."
>
> **—Jason Zweig**

Our purpose is to examine some behavioral aspects of financial planning and investing. We begin by differentiating between traditional or standard finance and behavioral finance and stressing the importance of understanding investor psychology. We then focus on how behavioral biases, emotions, and systematic cognitive errors can affect investment decisions. We conclude with a few observations about how understanding investor behavior can help improve decision-making processes.

Traditional and Behavioral Finance

Standard or traditional finance assumes that participants, institutions, and markets are rational and that people make unbiased decisions and maximize their self-interests. The rationality of market participants led to such classic theories of standard finance as the efficient market hypothesis (EMH) and the capital asset pricing model (CAPM). Although traditional paradigms can be useful in many applications, empirical evidence contradicting traditional finance models began to mount. Despite assumptions to the contrary, people exhibit behavioral biases that influence their investment decisions. Studies document long-term historical phenomena in securities markets that contradict the EMH and cannot be captured plausibly in models based on perfect investor rationality such as the CAPM.[2] Thus, behavioral finance theorists started to incorporate what they had learned from the social sciences into models of financial behavior.

Behavioral finance proposes psychology-based theories to explain market inefficiencies or anomalies and other results that are inconsistent with traditional finance. In many instances, behavioral finance models not only explain the current financial conditions better than does the EMH, but also generate new empirical predictions. An assumption in behavioral finance is that the information structure and the characteristics of market participants systematically influence both individuals' investment decisions and market outcomes. As Baker and Nofsinger (2010) note, the traditional finance paradigm is appealing from a market-level perspective, but it places an unrealistic burden on human behavior. Real people are not totally rational or irrational when making investment and other financial decisions. As Charles Ellis, a leading American investment consultant, once quipped: "Las Vegas is busy every day, so we know that not everyone is rational."

Traditionalists initially rejected this new paradigm because it was too complex and incapable of refutation. The mounting evidence that many of the standard

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assumptions of traditional theoretical finance models are unrealistic and require modification contributed to the growing acceptance of behavioral finance. Over time, behavioral finance has become part of the fabric of finance. The observed persistent deviations from theoretical prediction provide useful information about how and why people make decisions. As Ackert (2014) notes, "Observation of actual behavior informs the development of good theory." Today, few accept the notion that markets are always efficient or that people are always rational in making investment decisions.[3]

Role of Financial Planners and Advisers

Many financial planners and advisers now incorporate the insights gained from behavioral finance in working with their clients. They are becoming increasingly aware that personality traits, demographic and socioeconomic factors, household characteristics, cognitive and emotional biases, and even religion can affect financial and investing decisions.[4]

Being an effective financial planner or adviser requires understanding investor psychology. Sometimes facts and figures are no match for human emotions. As Fisher (2014) notes, "One of the greatest services a financial adviser can provide to clients is helping to ensure that in times of market turbulence, reason, discipline, and objectivity triumph over emotions such as fear, greed, and regret."

Fisher (2014) offers several key strategies advisers can use to help the behavioral investor. First, advisers need to know each client's investing and risk-taking history. Understanding the client's past experience can provide clues about the investor's risk tolerance. Second, advisers should lay the groundwork during calm times. That is, advisers should discuss what individual investing strategies should be followed in the event of turbulent markets. This imposes a disciplined approach instead of an emotional reaction if that situation presents itself. Third, advisers should support what they are recommending with facts and evidence instead of merely stating their opinions and beliefs. Fourth, when logic and facts do not prevail over investor emotions, advisers should draw on past experiences from dealing with other investors with similar fact patterns. Finally, advisers with discretion over an individual's account should act in the client's best interests.

How Investor Behavior Affects Investment Decisions

Individuals reveal many biases. Few of these psychological traits occur in isolation because these different biases often interact. The following list represents some widespread biases investors exhibit. Understanding how these behavioral finance issues apply to investor behavior can provide planners and advisers with additional knowledge to help their clients make better judgments and decisions.

Heuristics. Heuristics are simple and general rules of thumb that individuals employ to solve a specific category of options under conditions that involve a high degree of risk-taking behavior and uncertainty. Heuristics are a "cognitive instrument" for reducing the time and effort of the decision-making process for individual investors or investment professionals. Although this type of mental process sometimes leads to satisfactory decisions, heuristic perceptions often result in mental mistakes.

For instance, if planners use a heuristic that female investors are less risk tolerant than their male counterparts, they may suggest more conservative portfolios. Because every female client does not fit this stereotype, applying such a heuristic could result in bad financial decisions. Researchers suggest that many of these heuristics can lead to serious miscalculations, inaccurate categorizations of investors, and bad investment advice (Grable 2008).

Disposition effect. This bias refers to the inclination of selling stocks that have appreciated in value since the original purchase ("winners") too early and holding on to losing stocks ("losers") too long. This effect is harmful to clients because it can increase the capital gains taxes that individuals incur and can reduce returns even before taxes. Planners should advise clients to reduce their losses and let profits grow as part of a long-term investment strategy. This enables clients to engage in disciplined investment management that can produce higher returns.

Mental accounting. Mental accounting is a cognitive process in which individuals separate their financial assets and liabilities into different groupings or mental accounts. For example, if an investor has a negative total return for the year on a common stock, he or she will use a cognitive decision-making process that focuses on the optimistic aspects of the investment such as a high dividend yield by placing it into a positive mental account. To overcome this bias, planners should advise their clients to view investments based on the content of a diversified portfolio.

Mental accounting also has its benefits during the financial planning process. Yeske and Buie (2014) recommend that certain investment accounts be treated as "buckets" such as retirement funds and college savings for children. If clients treat these accounts as long-term investments that should not be disturbed, they are more likely to reach their financial goals.

Overconfidence versus status quo bias. Some individuals experience overconfident behavior resulting in over trading, higher expenses, and lower returns in their portfolios. By contrast, some retirees suffer from status quo bias or inertia and under-manage their accounts. A compromise would be to create a solid approach between these two biases based on the proper risk tolerance profile, a diversified asset allocation strategy of mutual funds, exchange-traded funds and other investments, and yearly portfolio rebalancing.

Trust and control. As Howard and

Yazdipour (2014) note, trust is an essential factor within retirement planning and investment management. An important aspect of this process is establishing a balance between trust and control in the client-adviser relationship. Clients who place too much trust in financial planners or overly delegate control about investment decisions can suffer. The Bernie Madoff scandal is a major case study. Yet, clients who have a lack of trust or are overly controlling are unlikely to listen to the advice of a financial expert. Investment professionals need to work with clients to develop a balanced relationship of trust and control about the financial planning process.

Self-control bias and framing. Individuals often lack self-control and prefer spending money today instead of investing for the future such as savings for retirement with an annuity. The high level of credit card debt and the generally inadequate level of retirement savings that many individuals face provide support for this self-control bias. If financial planners simply describe annuities in the context of an equal amount of money in retirement age such as $1,000 per month, clients are less likely to make the investment. To overcome this behavior, planners should "reframe" the issue. In this context, the issue of framing is how planners present a financial product or service to a client based on the correct word association. For instance, advisers could frame the annuity decision to the client as a resource of funds they can spend in retirement age such as $1,000 per month for purchasing a new car. When the investing decision is linked to a future spending activity, this dramatically increases the likelihood that the client will invest in the annuity.

Familiarity bias, risk, and return. Individuals often prefer to invest in familiar assets. This can result in under-diversification in their investment portfolios. For example, people have a tendency to invest in local securities with which they are more familiar (local bias) and portfolios overweighted in domestic assets (home bias). Investors also perceive these familiar assets as less risky and generating a higher return.[5] As a result, they have sub-optimal portfolios. To overcome this situation, planners should communicate to clients the need to have an ample long-term diversification strategy in order to achieve enough risk reduction and expected return in their portfolios.

Worry. For many investors, the role of worrying is an ordinary and widespread experience. Worry educes past memories and visions of future events that alter short-term and long-term decisions about personal finances.[6] For example, Ricciardi (2011) reports that a large majority of individuals associate the term "worry" with stocks (for 70 percent of the sample) over bonds (for 10 percent of the sample). A higher degree of worry for a security such as a stock increases its perceived risk, lowers the degree of risk tolerance among clients, and increases the likelihood of not engaging in the investment. To avoid this bias, planners should match a client's level of risk tolerance with a pre-determined asset allocation strategy. Planners should apply a simple experiment by communicating to clients that if they lose sleep because of anxiety or worry about their common stocks, they probably should own more conservative securities and therefore hold a less risky investment portfolio.

Risk-taking behavior and the anchoring effect. An essential aspect of the investment decision-making process is to understand a client's level of risk perception and risk tolerance. Risk perception incorporates various objective and subjective factors that affect how individuals make judgments about financial products and investment services. Risk tolerance is the degree of risk that a person is willing to accept in the pursuit of an investment objective or the maximum amount of loss an individual is willing to endure when making a financial judgment. Anchoring is the inclination of clients to have a viewpoint and then apply it as a reference point for assessing future decisions.

Investors often base their judgment on the first piece of information to which they are exposed (e.g., an initial purchase price of a security) and thus find modifying or changing their assessment to new information difficult. Because many individuals still anchor on the financial crisis of 2007–2008[7] as a bad experience, they can become excessively risk-averse and loss-averse. This results in a higher degree of worry, leading them to underweight equities in their portfolios (Ricciardi 2012). To avoid this risk-taking bias and anchoring effect, financial planners can assist clients by assessing their level of risk tolerance and emotional reactions of perceived risk for a wide variety of securities or investments. Advisers should communicate to clients the importance of not focusing their investment decisions on a specific reference point of information such as the financial crisis.

Concluding Observations

Understanding fundamental human tendencies can help financial planners and advisers recognize behaviors that may interfere with their clients achieving their long-term goals. People typically do not have investment problems; instead, investments have people problems.

Although individuals cannot prevent all behavioral biases, investment professionals can advise clients how to reduce their influence during the financial planning process. This requires gaining an understanding of the clients' psychological biases, resisting the inclination to engage in such investor behaviors, and establishing and implementing disciplined investment strategies and trading rules. An important strategy is to invest for the long-term, identify the client's level of risk tolerance and risk perception, determine an appropriate asset allocation strategy, and rebalance the client's portfolio on a yearly basis. ■

This article draws upon some themes and strategies in the authors' book Investor Behavior—The Psychology of Financial Planning and Investing. *2014. Hoboken, NJ: John Wiley & Sons.*

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Endnotes

1. Taffler and Tuckett (2010) discuss how emotions affect financial decisions.
2. Shleifer (2000) and Haugen (2002, 2004) provide evidence supporting inefficient markets.
3. Bloomfield (2010) and Ackert (2014) provide a detailed discussion of traditional and behavioral finance.
4. In *Investor Behavior—The Psychology of Financial Planning and Investing,* edited by H. Kent Baker and Victor Ricciardi, and published in 2014 by John Wiley & Sons, Fung and Durand discuss how personality traits affect decision-making (99–115); Farrell examines how demographic and socioeconomic factors influence investor behavior (117–134); Bogan describes the role of household investment decisions (83–98); and Mansour and Jlassl explain the effect of religion on financial and investing decisions (135–151).
5. Ricciardi (2008) describes the emerging topic of an inverse relationship between perceived risk and return.
6. In a survey of 265 financial advisers, MacGregor, Slovic, Berry, and Evensky (1999) report that 98 percent of an expert's risk perception is attributable to three major factors: worry, volatility, and knowledge.
7. Ricciardi and Rice (2014) provide an extensive discussion of the influence of the financial crisis on the risk-taking behavior of different categories of investors.

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