When Your Clients Are Working Against You.

Six pitfalls your clients may be susceptible to—
and how to overcome them.

Introduction

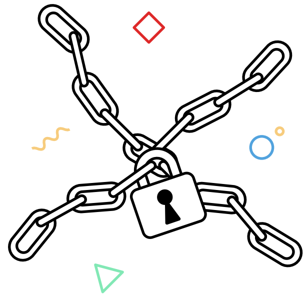
It would be great if clients always acted in wise, rational ways when it came to their money. But your own observations—and a good bit of economic and psychological research—show that when it comes to making decisions, our clients (and, let's be honest, the rest of us) are prone to misguided thinking and tripping over their emotions from time to time.

While these irrational behaviors might drive you batty when they appear, remember the inherent opportunity they present.

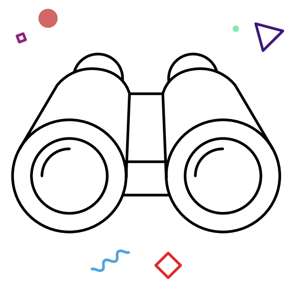
Part of what your clients come to you for is your coaching.

Sometimes it's strictly financial, and sometimes it's behavioral. But don't worry—no need for your clients to recline on the couch or for you to channel your inner Freud. We've provided solutions to help you set your clients on a more logical course without having to ask them, "And how did that make you feel?"

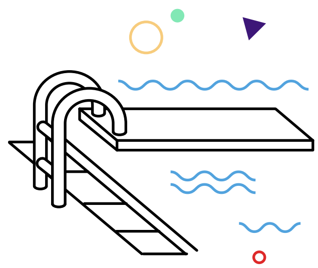
The Six Pitfalls



The Worrier

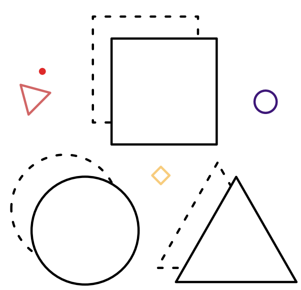


The Stalwart

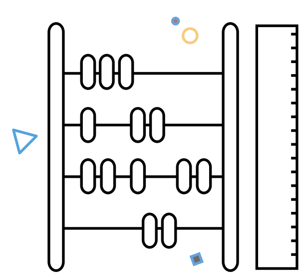


The Hesitator

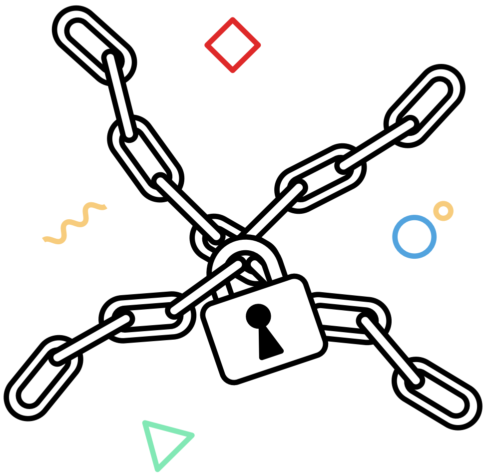
The Preservationist



The Familiar



The Mathematician



The Worrier

A CLIENT IS RELUCTANT TO INVEST IN STOCKS BECAUSE "THEY ALWAYS CRASH."

The world is complex and can easily tax our mental resources, so to keep things simple we come up with time- and cognition-saving rules of thumb, or *heuristics*. The **availability heuristic** is applied when people overestimate the frequency of events based on how easily they come to mind. For example, shark attacks—like stock market crashes, and unlike cows—are fear-inducing and well-publicized in the media. But cows kill more than three times as many people each year in the U.S.[1] as sharks kill worldwide.[2] Like cows, average market gains over long periods aren't as headline-grabbing as crashes—and not as salient in your clients' minds.

Cost to Clients

A client may avoid "riskier" asset classes such as equities and high-yield bonds that grab the spotlight in crashes and corrections, discounting that over the long haul, these assets are responsible for a significant amount of portfolio growth. Failure to invest in these more volatile assets could lead to longevity risk, where a client outlives his or her assets.

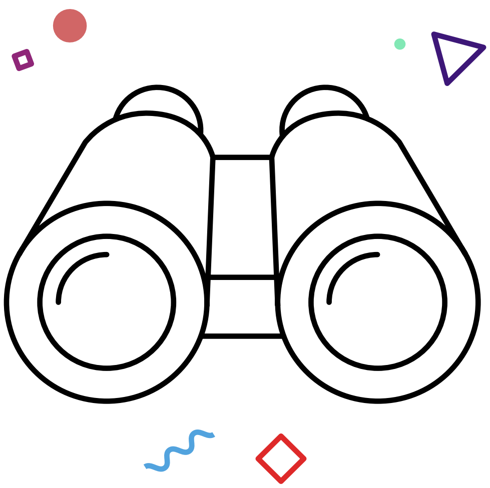
What You Can Do About It

Your clients may be more risk tolerant than they think they are, but are just focusing on the memorable stories instead of the less-memorable statistics. In other words, they may be afraid to swim in the ocean, but just fine strolling in the paddock. For example, a client may be hesitant to invest in equities, but shrug off a 20% dip in the market (a behavior many advisors saw at the end of 2018). Remind clients that the annual returns for the S&P 500 have been positive for 29 of the past 39 years, despite the average intra-year drop being 13.9%. Market dips and shark attacks are scary, but taken on average and over time, they won't ultimately affect you.

Et Tu, Bessie?

On average, cows kill about 20 people in the U.S. each year, whereas sharks kill about six people a year *worldwide*. You'll never go in the pasture again.

[1] Centers for Disease Control and Prevention, Morbidity and Mortality Weekly Report, July 31, 2009. 58(29);800-804.
[2] University of Florida International Shark Attack File. Retrieved from www.floridamuseum.ufl.edu/shark-attacks/yearly-worldwide-summary/ on 4/24/2019.



The Stalwart

A CLIENT DOES NOT WANT TO MAKE ANY CHANGES TO THEIR PORTFOLIO.

Change takes effort. It involves thinking through the implications and that can be time consuming and mentally taxing. For some clients, no decision is the easy decision and “staying the course” becomes the norm. Clients with this **status quo bias** are in good company: the reason so many 401(k) providers require a decision to opt out rather than opt in is they know people will simply not make a decision, no matter what the decision is. Add in a dose of regret avoidance, where clients are afraid of the consequence of making the wrong decision, and it’s easy to see why inaction is so prevalent.

Cost to Clients

Indecision and the resulting inaction can cause a client to avoid making a budget, changing their spending or saving habits, paying down debt, or making changes to their portfolio. If they don’t understand the opportunity costs associated with this inertial stance, they may be unable to consider the possibilities change can bring.

What You Can Do About It

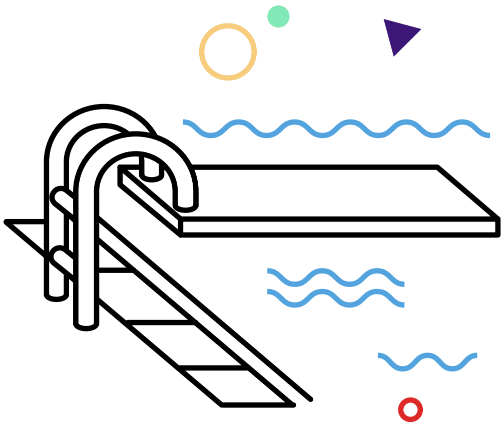
Your clients likely want a healthier portfolio or bank account, but may be suffering from information overload or uncertainty about the changes needed to get there. To get them over that hump, start with the positive, and don’t bog them down with details: “I’ve looked over your finances, and there are a few simple actions we can take to give you a healthier portfolio and help you save more of your income. Would you like to hear what they are?” The yes they give you (if they say no, there are bigger problems in play) is a little buy-in that will make them more amenable to what you have to say next, which might be, “Great! Let’s start with your portfolio. You have some holdings that are overvalued that we might want to sell. This can help us take advantage of better growth opportunities—sound good so far?” Each step gets them closer to the change they need to make.

Mind if I Work In (Some Psychology)?

Most people welcome positive change—it’s the transition they tend not to like. For instance, those of us who could stand to lose a few pounds might like the idea of having a more athletic physique, but not so much the hours at the gym necessary to achieve it.

Focusing on the end state first—and saving the details on how to get there for later, if at all—can help clients avoid **decision fatigue**. Working slowly through their options posing only questions that require yes or no answers can minimize **choice overload**, which is especially important for clients prone to decision fatigue.

The Hesitator



A CLIENT IS RELUCTANT TO SELL A SECURITY AT A LOSS EVEN THOUGH THERE ARE BETTER PROSPECTS.

People are more sensitive to losses than gains, and the pain associated with a loss is generally considered to be twice the magnitude of the pleasure associated with the same gain.[3] In other words, the pleasure your client feels when an investment gains a certain amount is only half as great as the pain they feel when it drops the same amount. This phenomenon is known as **loss aversion**, and it explains a plethora of human behavior, such as staying in a dead-end job or beating ourselves up over what we did wrong in a situation instead of realizing everything we did right.

Cost to Clients

Clients who hold on to a flagging stock are missing out on the potential returns gained by investing in securities with better prospects. But loss aversion can also drive the desire to sell a winning stock too soon, as clients may be inclined to take fewer gains now to avoid the risk of loss in the future. If unmitigated, loss aversion can have significant consequences to portfolio performance.

What You Can Do About It

Loss aversion is engrained in the human psyche, and overcoming it is no easy task. Start by letting your clients know that it's normal for declines to stir emotions, and that they are ahead of the game by choosing to work with a professional, as you can set up objective performance parameters that avoid emotion-driven choices. Then, establish an agreed-upon process to sell securities once a target is hit or once the original rationale for investing in them is no longer valid. Lastly, advise your clients to not monitor their investments too regularly—performance is smoothed out over time, and the peaks and valleys of daily (!), weekly, or even monthly monitoring can distort the reality of a long-term upward trend.

The Rat Pack in Vegas

Turns out that if rats were given a seat at the roulette table, they'd behave a lot like humans. Research from Stanford University[4] has shown that rats employ the same win-stay/lose-switch strategy people do when assessing risk. The furry subjects were more likely to make a risky choice if they saw success from an earlier gamble, and acted less riskily if that earlier gamble led to a loss. It's the same thinking that can cause clients who over-monitor their portfolio to make poor choices that lower long-term performance.

Sadly, the research did not involve diminutive decks of cards or tiny craps tables, but little slot machines may be in the offing: the rats were given set amounts of sugar water or, on random occasion, an even tastier treat after choosing among levers.

[3] A. Tversky, D. Kahneman. (1992). Advances in prospect theory: Cumulative representation of uncertainty. Journal of Risk and Uncertainty. 5, 297–323

[4] K.A. Zalocusky, et al. (2016) Nucleus accumbens D2R cells signal prior outcomes and control risky decision-making. Nature 531 (7596), 642.

The Preservationist

A CLIENT DOES NOT WANT TO SELL AN INHERITED SECURITY.

If you've ever tried to buy a used car and found that the owner was asking more than the car was objectively worth, you've experienced the **endowment effect**: people tend to value what they already own more than it's actually worth. Things can get more complicated if there's an emotional attachment to the item, such as when the car—or stock—is inherited from a deceased relative.

Cost to Clients

Clients who inherit securities may disrupt the thesis of their portfolio or its diversification with overconcentration in a particular asset or asset class. They may give that inherited portion of their portfolio greater emotional significance, seeing it more as a gift or memento than part of a larger tool designed to help them achieve their financial goals.

What You Can Do About It

The endowment effect is essentially a form of loss aversion with an added emotional twist. It may be hard for a client to surrender their grandfather's GE stock certificates because of their decline in value *and* because they were grandpa's *and* because they are now in your client's possession. These can be sizable psychological hurdles to overcome. Explaining the endowment effect to your clients can open up a conversation about why they find the security so meaningful. You may also inquire why they believe the decedent gifted them the stock in the first place: to treat like a family heirloom or to use to help them achieve their financial goals? A compromise might also do the trick: they can hold on to some stock or frame a stock certificate as a memento and use the rest to fund a more promising position.

You Tap and Swipe It, You…Own It?

Many studies demonstrating the endowment effect involve giving an object, like a coffee mug or chocolate bar, to a random subset of students and then asking those who received the item and those who did not to place a monetary value on it. In the coffee mug example, those who received it valued it at twice the price of those who did not.[5]

Subsequent studies have shown that shoppers who touch an object similarly feel a sense of ownership over it, and give it a higher value than those who merely look at it—but it doesn't stop there.[6]

A team of researchers at Boston University asked subjects to browse a website and select a sweatshirt they liked as if they were about to purchase it. One group used a mouse connected to a computer, another a trackpad and computer, and the third purchased the items via the touchscreen on an iPad. When asked how much they would be willing to sell the sweatshirts for, the iPad group priced them an average of 46% higher than the other two groups.[7]

So strong is the endowment effect, you don't even need to own the item or have it in your possession to act as if you do.

[5]Kahneman, D., Knetsch, J. L., and Thaler, R. H. (1990). Experimental tests of the endowment effect and the Coase theorem. Journal of Political Economy, 98(6), 1325-1348.
[6]J. Peck, J., and Shu, S.B. (October 2009). The effect of mere touch on perceived ownership. Journal of Consumer Research. Vol. 36, No. 3, pp. 434-447.
[7]Brasel, S., Gips. J. (April 2014). Tablets, touchscreens, and touchpads: How varying touch interfaces trigger psychological ownership and endowment. Journal of Consumer Psychology. Volume 24, Issue 2, pp. 226-233.

The Familiar

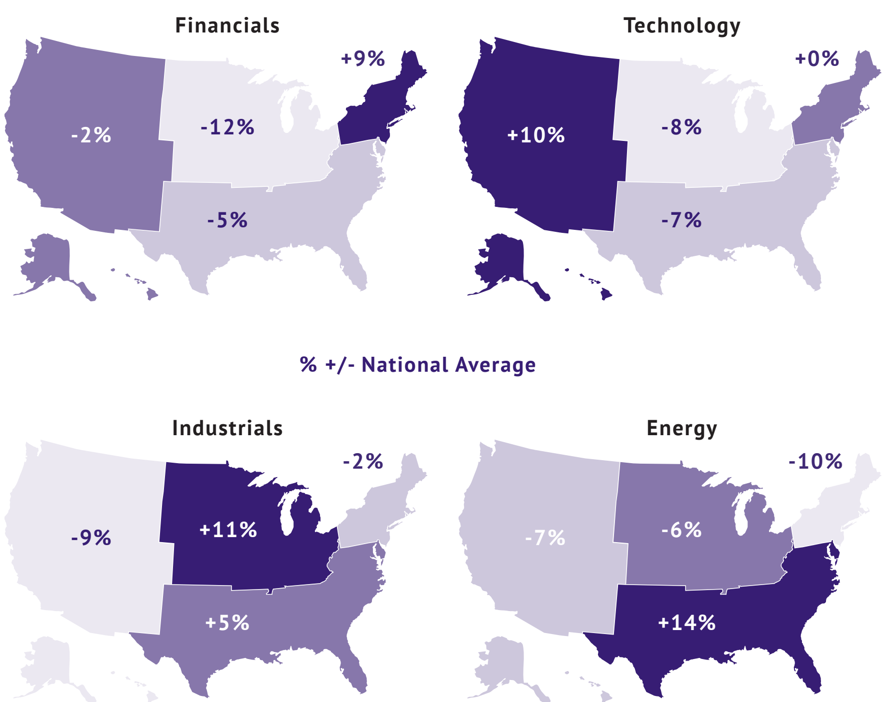
A CLIENT ONLY WANTS TO BE INVESTED IN U.S. SECURITIES OR SECTORS THEY ARE FAMILIAR WITH.

People tend to be drawn to the familiar, be it people, brands, or even investments. JPMorgan demonstrated this **familiarity bias** for securities in different regions of the country **[Figure 1]**. They found that people living on the West Coast (home to Silicon Valley, Amazon, and Microsoft) overweight the technology sector; people living in the oil-rich South, including Texas, opt for energy; people in the Northeast like financials; and people in the factory-laden Midwest prefer industrials.

Figure 1:

Investor allocation by region

Likelihood of owning stocks in an industry vs. national average



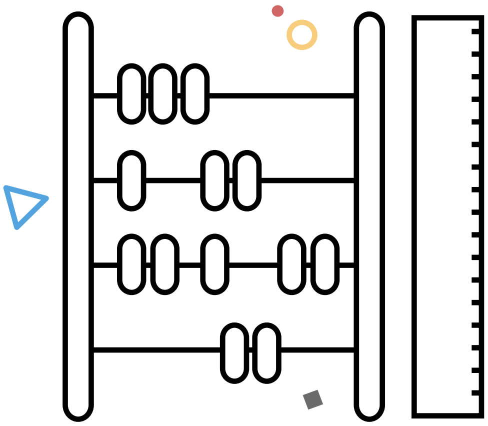
Source: JPMorgan Asset Management, Openfolio, Insight Simfund

Cost to Clients

When a client invests only in securities or industries they're familiar with, their portfolio can suffer from overweighting and lack of diversification. This can leave them susceptible to concentrated risks if that sector underperforms, and doubly expose them to that risk if they're employed in that industry as well—with even more dire results if the downturn causes them to lose their job.

What You Can Do About It

Cautioning clients to the dangers of putting all or too many of their proverbial eggs in one basket may be your best bet. Remind them that one of the values of working with a professional like yourself is your familiarity with a broad array of sectors, asset classes, markets, and securities—the goal of which is to help clients spread those eggs around to increase their likelihood of success. Lastly, inform them that their income stream is also an asset, and factors into their diversification targets: if their salary and portfolio are too-heavily positioned in the same sector, downturns can have an outsized effect on their ability to pursue their goals.



The Mathematician

A CLIENT HAS A LARGE BALANCE IN A CHECKING ACCOUNT, BUT ALSO CARRIES SIGNIFICANT DEBT.

People do all sorts of **mental accounting**, treating money differently based on its source or planned use. Despite one of the core values of money being its fungibility—it has the same value no matter where it is or comes from—many people simply find it easier to divide it up *mentally*, such as when treating found or gifted money as more frivolous than earned money, or *physically*, such as creating a vacation savings account separate from their regular savings.

Cost to Clients

Your clients should have a liquid emergency fund that will help them weather a job loss or unexpected bill. However, when the desire to keep cash on hand ignores the underlying economics—such as earning low interest on a large savings account balance while simultaneously carrying high-interest debt—their financial well-being is undermined.

What You Can Do About It

Mental accounting is often a way for clients to exercise self-control and simplify their finances. Rather than taking on the yeoman's task of seeing their assets as a big pool of money that needs rational allocation towards needs and goals (ultimately, isn't that the reason they came to you?), they use on-the-fly mental accounting to determine its purpose and relative value. For some, the cash on hand is simply more valuable than the dissolution of debt, even though the interest rates say otherwise. To overcome this thinking, you can piggyback on your clients' mental accounting methods with a bucket strategy, with each bucket not only serving a different goal but also employing a different risk and return objective.

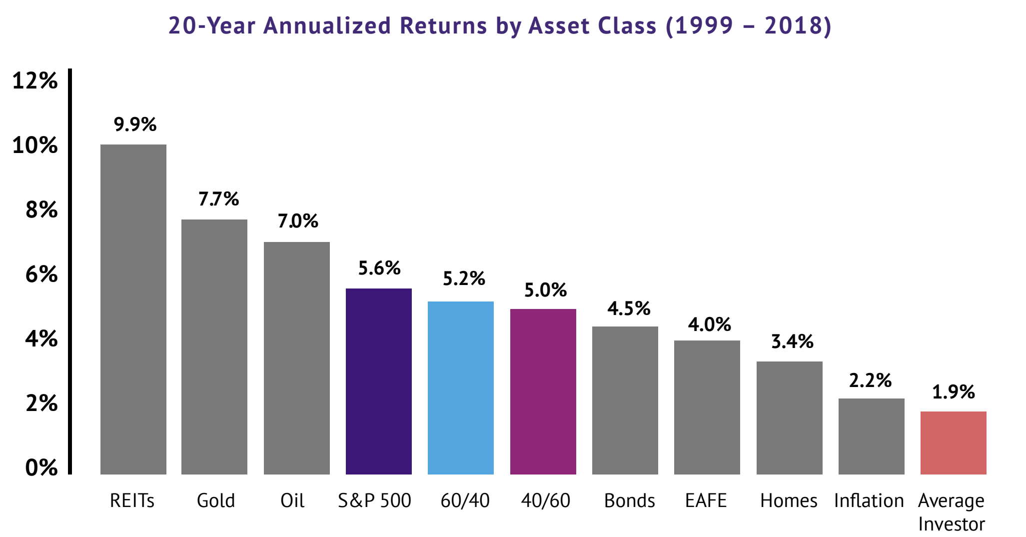
Conclusion

OR, THE REAL REASON ALL THIS MATTERS

Humans are irrational—even predictably so. The world has evolved at a rate that far outpaces our own neural and behavioral development. Thought processes and brain networks that may have served us well in our hunter-gatherer days can trip us up in the marketplace.

Knowing where clients go wrong, how to identify when they do, and what to do about it doesn't just allow them to overcome their quirks and biases—it can help them boost their bottom line. In an analysis done by Dalbar looking back over the past 20 years, the average investor underperformed in every single asset class **[Figure 2]**. If one of those investors simply picked an asset class—any one—dropped their money in it and left it alone, they would have been better off than the rest of their peers in the study who were actively managing their investments.

Figure 2:



Source: JPMorgan, Barclays, Bloomberg, FactSet, Standard & Poor's, Dalbar Inc. Indices used are as follows: REITS: NAREIT Equity REIT Infex, EAFE: MSCI EAFE, Oil: WTI Index, Bonds: Bloomberg Barclays U.S. Aggregate Index, Homes: median sales price of existing single-family homes, Gold: USD/troy oz., Inflation: CPI, 60/40: A balanced portfolio with 60% invested in S&P 500 Index and 40% invested in high-quality U.S. fixed income represented by Bloomberg Barclays U.S. Aggregate Index. Average asset allocation investor return is based on an analysis by Dalbar Inc. Returns are annualized (and total return where applicable) and represent the 20-year period ending 12/31/2018.

We're all swayed by biases and fallacious thinking from time to time, some of which is outlined on the previous pages. A significant part of the value your clients receive from working with you, and not an online self-service resource, is your ability to help them overcome these missteps and use economics, not emotions, to drive their financial decisions and achieve greater success. Much of financial coaching is behavioral coaching—a perfect financial plan is of little value without the behaviors needed to execute it.

Dive Deeper into Your Clients' Mindset

Your casual conversations about life that open and close meetings and help you get to know your clients better can give you insights into the way they think and the biases they are most susceptible to. Just as with a doctor-patient relationship, the more you know about your clients' lives, the more comprehensive and targeted the advice you can give them, and the more you can ward off potential problems in the future.

Clients aren't always forthcoming, however, and may be guarded about their lives and emotions. They also may not be truly in touch with their feelings about their own financial situation. Money issues—especially when there is debt, uncertainty for the future, or a difference of opinion within a marriage—are a primary source of anxiety for many people, and they may suppress their actual feelings, or not be completely open with you, in an attempt to minimize their angst.

To help you get through to the true emotions your clients have about money, their future plans and financial goals, and their satisfaction with their current state, Cetera® has launched Decipher™, an emotion recognition tool that captures your clients' involuntary facial movements to help you understand their potentially unexpressed thoughts and feelings about their finances. A camera unobtrusively records and analyzes a client's facial expressions as they answer questions on a computer. Once complete, it provides a graphical and written report you can use to drive deeper and more focused conversations to help them better understand what matters to them most and how to prioritize their goals.

To learn more about how we're developing capabilities that increase the depth of your relationships and the value you provide, contact the Cetera Business Development team at 800.336.8842 or visit cetera.com.