The Evolving Role of Behavioral Finance in 2020

By Scott Smith, Director, Advice Relationships, Cerulli Associates

Behavioral finance can play an important role in helping investors successfully pursue their financial goals, especially during periods of pronounced market volatility. This issue of Investments & Wealth Research examines the prevalence of emotional and cognitive biases within advisors’ client bases and the benefits of using behavioral finance as a tool to help minimize the biases’ impact.

Methodology
Charles Schwab Investment Management, Inc., in collaboration with the Investments & Wealth Institute® (IWI), retained Cerulli Associates—a leading independent market research and consulting firm—to learn how advisors view and use behavioral finance when working with clients. In May and June 2020, Cerulli Associates conducted a survey of more than 300 financial advisors. Respondents were members of IWI and diversified across business models, including wirehouses, registered investment advisors, and national and regional broker-dealers. Select findings from the survey, BeFi Barometer 2020, are discussed here.

Key Points
- Over the past year, advisors’ reported use of behavioral finance increased significantly, especially within client communications.
- Advisors widely leveraged behavioral finance to help them develop a better understanding of clients’ actual appetites for risk and keep them invested during turbulent markets early in 2020.
- Advisors’ clients most frequently demonstrated recency and loss aversion biases while instances of framing and mental accounting grew sharply in the past year.
- Advisors who incorporated behavioral finance into their practices reported elevated client acquisition activity as they increased proactive client communication.

In 2020, it is proving to be extremely challenging for investors to differentiate between “unprecedented times” and “the new normal.” Despite an ongoing worldwide pandemic and record-breaking unemployment and declines in gross domestic product, by late summer equity markets regained their alarming first-quarter declines. At the same time, headlines have been filled with stories about investors ramping up trading activity, with many recording outsized gains, only occasionally tempered by accounts of disconcerting losses.

Even in the best of times, it can be difficult for investors to understand the day-to-day fluctuations of the market, but 2020 has presented ever-changing combinations of news and market reactions that have left even the most self-assured market experts baffled. In times like this, investors need a helping hand more than ever. They are understandably
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distressed by the potential impact of the pandemic on their health, their jobs, and their portfolios. Advisors must help investors create and maintain a mental framework to help ease concerns about fluctuations of the markets. Behavioral finance can be a crucial element of advisors’ efforts to help investors overcome their emotional reactions in pursuit of long-term financial goals.

The results of the BeFi Barometer 2020 reflect a notable uptick in advisor adoption of the principles of behavioral finance, especially with regard to client communication. The 2019 edition of this research found that 71 percent of respondents indicated that they were leveraging behavioral finance in their outreach efforts.1 In the 2020 edition, this figure grew to 81 percent, reflecting respondents’ increased efforts to help clients create a durable mental framework to deal with the adversity presented by increased uncertainty in the markets and in life overall in 2020 (see figure 1).

Though advisors are increasingly adding behavioral finance to their toolkits, the most frequently cited challenge with behavioral finance is difficulty implementing the fundamentals into their existing practices. One of the goals of this research, as well as the Charles Schwab Investment Management Diagnostics® program, is to help advisors understand the potential benefits of incorporating the principles of behavioral finance, and to provide tools and best-practice recommendations to help them navigate these challenges.

OVERCOMING INVESTORS’ BIASES IN A CRUCIBLE
The pursuit of long-term financial goals through investing can easily trigger protective instincts in clients during periods of adversity and volatility. Without any ability to control their situations, investors may feel uncertain or helpless. The combination of epidemiological, economic, and political factors evolving over the course of 2020 has created an incomparable environment feeding these protective instincts among investors.

When the COVID-19 pandemic hit, suddenly millions of investors, and their friends and relatives, faced the twin threats of illness and unemployment, with no clear path to recovery on either front. Regrettably, these challenges are further compounded by the behavioral biases that advisors observe most frequently within their client bases. In both 2019 and 2020, advisors identified recency as the most commonly observed client bias, with 35 percent of advisor respondents indicating that it significantly contributed to their clients’ decision-making. Similarly, loss aversion maintained its position as the second-most recognized bias, growing from 26 percent to 30 percent over the same period (see table 1).

The frequency of these two responses underscores the intertwined nature of investors’ behavioral biases. Clients are rarely affected by a single behavioral bias. Instead, they are commonly affected by a variety of biases, each with its own unique combination based on personal predispositions and concerns. For example, in March 2020, a client very easily could have been concerned about the recent losses in a portfolio and sought out information to confirm their own pre-existing beliefs about how to grow a portfolio back to its previous high-water mark. With at least five biases playing a potential role in this thought process, it is easy to see how complicated unwinding a client’s behavioral susceptibilities can be.

With this in mind, advisors should consider each of the various biases an investor is exhibiting as contributing to the overall affliction of letting emotions interfere with meeting financial goals. In addition, advisors must try and build a framework that facilitates a path of least resistance to pursuing an overall remedy, or at least a treatment that reduces the most adverse effects.

When asked in 2019 about the benefits of incorporating behavioral finance, advisors were most likely to cite strengthening relationships (50 percent), improving decisions (49 percent), and better managing client expectations (45 percent). Though all these benefits remained relevant in 2020, they were handily eclipsed by the benefit of keeping clients invested, which grew from 30 percent to 55 percent. Likewise, developing a better understanding of
TABLE 1
CLIENTS’ BEHAVIORAL BIASES, 2019 VS. 2020

<table>
<thead>
<tr>
<th>Bias</th>
<th>Description</th>
<th>2019</th>
<th>2020</th>
<th>2019–2020 change (percentage points)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Recency bias</td>
<td>Being easily influenced by recent news events or experiences</td>
<td>35%</td>
<td>35%</td>
<td>0.5 pp</td>
</tr>
<tr>
<td>Loss aversion</td>
<td>Opting for less risk in portfolio than is recommended</td>
<td>26%</td>
<td>30%</td>
<td>4 pp</td>
</tr>
<tr>
<td>Familiarity/home bias</td>
<td>Preferring to invest in familiar (U.S.-domiciled) companies</td>
<td>24%</td>
<td>27%</td>
<td>3 pp</td>
</tr>
<tr>
<td>Framing</td>
<td>Making decisions based on the way the information is presented</td>
<td>17%</td>
<td>26%</td>
<td>9 pp</td>
</tr>
<tr>
<td>Mental accounting</td>
<td>Separating wealth into different buckets based on financial goals</td>
<td>15%</td>
<td>26%</td>
<td>11 pp</td>
</tr>
<tr>
<td>Confirmation bias</td>
<td>Seeking information that reinforces existing perceptions</td>
<td>25%</td>
<td>24%</td>
<td>-0.9 pp</td>
</tr>
<tr>
<td>Anchoring</td>
<td>Focusing on a specific reference point when making decisions</td>
<td>24%</td>
<td>23%</td>
<td>-0.7 pp</td>
</tr>
<tr>
<td>Herding</td>
<td>Following the crowd or latest investment trends</td>
<td>13%</td>
<td>19%</td>
<td>6 pp</td>
</tr>
<tr>
<td>Endowment effect</td>
<td>Assigning a greater value to investments or assets already owned</td>
<td>10%</td>
<td>17%</td>
<td>7 pp</td>
</tr>
<tr>
<td>Inertia/status quo</td>
<td>Failing to take action or avoiding changes to a portfolio</td>
<td>22%</td>
<td>16%</td>
<td>-6 pp</td>
</tr>
<tr>
<td>Selective memory</td>
<td>Recalling only positive experiences or outcomes</td>
<td>15%</td>
<td>15%</td>
<td>0.3 pp</td>
</tr>
<tr>
<td>Regret aversion</td>
<td>Fearing to take action due to previous mistakes or regret avoidance</td>
<td>11%</td>
<td>14%</td>
<td>3 pp</td>
</tr>
<tr>
<td>Availability bias</td>
<td>Basing decisions only on readily available information</td>
<td>13%</td>
<td>13%</td>
<td>-0.6 pp</td>
</tr>
<tr>
<td>Overconfidence</td>
<td>Being overly confident in one’s own ability</td>
<td>9%</td>
<td>11%</td>
<td>2 pp</td>
</tr>
<tr>
<td>Self-control</td>
<td>Spending excessively today at expense of the future</td>
<td>12%</td>
<td>6%</td>
<td>-6 pp</td>
</tr>
</tbody>
</table>

Analyst Note: Advisors were asked, “To what degree do you believe the following biases may be affecting your clients’ investment decision-making?”

FIGURE 2
ADVISORS’ BENEFITS OF INCORPORATING BEHAVIORAL FINANCE, 2019 VS. 2020

- Kept clients invested during market volatility (e.g., stuck with long-term plan)
- Strengthened trust and relationship with clients/increased client retention
- Better managed client expectations through effective communication
- Reduced short-term or emotional decision-making (e.g., clients were less anxious)
- Developed better understanding of clients’ comfort levels with risk
- Helped improve clients’ financial decisions and prioritize goals
- Helped clients achieve better investment outcomes
- Provided highly customized service offering
- Attracted new clients due to differentiated value-add program
- Had no major impact or benefit
- Increased assets or walletshare

Analyst Note: Advisors were asked, “Given the increased market volatility over the past several months, what have been the greatest impacts of incorporating behavioral finance techniques/programs into your practice?” Advisors were allowed to select up to three responses. The option of having no major impact or benefit was not included in the 2019 survey.
clients’ comfort level with risk jumped from 20 percent in 2019 to 33 percent in 2020 (see figure 2).

These results highlight the dual role of behavioral finance in client relationships: serving as a framework for deeper engagement to strengthen communication and prioritize goals during good times, and to help minimize clients’ instinctual adverse reactions during periods of acute volatility. Nothing highlights the directly applicable benefits of behavioral finance quite as clearly as a sudden equity market decline. When faced with panicking clients, advisors were able to rely on the behavioral finance foundations that had been built to help keep clients focused on the strategic pursuit of financial goals rather than being distracted by temporary volatility.

One way that advisors can help guide investors toward improved outcomes is by leveraging the power of investors’ behavioral biases themselves. In 2020, advisors reported a notable uptick in the prevalence of both framing, up from 17 percent to 24 percent, and mental accounting, which grew from 15 percent to 26 percent. Although these biases have the potential to negatively impact investors’ decision-making, they also can be useful when wielded by an adept advisor. For example, by using mental accounting, an advisor can help investors consider their current cash-flow needs separately from their retirement portfolios. Or by taking a framing approach, an advisor can emphasize how rebalancing a portfolio during an equity market decline allows investors to accumulate more shares of a favorite stock or fund at a reduced price. In either case, by embracing the principles of behavioral finance, advisors can nudge clients toward more-constructive ways to think about their portfolios.

**GROWING THE BASE**

Cerulli Associates’ research has found consistently that, during periods of market volatility, the demand from investors for personalized advice increases substantially. This scenario held true in 2020 as 55 percent of advisor respondents indicated they had added new client households since the first quarter of 2020, versus just 4 percent who indicated they had experienced net client losses. However, these results differed significantly between advisors who indicated that they regularly incorporate elements of behavioral finance in their practices and those who do not. Two-thirds (66 percent) of behavioral finance users reported adding to their client base, compared to just 36 percent of advisors who are not incorporating behavioral finance in their practices (see figure 3).

Among both groups, approximately two-thirds of new clients were sourced from other advisors with whom clients had become dissatisfied, or as an outcome of investors seeking to consolidate their accounts and maintain fewer advisor relationships. This is frequently attributable to satisfied clients referring friends and family who are discontented with their current advisory relationships. Although clients generally are reluctant to spend the time and effort necessary to seek out new advisory relationships, getting a direct referral during a period of frustration with a current advisor can make this process much more appealing. The other third of new client relationships was attributable to the conversion of formerly self-directed investors who found the current conditions an opportune time to seek professional advice for the first time.

Regardless of the reason behind new client relationships, during periods of adversity, investors are more likely to question the advice that is shaping their portfolios, whether they came up with it themselves or used a professional advisor. Some advisors’ portfolios may incorporate tactical elements that help damp the impact of market declines, but diversified strategic allocations make up the core of retail investor relationships. By their very nature, the value of these accounts will be largely attributable to movements of the market overall.

Unfortunately, when investors see their portfolios incurring losses, they tend to blame the incumbent advice provider, regardless of how competently the provider executed on the services they had promised. Despite disclosure to the contrary, many clients expect that their advisors possess skills or tools that will enable them to steer client portfolios away from losses in periods...
of pronounced volatility. Although some advisors see no benefit in dissuading clients of this misconception, behavioral finance adherents are more likely to educate clients regarding the potential for volatility, and to urge clients to expect it. This scenario reinforces many of the key benefits of leveraging behavioral finance in advisory relationships, especially with regard to managing expectations and remaining invested during periods of volatility.

DEEPENING CONNECTIONS
This increased level of communication by advisors who embrace behavioral finance also carries over to ongoing client outreach efforts. Cerulli Associates’ research has found consistently that the level of an advisor’s proactive communication efforts during volatility is the most reliable indicator of the degree to which the advisor will add new clients during the period. To understand this tendency further, we asked advisors about the specific ways they chose to alter their client communications plan early in 2020 in order to investigate which were most highly correlated with adding new clients (see figure 4).

The first step in this process was to identify which communication activities each respondent had increased in 2020 and then overlay those results with how successful the advisor had been in adding new client households during the year. As noted above, advisors’ communication efforts have been a strong predictor of client acquisition efforts during periods of volatility; however, there was a notably elevated level of effectiveness of communications among advisors who incorporate elements of behavioral finance into their practices. For example, among behavioral finance users who increased the use of text messaging, 78 percent reported adding clients this year compared to just 27 percent among non-users. Similarly, 72 percent of behavioral finance users who increased outgoing calls added new clients, compared to just 42 percent of non-users.

The unifying element in these results is that proactive personal communication was valued by investors and was especially effective for advisors who have made behavioral finance a part of their client engagement strategy. Instead of having to pivot from touting their investment returns to focusing on explaining volatility, behavioral finance users were able to frame current conditions as expected developments within the context of the long-term plans they had previously developed and discussed.

It’s up to advisors to understand what type of communication their clients and prospects prefer. Investors want to know that their advisors are taking the time to truly get to know them and are using insights to create personalized action plans to help them achieve goals. Calls and text messages are the personal communication methods investors use...
with people they trust the most. Newsletters and social media postings can serve as useful complements to broadcast key themes, but they simply will not build the level of rapport and empathy that comes with personal communication methods. Communicating with investors on their terms helps advisors convey to clients that they are important and that their advisors are ready to listen.

**CONCLUSION**

Staying active in times of volatility is key to adding clients from a variety of sources. Clients and prospects want to know that their advisors are looking out for them, even when the advice they are delivering is to stay the course or focus on the long term.

Behavioral biases create an impulse for defensive action during market declines, but many times the best advice is to try and take emotion out of the process. Laying a foundation for communication on the basis of behavioral finance allows advisors to better set expectations early on in client relationships, while also offering an opportunity to maintain an open dialogue when markets become turbulent.

When properly employed, behavioral finance allows advisors to more nimbly pursue the twin goals of helping investors feel less financial stress and making better decisions in pursuit of their long-term goals.

**ENDNOTE**

Behavioral Finance for 2020 and Beyond

The Investments & Wealth Institute has the resources you need to stay ahead of the game with the latest research and developments in behavioral economics, social sciences and the cross section where the two meet. From complimentary podcasts, research and blogs to more in-depth and comprehensive courses, webinars and on-demand recordings, stay updated and refreshed by visiting our Behavioral Finance Resource Center at: www.iwicentral.org/behavioral