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The Evolving Role of Behavioral Finance 2020

As market volatility escalated, advisors increasingly turned to behavioral finance to help keep clients invested and focused on their long-term goals.

Executive Summary

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

Methodology

Charles Schwab Investment Management, 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 (RIAs), and national & regional broker/dealers. Select findings from the survey, BeFi Barometer 2020, are discussed in this white paper.

Key Points

- Over the last 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 last year.
- Advisors who incorporate behavioral finance into their practices reported elevated client acquisition activity as they increased proactive client communication.

What is Behavioral Finance?

Behavioral finance is the study of the emotional and intellectual processes that combine to drive investors' decision making, with the goal of helping clients optimize financial outcomes and emotional satisfaction.

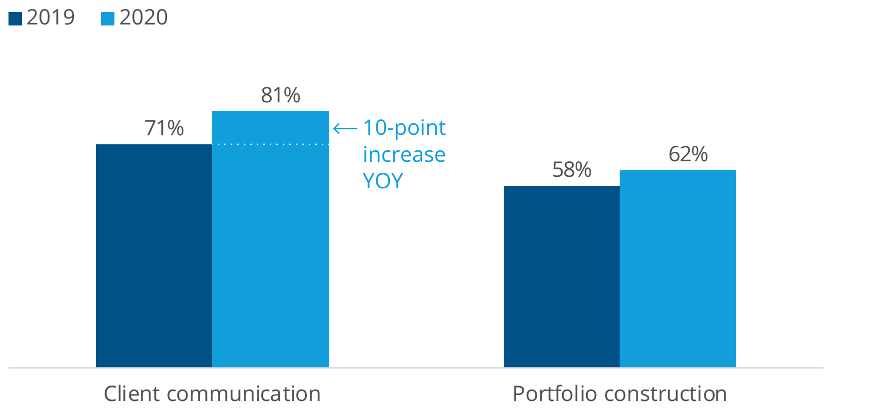
In 2020, it is proving to be extremely challenging for investors to differentiate between "unprecedented times" and "the new normal." Despite an ongoing worldwide pandemic and record-breaking declines in unemployment and GDP, by mid-summer, equity markets have regained almost the entirety of their alarming first-quarter declines. At the same time, headlines are filled with stories about investors ramping up their 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 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 their concerns about the fluctuations of the market. Behavioral finance can be a crucial element of advisors' efforts to help investors overcome their emotional reactions in pursuit of their long-term financial goals.

The results of the BeFi Barometer 2020 reflect a notable uptick in advisor adoption of principles of behavioral finance, especially with regard to client communication. The 2019 edition of this research found that 71% of respondents indicated that they were leveraging behavioral finance in their outreach efforts. In the 2020 edition, this figure grew to 81%, 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.

EXHIBIT 1

ADVISORS' BEHAVIORAL ADVICE IMPLEMENTATION, 2019 VS. 2020



Sources: Cerulli Associates, in partnership with the Investments & Wealth Institute.
Analyst Note: Advisors were asked how often they incorporate behavioral finance into their advisory practice with respect to client communications/portfolio construction. Below responses indicate advisors that selected "Frequently" or "Always."

Though advisors are increasingly adding behavioral finance to their toolkits, their 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 Charles Schwab Investment Management's Biagnostics® program, is to not just help advisors understand the potential benefits of incorporating the principles of behavioral finance, but also to provide tools and best-practice recommendations to help them navigate these challenges.

Overcoming Investors' Biases in a Crucible

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 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% 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% to 30% over the same period.

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 their own unique combination based on their personal predispositions and concerns. For example, in March 2020, a client could very easily have been concerned about the recent losses in their portfolio and sought out information, to confirm their own pre-existing beliefs about how to grow a portfolio back its previous

EXHIBIT 2

CLIENTS' BEHAVIORAL BIASES, 2019 VS. 2020

Bias	Description	% of Advisors who observe bias "Significantly" among clients 2019	2020	19-'20 Change (Percentage Points)
Recency bias	Being easily influenced by recent news events or experiences	35%	35%	0.5 pp
Loss aversion	Opting for less risk in portfolio than is recommended	26%	30%	4 pp
Familiarity/home bias	Preferring to invest in familiar (U.S. domiciled) companies	24%	27%	3 pp
Framing	Making decisions based on the way the information is presented	17%	26%	9 pp
Mental accounting	Separating wealth into different buckets based on financial goals	15%	26%	11 pp
Confirmation bias	Seeking information that reinforces existing perceptions	25%	24%	-0.9 pp
Anchoring	Focusing on a specific reference point when making decisions	24%	23%	-0.7 pp
Herding	Following the crowd or latest investment trends	13%	19%	6 pp
Endowment effect	Assigning a greater value to investments or assets already owned	10%	17%	7 pp
Inertia/status quo	Failing to take action or avoiding changes to a portfolio	22%	16%	6 pp
Selective memory	Recalling only positive experiences or outcomes	15%	15%	0.3 pp
Regret aversion	Fearing to taking action due to previous mistakes or regret avoidance	11%	14%	3 pp
Availability bias	Basing decisions only on readily available information	13%	13%	-0.6 pp
Overconfidence	Being overly confident in one's own ability	9%	11%	2 pp
Self-control	Spending excessively today at expense of the future	12%	6%	-6 pp

Sources: Cerulli Associates, in partnership with the Investments & Wealth Institute.
Analyst Note: Advisors were asked, "To what degree do you believe the following biases may be affecting your clients' investment decision making?"

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 symptoms contributing to the overall affliction of letting emotions interfere with meeting their financial goals. Instead of trying to treat each symptom (bias) individually, 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.

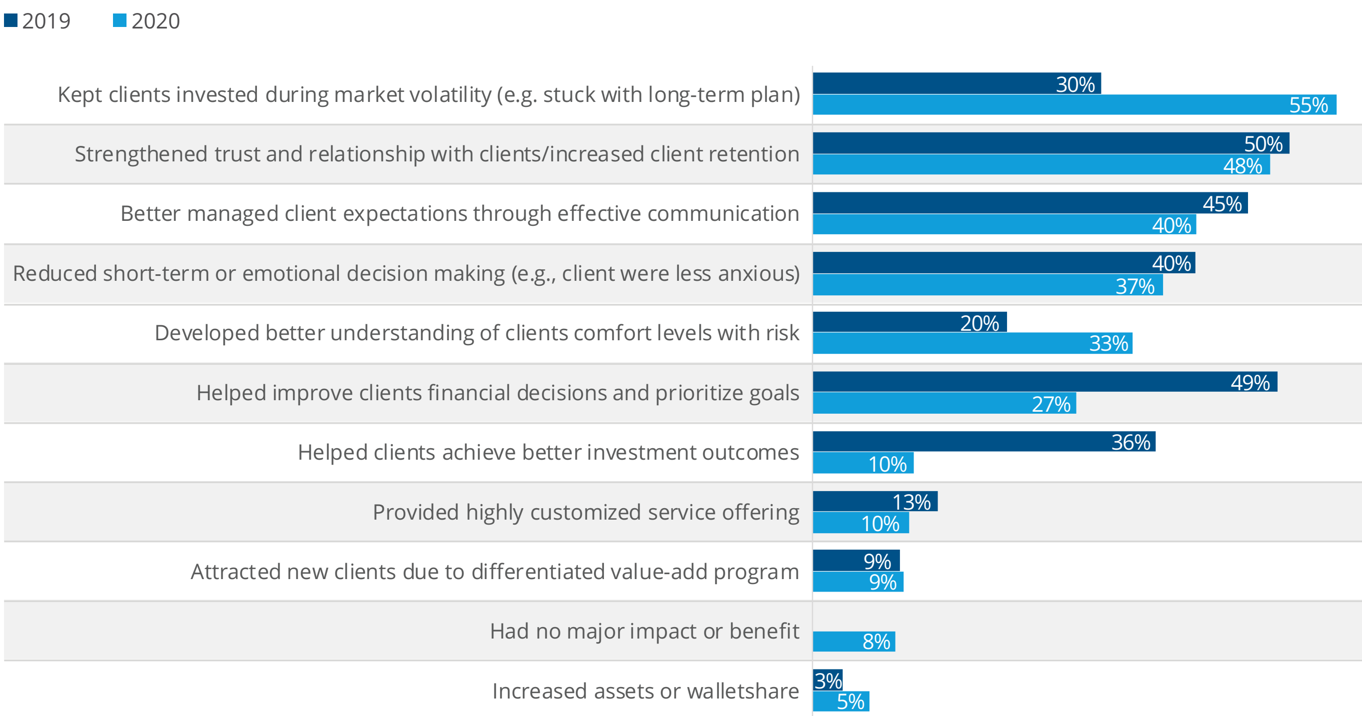
When asked in 2019 about the benefits of incorporating behavioral finance, advisors were most likely to cite strengthening relationships (50%), improving decisions (49%), and better managing client expectations (45%). Though all these benefits remained relevant in 2020, they were handily eclipsed by the benefit of keeping clients invested, which grew from 30% to 55%. Likewise, developing a better understanding of clients' comfort level with risk jumped from 20% in 2019 to 33% in 2020.

These results highlight the dual role of behavioral finance in client relationships: serving as 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 keep their clients focused on their 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% to 26%, and mental accounting, which grew from 15% to 26%. While these biases have the potential to negatively impact investors' decision making, they can also 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 their favorite stock or funds 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.

EXHIBIT 3

ADVISORS' BENEFITS OF INCORPORATING BEHAVIORAL FINANCE, 2019 VS. 2020



Sources: Cerulli Associates, in partnership with the Investments & Wealth Institute.
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.

Growing the Base

Cerulli's research has consistently found that, during periods of market volatility, the demand from investors for personalized advice increases substantially. This scenario held true in 2020 as 55% of advisor respondents indicated they had added new client households since the first quarter of 2020 the versus just 4% 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%) of behavioral finance users reported adding to their client base, compared to just 36% of advisors who are not incorporating behavioral finance in their practices.

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 relationship. While clients are generally 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 the new client relationship, 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. While some advisors' portfolios may incorporate tactical elements that help dampen the impact of market declines, 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. While some advisors see no benefit dissuading clients of this misconception, behavioral finance adherents are more likely to not only educate clients regarding the potential for volatility, but also 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.

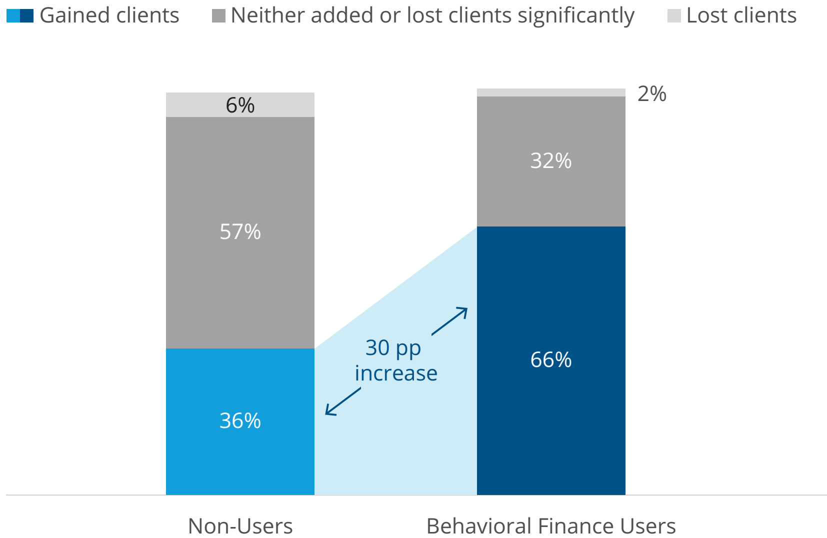
Deepening Connections

This increased level of communication by advisors who embrace behavioral finance also carries over to their ongoing client outreach efforts. Cerulli's research has consistently found 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 communication plan early in 2020 to investigate which were most highly correlated with adding new clients.

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 covered earlier, 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 their use of text messaging, 78% reported adding clients this year compared to just 27% among non-users. Similarly, 72% of behavioral finance users who

EXHIBIT 4

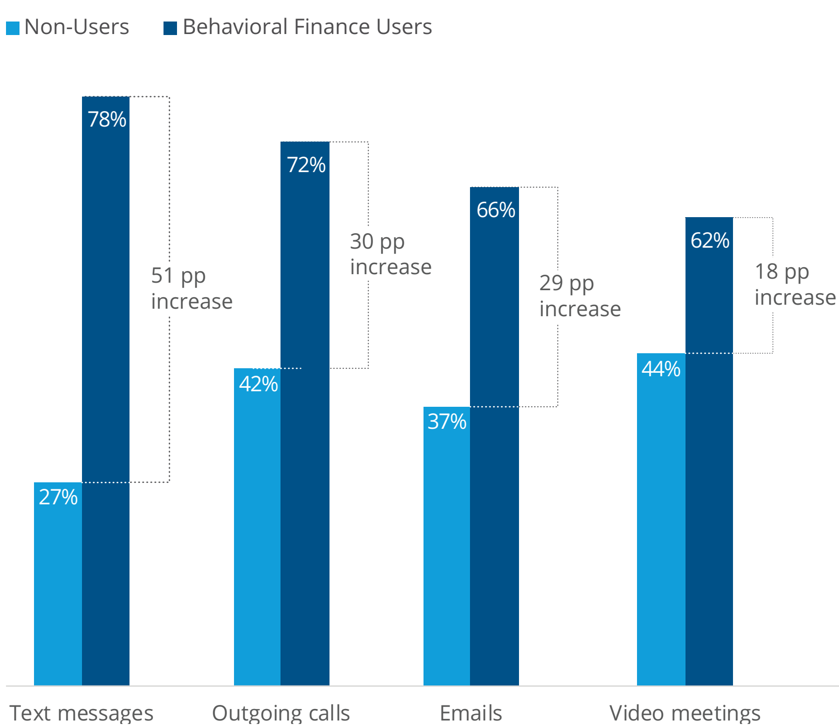
CLIENT ACQUISITION IN ADVERSITY, Q2 2020



Sources: Cerulli Associates, in partnership with the Investments & Wealth Institute.
Analyst Note: Advisors were asked "Since 1Q 2020, has your practice gained or lost clients?"

EXHIBIT 5

INCREASING COMMUNCIATIONS' EFFECT ON NEW CLIENT ACQUISITION, Q2 2020



Sources: Cerulli Associates, in partnership with the Investments & Wealth Institute.
Analyst Note: Data reflects the percentage of advisors that gained clients since Q1 2020 after increasing use of noted communication types.

increased outgoing calls added new clients, compared to just 42% 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 their insights to create personalized action plans to help them achieve their goals. Calls and text messages are the personal communication methods investors use with people they trust the most. Newsletters and social media posting can serve as a useful compliment to broadcast key themes, but 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 advisor is 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 advisor is looking out for them, even when the advice they are delivering is stay the course or focus on the long term. While behavioral biases create an impulse for defensive action during market declines, 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 while making better decisions in pursuit of their long-term goals.

BeFi Barometer 2020 is a survey of 310 financial advisors to learn how advisors view and use behavioral finance when working with clients. Conducted by Cerulli Associates in May and June 2020. Respondents were members of the Investments & Wealth Institute® and diversified among business models, including wirehouses, registered investment advisors (RIAs), and national/regional broker dealers. All data is self-reported by survey participants and is not verified or validated.

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