Addressing a Surge in Client Behavioral Biases

Even as markets climbed, advisors observed an increased expression of behavioral biases among their clients.

Executive Summary

Over the past year, advisors have observed a more pronounced impact of behavioral biases affecting their client base, but they have also been having success leveraging several mitigation techniques to limit the potential negative impacts these biases could have. The surge of interest in speculative investments in the past year served as a prime example of the benefits of employing behavioral finance in advisor practices.

What is behavioral finance?

Behavioral finance is the study of the emotional and intellectual processes that combine to drive investors' decision making, giving advisors the chance to help clients optimize financial outcomes and increase emotional satisfaction.

METHODOLOGY

Schwab Asset Management, in collaboration with the Investments & Wealth Institute (IWI), retained Cerulli Associates—a leading independent market research and consulting firm—to better understand advisors' views on and use of behavioral finance when working with clients. In May and June 2021, 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 2021, are discussed in this white paper.

KEY POINTS

- Over the last year, advisors observed a widespread increase in behavioral biases among clients
- Advisors reported increased effectiveness in the use of a variety of bias mitigation techniques
- Ongoing client communications serve as a valuable tool to reinforce optimal behaviors
- Advisors noted success using behavioral finance to divert client interest away from excessive allocations to cryptocurrencies, "meme stocks," and other recent investment fads

Advisors observed that behavioral biases have become more evident amidst the COVID-19 pandemic. Market volatility and the ongoing unease caused by the global pandemic have combined to make bias management an integral element of client relationships. Never has there been a more critical time for advisors to incorporate behavioral finance principles into the core elements of their practices to help align clients' emotions with the process necessary to achieve their long-term goals.

Throughout this adversity, advisors who have incorporated the key elements of behavioral finance into their practices widely indicate that it has helped them strengthen their client relationships overall. In addition, advisors report that leveraging behavioral finance has helped them address specific challenges common among clients during this period of elevated anxiety, from staying invested to managing expectations and prioritizing goals.

Even as major equity indices pushed to new highs over the last year, many clients could not help but be concerned about how the turmoil associated with the ongoing pandemic and a contentious election cycle might affect their financial security. Fortunately, advisors who employed behavioral finance reported better outcomes from ongoing communications with clients, helping them strategically approach the long-term pursuit of their goals, rather than potentially overreacting to every bit of bad news.

The results of the BeFi Barometer 2021 serve as a useful reminder that many clients have engaged advisors not just to manage their portfolios, but also to help reduce the anxiety tied to their investments. This research, as well as Schwab Asset Management's Biagnostics® program, provides advisors with a workable framework to help optimize their use of behavioral finance to help clients' views of their finances trend toward serenity rather than apprehension.

Exhibit 1

Behavioral Finance Users: Top-Five Benefits of Incorporating Behavioral Finance, 2021

1. Strengthen trust and relationship with clients / increase client retention
2. Keep clients invested during periods of volatility
3. Reduce short-term or emotional decision making
4. Better manage client expectations
5. Help improve clients' financial decisions and prioritize goals

Observed Bias Increase

The most notable change in the results of the BeFi Barometer 2021 was advisors' markedly increased observations of behavioral biases within their client base. Between 2019 and 2020, changes in advisor reported biases among clients averaged just 3 percentage points with a mix of increases and decreases. In contrast, in 2021, observations of each bias increased at least 11 percentage points, with an average gain of 18 percentage points across options.

Recency bias retained its position as the most widely observed client bias, growing from 35% in 2019 and 2020 to 58% in 2021. Likewise, instances of confirmation bias (50%) and framing (44%) each grew at least 25 percentage points in the past year, pushing them to the second and third positions ahead of familiarity (43%) and loss aversion (43%), which grew at a slightly less rapid rate.

Such elevated growth of observed behavioral finance biases is likely attributable to a combination of factors. Foremost is the degree to which overall interest in investing exploded in the past year. While data for the BeFi Barometer 2020 was collected after the initial equity market declines and rebounds of March 2020, the succeeding 12 months were surprisingly even more chaotic and confusing for investors.

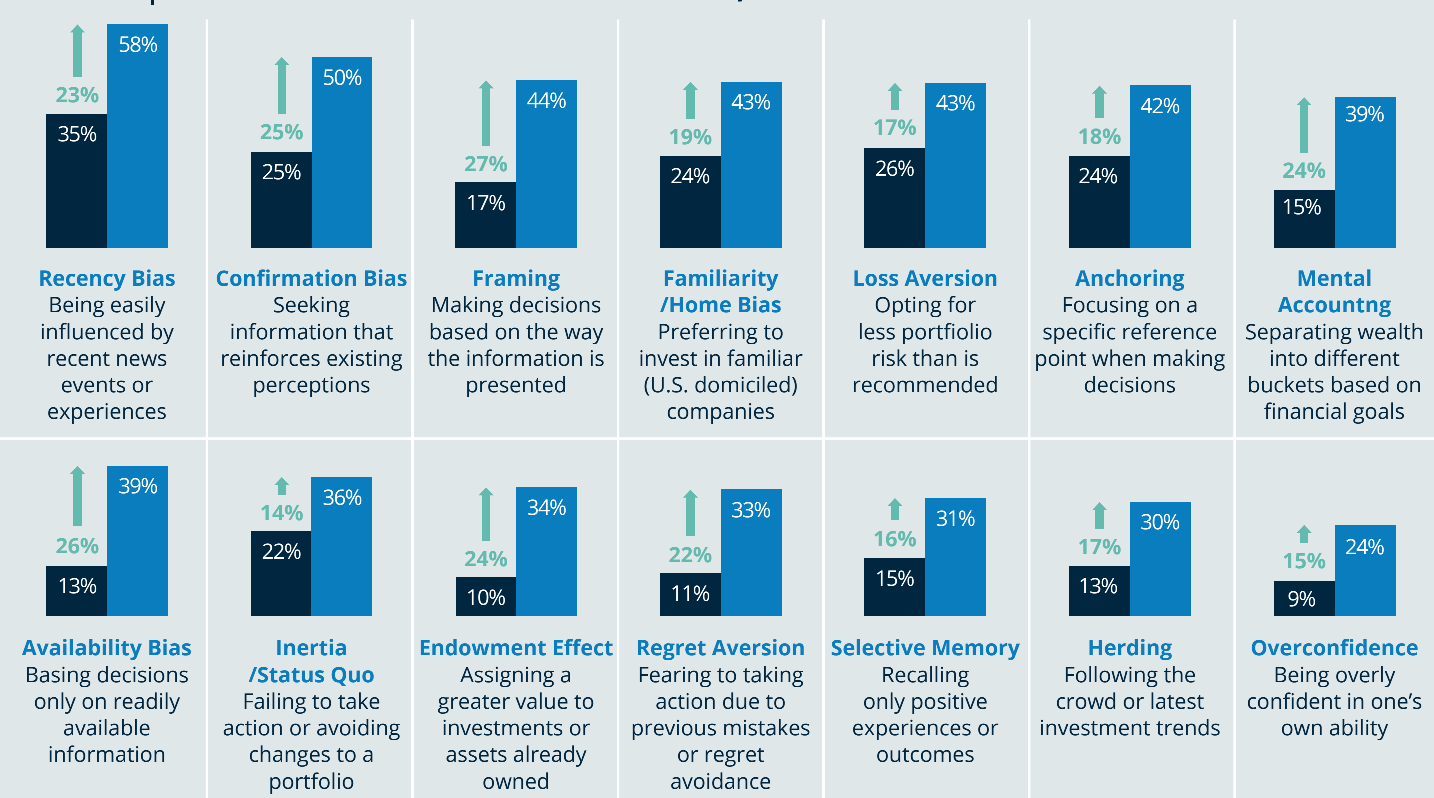
Despite the uncertainty presented by COVID-19 and a summer of protests leading into a contentious election cycle, domestic equity markets continued to climb to new highs, largely driven by the success of a concentrated group of leading technology providers, including Apple, Amazon, Alphabet, Microsoft, and Facebook. The idea that equity markets could climb while hundreds of thousands of small businesses struggled to survive had many investors across the country questioning the very foundations of our economic system.

Investors were further confounded by the largely baffling intricacies of the markets that led to well-documented meteoric gains in Bitcoin, GameStop, and AMC Entertainment, followed by staggering losses, sometimes repeatedly, in the past year. Given this largely incomprehensible combination of factors, it should be little surprise that investors generally sought to find a degree of reassurance by assuming that trends would continue (recency), seeking out information that matched their opinions (confirmation), or simply seeking comfort in the form of familiarity and loss-aversion biases.

In an environment where it seemed every decision was a challenging one, investors needed help more than ever. When the present is so challenging, investors intuitively look to the future with the hope that things will get better. Worrying that their assets are in jeopardy can just add to an investor's burden. Fortunately, advisors who have integrated behavioral finance techniques as a core element of their practices report significant success in helping their clients quell these fears in the last year.

Exhibit 2 | Clients' Observed Behavioral Biases, 2019 vs. 2021

■ 2019 ■ 2021 ↑ Change 2019-2021



Sources: Cerulli Associates, in partnership with the Investments & Wealth Institute, and Schwab Asset Management. **Analyst Note:** Advisors were asked, "To what degree do you believe the following biases may be affecting your clients' investment decision making?" Figures reflect advisors who observe bias "Significantly" among clients.

Leveraging the Toolset

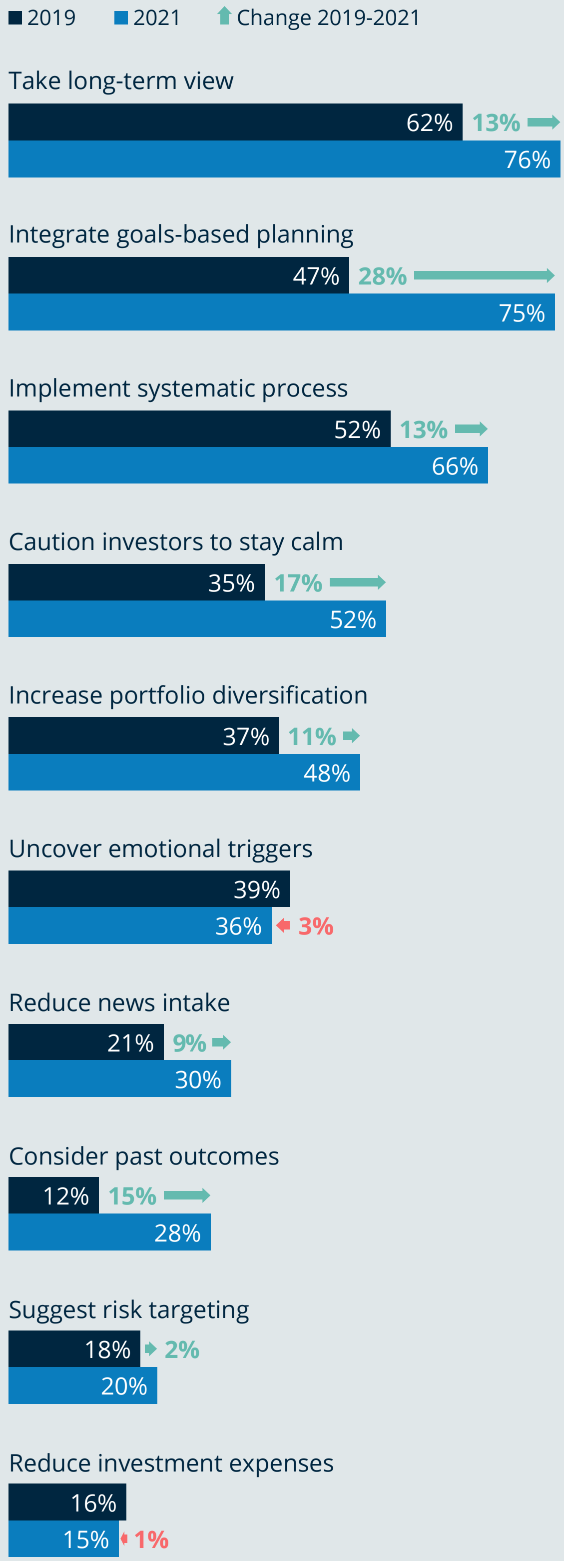
As part of this year's data collection process, advisors reported markedly increased effectiveness when employing fundamental bias mitigation techniques, including taking a long-term view (76%), integrating goals-based planning (75%), implementing a systematic process (66%), and reminding investors to stay calm (52%). Taken in totality, these techniques work together to underscore the fundamental principle of wealth management: given enough time, a properly designed and managed portfolio will ultimately help investors in the pursuit of their financial goals. By using a variety of media and messages to deliver versions of this message customized to their client bases, advisors have the opportunity to reinforce their own value and help shape clients' behavior away from a preoccupation with daily movements of the market.

For some advisors, this effort could simply be focused on the overall theme of the benefits of asset allocation and rebalancing, while other advisors find greater success in trying to inform their clients of the specific challenges posed by the impact of behavioral biases. However, moving these discussions from the general theoretical level to client-level biases poses its own difficulties. When considering their efforts to try to uncover emotional triggers with their clients, just 36% of BeFi Barometer respondents reported a high level of effectiveness, trending down slightly from previous years. These results underscore the challenges that arise when discussions truly become personal. People are open to discussing how investors may be affected by recency or loss aversion biases but can shut down quickly when presented with examples of themselves exhibiting the same behaviors. For example, while the concept of using multiple sources to conduct research is widely lauded, many investors tend to rely on one or two outlets whose views largely align with their own, as the validity of others is undermined by the conflicting views themselves.

With this is mind, it is often more impactful for advisors to adopt behavioral finance elements as a core part of their overall strategic client-communication strategy. The environment of the last year has highlighted the vast extent of clients' biases as conveyed through concerns and preferences. By widely incorporating the principles of behavioral finance into their practice model, advisors can address these biases on a proactive basis across their client bases. Instead of starting with a diagnosis of each client's specific biases, advisors can acknowledge the potential impact of biases and how their clients' portfolios are designed to mitigate them. In some cases, clients may prefer an extended exploration of the topic as specific to them, but in most cases, clients are content knowing their advisor has considered these elements and worked to offset them early in the process.

Exhibit 3

Most Effective Behavioral Bias Mitigation Techniques, 2019-2021



Sources: Cerulli Associates, in partnership with the Investments & Wealth Institute, and Schwab Asset Management.
Analyst Note: Advisors were asked, "Which of the following techniques have proven to be most effective when working with your clients to help them reach their long-term goals?" Results reflect advisors who selected "Very Effective."

Behavioral Finance In Action – Portfolio Management and Communication

Since the launch of the BeFi Barometer in 2019, advisors have consistently indicated that they are more likely to use behavioral finance techniques in their client communications than within their portfolio construction process itself. This tendency remained consistent in 2021, with 74% of respondents reporting using behavioral finance concepts in their outreach, predominantly to align their communications with clients' emotional tendencies (68%), while 56% leveraged these concepts within their portfolios to match risk tolerances (78%) as well as age (73%) and wealth (62%) factors.

In order to more deeply understand exactly how advisors are implementing the elements of behavioral finance, this year's edition of the BeFi Barometer survey asked respondents to describe their actual use within their practices, both in communications and portfolio management.

Portfolio Construction – Maintaining a Disciplined Approach

Setting Policies and Expectations

> New retirees and loss aversion. We put fixed-income reservoir in place to last a minimum of 10-15 years, so stock market losses have no impact on their 'paycheck' or quality of life, because we are only taking from the income reservoir, not from equities.

> We try to manage by using a bucketing approach. Funds needed for now through 4 or 5 years, funds needed for future needs and goals, and funds dedicated to legacy. Sounds simple and it is simple but is perhaps the best way to keep people from making bad decisions in tough markets.

> Using lower beta strategies for client with loss aversion. Clients love the market when it's positive and become discouraged when it is down. By limiting downside risk, the client can participate on the upside while being protected on the downside.

> I build a financial plan that shows both staying all in cash vs. taking on a small amount of risk. Then by using Monte Carlo analysis, clients change their mind about investing. Why? Inflation and emergency spending crushes the all-cash option. I call that 'phantom loss.' It's hidden, but still a loss. They begin to understand that, even taking on "no risk", they can still lose money to inflation. This helps to overcome the 'fear' of losing money. They can be conservative but be in a better position financially with taking on a little risk, compared to what they perceived as 'no risk' i.e., all cash.

Managing through Adversity

> Using an investment policy statement to document and then guide the decision-making process in times of portfolio stress as an anchor to counteract client paralysis.

> We have a conversation about rebalancing and how many clients do the opposite of what investment advisors do. Clients have the tendency to sell the portion of their portion when it's down—equity in March 2020—and move the money into safe territory—bonds in March 2020. I show them why that's not a good thing,and convince them to allow us to rebalance their portfolio to sell bonds and buy equity. Now, I have to convince clients to do the opposite: take gains off the table by selling equity. The question I get now is, 'Why? The stock market is doing so well!

> The best portfolio/allocation for the client is the one the client can handle through any market turmoil without panicking.

Client Communications - Defining the Narrative

Starting Off Right by Introducing Behavioral Finance

" In the beginning, we collect a healthy amount of data and it's not all numbers. We ask them if they are disciplined in decision making and whether they are rational or emotional decision makers and we talk about it and how it affects decisions. We explain that we actively consider the behavioral tendencies of our clients and that we anticipate there being times when they may have to remember these conversations and alter their plans. The conversations are continual and ongoing with respect to recognizing when we can improve decision making.

" I use discovery cards for the new client first meeting that pull many behavioral and goal-setting opportunities they are often surprised that they share. We then discuss several behavioral finance themes to alert them to our potential biases and how they can hurt their ability to achieve their goals.

" We use risk questionnaires that assign a risk number with historical volatility to show the client the ride before they get on the bus. Communication is key to understanding client expectations and uncover hidden thoughts, emotions, and experiences.

Ongoing Communication with Consistent Reinforcement

" I always tell clients to not get caught up in fads. What everyone else is doing doesn't matter for their situation.

" We use current events to tell a story of how it relates to past events. Drawing emotions out from those experiences to allow them to feel the similarities of what they have been through and how they made it through those.

" I constantly remind our clients that stock market pull-backs are common but temporary and the greatest mistake investors can make is letting their emotions influence their investment decision making.

" We try to frame almost everything we talk about to the client's specific goals and objectives. Yes, March of 2020 was terrible for investors, but did it impact your goals? If not, we can hopefully help them relax and not worry about things that don't compromise what they are hoping to accomplish.

" We invited clients to a seminar on 'Understanding why humans make the decisions they do.' Clients loved the stories and examples and could see themselves in the examples. Resulted in a better educated client and less stress during the COVID-19 market downturn.

Addressing Inquiries: Cryptocurrency, Special Purpose Acquisition Companies, Meme Stocks, and Non-Fungible Tokens

In addition to the attention lavished on traditional equity investments as indices pushed new highs, over the last year we have seen a variety of potential investments emerge, or in some cases reemerge, as the “next big thing.” From cryptocurrencies to GameStop to special purpose acquisition companies (SPACs) to non-fungible tokens (NFTs), investors were worried about missing out, even if they weren’t quite sure what they were trying to invest in.

Crypto, meme stocks, SPACs, and NFTs drew much media attention, but ended up having relatively little impact on client portfolios. Using BeFi techniques allowed advisors to mitigate the impact of recency, herding, and FOMO biases.

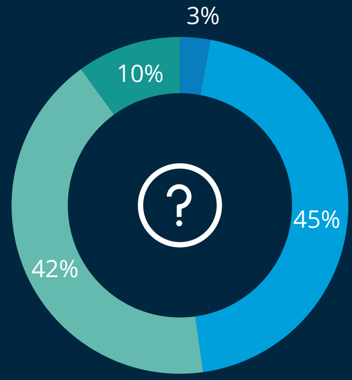
Exhibit 4

Addressing Inquiries

Inquiry

In the last year, how often have your clients asked you about investments they’ve read about on social media (e.g., GameStop, Bitcoin, NFTs, SPACs)?

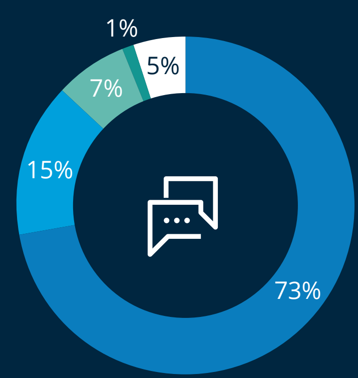
- Never
- Rarely
- Somewhat often
- Very frequently



Reaction

In response to these client inquiries, how did you typically respond)?

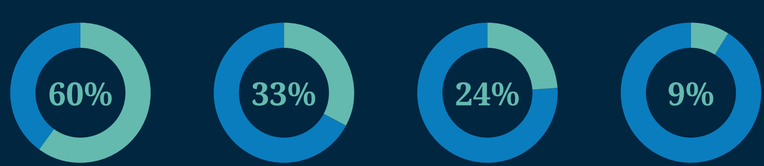
- Advised clients that these were unsuitable for their portfolio and did not invest
- Suggested they make small allocation in brokerage/self-directed account
- Added appropriate position to the portfolio that you manage
- Added disproportionate position to the portfolio that you manage
- Other



Outcomes

In the past year, have any of your clients invested in the following?

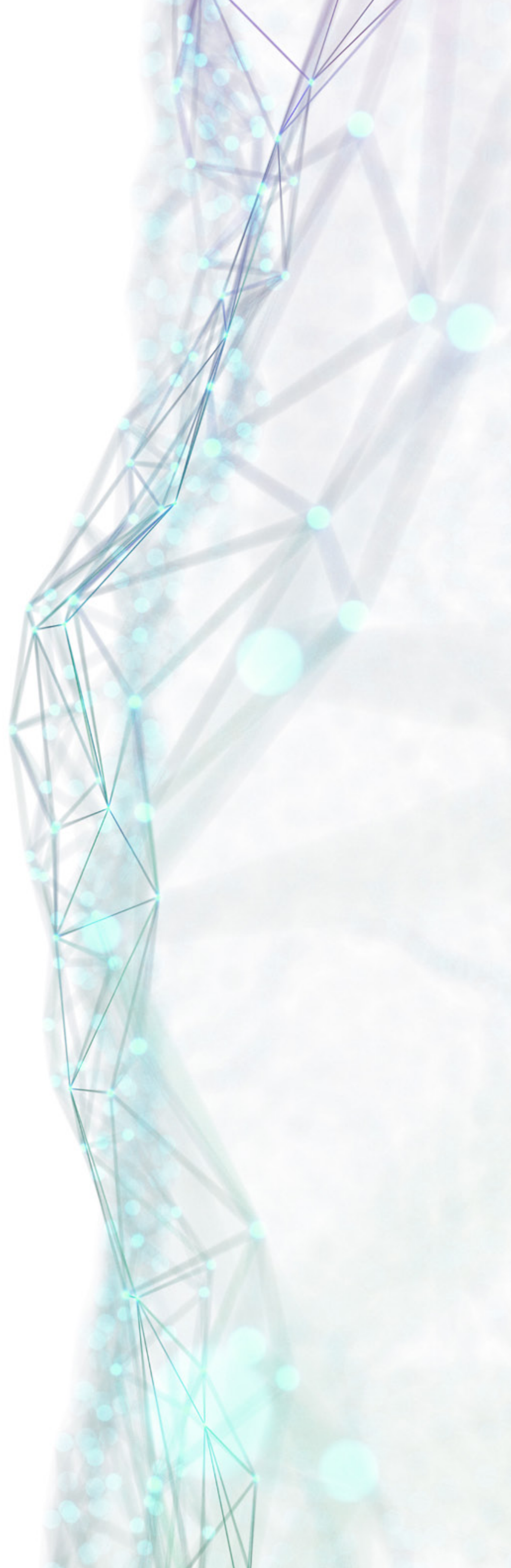
- Yes



Cryptocurrency (e.g., Bitcoin)	SPACs (special purpose acquisition company)	Meme stocks (e.g., GME, AMC etc.)	NFTs (non-fungible tokens)

CONCLUSION

The last year has notably increased investor unease in the face of an ongoing pandemic and an antagonistic election cycle. With traditional and social media outlets poised to spread breaking news of virus variants, natural disasters, and political upheaval, it seems unlikely that investors will settle into a period of comfort any time in the near future. With this in mind, advisors' ability to use the tools of behavioral finance to help investors limit the impact of their emotions on their portfolios has never been more critical. From setting realistic expectations to taking uncomfortable steps in the face of adversity or steering clients away from the latest investment fad, advisors play an important role in optimizing client behaviors.
By incorporating the principles of behavioral finance into their practices, advisors can personalize the experience they offer clients to optimize the pursuit of their financial goals.



BeFi Barometer 2021 is a survey of 301 financial advisors to learn how advisors view and use behavioral finance when working with clients. Conducted by Cerulli Associates in May and June 2021. 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.

(1021-1BPS) MKT116137-00 (10/21)
00265663