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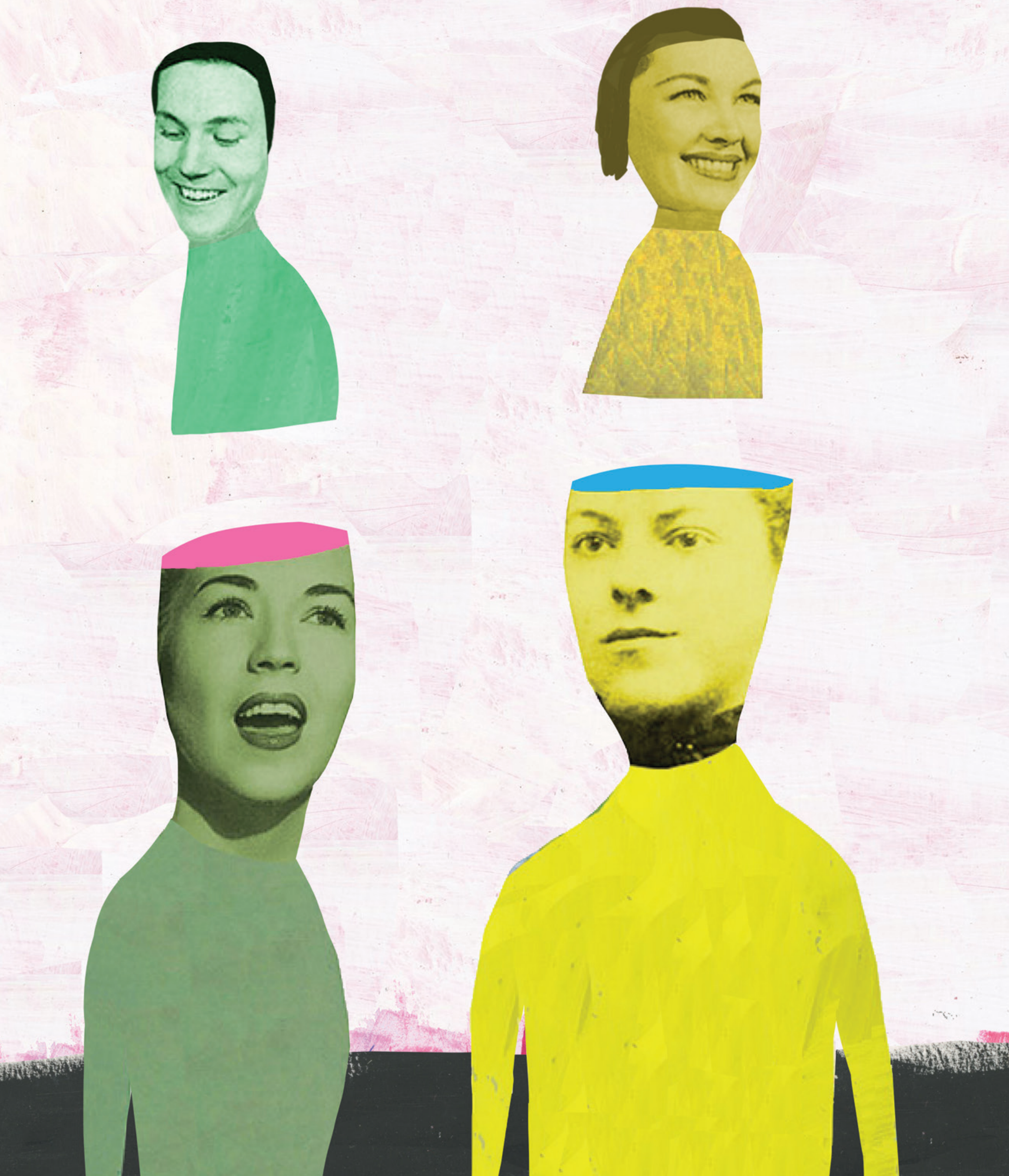

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Behavioral Finance

Stop Teaching, Start Coaching **34**
Coaching to Mitigate Panic **37**

Better Than an Algorithm

Advisors should focus on the human side of investing.

OVERVIEW

Ray Sin, Samantha Lamas, and Michael Leung

With the rise of robo-advice, new regulations, and other changes, it often seems like the traditional role of the advisor—particularly that of portfolio manager—is under threat. We believe, however, that advisors are in an excellent position to capitalize on these changes by building on longstanding skills and roles. Being a good advisor has always been more than selecting investments and managing portfolios. Psychology is an essential part of working with clients. To quote Benjamin Graham, "The investor's chief problem—and even his worst enemy—is likely to be himself."

As investors, we all have behavioral biases, such as overconfidence, confirmation bias, and loss aversion, that lead us astray when making financial decisions. Advisors, however, are in a unique and powerful position to help their clients overcome these. To capitalize on the changing landscape, advisors need to serve as behavioral coaches and help clients navigate their biases and make more rational decisions. Advisors help investors cultivate good financial habits, stick to their investment plans, and avoid emotional responses that affect behavior and undermine long-term success.

In this article, we will summarize the ways in which the best advisors already serve as behavioral coaches, and we'll offer additional techniques to help advisors improve by applying recent lessons from behavioral science to their practice.

The Challenges of Advisors-as-Portfolio-Managers

Looking across the advising industry, we see three major changes occurring:

1. The global expansion of advisor regulation, with the Department of Labor's fiduciary rule in the United States and MiFID II in the European Union.
2. The "greater" wealth transfer of $30 trillion in assets that will be passed down within the next 30 to 40 years to the next generation of investors—many of whom will be millennials.[1]
3. The growth of robo-advisors, which are attracting investors with lower fees, enhanced accessibility, and low-cost portfolios.

Why do these changes matter for advisors and the value they add for investors? Clearly, there are implications for advisors' income. Robos are driving down fees by making portfolio selection a commodity (at least for standard scenarios faced by most of the investing public). In addition, millennials interact very differently with their finances than do older generations. With easy access to more information on the Internet, and a tendency to look to it for guidance, younger investors are more likely to form their own strong opinions about the "right" investment strategy, separate from their advisor, for good or for ill. And finally, much of the attention in global regulation is on the investment-selection process. While this development is good for investors in the long run, it complicates the process for advisors in the meantime.

Despite these changes, what remains unchanged is the psychology of investing: the common behavioral obstacles that investors face due to the quirks of the mind. These biases can't be regulated away or completely solved by technology. But they can be coached and managed. The role of the advisor as a behavioral coach is one of the most valuable contributions advisors can bring today to the advisor-client relationship.

The Impact of Behavioral Coaching

In 2001, Vanguard began studying the concept of the "advisor's alpha"—the value advisors bring to clients—and has conducted a series of studies over the years to quantify it. In its 2016 study, Vanguard found that the single most impactful service an advisor can offer clients is behavioral coaching.[2] According to the study, behavioral coaching alone, on average, added about 150 basis points to clients' portfolios.

Simply helping clients mitigate their biases had a greater effect on clients than any other service, such as rebalancing, being cost-effective, and asset-location strategies. Stephen Wendel writes more about the Vanguard study in "Coaching to Mitigate Panic" (Page 37).

Although more industry professionals are beginning to appreciate the value of behavioral finance, investors rarely have the same level of expertise. Most investors do not seem to understand the impact their biases can have on their finances, nor do they have practical ways to counteract the effects. Without the guidance of a behavioral coach, many investors are at the mercy of their own emotions.

What This New Job Description Means for Advisors

For many advisors, acting as a behavioral coach isn't new. Even without using the term, some of the best advisors incorporate wise and impactful techniques in their practice to help their clients overcome common behavioral obstacles. However, for those advisors who are new to the practice, and for those who are looking to incorporate new techniques, let's break behavioral coaching down into three main roles advisors can play for their clients:

1. Behavioral teacher
2. Behavioral trainer
3. Behavioral counselor

Behavioral Teacher: Focus on the Psychology of the Mind

The first thing that may come to mind when thinking about how to help clients manage their finances is financial literacy: the teaching of fundamental investing concepts such as the time value of money and compound interest. Industry professionals and policymakers have traditionally relied on this approach to improve investors' day-to-day financial behavior. However, as Sarah Newcomb details in "Stop Teaching, Start Coaching" (Page 34), the approach may not be effective. Newcomb cites, for example, compelling research by Fernandes et al. on the relationship between financial literacy and financial behaviors.[3] They found that financial education has a negligible effect on people's subsequent financial behaviors, only explaining 0.1% of the variance in financial outcomes participants experienced. Moreover, this small effect diminished over a matter of months.

Instead, advisors should serve as behavioral teachers. A behavioral teacher educates clients about the psychology of investing and how common biases may affect their financial behavior.

A good way to begin this conversation is to talk about how our minds work. According to the research, our brains have two relatively distinct modes of thinking—a reactive "System 1" and deliberative "System 2."[4] Reactive System 1 thinking operates quickly in an unconscious, intuitive way, while our deliberative System 2 operates slowly in a logical, rational way. We use both systems to navigate through our daily lives. For example, we use reactive thinking when driving to a familiar place such as to our jobs. We rarely think carefully about the hundreds of minute decisions we make while driving; it just happens intuitively. In contrast, we activate deliberative thinking when calculating complex mathematical problems or making serious decisions like purchasing a house. Deliberative thinking is effortful and requires concentration.

1 Pigliucci, A., Thompson, K., & Halverson, M. 2015. "The 'Greater' Wealth Transfer." *Accenture*.
2 Kinniry Jr., F.M., Jaconetti, C.M., DiJoseph, M.A., Zilbering, Y., & Bennyhoff, D.G. 2016. "Putting a Value on Your Value: Quantifying Vanguard Advisor's Alpha." Vanguard white paper, September.
3 Fernandes, D., Lynch, J., & Netemeyer, R. 2014. "Financial Literacy, Financial Education, and Downstream Financial Behaviors." *Management Science*, Vol. 60, No. 8, pp. 1861–1883.
4 For example, see Kahneman, D. 2011. *Thinking Fast and Slow*. New York: Farrar, Straus and Giroux.

When investing, investors may, without realizing, evoke reactive thinking. For example, clients may be so overwhelmed by investment options they avoid taking any action to start investing (we call this choice paralysis).[5]

As behavioral teachers, advisors help clients recognize the conditions under which their reactive thinking is activated and nudge them toward making more deliberate decisions. Research shows that helping people understand and recognize their biases improves decision-making processes and that the effect persists at least two months later.[6]

In short, the teaching aspect of behavioral coaching means educating clients about the psychology of investing—not just financial concepts.

Behavioral Trainer: Change the Environment, Not the Person

As a behavioral trainer, advisors can establish an environment that supports their clients' success. Here's a familiar example to show why this matters.

Let's say John is a new client who says he plans to set aside 10% of his aftertax paycheck to a retirement account. In the first month, John successfully invests 10% of his salary. However, over the subsequent months, John begins to fall short of his monthly goal—he either saves less than 10% or fails to put any money away.

Despite John's good intention of saving more for retirement, something prevents him from following through. This is what behavioral scientists call the intention-action gap, and it's one of the most common behavioral challenges that investors face. In fact, researchers estimate that only about half the time do our intentions translate into action.[7]

Some advisors may interpret John's failure as a personal shortcoming, a tendency to procrastinate or to disregard future needs. Some might even assume that John just isn't serious about saving for retirement. However, behavioral research suggests that the tendencies to procrastinate and overvalue immediate rewards are inherent in everyone; that's just the way our minds work. Researchers have found that by changing the *environment*—with nudges and a supporting structure such as a trainer—we can keep clients on track, despite the mind's quirks.

John's advisor could lecture him on the importance of staying on track. But chances are, that won't be helpful. Instead, the advisor as trainer could help John change his environment to overcome his behavioral obstacles. The advisor could help John set up a voluntary payroll deduction that automatically invests 10% of each paycheck. This way, John does not have to make a conscious effort to put money aside—it's done out of sight and out of mind. Next, the advisor could help John develop good investing habits such as avoiding minute-by-minute market-watching and instead doing quarterly check-ins.

Behavioral Counselor: Manage Emotional Reactions

Market volatility is part and parcel of investing. Yet during market fluctuations, some investors panic and liquidate investments, causing them to veer off course. This panic, in part, is derived from their behavioral biases. During these emotional periods, investors might believe that what has just happened (a drop in the market) is going to continue to happen in the future. This arises from what is known as recency bias. In their minds, market volatility turns into long-term capital loss. During trying times like these, advisors playing the role of behavioral counselor can have a large impact by helping clients manage their emotions and stay focused on long-term goals.

One way to help clients control their emotions during market volatility is to intentionally introduce friction into the advising process—such as a prearranged three-day waiting period before making major trades. This will allow clients to take a step back from their emotions and bring deliberative System 2 thinking to the forefront. Another technique is to prepare clients for future market corrections and the possibility that they may be tempted to jump ship. Advisors can have clients think through the scenario and what they will feel and want to do. This is akin to the process of inoculation in the medical field. Mentally preparing clients for volatility is like giving a vaccine against panic, before it arises.

Another exercise involves using a "precommitment device," such as a personal commitment letter. Advisors can ask new clients to put in writing their life plans, goals, values, and for whom they are investing—the root reasons of why clients are investing. Then, during times of panic, advisors can forward this letter to their clients, reminding them why it is important to stay on track.

A Challenge Is an Opportunity in Disguise

The advisor ecosystem is undergoing major changes, from new regulations to robo-advising to the unique expectations of millennials. These changes will have an impact on an advisor's bottom line, but they also provide an opportunity for financial professionals to showcase and build upon the value they bring as behavioral coaches.

While the industry shifts, what remains unchanged is the psychology of investing. One of the greatest sources of value an advisor can provide to clients is to help them navigate the emotional ups and downs of investing. M

Ray Sin is a behavioral scientist, behavioral science, with Morningstar.

Samantha Lamas is an associate behavioral researcher, behavioral science, with Morningstar.

Michael Leung is an associate behavioral designer, behavioral science, with Morningstar.

5 Iyengar, S. & Lepper, M. 2000. "When Choice Is Demotivating: Can One Desire Too Much of a Good Thing?" *Journal of Personality and Social Psychology*, Vol. 79, No. 6, pp. 995–1006.
6 Morewedge, C.K., Yoon, H., Scopelliti, I., Symborski, C.W., Korris, J.H., & Kassam, K.S. 2015. "Debiasing Decisions: Improved Decision Making With a Single Training Intervention." *Policy Insights from the Behavioral and Brain Sciences*, Vol. 2, pp. 129–140.
7 Sheeran, P. 2011. "Intention-Behavior Relations: A Conceptual and Empirical Review." *European Review of Social Psychology*, Vol. 12, pp. 1–36.