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A Practical Approach to Behavioral Guidance

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INVESTMENTS & WEALTH INSTITUTE®

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Much has been written about the importance of appropriate behavioral management, in addition to investment management, particularly during periods of market volatility. After all, behavioral biases can have a material impact on the decisions made by investors and their eventual outcomes.

Classic economics assumes that investors are rational—that they incorporate available information to determine appropriate probabilities and to optimize their investment decisions. The study of behavioral science, which incorporates cognitive and behavioral psychology, recognizes that investors are emotional and are subject to cognitive and emotional biases that may lead to erroneous conclusions and suboptimal investment decisions.

Cognitive errors are defined as basic statistical, information processing, or memory errors that cause a person's decision to deviate from the rationality assumed in traditional finance. These errors fall into two subcategories: belief preservation errors (the tendency to cling to one's initial belief even after receiving new information that contradicts it) and information processing errors (mental shortcuts).

Emotional errors arise as a result of attitudes or feelings that cause the decision to deviate from the rationality assumed in traditional finance. Although these may be more difficult to manage than cognitive errors, it's important to understand how emotions can influence investor behavior.

Some of the more common biases that affect decision-making include the following:

Loss aversion: Investors feel the pain of loss more severely than they feel the pleasure associated with gains. This aversion to loss causes investors to sell winning investments too early, to hold losing investments too long, or to invest in safe positions to avoid the possibility of loss.

Recency: Investors tend to focus on recent returns and current trends instead of incorporating a more complete universe of historical data. This can lead to portfolio decisions that are driven by emotion and inconsistent with investors' risk tolerance and long-term financial goals.

Framing: Investor decisions are influenced by the manner in which information is presented. This bias can produce decisions that are potentially subject to external manipulation and ignore the important fundamental characteristics of various investment choices.

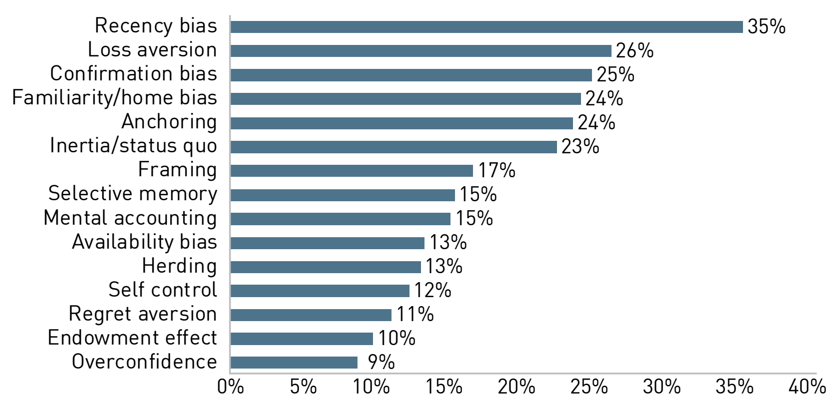
Anchoring: Investors cling to arbitrary datapoints (initial purchase price, self-selected benchmarks, etc.) when deciding to buy or sell portfolio holdings. This approach can lead to decisions that lack fundamental rationale.

Familiarity: Investors feel comfortable investing in themes, industries, and companies that they know through personal experiences. This can lead to overconcentration, insufficient diversification, and elevated risk.

Overconfidence: Investors believe that they know more than they do, or they have an exaggerated degree of certainty

Figure 1

MOST SIGNIFICANT BIASES AFFECTING CLIENT INVESTMENT DECISIONS



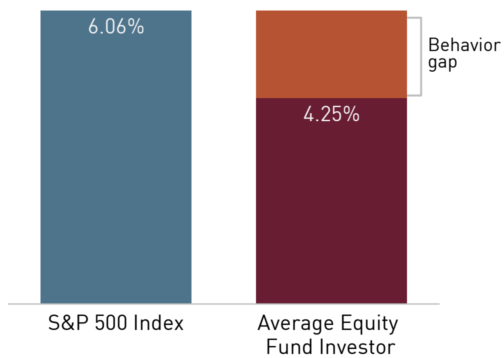
Analyst Note: Advisors were asked, "To what degree do you believe the following biases may be affecting your clients' investment decision-making?"

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

Figure 2

INVESTORS ARE THEIR OWN WORST ENEMY

20-year average index vs. investor returns ending December 31, 2019

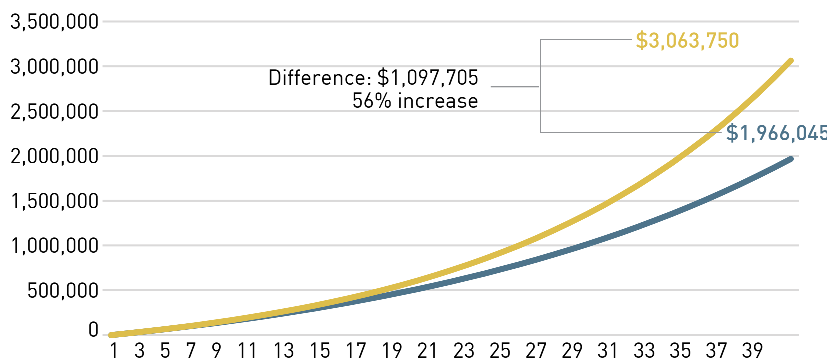


Period ended December 31, 2019

Source: Quantitative Analysis of Investor Behavior, 2020, DALBAR, Inc. dalbar.com

Figure 3

THE IMPACT OF BAD BEHAVIORS



Assumptions

- Annual contribution: $19,500
- 40 years
- Investor return: 4.25%
- Investment return: 6.06%

Source: PIMCO

Hypothetical example for illustrative purposes only. Charts are provided for illustrative purposes and are not indicative of the past or future performance of any PIMCO product.

regarding their views. Overconfidence can lead to snap decisions and increased trading activity that can hurt returns.

Figure 1 lists the most significant behavioral biases affecting client investment decisions.

IMPACT OF BEHAVIORAL BIASES

The impact of these behavioral biases on portfolio returns can be significant. A recent study by DALBAR[1] illustrates the difference between investment returns (time-weighted) and investor returns (dollar-weighted) in equity funds. Time-weighted returns reflect the performance of the investments selected during a specific holding period, and dollar-weighted returns include the impact of investor behaviors, including cash flows. The difference in results for the 20-year period covering 2000 through 2019, driven by investor behaviors, is significant. The annualized investment return, reflected by the S&P 500, was 6.06 percent, but the average equity fund investor return was 4.25 percent during that period (see figure 2).

The difference in annualized returns might appear to be modest, but these differences compound over time to create very different ending levels of wealth. Using an annual contribution of $19,500 (the current 401(k) limit for 2020) over a 40-year horizon, the ending values are $3,063,750 at 6.06 percent versus $1,966,045 at 4.25 percent—a difference of $1,097,705 or almost 56 percent in dollar terms (see figure 3).

Investors often feel more comfortable allocating capital after periods of stronger recent results, and they become discouraged after periods of market declines, leading to withdrawals. However, successful investing requires a counterintuitive approach that is often at odds with our emotional state. Behavioral coaching from a competent advisor can help investors avoid these common mistakes and provide significant value to their clients.

Another study by Morningstar titled "Mind the Gap" found similar results in various asset classes.[2] The study of investor returns attempts to measure how investors have timed their fund investments by estimating the average fund investor's performance compared to the fund's time-weighted return. According to Morningstar, the "gap" represents the impact that the timing of investors' purchases and sales had on the investment outcomes achieved (see figure 4).

The DALBAR and Morningstar studies show that bad timing can cost investors dearly by quantifying the aggregate mutual fund investor gap, an opportunity for advisors to help narrow that gap through behavioral guidance.

ADVISOR BEST PRACTICES

Advisors have an opportunity to add value to client relationships by providing appropriate behavioral coaching, in addition to the other services offered. In fact, a recent study by Vanguard estimated that the impact of prudent behavioral coaching could add 150 basis points to the annual returns earned by investors.[3] The objective of the study is to try to quantify the incremental returns, or advisor value, by nudging clients to stick to their financial plans rather than trying to time the market (see table 1).

Identifying various behavioral biases and studying their effects on investor decisions may help advisors from an educational perspective, but it may not help clients change their behaviors. Adopting a behavioral coaching approach may be more effective at improving both the investor's behavior and investment experience (see figure 5). A behavioral coaching approach might include the following:

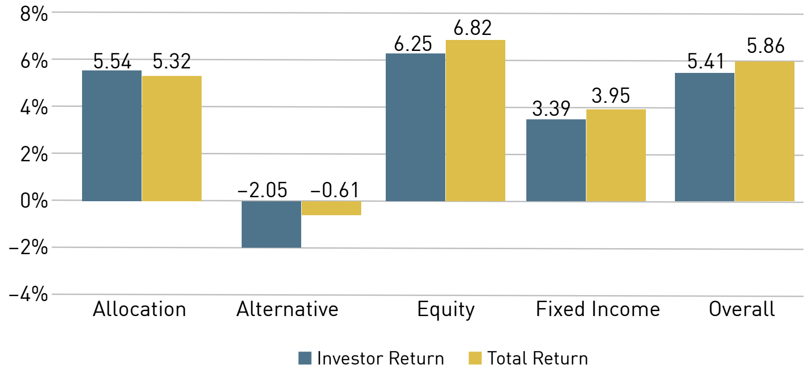
Proactively setting expectations in advance. Advisors can refer to past market cycles and the variability of investment returns to educate clients. They also can adopt an effective discovery process that helps investors project their potential range of experiences and their personal reactions under various conditions. Although this educational approach won't guarantee rational behavior during volatility, preparing clients for it in advance can help to improve their odds.

Appealing to clients' emotional approach. Common modes of persuasion include ethos (credibility and ethics), pathos (emotions and feelings), and logos (logic and reason). Many investment decisions are based on emotional response, not the logic of the information and data presented. Advisors who appeal to emotions in their approach to behavioral coaching, rather than relying solely on a rational approach based in logic, may enjoy greater success.

Adopting a client perspective. Advisors often provide counsel with a rational orientation, neglecting to consider the investor's orientation. Advisors need to recognize clients' individual response to market conditions in order to understand their perspectives, acknowledge their feelings, and demonstrate empathy.

Figure 4

AVERAGE OF ROLLING 10-YEAR INVESTOR RETURNS IN THE UNITED STATES



Source: Morningstar Inc. Data as of December 31, 2018.

Table 1

THE VALUE-ADD OF BEST PRACTICES IN WEALTH MANAGEMENT

		Benefit of moving from the scenario described to Vanguard Advisor's Alpha methodology
Vanguard Advisor's Alpha Strategy	**Module**	**Typical value added for client (basis points)**
Suitable asset allocation using broadly diversified funds/ETFs	I	> 0*
Cost-effective implementation (expense ratios)	II	34
Rebalancing	III	26
Behavioral coaching	IV	150
Asset location	V	0–75
Spending strategy (withdrawal order)	VI	0–110
Total return versus income investing	VII	> 0*
Range of potential value added (basis points)		About 3 percent in net returns

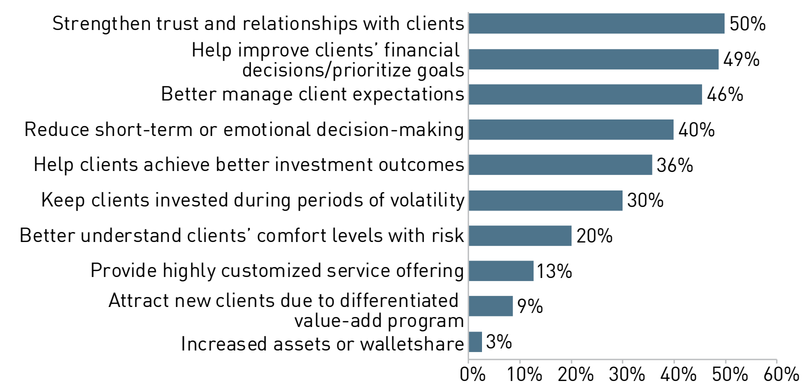
**Value is significant but too unique to each investor to quantify.*

Notes: We believe implementing Vanguard Advisor's Alpha framework can add about 3 percent in net returns for your clients and also allow you to differentiate your skills and practice. The actual amount of value added may vary significantly depending on client circumstances.

Source: Vanguard

Figure 5

GREATEST BENEFITS TO ADVISORS OF INCORPORATING BEHAVIORAL FINANCE, 2019



Sources: Cerulli Associates in partnership with Investments & Wealth Institute

Advisors can implement various tactics in their practices to help overcome behavioral biases in the decision-making process and improve investor outcomes, including:

- Identifying investor behavioral risk
- Maintaining perspective
- Using diversification to reduce portfolio volatility
- Portfolio rebalancing
- Developing investment policy statements
- Asset bucketing for specific goals
- Automated investment programs

IDENTIFYING INVESTOR BEHAVIORAL RISK

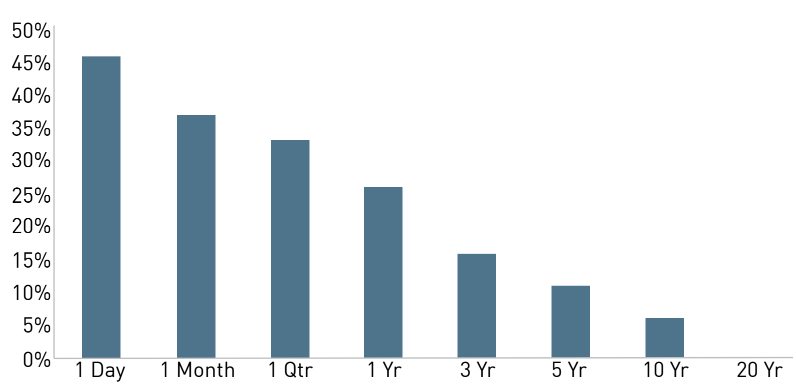
Investment consultants often rely on quantitative risk metrics to measure and communicate risk to their clients. Standard deviation is commonly used to measure the variability of investment returns relative to the historical average or expected returns, illustrating the potential consistency of an investment experience. Beta is used to measure the relative volatility of an investment to a market benchmark and the potential sensitivity to a market rise or fall. Value-at-Risk can help to quantify a portfolio's maximum loss, in dollar terms, during periods of market decline. Although these metrics can help to frame the risk discussion, they may not be sufficient in helping advisors fully understand a client's emotional tolerance toward risk. Incorporating a deeper discussion through appropriate discovery questions, such as the following, may provide advisors with additional insights:

- How has the recent volatility affected you? Has it changed any of your personal goals?
- Are you comfortable with your current allocation and holdings? What specific changes are you considering?
- If you received new funds today, how would you invest them?
- What's more important to you now: regaining the value recently lost, or protecting the capital you have today?
- What action would you take if your portfolio increased 10 percent next month? Declined 10 percent next month?
- What would be more disturbing: holding securities that continue to decline in value, or selling securities that eventually rise?
- How do you define risk? How do you measure it? How do you try to manage it?
- Which would you prefer: a portfolio with lower volatility and lower returns, or one with higher returns and greater volatility?

Apart from gaining a better understanding of client risk tolerance, this approach of deeper discovery provides advisors with an additional benefit in relationships with clients: differentiation. Advisors are often tempted to demonstrate their value by delivering advice and recommendations to clients. But taking the time to understand a client's passions and concerns using thorough and thoughtful discovery can help demonstrate both competency and empathy, two important qualities that clients value highly.

Figure 6

ODDS OF NEGATIVE RETURNS BY TIME HORIZON



Source: BoA Global Research, period ending March 12, 2020

MAINTAINING PERSPECTIVE

Periods of extreme market volatility, such as the large declines suffered in early 2020, can cause investors to lose appropriate perspective and engage in behaviors that are destructive. These periods may be unsettling, but it's important for advisors to help clients understand the impact of these declines relative to their personal time horizons. A focus on the increased probabilities of successful outcomes by maintaining a long-term perspective can help. Figure 6 illustrates the odds of a positive return in equities over different holding periods and the increased odds of success through a longer-term investment horizon.

In addition to increasing the odds of positive returns, longer holding periods also reduce the variability of the annual returns. Figure 7 shows annualized returns of stocks, bonds, and cash for the period 1926–2019 and provides the following useful insights:

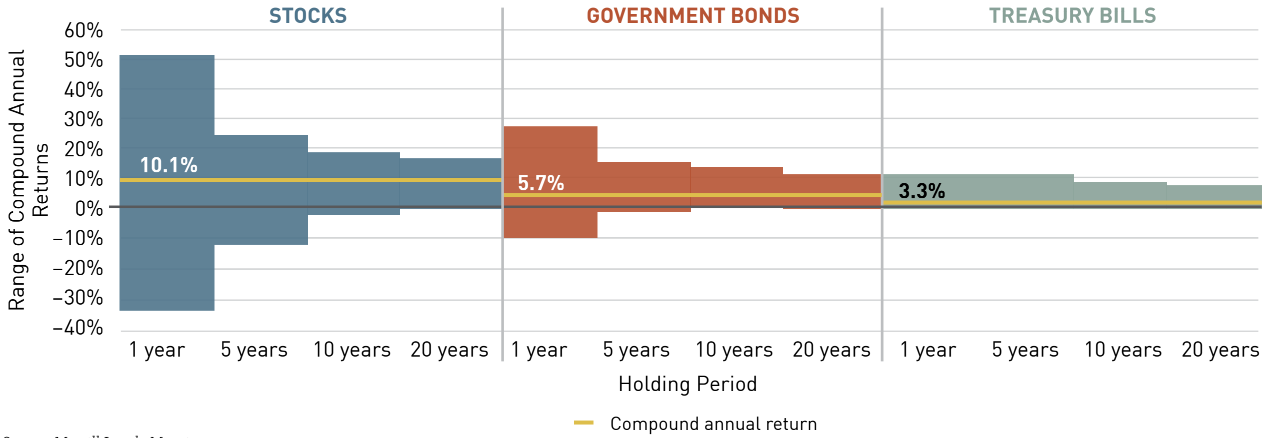
- The average return of stocks (10.1 percent) is greater than bonds (5.7 percent), which in turn is greater than cash (3.3 percent).
- The variability of returns over each holding period for stocks is greater than bonds, which in turn is greater than cash.
- The variability (or range) of returns for each asset class is greatest over shorter holding periods, but it diminishes over longer periods.

USING DIVERSIFICATION TO REDUCE PORTFOLIO VOLATILITY

Portfolio volatility affects investors in two important ways: financially and emotionally. Prudent portfolio diversification can help to reduce overall volatility to limit portfolio declines during periods of market stress and to minimize

Figure 7

ANNUALIZED RETURNS OF STOCKS, BONDS, AND CASH, 1926–2019

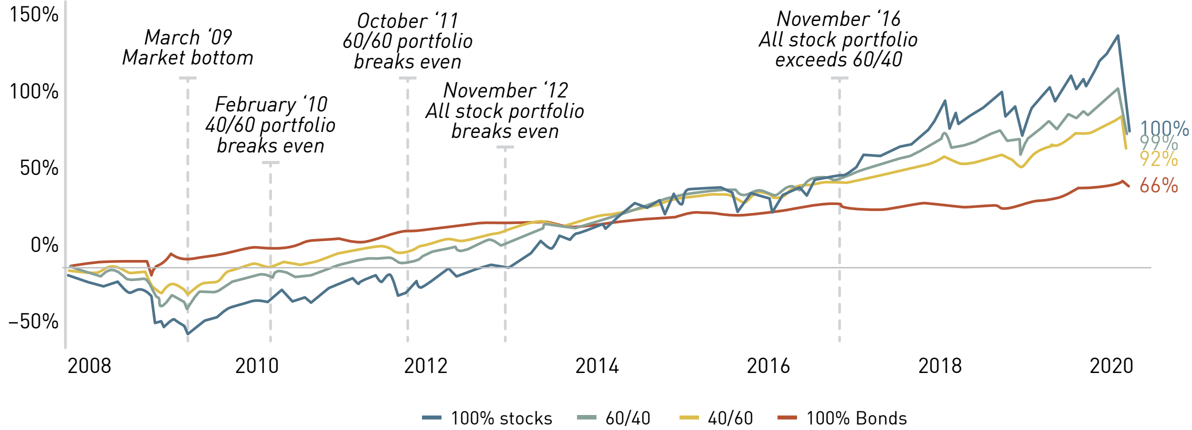


Source: Merrill Lynch, Morningstar

Each bar shows the range of historical compound annual returns of each asset class for different holding periods over the 1926–2019 period. The range within the top and bottom of each bar includes 95 percent of the historical compound annual returns. Stocks, government bonds, and Treasury bills are represented by the S&P 500 Total Return Index, the Ibbotson US Long Term Government Total Return Index, and the Ibbotson US 30-Days T-Bill Total Return Index, respectively. Calculations are based on monthly returns, are gross of any fees, and do not take into account tax implications.

Figure 8

ASSET ALLOCATION PERFORMANCE: TOTAL RETURNS OF HYPOTHETICAL STOCK/BOND PORTFOLIOS SINCE 2008 PRE-FINANCIAL CRISIS PEAK



Source: Clearnomics, Standard & Poor's, Refinitiv

Total returns of hypothetical stock/bond portfolios since 2007 pre-financial crisis peak using the S&P 500 and iShares Core U.S. Bond Indexes, before expenses/fees.

Note: Last datapoint is March 16, 2020.

the emotional responses that often follow. Figure 8 shows the performance of various portfolio constructs and the less-volatile experience of a diversified approach, during 2008–2020.

Unfortunately, investors often fail to appreciate the true benefits of proper portfolio diversification and seek to overweight the investments they perceive to offer the greatest return potential. Diversification can be viewed as an important "free lunch" in successful investing, because it provides 100 percent of the weighted returns of the assets included while enduring less than 100 percent of the weighted risks. This provides greater risk-adjusted returns, and more-efficient portfolios, as measured by Sharpe ratios, and the smoother ride that helps to keep clients on track.

Proper diversification is achieved by strategically combining various asset classes and holdings, both traditional as well as alternatives including commodities, real estate, and private equity and credit exposures, particularly those that have exhibited lower correlations to traditional assets. Correlation is a useful tool that measures the relative movements among independent variables, but it has some limitations:

- It is backward-looking and may not be representative of future experiences.
- It measures the relationship among assets in all market conditions, including rising and falling prices,

which may blur the important concept of relative behaviors during market drawdowns.

- Correlations among asset classes tend to rise during periods of extreme market volatility—exactly the point where investors need protection the most.

PORTFOLIO REBALANCING

Various studies have suggested that systematic rebalancing can produce the financial benefits of greater returns and lower volatility. Regular portfolio rebalancing also can provide discipline to investment decisions, reducing the negative impact of emotional stress. Rebalancing forces the investor to engage in behaviors that are emotionally uncomfortable (reducing exposure to assets that have performed well and adding to those that have lagged) but financially productive. A recent study by Morningstar found that a 60/40 portfolio rebalanced annually produced significantly lower drawdowns and experienced quicker recoveries (see table 2).[4]

The notable volatility endured during the financial crisis of 2008–2009 provides a deeper perspective of the potential value of disciplined portfolio rebalancing. After experiencing significant losses in their equity holdings, many investors were reluctant to maintain exposure to equities, let alone add funds to the asset class. A formal rebalancing approach would have required the investor to shift assets to equities, setting up for the eventual rebound, and would have prevented the destructive temptation to move to cash after the significant decline.

The hypothetical illustration shown in figure 9 demonstrates the required actions and potential benefits of disciplined portfolio rebalancing during the volatility endured during the 2008–2009 financial crisis. After holding a blended portfolio of equity and fixed income investments, the significant market declines endured resulted in large declines in equity holdings and modest positive returns in the fixed income allocation. Although many investors were tempted to abandon their strategies by liquidating equities, a disciplined approach would have required the investor to stay the course and add to the underweighted asset class.

There are many potential approaches to rebalancing. Periodic rebalancing involves shifting exposures at regular intervals (monthly, quarterly, annually, etc.); a variance method invokes re-allocations based on deviations from the intended allocations (e.g., ±5 percent or ±10 percent). The potential benefits of rebalancing (risk reduction and enhanced returns) are dependent on the various asset classes employed and the correlation among them.

Table 2

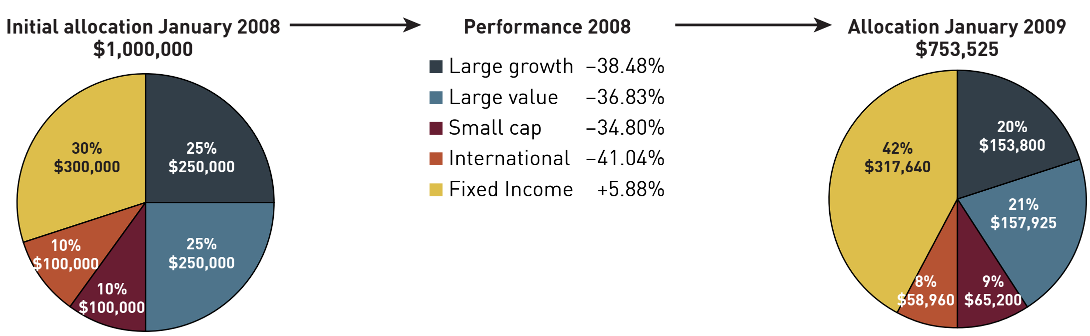
DRAWDOWN AND RECOVERY PERIODS

Period		Buy and Hold	Annual Rebalance
2000 Recession	Drawdown	–28.3	–20.7
	Recovery periods	29.0	15.0
2007–2008 Crisis	Drawdown	–36.6	–31.9
	Recovery periods	26.0	20.0
2020 Pandemic	Drawdown	–25.7	–19.7
	Recovery periods	NA	NA

Source: Morningstar Direct. Data as of March 20, 2020.

Figure 9

PORTFOLIO REBALANCING AFTER MARKET DECLINE



	2009 portfolio	Target allocation	Required change
Large growth	$153,800	$188,381	+$34,581
Large value	$157,925	$188,381	+$30,456
Small cap	$65,200	$75,353	+$10,153
International	$58,960	$75,353	+$16,393
Fixed Income	$317,640	$226,057	-$91,583

Large growth = Russell 1000 Growth Index; Large value = Russell 1000 Value Index; Small Cap = Russell 2000 Index; International = MSCI EAFE; Fixed Income = Bloomberg Barclays US Aggregate Bond Index.

Hypothetical example for illustrative purposes only. No representation is being made that any account, product, or strategy will or is likely to achieve profits, losses, or results similar to those shown.

Source: PIMCO

Rebalancing may not provide benefits all the time, but it can provide benefits over time. Above all, rebalancing forces an adherence to the intended policy allocation and encourages appropriate behaviors that are often counterintuitive.

DEVELOPING INVESTMENT POLICY STATEMENTS

Many advisors think of investment policy as a tool to guide institutional client behaviors (pension, nonprofit, etc.), but the benefits also apply to private client relationships. The written policy document may provide value to both client and advisor, but the process of creating an investment policy statement (IPS) may provide the greatest benefits. The discussion provides the client an opportunity to specify unique requirements, objectives, concerns, and constraints in an attempt to develop a personalized investment approach. The process also allows the advisor to demonstrate professionalism, manage client expectations, and gain a deeper understanding of the client's specific objectives and preferences. Additional benefits include:

- A specified asset allocation to guide investment decisions
- Identified benchmarks for appropriate performance measurement
- Specified guidelines for portfolio implementation
- Assurances to corporate and public contributors, as well as individual donors to foundations and endowments
- Discipline for periods of market difficulty to minimize emotional decision making

Creating an IPS often can involve multiple meetings in an evolving process. Here are the common steps used in creating an investment policy statement:

Establish executive summary and purpose: includes key attributes including client mission, legal structure, portfolio size, stakeholders

Document background and investment objectives: includes types of accounts, specific financial objectives, time horizon, liquidity constraints

Outline roles and responsibilities: specifies various participants including advisor, investment managers, custodian, investment committee, family members

Determine investment guidelines/allocation: includes risk tolerance, time horizon, asset class preferences, portfolio benchmarks, asset allocation guidelines, rebalancing methodology, acceptable security characteristics

Provide investment/fund/manager selection criteria: includes performance, firm longevity and stability, correlations to peer group, style consistency, expense ratios

State monitoring and reporting requirements: includes schedule for meetings, review criteria, manager change process, policy amendment procedures

Developing and adhering to a formal IPS can help to deliver the discipline required to avoid many common mistakes made during periods of market volatility.

ASSET BUCKETING FOR SPECIFIC GOALS

Mental accounting suggests that investors treat resources differently based on where they were sourced or where they are held—think about how individual retirement account dollars might be viewed or managed differently from other brokerage assets, despite their common purpose. Although mental accounting can have negative implications when investors fail to view or manage their assets in a comprehensive fashion, it may provide some emotional benefit during periods of market stress.

Advisors often express their desire to manage and monitor the entirety of client resources. The benefits of a consolidated and comprehensive approach to client financial management are numerous:

- The ability to develop and maintain an appropriate asset allocation strategy
- Consolidated performance measurement and reporting
- Implementation of intentional asset location of various holdings in a tax-sensitive management plan
- The ability to engage in appropriate tax-loss or -gain harvesting
- Guidance on effective charitable giving strategies, including the identification of specific holdings
- The development of an effective estate plan, including various advanced strategies involving various assets

Although the benefits of a consolidated view of all financial holdings may be enticing, there can be an unintended consequence …

Although the benefits of a consolidated view of all financial holdings may be enticing, there can be an unintended consequence: the emotional strain produced during periods of large market drawdowns. Investors may lose sight of the idea that not all holdings have declined in unison, and that all assets are not immediately required to meet short-term financial goals.

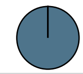
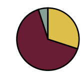
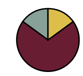
Asset bucketing may provide benefits. An asset bucketing approach, shown in figure 10, involves the identification of:

- Various financial goals (e.g., college costs, purchase of a second home, retirement, etc.)
- The expected timing of these liabilities
- Amounts required to fund them
- Segregated investment sleeves containing appropriate assets given the required liquidity and volatility constraints

Portfolio declines can be unsettling, but the recognition that appropriate resources have been set aside to meet

Figure 10

STRATEGY ASSET BUCKETING

Goal	Time Horizon	Dollar Amount	Priority Level	Strategy
Buy second home	6 months	$1 million	High	
Education for four children	4 years each; 5 years out	$1 million	High	
Lifestyle	25 years out	$1 million	Low	
Bequest for children	50 years out	$1 million	Low	

Cash
Fixed Income
Equities
Alternatives

Sample for illustrative purposes only.

Source: PIMCO

near- and intermediate-term liabilities can provide emotional comfort. Additionally, this approach allows the investor to take a more aggressive approach, with the goal of greater returns, with other financial holdings given the longer time horizon.

AUTOMATED INVESTMENT PROGRAMS

Automating financial functions, including savings, allocation, and withdrawal strategies, can help to remove emotions from the decision-making process for investors and simultaneously create efficiencies for advisors.

The virtues of dollar-cost averaging are well known—by committing consistent investment amounts to their accounts, investors are buying more units at lower prices and fewer units at higher prices, leading to a lower overall price. Systematic investing, including regular payroll contributions to fund 401(k) savings, can help to overcome investor inertia and the status-quo bias where it's easiest to stick with a current plan and to avoid new decisions, despite their potential benefit. Additionally, committing to regular and consistent investment contributions also removes the temptation to time the market by looking for optimal entry points, a behavior that historically has hurt investor returns.

Model portfolios, where the investment function (i.e., allocation, fund selection, etc.) is outsourced to discretionary third parties, is another form of automated investing. The usage of model portfolios has increased in recent years. Cerulli Associates estimates that approximately half of all advisors have employed models and expects that number to increase to 90 percent in coming years. By outsourcing the investment management function, model usage can help advisors save time for other important functions including client servicing, financial planning, and new client acquisition.

Model investing may help advisors and investors avoid the temptation of allocating capital based on trailing returns—a behavior known as recency bias—by emphasizing forward-looking return potential. Model usage also can limit unexpected portfolio outcomes and reduce the return dispersion of advisor-managed accounts, providing a smoother ride for the advisor and the client.[5] Most importantly, models offer a way to potentially reduce the impact of cognitive and emotional biases on investment decisions. By entrusting portfolio construction or guidance to a professional asset manager, advisors can help clients keep emotions in check, and maintain a disciplined long-term approach to managing assets for specific outcomes.[6]

CONCLUSION

Understanding behavioral finance and biases may enhance an advisor's knowledge, but it is only a first step in mitigating the impact on an investor's experience. Advisors who implement effective behavioral coaching through framing and communication techniques that connect with clients' unique perspectives can help to improve clients' overall experience. Behavioral coaching best practices, combined with several of the practical tactics offered here, also can help advisors to provide unique value to their clients and help them to differentiate their practices from other advisors. Ultimately, each advisor must determine how to best apply behavioral guidance to effectively narrow the behavior gap and help clients select an acceptable investment approach to earn the returns required to achieve their unique objectives.

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A PRACTICAL APPROACH . . .

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ENDNOTES

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