if you were to boil the discipline of behavioral finance down to one key concept, it would be heuristics. Heuristics are the built-in decision-making shortcuts that the human brain uses to process huge amounts of information quickly. Heuristics have evolved over millions of years, are hardwired into our thinking processes, and are necessary because the world is a complicated place; from moment to moment, there’s a lot going on that the brain must process instantaneously.

Think for a moment about your brain. Its primary responsibility is to help you survive in a complicated and threatening environment. To do so, it must constantly cope with and sort through an incredible amount of information. When faced with a threat or even just a stress, the brain seeks to find the right heuristic to arrive at a decision quickly.

When it comes to survival, especially in a complicated and threatening environment, time is crucial. Consider this: If you needed to catalog all the relevant information and carefully review all the potential options and their consequences every time you had to make a decision, you would still be pondering long after the time to act had passed. As a result, the brain’s deliberate “slow thinking” processes are frequently abandoned in favor of a heuristic that provides a “fast thinking” alternative (Kahneman 2011). In times of stress, the brain exclusively uses heuristics as a way of coping with the threat.

Good Enough—Usually
Let’s look more deeply at behavioral finance, the academic discipline that studies and catalogs the heuristics that affect human financial decision-making. Individuals can develop unique patterns of coping with the world, but behavioral finance looks at the common heuristics—those that are built in to the brain—that human beings use across cultures. Daniel Kahneman and Amos Tversky began researching heuristics in the 1970s (Lewis 2016), and the discipline is now being expanded by a third generation of researchers. These combined efforts have resulted in a huge body of literature and a growing number of insights into how the human brain works.

An important insight emerged early in Kahneman and Tversky’s research that has been confirmed repeatedly: Heuristics are helpful, efficient, and crucial for our species’ survival, but they don’t always lead to the best possible decisions. Because heuristics evolved to help us cope with threats, they can be misapplied in the modern world and lead to negative consequences. As Pulitzer Prize-winning sociobiologist Edward O. Wilson said, “The real problem of humanity is the following: we have Paleolithic emotions, medieval institutions and godlike technology.”¹ In fact, behavioral finance has pointed out specific heuristics to be avoided because they have negative consequences when applied to today’s challenges.

For Advisors Working with Clients
Client-facing advisors who want to benefit from the insights of behavioral finance should be aware of two challenges. First, there has been an enormous amount of information cataloged that details how various heuristics work and what they look like in human behavior. Unless you are dedicated to mastering the vocabulary of the discipline, the sheer magnitude of the available information may be overwhelming. The discipline reveals the nuances of how the human brain works, which is very useful for advisors, so the temptation is to try to read it all.

Second, many of the heuristics are well studied, described, and understood, but relatively little has been written about how to use the insights tactically when working with clients. The practical-minded advisor should focus on the heuristics that can influence clients to make better decisions and learn how to apply them. This is more advantageous than knowing all about heuristics but being unable to use the information.

I’m reminded of a comedy skit on Tracey Ullman’s television show some years ago involving a conversation between a psychologist and a patient. The patient was complaining about an intense fear of flying and going on about his vivid anxiety about heights and the potential for disaster. The psychologist listened for a long while to the patient’s intense dread and said: “I know that it won’t be of any comfort to you for me to explain that airline travel is by far the safest form of transportation; phobias such as yours are irrational and deeply seated. You poor man; treating this fear will take time.”

The patient’s reply was unexpected: “Wait, what did you say? Flying is the safest form of transportation? Really? That changes everything.” At that point the patient jumped up, declared the psychologist a genius, and left the room a cured man. Stunned, the psychologist was left sitting
alone and said to the empty room, “But it’s not supposed to work like that.”

Client-facing advisors know that, in fact, it doesn’t work like that. No matter how much we know about how irrational we tend to be, we still act irrationally. The annual DALBAR (2016) Quantitative Analysis of Investor Behavior reminds us that when left to their own heuristic-driven decisions, clients will make the same bad decisions repeatedly based on the same irrational conclusions (see figure 1). But a good financial advisor can help. In fact, advisors who can effectively coach their clients out of these heuristically driven decisions can add as much as 2-percent total return annually to a client’s portfolio when averaged across the full market cycle (Bennyhoff and Kinniry 2016).

Every advisor should invest time and effort in becoming familiar with some of the most common heuristics as a tool for working with clients. But the advisor who wants advanced skills in coaching also needs to develop tactics for engaging clients and influencing their thoughts (see figure 2).

### Coaching and Heuristics

One of Kahneman and Tversky’s great contributions to behavioral finance was the discovery that, rather than being hidden in the patterns of our unconscious thinking, heuristics can be seen clearly in human behavior if you know where to look. The genius of their collaboration was in the designs of studies that revealed these patterns. For practical-minded advisors, the good news is that many heuristics and patterns are not hiding at all; a curious professional will spot them easily and find they are quite coachable.

One of the easiest patterns to work with is a heuristic we call “the structure of hope.” The way people experience hope is a component common to all types of decision-making and is critical to the relationship between client and financial advisor.

In this regard, hope is a universal human experience, necessary for healthy emotional functioning. Someone who has lost hope is deeply depressed and may consider death to be an attractive alternative to living hopelessly. Studies of humans living in hopeless situations, such as having a terminal illness or being trapped in a war zone, reveal that sustained hopelessness can lead to serious illness and even death. Having some form of hope about the future is necessary for everyone.

For our purposes, a big part of the decision to hire a financial advisor is motivated by an investor’s desire to increase the quality of hope about the future. For the advisor, understanding the different qualities hope presents in the thinking patterns of clients is a key element of managing those relationships.

### Different Types of Hope

Hope is actually a highly malleable human experience that can be profoundly influenced by external events. Consider the challenge of coping with a potentially terminal illness. On the day the diagnosis is delivered, the patient’s sense of hope for a positive future is dimmed or eclipsed, and the patient feels dark and hopeless. The next day, when the doctor calls to explain that a mistake was made and the patient is not ill at all, the patient’s hope for a bright future returns and perhaps becomes even more vivid than before. In either case, a small amount of information has an

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* Returns are for the period ending December 31, 2015. Average equity investor performance results are calculated using data supplied by the Investment Company Institute. Investor returns are represented by the change in total mutual fund assets after excluding sales, redemptions, and exchanges. This method of calculation captures realized and unrealized capital gains, dividends, interest, trading costs, sales charges, fees, expenses, and any other costs. After calculating investor returns in dollar terms, two percentages are calculated for the period examined.

enormous impact on the quality of hope. In both cases, the structure of hope is a visual image generated in the mind with particular qualities that stimulate strong positive or negative emotions.

In the case of life or death, those visual qualities and emotions can be extreme. Interestingly, most human beings relate naturally to the idea that hope is represented by the brightness or dimness of the mental pictures that are made. Look at the previous paragraph and think about the descriptive terms used: “a positive future is dimmed or eclipsed,” “she feels dark and hopeless,” and “her hope for a bright future returns and perhaps becomes even more vivid than before.” Most humans code their mental vision of upcoming events as bright and colorful when they’re hopeful and as dark or even black when they’re hopeless.

This coding is quite extensive and yet extremely nuanced. A hopeful client’s mental images will be brightly lit, vividly colorful, and detailed. On the other end of the spectrum, when hope is lost, color and light drain out of the picture as the brain recodes the anticipated future. Between these two extremes, the brain codes experiences that are desirable but unlikely (fantasies) and experiences that are desirable and likely (plans). The more the brain is convinced that a particular future is likely, the stronger the coding. Clients know that they can be confident about a particular future by the brain creating a code that stimulates hopeful feelings. Important elements of that code include vivid details, colorful patterns, and brightly illuminated scenes. The more real a future mental image seems, the more it conforms to the structure of hope in most clients. With this in mind, the advisor’s strategy is to explore a client’s goals in depth by asking for details and vivid descriptions.

However, if time passes and the client sees the future as darker and less desirable, the confident feelings may diminish and hope may degrade. Ultimately, the working relationship between client and advisor will not survive without a hopeful vision of the future and a growing confidence in the likelihood of that future. In this way, confidence and hope are closely related experiences: We are hopeful about upcoming events and confident that the actions we are taking today will make that future more likely.

The brain is constantly assessing our actions and asking, “Is this the right thing to do?” and “Will this get me what I want?” Much of the analysis is focused on determining the cause-and-effect relationships between current actions and possible outcomes. When actions are seen as leading to highly desirable outcomes, feelings of hope become intensified. But if the brain cannot see any actions that will lead to desired outcomes, hope is replaced by depression or, in extreme cases, hopelessness.

Much of the dynamic process operating beneath the surface of the client-advisor relationship relates to the client’s level of confidence in the advisor’s fee-based work and the quality of hope the advisor’s efforts inspire in the client about the future.

Tactics for Managing Hope

With these dynamics in mind, the prudent advisor is aware of the need to deliver regular messaging that fosters hope in the future and provides reasons for clients to have confidence in the advisor’s skills and process. There are five practical strategies that an advisor can use to support these messaging efforts.

Explore the client’s goals—and make them detailed and vivid. As we have seen, the brain creates a code that stimulates hopeful feelings. Important elements of that code include vivid details, colorful patterns, and brightly illuminated scenes. The more real a future mental image seems, the more it conforms to the structure of hope in most clients. With this in mind, the advisor’s strategy is to explore a client’s goals in depth by asking for details and vivid descriptions.

Invite the client to examine and comment on various aspects of each goal and to make those ideas as bright and vivid as possible. By starting with a clear visual representation of what the client wants to experience in the future, you can inspire (literally “breathe into”) hope by helping to make important images more detailed and colorful and, therefore, more real.

Connect the plan to the goals—and invest time in this part of the conversation. Advisors are often so eager to present their proposals that they don’t spend enough time connecting the plan to the client’s life—which, after all, inspired the plan. When creating a proposal for services, the savvy advisor starts by reviewing what was discovered: “When we discussed your goals and what is important to you, I heard...” By reviewing and restating the findings from discovery, especially the desired outcomes that are most important to the client, the advisor makes an emotional connection for the client between what the client wants most in the future to the financial plan designed to make those things come true.

Provide evidence that supports hope for the future—and return to that evidence often. Most popular financial plans offer a stochastic modeling component that can be used to generate an analysis of the probability of the client’s financial goals being achieved based on the definitions and assumptions of the plan. These tools can provide powerful support for the client’s sense of hope. By projecting investment outcomes forward in time and providing a visual map of the path the investments are likely to take, the advisor provides evidence to the client that there is a measurably high likelihood of success. By mapping a path into the desired future, the planning software provides visual support for hope and a reason for the client to feel more confident that those anticipated outcomes will be realized.

Provide evidence of competency by explaining the portfolio—and reveal insights into the mechanisms of the market. In the client’s brain, the structure of hope is built on vivid, detailed, and brightly colored pictures of the
future that feel real and likely to happen. The financial plan and the way that plan is described to the client and then observed as progressing provide evidence to support the likelihood of it occurring. Inevitably, the portfolio you build for the client becomes connected to those pictures of the future as well: when the portfolio provides evidence of progress (performance), the client’s sense of hope increases; however, hope will diminish when the portfolio disappoints.

With this connection in mind, the advisor can take action to sustain hope by explaining the recent and current behaviors of the portfolio in terms of the mechanisms that are unfolding and how those mechanisms are likely to affect the near-term results. It’s helpful to remind clients of the long-term march of the markets upward and to provide visual evidence of this from time to time with the appropriate charts. It’s a powerful tool for making sense of a correction or missed opportunity. Because hope is so malleable and easily impacted by events in the world, the prudent advisor will see any decline in value as an opportunity to educate clients, interpret events, and reinstall confidence that the current situation will evolve into the desired future despite the detour. In this way, the advisor’s job in these moments is to put things in perspective so that the client can maintain an inner vision of the future.

Pay attention to how the client is making sense of market dynamics—and intervene quickly when you see inappropriate extrapolation. One primitive heuristic built into the human brain is the tendency to recognize patterns in the environment and assume, often mistakenly, that those patterns will continue permanently. This is especially true for negative patterns, because the brain is highly sensitive to anything that is threatening or dangerous. Negative stimuli tend to register as significant, and the brain will focus intensively on these patterns and interpret them as continuing far into the future.

Inevitably, the markets correct, and at some time a client’s portfolio will lose value. The client’s brain likely will interpret this correction as threatening and will project a continued downward pattern into the future. Even a client who knows better may experience diminished positive expectations for the future during a market correction. Most advisors have been surprised by how easily some clients can magnify the dimensions of a correction and descend into despair.

In these cases, the task is to interrupt the pattern-recognition process that the brain is using and provide alternative perspectives. One excellent way to do this is to offer the client a series of charts that show past recoveries and how quickly those corrections resolved. Another way to do this is to draw a simple sine-wave chart on a piece of paper (see figure 3). You can use the chart to show the client how the brain tends to extrapolate inappropriately in both directions, and how destructive impulsive decision-making can be to the investment process when flawed perceptions are allowed to run wild.

By actively interrupting the client’s inner experience and providing alternative stimuli, you can interrupt the brain’s natural tendency to project current patterns into the distant future. Most clients can learn to manage their own emotions for short periods of time after they have been exposed several times to these types of effective visual coaching.

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