Behavioral Finance

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Introduction

You witness it in your business everyday. The way your clients and prospects think and feel affects their financial behaviors and decisions.

Simply put, investors make financial decisions based on emotion and feelings. At times, your clients' decisions and behavior may confuse you. Their expectations may seem irrational.

Behavioral finance is the science and psychology of understanding how people make financial decisions. The study of it has gained in popularity amongst financial advisors, as it should. Advisors need to understand the power of the human brain and that their clients may be influenced by past experiences and personal beliefs. This may unconsciously deviate their financial decisions from both logic and reason.

The History of Behavioral Finance

In 1912, G.C. Selden authored the book The Psychology of the Stock Market. Some believe this was the informal genesis of behavioral finance.

It was in 1979, however, that Daniel Kahneman and Amos Tversky wrote the paper "Prospect Theory: An Analysis of Decision under Risk." This paper catapulted the origin of the field of behavioral finance. Prospect Theory essentially is a behavioral model that shows how people decide between alternatives that involve risk and uncertainty.

Later, in 1980, Richard Thaler published the paper, "Toward a Positive Theory of Consumer Choice" In 1985, he published, "Does the Stock Market Overreact?" He has published numerous works since.

Kahneman, Tversky and Thaler have been named the "founding fathers" of the emerging arena of behavioral finance. Kahneman's work with Tversky was awarded the Nobel Memorial Prize in Economic Sciences in 2002. In 2017, Thaler was also awarded the Nobel Memorial Prize in Economic Sciences.

Thanks to the work of these gentlemen and the abundant studies since then, as an industry we know much more about this subject than ever before. Behavioral finance is a deep area of study and truly has significant importance to the client-advisor relationship.

Common Behavioral Finance Biases

Behavioral finance helps us to recognize our natural biases that lead clients to make illogical and sometimes irrational investment decisions. When it comes to investing, there are several biases that affect how we invest. Some of the common biases include confirmation bias, loss aversion bias and mental accounting.

1. Confirmation Bias

First, let's look at confirmation bias. As humans, we are usually drawn to listen to or to read information and ideas that confirm or validate our personal opinions and core beliefs. In other words, we pay much more attention to information that confirms our beliefs and we tend to tune out the rest of the information. This happens with financial information as well. An investor with confirmation bias will likely seek information that validates his or her thoughts about an investment, for example versus researching information that differs from his or her beliefs. Experts say the best way to overcome confirmation bias is to seek and consider information from several sources, including information that contradicts our personal opinions. Encourage your clients who may have confirmation bias to actively seek third-party information.

2. Loss Aversion

Loss aversion bias is also referred to as regret aversion bias. People experience the pain of loss more than the joy they feel from gains. In other words, investors want to prevent feeling regret after making a decision with a bad result. Clients who have loss aversion bias may not want to sell investments that are performing poorly, for example, as they don't want to face that they may have made a bad investment decision. Clients tend to remember their investment losses for a long time instead of remembering all the years they experienced great performance. For your clients who may experience loss aversion bias, remember to remind them of market volatility and managing emotions during market declines.

3. Mental Accounting

Mental accounting bias occurs when people separate their money into different sources and view the sources as being different from each other. Mental accounting bias is also referred to as the "two-pocket" theory. For example, people may view their salary as different from receiving a bonus from work or an inheritance. Or people may save money for a vacation or leisure, while still carrying significant credit card debt. Categorizing their money into different groups may affect their decisions and behaviors. Mental accounting bias can occur in your clients' portfolios as well. Clients may invest differently for their children's college educations than their retirement, for example. Clients also may become emotionally tied to a particular stock because it was gifted to them or because it was from a company they used to work for. Mental accounting can sometimes be beneficial, but it may also prevent your clients from allocating well in their overall portfolio. Be sure to emphasize the importance of proper asset allocation and goals-based planning.

Behavioral financial insghts may be able to guide your clients to help them keep their emotions out of the financial decision-making process.

The Bottom Line

Applying behavioral finance knowledge is growing more and more important for financial advisors every day. Advisors should help their clients become aware of their behavior finance biases. These biases are natural to human behavior. While not all behavioral finance biases are fundamentally bad, they could potentially negatively impact your clients' overall ability to improve their financial portfolio.