Manulife Investment Management

Using behavioural economics to help clients make *better* financial *decisions*

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"The danger of panic – of investors undermining their own goals by violating their investment plans – is inherently about investor behaviour. It is not the portfolio that needs assistance, rather it is the investor. To assist the investor directly, financial planners can use tools from behavioural science."

— Dr. Steven Wendel,
Head of Behavioural Science, Morningstar

For both investors and advisors, investing is more than a dispassionate analysis of risk and return. Time constraints, lack of knowledge and energy and the influence of emotions can lead people to make irrational and sub-optimal investment decisions. This premise is the foundation of Behavioural Economics (BE).

Basing investment decisions on emotion rather than logic can lead to a host of problems. Emotions are what drive investors to exit a declining market en masse, typically just before it starts to recover, or to purchase a "hot" stock at the peak of its cycle and then watch it plummet.

An important part of your role as an advisor is to:

- **Proactively prevent emotional investing** — with an investment plan formulated to instill the confidence that can help your clients ride out market fluctuations.
- **Address emotional investing in the moment** — by being vigilant for the telltale signs in your clients' behaviour.

How this toolkit can help *you*

This toolkit is designed to help you see investor behaviour through a psychological lens and then apply psychological tactics to help your clients make better financial decisions.

It is divided into two sections:

The 7 biases — characteristics and traits that indicate emotional bias.

17 BE-based tactics — strategies for combatting emotion-based investing.

The 7 biases

Different biases may manifest in different clients at different stages in their life journey.
In addition, the biases are not mutually exclusive, and telltale characteristics may overlap across categories. And, of course, there may be a perfectly valid, rational reason for your client's behaviour. That's why your starting point — as in any client interaction — is to know your client. Ask questions, listen carefully to your client's response and probe for details. Be supportive, empathetic and non-judgemental to get to the root of the issue and advise your client on the best way forward.

1. Overconfidence

"I can make better decisions than my advisor. I just rely on her for ideas."

What it is: The tendency for people to believe that they are more knowledgeable or capable than they actually are. For example, investors may believe they have an above-average aptitude for selecting stocks. The reality, however, is just the opposite. A 2018 study found that 55.4% of those who considered themselves investment "experts" scored below average when their investment expertise was put to the test.[1]

Typical investor characteristics

- Unrealistic view of their ability to predict outcomes
- Believe they can outsmart the market
- Unwilling to take advice
- Likely to overtrade
- Likely to neglect risk

What you can do:

Pre-commitment, Information accessibility, Reframing positive outcomes

[1]Lewis, D. R. (2018). The perils of overconfidence: Why many consumers fail to seek advice when they really should. Journal of Financial Services Marketing, 23(2), 104-111. doi: 10.1057/s41264-018-0048-7

2. Loss aversion

"I would rather not lose any money than risk even a small loss in order to gain more."

What it is: The tendency for people to feel the pain of a loss more acutely than the pleasure of an equivalent gain. In other words, the *unhappiness* of losing $10 is far greater than the happiness of finding $10. Loss aversion is why people may leave money in a savings account that's earning less than the rate of inflation. Even more puzzling, loss-averse investors are often willing to assume a risk to avoid a potential loss but unwilling to assume a risk to capture an equivalent potential gain.

Typical investor characteristics

- Frequent account-checking
- Unwillingness to assume even modest risk
- Willingness to take risks to avoid loss

What you can do:

Mental accounting, Loss-framing, Long-term goal-framing, Anchoring

3. Representative bias

"This investment has been underperforming so it will continue to underperform."

What it is: Inferring likelihood from similarity. For example, investors may assume that a company's positive characteristics, such as its large size, imply a good investment. Similarly, investors may consider recent returns to be reflective of future returns, in spite of evidence to the contrary.

Typical investor characteristics

- Short-sighted decision-making
- Highly sensitive to momentary information
- Believe that current emotion (e.g., fear) or circumstance (e.g., down market) will persist into the future

What you can do:

Future self, Explicit-emotion priming, Balanced perspective

4.
Illusion of control

"I can control my returns by timing the market."

What it is: The tendency for people to believe they can control outcomes. For example, when investors continue to see a decline in stock value, they feel a loss of control. In order to regain a sense of control, they feel compelled to take action rather than wait for the market to recover. Selling provides them with the illusion of control.

Typical investor characteristics

- Tendency to react immediately
- May trade more than is prudent
- Likely to overweight investments they feel they have some control over, such as the company they work for

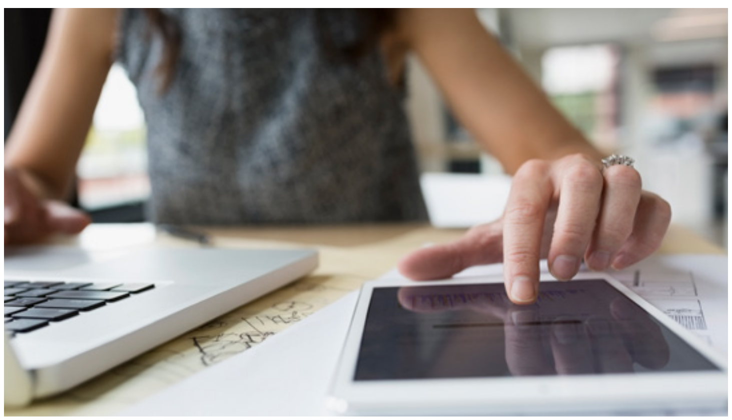
What you can do:

Enhanced active choice, Priming self-consistency

5.

Confirmation bias

“I’ve seen that information before.
It must be true.”



What it is: The tendency to pay undue attention to or even actively seek out information that confirms existing beliefs. For example, suppose an investor hears a rumour that a company is struggling. Based on this information, the investor considers selling the stock. The investor goes online to read the latest news about the company, focusing solely on rumours regarding lower revenue and skipping other stories about the company’s new product that is predicted to increase sales. Instead of holding the stock, which is likely to increase with its coming product launch, the investor sells.

Typical investor characteristics

- Filters out potentially useful facts and opinions that don’t coincide with their preconceived notions
- Holds one-sided or skewed view of a situation
- Bulls will remain bullish and bears will remain bearish regardless of what is happening in the market

What you can do:

Prospective hindsight, Perspective-taking

6. Herd bias

"Everyone is buying (or selling), so I should too!"

What it is: The tendency for people to follow the crowd rather than basing investment decisions on their own analysis. An investor with herd bias will invariably be attracted to the most recent hot stock (or sector or fund).

Typical investor characteristics

- Buys or sells an asset solely because everyone else is
- Makes decisions based on FOMO (fear of missing out)
- Overweights the opinion of the majority versus expert analysis
- Likely to buy high and sell low

What you can do:

Framing, Positive reinforcement

7. Present bias

"I would rather have $100 now than $150 a month from now."

What it is: Focusing on immediate needs at the expense of future needs. Investors with present bias are likely to borrow now and worry about the consequences later.

Typical investor characteristics

- Likely to make short-sighted decisions
- Highly sensitive to momentary information
- Tendency to live beyond their means in the hope that some unknown future event (e.g., inheritance, lottery win) will enable them to repay debt

What you can do:
Easy-to-remember rules

17 BE-based tactics to combat *emotional bias*

This section is designed to arm you with easy-to-use tools for taming investor emotions and helping your clients stay on track to reach their goals. It includes both proactive tactics you can employ to prevent biases from developing in the first place as well as strategies for dealing with them when they appear.

You are probably already practising many of these strategies intuitively. This is your opportunity to fine-tune them and learn some new ones.

1.
Pre-commitment

What it means: Encourage your clients to set goals and make a plan in advance of a potential market crash or before they look at their portfolio performance following a downturn.

Example: Develop a written plan with your clients' risk profile, financial goals and recommended portfolio. Make sure they understand it and sign it to acknowledge they are in alignment. Both you and the client should keep a copy. Review this document with clients regularly to make sure it remains accurate and refer them to it should they ask you to execute a buy or sell decision that seems inappropriate.

Make it clear what your clients are committing to. The more specific you can be, the more effective. For example, a client statement like "In the event of a market crash, I will sell 10 of my Amazon shares" will be more effective than just a general statement.

Why it works: People feel mental discomfort when they hold two contradictory beliefs. This phenomenon is known in psychology as cognitive dissonance and is triggered by situations where a person's current belief (like selling now) contradicts prior evidence (a written statement to stay invested).

Relates to: Overconfidence

2.
Mental accounting

What it means: Separate short-term from long-term needs.

Example: Divide your client's portfolio into two segments:

- A short-term account of safe, liquid funds equivalent to one to two years of spending
- A growth account for reaching longer-term goals

Why it works: People tend to categorize their money according to its intended use. Anxiety over short-term cash flow (e.g., "I might need some of that money soon for ...") can easily undermine long-term goals. Segmenting their portfolio provides the security of a supply of safe funds to see them through temporary market downturns so their growth account has time to recover and post new gains.

Relates to: Loss aversion

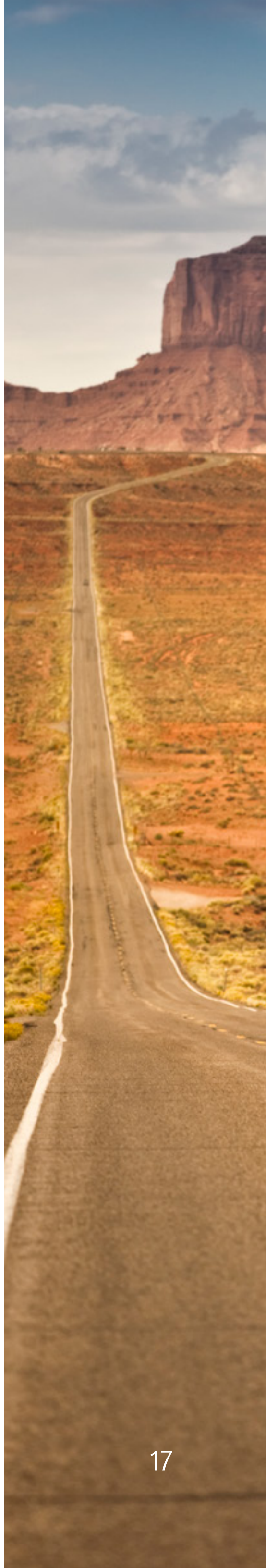
3.
Loss-framing

What it means: Demonstrate that missing out on potential gains is the same as losing money.

Example: Simple mathematics can help prove your point. Selling an investment at $90 that subsequently rises to $110 is effectively the same as losing $20.

Why it works: People do not like to lose things. In fact, people will often take active steps or even take on risk in order to avoid a loss. By framing foregone gains as a loss, you can encourage your clients to move beyond highly secure but low-earning assets and ride out short-term market declines.

Relates to: Loss aversion



4.
Future self

What it means: Bring your clients' future self closer to their present self.

Example: Ask questions to make your client think about their future self and consider the potential impact of straying from their plan, such as:

- What do you spend your money on now?
- What would you like to spend your money on in 10 years?
- How would your future spending change if you sold too early and lost out on market recovery?
- Are you sure that selling now is not going to affect your ability to spend money on [what client mentioned in bullet 2] in 10 years?

Why it works: When making decisions about money, people are estranged from their future selves. Bringing the future into the present motivates future thinking and decision-making. Your clients may be less likely to make rash decisions to benefit their present self and more likely to take into consideration their future needs.

Relates to: Representative bias

5. Explicit-emotion priming

What it means: Have your clients acknowledge their fears.

Example: Ask your clients, "What scares you the most about the economy right now?" They are likely to rhyme off a long list of reasons. Then ask, "How does this make you feel?" Not only does this show that you empathize, but it enables you to identify specific pain points and take action to remediate them.

Why it works: When people acknowledge a negative emotion, they are better able to prevent it from influencing their behaviour. By asking your clients what is the worst that could happen, they begin to realize that "the worst" is not actually as likely or as bad as they thought.

Relates to: Representative bias

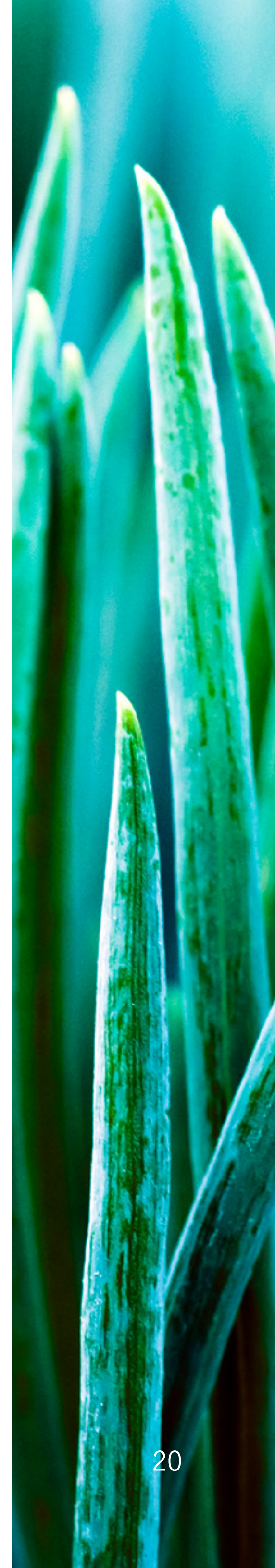
6.
Priming self-consistency

What it means: Help your clients stick to their game plan.

Example: When clients are in panic mode, they may be tempted to make rash decisions. Pointing out inconsistency from their prior behaviour can help them reset successfully. For example, you might say, “You’re a smart investor and you have made great investment decisions. We’ve put a lot of effort into creating this portfolio; what is causing you to second-guess yourself now?”

Why it works: People like to maintain their self-concept. When you highlight the amount of effort your clients have put into their portfolio and point out that changing it seems out of character, they are likely to reconsider their actions.

Relates to: Illusion of control



7.
Positive reinforcement

What it means: Provide encouragement and congratulate clients on their progress.

Example: Every time you interact with your clients, congratulate them for sticking to their written financial plan and investment strategy. This is especially important during periods of market volatility.

Why it works: Rewarding a behaviour increases the likelihood that it will be repeated. Providing your clients with frequent encouragement shifts their focus from negative to positive and reassures them that they're doing the right thing.

Relates to: Herd bias

8. Information accessibility[2]

What it means: Make it difficult for investors to think of supporting reasons to sell.

Example: Ask your clients if they can name the top 10 market timers from among well known stock market experts or the top five – or even one. As very few high-profile stock market experts advocate market timing, your client is unlikely to know of one.

Why it works: When people lack knowledge of a topic, they tend to believe information that is easier to retrieve. The harder it is to think of supporting reasons, the less convincing the initial argument. Because clients are likely to draw a complete blank, they are likely to reconsider their decision to sell.

Relates to: Overconfidence

[2]Tybout, A. M., Sternthal, B., Malaviya, P., Bakamitsos, G. A., & Park, S.-B. (2005). Information accessibility as a moderator of judgments: The role of content versus retrieval ease. *Journal of Consumer Research,* 32(1), 76-85).

9.
Reframing positive outcomes[3]

What it means: Reframe the selling of equities from a strategy that seems positive because clients believe they will achieve their goals to a strategy that is viewed negatively because they may be unable to achieve their financial goals.

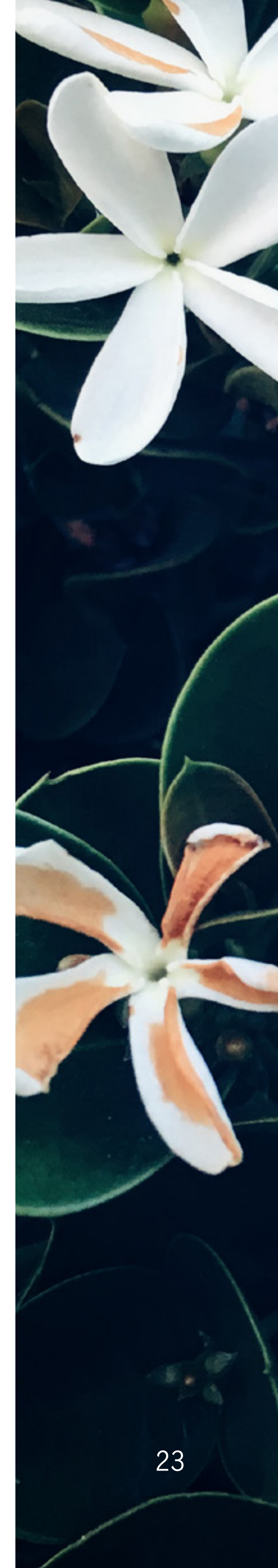
Example: Say to your client, “Selling those equities sounds like an interesting investment strategy. Tell me more about it.” This allows your client to share the excitement of a new investment idea.

Then follow up with, “As I said, I am unfamiliar with that investment strategy, so I was wondering what might go wrong.” At this point a certain gain is reframed as a possible gain. This triggers your client to think about the investment risk.[3]

Why it works: People tend to make poor decisions when they are losing money. They often approach advisors anxious to buy or sell an investment recommended by a neighbour, family member or friend or based on a story in the media. Reframing your clients’ focus from the expected positive outcome of a decision to the potential negative result can help them stick with their original portfolio.

Relates to: Overconfidence

[3] Baker, H. K., Filbeck, G., & Ricciardi, V. (2017). How Behavioural Biases Affect Finance Professionals. *The European Financial Review*, 25-29.



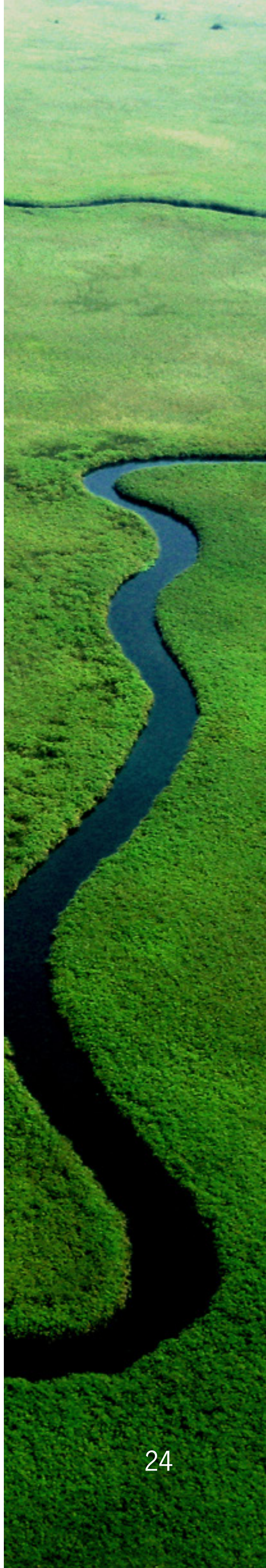
10. Long-term-goal framing[4]

What it means: Encourage less account-checking by using rules of thumb. Research has shown a negative correlation between the frequency of account-checking and investment returns.[5]

Example: Suggest to your clients that they keep track of how often they check their account and try, on their own, to stay below a limit. As a rule of thumb, encourage them to check their account only as often as they visit the dentist.

Why it works: Encouraging clients to look at their portfolio performance less often or in its entirety reduces the granularity they take in assessing their investments. This encourages your clients to look at trends over time, decreasing the anxiety and subsequent poor decisions they might make if they looked daily.

Relates to: Loss aversion



[4]Ariely, D. H. (2018). Unpublished Internal BEworks Research.

[5]BEworks (2018). Unpublished Internal BEworks Research.

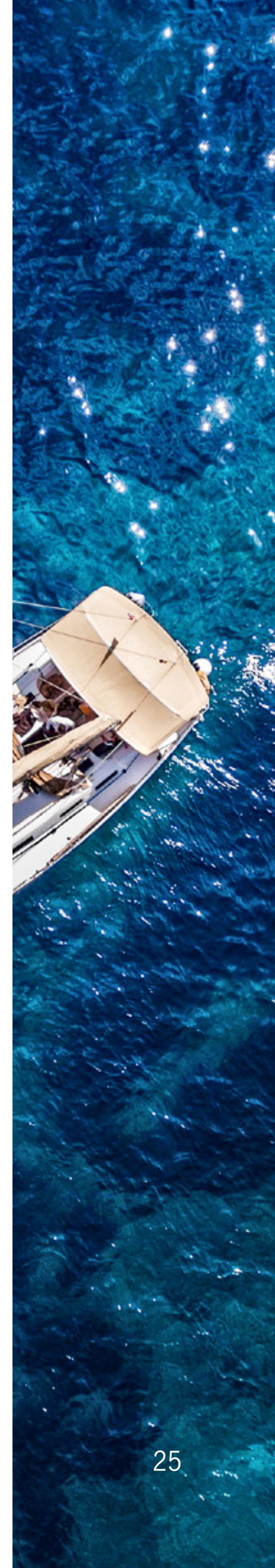
11. Anchoring

What it means: Remind clients of a previously arbitrary number, like the last high reached by a stock they are trying to sell — people rely heavily on arbitrary pieces of information (like highs of other, similar stocks or previous highs) to inform their decisions.

Example: Remind your client of a recent high point: "One month ago, this stock was $100 a share. Are you sure you want to sell now, at $80?" Alternatively, you could say, "Stocks in this industry tend to reach highs of $110. Are you sure you want to sell now?"

Why it works: When you remind your clients of what the stock achieved in the past, they latch on to this number and believe it is possible to achieve it again. In this way, clients will resist selling because they feel they must sell the stock only when its price rebounds to the $100 a share it achieved a month ago.

Relates to: Loss aversion



12.
Balanced perspective

What it means: Ask your clients to list all of the reasons they might hold onto their investments and all of the reasons they might sell.

Example: Ask your clients, "Can you give me five reasons why you would sell? Now name five reasons why you should hold on to your investments."

Why it works: When people put effort into considering a contrary view, their effort makes those ideas more available in their memory and they are more likely to consider the contrary position as being true. There is also an element of self-servicing bias, whereby the investor would consider the contrary arguments might be true since they were the ones who substantiated support for the contrary viewpoint. Finally, confronting contradictory perspectives tends to move people away from either extreme.

Relates to: Representative bias

13. Enhanced active choice[6]

What it means: Create the perception of a choice to increase the belief that your clients have taken matters into their own hands.

Example: Referring to the written financial plan your clients have agreed to, select several funds or investments that align with their profile and goals. Discuss them with your clients and encourage them to choose.

If they are intent, instead, on selling, remind them about the loss in missing out on future returns and encourage them again to select one of the recommended options.

Why it works: Questions that are phrased as a choice provide investors with a sense of control over their decisions while simultaneously nudging them toward one option over the another. In doing this, investors stick with their initial holdings as they feel a sense of control over their investments.

Relates to: Illusion of control

[6]Keller, P. A., Harlam, B., Loewenstein, G., & Volpp, K. G. (2011). Enhanced active choice: A new method to motivate behavior change. *Journal of Consumer Psychology,* 21(4), 376-383.

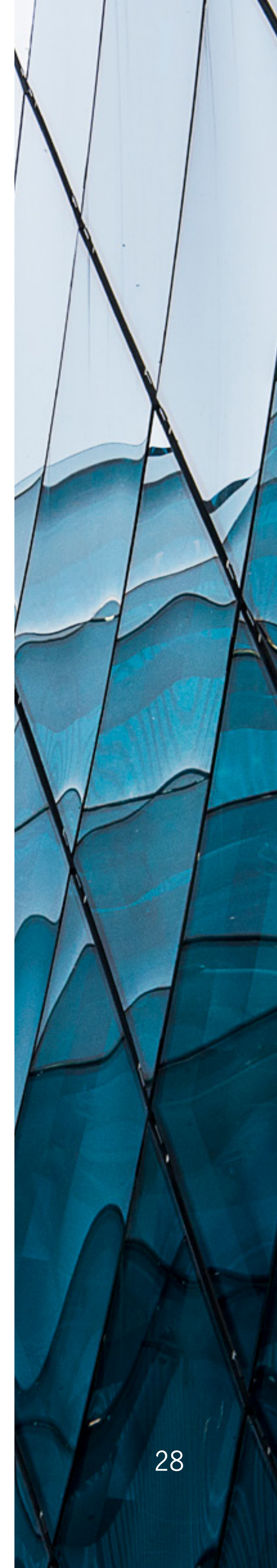
14.
Framing

What it means: Make your clients feel that by not selling they are following a more elite, intelligent group of investors rather than the average person.

Example: When many people are selling and moving money into cash, remind your clients that this is also the same number of people who sold during the 2008 market crash and missed out on the subsequent recovery. The smart money stayed in the market. If your clients stay with their current holdings, they remain with the top [X%] of smart investors, like the Warren Buffetts of the world, who tend to see higher returns in the future.

Why it works: People like to view themselves as smarter than the average person, a bias known as overconfidence. By framing a decision to sell as something the average person would do and reinforcing that your client is above average, it makes the decision to sell less appealing.

Relates to: Herd bias



15.
Prospective hindsight

What it means: Have your clients imagine a future in which their decision to sell is wrong and follow up with a question asking them to explain why this might happen.

Example: Ask your clients to imagine a future in which their decision to sell is wrong. Probe for what might cause the negative outcome and ask them to consider "in hindsight," what they might have done differently — which they are free to do now, in the present.

Why it works: When their actions are driven by bias, investors tend to consider only one side of the story. By asking your clients to consider a different future outcome, you can prompt them, in a low-risk setting, to carefully think through an opposing viewpoint. This consideration of an opposing viewpoint increases the likelihood that they won't sell.

Relates to: Confirmation bias

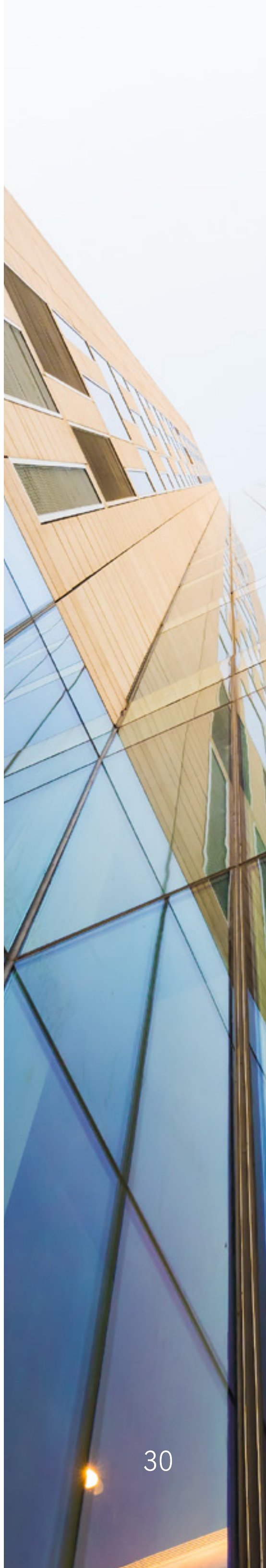
16.
Perspective-taking

What it means: Show your clients information from their peers that supports an alternative view.

Example: Drawing on (anonymous) examples of a few of your other clients or your colleagues' clients, share a vivid and powerful story that illustrates how a lack of perspective worked out poorly. The story would describe a client who held firm to a belief without considering other facts or viewpoints and suffered a loss as a result.

Why it works: By revisiting the thought processes of their peers, clients can recognize the risk of bias without being aware that they, too, are applying this bias. In this way, they participate in the thought experiment with an open mind and are able to reflect on how the outcome of the story might influence their own investment decisions.

Relates to: Confirmation bias



17. Easy-to-remember rules

What it means: Arm your clients with easy-to-remember rules that provide an alternative way to interpret a market downturn.

Example: "When prices go down, the opportunity to profit usually goes up" or "Everything in the market just went on sale — let's go bargain-hunting for some long-term value," are a few examples to consider.

Why it works: Mental rules of thumb are easy for investors to remember and retrieve during a market downturn. They rely on the same principles as rules such as "stop, drop and roll." The rule is simple, involves inaction and is easy to remember.

Relates to: Present bias

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