

Helping investors stay rational in irrational times

David Kitai:

All right. Hello again, everybody, and welcome to today's webinar about a crucial issue that I'm sure we've all been facing in the past few months, which is how to keep investors rational in irrational times. And it's brought to us by Manulife Investment Management.

I'll begin with a few housekeeping notes just to familiarize you all with our new webinar platform, and these notes will also be posted in the public chat page on our chat thread. So please make sure, as I said a little bit earlier, that you are attending on either Mozilla Firefox or Google Chrome, and not on Internet Explorer. And once you've begun attending, if you are prompted to, please press the Allow audio button. That will allow you to hear what our wonderful presenters have to say.

And please make note as well of the chat bubble, which should be located on the right side of your screens. Clicking that bubble will open up a number of chat threads that we'll be using throughout this presentation. The Q&A thread that you can see within that chat bubble will be used for our live Q&A session at the end of the presentation. You could submit any questions that you might have about the contents of the presentation in that thread specifically.

Next to the Q&A thread is a public chat thread. Please use that to raise technical issues or comments unrelated to the content if they do arise during the presentation. Please don't post questions about the content in the public chat thread; please use the Q&A thread only for that.

There's also a poll thread. At certain points in the presentation, polls will pop up where you'll be prompted to answer some polling questions. I invite you all to please participate in the polls and you should be able to look at some of the results in that thread. Now, on to the webinar at hand.

My name is David Kitai. I am one of the editors at Wealth Professional Canada Magazine and I'll be your host for today. It is my distinct pleasure to introduce our two speakers, Catherine Milum and Dr. David Lewis.

Catherine Milum is the Head of Wealth Sales, Wealth and Asset Management for Canada at Manulife Investment Management. She guides Manulife IM's national sales team and brings her wealth of knowledge and experience directly to advisors, helping them grow their business using the best tools available. She's a sales trailblazer for Manulife and a champion for women in the financial services industry.

Dr. David Lewis is Chief Client Officer at BEworks. He holds a PhD in marketing, with a focus on consumer behaviour, and previously held the post of assistant professor at the Ted Rogers School of Retail Management at Ryerson University. Before his foray into academia, Dr. Lewis had an illustrious career in the financial services industry, serving as the head of banking at Barclay's Wealth USA and the Head of Banking Products at UBS Financial Services. Today, he's bringing his understanding of behaviour science to the advisors who can best make use of that knowledge.

Catherine, David, please take it away.

Catherine Milum:

Well, thank you so much for the introduction, David, and all the folks at Wealth Professional. And welcome, everyone. I'm really happy to be here, and I'm certainly proud to be representing Manulife.

So I'd like to start the afternoon, and for you folks out west, the morning, off with a question. And the question is: What does this number represent? You may have seen me present this before, but the only clue I'm going to give you is it has something to do with a couple's retirement. So put your thinking caps on, the number is 54,750.

We'll take a little pause so you can all think about what this number represents.

I've been showing this number for about, well, more than 20 years now, and nobody, unless they've already seen the number from me, has ever been able to get the answer right. Typically, I get that it's the average number of dollars people save for their retirement or it's the average number of Canadians that retire every year. I get a plethora of responses, but none of them are the correct answer. And the correct answer is it's the average number of meals that a couple will eat in their retirement.

So that's the number, 54,750. And how did I get to that number? Well, it was simple math, and I'll walk you through it. Okay, let's assume you've got 25 years of retirement, you multiply that by the two people, multiply that by an average of three meals per day, and there's 365 days in the year. So you might say, "So what? Who cares?" But then I'm going to ask you to multiply that number by \$10, and you get a very interesting number of just over half a million dollars.

And what I say to people is that's the amount of money that you're going to need just to eat in your retirement. And it's something that really hits a chord with people. And what's interesting is when I started using this number that I got from one of the top financial advisors in the US just over 20 years ago, is I didn't know that it's tied to the science behind behavioural economics. And what it is tied to is it enables your clients to envision their future selves. And the ability to envision your future self is so important, because it actually helps you to save. And David's going to get more into that later when I introduce him.

So in Q1, we saw unprecedented dollars moving into money markets. You probably all know the volatility index, or the VIX, which is the measure of market risk, hit an all-time high in March, and long-term mutual fund assets contracted by 12% in March alone. And when you look at those kinds of statistics, you realize there's really a classic case of investors buying high and selling low. In fact, it's the exact opposite of what we want them to do. So how do we help these investors stay rational in irrational times?

Well, one way we do this, is we help them understand some key principles of behavioural economics, and also learning how to become better coaches ourselves. And better behavioural coaches. And that's what we're really going to teach you today. And really, who better to teach you—and David, I thought you did a great introduction of David Lewis—but who better to teach you than a professor, a CFA, an MBA and a PhD. He's also a guru of our industry and a guru of behavioural economics, Mr. David Lewis. So please give a warm virtual welcome to David Lewis. David?

David Lewis:

Thanks, Catherine. Working in the financial services industry for many years, I was always puzzled by the fact that many times consumers, despite the best advice, don't follow it. And as Catherine pointed out, buying high and selling low has been a consistent pattern, and I was always curious as to why that was. And I'll applaud Manulife as well, because Catherine similarly recognized that something is going on with consumers and that we needed to understand their behaviour better if we were going to help them.

And so we're in an environment right now where we have robo-advisors, fearmongering ads, low-fee investment platforms, and advisors questioning the value of advice and they question the cost of advice. And a lot of them are tempted and say, "Hey, I can do this myself, how hard could it be?"

So Manulife really wanted to understand what was going on in the minds of clients. And Manulife partnered with BEworks, who are a behavioural economics consulting firm, to conduct a really rigorous experimental study. We wanted to look at what are the benefits of advice? Can behavioural economics improve on those benefits and create better asset allocation decisions and increase the likelihood that clients will actually seek and follow financial advice?

It was a very large study, North America-wide, with over—it was 2,991 consumers—all with \$50,000 in investable assets or more. It was representative of every different demographic group, so it was a good sample of a typical investor. And we looked specifically at the advice and the value of advice, but we also looked to see how people behaved, because it's a real question. It's not just whether you give advice, it's whether people actually follow the advice. Because if they don't follow it, then there's not going to be good outcomes.

We looked at some of the additional benefits as well. How does the advice that you give affect trust, intention to follow advice, your client's decision to consolidate assets with you or consolidate assets away? Those are all really important outcomes as well, rather than just the advice itself.

So this is our first polling question. Here's an open question for you. What percentage of participants in the study, which reflects your clients, have an advisor and follow all of the advice from their advisor? So you can answer one of those four there. Zero to 30%, 30 to 60, 60 to 80, or 80 to 100%. So thinking of your clients, how many of them follow all of your advice?

And this will close after about 15 seconds, so don't think too hard about it.

<Pause>

So the numbers that come up, the most popular answer was 30 to 60% of your clients follow all of the advice. Twenty percent of you believe that 60 to 80% follow all of it, and 5% believe between 80 and 100% follow all of the advice. The right answer was actually 0 to 30%, and 25% of you answered that question.

So let's dig in a little more, and I can tell you that only 13.2% said they have an advisor and follow all of the advice. An equal number said they follow none of the advice or very little. And then the rest were spread out throughout the rest of the distribution. So the challenge here isn't just to get clients to have an advisor; the challenge, really, is to get clients to follow the advice. The problem is, there's something called attribution bias. We tend to have a tendency to attribute successful decisions to ourselves and unsuccessful decisions to others.

Part of the danger here is that you may be giving advice to your client, they may be acting contrary to that advice, and then they'll blame you for their bad decision-making. Behavioural economics really offers an interesting way for us to assist clients and ensure that more of them follow advice.

Now, let's look at some of the other interesting findings coming out of that research. We looked at whether we can change the way advice is delivered. And in the particular study what we did is there were seven different groups in the study and they were given an asset allocation decision. They were to allocate a portfolio for five years and they were given a selection of 35 different mutual funds that they could choose from, spread over multiple different asset classes. So we had equity, fixed income, money market. But then within asset class we had different types. So within equity, for example, we had domestic, we had US, we had global.

In the "No advice" condition, they simply saw a financial commentary that didn't actually give them any advice on how they should allocate their portfolio. Another condition they were given a typical advice script which would be common in the industry. In the "Behaviourally informed advice," we built in behavioural interventions to increase the likelihood that the people receiving the advice would follow the advice. And then we tested afterwards a number of different variables. And interestingly, this particular graph shows the divergence from the average on the value of the relationship with the financial advisor.

And you can see that in "No advice," they valued the relationship with that advisor much less. Typical "Advice," you can see, is slightly above zero. But the "Behaviourally informed advice" has a significantly higher level of reported value of the financial advisor. So if advice is given using behavioural techniques, clients actually value their relationship much more.

Another interesting finding was looking at the level of trust in the advisor. And so similarly, you can see in the "No advice" condition, trust was lower. In the typical "Advice" condition, it was also lower. Using "Behaviourally informed advice," or behavioural techniques, resulted in higher levels of trust in the advisor. These are all very interesting and very important, because these are indicators of the strength of that relationship and how much the client values you as an advisor.

There are other things we can learn from this. We know, for example, that behavioural biases have a very real and important effect on investors, and we'll demonstrate that in a moment. Behavioural economics is a tool to help you achieve better outcomes, to help clients actually listen to your advice and value the advice. And what we found was that those behavioural techniques increased the perceived importance of both seeking and following advice, increased the perceived value of advice, increased the perceived value of the relationship with the advisor and the trust in the advisor, increased the perceived benefits of working with an advisor, and increased the likelihood of consulting with an advisor in the future.

And there are implications there for both advisors, as well as clients. For advisors, this means a better relationship with clients, stronger business, assets consolidated to you instead of away. But for clients, and in the end this is what we're all here for, it resulted in them actually following the advice. And as a result of that, achieving better outcomes.

Let's look at what history has taught us. We know that there are always sharp market sell-offs, and these are the biggest market declines, the 10 biggest market declines. And you can see, for example, let's look at October 15, 2008. It was a -9% on that day. But if you stayed in the market after a year, it was +24. After three years, it was +41. And you can see the pattern going all the way through. There's a correction, but there's a recovery and the market always comes back.

I started in financial services on Black Monday, in 1987. And that was quite a start because, here I'm brand-new in the industry and walk in and I go, "Wow, that was interesting, the markets went down almost 35% and took three months to recover." I also remember 1998; that was long-term capital markets. Markets were down 22% and there was a bear market rally with a W-shaped pattern before a recovery three months later.

Then there was the 2000-2003 tech bubble. That hit tech stocks, really, but the broader market took three years to recover. And I was also on Wall Street during the 2007-2009 crash, and it took until March 2013 to recover. But the bottom of that crash was actually the start of the longest bull market in history.

And sure, you have bears always claiming that they saw all this coming and they sold out. And you've also got bears that have said that every year for a decade. Even a broken clock is wrong twice a day and when the market finally does decline, they crow about the fact that they called it.

That really is just a pattern that we see, right? But one thing that is consistent is that it's people's subsequent behaviour that determines their performance. If they panic and exit the market, their performance suffers.

And this is a chart that compares what would happen starting January 1, 2007, if you were invested in a balanced 60-40 split of equities versus fixed income, and that's the green curve. And then the next curve down, the gold curve, that's what happens if people panic, pull out of the market and then decide they're going to jump back in. But because no one can time the market properly, they have a permanent decline in what the return could have been. You can see that staying out of the recovery costs you. And by the way, each time there's a correction and you stay out of the recovery, it costs you.

The blue one is if people switched out of equities into bonds. And the red one is the worst case, that's people pulling out and staying in T-bills. And you can see that they never recover as a result of that.

So the question here is: How do we prevent people from making these terrible decisions which have enduring negative consequences that affect them going forward that they never recover from? And why do they do it? That's the other question. In order to actually be able to assist people and help them make better decisions, we have to understand something about why they're making these sub-optimal decisions to begin with.

So let's look at... This is from the December 2018 crash, and we all know what happened then, right? The markets declined at the end of December and by January—it was actually early February—they had substantially recovered. But if you were reading the headlines during that period, and these are real headlines from that period, between—we've got December 24, January 4, January 11 and January 21—and you can see it goes from wildly positive to wildly negative. We've got panic selling and panic buying, all occurring during the course of the month. So is it any wonder that our clients are suffering from anxiety and don't know who to listen to and may, in fact, ignore your advice as a result of that?

And this is very recent data coming from the Australian Securities and Investment Commission, and it was published in May 2020. But it shows investor behaviour between February and March, and it actually shows, so green bars are the net buying or selling on that day, the grey bars are what happened to the price change the next day.

So let's look at the first one, February 24, 2020, all the way to the left. People bought and the next day markets went down. And let's look at some really bad examples around March 2. Huge

buying, the next day the markets declined. And then you can also see February 2. Huge selling, the next day the markets recovered. The fact that the grey bars and the green bars are in the opposite means that people are buying high and selling low. And this is exactly the sort of behaviour that we seek to understand with behavioural economics, to understand why people are making these obviously suboptimal decisions.

And this is a quote I like from Stephen Wendel. He basically says here that it's not the portfolio that needs assistance, it's not your client's portfolio that needs assistance, it's the client, it's the investor. You have to use tools from behavioural science to actually overcome the anxiety and panic, and help them make better decisions. And that's a lot of what we're going to be talking about today.

The question is: What is behavioural economics? You may have heard the term behavioural science, behavioural finance, behavioural economics. What they all combine is a look at the psychological side of investment decision-making or decision-making, and compare that to what optimal decision-making would be, and understand why they may not be making optimal decisions. And once we can understand it, then we can try and do something to correct that suboptimal decision-making.

A lot of this stems from the basic view of the nature of investors and their decision-making. Typical economics assumes that people will seek information, calculate costs and benefits of incentives, and then make rational choices. The fundamental assumption there just doesn't seem right. The average typical person doesn't do a full calculation of cost and benefit, and do a probability distribution of likely outcomes, model it and then make a decision that way. We know that's likely not true.

Now, typical economists would say it's not relevant whether the assumptions are true, what matters is whether the model makes accurate predictions of behaviour. That's essentially the difference between behavioural economics and economics. Behavioural economics says that's part of the picture, but it's not the whole picture, because the other part of the picture is the fact that people really are psychological beings and they are subject to biases and heuristics, and they make decisions that may not be rational as a result of it.

And essentially what it says, the foundations of behavioural economics, rather than assuming consumer decision-makers are rational utility-maximizing consumers, it says we try to be rational, but we're bounded by our ability to be rational. And when we say rational here, this doesn't mean sane versus insane or irrational being insane. What it says is that they're making decisions that may not actually be fully analytical and fully considered. They're trying, but they don't have the time, the mental energy and the willpower to fully analyze every decision, so they do their best. They're boundedly rational.

And one of the things we do is use heuristics and biases. It's not possible for us to fully analyze most decisions. Most of our clients don't have the financial skills and the understanding of markets to even be able to do it. But we do that in many areas of life. We use heuristics, which are shortcuts. For example, if you give people two glasses, one is short and fat, one is tall and skinny, most people will say that the tall, skinny one contains more liquid. And that's just a shortcut we go through life with. The right way to analyze that would be to calculate the volume of each of the glasses. But we don't do that. And time and again you can see that people say the taller glass has more liquid, even though it doesn't.

And so that's an example of a bias where we're using a shortcut—how tall is the glass—and making a decision and that bias means that the decision is biased away from a purely analytical, correctly rational decision. And we do that in all areas of our life. And in particular, we do that when making investment decisions.

And in part the reason is our brains evolve...

Catherine Milum:

David? David?

David Lewis:

Yes?

Catherine Milum:

It's Catherine. Maybe you could just go back, because I find when I'm speaking to advisors, the mental shortcut, maybe give one more example. I really like your example of buying the TV. Maybe just to clarify the point on the mental shortcuts that we use in buying a TV.

David Lewis:

Yeah, sure. So if you can think of the study that we did for Manulife, they had 35 portfolios. They had one-, three- and five-year returns and three-year standard deviation. Using capital asset pricing model and modern portfolio theory, you could calculate the optimal allocation. But we know no one did that. It's not hard to do it, but we know no one did that. And think of when we go to buy a TV. A very small number of us may put a spreadsheet together where we list all of the different features: What's the operating system of the TV? Is it Web 2.0., Web 3.0? What's the resolution? Is it 10 ADP, 10 ADI, 4 K, UHDP? Put it all down in a spreadsheet, put the prices beside it, assign a weight to each one of those features, calculate the weighted average of each one of those features and determine the optimal decision.

A very small number of us might do that, but most of us just walk into the TV store and take a look at it and say, "Ah, LG, I've heard of that. Um, yeah, picture's okay. I think I'll buy that." So the heuristic, or the shortcut there is relying on the brand, saying it's an LG, it must be good. You're not doing the analysis, you're not doing the calculations, you're not creating a weighted decision matrix, you're just using a shortcut. Because frankly, we don't have time to do that. And people do that with investment decision-making, as well.

And part of the reason is...

Catherine Milum:

Thank you.

David Lewis:

Yeah, no problem, Catherine. We just don't have the mental capacity to do that for many decisions. And our brains actually evolved, from an evolutionary standpoint, your brain consumes a tremendous amount of your metabolic energy. It's about the equivalent of a 12-watt lightbulb, so you can see how that uses a lot of energy. And it's not necessarily adapted to spend all that time thinking through every decision, because then you won't have energy to do other things, like go and find food, protect your offspring and create more offspring.

And so what our brains evolved was two systems of thinking. System 1 is sort of intuitive and emotion-based, and that's the one that takes shortcuts. And for most decisions that are low risk and don't have long-term consequences, that's perfectly fine. So I'm going to leave the tree, leave my offspring in the tree and I'm going to go and find food. Do I turn left or right? Most of the time, that's not going to be a bad decision.

But let's assume as you're walking down the path, suddenly this giant carnivore jumps out and is about to eat you. If you sit down and think, should I run left, should I run right, should I climb a tree, you're eaten and your offspring starve and you exit the gene pool. If instead you just react intuitively and emotionally and just run, that's the proper use of System 1, because the risk of making a bad decision is much less than the risk of making no decision.

Whereas a lot of our decisions, like investment decision-making, require us to be effortful and deliberate. We really should sit down and look at the standard distribution and the probability distribution of expected returns. But we don't, because oftentimes we're hijacked by emotions, like anxiety right now. And so where we should be effortful and deliberative, we're often intuitive and emotion-based, and that's what leads to bad decisions.

The question is: Does behavioural economics apply to investments? We're going to do a simple exercise here demonstrating some investment decision-making principles.

So here's the first question. You've got four different portfolios to choose from. Portfolio A, B, C and D, and those are going to be your choices here. Portfolio A has a maximum gain of \$11,200 and a maximum loss of \$1,600. B is \$11,800 and a maximum loss of \$2,900. C is a maximum gain of \$2,400 (SIC) and a maximum loss of \$4,000. D is a maximum gain of \$13,000 and a maximum loss of \$5,100. You can kind of see that in the background behind the question here, so what I'll ask you to do is just pick which one you would pick for a long-term investment strategy.

<Pause>

So again, it's about 15 seconds and then this will finish.

<Pause>

All right. We're going to give you another one now. Here it is. You've got \$10,900 versus \$0, so gain of \$10,900 and no loss. Or a possible gain of \$11,200 and a loss of \$1,600. A possible gain of \$12,400 (SIC) and loss of \$4,000 (SIC). Or a possible gain of \$13,000 (SIC) and a loss of \$5,100 (SIC). So which would you pick?

<Pause>

Okay. And now we've got a third set of choices for you. Now you've got \$11,800 as a gain and \$2,900 as a loss. You've got \$12,400 as a gain and \$4,000 as a loss. \$13,000 as a gain and \$5,100 as a loss. Or \$14,000 as a gain and \$7,100 as a loss. Now, which one would you pick?

<Pause>

All right. Now if you go to the polls and look at the closed polls, you can see how you answered. And in the first example, 20% picked A, 21% picked B, 24% picked C and 34% picked D. So the lowest-risk option was 20%. People who were risk-averse and picked the lowest risk, 20% of them picked A.

Question 2, we removed D and added a lower-risk option. And then that's when the \$10,900 with no loss became an option. So what we found there was that 16% picked that lowest risk option and 17% picked B, which was the previous A.

And so, you know, that's kind of an interesting outcome, because now you've got 33% picking the lowest-risk option, whereas previously only 20% picked the lowest-risk option. And I'll make this clearer when I present this example again a little later on, and you'll see exactly what happened.

Sorry, that was question 3. Question 3 then... So in question 2 we added a lower-risk option and question 3 we added a higher-risk option. So in the original one, question 1, 39% picked the highest-risk option. But when we added an even higher risk in question 3, we had 24% picking C, which was the previous D, and 34% picking the new D, which was actually higher risk. So we had 58% going for the highest-risk option, whereas in the first question only 39% picked the highest-risk option. So what's going on here? I'm going to make this clearer as we go to the next slide.

We ran this exact same study with 2,000 retail investors recruited from a personal finance website. And here's what the experiment actually looked like. The first time you saw it, you saw options. Question 1, you were given option A, B, C and D. Question 2, we eliminated D and gave you A-, A, B and C. Question 3, we eliminated A and gave you B, C, D and D+. And if we're rational decision-makers each time, the options that are out there really shouldn't affect whether we're risk avoiders or risk seekers.

And so here's what we saw for the first time with the experiment of 2000 people. In the baseline, 27%, so this is when it was just A, B, C and D, the baseline, 27% picked A, 23% picked B, 33% picked C and 17% picked D. Now when we eliminated D what should have happened is the people who previously picked D, the highest-risk option, should have picked A, the next highest-risk option. So C and D together in the baseline was 50%. But when we added this low-risk decoy, A-, the \$10,900 and the zero, suddenly people became more risk-averse. There should have been still 50% in the highest-risk option because that's what it was in the baseline.

Simply adding a new option down there, suddenly everyone became more risk-averse. And of course, you're going to say, "Huh, I wonder if it works the other way?"

So when we did it the other way and we had A and B in the baseline, right, they equalled 50%. When we got rid of A and put in D+, which is even higher, instead of being 50% in the lowest available risk option, which was now B, it's only 20%. And now suddenly people are taking even more risk.

What this shows is that people didn't analyze these portfolios. And if you look at the risk of the portfolio, the risk is the divergence between the maximum gain and the maximum loss. The

more the maximum gain and the divergence between the maximum gain and the maximum loss, the more risk there is in the portfolio.

Changing the extreme ends, A- and D+ shouldn't have made people more risk-averse or more risk seeking, but it clearly does. And so this shows, under rational choice theory in traditional economics, we would have made a calculation as to our utility given the expected outcome under various risk scenarios and said I either want low risk, medium or high risk, and it shouldn't change. But clearly, it does. Which says we aren't necessarily rational decision makers when it comes to investing, and this gives the opportunity for behavioural economics to inform how people make decisions, and try and help them make better decisions.

You know, typically the challenge is getting people to accept enough risks so that they achieve their long-term objectives. And going into T-bills or going into a savings account right now due to market volatility is the exact opposite of that. So we can see how the context really affects decision-making.

Now, how can we as advisors help people take a long-term view and say ignore what's going on around you right now, all of this short-term noise. Focus on the long-term and you're going to have a better outcome. Because what we're seeing is people slide downwards, as Catherine said at the beginning. People are sliding downwards in their risk preference when they really shouldn't, because we know there's long-term consequences for them that they won't be able to achieve many of their financial goals if they take too little risk in their portfolio.

Catherine Milum:

So, David, maybe we could just go back a slide again. You know, we have close to 600 advisors on the call and I have to tell you, when I saw this research, I was shocked. And putting myself in the seat of an advisor, what does this do to the "Know your client"? What does this do with asset allocation? So if you are listening to all of this and you found this as shocking as I did, we're going to make these slides available to you through our sales team because I think this is something that could really be a great conversation with your clients. So thank you, David, for sharing that research.

David Lewis:

Yeah, no problem.

So the question is: Why are people making these sub-optimal decisions? There's many, many different biases that can affect decision-making and we as advisors have to be aware of them, because if we're aware of them, then we can think about tactics to overcome them.

Overconfidence bias is probably one of the biggest ones. People overestimate their ability to predict the market. I'm sure many of you are familiar with clients that think they know more than you do and they can be, you know, you can call that overconfidence bias. Ninety-three percent of American drivers believe they're above average. We know mathematically only 50% are above average and 50% are below average. But 93% of American drivers believe they're above average.

I've also done a lot of research in this area and found exactly the same thing. One of the biggest reasons why people don't follow advice – remember how few actually follow all of your advice – one of the biggest reasons is overconfidence. Understanding that means that we can then take steps using behavioural science to overcome those biases so that people listen to the advice, they get good outcomes and they don't blame you for their bad decision-making.

Another big one is loss aversion bias. And happiness isn't a scale from negative 10 to plus 10, but if it were, assume that you won \$100 gambling at a casino. And assume you lost \$100 gambling at a casino. Winning \$100, you're kind of happy. Losing \$100, you should be kind of unhappy. But what actually happens is winning \$100 you're kind of happy, losing you're really unhappy. It's still \$100, plus one, minus one, it shouldn't change. But what we find is people see losses as being twice as painful as equivalent gains. And that explains why many times people just don't want to take risks because the benefit of winning is less than the benefit of losing.

They feel much more pain from the decline that has occurred since March than they feel pleasure from the gain, even though on many indexes we're back to where we started. But people aren't even in terms of their happiness, they're unhappy, and that leads them to make sub-optimal decisions.

Another is the illusion of control bias. People tend to believe that they can control random events. They think they can time the market. They think that they know when to enter and when to exit the market. But we can see from the sell high, buy low, or sell low, buy high, that people actually don't know how to time the market, and they do the exact opposite.

Catherine has a great example here of wearing her Raptors jersey to help the Raptors win. We know it doesn't really help, but we have the feeling that it does.

Finally, representativeness bias. People tend to believe that current performance is representative of future performance. And no matter how many disclosures you can put down, it doesn't change the fact. I can recall being on Wall Street in '07-'09, people saying, "Oh, the indexes are going to go to zero, that's the end of the capital markets." And, you know, the deepest, darkest part was in March of 2009. I can remember people saying, predicting the NASDAQ would go to zero and the S&P would go to zero. And the smart people were the ones that piled in then and bought because they bought at the bottom in the beginning of the longest bull market in history. But it's really hard to overcome. You know, when markets are up, nothing can go wrong. When markets are down, nothing can go right.

These are the biases. And recall biases are things that lead you to make a decision that's not strictly rational. How do we overcome some of these biases?

Here's a great idea. This is called pre-commitment. And recall that we have two systems of thinking. There's the emotional thinking and there's the rational thinking. What you need to do is switch off the emotional side and tap into the rational side. And when people are in a hot bothered state, they're not rational. When they're in a rational state, get them to pre-commit and say, "In the event of a market crash, I will only sell if the S&P declines by at least 700 points." And pick a number. It can be 700, could be 20%, 30%, whatever it is, but pick a number that they're unlikely to hit.

Then when, say, it goes down 15% and they panic and they say, "Oh, we gotta sell! We gotta sell, the market's going down, it's the end of the world," you pull out the pre-commitment and say, "Look, we talked about this. You're a smart person. We've been planning this portfolio for a long time; it's been doing well. You committed that you'd only sell if it went down 25% and it hasn't done that. So what's really changed?" And that gets them out of the hot emotional state into a cold rational state. And people like to be self-consistent. If you remind them and say, "Look, you put a lot of thought into this. You were careful when you made that decision, what's changed?" And that can derail system 1 and activate system 2 when they go, "Yeah, I remember saying that. And why am I so concerned now on why am I going to do this when I know that if I miss the recovery that's the same as a loss?" Because remember, loss aversion, right? People feel the pain of losses more than gains.

Think of the pain of missing a recovery as equivalent to a loss. You were sitting on a savings account; the market went up 20% during the recovery and you lost out on that gain. You lost 20% of your portfolio. Going back to the previous coloured chart with the gold and the green and the blue and the red, do you really want to be on this red line and miss all of that recovery? Because you'll never get it back, that's permanent. So this is one good way of doing that, pre-commitment, and this can help overcome that overconfidence bias where people think that they can time the market and they know exactly what's going to happen next.

So here's another one. Explicit emotion priming. And that's kind of a fancy word, but that's what the behavioural scientists refer to it as. Essentially what it is, when we acknowledge our emotions and confront the emotions, then we prevent system 1 from hijacking system 2. It's normal to be anxious. It's normal to be concerned. It's normal to worry about what's going on in the markets, about COVID, about a social meltdown in the US.

That anxiety is normal, but it shouldn't drive our decision-making. And when people say "Yeah, you're right, I am kind of anxious about that," they shut down system 1 and they start using system 2 and they start to say, "Why am I panicking and what's really changed in the fundamentals? And has anything really changed that's going to affect my portfolio over the next 15 years, or is this just something that's happening right now that's making me anxious?" And when people are anxious, they search for more information, they tend to interpret neutral information as being negative. You know, they expect the worst, they believe the worst. They become hyper vigilant for threats, so they're constantly looking. They check their account more frequently. And checking the account frequently has its own problems.

And so when they acknowledge and say, "Yeah, I am anxious and yeah, I'm probably letting my emotions drive my decision-making, so thank you, my valued financial advisor, for getting me to step back off the ledge. You're right. We have a plan, we have a long-term plan, let's stick with it because that's going to be a better outcome in the long run."

And here's a third idea. And I kind of hinted at this in the last one. If you just look, so, you know, the graphic with the gold, that's just an illustrative market chart. It could be over a one-day period, it could be over a 20-year period. But when it's over a 20-year period and you look at some minor blip, right, each one of the blips that we've had, there's always a recovery afterwards. We demonstrated that at the beginning. But if you take it out of context and just focus on the downturn, you're going to miss the big picture. And again, this is about shutting down system 1 and opening up system 2 and, you know, saying in 2009 the people who sold and left their money sitting in a savings account or stuffed in under their mattress, missed out on the longest bull market in history.

Let's look at the long-term, and then they're less concerned about those short-term losses. And on the left, you'll see this is a study that was done that shows the more frequently people check their account, the lower their returns. So the best returns were people who checked their account twice a week. And I tell anyone who asks me for advice, I tell them don't look at your account. Stop looking at your account every day. It's going to do is make you more anxious. It's going to give you an illusion of control. It's going to make you think that the current market is representative of future markets. It's going to make you overconfident and it's going to drive you to make a trade that you're going to regret in the long run, right. Dumping a good 60-40 balanced split and going into – you know, waiting a year or going into bonds or going into the money market, you're never going to win. So look at the big picture in the long run and ignore the short-term blip because it is exactly that, a short-term blip. And again, this gets out of the granularity of looking at day-to-day fluctuations, which can do nothing to reduce anxiety and only increase anxiety, and gets them looking at the big picture.

Have them think about how they're going to spend their retirement. Catherine gave a great example at the beginning. You need \$547,000 just to eat. So if you think about that and think about the long run, then you're going to be less likely to be anxious about what's going on in the short-term.

Catherine Milum:

Hey, David? Another thing, and I love your recommendation. I think advisors will appreciate this. How often do you recommend that advisors – sorry, that clients check their accounts? I think you have a really good analogy.

David Lewis:

Yes. I would recommend people check their account as often as they go to the dentist. It's hard to do, it's hard to tell people not to check their account, and it's difficult to tell them, but we know that it's great advice. We know that it increases the returns, we know that it reduces their anxiety. And all of these things were what we found in the Manulife/BEworks Value of Advice Study, was, as an example, if the advice encourage long-term gain-framing, so if the advice encouraged them to think about how they were going to use their portfolio at the end of a period of time, they were much more likely to take that advice and invest it appropriately in the right mix of equities versus fixed income versus money market.

You know, a great example: Have your client write down five things they intend to do in their retirement. Where are you going to be living? Are you going to have a cottage? Are you going to have a boat? How often are you going to travel? Where are you going to travel to? Then instead of thinking about the fact that markets were down two days ago and they were up today and they're even, instead of thinking about very granular things, they think about the long-term, and then they're much more likely to actually listen to your advice and say, "Yes, you're right. WE have a plan, we have a good plan, I'm going to stick with it."

And I will say, a lot of these ideas seem really simplistic and obvious, but they're founded in science. And there's also something called hindsight bias, where when people are given information and they believe the information, they often say, "Oh, I knew that. I knew that all along." And many of you may have been using many of these tactics and using them very successfully. I think now you have some insights into why they work. And for some of you who are looking at these saying "I wonder if this will work," there's a great way to find out, and that's trying it. Because we know from behavioural research that they work and we know from analyzing the performance of the investments that people selected in the Manulife/BE Works

Value of Advice Study, that when we did things like long-term gain-framing, people picked more optimal allocation of equity. They diversified more between asset classes. And they diversified more between funds in those asset classes, which means they constructed better portfolios.

As an example, one of the only differences between typical advice and behaviourally informed advice was long-term gain-framing. So we know experimentally that these tactics work and we also know from advisors that follow this that these tactics work.

Just having trouble advancing here. There we go.

So here is idea 4. This is nudging to overcome representativeness bias, and this is a concrete example of getting people to think about their future self. The guy in that picture is Hal Hershfield, who is a behavioural researcher at UCLA. And all he did here was he had people decide how much they were going to save in a hypothetical account. When they saw a picture of their current self, and that's Hal on the left, the average person said, "I'm going to save \$80 per week for my retirement." Or per month, I'm not sure the exact timeframe here, but you can see the reference there, it's a paper written in 2011.

When they saw a computer enhanced photo of themselves looking older, they saved more money. We actually did exactly this same thing in the real world for a very large bank in the US that was trying to encourage millennials to save more money. And one group of millennials just picked how much they would save and the other group of millennials was given a computer-enhanced and aged picture of themselves, and they saved more money. And that's not an experiment in a lab, that's actual real dollars going into real accounts at this, it's one of the five largest banks in the US. And they saw over time a real difference in the amount of money that these millennials were willing to save.

So for your clients, you can do the same thing. When they're thinking about their portfolio and making changes to their portfolio, have them think about their future self. Make that future self more real. There's a great Jerry Seinfeld skit about Night Guy, Morning Guy and Day Guy. You'll find it online, have a look at it. I think it was on Jay Leno. But it's exactly that. When we're sitting in front of the TV at night and thinking about streaming one more episode, we don't think about how we're going to feel in the morning. If you ever want to stop yourself from streaming one more episode at midnight, say, "How am I going to feel in the morning?" And then you'll make a better decision.

In summary, we've got overconfidence bias, people overestimating their ability to predict the market. The illusion of control bias where they think they have control over random events. Loss aversion bias where losses are twice as painful as gains. And representativeness bias where people think that what's currently happening is going to continue. You know, that says, you know, in March when the market down it was going to keep going down. But we know in hindsight that it didn't, that it went back up. And we've talked about some of the tactics that can be used to overcome these behavioural biases. And with that, I'm going to pass it on to my colleague, Catherine.

Catherine Milum:

Wow, thanks, David. That was a ton of great information. But there was something that I'm going to have to correct you on. You know my favourite bias is the illusion of control, and I just want to state that the Raptors actually did win because of the lucky sweater I was wearing that night, okay? So just wanted to make that clear.

David Lewis:

Okay, sorry.

[Laughter]

Catherine Milum:

Okay, so we started this with the real goal to help your clients do the right thing and to help them become more rational in irrational times. And I've got to tell you, these are irrational times. And we really want to help you become a better behavioural coach. And I want to tell you that I don't know about you, but I walked away from these sessions and I sometimes feel a little overwhelmed and you kind of say, "Well, now what? Now what do I do?" And I know there are quite a few questions also coming through on the chat line, but I wanted to tell you that we do have resources. We have a fabulous website, manulifeim – the 'im' stands for Investment

Management, that's how you can remember it – .ca, and we have a lot of resources that David and his team, they've written themselves, and our marketing people have packaged to really help your clients navigate the volatility and help you have better conversations.

Somebody online asked David, they said, "Well, you know, how do I convince my client not to check their accounts, you know, every day?" And I've got to tell you, on this website, it has the slide that David was referring to with the actual research. And you know what I do, I just show them that. You know what? There is research that proves that checking your account too often is going to cause you anxiety and it's going to make you maybe buy high and sell low. So the research is all there on the website, and obviously, by contacting anybody our sales team.

I hope you stuck around till the end because there's something else that I want to announce. We're going to be offering to financial advisors across Canada a course on behavioural coaching, and it will be designed – it is being designed – by David Lewis and the team at BE Works. We are prepared to have this course ready for financial advisors in September. It's going to be an online self-guided course. I believe there's going to be about seven hours of content in it, so we're going to make you work for it, but I think – you know, I've taken the course myself and it was somewhat life-changing, understanding people's biases and, quite frankly, a lot of my own. So stay tuned for that. BEworks, the entire team is PhD's, they're experts in behavioural economics, in psychology and also finance. So we're really, really looking forward to sponsoring that for you and really to support you through this volatility.

Okay, wow, we have three minutes left, David, I guess, for questions. So I'm going to turn the call back to you. And I just want to say on behalf of everyone at Manulife, thank you so much for being on the call.

David Kitai:

Thank you so much, Catherine. Yeah, this is David here again from WP, and thank you, David, as well. Thank you both for such an amazing presentation and sharing such great information.

As you said, we don't have a ton of time left for questions, but I had one that came through that was I thought pretty pertinent, and I'll ask this to both of you. But if investment advisors were to address one single behavioural bias today with their clients, which one, in your opinion, is the most prevalent and the most in need of addressing?

David Lewis:

So, Catherine, would you like me to answer it?

Catherine Milum:

Absolutely. And then I'll agree with your answer.

David Lewis:

There is a bit of a metaphor here, right. Behavioural economics is kind of like a bag of golf clubs. You don't use the same club on every hole. Well, Catherine's an excellent golfer, I am a terrible golfer and I would use the same club on every hole because it doesn't affect the outcome. But in this instance, I think overconfidence bias is probably the biggest one that has the biggest impact. And a good way to reduce that, go online and look for financial literacy questionnaires, and there's a bunch of them, and just have people go through the financial literacy questionnaire. And it's not—you don't need to score it, just having them think about the types of questions will make them self-assess their own expertise and say, "Ha, maybe I don't know as much about this as I thought I did, and maybe I will listen to my advisor a little more."

David Kitai:

That's fantastic.

David Lewis:

Yeah.

David Kitai:

Sorry, Catherine, did you want to...?

Catherine Milum:

No, David and I have talked about this before so I would agree. Overconfidence is something – and I actually think the illusion of control, I look inward and I know that when I feel anxiety, I typically like to take control of things, not just my finances, but just anything in my personal life. And we have an illusion that we can effect change when most of the time we can't. So that's another thing that I think is really prevalent in these times.

David Kitai:

Absolutely. So I'll ask one final question about this study that BEworks conducted. From the study, which behavioural economics tactic was the most effective, and which one was actually surprisingly the least effective in terms of addressing these biases?

David Lewis:

Yeah, that's an interesting question. You know, I started out as a client, and so I tended to believe that data and analytics is the right answer. What we found actually was salience was one of the most effective. People have to understand, so salience just means how it is relevant. If you make the advice relevant by saying, "If you follow this, you will achieve your outcome. If you don't follow this, you won't achieve your outcome." And just making it very real for them.

Many times, you know, I'm guilty of having done marketing that, you know, one-, three-, five-year return, standard deviation, charts, graphs, pie charts. People don't understand that. You need to simplify it and make it salient and say, "If you leave your money in a savings account, you will have to work longer and you will not have the same quality of life in retirement. If you follow a good asset allocation and stick with it, we're going to achieve the outcomes that we talked about."

David Kitai:

Catherine, did you want to weigh in on that at all?

Catherine Milum:

No, I think David did a great job.

David Kitai:

Perfect. Well, I think you both did a great job. I can only really express my sincere thanks on behalf of WP and the whole team at Key Media to yourselves and to all of our attendees for asking such great questions and being such active listeners. We're already getting so many people asking to take the course and to hear the recording of our presentation. So I can only say thank you so, so much, it's been such a pleasure hosting this webinar for you all and I hope everybody still stays safe and stays sane out there and we'll all get through this.

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