



## THREE PRACTICAL WAYS TO LEVERAGE THE POWER OF BEHAVIORAL FINANCE AND GROW YOUR BUSINESS

Behavioral economics, or behavior finance, runs counter to the traditional economic view that people make rational decisions. In fact, it assumes that people make irrational decisions based on emotions. These irrational decisions follow patterns which can be identified and potentially channeled to help people make wiser and more beneficial choices.

Interest in behavioral finance has been boosted by attempts to understand and explain the causes of the housing and financial market cataclysms. We have been forced to examine and re-examine just how we were sucked into a belief in perpetually rising housing and stock markets.

Emotion-driven choices got us into our current troubles, some observers say. And now, if emotions are understood and properly managed, perhaps they can help get us out.

What does all this mean for your practice as a financial advisor? Plenty! In this paper, we will look at the growing influence of ideas based on behavioral finance and offer recommendations as to how you can leverage these ideas to benefit your clients and your business.

### ***Growing Recognition in the Press and Beyond***

Once you become aware of the basic ideas of behavioral finance, you will notice that they are popping up everywhere. This month's *Money* magazine tells readers how to "Make Fear and Greed Work for You," and potentially profit from Wall Street's swings between the two extreme emotions.<sup>1</sup> In the latest *New Yorker*, "Cocksure: Banks, battles and the psychology of overconfidence," by Malcolm Gladwell analyzes Wall Street's troubles, laying some of the blame on irrational overconfidence, especially in the failure of Bear Stearns.<sup>2</sup>

In another arena, fund managers are getting behavioral finance help from consultant Michael Ervolini. Ervolini advises managers on how to create alpha by better understanding the link between their emotions and behavior. According to Ervolini, buying is a positive and even fun action, while selling creates negative emotions.

But the most influential ideas – that will very likely affect your practice and the advice you give clients – are those articulated in *Nudge: Improving Decisions About Health, Wealth and Happiness*. The authors build on behavioral economic theory to "design choice environments that make it easier for people to choose what is best for themselves, their families, and their society."<sup>3</sup>

The proposed Consumer Financial Protection Agency would be charged with making and enforcing rules relating to retail financial products such as credit cards and mortgages. Taking a cue from *Nudge*, the plan is for the agency to use a carrot and stick approach to help consumers make wise choices from among the hundreds of mortgages available. Reports indicate that the agency would create two “plain vanilla” universal mortgages – a 30-year fixed and a simple adjustable rate mortgage. While lenders could offer any number of other types of mortgages, and consumers would be free to use them, the agency would have authority to restrict some of the terms.

These proposals directly affect your work with clients. Because of *Nudge*, you will be learning about new practices in consumer finance that may impact your clients. But there is more to behavioral finance than the government’s role. There are a number of practical applications which can help you do a better job for your clients today.

### ***Behavioral Finance Can Make Your Practice More Successful***

How can you channel the powerful ideas of behavioral finance to make yourself a more effective advisor and to help your clients recover and move forward from the volatile markets of 2008-09?

Behavioral finance covers a range of concepts, and it is just now moving from the testing and theory stage into practical application. It appears that the discipline will continue to develop information about the connection between human nature and financial decision-making. In the meantime, here are a few recommendations, based on behavioral finance concepts, that can help your practice now.

#### **1- Optimize your communications.**

Effective client communications are not simply a matter of providing a shiny brochure or delivering a new business presentation that looks good. To make a powerful impact on your client relationships, make sure that your choice of words – whether spoken or written – is designed to lead clients and prospects toward the desired decision.

In the language of behavioral finance, this is the concept of *framing* – that is, the way that information is presented, or framed, plays a significant role in the decision that is ultimately made. Recognize that you have the power to frame information and influence decisions. Even in today’s uncertain economy, you can anticipate and acknowledge the negative emotions that are so common today – fear, anxiety, remorse.

As an example, studies have demonstrated that investors are willing to assume greater risk as they look toward a more distant time horizon. In today’s uncertain world, that may mean recommending a tactical allocation of short-term, lower risk investments or asset classes. To frame your information and encourage the longer-term allocation component, present historic equity results over two-, five- or even decade-long time spans.

#### **2- Keep your presentations and recommendations clear-cut and straightforward.**

In today’s information-cluttered world, you can help clients and prospects see their way through

## FURTHER READING

**Want to find out more about behavioral finance? Here are three popular books on the subject.**

- Ariely, Dan. *Predictably Irrational*. New York: HarperCollins, 2008.
- Bradlow, Eric T., Keith E. Niedermeier and Patti Williams. *Marketing for Financial Advisors*. New York: McGraw Hill, 2009.
- Thaler, Richard H. and Cass R. Sunstein. *Nudge: Improving Decisions About Health Wealth and Happiness*. New Haven and London: Yale University Press, 2008.

the 24-hour onslaught of financial news (which at this time is about 99% negative!). Further, the array of available investment products is virtually infinite; compare that with just 25 years ago when investment options were largely focused on stocks, bonds and mutual funds. \_

People want a lot of choices ... or do they? According to behavioral finance, the *paradox of choice*, tells us that individuals are drawn to situations where they have many possibilities to choose from. They appear to want a lot of opportunities. However, a large number of choices does not necessarily support decision-making. One study of company retirement plans “found that an abundance of choices actually had a detrimental effect on plan participation. There was a clear negative correlation between the number of investment choices available and the enrollment of employees in the plan.”<sup>4</sup>

Your clients deserve to understand the full range of paths that can get them to their goals. But it is up to you to develop a process which strips back the complexities of choices so that they can make intelligent choices. A Unified Managed Account (“UMA”) is one product on the platform that can help you clarify choices for clients, since all investments are presented in one reporting document.

### **3- Help clients get decisions made.**

Every advisor knows how challenging it can be to get clients to make decisions. Behavioral finance experts have studied this frustrating side to human nature, and they have come up with some promising ways to help clients make decisions and move forward. Broadly speaking, the term *psychological inertia* has been applied to the human tendency to stay with the status quo. That is, if an individual is in motion, he or she will stay in motion. But if a prospect or client has not taken an action, he or she has in effect made a commitment to the inaction.

As an advisor, the tendency to stick with the status quo will impact your efforts to get clients to reallocate portfolios. Even if they have an intellectual understanding of the value of a balanced portfolio, they are reluctant to do so. One way to encourage portfolio balancing or any other stressful decision is to schedule a meeting to discuss the issue far in advance. This is a tactic dentists seem to understand better than anyone; by getting us to make appointments six months out, we must either cancel or change the appointment. It is usually easier to just go and get your teeth cleaned. For your clients, another option is to take part in an automatic reallocation program, such as those available in a UMA, and avoid that ongoing decision-making altogether.

### ***A Tool that Can Work for You***

While a UMA account is not the subject of this paper, the tools available in the best of these comprehensive accounts can help you as you help your clients. The UMA encompasses a full range of asset class choices, screened by professional due diligence. At the same time, it simplifies reporting by including all assets within one statement. So, while many choices are still available, the structure has been simplified. The UMA process can help you determine an appropriate asset allocation for your client's situation and risk tolerance, supporting your efforts and confidence. And it can move the decision-making process forward by providing automatic rebalancing along with a tax overlay component.

Understanding ourselves and, understanding the stock market – two of the most elusive areas of knowledge – may be coming closer together through the field of behavioral economics. As advisors, we can take advantage of this growing body of knowledge to help grow our practices.

<sup>1</sup> Janice Revell, "Make Fear and Greed Work for You," Money magazine, August 2009, 88-98.

<sup>2</sup> Malcolm Gladwell, "Cocksure: Banks, battles and the psychology of overconfidence," New Yorker, July 27, 2009, 24-28.

<sup>3</sup> Nudge: Improving Decisions about Health, Wealth, and Happiness by Richard H. Thaler and Cass R. Sunstein (New York and London: Yale University Press, 2008), book jacket.

<sup>4</sup> Study by Vanguard Group, cited in Marketing for Financial Advisors by Eric T. Bradlow, Keith E. Niedermeier, and Patti Williams (New York: McGraw Hill, 2009), page 135.

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