PART One

Introduction to the Practical Application of Behavioral Finance
What Is Behavioral Finance?

People in standard finance are rational. People in behavioral finance are normal.
—Meir Statman, Ph.D., Santa Clara University

To those for whom the role of psychology in finance is self-evident, both as an influence on securities markets fluctuations and as a force guiding individual investors, it is hard to believe that there is actually a debate about the relevance of behavioral finance. Yet many academics and practitioners, residing in the “standard finance” camp, are not convinced that the effects of human emotions and cognitive errors on financial decisions merit a unique category of study. Behavioral finance adherents, however, are 100 percent convinced that an awareness of pertinent psychological biases is crucial to finding success in the investment arena and that such biases warrant rigorous study.

This chapter begins with a review of the prominent researchers in the field of behavioral finance, all of whom support the notion of a distinct behavioral finance discipline, and then reviews the key drivers of the debate between standard finance and behavioral finance. By doing so, a common understanding can be established regarding what is meant by behavioral finance, which leads to an understanding of the use of this term as it applies directly to the practice of wealth management. This chapter finishes with a summary of the role of behavioral finance in
BEHAVIORAL FINANCE: THE BIG PICTURE

Behavioral finance, commonly defined as the application of psychology to finance, has become a very hot topic, generating new credence with the rupture of the tech-stock bubble in March of 2000. While the term behavioral finance is bandied about in books, magazine articles, and investment papers, many people lack a firm understanding of the concepts behind behavioral finance. Additional confusion may arise from a proliferation of topics resembling behavioral finance, at least in name, including behavioral science, investor psychology, cognitive psychology, behavioral economics, experimental economics, and cognitive science. Furthermore, many investor psychology books that have entered the market recently refer to various aspects of behavioral finance but fail to fully define it. This section will try to communicate a more detailed understanding of behavioral finance. First, we will discuss some of the popular authors in the field and review the outstanding work they have done (not an exhaustive list), which will provide a broad overview of the subject. We will then examine the two primary subtopics in behavioral finance: Behavioral Finance Micro and Behavioral Finance Macro. Finally, we will observe the ways in which behavioral finance applies specifically to wealth management, the focus of this book.

Key Figures in the Field

In the past 10 years, some very thoughtful people have contributed exceptionally brilliant work to the field of behavioral finance. Some readers may be familiar with the work Irrational Exuberance, by Yale University professor Robert Shiller, Ph.D. Certainly, the title resonates; it is a reference to a now-famous admonition by Federal Reserve chairman Alan Greenspan during his remarks at the Annual Dinner and Francis Boyer Lecture of the American Enterprise Institute for Public Policy Research in Washington, D.C., on December 5, 1996. In his speech, Greenspan acknowledged that the ongoing economic growth spurt had been accompanied by low inflation, generally an indicator of stability. “But,” he posed, “how do we know when irrational exuberance has un-
duly escalated asset values, which then become subject to unexpected and prolonged contractions as they have in Japan over the past decade?”¹ In Shiller’s *Irrational Exuberance*, which hit bookstores only days before the 1990s market peaked, Professor Shiller warned investors that stock prices, by various historical measures, had climbed too high. He cautioned that the “public may be very disappointed with the performance of the stock market in coming years.”² It was reported that Shiller’s editor at Princeton University Press rushed the book to print, perhaps fearing a market crash and wanting to warn investors. Sadly, however, few heeded the alarm. Mr. Greenspan’s prediction came true, and the bubble burst. Though the correction came later than the Fed chairman had foreseen, the damage did not match the aftermath of the collapse of the Japanese asset price bubble (the specter Greenspan raised in his speech).

Another high-profile behavioral finance proponent, Professor Richard Thaler, Ph.D., of the University of Chicago Graduate School of Business, penned a classic commentary with Owen Lamont entitled “Can the Market Add and Subtract? Mispricing in Tech Stock Carve-Outs,”³ also on the general topic of irrational investor behavior set amid the tech bubble. The work related to 3Com Corporation’s 1999 spin-off of Palm, Inc. It argued that if investor behavior was indeed rational, then 3Com would have sustained a positive market value for a few months after the Palm spin-off. In actuality, after 3Com distributed shares of Palm to shareholders in March 2000, Palm traded at levels exceeding the inherent value of the shares of the original company. “This would not happen in a rational world,” Thaler noted. (Professor Thaler is the editor of *Advances in Behavioral Finance*, which was published in 1993.)

One of the leading authorities on behavioral finance is Professor Hersh Shefrin, Ph.D., a professor of finance at the Leavey School of Business at Santa Clara University in Santa Clara, California. Professor Shefrin’s highly successful book *Beyond Greed and Fear: Understanding Behavioral Finance and the Psychology of Investing* (Harvard Business School Press, 2000), also forecast the demise of the asset bubble. Shefrin argued that investors have weighed positive aspects of past events with inappropriate emphasis relative to negative events. He observed that this has created excess optimism in the markets. For Shefrin, the meltdown in 2000 was clearly in the cards. Professor Shefrin is also the author of many additional articles and papers that have contributed significantly to the field of behavioral finance.
Two more academics, Andrei Shleifer, Ph.D., of Harvard University, and Meir Statman, Ph.D., of the Leavey School of Business, Santa Clara University, have also made significant contributions. Professor Shleifer published an excellent book entitled *Inefficient Markets: An Introduction to Behavioral Finance* (Oxford University Press, 2000), which is a must-read for those interested specifically in the efficient market debate. Statman has authored many significant works in the field of behavioral finance, including an early paper entitled “Behavioral Finance: Past Battles and Future Engagements,” which is regarded as another classic in behavioral finance research. His research posed decisive questions: What are the cognitive errors and emotions that influence investors? What are investor aspirations? How can financial advisors and plan sponsors help investors? What is the nature of risk and regret? How do investors form portfolios? How important are tactical asset allocation and strategic asset allocation? What determines stock returns? What are the effects of sentiment? Statman produces insightful answers on all of these points. Professor Statman has won the William F. Sharpe Best Paper Award, a Bernstein Fabozzi/Jacobs Levy Outstanding Article Award, and two Graham and Dodd Awards of Excellence.

Perhaps the greatest realization of behavioral finance as a unique academic and professional discipline is found in the work of Daniel Kahneman and Vernon Smith, who shared the Bank of Sweden Prize in Economic Sciences in Memory of Alfred Nobel 2002. The Nobel Prize organization honored Kahneman for “having integrated insights from psychological research into economic science, especially concerning human judgment and decision-making under uncertainty.” Smith similarly “established laboratory experiments as a tool in empirical economic analysis, especially in the study of alternative market mechanisms,” garnering the recognition of the committee.5

Professor Kahneman (Figure 1.1) found that under conditions of uncertainty, human decisions systematically depart from those predicted by standard economic theory. Kahneman, together with Amos Tversky (deceased in 1996), formulated *prospect theory*. An alternative to standard models, prospect theory provides a better account for observed behavior and is discussed at length in later chapters. Kahneman also discovered that human judgment may take heuristic shortcuts that systematically diverge from basic principles of probability. His work has inspired a new generation of research employing insights from cognitive psychology to enrich financial and economic models.
Vernon Smith (Figure 1.2) is known for developing standards for laboratory methodology that constitute the foundation for experimental economics. In his own experimental work, he demonstrated the importance of alternative market institutions, for example, the rationale by which a seller’s expected revenue depends on the auction technique in use. Smith also performed “wind-tunnel tests” to estimate the implications of alternative market configurations before such conditions are implemented in practice. The deregulation of electricity markets, for example, was one scenario that Smith was able to model in advance. Smith’s work has been instrumental in establishing experiments as an essential tool in empirical economic analysis.

**FIGURE 1.1** Daniel Kahneman
Prize winner in Economic Sciences 2002. © The Nobel Foundation
Behavioral Finance Micro versus Behavioral Finance Macro

As we have observed, behavioral finance models and interprets phenomena ranging from individual investor conduct to market-level outcomes. Therefore, it is a difficult subject to define. For practitioners and investors reading this book, this is a major problem, because our goal is to develop a common vocabulary so that we can apply to our benefit the very valuable body of behavioral finance knowledge. For purposes of this book, we adopt an approach favored by traditional economics textbooks; we break our topic down into two subtopics: Behavioral Finance Micro and Behavioral Finance Macro.

FIGURE 1.2  Vernon L. Smith
1. Behavioral Finance Micro (BFMI) examines behaviors or biases of individual investors that distinguish them from the rational actors envisioned in classical economic theory.
2. Behavioral Finance Macro (BFMA) detects and describe anomalies in the efficient market hypothesis that behavioral models may explain.

As wealth management practitioners and investors, our primary focus will be BFMI, the study of individual investor behavior. Specifically, we want to identify relevant psychological biases and investigate their influence on asset allocation decisions so that we can manage the effects of those biases on the investment process.

Each of the two subtopics of behavioral finance corresponds to a distinct set of issues within the standard finance versus behavioral finance discussion. With regard to BFMA, the debate asks: Are markets “efficient,” or are they subject to behavioral effects? With regard to BFMI, the debate asks: Are individual investors perfectly rational, or can cognitive and emotional errors impact their financial decisions? These questions are examined in the next section of this chapter; but to set the stage for the discussion, it is critical to understand that much of economic and financial theory is based on the notion that individuals act rationally and consider all available information in the decision-making process. In academic studies, researchers have documented abundant evidence of irrational behavior and repeated errors in judgment by adult human subjects.

Finally, one last thought before moving on. It should be noted that there is an entire body of information available on what the popular press has termed “the psychology of money.” This subject involves individuals’ relationship with money—how they spend it, how they feel about it, and how they use it. There are many useful books in this area; however, this book will not focus on these topics.

THE TWO GREAT DEBATES OF STANDARD FINANCE VERSUS BEHAVIORAL FINANCE

This section reviews the two basic concepts in standard finance that behavioral finance disputes: rational markets and rational economic man. It also covers the basis on which behavioral finance proponents challenge each tenet and discusses some evidence that has emerged in favor of the behavioral approach.
Overview

On Monday, October 18, 2004, a very significant article appeared in the Wall Street Journal. Eugene Fama, one of the pillars of the efficient market school of financial thought, was cited admitting that stock prices could become “somewhat irrational.” Imagine a renowned and rabid Boston Red Sox fan proposing that Fenway Park be renamed Steinbrenner Stadium (after the colorful New York Yankees owner), and you may begin to grasp the gravity of Fama’s concession. The development raised eyebrows and pleased many behavioralists. (Fama’s paper “Market Efficiency, Long-Term Returns, and Behavioral Finance” noting this concession at the Social Science Research Network is one of the most popular investment downloads on the web site.) The Journal article also featured remarks by Roger Ibbotson, founder of Ibboston Associates: “There is a shift taking place,” Ibbotson observed. “People are recognizing that markets are less efficient than we thought.”

As Meir Statman eloquently put it, “Standard finance is the body of knowledge built on the pillars of the arbitrage principles of Miller and Modigliani, the portfolio principles of Markowitz, the capital asset pricing theory of Sharpe, Lintner, and Black, and the option-pricing theory of Black, Scholes, and Merton.” Standard finance theory is designed to provide mathematically elegant explanations for financial questions that, when posed in real life, are often complicated by imprecise, inelegant conditions. The standard finance approach relies on a set of assumptions that oversimplify reality. For example, embedded within standard finance is the notion of “Homo Economicus,” or rational economic man. It prescribes that humans make perfectly rational economic decisions at all times. Standard finance, basically, is built on rules about how investors “should” behave, rather than on principles describing how they actually behave. Behavioral finance attempts to identify and learn from the human psychological phenomena at work in financial markets and within individual investors. Behavioral finance, like standard finance, is ultimately governed by basic precepts and assumptions. However, standard finance grounds its assumptions in idealized financial behavior; behavioral finance grounds its assumptions in observed financial behavior.

Efficient Markets versus Irrational Markets

During the 1970s, the standard finance theory of market efficiency became the model of market behavior accepted by the majority of academ-
ics and a good number of professionals. The Efficient Market Hypothesis had matured in the previous decade, stemming from the doctoral dissertation of Eugene Fama. Fama persuasively demonstrated that in a securities market populated by many well-informed investors, investments will be appropriately priced and will reflect all available information. There are three forms of the efficient market hypothesis:

1. The “Weak” form contends that all past market prices and data are fully reflected in securities prices; that is, technical analysis is of little or no value.
2. The “Semistrong” form contends that all publicly available information is fully reflected in securities prices; that is, fundamental analysis is of no value.
3. The “Strong” form contends that all information is fully reflected in securities prices; that is, insider information is of no value.

If a market is efficient, then no amount of information or rigorous analysis can be expected to result in outperformance of a selected benchmark. An efficient market can basically be defined as a market wherein large numbers of rational investors act to maximize profits in the direction of individual securities. A key assumption is that relevant information is freely available to all participants. This competition among market participants results in a market wherein, at any given time, prices of individual investments reflect the total effects of all information, including information about events that have already happened, and events that the market expects to take place in the future. In sum, at any given time in an efficient market, the price of a security will match that security’s intrinsic value.

At the center of this market efficiency debate are the actual portfolio managers who manage investments. Some of these managers are fervently passive, believing that the market is too efficient to “beat”; some are active managers, believing that the right strategies can consistently generate alpha (alpha is performance above a selected benchmark). In reality, active managers beat their benchmarks only roughly 33 percent of the time on average. This may explain why the popularity of exchange traded funds (ETFs) has exploded in the past five years and why venture capitalists are now supporting new ETF companies, many of which are offering a variation on the basic ETF theme.

The implications of the efficient market hypothesis are far-reaching.
Most individuals who trade stocks and bonds do so under the assumption that the securities they are buying (selling) are worth more (less) than the prices that they are paying. If markets are truly efficient and current prices fully reflect all pertinent information, then trading securities in an attempt to surpass a benchmark is a game of luck, not skill.

The market efficiency debate has inspired literally thousands of studies attempting to determine whether specific markets are in fact “efficient.” Many studies do indeed point to evidence that supports the efficient market hypothesis. Researchers have documented numerous, persistent anomalies, however, that contradict the efficient market hypothesis. There are three main types of market anomalies: Fundamental Anomalies, Technical Anomalies, and Calendar Anomalies.

**Fundamental Anomalies.** Irregularities that emerge when a stock’s performance is considered in light of a fundamental assessment of the stock’s value are known as fundamental anomalies. Many people, for example, are unaware that value investing—one of the most popular and effective investment methods—is based on fundamental anomalies in the efficient market hypothesis. There is a large body of evidence documenting that investors consistently overestimate the prospects of growth companies and underestimate the value of out-of-favor companies.

One example concerns stocks with low price-to-book-value (P/B) ratios. Eugene Fama and Kenneth French performed a study of low price-to-book-value ratios that covered the period between 1963 and 1990. The study considered all equities listed on the New York Stock Exchange (NYSE), the American Stock Exchange (AMEX), and the Nasdaq. The stocks were divided into 10 groups by book/market and were reranked annually. The lowest book/market stocks outperformed the highest book/market stocks 21.4 percent to 8 percent, with each decile performing more poorly than the previously ranked, higher-ratio decile. Fama and French also ranked the deciles by beta and found that the value stocks posed lower risk and that the growth stocks had the highest risk. Another famous value investor, David Dreman, found that for the 25-year period ending in 1994, the lowest 20 percent P/B stocks (quarterly adjustments) significantly outperformed the market; the market, in turn, outperformed the 20 percent highest P/B of the largest 1,500 stocks on Compustat.

Securities with low price-to-sales ratios also often exhibit performance that is fundamentally anomalous. Numerous studies have shown
that low P/B is a consistent predictor of future value. In *What Works on Wall Street*, however, James P. O’Shaughnessy demonstrated that stocks with low price-to-sales ratios outperform markets in general and also outperform stocks with high price-to-sales ratios. He believes that the price/sales ratio is the strongest single determinant of excess return.\(^{11}\)

Low price-to-earnings (P/E) ratio is another attribute that tends to anomalously correlate with outperformance. Numerous studies, including David Dreman’s work, have shown that low P/E stocks tend to outperform both high P/E stocks and the market in general.\(^{12}\)

Ample evidence also indicates that stocks with high dividend yields tend to outperform others. The Dow Dividend Strategy, which has received a great deal of attention recently, counsels purchasing the 10 highest-yielding Dow stocks.

**Technical Anomalies.** Another major debate in the investing world revolves around whether past securities prices can be used to predict future securities prices. “Technical analysis” encompasses a number of techniques that attempt to forecast securities prices by studying past prices. Sometimes, technical analysis reveals inconsistencies with respect to the efficient market hypothesis; these are *technical anomalies*. Common technical analysis strategies are based on relative strength and moving averages, as well as on support and resistance. While a full discussion of these strategies would prove too intricate for our purposes, there are many excellent books on the subject of technical analysis. In general, the majority of research-focused technical analysis trading methods (and, therefore, by extension, the weak-form efficient market hypothesis) finds that prices adjust rapidly in response to new stock market information and that technical analysis techniques are not likely to provide any advantage to investors who use them. However, proponents continue to argue the validity of certain technical strategies.

**Calendar Anomalies.** One *calendar anomaly* is known as “The January Effect.” Historically, stocks in general and small stocks in particular have delivered abnormally high returns during the month of January. Robert Haugen and Philippe Jorion, two researchers on the subject, note that “the January Effect is, perhaps, the best-known example of anomalous behavior in security markets throughout the world.”\(^{13}\) The January Effect is particularly illuminating because it hasn’t disappeared, despite
being well known for 25 years (according to arbitrage theory, anomalies should disappear as traders attempt to exploit them in advance).

The January Effect is attributed to stocks rebounding following year-end tax selling. Individual stocks depressed near year-end are more likely to be sold for tax-loss harvesting. Some researchers have also begun to identify a “December Effect,” which stems both from the requirement that many mutual funds report holdings as well as from investors buying in advance of potential January increases.

Additionally, there is a Turn-of-the-Month Effect. Studies have shown that stocks show higher returns on the last and on the first four days of each month relative to the other days. Frank Russell Company examined returns of the Standard & Poor’s (S&P) 500 over a 65-year period and found that U.S. large-cap stocks consistently generate higher returns at the turn of the month. Some believe that this effect is due to end-of-month cash flows (salaries, mortgages, credit cards, etc.). Chris Hensel and William Ziemba found that returns for the turn of the month consistently and significantly exceeded averages during the interval from 1928 through 1993 and “that the total return from the S&P 500 over this sixty-five-year period was received mostly during the turn of the month.” The study implies that investors making regular purchases may benefit by scheduling those purchases prior to the turn of the month.

Finally, as of this writing, during the course of its existence, the Dow Jones Industrial Average (DJIA) has never posted a net decline over any year ending in a “five.” Of course, this may be purely coincidental.

Validity exists in both the efficient market and the anomalous market theories. In reality, markets are neither perfectly efficient nor completely anomalous. Market efficiency is not black or white but rather, varies by degrees of gray, depending on the market in question. In markets exhibiting substantial inefficiency, savvy investors can strive to outperform less savvy investors. Many believe that large-capitalization stocks, such as GE and Microsoft, tend to be very informative and efficient stocks but that small-capitalization stocks and international stocks are less efficient, creating opportunities for outperformance. Real estate, while traditionally an inefficient market, has become more transparent and, during the time of this writing, could be entering a bubble phase. Finally, the venture capital market, lacking fluid and continuous prices, is considered to be less efficient due to information asymmetries between players.
Rational Economic Man versus Behaviorally Biased Man

Stemming from neoclassical economics, *Homo economicus* is a simple model of human economic behavior, which assumes that principles of perfect self-interest, perfect rationality, and perfect information govern economic decisions by individuals. Like the efficient market hypothesis, *Homo economicus* is a tenet that economists uphold with varying degrees of stringency. Some have adopted it in a semistrong form; this version does not see rational economic behavior as perfectly predominant but still assumes an abnormally high occurrence of rational economic traits. Other economists support a weak form of *Homo economicus*, in which the corresponding traits exist but are not strong. All of these versions share the core assumption that humans are “rational maximizers” who are purely self-interested and make perfectly rational economic decisions. Economists like to use the concept of rational economic man for two primary reasons: (1) *Homo economicus* makes economic analysis relatively simple. Naturally, one might question how useful such a simple model can be. (2) *Homo economicus* allows economists to quantify their findings, making their work more elegant and easier to digest. If humans are perfectly rational, possessing perfect information and perfect self-interest, then perhaps their behavior can be quantified.

Most criticisms of *Homo economicus* proceed by challenging the bases for these three underlying assumptions—perfect rationality, perfect self-interest, and perfect information.

1. **Perfect Rationality.** When humans are rational, they have the ability to reason and to make beneficial judgments. However, rationality is not the sole driver of human behavior. In fact, it may not even be the primary driver, as many psychologists believe that the human intellect is actually subservient to human emotion. They contend, therefore, that human behavior is less the product of logic than of subjective impulses, such as fear, love, hate, pleasure, and pain. Humans use their intellect only to achieve or to avoid these emotional outcomes.

2. **Perfect Self-Interest.** Many studies have shown that people are not perfectly self-interested. If they were, philanthropy would not exist. Religions prizing selflessness, sacrifice, and kindness to strangers would also be unlikely to prevail as they have over centuries. Perfect self-interest would preclude people from performing such unselfish deeds as volunteering, helping the needy, or serving in the military. It
would also rule out self-destructive behavior, such as suicide, alcoholism, and substance abuse.

3. Perfect Information. Some people may possess perfect or near-perfect information on certain subjects; a doctor or a dentist, one would hope, is impeccably versed in his or her field. It is impossible, however, for every person to enjoy perfect knowledge of every subject. In the world of investing, there is nearly an infinite amount to know and learn; and even the most successful investors don’t master all disciplines.

Many economic decisions are made in the absence of perfect information. For instance, some economic theories assume that people adjust their buying habits based on the Federal Reserve’s monetary policy. Naturally, some people know exactly where to find the Fed data, how to interpret it, and how to apply it; but many people don’t know or care who or what the Federal Reserve is. Considering that this inefficiency affects millions of people, the idea that all financial actors possess perfect information becomes implausible.

Again, as with market efficiency, human rationality rarely manifests in black or white absolutes. It is better modeled across a spectrum of gray. People are neither perfectly rational nor perfectly irrational; they possess diverse combinations of rational and irrational characteristics, and benefit from different degrees of enlightenment with respect to different issues.

THE ROLE OF BEHAVIORAL FINANCE WITH PRIVATE CLIENTS

Private clients can greatly benefit from the application of behavioral finance to their unique situations. Because behavioral finance is a relatively new concept in application to individual investors, investment advisors may feel reluctant to accept its validity. Moreover, advisors may not feel comfortable asking their clients psychological or behavioral questions to ascertain biases, especially at the beginning of the advisory relationship. One of the objectives of this book is to position behavioral finance as a more mainstream aspect of the wealth management relationship, for both advisors and clients.
As behavioral finance is increasingly adopted by practitioners, clients will begin to see the benefits. There is no doubt that an understanding of how investor psychology impacts investment outcomes will generate insights that benefit the advisory relationship. The key result of a behavioral finance–enhanced relationship will be a portfolio to which the advisor can comfortably adhere while fulfilling the client's long-term goals. This result has obvious advantages—advantages that suggest that behavioral finance will continue to play an increasing role in portfolio structure.

**HOW PRACTICAL APPLICATION OF BEHAVIORAL FINANCE CAN CREATE A SUCCESSFUL ADVISORY RELATIONSHIP**

Wealth management practitioners have different ways of measuring the success of an advisory relationship. Few could argue that every successful relationship shares some fundamental characteristics:

- The advisor understands the client’s financial goals.
- The advisor maintains a systematic (consistent) approach to advising the client.
- The advisor delivers what the client expects.
- The relationship benefits both client and advisor.

So, how can behavioral finance help?

**Formulating Financial Goals**

Experienced financial advisors know that defining financial goals is critical to creating an investment program appropriate for the client. To best define financial goals, it is helpful to understand the psychology and the emotions underlying the decisions behind creating the goals. Upcoming chapters in this book will suggest ways in which advisors can use behavioral finance to discern why investors are setting the goals that they are. Such insights equip the advisor in deepening the bond with the client, producing a better investment outcome and achieving a better advisory relationship.
Maintaining a Consistent Approach

Most successful advisors exercise a consistent approach to delivering wealth management services. Incorporating the benefits of behavioral finance can become part of that discipline and would not mandate large-scale changes in the advisor’s methods. Behavioral finance can also add more professionalism and structure to the relationship because advisors can use it in the process for getting to know the client, which precedes the delivery of any actual investment advice. This step will be appreciated by clients, and it will make the relationship more successful.

Delivering What the Client Expects

Perhaps there is no other aspect of the advisory relationship that could benefit more from behavioral finance. Addressing client expectations is essential to a successful relationship; in many unfortunate instances, the advisor doesn’t deliver the client’s expectations because the advisor doesn’t understand the needs of the client. Behavioral finance provides a context in which the advisor can take a step back and attempt to really understand the motivations of the client. Having gotten to the root of the client’s expectations, the advisor is then more equipped to help realize them.

Ensuring Mutual Benefits

There is no question that measures taken that result in happier, more satisfied clients will also improve the advisor’s practice and work life. Incorporating insights from behavioral finance into the advisory relationship will enhance that relationship, and it will lead to more fruitful results.

It is well known by those in the individual investor advisory business that investment results are not the primary reason that a client seeks a new advisor. The number-one reason that practitioners lose clients is that clients do not feel as though their advisors understand, or attempt to understand, the clients’ financial objectives—resulting in poor relationships. The primary benefit that behavioral finance offers is the ability to develop a strong bond between client and advisor. By getting inside the head of the client and developing a comprehensive grasp of his or her motives and fears, the advisor can help the client to better understand why a portfolio is designed the way it is and why it is the “right” portfolio for him or her—regardless of what happens from day to day in the markets.