How to Integrate Behavioral Finance into Your Practice

Guide for Common Challenges and How to Address Them

Despite the countless articles, research studies, and books published on behavioral finance and its impact on financial advice, very few writings provide actionable insights for how to incorporate these concepts into client relationships or the fundamentals of investing.

Most of the content published on this topic explains what behavioral finance is, its significance, and the definitions of various biases that plague investors.

As a result, advisors are left with interesting anecdotes or pop-psychology musings when what is really needed is a multi-step solution of coaching, investment selection, and repeated communication to fully address the ingrained instincts that drive "irrational" investor behavior.

Advisors face three challenges in their attempts to meaningfully implement behavioral finance concepts in their advisory practice; fortunately, there are actionable solutions for how advisors can address each issue.

Challenge 1:
Investors Don't See the Value in Behavioral Coaching.

Behavioral coaching is vitally important to any advisor-client relationship. In recent research from Vanguard's Adviser Alpha[1], behavioral coaching was considered the most valuable component of financial advice.

Yet investors have a hard time seeing the value of it.

A recent study from Morningstar[2] listed 15 attributes of financial advisors asking investors and advisors to rank them from most important to least important. Investors ranked behavioral coaching dead last while ranking "maximizing returns" in the top five.

While investors found "helping me reach my goals" to be the top priority, they see maximizing returns as the best way to get there.

This is at odds with the fact that helping investors stick to a financial plan may add at least 150 basis points of portfolio performance—to add to this, minimizing losses is more important to the success of a financial plan than maximizing returns.

So why this disconnect? Why is behavioral coaching valued so little?

First, many think they don't need coaching. While this may be true for some, for many it is not. No client wants to hear their advisors tell them "You make stupid mistakes" or "You're your own worst enemy."

So overcoming this initial bias can be difficult.

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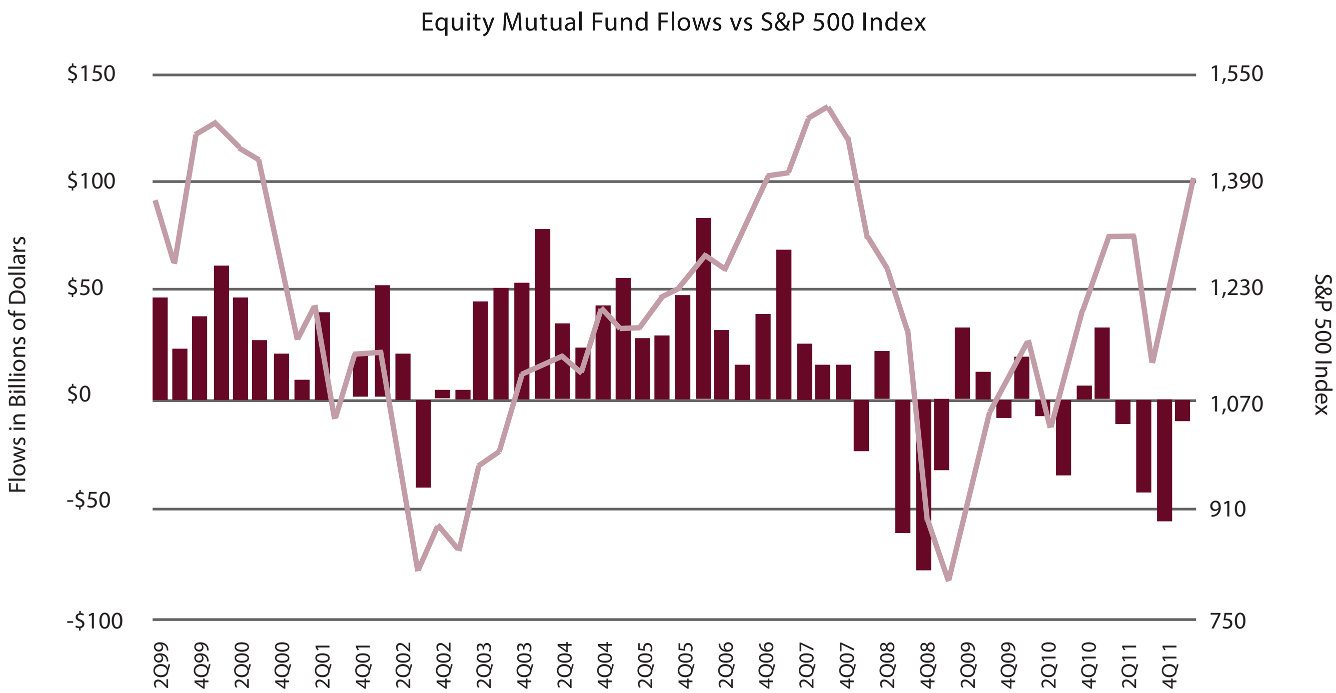
[1]"Putting a value on your value: Quantifying Vanguard Advisor's Alpha," September 2016
[2]"The Value of Advice," Morningstar

Second, it is difficult to measure the immediate value of behavioral coaching. The need for immediate gratification overpowers the abstract future reward, despite their understanding of its importance. When a bias does factor into a request or decision, the emotional impulse is stronger than logical reflection and action. Does defining what anchoring means or pointing to a client's herding bias really prevent them from selling low or buying high?

Not really.



Source: Standard & Poor's, Morningstar; data through 5/31/12

Third, the burden is fully on the shoulders of the advisor with little support from the industry or investment products. Advisors are expected to manage their clients' emotions in an environment that works against advisors who seek to implement behavioral coaching.

Challenge 2:
The Industry Encourages Biased Investor Behavior.

A direct challenge to behavioral coaching and minimizing biased investment decisions is the way the industry over-emphasizes returns and benchmark performance. The financial industry often contradicts itself: The industry preaches that investors should emphasize the long-term, yet the investing landscape has evolved to focus upon short-term distractions.

The industry as a whole reinforces this short-term investor mindset and focus:

- A 24-hour news cycle
- Social media information overload
- Short-term monthly metrics
- Daily account access
- Stress on gains rather than goals
- Research ratings focus on gains and fees

This has magnified behavioral biases and trained investors to focus on beating the market, chasing the next best investment, and keeping up with the Joneses.

The "meet or beat" the market mantra reinforces the preoccupation with returns instead of goals.

Because of this, investors evaluate their advisors based on investment or portfolio performance and the "what have you done for me lately" mentality. Investors overvalue short-term performance and devalue the guidance a financial advisor can provide, making it easier for investors to sell in a panic, buy high, abandon financial plans, or ignore experienced advice.

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Challenge 3:
Loss Aversion Is Not Truly Being Addressed at the Portfolio Level.

The biggest challenge to the broader success in addressing behavioral finance challenges is that the products and strategies implemented by advisors, investors, and the industry fail to address the most important emotional driver in investment decisions: fear of losing money, known as loss aversion.

A Cerulli[3] study found that investors really care most about two things:

1. They don't want to lose money.
2. They don't want to run out of money.

People feel the pain of loss twice as much as the pleasure from an equal gain[4]. Loss aversion has serious implications for investment decisions and is an important behavioral bias that advisors need to emphasize in their practice. Behavioral coaching is tricky enough in up markets, but all that educating and intermittent behavioral coaching flies out the window in big down markets, when it matters most.

Investors often don't stick to their long-term plans. Advisor will meet with clients, develop a plan that both agree to, the plan looks logical on paper, but when a crisis produces volatile markets, clients deviate from the logical plan in a moment of panic. When markets misbehave, investors follow suit.

The traditional 60/40 and asset allocation haven't kept investors from giving into their loss aversion bias and going to cash during tough markets.

Cash Increases during Market Pull-backs

Dot-Com Bust
March 2000 - October 2002
$491B

Global Financial Crisis
October 2007 - March 2009
$943B

Source: Federal Reserve Bank of St. Louis.

It's easy for investors to stick to a plan and coach when things are going great. It's much tougher during life-altering market drawdowns. Will telling clients to stay calm and stay invested really assuage their emotions when their accounts are going down 30% or 40%? Probably not.

With the future of bonds looking bleak, depending on them for capital preservation or income may not be a prudent strategy going forward.

Investors generally crave a smooth and calm investment experience. Building portfolios and investment products that seek to provide a calmer experience by managing risk to achieve a goal, rather than chasing gains, need to be at the core of portfolio construction.

[3] "U.S. Asset and Wealth Management Edition," The Cerruli Edge, Cerulli Associates, January 2018

[4] "Prospect Theory: An Analysis of Decision Under Risk," Daniel Kahneman & Amos Tversky, March 1979

A Way Forward

Redefine Your Practice with Behavioral Finance

Advisors are burdened. The responsibility is fully on their shoulders to reeducate, refocus, and redirect investors' understandings and expectations of financial advice. For advisors, incorporating a successful behavioral coaching approach into their practice is much harder without the support and encouragement of the industry or portfolio strategies.

Redefining the value proposition beyond a provider of financial advice to include behavioral coaching elevates advisors and helps align their practice with the fiduciary standard. Effecting fundamental changes to portfolio construction and investment products that address behavioral challenges is paramount for the long-term success of any financial plan.

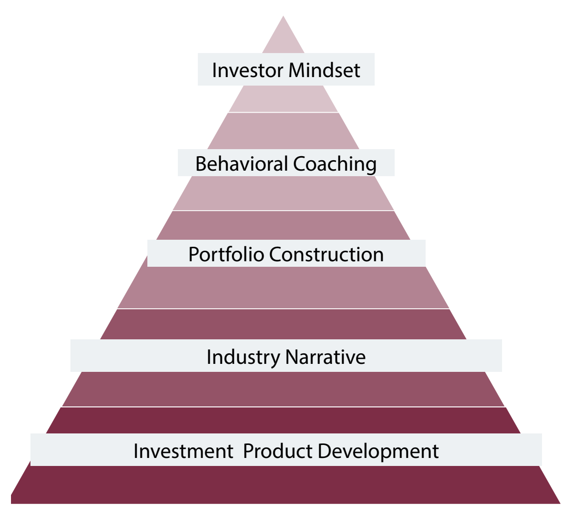
If the industry is truly focused on goals-based investing and helping investors see the true value of behavioral coaching, it is necessary to redefine the way it looks at returns, planning, and advice.

Multi-Step Solution

Behavioral Coaching Begins at the Foundation

Human behavior is largely shaped by our habits and our environment. Behavioral coaching is no different. Wanting investors to redirect their behavior and mindset takes more than a quarterly meeting or an occasional email newsletter. It requires advisors to restructure portfolios, conversations, and relationships. In some cases, advisors may need to redefine their value proposition to investors.

The industry needs to deliver a solution to current market and behavioral challenges. Pushing investors into higher beta or passive products isn't helping. New investing strategies and products need to address investor behavior at the portfolio level. This foundational level may systematically prevent or reduce irrational behavior—to encourage investors to instinctively react in more "rational" ways.



Expecting investors to rewire their ingrained behavior when their environment refuses to do so is like expecting dieters to stick to a healthy diet when junk food is readily available and pushed on them daily. To successfully change bad habits, a person needs to be determined and consistent, but support from the environment and people around them can make or break them.

Creating a structural change around how the industry creates product and pushes a narrative is largely beyond advisors' control. But reconstructing portfolios is not. Changing how the investor experiences their investing journey is the best way to prevent the emotional impulses and biases that cause underperformance, dissatisfaction, and missed goals.

Advisors are, essentially, the last line defense between emotionally driven behavior and catastrophic financial decisions. So how can advisors meaningfully implement behavioral coaching and investment selection into their practice for a lasting impact on their clients and their portfolios?

Redefine Behavioral Finance

Four Practical Solutions to Behavioral Finance Challenges

Make behavioral coaching the center of your client relationship philosophy.

Investors seek out advisors because they want expertise and someone to help manage their emotions when it comes to money management. With the rise of robo-advisors, traditional advisors need to demonstrate their value by applying their experience and knowledge to behavioral coaching and client management. The human factor will be more important than ever.

We believe by readjusting your value proposition around behavioral coaching you can make it the core of your advisory practice, effectively differentiating you as an advisor. By centering your practice around behavioral coaching, you can base your client communication and conversations on behavioral lessons and applications more holistically. This will keep your value proposition of a redefined, goals-based, rational investing plan top of mind for investors, instead of reducing it to an after-thought.

Actionable Steps:

- Adjust your website to reflect the behavioral coaching as your core value to clients.
- Emphasize how behavioral coaching helps them be better investors through daily social media engagement, monthly email newsletters, and regular seminars.
- You can support this by directing client conversations around goals, long-term returns, and behavioral bias education.
- Start them off with a "behavioral investor" journaling exercise where they keep track of their emotional reactions to investment news, portfolio updates, and more.

Explain to clients what's worth worrying about and what's not.

Combating the daily deluge of investment and economic news can be difficult. Determining and communicating what your clients should act on and what they shouldn't act on will help them look at the news differently and help them acknowledge their own bias.

For clients that are easily swayed by these updates, regular communication and reminders of your systematic approach to investing and the purpose of their goals-based plan should alleviate in-the-moment concerns. This will work best when combined with a holistic approach to behavioral coaching.

Actionable Steps:

- Explain why corrections are not worth panicking about.
- Remind investors the risks of timing the market and the gains they can miss out on if they're not always invested.
- Refer to previous "news-worthy" market events that didn't leave much of an impact and explain why embracing risk is key for a long-term investing strategy.

Emphasize long-term, goals-based investing with aligned performance metrics.

The industry depends on short-term trailing returns that focus on gains, thus perpetuating the demand for gains. Instead, there are many other metrics that will provide a more holistic approach to measuring risk, returns, and the trade-off between the two.

Metrics and tools that evaluate the risk, measure long-term consistency, and seek to provide better understanding of the investment journey are necessary for changing the way you and your clients view and discuss investments.

Action Steps:

- Incorporate metrics into your meetings that measure what investors truly care about like Pain Index, depth, duration, and frequency of losses.
- Include rolling returns for a better look at long-term performance consistency.
- Utilize measures that better assess the risk/return tradeoff like the Pain Ratio.

Construct portfolios with investment solutions that seek to provide a calmer investment experience.

Due to behavioral biases, many investors have a difficult time sticking to a simple broadly diversified portfolio. Investors tend to chase markets, compare with peers, buy high and sell low, give up on stocks at exactly the wrong time, and so on. Improving the quality of the investment experience should be the goal of every financial advisor.

Action Steps:

- Diversify with truly non-correlated strategies and investments, such as options-based strategies.
- Build in buy low, sell high strategies and processes.
- Accept low volatility or performance drag for a smoother experience and potential better long-term returns.
- Incorporate strategies that systematically seek to reduce big losses.
- Select money managers that seek to do one or all of the above.

Investors can be their own worst enemy—that's why they hire you. An investor's behavior can be one of the biggest risks to achieving a desired long-term outcome.

The media isn't helping. The industry isn't helping. Human nature isn't helping. In the face of these challenges, it's not enough to merely educate. Coaching needs to be an integral part of your value proposition from the start of the client relationship and carried throughout your communications. That holistic behavioral coaching needs to be coupled with investments designed to address behavior.

Better portfolio construction and consistent behavioral coaching that seek to minimize the biased investor mindset are essential for successfully incorporating the behavioral finance concepts into your practice.

About Swan Global Investments

Investing Redefined

Since 1997, our hedging and options strategies have been redefining investing to directly address the biggest threat long-term investors face: market risk.

Market risk is too big a threat to investors to be dealt with passively. So we hedge it.

Our simple, yet innovative investment philosophy is the foundation of our Defined Risk Strategy, a rules-based, multi-asset hedged equity strategy, with a track record of seeking to generate consistent returns while defining, or limiting, downside risk to improve investment outcomes and managing risk for irreplaceable capital through full market cycles (bull and bear).

Swan Global Investments is an asset manager headquartered in Durango, Colorado, with offices in Puerto Rico and Tampa, Florida.

Important Notes & Disclosures

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SWAN GLOBAL INVESTMENTS

1099 Main Ave. Suite 206
Durango, CO 81301