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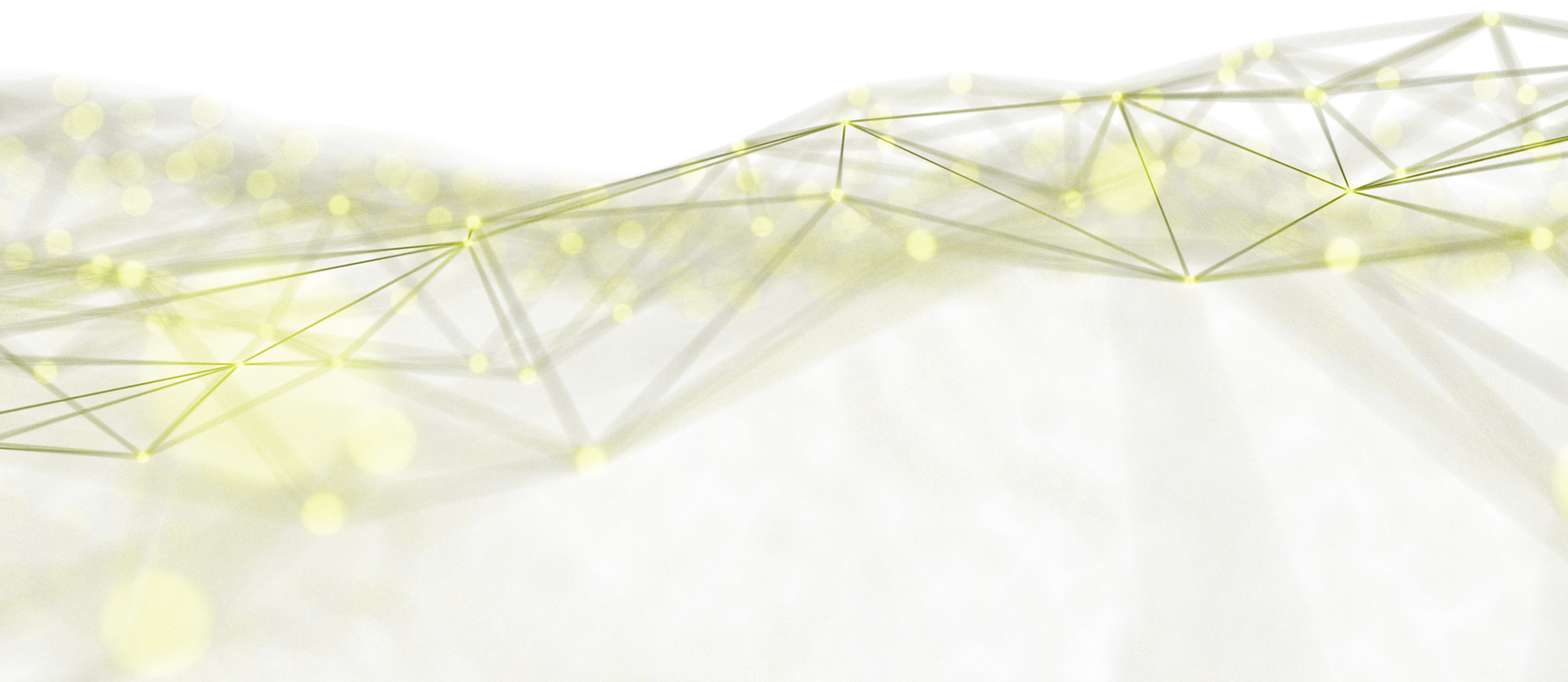


Mitigating the Impact of Advisors’ Behavioral Biases

Advisors can improve their portfolio construction and management processes by acknowledging that they are subject to many of the same behavioral biases that they hope to help investors avoid.

Executive Summary

According to the BeFi Barometer 2019 survey, the most frequent challenge advisors face in using behavioral finance principles in their practices is difficulty in translating theory into implementation. The goal of this white paper is to help advisors do just that. First, we help advisors understand the biases to which they may be subject. Then we review how advisor biases may be impacting their client relationships. Finally, we offer advisors specific suggestions to help build and maintain portfolios that optimize clients' opportunity to achieve their desired outcomes given their risk preferences.

Methodology

Charles Schwab Investment Management, in collaboration with the Investments & Wealth Institute (IWI), retained Cerulli Associates—a leading independent market research and consulting firm—to learn how advisors view and use behavioral finance when working with clients. In July 2019, Cerulli Associates conducted a survey of more than 300 financial advisors. Respondents were members of IWI and diversified across business models, including wirehouses, registered investment advisors (RIAs), and national & regional broker/dealers. Select findings from the survey, BeFi Barometer 2019, are discussed in this white paper.

Key Points

- Advisors self-identify loss aversion, overconfidence, availability, confirmation, and recency as the behavioral biases most likely to be affecting them.
- Implementing a rigorous, process-driven portfolio management structure can help mitigate the impact of advisors' and clients' behavioral biases.
- The "best" portfolio for a client is one that is customized to maximize the probability of achieving their financial objectives while remaining within their investment risk comfort level.
- Ongoing communication is essential to ensuring a client's portfolio remains aligned with their evolving financial needs.

With the emergence of pronounced market volatility in the first quarter of 2020, it is important for advisors to understand the biases that can undermine their portfolio management efforts. Advisors are subject to the same emotional responses as their clients, but the value of advisors is deeply tied to overcoming these challenges to help improve the likelihood of clients reaching their financial objectives. Advisors can help enhance the client experience by identifying their own behavioral tendencies and creating a disciplined investment process that reduces the impact of these tendencies. This white paper is designed to help advisors adopt this approach.

Understanding Behavioral Biases

It is difficult for people to see their own imperfections. With this in mind, the 2019 BeFi Barometer survey asked respondents to what extent they agree with statements that imply behavioral biases. Advisors identified loss aversion (82%), overconfidence (65%), availability (58%), confirmation (54%), and recency (51%) as the behavioral biases most likely to be affecting them (See Exhibit 1). To help improve their clients' long-term financial outcomes, advisors must understand how their own predispositions can impact client portfolios before taking measures to counteract them.

Loss aversion

Loss aversion is by far the most common behavioral bias affecting advisor practices: 82% of advisors reported feeling an unwarranted level of distress over portfolio declines. Advisors who exhibit loss aversion may be more likely to sell winners too early and hold on to losers too long (not willing to admit/accept loss). Alternatively, these advisors may be reluctant to propose an initial portfolio that takes on an optimal risk level in fear of disappointing a client in the short term, which ultimately undermines the likelihood of reaching the client's targeted financial outcomes. In either case, advisors are doing a disservice to themselves, and their clients, by allowing their personal loss aversion to impact their investment process.

EXHIBIT 1

ADVISORS' BEHAVIORAL BIASES, 2019

Advisor Bias	Statements	Agree
Loss aversion	I tend to feel twice as bad about a loss as I feel good about an equivalent gain	82%
Overconfidence	I think my portfolio management skills can help clients outperform the market	65%
Availability bias	I tend to rely on information that is readily available or easily recallable	58%
Confirmation bias	I seek information that confirms my perception or current views	54%
Recency bias	I am influenced by recent news events or experiences when making investment decisions	51%

Sources: Cerulli Associates, in partnership with Charles Schwab Investment Management, Inc., and the Investments & Wealth Institute.
Analyst Note: Respondents were asked to what extent they agreed with the statements regarding their personal behavioral biases.

Overconfidence

There is a substantial likelihood of overconfidence bias in the advisor community. Nearly two-thirds (65%) of advisors asserted that their portfolio management skills are likely to help their clients outperform the market. Despite any evidence to the contrary, many advisors simply will not admit that portfolio management is not their forte. Addressing this challenge can be especially difficult as many conversations on this topic devolve into rationalization sessions—advisors pivot to defending past actions rather than ensuring that suboptimal choices are not repeated moving forward. The modern financial advisor can provide value to clients in myriad ways, but many cling to the notion that portfolio management skills are the core of their value to investors. While this view was more common in the past, recent Cerulli research has found that just 30% of investors surveyed believe their personal advisor is best suited to manage their portfolios (See Exhibit 2).

Availability and confirmation biases

Advisors' tendency to rely on the most readily available data (58%) is highly correlated with their tendency to seek out information that aligns with their own views (54%). In both cases, advisors are unlikely to spend much time or effort exploring contrarian views that challenge their existing opinions. With a multitude of responsibilities on their calendars, there should be little surprise that the majority of advisors rely on available resources that support their current beliefs. Of course, this scenario can result in outstanding client returns, until market sentiment conflicts with those beliefs, at which point underperformance becomes a preeminent hazard.

EXHIBIT 2

INVESTORS' PREFERRED PORTFOLIO MANAGER, 2019

Type of Portfolio Manager	All Households
The dedicated team of investment professionals at my primary provider	33%
My individual advisor/representative at my primary provider	30%
Professional money managers (e.g., mutual fund managers, hedge fund managers)	19%
Objective third-party research providers (e.g. Morningstar, Bloomberg)	13%
Financial and news media (e.g., Wall Street Journal, CNBC, Financial Times)	4%

Sources: Phoenix Marketing International, Cerulli Associates.
Analyst Note: Investors were asked which group they thought is best equipped to manage their portfolios.

Addressing Investor Apprehension

Advisors regularly face scenarios in which clients' preferred level of portfolio risk diverges substantially from the advisors' recommendations. When asked how clients' risk preferences compare to assessed risk levels, advisor respondents estimated that 58% of the time clients and advisors risk tolerance perspectives align, while 18% of the time advisors say clients are more aggressive than their recommended risk profile and 24% of the time, clients are more conservative than the advisor's recommended risk profile. (See Exhibit 3).

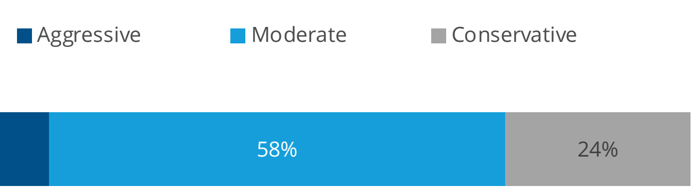
From the advisors' perspective, overconfidence and availability biases are the most common contributors to misalignment between investor preferences and the advisors' portfolio recommendations. With years of experience and accumulated expertise, advisors are apt to recommend portfolios they believe "should" fit clients' needs, but, in many cases, this undervalues the role of client discovery sessions. While an advisor may devise a portfolio that optimizes the expected return, given the amount of risk the advisor deems appropriate, the recommendation must be made in accordance with the degree of investment risk a client is comfortable accepting. The brief risk tolerance questionnaires many advisors use in this process can serve as a good starting point, but there is no better way to understand a client's perspective than a frank discussion on the topic. Ultimately, the "best" portfolio for a client is one that is customized to maximize the probability of securing their financial objectives while remaining within the client's investment risk comfort level.

Presenting portfolio recommendations in an outcome-based investment framework can be an effective way to help clients understand the tradeoffs necessary to achieve their objectives. For example, instead of starting with how to maximize the growth of a client's current assets, in an outcome-based approach, an advisor should first explore what type of lifestyle the client is hoping to use these assets to support in the future. With that objective established, the advisor can then design a portfolio with an expected return commensurate with achieving that outcome. If the recommendation does not match the client's preferred level of investment risk, the advisor must be willing to facilitate a discussion of the tradeoffs necessary between risk and objectives to reach an appropriate balance.

By taking a longer-term perspective, advisors should be able to reframe portfolio risk from a measure of market volatility to focus on the risk of not achieving clients' targeted financial objectives. With ongoing communication, advisors can reinforce the importance of minimizing emotional decision making to achieve clients' desired financial goals.

EXHIBIT 3

ADVISORS' INTERPRETATION OF CLIENTS' RISK TOLERANCE PERSPECTIVES, 2019



Sources: Cerulli Associates, in partnership with Charles Schwab Investment Management, Inc., and the Investments & Wealth Institute.
Analyst Note: Advisors were asked to estimate the percentage of their clients within the following risk tolerance profiles. Aggressive (clients' risk preference is greater than recommended risk capacity level); Moderate (clients' risk preference is equal to recommended risk capacity level); Conservative (clients' risk preference is lower than advisors' recommended risk capacity level).

Applying Behavioral Finance Principles to Portfolios

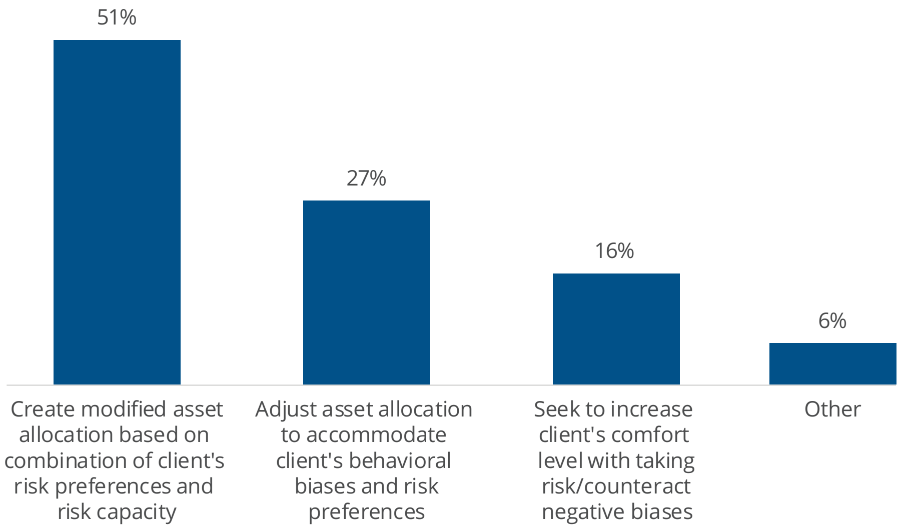
After identifying the potential impact of their own behavioral biases and those of their clients, advisors are tasked with constructing portfolios that optimize the potential for clients to meet their desired financial outcomes within the agreed-upon limitations. In the majority of cases where clients' risk preferences vary from an advisor's initial recommendation, 51% of advisors reported creating modified portfolios that include client input (See Exhibit 4). This option allows advisors to demonstrate to their clients that their feedback is valued and that recommendations are truly customized, which are both important parts of advisory relationships from the clients' perspective.

Once a client's portfolio has been implemented, advisors need to make sure that biases do not undermine their initial work. A broad range of behavioral biases can impact the way that advisors manage portfolios on an ongoing basis. Even when advisors implement a portfolio with a set of trading guidelines, there is always a temptation to make an exception "just this once." For example, a position that has grown 50% in value would normally be subject to rebalancing, but, seeing its appreciation, an advisor may be tempted to leave the holding untouched. Unfortunately, this type of emotional decision can fundamentally undermine clients' portfolio growth. Staying disciplined in a highly emotional industry can be challenging; successful advisors must make the conscious decision to fight against many of their natural impulses. Implementing a rigorous, process-driven portfolio management structure can help mitigate emotional tendencies.

A practice-level investment policy statement (IPS), which offers customization options at the client level, serves as the initial step in this process. An IPS offers the firm the opportunity to set the framework under which they wish to operate, while still allowing advisors to make reasonable accommodations for client preferences. Of course, a practice can update its IPS over time, but the documentation process ensures that these decisions are driven by an evolution of the practice's overall investment philosophy rather than a reaction to short-term market disruptions. To maximize its effectiveness in mitigating behavioral biases, an IPS should be as specific as possible about the core principles of the advisory relationships.

EXHIBIT 4

ADDRESSING CLIENTS' BEHAVIORAL GAP WHEN CONSTRUCTING PORTFOLIOS, 2019



Sources: Cerulli Associates, in partnership with Charles Schwab Investment Management, Inc., and the Investments & Wealth Institute.
Analyst Note: Respondents were asked, "How do you typically address the mismatch between a client's preference and their capacity to take risk when determining an optimal asset allocation?"

Key Elements to Mitigate Behavioral Biases:

1. Relationship specifics
Documenting a client's risk tolerance, investment objective, and the time horizon of expected use helps remind investors to remain focused on long-term objectives rather than short-term market fluctuations.

2. Asset allocation
This entails an explanation of the initial strategic asset-allocation targets of the portfolio, any relevant details about what may be expected over time, and the events that may trigger a review. Unless an advisory practice is specifically focused on taking advantage of tactical investing, all investment decisions should be subject to well-documented strategic asset-allocation guidelines.

3. Operational fundamentals
This involves details about the central procedures governing the portfolio, including the timing and variances allowed within the rebalancing process. To limit the potential for negative impact of behavioral biases, notably overconfidence and loss aversion, specific trading rules should be detailed to set expectations and reduce the need to make decisions during periods of market volatility.

4. Investment monitoring
It is important to document the ongoing screening process used in a practice to select and review

EXHIBIT 5

ADVISOR UPDATE FREQUENCY BY CLIENT GENERATION, 2019

Client Generation	Never/Rarely	Monthly	Quarterly	Annually	Per Client's Request
Millennials (<38)	7%	7%	31%	35%	20%
Generation X (38–53)	2%	7%	43%	30%	17%
Baby Boomers (54–72)	1%	17%	51%	19%	13%
Silent Generation (73+)	1%	15%	47%	22%	15%

Sources: Cerulli Associates, in partnership with Charles Schwab Investment Management, Inc., and the Investments & Wealth Institute.
Analyst Note: Respondents were asked, based on age tier, how often they interact with clients to ensure their comfort level with the recommended asset allocation.

the investments used within client portfolios. Advisors frequently rely on past performance when selecting managed investment products, potentially allowing recency and availability biases to negatively impact client portfolios. By documenting the key criteria and procedures used in the investment review process, advisors can feel confident that their client portfolios are receiving the ongoing due diligence necessary to optimize their long-term performance.

Ongoing Advice: Vigilance and Communication

Once a client's portfolio has been implemented and its monitoring process has been defined, the focus of an advisory relationship shifts to consistent communication to ensure that clients are informed about their progress toward their desired outcomes and to keep abreast of any developments that may fundamentally alter clients' financial status.

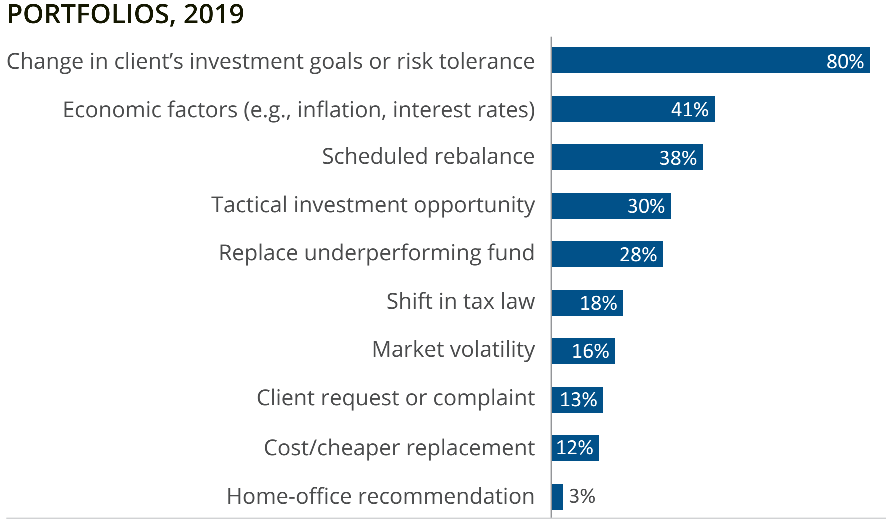
Over the last several years, with the growth of digital technology, the standard quarterly client update has become decidedly less typical, especially among younger clients. The majority of advisors reported meeting with their Millennial clients annually or only as needed per client request (See Exhibit 5).

With the ability to connect virtually any time, regularly scheduled formal meetings feel more obligatory than necessary. However, this does not reduce an advisor's obligations; it simply changes the set of delivery options available. Clients highly value ongoing advice and updates from their advisors, but it is up to advisors to determine the right frequency and medium of communication that best serves their client bases. Advisors should use these opportunities to reinforce the fundamentals of long-term investing to reduce the likelihood of clients being excessively influenced by any short-term developments.

With a foundation of strategic asset allocation, there should be relatively few updates to the central investment theses of a client's portfolio. However, it is incumbent upon advisors to inquire regularly about their clients' overall financial situation to make sure that there have not been fundamental changes to their objectives or risk tolerance that could mandate portfolio updates (See Exhibit 6).

EXHIBIT 6

MOST IMPORTANT FACTORS WHEN CHANGING CLIENTS' PORTFOLIOS, 2019



Sources: Cerulli Associates, in partnership with Charles Schwab Investment Management, Inc., and the Investments & Wealth Institute.
Analyst Note: Respondents were asked which of these factors they consider most important when making a change to a client's portfolio or asset allocation. Respondents were allowed to select more than one response.

Conclusion

Identifying and mitigating the impact of behavioral biases is an integral part of advisory wealth management relationships. Embracing a proactive approach to reducing the impact of these biases enables advisors to strengthen the value of the services they deliver to their clients. Advisors can substantially decrease their exposure to behavioral biases by applying these principles to their practices:

- Review their portfolio construction methodology to ensure that they are using a variety of resources to inform and refine their decision making processes on an ongoing basis.
- Implement a rigorous, process-driven portfolio management structure that increases efficiency while reducing the need for decision making that could be emotionally influenced.
- Recognize that the “best” portfolio for a client is one that is customized to maximize the probability of obtaining the client’s financial objectives while remaining within the client’s investment risk comfort level.
- Engage in ongoing communication, based on client preferences, to make sure that portfolios remain aligned with clients’ evolving financial statuses.

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