For adviser use only

nucleus

Nucleus white paper

The role of behaviour in financial planning

Date of publication 7/9/2020

Be-IQ

Prepared in partnership with Be-IQ

Contents

1. Introduction 3

2. The information age 6

3. The behavioural theory 7

4. Helping clients understand their behaviour 10

5. Applying behavioural insights to advice 13

6. The rise of the behavioural adviser 17

7. Conclusion 18

8. Further information and reading 19

9. References 20

10. Finding out more 21

1. Introduction

For many people, making the right decisions in order to secure their financial future and their long-term wellbeing is easier said than done.

As we have seen over recent months, the world is an increasingly uncertain and complex place. And if that wasn't enough to contend with, our financial behaviours mean we can get in our own way – often without us knowing.

Our tendencies to prioritise the short term over the long term for example, or our inability to always understand the implications of our financial choices, can make it difficult for us to really engage with our finances.

Advisers and planners are well-versed in making the complex simple, and bringing money to life through lifestyle financial planning and the use of coaching.

The next piece in the puzzle may well be behavioural insights; understanding our own biases and those of clients to make sure that advice really sticks, whatever noise is going on around us.

Nucleus has compiled this white paper, together with Neil Bage and Dr. Ariel Cecchi of Be-IQ, to support advisers in their work with clients to navigate a complex financial landscape. We start by explaining the basics of behavioural science and how you can help clients understand their behaviour. But we then go one step further to show how you can apply behavioural insights to the advice process, including a couple of case studies which look at how behavioural financial planning can be used in practice.

This paper is designed to arm you with the resources and knowledge to build behavioural insights into your planning process, from the beginning of your adviser-client relationship, through the planning and monitoring stages and beyond.

Natalie Holt
Content editor, Nucleus

Heuristics

Mental shortcuts or rules of thumb that allow people to simplify decision making.

Examples of heuristics

The availability heuristic, where you have to get past the first thing that comes to mind.

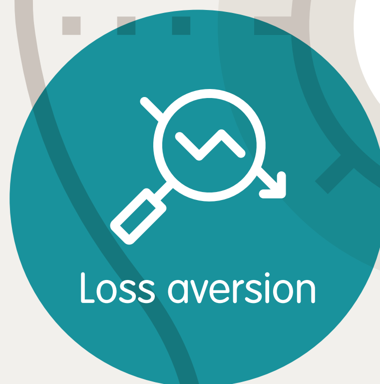
The representativeness heuristic, where a person or thing is grouped into a certain category such as safe or dangerous, based on what we think is typical.

Loss aversion

Feeling a loss more strongly than an equivalent gain.

Example of loss aversion

Where a client saving for retirement takes less risk than they need to over fear of potential investment losses, leading to an overly cautious approach over time.



Where behaviour fits into the advice process

1. Initial advice

- Understanding the client's risk preferences, the risk they are comfortable with taking and the risk they need to take.
- What are the client's personality traits?
- What are the interventions needed to help keep clients on track?

Bias

The filters we apply in judgement. Biases can be cognitive (how we process information) or affective (influenced by feelings and emotions).

Examples of bias

Confirmation bias – Looking for information that backs up your own view.

Negativity bias – A tendency to focus on vivid or negative messages, especially those that seem more frequent.

Present bias – The preference for immediate gratification compared to a bigger, but future-based reward.

Anchoring

Showing an investment return example of five per cent will make it the psychological reference point.

Examples of anchoring

If high-risk funds are presented first, this will be the preference when offered a wider fund choice.

2. Planning

- Think about how clients process information.
- Is information being presented in a positive, negative or neutral way?
- How do you take what you know about the client to trigger action?

3. Managing the plan

- What can you do to soften clients' biases and improve their strengths?
- Think about frequency of updates, and whether these are suited to clients' needs.
- How can you coach clients to build their financial wellbeing?

2. The information age

We live in a dynamic and ever-changing world. With the advancement of technology over the last 20 years, it's fair to suggest that the world we live in today is significantly different to the world of the late 1990s and early 2000s. The world has been forced to change again through the fallout of the coronavirus pandemic and subsequent global lockdowns.

It's now hard to imagine a world of work, communication or connecting with others without the internet. In 1998, only 3.6 per cent of the world's population was online. Today that figure is 59 per cent.

Over the same period, the proportion of the UK population who own a mobile device has gone from 20 per cent to 95 per cent.

But this monumental shift in technology has also brought with it the ability to access information 24/7. There is almost nothing that can't be searched for online and accessed within milliseconds.

For example, when you type into Google "Where should I invest my money?" the results page will return 741 million results in 0.53 seconds. On the one hand that is a truly amazing statistic, but on the other hand, it's rather problematic.

It's amazing because of the speed at which we can now access vast amounts of information. We now have access to more information than ever before in human history, and it's available to access when we want, where we want.

Cutting through the noise

Yet within those 741 million search results on investing, there's a lot of noise and opinion that isn't necessarily based on fact or evidence. Those search results will be loaded with people's views on what they think is best. In other words, there will be information that plays to a whole host of biases as well as the heuristics or mental shortcuts we all use. More on this later.

But this assault on our unconscious mind isn't the preserve of the internet and search engines. It's evident in the daily news headlines, and in the marketing literature of companies trying to sell their services and their investment solutions to clients. The information era we're living in today brings with it a whole host of issues that can make it difficult for us to navigate the world in a way where we're always making decisions based on facts and evidence.

Decisions are made in that space between the unconscious and the conscious, and anything that impacts that should at least be understood to give the client the best chance of making the right decisions. But linked to this is also understanding the decision-making process at a high level, and how much of that we can influence through our engagement with our clients, and how we help them navigate the current landscape.

Major financial decisions, such as those involving savings, mortgages, retirement or investments, often represent crucial landmarks in a client's life.

To make appropriate financial decisions, consumers need to learn how to navigate an environment marked by uncertainty about life and the financial markets, as we've seen with the Covid-19 crisis. What's more, they are deluged with the complexity surrounding financial products, services and options. They need to be aware of the intricacies of human psychology and behaviour in order to understand their current and future financial needs, such as prioritising short-term spending or long-term financial objectives. They need to choose between financial products, understand the implications of their financial choices, and then make decisions accordingly.

Each of these two aspects, the financial environment and consumer psychology, create conflict and confusion, and represent a challenge for financial decision-making. When several of these factors come together and combine, decision-making can become a minefield for even the most seasoned financial decision-maker.

To take this forward, we need to start with an understanding of financial behaviour and an analysis of how humans make decisions.

Key takeaways

- We live in an age where information is readily available, but this information is made up of noise and opinion as well as facts and evidence.
- To make appropriate decisions clients need to navigate an environment that's more uncertain than ever, alongside a complex financial landscape. They also need to manage the intricacies of human psychology and behaviour.
- Understanding how we make decisions can help guide clients to the best financial decisions for them, and supports client engagement.

3. The behavioural theory

Rational thinking and the reality of financial behaviour can often be very different things. The decisions we make are guided by a number of variables, including the mental shortcuts we use, our beliefs and emotions and our biases, all of which can impact our judgement for better or for worse.

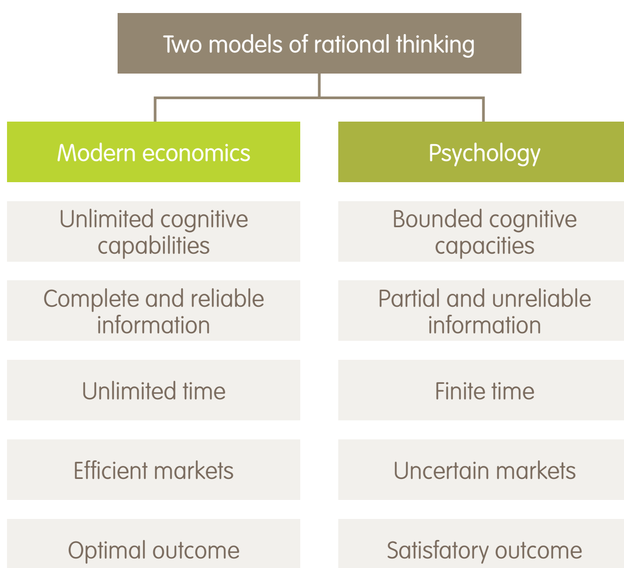
Making decisions

Modern economics assumes humans are rational and motivated by self-interest, and can work out the path that leads them to the best outcomes. However, this approach is based on the hypothesis that people have extensive mental computing capacities, unlimited time, exhaustive information, and a total understanding of their surroundings so they can calculate the outcomes of any possible option and behaviour.

Yet the study of psychology shows us humans have limited processing resources and memory, a finite amount of time and scarce information about the world. People face great uncertainty, making outcomes difficult to estimate, and many matters seem to be unpredictable, especially in the long term.

To cope with cognitive limitations in a changing environment, humans have developed something called heuristics (see box on page eight).

Humans use heuristics to make decisions in a changing world. Within this approach, it's common for people not to seek an optimal outcome (as modern economic theory would suggest), but merely a satisfactory one.



Decision-making, beliefs and emotions

When it comes to choosing investments, the rational approach is for someone to consider their preferences and beliefs based on maximising gains, and choose the most efficient portfolio accordingly. However, as an adviser you'll know from experience this is not how decisions are made.

Humans also have feelings and emotions, and decisions and emotions are intrinsically linked.

Everyday life decisions are guided by emotions to avoid negative feelings and increase positive feelings. For example, we want to avoid the stress caused by monetary losses and we look for the happiness caused by monetary gains. From a psychological viewpoint, humans tend to make decisions based on their beliefs and preferences, as well as their emotions. Maximising gains isn't the ultimate financial goal, but just another component in the decision-making process.

Some other elements that can guide a particular decision are wanting to increase happiness; reducing the fear around potentially losing money; and avoiding anxiety and being able to sleep at night. Rather than maximising their financial outcome by choosing a risky but lucrative investment, consumers may choose a safer option that accommodates both their beliefs and their feelings.

Decisions can also be a major trigger for emotions. A decision can lead to new emotion, such as regret over past bad decisions, or can decrease positive emotions, for example, someone who is happy to secure credit but ultimately worried about their level of indebtedness. And when consumers face a complex decision that could trigger emotions such as regret or fear, the decision will be delayed or avoided altogether. This explains in part why consumers tend to procrastinate with their retirement decisions.

Affective empathy, where we share another person's emotions and feel what someone else is feeling, provide a deep personal dimension to financial planning. This allows advisers where necessary to adjust financial goals to the client's psychology ensuring financial and mental wellbeing. We'll return to this idea of applying behavioural insights to financial planning later in this white paper.

3. The behavioural theory

Biased decisions

As we've discussed, heuristics or mental shortcuts are usually effective at producing good outcomes, but they can also lead to biases. In decision-making, psychological biases refer to when people consistently veer away from rational decisions or good judgement.

Biases can stem from heuristics when the mental shortcut isn't a suitable strategy for the decision at hand. Biases can also be caused by intense or strongly held beliefs or emotions. For example, high levels of confidence in our own financial skills, or alternatively severe levels of anxiety and worry around losses, will bias the outcome of financial decisions.

To sum up, we use heuristics to cope with limited brain power and a changing environment in order to reach satisfactory decisions. Decision-making depends in equal measure on beliefs and preferences as well as emotions and feelings. Decisions and behaviour are frequently impacted by biases that arise from unsuitable mental shortcuts to certain situations, and where beliefs and emotions can get in the way of rational decision-making.

All this begs the question: Who is responsible for making sure a client ends up taking the best decision for them? The answer is two-fold. The adviser has a major role to play in how information is presented and how the advice is given. The client, however, is ultimately responsible for any decision taken, so clearly they too have a significant role to play. It's the role of the client we'll explore next.

Bias stems from…

Heuristics – decision mistakes that occur when a mental shortcut is used as the strategy to take a decision, even though it's not suitable for the current decision.

Limited cognitive capacities – mistakes that arise because the decision requires us to process a significant amount of information, exhausting our attention, memory and mental resources.

Deviating beliefs and emotions – strong beliefs or emotions can affect a well-reflected decision-making process and cause it to go off course, due to the importance strong beliefs or emotions have on the decision itself.

What are heuristics?

Heuristics are described as an "alternative set of simple psychological strategies for decision-making" which "ignore part of the information, with the goal of making decisions more quickly, frugally and/or more accurately than more complex methods."

In other words, they are mental shortcuts or rules of thumb that allow people to simplify ways of making choices and decisions without spending an incredible amount of effort and energy.

Sources: Gigerenzer and Gaissmaier 2011

Key takeaways

- We use mental shortcuts or rules of thumb to simplify choices and decision-making.
- Decisions depend on beliefs and preferences, but also on emotions like regret or fear that lead to the decision being put off, as we see when people procrastinate over retirement planning.
- Decisions and behaviour are impacted by biases, which can lead us away from rational decisions or good judgement.
- Clients are responsible for their own decisions, but advisers also have a responsibility around how information is presented.

Adviser case study

Pete Matthew, creator, MeaningfulMoney

"People are going to need deeper support around behaviour and coaching"

My interest in behavioural finance dates back a few years to a podcast interview I did for MeaningfulMoney, the personal finance brand I set up to help people on their financial journey.

The interviewee was Greg Davies, then head of behavioural-quant finance at Barclays and now head of behavioural science at Oxford Risk.

Greg recounted the story of Ulysses and the Sirens as an entry point for understanding behaviour. For those of you who aren't familiar with it, Ulysses is tasked with taking his ship past the island of the Sirens. The Sirens are known for their beautiful singing, but lure sailors to their deaths as they get closer to hear the singing and crash on the rocks.

Ulysses wanted to hear the singing, but he didn't want to put his ship in danger. So he had his crew tie him to the mast so that he couldn't move, and had them stop up their ears with beeswax.

The point is that he thought ahead and said to himself: how can I put a framework in place that gives me the best of all options here? Greg uses that story to demonstrate that by knowing what our tendencies are, and by having some insight into them, then perhaps we can build frameworks and systems to then make better decisions. We almost force ourselves to make better decisions by 'pre-thinking' them. That idea really resonated with me.

This period in history we're in right now, what with coronavirus, the lockdown and the initial market volatility, is exactly the kind of time where having in-depth insight into client behaviour can be really useful. Most advisers will instinctively know which of their clients are more likely to be anxious in any given situation. But I think a knowledge of behavioural finance just adds meat to that.

For advisers, probably the biggest benefit of having behavioural insights at your disposal will be the ability to set things up in the right way for new clients who you don't know well. If you've had a client for 10 or 15 years, you should have a pretty good understanding of how they tick. If not, you're failing them as an adviser. But when a brand-new client comes to you, it can be hard to get that information.

Increasingly, advisers live in a world where you just don't need to intermediate products for people. In a sense the adviser role has always been about relationships, and the idea that 'people buy people'. If you've earned a client's trust, then that's an incredible privilege.

But I just think people are going to need deeper and deeper support around behaviour and coaching. Advice won't be about choosing the investments, or the platform or anything like that. It will be about having a plan and helping clients manage themselves. That's exactly what we do - we manage people, not money. Behavioural insights are a tool in that box.

Costs will continue to be squeezed, the regulatory burden will increase, and we have the prospect of new players coming to the advice market. In a world where people can do everything themselves, as long as they know the questions to ask, then what are advisers going to get paid for?

I'm expecting a shift to more of a coaching model, and if and when that happens, this kind of insight into the client's financial psyche is going to be invaluable.

We've recently also seen an increasing momentum around the importance of financial wellbeing. Yet both coaching and wellbeing have very little to do with money in and of itself. It's about how we interact with our aspirations and goals. To what extent are these in focus, and do they feel achievable?

The difference behavioural insights make to the financial planning process is hopefully a deepening of the relationship between clients and advisers. I appreciate that sounds dreadfully touchy feely, and we tend not to do that sort of thing in the UK.

But it's an intensely trusting relationship. When you've got money on the table, and you're handing over control of that to an individual, that's just an insane amount of trust, and I think we forget that as advisers sometimes.

You might share your darkest concerns or worries with your priest or your minister, and share your health stuff with your doctor, and your financial stuff with your accountant. But an adviser gets to deal at a deep level with all three of those.

When you meet somebody who really gets you, that's an incredible power. If we ever meet somebody we really connect with, it can feel like you've known that person all your life.

Having behavioural tools and this kind of insight at your disposal potentially gives advisers a headstart on that. By being able to pick out one thing about a client's financial behaviour and speak it back to them, then they'll connect.

Hopefully this represents a marked headstart in building deeper adviser/client relationships and, as such, a greater level of trust. I think the good advisers do that instinctively anyway, but this can only help. I'm excited about the potential.

4. Helping clients understand their behaviour

For a long time, consumers trusted governments as the guarantors of financial wellbeing. When it came to retirement planning, thanks to generous defined benefit pension schemes governments were seen as not only protecting the elderly from poverty, but also ensuring a basic standard of living for those in retirement. However, demographic changes such as increasing life expectancy and falling birth rates have seriously affected the capacity of governments to provide for all citizens.

Research suggests 17 per cent of people in the UK don't save at all for retirement. It's also disheartening to note recent data from the Bank of England which show householders' unsecured debt has increased by 25 per cent in the past 10 years, equating to £45bn more in personal debt compared with the beginning of 2010.

Failing to save enough for retirement, falling into debt and having trouble making ends meet can be due to low income and households suffering financial strain.

But this is also a consequence of struggling to adapt to the new world where we need to look after our own financial wellbeing. These difficulties can be caused by our lack of understanding of financial matters, poor money management skills, or simply by our psychological biases.

The different heuristics

When we make a decision, we have to get past the first thing that comes to our mind. This is known as the availability heuristic. It's easier said than done, especially when it's easy to quickly recall salient information, that is, information that's new, stands out or seems more relevant to us. Equally, it's easy to just see what's in front of us.

On top of this, we all have a natural tendency to focus on vivid or negative messages and those that are seemingly more frequent. As an example, we may make a decision that a holiday destination is unsafe to visit, simply because the media are talking about it a lot in a negative way. It distorts our fact-based reality, and it's an important point to keep in mind when we're making important decisions.

Inexperienced investors might see the sharp decline of a stock as a sign to avoid investing in the stockmarket. The steep decline of a stock or group of stocks becomes more salient and vivid than the likelihood that the whole stockmarket falls, which is a rare situation outside of a financial crisis.

The representativeness heuristic is another mental shortcut used to determine whether a person or an event should be put into a certain category (safe, dangerous, friendly, nasty). In this case, a judgement is made as to how similar the person or event is to what we deem to be typical.

This heuristic serves us well in most of cases. But when it comes to investments, investors might be inclined to forecast future performance based on the last few days of growth of a company's stock, instead of based on several months or years of data.

Limited cognitive capacities

Being skillful at managing our finances depends in great measure on our financial knowledge.

The level of education is an essential element at the time of making financial decisions – in general, the higher educated a person is, the better the decisions. However, this is not enough. Although educated, young people have a tendency to make financial mistakes more often than when they reach their 40s and 50s, an age considered as the period of maturity for financial expertise. And after we reach our 60s, the accuracy of our knowledge recall declines.

Beliefs and emotions

People seem to prefer a smaller and more immediate present reward than a reward more distant in time; this is a psychological tendency known as present bias. This is attributed to what's called temporal discounting, where individuals attribute more value to a gain obtained immediately (now) than to a greater gain obtained later, say in six months' time. It appears that preferences for immediate possession and gratification prevail over future financial benefits.

If you were to place two options in the future to either receive a reward in six months or a higher reward in a year, people tend to go for the 'smaller sooner' reward rather than the 'higher later' one. Known as hyperbolic discounting, this bias has a serious impact on retirement planning as people prefer to spend more money now than defer consumption in favour of increasing savings or their pension contributions for the future.

4. Helping clients understand their behaviour

When psychologists analyse loss aversion, they find that losses produce a stronger psychological response than the response to the same gains. Believing that a financial crisis is imminent or experiencing high levels of anxiety over potential losses might be detrimental for the client's financial goals. A person might choose to invest for retirement in a way which has marginal losses but also low returns. Eventually, their strong inclination to avoid losses will prevent the person from choosing a riskier but more profitable portfolio.

Self-awareness

In amongst all of this, we need to accept that when we need our clients to make important and often complicated financial decisions, their behavioural biases can, and often do, become dominant. Clients aren't even aware of their presence, yet when we analyse the decisions they have previously made and we know what we're looking for, we can often spot individual behavioural biases in the very DNA of a decision.

This is often a result of not understanding these unconscious forces at play during decision-making. It's like trying to bake a cake without knowing the ingredients, and then wondering why it collapsed when you took it out of the oven.

Decision-making is no different, except the ingredients in this instance are typically hidden from view.

But clients can remedy this through self-awareness. Clients need to be helped to understand the financial challenges and consequences that contemporary society poses for them. On the one hand, there is the world we live in. A person's future might not look so bright if they are not aware of their financial challenges: how to save enough for retirement and how to manage debts. On the other hand, there is psychology and biases.

First, we need to make sure clients are aware of the complexity involved in financial decision-making and processing of information. Second, even when they manage to filter out the noise and select the relevant course of action, we still need to deal with scarce cognitive resources. The overwhelming complexity of financial products and our limited cognitive capacities make it difficult to escape our biases.

Finally, we are characterised by strong opinions and beliefs as well as fears and worries. All of them can trick us while we're making judgements and are capable of undermining the best thought-out plan of action.

A way to understand our financial and life goals and be as prepared as possible is to turn to a professional. Advisers and planners therefore have an essential role to play.

By taking the time to learn about who your clients really are, and at the same time provide them with a framework to learn about their underlying behavioural biases, then you'll be better placed to recognise those biases when they appear. In turn, you can then prevent biases from becoming dominant or overly influential in clients' decisions.

The ideal place for everyone to get to is where the adviser or planner really sees their client and understands how they navigate the world they live in more clearly. When we can understand our clients intellectually, emotionally, consciously and unconsciously, it provides an insight that allows us to help clients cut through the noise and make decisions with clarity and a new level of understanding.

But in addition, having an understanding of how people make decisions in the first place provides a great foundation on which to build out from clients' self-awareness. This is a key role for today's adviser. It's about moving the Know Your Client approach from a regulatory tick-box exercise to one where advisers really do know their clients; not only who the client thinks they are, but who the client really is.

Key takeaways

- We all have a tendency to focus on messages that are vivid or negative, or those that seem more frequent.
- Financial decisions are influenced by our education, but age is also a factor.
- When clients are making financial decisions, their behavioural biases often become dominant.
- If clients understand their biases, they can start to do something about them.
- Advisers have a role to play in aiding client understanding and recognising biases when they appear, to avoid biases having undue influence on clients' decisions.
- Clients are then better placed to make informed, clear financial choices.

Adviser case study

Tom Morris, director, Ovation Finance

"The combination of behaviour, coaching and financial wellbeing is really powerful"

It's been interesting to see how clients have behaved financially during lockdown, and how their biases have come into play.

There were actually quite a few of our clients who proved to be pretty relaxed and stoic during the volatility we saw in March. There's probably a lot to be said for the coaching that happened beforehand with these clients, and the financial planning that reassures them they're equipped to deal with these kinds of shocks. The people who have those wonderful guaranteed indexed pensions are really enjoying them right now.

But there will be those clients that need some hand-holding.

We've definitely seen some negativity bias emerging, and that focus on negative outcomes. When the markets go down, people get that sense of loss aversion, and that feeling of "Wow, this is really hurting."

Using behavioural insights as part of our process has helped show us how people actually feel about losing money.

I remember one client who worked in financial services, who on paper had quite a high attitude to risk. They understood the mechanisms of the market, and seemed comfortable with investing. Yet when they were asked questions about losses framed not in a financial sense but more generally, we found they really didn't enjoy that.

When confronted with that, they agreed that was 'them' – understanding the need to take risk, but also aware that when things do wobble they would need some support.

I wonder if that would have come out had we not objectively tested their initial answers, as there's no doubt that people sometimes say things to us because they think that's what they should say.

With a more behavioural approach, it's quite difficult for clients to try and second guess what they're 'supposed' to say.

In another case, I had a fairly young client who was a first-time investor, who had inherited money in unfortunate circumstances. We discovered he was subject to confirmation bias, where he'll look for information that backs up his original view. Knowing that, it might be my job as an adviser to help him see the other side of the argument. This is something that has played out massively over the past few months, as people have sought out articles and views that agree with their own guesses about what was going on in the world.

At Ovation we focus on coaching, and learning the skills that enable us to really understand somebody. What comes up quite a lot in coaching is that it's not about your own values as an adviser, but the client's world view.

When you've got somebody in front of you who thinks like you do and has similar biases, it's easy to be able to manage that because you can see it in yourself. You can relate and you can empathise.

When somebody is very different to you it's good to know that, and understand that for some of the things they're going through, you might not necessarily relate.

For clients, it's just about being aware of their likely behaviour. They can then make a judgement call about how they'd feel about losses, and whether they'd like to perhaps take less risk as a result. It may be they decide their wellbeing is far more important than say, retiring two years early, or whatever their goal happens to be.

For us as financial planners, by knowing the way somebody might behave in certain circumstances, we're able to communicate to that type of person in a tailored way.

We have to make sure what we're saying actually resonates with clients and what's important to them. Having this kind of behavioural insight and the visibility to communicate with a certain sub-section of clients – to be honest, it's a game changer. If we know that 50 per cent of our clients act like this in a given circumstance, we can then send them a particular type of communication, because we know that's going to be really useful for them at that time.

With coaching, you learn to really understand what makes someone tick, what's their purpose and what makes them happy.

Then you add the behavioural work that Neil Bage and others have done, that allows us as planners to understand clients at a subconscious level. Clients can make good decisions because they know certain biases exist, and can then ultimately work towards a lifestyle that will make them happy.

When you combine those two together with the theories of financial wellbeing, and the client's ability to use their money to get to a life that works for them, that's a really powerful combination.

The key thing is the planner's role in interpreting the behavioural results and turning them into something meaningful. That's where the skill is.

Don't get me wrong, it's important that once people know where they want to get to, the tools need to be in place to make sure that happens. Investing people's money properly, advice around tax planning, it's all still part of financial planning. But I think there's a whole piece of work to be done before you even start going down that road. No robot in the world can replace that kind of value in my view.

5. Applying behavioural insights to advice

As we've discussed, clients are navigating a world like never before, where information is available 24/7, and anything they want an answer to is only a Google search away. This presents particular challenges for financial planners.

How do you make sure the advice you give, and the services you offer, land as you expect? How can we make sure that in a world of noise and distraction, our messages, and importantly our advice, gets through?

The world that we and our clients inhabit can create real problems when processing the information we need in order to make decisions. Thanks to an abundance of behavioural research over the years, we are beginning to understand that clients' behaviours can lead to poor decisions around money and investments. We're also now in a place where many advisers recognise that it's part of their job to support clients in making better decisions.

So the question is this. Are we as an advice profession and financial services industry fit for purpose? Do we have the insights we need to really understand the client? Are the tools we use still relevant for a financial planning business today?

Behavioural insight and coaching

Advisers and planners have long been 'knowledge providers', as well as decision-making experts. Advisers help clients navigate sophisticated concepts and an uncertain environment in order to narrow down choices. They are pivotal in designing strategies so that clients can set their financial and life priorities, and so clients can manage their wealth to support those priorities.

In recent years, the advice sector has moved from a traditional role – where a pure financial analysis was enough to design an investment strategy – into a behavioural-oriented approach, where human psychology is beginning to play a greater role in the planning process.

Advisers have begun to take on a different kind of role than in the past, developing financial plans that help clients achieve financial wellbeing, and monitoring those plans to redress any unconscious behaviours to prevent clients from making costly financial mistakes.

This rapid paradigm shift has arguably left advisers with little time and resources to gain the necessary insights and skills, and adapt themselves to this new way of working with clients. Without these skills, it can be challenging for advisers to have that thorough understanding of what's driving clients' decisions.

In a nutshell, the role of the adviser can be summarised in three stages with an overarching 'coaching' strategy:

- Advising – providing scrutiny and counsel;
- Planning – designing and implementing a plan;
- Managing – monitoring and adapting the plan;
- Coaching – enhancing personal and financial wellbeing through applying behavioural insights.

Let's look at each of these individually, and how behavioural insights can be applied at each stage.

5. Applying behavioural insights to advice

Advising

At the beginning of the adviser-client relationship, advisers and planners help clients articulate their future financial and life goals. In order to deliver a financial plan, the conversations need to draw out multiple elements, such as what a client wants and when they want it. But the discussion also needs to reveal the client's preferences on how the journey from 'what' to 'when' should be designed (that is, the levels of risk clients can take).

The challenge we face with financial goals is they're not always very specific or clear. The issue with an undefined and unclear financial goal is psychologically it can cause people to believe that money invested can simply be used at any time for other reasons., Of course, this can undermine any growth strategy which the plan is built on.

Take the example of a couple having a child and deciding to buy a bigger house in due course. This can change the time horizon of money that's been invested. Money is withdrawn sooner rather than originally planned and what a client thinks their risk level is becomes relative. In general, a single individual will assume a higher risk level for their investment than the same individual with a family. Being a 'provider to others' makes people more conservative and more cautious.

The role of advisers is key in helping clients to identify priorities and set up goals. Consider using your expertise to put clients' potential goals in order from the most to the least relevant. Based on this, clients will have a better understanding of what's needed to adopt an informed investment strategy.

Let's assume the clients want to invest to buy a house with a 10-year investment horizon, invested at a moderate level of risk.

On the one hand, it's important to assess the client's commitment towards the investment process and a goal – in other words, the client's ability to stick to the plan. On the other hand, it is crucial to evaluate the client's skills, strengths and weaknesses. Strong personality traits such as overconfidence and inclinations to maybe follow the news too much will require regular adviser engagement. This should help prevent damaging decisions, such as a tendency to bail out of investments, and highlight weaknesses, for example, a lack of knowledge about how investments work.

Advisers can then walk clients through financial complexity, introducing specific recommendations adapted to individual circumstances and needs, and prepare a roadmap with a series of interventions necessary to tackle clients' inclinations and support them in making appropriate decisions.

Planning

Planning requires the design of a tailored course of action to best integrate the client's financial goals and resources with their psychology, preferences and feelings.

From a coaching perspective, at the planning stage advisers are required to facilitate and trigger action.

Improving communication is key in the client-adviser relationship. To improve decision-making, advisers need to avoid jargon and complexity. People feel closer to their advisers when they share common interests, have similar levels of education, but also when they can understand financial matters without effort. Using plain language improves understanding as well as trust.

People frequently have moderate financial literacy and numeracy. Advisers clearly have a role to play in not only helping understand all possible outcomes, but also provide simple formulas to obtain these results. Often people like to explore more options. Providing them with the tools to do so makes them feel more independent and confident.

We have seen that heuristics play a major role in judgement, but that these rules of thumb can also undermine financial decisions. Advisers should take into account certain psychological inclinations observed in clients when it comes to information processing.

Priming, anchoring and framing

- Priming – Where we're exposed to words or ideas that can trigger certain stereotypes or attitudes, which can then unduly influence us in subsequent, even unrelated, tasks.
- Anchoring – Where we value an asset or investment in relation to an earlier reference point or 'anchor', rather than assessing it independently.
- Framing – How we are affected by the way things are presented or 'framed'.

5. Applying behavioural insights to advice

To put the definitions of priming, anchoring and framing into context, it's worth understanding that the order of information being presented influences decisions. The first option presented in a series of investments will function as an anchor influencing subsequent choices.

For instance, people who are first presented with choices including high risk pension funds get anchored to these options. They subsequently prefer higher-risk funds when offered a choice from a wider range of funds. The opposite occurs when clients are first presented with low risk pension funds, they in turn prefer lower-risk funds. From the start, how options are presented will affect risk preferences. To avoid biasing clients, advisers should employ moderate 'defaults' as the first option in a series of choices.

In other words, information about investments should be presented in neutral terms. The way information on a portfolio is framed, and whether it's presented in positive or negative terms, will change the client's choice. A conservative portfolio presented in positive terms will be more likely to be chosen than a risky portfolio framed in negative terms. If neutral terms are not possible, the default strategy is to present pros and cons at the same time so that clients have the opportunity to contrast positive and negative aspects at the same time.

To promote client engagement, advisers should be open and disclose some of the psychological inclinations clients might suffer from. Explaining how decisions are affected by information that's readily available, stands out in some way or is more vivid, for example, alerts the client and makes them aware of how they could potentially stray from good outcomes. It also helps the client take the necessary measures to prevent, if possible, their tendency to be biased.

Managing

During the managing phase, advisers track the client's progress towards their objectives, reviewing and updating the strategy where necessary. This is probably the most difficult stage in the advice process. Well-crafted plans can easily be jeopardised by the intricacies of the client's psychology.

After a scrupulous financial plan has been implemented, market fluctuations may cause clients to change their minds and follow the opinion of their peers, choosing similar investment options and downplaying their own concerns. Fear of missing out on profit, or believing in the wisdom of the crowd, might be some of the reasons that motivate this behaviour.

Preventing clients from selling their holdings or entire portfolios can be achieved by showing them how specific the plan is to their particular goals and current situation. Reiterating the plan's personalised approach serves to highlight why their plan works for them.

Advisers may need to adjust an investment strategy to recover losses when clients tend to hold losing investments for too long. Clients tend to sell winning investments too soon to cash in the benefits, increasing personal satisfaction, and hold on to losing transactions too long as they wait for an 'imminent' recovery. In the long run, this behaviour makes investors, particularly those who don't have an adviser, suffer substantial but ultimately avoidable losses.

As we saw earlier, humans have a clear tendency to prefer present rather than future rewards. Clients prefer to avoid present losses even if they know that investments will recover in future. To prevent clients from bailing out, research indicates that the client should not be presented with the classical choice: a gain if selling now and a potential gain if holding until the end of the investment. This way of presenting information shows a choice that equates to a gain now or a gain in the future and is therefore subject to present bias.

5. Applying behavioural insights to advice

A better way of presenting information to encourage clients to work within their investment horizon and prevent them from making costly mistakes is to present the choice as a loss if selling now and a potential gain if selling in the future. This presentation delays or stops selling intentions because the options are presented as loss now or likely gain over the longer term. (When taking this approach, advisers must be careful not to give the impression that gains are guaranteed). Framing the future choice as the pain of losing money now prevents investors from bailing out.

The course of action could be altered at any moment as financial goals might collide and overlap after some time. To prevent clients from making costly mistakes, advisers need to remind clients what their goals and intentions for the investments are in order to maintain client 'buy-in'.

Advisers should also help clients soften their biases and enhance their strengths. If financial knowledge is a known soft spot, advisers can provide frequent updates on financial matters to ease understanding. If clients have unhelpful beliefs about financial markets, appropriate updates might point out overlooked but relevant information.

As a coach, the role of the adviser is to provide clients with continuing training capable of improving their financial skills in the medium to long-term and improve their financial wellbeing overall.

Key takeaways

- Behavioural insights and coaching can be used to support your advice and help it 'stick'.
- Knowing individual clients' strengths, weaknesses and personality traits should support you in further tailoring your advice, and also in designing interventions where necessary to keep clients' plans on track.
- The more clients can be helped to boost their financial knowledge and to understand the options available to them, the better.
- Think about the way you are presenting information – is it overly positive or negative? Work to present information in neutral terms, and offer moderate 'defaults' where possible.
- If clients are wavering about their investments or their financial plan more generally, try to understand what's driving this behaviour.
- Emphasise the personal, specific nature of the client's plan, and what the client is ultimately working towards.
- Support clients in softening their biases, and enhancing their financial and decision-making strengths.

6. The rise of the behavioural adviser

This white paper highlights three key areas: where we've been, where we are now, and where we are heading.

In the scheme of things, behavioural science is now a much more established approach than it was before. It provides understanding and insight into who we are, how we navigate the world around us, and how we make decisions. These insights have been used for many years in healthcare, regulation, and public policy, and are now starting to find their way into financial services. The creation of the FCA's Insight unit saw the publication of their first behavioural economics white paper 'Applying behavioural economics at the FCA' published in April 2013. And yet, in the main, while financial regulators are using behavioural insights to help inform their approaches, some advice firms have arguably been slower to adopt behavioural insights as part of their process.

Behavioural science is a dynamic branch of science, adapting to the ever-changing world around us, and seeking to understand our place in it. But more to the point, it offers advisers and planners the opportunity to factor into their business an approach where scientists and behavioural researchers are constantly bringing precision to the table.

Many advisers and planners will suggest they know their clients very well – far greater than a Know Your Client approach would ever afford. This is true. Many advisers have very close and personal relationships with their clients. But behavioural science and behavioural insights go beyond that. It is not only about a new way of thinking, it's about bringing structure to what many advisers have being doing intuitively all the time.

It's about providing a scientific, repeatable, robust framework and methodology to explore, explain, and factor in human behaviour. This allows us to be more proactive, better at predicting how people may react, and have a process where both the client and the adviser are continually learning and adapting to the world around them.

It allows for smarter conversations and smarter communications. It creates insights that can drive satisfaction, persistency of business, and increase trust and empathy. And it provides the evidence-base we need in order to apply coaching skills that can help clients through the most challenging of times and beyond.

Human behaviour evolves, as do humans in general. It's time for financial planning firms to grab this opportunity with both hands and build behavioural insight into their day-to-day practices. It's time to learn more about the clients we look after to make sure they are best served. In short, it's time for the rise of the behavioural adviser.

Key takeaways

- Behavioural insights can bring a structure and a framework to what you're doing intuitively with clients, at a deeper level than what's required under the Know Your Client rules.
- Understanding client behaviour can lead to insights into how clients will react in certain scenarios, and how you can shape your advice accordingly.
- Together with a coaching approach to advice and planning, the use of behavioural insights can drive many business benefits, and help clients towards better financial decision-making.

7. Conclusion

The use of behavioural insights is a natural fit with today's financial planning practice.

It is particularly apt as advice has shifted away from being transaction-led and has evolved to become a service focused on client-centric lifestyle financial planning.

When you factor in a coaching style of planning and the gathering momentum around financial wellbeing, gaining a greater understanding of client behaviour seems even more relevant.

At a time when there's a growing demand and need for financial planning services, applying behavioural insights to the advice process can offer a distinct advantage and point of differentiation. By understanding how your clients tick, and what drives their decisions at a deeper level, this can lead to a number of client and business benefits. Used well, behavioural insights can prompt better client engagement, more tailored client communications and can ultimately build on the already high levels of trust between advisers and their clients.

Advisers and planners have a crucial role in helping clients get to where they want to be in life. Giving clients not only an insight into their financial decision-making, but also to interpret this on behalf of clients so they can hone their behaviour over time, is a powerful concept. It's one that should propel financial planning firms forward as the advice process continues to evolve and adapt for the better.

We hope you found this white paper useful.

Natalie Holt
Content editor, Nucleus

8. Further reading and information

The Behavioral Investor
by Daniel Crosby

The Geometry of Wealth
by Brian Portnoy

The Psychology of Money
by Morgan Housel

Predictably Irrational
by Dan Ariely

Behave
by Robert Sapolsky

FCA Insight – Behavioural economics
https://www.fca.org.uk/insight/topic/behavioural-economics

9. References

Amar, M., Ariely, D., Ayal, S., Cryder, C. E., & Rick, S. I. (2011). Winning the Battle but Losing the War: The Psychology of Debt Management. Journal of Marketing Research, 48(SPL), S38–S50.

Barber, B. M. and T. Odean (2004). Are individual investors tax savvy? evidence from retail and discount brokerage accounts. Journal of Public Economics 88(1–2), 419–442.

Gigerenzer, G. and Gaissmaier, W. (2011). Heuristic Decision Making, Annual Review of Psychology 2011 62:1, 451-482.

Gigerenzer, G., & Selten, R. (2001). Rethinking rationality. In G. Gigerenzer & R. Selten (eds.), Bounded rationality: The adaptive toolbox (pp. 1–12). Cambridge, MA: MIT Press.

Gigerenzer, G., Todd, P. M., & the ABC Research Group. (1999). Simple heuristics that make us smart. Oxford, England: Oxford University Press.

Haselton, M. G., Nettle, D., & Andrews, P. W. (2005). The Evolution of Cognitive Bias. In D. M. Buss (Ed.), The handbook of evolutionary psychology (p. 724–746).

Keltner, D. and Lerner, J.S. (2010). Emotion. In Handbook of Social Psychology (eds S.T. Fiske, D.T. Gilbert and G. Lindzey).

Lerner, J. S., Y. Li, P. Valdesolo, and K. S. Kassam (2015). Emotion and decision making. Annual Review of Psychology 66, 799–823.

Lerner, J. S., Y. Li, P. Valdesolo, and K. S. Kassam (2015). Emotion and decision making. Annual Review of Psychology 66, 799–823.

Loewenstein, G. F., E. U. Weber, C. K. Hsee, and N. Welch (2001). Risk as feelings. In G. Loewenstein (Ed.), Exotic Preferences. Behavioral Economics and Human Motivation, Chapter 19. Oxford University Press.

Reimers, S. and N. Harvey (2011). Sensitivity to autocorrelation in judgmental time series forecasting. International Journal of Forecasting 27(4), 1196–1214.

Simon, H. A. (1956). Rational choice and the structure of the environment. Psychological Review, 63, 129–138.

Thaler, R.H. (1999), Mental accounting matters. J. Behav. Decis. Making, 12: 183-206.

Tversky A, Kahneman D. 1973. Availability: a heuristic for judging frequency and probability. Cogn. Psychol. 5:207–32.

Tversky A, Kahneman D. 1974. Judgment under uncertainty: heuristics and biases. Science 185:1124–30.

Västfjäll, D., P. Slovic, W. J. Burns, A. Erlandsson, L. Koppel, E. Asutay, and G. Tinghög (2016). The arithmetic of emotion: Integration of incidental and integral affect in judgments and decisions. Frontiers in psychology 7(325).

10. Finding out more

Nucleus is an award-winning, adviser-built wrap platform. Since launch we've established ourselves as a major force for change in the market. We're a thriving community of over 900 adviser businesses who currently manage £15.8bn of assets (as at 30 June 2020).

For further details please go to www.nucleusfinancial.com.

For more Nucleus publications, please visit www.nucleusfinancial.com/support/publications.

Can we help?

For any more information on Nucleus please contact your regional business development director.

Be-IQ

Neil Bage
Be-IQ

Be-IQ was founded in 2013 by Neil Bage and Michael Free. Be-IQ develops solutions to enable individuals to understand the impact of their behavioural biases on their decisions across all money domains; investing, borrowing, spending, saving, whilst at the same time, providing the data to allow financial planning firms to account for them. Be-IQ's solutions have been rooted in cutting-edge behavioural science since its foundation, and are grounded in the belief that factoring in behaviour is central, not an add-on, to modern services and relationships.

For more information please go to www.beiq.co.uk

Darren Lowry
Head of sales
e: darren.lowry@nucleusfinancial.com
m: 07803 171 958

Chris Macdonald
Regional business development director: Scotland, north London and east of England
e: chris.macdonald@nucleusfinancial.com
m: 07595 820 112

John Daly
Regional business development director: Northern Ireland
e: john.daly@nucleusfinancial.com
m: 07714 900 703

Russell Dowd
Regional business development director: North England
e: russell.dowd@nucleusfinancial.com
m: 07739 340 473

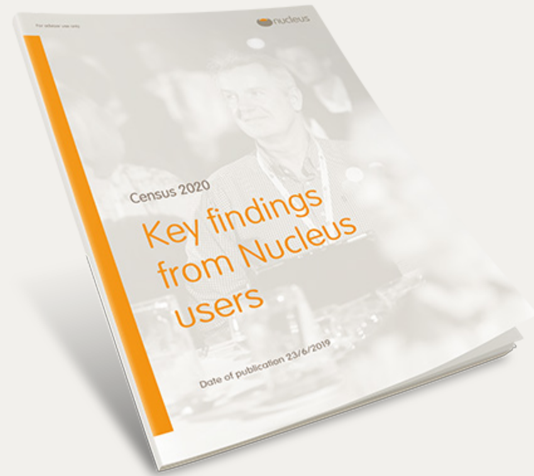
Alan Jordan
Regional business development director: South west and Wales
e: alan.jordan@nucleusfinancial.com
m: 07715 090 223

Martin Clement
Regional business development director: South England
e: martin.clement@nucleusfinancial.com
m: 07739 339 908

Alex Pemble
Regional business development director: South east and south London
e: alex.pemble@nucleusfinancial.com
m: 07568 129 310

Our other publications…

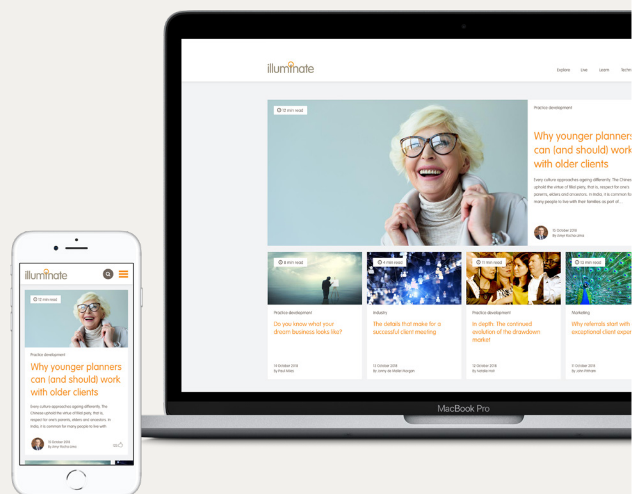
To help you to keep on top of the latest industry developments we've created a number of white papers that respond to the current legislative and market environment and anticipate future developments. As well as our white papers you'll also be able to access previous versions of our census dating back to 2015.



Check out our other publications – nucleusfinancial.com/support/publications

Illuminate online

Check out illuminate, an online information hub to help you build and share knowledge in areas that are vital to the successful development of your business including technical issues, marketing, compliance, regulation and practice development.



Find out more – illuminate.nucleusfinancial.com

illuminate

For adviser use only

nucleus

0131 9800 226 tellmemore@nucleusfinancial.com @nucleuswrap www.nucleusfinancial.com

Nucleus Financial Services Limited is authorised and regulated by the Financial Conduct Authority, is registered in England with company number 05629686 and has its registered office at Elder House, St Georges Business Park, Brooklands Road, Weybridge, Surrey KT13 0TS. Please note that telephone calls may be recorded in order to monitor the quality of our customer service and for training purposes.

0323CA.01
8-2020