Behavioral finance and wealth management

Finance

Some financial advisors are needlessly struggling with behavioralfinancebecause they lack a systematic way to apply it to their client relationships. In my 2006 book, Behavioral Finance and Wealth Management, I outline a method of applying behavioral finance to private clients in a way that I now refer to as " bottom-up. " This means that for financial advisors to diagnose and treat behavioral biases, he or she must first test for all behavioral biases in a client, and then determine which ones a client has before being able to use bias information to create a customized investment plan.

In my book I describe the most common behavioral biases an advisor is likely to encounter, explain how to diagnose these biases, show how to identify behavioral investor types, and finally show how to plot this information on a chart to create the client's " best practical allocation. " But some advisors may find this bottom-up approach too time-consuming or complex. So, I created a simpler, more efficient approach to bias identification that is " top-down," a shortcut if you will, that can make bias identification much easier.

I call it Behavioral Alpha, and the core of this process is four behavioral investor types. Over the next four articles, we will learn the four behavioral investor types and how to deal with each of these types of investors. For readers to understand behavioral investor types, they need to get a fundamental understanding of the 20 behavioral biases I outline in my book. In this article, we will review these biases that are encountered with actual clients, with a description of the bias and a classification of whether the bias is cognitive or emotional.

Behavioral biases fall into two broad categories, cognitive and emotional, with both varieties yielding irrational judgments. A cognitive bias can be technically defined as a basic statistical, information processing, or memory error common to all human beings. They also can be thought of as " blind spots" or distortions in the human mind. Cognitive biases do not result from emotional or intellectual predisposition toward a certain judgments, but rather from subconscious mental procedures for processing information.

On the opposite side of the spectrum from illogical or distorted reasoning we have emotional biases. Although emotion is a difficult word to describe and has no single universally accepted definition, an emotion is a mental state that arises spontaneously, rather than through conscious effort. Emotions are physical expressions, often involuntary, related to feelings, perceptions or beliefs about elements, objects or relations between them, in reality or in the imagination.

Emotions can be undesired to the individual feeling them; he or she might wish to control their emotions but often cannot. Investors can be presented with emotionally based investment decisions, and may make suboptimal decisions by having emotions affect these decisions. Often, because emotional biases originate from impulse or intuition rather than conscious calculations they are difficult to correct. Emotional biases include endowment, loss aversion, and self-control.

We will investigate both cognitive and emotional biases in the next section. The distinction between cognitive and emotional is an important one, because advisors will want to advise their clients differently based on which

types of biases are being acted out. In the next four articles, we will use the biases described here a lot, so I encourage readers to get to know the biases presented here in concept. We will apply them to client situations in subsequent articles.