

Behavioural Aspects of Financial Advice

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Abstract

As financial products and financial markets become more complex, there is an increase in people seeking out financial advice to make important financial decisions. Financial planning is emerging as a profession that provides clients with comprehensive financial plans to achieve their financial goals. Yet the practice of providing financial advice is an under-researched topic and worthy of more interest. This chapter reviews behavioural research to provide insights into financial planning. It accomplishes this in two ways. Firstly, it reviews behavioural research on how people make financial decisions, showing that the concepts of the disposition effect, home bias, and mental accounting are relevant for financial planners who want to understand their clients' behaviours. Secondly, the chapter reviews research on the advisor-to-advisee relationship covering the topics of conflicts of interest, disclosure, and persuasion, which inform the process of providing financial advice. Overall, behavioural research can offer unique insights into financial planning. This knowledge should be developed further and incorporated into the financial planning curriculum.

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Introduction

Many parts of the world have experienced a deregulation of financial systems and decrease in state provided pensions (Holzmann, 2013). These changes have increased the complexity of financial products and also an individual's responsibility for planning and funding their own retirement. In light of these changes, people are seeking financial advice to guide them through the large financial decisions that they must make. Thus, demand for financial advice, especially in Australia, has increased over the past two decades. Concurrently, the financial planning vocation emerged as the leading discipline to provide financial advice to the clients (Cull, 2009). Financial planning is in the process of becoming a profession and it separates itself from cognate professions such as accounting and occupations such as stock broking. To professionalise financial planning needs to build a body of knowledge about financial advice to create a clear jurisdiction of expertise. To this end, financial planning professional bodies, universities and regulatory authorities are incorporating aspects of financial planning into their curriculum¹.

In this chapter, I review pertinent behavioural research which can be applied to financial planning or the process of providing financial advice. This is completed in two sections. The first section focuses on financial planners' knowledge of clients. Financial planning is defined as "the process that takes into account [a] client's personality, financial status and the socio-economic and legal environments and leads to the adoption of strategies and use of financial tools that are expected to aid in achieving the client's financial goals" (Warschauer, 2002, p. 204). This quote illustrates that financial planning incorporates the client's personality into the financial advice recommended. Accordingly, knowledge on financial planning curriculum is drawing on insights from behavioural research to understand exactly what 'a client's personality' entails. The first section this chapter reviews behavioural finance and behavioural economics research which highlights behavioural biases that influence people's financial decision making.

The second section of this chapter investigates behavioural research on the adviser-advisee relationship. This area of research area receives less attention from financial planning curriculum and, is therefore, less likely to be incorporated into developing the financial planning profession. However, behavioural research in this area shows great potential as it researches common practices adopted by financial planners when interacting with clients. Some of the specific topics that behavioural research highlights are conflicts of interest, disclosure and persuasion in the advisor (financial planner) to advisee (client) relationship. For financial planning to professionalise, these concepts need to be addressed by a body of knowledge and behavioural research offers knowledge on these concepts.

Behavioural research applicable to financial decision making

There are many books and articles which currently offer behavioural insights into financial decision making and financial planning (Baker & Ricciardi, 2014; Chaffin, 2018; Pompian, 2012; Statman, 2017). Some of the insights offered by these books focus on inferences of behavioural research to financial

¹ For example, see Financial Advisers Standards and Ethics Authority Educational Standard which details Behavioural Finance as a curriculum requirement. <https://www.fasea.gov.au/education-requirements/>

decision making. In this chapter, I limit the focus of behavioural concepts to those which meet two criteria. Firstly, there is evidence of the behaviour occurring both behavioural research, such as psychological experiments and secondly, there is evidence of this occurring in real world data, such as individual's financial records. The review below covers the disposition effect, home bias and mental accounting.

Disposition effect, loss aversion and emotions

Imagine you purchase shares in two companies; one purchase is a large financial institution and the other is a large supermarket chain. Following a period of 3 months, the coronavirus (covid) pandemic occurs, and one share has seen a large increase in price (the supermarket) while the other has an equivalent decrease (the financial institution). Due to the covid pandemic, you need money and choose to sell one stock. Which stock do you sell? Well, people who chose to sell the supermarket shares are illustrating a bias called the disposition effect.

The disposition effect is a bias where investors hold shares trading at a loss longer than those trading at a gain. Colloquially defined, the disposition effect is a behaviour where you “sell winners too early and ride losers too long” (Shefrin & Statman, 1985, p. 777). The bias peaked interest of academics when Odean (1998) analysed investors' brokerage accounts in the USA. His research showed that the disposition effect was prevalent amongst investors and he also showed that investors who had more disposition effect experienced worse returns. Specifically, Odean showed that the stocks investors sold at a gain subsequently outperformed the stocks investors continued to hold at a loss. Since Odean's research, additional research using the entire Finland stock market from 1995 to 2003 confirmed a relationship between individual investors level of disposition effect and reduced investment returns (Seru, Shumway, & Stoffman, 2010).

A key question for financial planners is why do people do this? One argument is that the disposition effect is related to Prospect Theory (Kahneman & Tversky, 1979), which illustrates that people have risk tendencies depending on whether they face gains or losses. For losses, people increase their risk taking attitudes (a concept often referred to as loss aversion). When faced with a loss in the share market, investors will continue to hold (take risk) to recuperate this loss. The opposite occurs for gains where risk taking decreases and people will sell that stock to crystallise the gain. An alternative explanation is the emotions involved in making investment decisions (Richards, Fenton-O'Creevy, Rutterford, & Kodwani, 2018; Shefrin & Statman, 1985; Summers & Duxbury, 2012). When people purchase a share which decreases in value, an emotion of regret is invoked and this emotion inhibits the action of selling a stock (Summers & Duxbury, 2012).

There is a lot of evidence of the disposition effect occurring throughout the world. Research has shown that this bias occurs in many culturally different countries from Taiwan (Shu, Yeh, Chiu, & Chen, 2005) and the United Kingdom (Richards, Rutterford, Kodwani, & Fenton-O'Creevy, 2017) to Estonia (Muhl & Talpsepp, 2018). It is also observed in trading experiments run by researchers at universities (Summers & Duxbury, 2012; Weber & Camerer, 1998). Academics are now turning their attention to what makes a person more or less susceptible to this bias. This new wave of research offers further insight relevant for those who provide work in financial planning or provide financial advice.

Some research suggests that investor can learn to reduce their own susceptibility to this bias. However, learning to avoid this bias is a very long and gradual process (Seru et al., 2010) which can be accelerated by turbulent market conditions (Muhl & Talpsepp, 2018) or amongst highly educated investors that trade frequently (Vaarmets, Liivamägi, & Talpsepp, 2018). Other research suggests that investors who are better able to regulate their emotions, and therefore handle the ups and downs of investing, have

less disposition effect (Kim & Ha, 2016; Richards et al., 2018). The research suggests that experience, combined with emotional awareness, can lead an investor to alleviate this bias. For those more prone to the bias, a direct method to inoculate against the disposition effect is use of stoplosses (Fischbacher, Hoffmann, & Schudy, 2017; Richards et al., 2017). Stop losses are automatic trading devices that sell stocks when they decrease in value. These are free to use and have been shown to be very effective at eliminating this bias. Finally, those investors who receive advice from experienced financial advisors show less disposition effect than those who do not (Shapira & Venezia, 2001). The financial advisor needs to have experience, as inexperienced advisors have been shown to increase the disposition effect (Hermann, Mußhoff, & Rau, 2019).

Home bias and familiarity heuristic

A common recommendation that financial planners offer their clients is to diversify their investments. This recommendation is rooted in traditional finance which shows that diversification is a method of reducing risk. An effective method to diversify and reduce risk is to invest in shares market in a different country because this offers improved diversification due to the different business cycle, and therefore returns, to your home country. However, Huberman (2001) has identified that investors are very reluctant to do this. Instead, investors invest where they currently live; a bias called the home bias. The home bias has roots in the familiarity heuristic, where people favour phenomena they are familiar with to those that they are not familiar with. Research has shown the home bias occurs and that investors are more likely to invest in firms that share their country, culture and/or language (Grinblatt & Keloharju, 2001).

This bias can occur due to a number of different factors, some of which are economic, and others that are behavioural in nature (Riff & Yagil, 2016). The economic reasons include asymmetric information (investors have more accurate and comprehensive data about the firms in their home country) exchange rate volatility and government regulations that impede international investment. However, behavioural reasons still play a prominent role of why this bias occurs because experimental research that removed the economic variants demonstrated a strong home bias in investment decision making (Lin & Viswanathan, 2016). Riff and Yagil (2016) find that the familiarity bias plays a substantial role in the home bias, where investors who feels acquainted with an asset are more likely to invest in it. This is similar to 'homophily' where people will have social networks which are homogeneous because we connect with other people who share similar sociodemographic, behavioral, and intrapersonal characteristics (McPherson et al., 2001). In addition, Riff and Yagil (2016) found that fluency, which is the extent to the name of the stock is easy to comprehend, increased the home bias as investors. In short, investors are more likely to invest in stocks they are familiar with and that they can pronounce, and these tend to be stocks in our home country.

The importance of the home bias for financial planners is that it illustrates a client's willingness to invest in different products. Research shows that investors believe home assets to be less risky (Wang, Keller, & Siegrist, 2011). That is when investors have knowledge and comprehension of an investment, they are less likely to view it as risky. This is important for financial planners as it highlights the importance of a client's understanding when recommending certain financial products or advice. If a planner recommends something not understood by clients, they will perceive it as a risky endeavour. Instead a financial planner may recommend international companies with a strong global brand because this ameliorates the home bias because they easily recognized, familiar and understood (Riff & Yagil, 2020). Secondly, research also shows that this bias is related to confidence. When investors feel competent, they are more likely to reduce their home bias and diversify internationally (Graham, Harvey, & Huang, 2009). Thinking about to recommend overseas diversification is important because the home bias occurs more frequently in a declining bear market than an increasing bull market (Riff

& Yagil, 2016). This aspect of the home bias highlights the need of financial planners to offer financial advice within the scope of understanding of a client so that they can feel confident about the decisions made.

Mental Accounting and choice bracketing

The concept of mental accounting was developed by Richard Thaler (1980, 1985) to outline how people categorize money into separate cognitive accounts. Money is fungible, or in other words, it is a transferable commodity across many aspects of our lives (Thaler, 1999). For example, we use the same money to pay for holidays, buy food and donate to charity. In order to make financial decisions easier, people create categories for money and assess decisions within categories. These categorisations of money create barriers to fungibility, where certain money is earmarked for intended purpose (such as funds for children's education) and cannot be used in other areas. Mental accounting is the behavioural economics term used to the categorization of money and shows unique insights into financial decision making (Zhang & Sussam, 2018; Zhang & Sussman, 2018).

Mental accounting can be attributed to a broader concept of choice bracketing (Bland, 2019; Read, Loewenstein, & Rabin, 1999). When faced with decisions people can choose to *broad bracket* where they assess all consequences of decisions, or *narrow bracket* where each choice is made in isolation. Narrow bracketing is far more common because the cognitive complexity of weighing multiple consequences across multiple decisions. The use of narrow bracketing can have both positive consequences (it increases efficiency), and negative consequences (important facets are not considered). Likewise, mental accounting in personal finance can be both an effective and detrimental way of organising money and making decisions. Mental accounting can be a powerful budgeting tool for a financial planner's client as it allows them to make simple decisions and develop a behaviour of saving.

The key determinant of whether mental accounting is positive or detrimental is the way in which money is categorised. One categorisation is by the source of funds; whether the money comes from wages, investments, inheritance etc. Some money can come from personal exertion or from investment decisions and feel like 'regular income'. Other funds can be perceived 'windfall gain' (Zhang & Sussam, 2018), where they money is not expected or treated like a bonus. Research has found that if money is a windfall gain, then people are more likely to spend such money easily and spend it on luxury good (Milkman & Beshears, 2009; Zhang & Sussam, 2018). As money can come from many sources, a person's categorisation of something as a regular or a gain has a big influence on whether that money is spent or invested. The 'Save More Tomorrow', where employees commit to putting future pay rises into retirement savings, is a good example of using windfall gains to increase savings behaviour (Thaler & Benartzi, 2004).

A second categorisation in mental accounting is purpose of the money. When money is categorized for a specific purpose, money within this category can be spent up rather than transferred to other sources. Hastings and Sharpiro (2013) found that when petrol prices decreased, households in the United States of America would buy more expensive petrol (higher octane), rather than utilising any left-over fuel money for a different purpose. That is, people had a certain mental account for petrol money and would spend that money rather than transfer that money. These results highlight a key ramification of mental accounting in financial planning which is mental accountings use for budgeting. Mental accounting can be used as an effective budgeting tool as it increases self-control and simplicity of how much to spend (Shefrin & Thaler, 1988). However, once set in place, it can lead to suboptimal financial decision making when situations change. Research has found for instance that money intended as savings is not utilised in times of a financial crisis and instead people opt for high interest

debt (Sussman & O'Brien, 2016). For financial planners, they can advise clients of mental accounting techniques for budgeting but should also review the use of these techniques in follow up sessions with clients.

A third categorization of money in mental accounting is a time preference and whether the money is categorized as being in the past, present or future. A concept related to this is temporal discounting where people place more value on something being available now rather than in the future (Frederick, Loewenstein, & O'donoghue, 2002). Much of financial planning is built on the time value of money so the ideology that future money (e.g. savings for retirement) has less value than current money (current expenditure) maybe common knowledge amongst advisors. However, behavioural research shows that people vary in the amount they temporal discount and this related to how much a person values the perceived reward (Tsukayama & Duckworth, 2010). When it comes to retirement planning, research has shown that people who discount more and engage in less healthy behaviours that place more emphasis on current gratification (e.g. smoking and sensation seeking), then to save less for retirement (Finke & Huston, 2013). This aspect of mental accounting has important implications for financial planning. A financial planner needs to understand how their client discounts the value of future money, or in other words, how they value future money. This will help the financial planner to develop strategies aimed at boosting retirement savings. Those clients who heavily discount future money, may need an investment product where the savings is difficult to access compared to clients who discount less heavily.

Behavioural research on the advisor-advisee relationship

This section of the chapter focuses on behavioural research that investigates the advisor-advisee relationship and I apply the findings to the financial planner to client relationship. This research topic is not specifically included in financial planning curriculum but offers unique findings into financial planning practices. The review below aims to highlight some behavioural insights into conflicts of interest, disclosure and persuasion and show how behavioural research on these concepts are applicable in financial planning. [Conflicts of interest](#)

An aspect of financial planning which is under scrutiny of are the conflicts of interest. Financial planners have a duty to act in the interests of their clients and thereby ensure that advice provided is based on the client's circumstances and fulfilling the client's needs (Richards & Morton, 2020). However, financial planners are often working for, or remunerated by, financial institutions that have different interests. A fundamental interest of financial institutions is a need for consumers of the financial products they create. Thus, the financial institutions encourage financial planners to recommend their products to clients by various incentives such as commissions. This creates a conflicted market for financial advice where a financial planner must weigh the interests of their clients on one hand and the interests of financial institutions and their own interests on the other. This is a simple depiction of conflicts of interest and it is important to note that these conflicts vary in different jurisdictions throughout the world (Angelova & Regner, 2013; Chen & Richardson, 2018).

Experimental research on financial advice, in addition to other types of research (Chater, Huck, & Inderst, 2010; Richards & Morton, 2020), show that these conflicts of interest are detrimental in financial advice settings. Conflicts of interest are detrimental for the advisee because advisors work in their own interest rather than the advisees interest (Chen & Richardson, 2018). A common issue is that financial advisors will not be honest about their own interests in advice situation. Angelova and Regner (2013) investigate how paying for advice can influence conflicts of interest and how this might affect an advisor to act truthfully. In financial planning, some advisors choose to receive their income through charging clients (called a fee for service model) and others choose to receive commissions from product providers. Thus, Angelova and Regner (2013) investigate differences between voluntary

payments and obligatory payments made by clients. They find that larger voluntary payments made by advisees both before and after advice, increases advisor truthfulness in advice. Furthermore, advisees are more likely to act upon advice when they make a voluntary payment. Overall, this research suggests the benefits of a fee for service model in financial planning. These findings are consistent with field research which finds that independent financial advisors' advice offers better returns than financial advisors employed by a bank (Hackethal, Haliassos, & Jappelli, 2012) and that a small percentage of clients take up offers of free unbiased financial advice with even fewer acting on the advice provided (Bhattacharya, Hackethal, Kaesler, Loos, & Meyer, 2012).

Disclosure

A common method of handling conflicts of interest in financial planning is disclosure, where a financial planner will inform a (potential) client of the incentives they receive. Advisors disclosing information to advisees became a research topic of interest in behavioural research following a seminal paper by Cain, Loewenstein, and Moore (2005). Cain et al., (2005) found that even though conflicts of interest are disclosed by advisors to advisees, advisees fail to discount the impact of these conflicts on the advice given. That is, they failed to adjust their behaviour appropriately in light of the disclosure. This implies that clients of financial planners do not reject the financial advice when conflicts are disclosed. Furthermore, Cain et al., (2005) found when advisors knew of their disclosure requirements, they would increase their bias knowing that advisees would adjust their views due to disclosures. They referred to this as strategic exaggeration and suggested that disclosure offered advisors a 'moral licence' to bias their advice. Results on strategic exaggeration and moral licencing are inconsistent. Chen and Richardson (2018) failed to find that strategic exaggeration and moral licensing occurred in advice giving experience. They did find that conflicts of interest impeded the advisee's interests and disclosing conflicts of interest reduced advisor's returns in their experiment.

What is the impact of disclosure on the relationship between the advisor and advisee? Sah, Loewenstein and Cain (2013) investigated the influence of advisor disclosure on advisee's perceived trust and advisee's compliance with the advice provided. Unsurprisingly, the results found that when an advisor discloses a conflict of interest, then the advisees have less trust in that advisor. Interesting, they found that an advisee is more likely to comply with the advice when a conflict is disclosed. They refer to this as the burden of disclosure where advisees feel obliged to comply with advice because the disclosure places the responsibility on the advisee to providing the incentive for the advisor. Similarly, Chen and Richardson (2019) found that disclosure of conflicts of interest did not increase advisee's rejection of the advice. Thus, even though financial planners disclose conflicts of interest, their clients may still engage with the advice.

The context in which disclosure occurs is also a key factor to consider when understanding the influence disclosure has on advisee trust. When disclosure occurs online by an advisor, an advisee's trust towards an advisor increases because the disclosure acts as a cue of integrity (Sah, Malaviya, & Thompson, 2018). This research contradicts earlier research which shows that disclosure decreases advisee's trust in an advisor (Sah et al., 2013). Sah et al., (2018) investigated why the inconsistent results occurred and found disclosure increases trust when the amount of information that advisees receive is high. That is, when advisees are have a lot of information to process, a disclosure of conflicts of interest acts as a heuristic of trust and therefore persuasion to accept advice. This would apply in financial planning, where a high volume of information is provided to clients and disclosure could increase the trust clients have in financial planners.

Finally, it is worthwhile considering the impact disclosure of conflicts of interest on the advisors themselves. That is, by disclosing conflicts how do advisors change their behaviour and when does this

help improve financial planning? Sah and Lowenstein (2014) show some insights into this topic when they investigate if advisors would avoid conflicts of interest. Participants in their experiment could choose to accept or avoid conflicts of interest and were either forced to disclose or could voluntarily choose to disclose these conflicts of interest (or lack of) to advisees. The results showed the majority of advisors chose to avoid conflicts of interest both when forced to disclose these conflicts but also when disclosure was voluntary. This occurred even when accepting a conflict of interest led to a better pay out for the advisor. Furthermore, Sah and Lowenstein (2014) found that advisors who chose to avoid the conflict of interest, subsequently chose to disclose this absence of conflicts to advisees. Advisees rated advisors as more trustworthy when they chose to disclose the absence of conflicts of interest. Overall, the results show that a practice of disclosure could influence financial planners beneficially when they can choose to avoid conflicts of interest but not when the conflicts of interest are unavoidable. Also, clients may increase their trust in their financial planners if they disclose an absence of conflicts of interest. [Persuasion](#)

A key concept in financial planning is the concept of persuasion. Persuasion is vital in many aspects of financial planning as it can be used by financial planners to obtain clients and then get clients to enact the advice financial planners provide them. The concept of persuasion is also of interest for researchers in behavioural sciences. Persuasion can be defined as when a person chooses to change their attitude or behaviour as a result of communication they receive (Hoffmann, Chesney, Chuah, Kock, & Larner, 2020). Hoffmann et al., (2020) investigated how persuasion changes in the advisor-advisee relationship depending on whether the advice provided is difficult or demonstrable. It is worth analysing these concepts individually.

Difficulty in advice occurs when an advisor has incomplete information and is unable to provide guaranteed advice as they do not have a correct solution to give. Difficulty occurs in financial planning as the stock market returns are never guaranteed, so the solution provided to clients cannot be 100% sure to succeed. Demonstrability is the ability to show that your advice provides a correct solution. Hoffman's research shows how persuasion is influenced by the amount of difficulty and amount of demonstrability in advice. In particular, they show if you can demonstrate your advice, then persuasion increases but if the advice is difficult, persuasion decreases. The authors explain that their results occur because advisors providing advice on difficult topics lack in confidence and do not have objective success criteria to fulfil promises.

This research highlights two important elements for providing financial advice. Firstly, financial planners should have mastery of the topics that they provide advice for because this is essential to persuade clients to take advice. In addition, financial planners should not give advice which is outside of their remit as this will increase the difficulty of advice and decrease persuasion. A second element is to improve the demonstrability of advice, where financial planners need to demonstrate the effectiveness of their advice for clients. Hoffman et al., (2020) identify three factors involved in demonstrability as: the ability to compare advice to alternatives, the ability to logically reason if advice is sound and the advisor and the advisee sharing the same criteria to identify success in advice. To increase persuasion, financial planners could offer comparisons between their advice and alternatives, could explain reasons for the advice given and engage with clients about how they will assess the value of the advice. Adoption of factors should lead to financial planners being more persuasive with clients.

Summary

The focus of this chapter was to highlight how behavioural research can inform financial planning. Financial planning is a vocation moving towards a profession and is building knowledge to establish itself from other types of financial services. An aspect of creating an area of jurisdiction is knowledge of how people make financial decisions. To this end, behavioural research from behavioural finance and behavioural economics has identified ways that people diverge from rational economic decision making. Financial planners value insights from these fields of research to help understand their clients. This chapter highlighted behavioural insights into a client's way of making financial decisions including the disposition effect, home bias and mental accounting. Behavioural research offers more insights to financial planning on topics that are currently not adopted into financial planning curriculum. These additional insights involve the relationship between an adviser and advisee. Thus, this chapter highlighted how behavioural research has investigated conflicts of interest, disclosure and persuasion. Each of these topics bear relevance for financial planning as it continues to professionalise and should be incorporated more educating financial planners of the future.

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