Behavioural Finance 2.0

New insights from behavioural finance can lead advisors to stronger client relationships and better outcomes

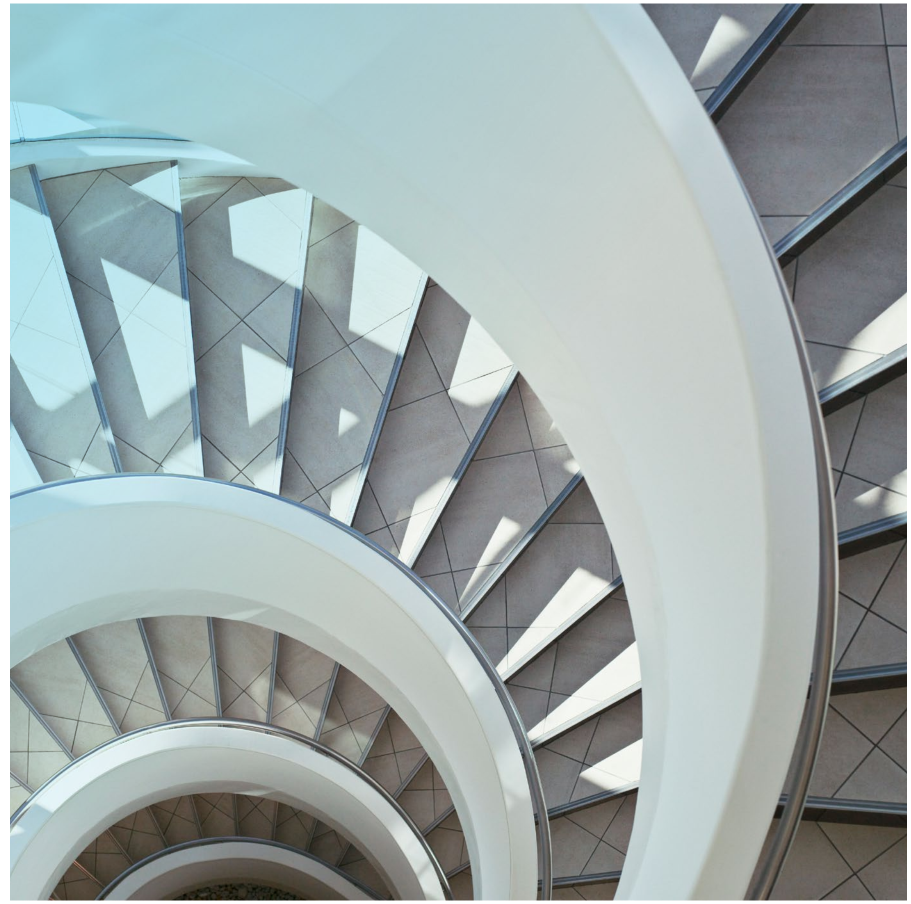
canada life™ | Investment Management

In his 1977 Alfred Hitchcock-inspired parody *High Anxiety*, Mel Brooks plays a psychiatrist who is hired as the new director at a mysterious hospital called the Psycho-Neurotic Institute for the Very, Very Nervous.

Indeed, there was plenty to be nervous about in the 1970s, especially for investors. The Dow Jones Industrial Average eked out a mere 5% gain over the entire decade, one beset by persistently high inflation, high unemployment and a severe oil price shock exacerbated by regional war.

While there is ongoing debate as to whether markets are set to repeat the malaise of the '70s, one thing is clear. Heightened market volatility, high inflation and rising interest rates are fueling Canadians' concerns and contributing to market conditions that few have faced in their investing lives.

> **One of the welcome developments on the 1970s investment scene, however, was the emergence of a new discipline known as behavioural finance,** aimed at explaining how – and why – we make the economic decisions we do, and the biases to which we often fall prey. An understanding of these principles will give you greater clarity into how clients make decisions and help you to guide them towards better ones, all while helping you to create more successful and stickier client relationships.



A new way of thinking

While early financial theory assumed that our economic decisions are geared towards optimizing risk-adjusted returns and little else, this approach greatly simplifies the reality of human experience. A second generation of behavioural finance has emerged in recent years that has attempted to capture this dynamic and provide a more holistic – and realistic – perspective.

As described in *Behavioral Finance: The Second Generation* (2019), by Meir Statman, PhD, it suggests there are three perspectives, or lenses, through which we view economic decisions: utilitarian, expressive and emotional.

The first, **utilitarian**, lens is akin to the more traditional view that our financial decisions are made in purely practical terms, with a view to maximizing returns while minimizing risk.

The **expressive** lens is one that drives us to invest or spend our money in ways that gives expression to our innermost values.

Finally, the **emotional** lens encapsulates how we feel when we make a particular investment or choice.

The three lenses

Lens	Utilitarian (the "Pragmatic")	Expressive (the "Purposeful")	Emotional (the "Personal")
Focus	Economic outcomes	Values expression	Emotional well-being
Goal	Optimizing risk adjusted returns, achieving financial objectives	Expressing a vision or values through investing, saving or spending choices	Deriving emotional benefit or a sense of personal satisfaction from economic decisions
Sample questions for clients	• What are your financial goals? • When do you plan to take retirement? • What level of risk are you comfortable with?	• What do you want your investments to say about you? • Are there any investments you would like to make but feel they may be out of reach?	• What causes are you most passionate about? • Aside from returns, what would help you derive satisfaction from your investments?

A new way of thinking – continued

In the case of expressive preferences, a client might, for example, wish to invest in emerging technologies like electric vehicles or cryptocurrencies, motivated by a desire to reinforce their status or self-perception as an early adopter. From a more emotional lens, a growing number of Canadians are looking to invest in a way that reflects their views or contributes to solutions on issues such as climate change and social justice. That might manifest itself in a desire to hold environmentally or socially responsible investments.

The three lenses are best viewed as a holistic framework (think "and," not "or"). In this way, advisors can deepen their client engagements while steering clients towards solutions that help deliver the desired trifecta of benefits: performance, values expression and emotional fulfillment. In the case of ESG motivated investors, for example, specialized solutions such as Canada Life Sustainable Portfolios™ exist to balance performance, strength and positive ESG attributes to help investors move toward their financial goals in a socially conscious way.

Paul Orlander, Executive Vice-President, Individual Customer at Canada Life, points out that when using the three lenses as a framework, the thoughtful advisor will seek to understand their individual client's needs and allow them to pursue their economic objectives, while also declaring who they are through their investment choices.

A 2021 Wealth Management Consumer Report from Accenture asked clients what they value most in their advisor interactions. Approximately 91% were looking for advisors who "get them." The data is clear: clients want to be recognized and understood by their investment professionals. Taking a more holistic perspective to client personalities and preferences, in keeping with the three lenses, is one way to do this.

"By using this approach as a framework and prompting them to articulate their needs and preferences across all three lenses, advisors can better meet the unique and complex needs of their clients with solutions whose benefits may extend beyond just the financial aspects of their lives."

Paul Orlander, Executive Vice-President,
Individual Customer, Canada Life

Battling bias

> While these new insights into behaviour provide a much more nuanced view into our financial psyches, they build on a body of existing research that shows how much of an impact emotion can have on financial decisions and the wealth building journey. A recent study showed that those who manage their own portfolios generally have a harder time keeping emotions in check, reporting higher rates of lost sleep and more regrettable decisions than those who rely on a financial advisor.

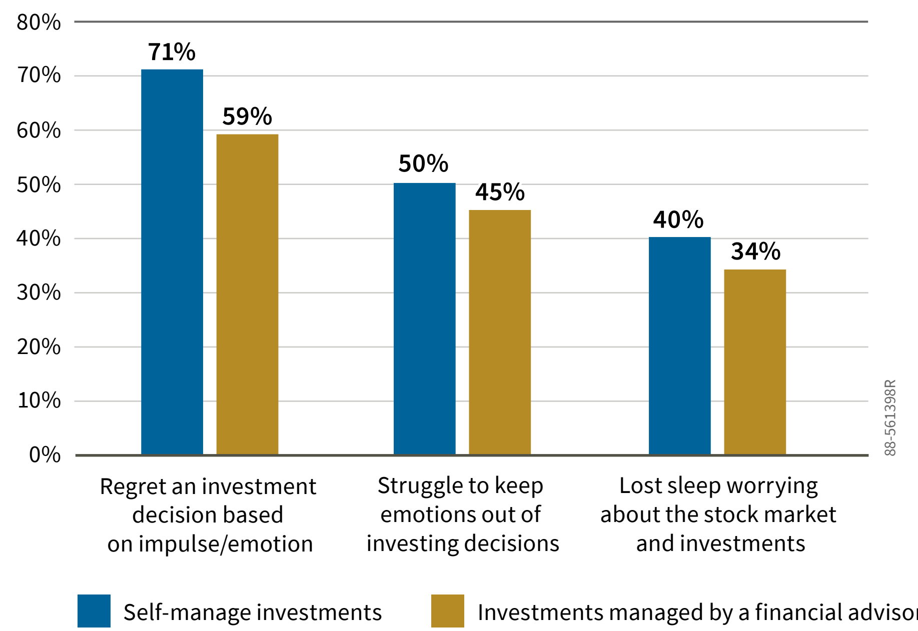
One of the most common investor biases we see is loss aversion, in which investors avoid perfectly appropriate risks, ones needed to achieve their ultimate goals. It is often exacerbated by increased market volatility, so it should come as no surprise that lower discretionary spending due to pandemic lockdowns, coupled with recent market jitters has resulted in Canadians sitting on record amounts of cash and leaving a significant amount of money sitting on the sidelines – about $300 billion according to a recent report in *The Globe and Mail*.

"Looking through the emotional and expressive lenses of investing can lead advisors to find new opportunities for superior investment options for their clients and have more holistic conversations about how money sitting in a savings account may limit their lifestyle in the long run," added Orlander.

Other notable biases like confirmation bias and herd behaviour also appear to be on the rise, as news outlets consolidate and social media giants control more of the flow of information. This can reinforce negative perceptions and create an intellectual echo chamber. Hives are for bees, not minds.

Emotional investing:

How consumers who self-manage their portfolio compare to those who use a financial advisor



Source: MagnifyMoney survey of 668 consumers who self-manage their investments and 352 consumers who use a financial advisor for investment management, conducted June 24-29, 2021.

The best bulwark against bias is you

Consistent, engaged and trusted advice is critical to help investors stay disciplined and achieve their goals. A recent report by Russell Investments found that in 2022, the typical advisor in Canada is worth approximately 3.85% to annual returns, meaning investors who rely on sound outside counsel should, on average, outperform those who go it alone by nearly four percent annually. Even more notably, half of this difference was attributed to behavioural coaching.

The best bulwark against bias is you – continued

Here are some tips on how to incorporate the three lenses into client discussions, as well as some potential approaches to consider when building portfolios that aim to deliver on multiple dimensions:

- ✓ **Stay attuned to your clients' personalities and values, not just their financial goals.** How do they view themselves? Whom do they aspire to be? Ask questions such as "What causes do you most care about?" or "How do you want to feel about your investment portfolio?" Targeted portfolio solutions such as ESG funds can then be used to align the client's values and objectives.

- ✓ **The best defense is a good offense.** From the outset, develop a financial plan that is properly diversified and anticipates the inevitable corrections that are a normal part of healthy and functioning markets.

- ✓ **Help clients understand their true risk level,** the relationship between short-term fluctuations and long-term returns, and the difference between volatility and risk.

- ✓ **Shifting market conditions and outlooks can increase your clients' concerns** and they may be tempted to make emotional decisions that might not be the best for their financial plan. A solution like Canada Life Risk-Managed Portfolios™ can provide your clients with a single fund solution that brings together risk management strategies and traditional and non-traditional investments. These portfolios are specifically designed to help Canadians protect and grow their hard-earned savings by helping guard against volatility while still allowing them to participate in the markets.

- ✓ **Managed solutions are run by industry-leading professional money managers** who leverage their deep research and insights, use sophisticated portfolio construction techniques and risk mitigation strategies to help deliver better outcomes. These expert managers can help you with the day-to-day details, including building, monitoring and rebalancing portfolios.

- ✓ **Clients are typically more inclined to speak in terms of objectives,** like paying for college, retirement or leaving a financial legacy, rather than in terms of risk-adjusted returns or volatility. These kinds of client-denominated metrics lend themselves to a goals-based investing framework. Goals-based investing lets clients apply different risk tolerance and time horizons to each goal and customize the investment mix to meet their individual needs. This becomes even more important in volatile markets because it focuses clients on goal tracking rather than short-term market fluctuations.

"Advisors who apply the latest behavioural finance insights in their practices provide a differentiated and enhanced client experience – one that balances valuations with values, and earnings with expression. With an attentive approach and a modern array of purpose-built investment strategies and tools, advisors can build multi-dimensional plans and portfolios that are designed to meet their clients' financial expressive and emotional needs all at once."

Paul Orlander, Executive Vice-President, Individual Customer, Canada Life

After *High Anxiety* premiered, Alfred Hitchcock sent Brooks a case of fine wine with a note saying it should "give you no anxieties of any kind." While a stress-free existence may seem like wishful thinking right now, advisors who incorporate some of these approaches and tools can indeed help clients face the challenges ahead while keeping them from joining the ranks of the Very, Very Nervous.

We know your clients' financial goals are as unique as they are

We offer a spectrum of high calibre managed solutions, including Canada Life Risk-Managed Portfolios and Canada Life Sustainable Portfolios, which are designed to provide your clients with a smoother investment experience that's tailored to their unique needs. Managed solutions not only help your clients reach their potential – they also help you reach yours. Each solution helps you apply a disciplined and consistent approach to managing client portfolios and gives you a simple, repeatable and scalable way to carry out your responsibilities, serve your clients and keep their portfolios on track, even in volatile markets.

To learn more about Canada Life's wealth offering including our suite of managed solutions, contact your Canada Life wealth wholesaler today.

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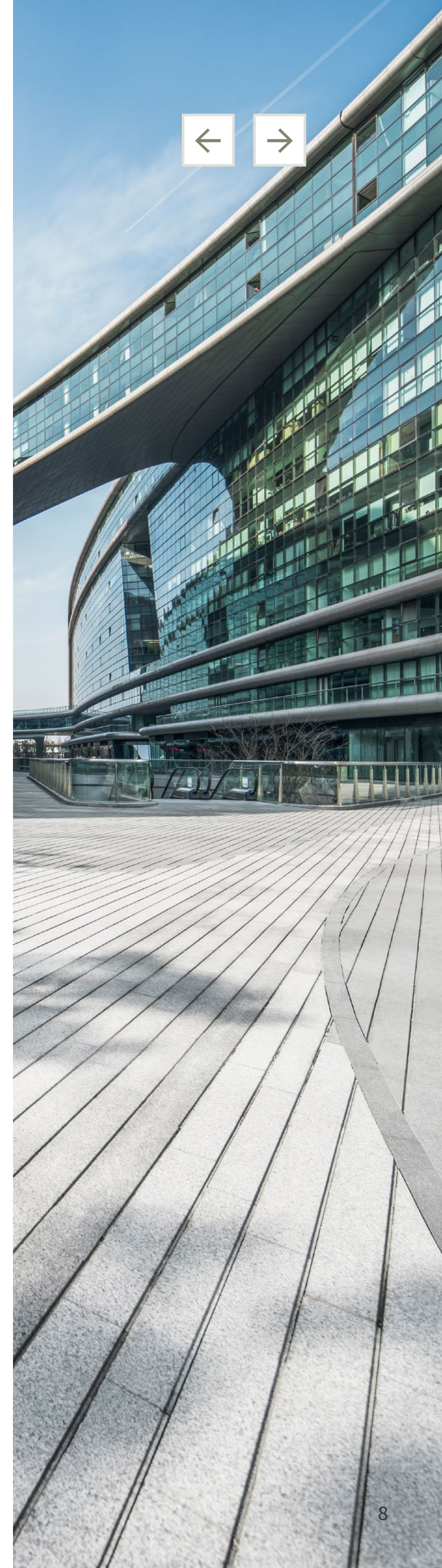

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