THE IMPACT OF BEHAVIORAL FINANCE ON THE PSYCHOLOGY OF INVESTING

HOW FINANCIAL PROFESSIONALS CAN HELP INFLUENCE THEIR CLIENTS' FINANCIAL WELLNESS

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WHAT IS FINANCIAL WELLNESS?

Whether celebrating wealth or calculating debt, money is powerful. Depending on individual circumstances and level of financial wellness, having money can be a source of enormous comfort while inadequate finances can derail future plans, threaten personal relationships, and impair one's overall enjoyment of life.

Financial wellness means having financial security and financial freedom of choice both today and in the future. Financial wellness influences decision-making in every season of life. It represents a state of being in which you:

- Have control over day-to-day, month-to-month finances
- Have the capacity to absorb a financial shock
- Are on track to meet your financial goals
- Have the financial freedom to make choices that allow you to enjoy life

Much more needs to be done to make Americans retirement ready. Over time, bad habits can be changed and valuable lessons about money management can be learned. Financial professionals who adopt the principles of behavioral finance will be best prepared to lead clients through this transformation.

WHY BEHAVIORAL FINANCE MATTERS

Behavioral finance is much more than a trendy topic. It represents a seismic shift in the ways financial professionals engage and understand their clients, and it will form the foundation of our industry's value proposition in the years ahead. It prioritizes client relationships over products.

Legitimized by Nobel Prize winner Richard Thaler, behavioral finance, a subset of behavioral economics, maintains psychological influences and biases affect the financial behaviors of consumers.

Since ideas regarding money and finances start very early in life, they can be difficult to change.

Responding to this universal challenge, holistic best practices have taken root within the financial services industry to initiate conversations that can help clients better manage their income and assets.

Financial professionals can profile their clients' mindset about money by asking some thoughtful, open-ended questions. Observing and effectively addressing the likely emotional reactions of clients creates an opportunity for a financial professional to build closer personal connections with clients. By knowing more about clients' attitudes, biases, and preconceptions about money, financial professionals can positively influence savings habits and deliver truly comprehensive retirement planning.

Along with these insights, financial professionals can leverage their understanding of behavioral finance fundamentals to improve attitudes and practices to help clients achieve the financial future they, and their family, deserve.

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MONEY MINDSET: A LIFELONG JOURNEY

The impact of personal finance is felt throughout life. Some of our earliest childhood memories relate to money: at a young age, most quickly appreciate the power of money but remain undereducated regarding the smartest ways to earn, spend, save, and invest. What appears extremely familiar to financial professionals, even intuitive, often seems quite alien to your clients and consumers in general. Simple examples include:

- Understanding how compound interest works
- Being aware of inflation's influence on buying power
- Knowing the advantages of homeownership over renting
- Describing the difference between stocks and mutual funds
- Appreciating why whole life insurance costs more than term life

Lacking the fundamental money basics, people cultivate **personal beliefs regarding finances** that are heavily influenced by parental modeling and reinforced by others' behaviors, mass media, and advertising. Such personal beliefs are self-validated by their own habits, attitudes, assumptions, and life experiences. Additionally, the adverse economic impact caused by major events over the past two decades (the current inflationary environment resulting from COVID-19, 9/11, the 2008 financial crisis) play a huge role in how people view money and investing.

A majority of Americans say the rising cost of goods is driving their stress. Additionally, roughly 40% say that a financially secure retirement is "going to take a miracle."[1] Whether it's saving for retirement or deciding how to pay for college, financial stress is impactful across generations.

Fortunately, you as a financial professional can provide the knowledge, expertise, access to resources, and necessary guidance for individuals and couples as they plan for a rewarding, dignified, and financially secure retirement. Today, an appreciation for the valuable concepts that emerged from behavioral finance research appear everywhere in the financial services industry. The relationship between financial professional and client has been reframed to emphasize people over product.

THE IMPORTANCE OF BEHAVIORAL COACHING

Many successful financial professionals recognize *behavioral coaching* is a critical part of the client relationship; it is essentially the foundation of a client's financial plan. Many financial professionals agree coaching should represent a significant portion of time spent with clients. Coaching involves more than sharing knowledge — it extends to actions and skills. Clients need to take what they know and put it into practice. One example: people already **know** they need to save more, and they'd prefer to save more, but they may lack the necessary willpower to reject the immediate temptation to spend.

Beyond knowledge, coaching must identify other influences that impair financial wellness (some even stronger than financial knowledge) when determining behavior. And this is where behavioral finance takes center stage in helping you guide your clients.

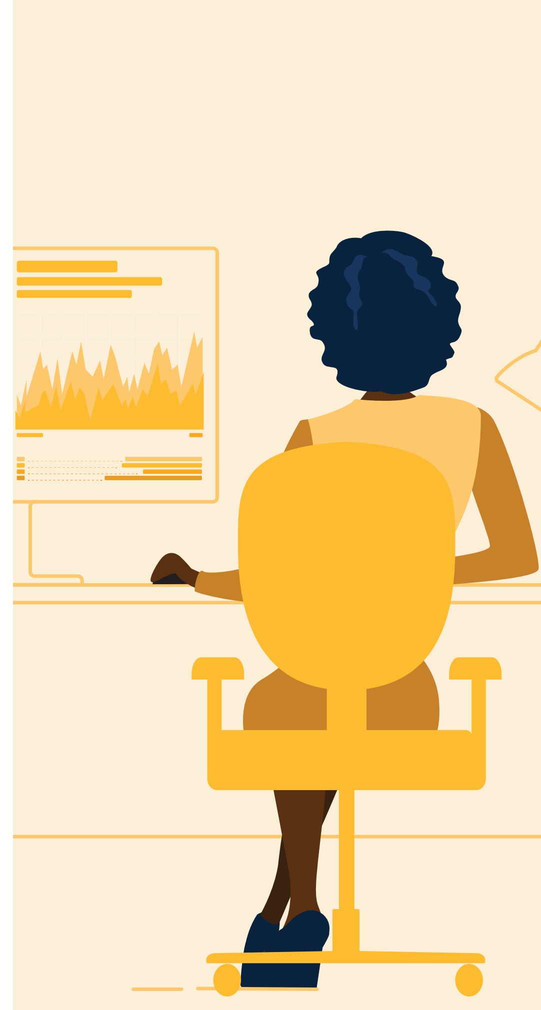
[1] "Americans Are More Stressed About Money Than Ever, And It's Hurting Our Mental Health," CNBC, May 2022

THE FOUR KEY FACTORS IMPACTING FINANCIAL WELLNESS

Healthy living and financial wellness are all about balance. In 2018, Sarah Newcomb, Behavioral Economist with Morningstar, identified four key factors that influence that balance, for better or worse, when it involves financial habits and behaviors:[2]

1. **Future concept:** creating a vision for financial wellness
2. **Impulsiveness:** inability to tolerate the "pain" of waiting
3. **Materialism:** possessions and comfort dominate decision-making
4. **Financial literacy:** knowing how to manage personal finances

These key factors are critical for financial professionals to understand. It will allow them to better understand the triggers and habits they will need to help coach clients through in order to pursue the best outcome for their financial plan and to achieve financial wellness.



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1 FUTURE CONCEPT

Future concept is all about leveling the playing field between future and present state.

For most, thinking about the here and now is easy compared to thinking about tomorrow. People appreciate and experience the current reality because everything is happening right now. They are able to justify hasty decisions about "today" because they believe they have all of the necessary information to process a wise spending decision. Compare that mindset to thinking about the future — a vague and uncertain concept with few clear insights and fewer rewards that motivate and incentivize today's consumer.

Future concept helps individuals appreciate a clearer understanding of their future self. Here's how future concept works: shortening the chronological distance between your present self and your future self can make the future feel more real and important, often resulting in more rational financial behavior.

An example of future concept thinking

Some couples, for example, unknowingly apply future concept when planning for a vacation scheduled 6–12 months down the road: *"There's no need to replace this noisy lawnmower. It still works great. We're saving for our big trip to Hawaii!"* If a couple can see into the future and make it real, they can withstand current spending temptations.

Behavioral psychology research repeatedly shows how future concept is consistently more powerful than the everyday noise of the present. Visualizing the specifics about a nicer home or, perhaps, a child's debt-free college education can be powerful drivers that help resist the temptations to spend and, instead, nurture the decisions to save.

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[2] "Stop Teaching, Start Coaching," Morningstar Magazine, April/May 2018

2 IMPULSIVENESS

The next key factor is impulsiveness: the inability to tolerate the "pain" of waiting, leading to undisciplined spending behavior.

Impulsiveness, as a personality trait, is just the opposite of future concept.

Science shows how patient and impatient people experience time differently.

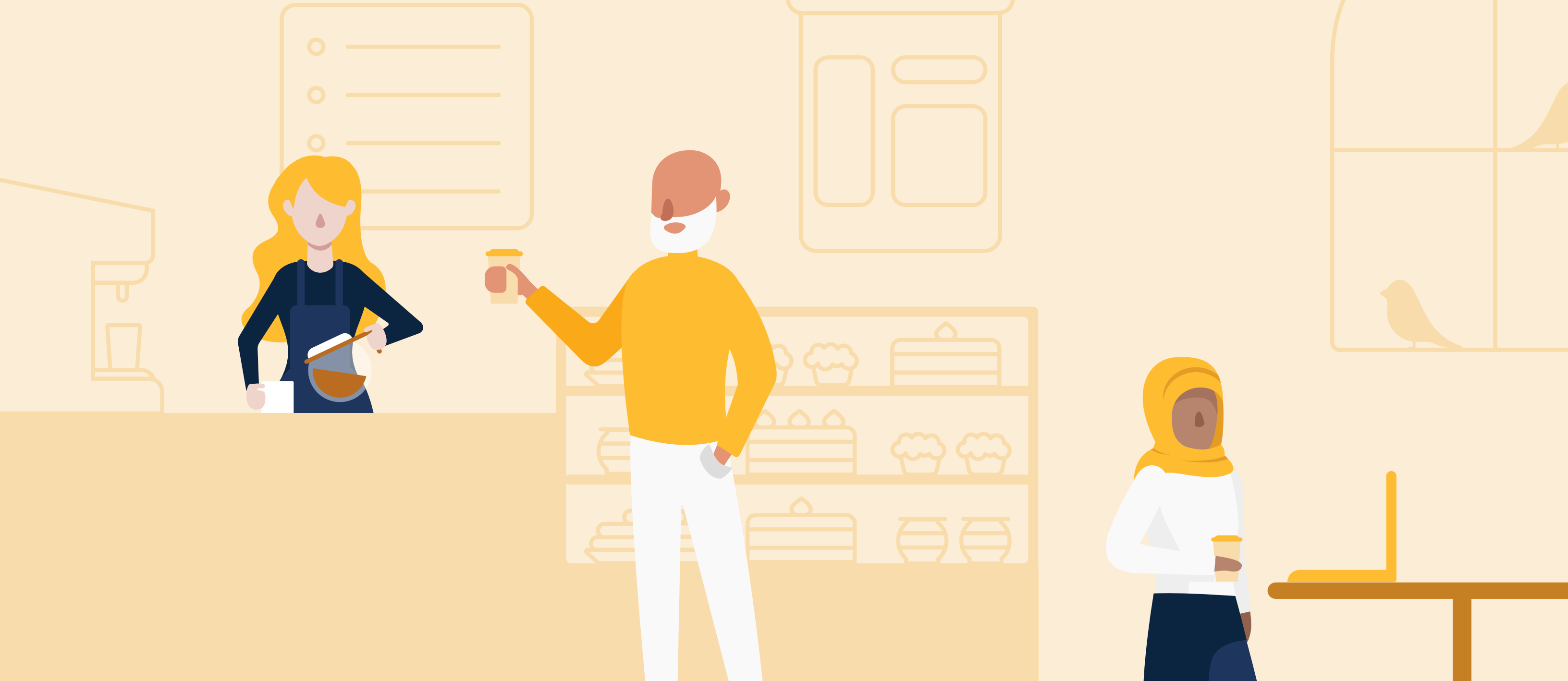
Time delays feel longer to impatient people, and that "cost of waiting" increases the calculated total cost of whatever purchase is being considered. This helps explain why impulsive people discount the future when it comes to financial planning.

Besides the pain of waiting, there's a far more primal discomfort that leads spenders further astray: people simply do not like to pay for things. The act of paying separates consumers from their money. Credit card companies discovered this sensitivity long ago. What credit card issuers promote as convenience is actually anesthesia. Credit cards numb the pain of paying by aggregating all monthly spending into one single agnostic number chronologically detached from the actual spending, so there's no emotional attachment ... and no pain.

The automation of paying takes the "tangibility" out of the equation.

The rapid evolution of digital technology has created a new and even more perplexing dynamic to undisciplined spending behaviors. Online wallets and smartphone apps have further streamlined the spending process so that it is both *pain-free* and *brain-free*. Now consumers can sidestep that pesky conversation with themselves (or their partner) as to whether or not a purchase should be made. Even your car is painlessly spending your money with automated toll pay devices such as E-Z Pass.

Why is this important? The pain of paying serves to help spenders master self-control. Restricting discretionary spending to a cash budget installs safety rails that may protect some impulsive spenders. Behavioral hacks like *psychological distance* and *mental imagery* help individuals focus more clearly on the future. They can be applied to combat impulsiveness and fortify savings habits.



3 MATERIALISM

The next key factor influencing a person's financial behaviors is materialism. It's what puts the "must" in "must-have".

We all have encountered those who frequently shop as a form of recreation. Many consumers satisfy their emotional needs through "retail therapy," including the elimination of boredom, achieving satisfying conquests with great deals, and the provision of self-comfort during blue periods. Psychologists and economists agree our brains categorize our possessions as an extension of self, so everything we buy becomes part of how we feel. A materialistic personality replaces feelings with things. Purchases can temporarily fill a gap in our identity, but the lost money (and corresponding lost savings opportunity) is permanent.

The marriage between impulsiveness and materialism

The oft-cited marshmallow experiments conducted at Stanford University in the 1970s successfully highlighted the impact of impulsive behavior and materialism. In the experiments, children were offered a single marshmallow now or two if they chose to wait a predetermined amount of time. In a 1990 follow-up study, it was determined that the children who chose to delay gratification were decidedly more successful than those who were impulsive, according to their parents.

There are many examples like this one, and financial professionals need to understand how materialism and instant or delayed gratification plays into their overall approach when coaching clients and setting up their plan for the future.

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[3] "Predicting Adolescent Cognitive and Self-Regulatory Competencies From Preschool Delay of Gratification: Identifying Diagnostic Conditions," American Psychological Association, 1990

4 FINANCIAL LITERACY

The final key piece is a person's actual financial literacy.

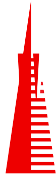
Financial literacy is defined as one's knowledge about financial concepts, including familiar topics like interest rates and inflation. In addition to a knowledge component, financial literacy has an action component — that is, the ability or skills to put financial knowledge to use. In more practical terms, financial literacy is knowing how to manage your money, how to pay your bills, how to borrow and save money responsibly, and how and why to invest and plan for retirement.

Financial knowledge is helpful; however, it isn't enough on its own. Studies have revealed how those first three pillars (future concept, impulsiveness, and materialism) yield far greater relative impact on behaviors, positive or negative, than financial literacy. Whereas impulsiveness and materialism degrade financial wellness, combining future concept with financial literacy orients adults in the right direction, and financial coaching paves that road to financial wellness.

SUMMARY

Strip everything away, and the central premise behind behavioral finance is getting people to behave more rationally regarding their money, beginning with saving more and spending less. Without a future concept, and without financial literacy or effective coaching, many individuals are isolated with their own attitudes and cannot improve an economic situation fueled by their impulsive spending habits.

Remember, when confronting an enormous challenge such as this, enduring change is best achieved through small, incremental steps. It is unrealistic to expect a rapid, total transformation after some financial coaching from you as the financial professional. It's a process that takes time. Reprogramming one's financial mindset requires time and patience, but it can be accomplished and will ultimately lead to a better financial outlook for your client.



When preparing for your client's future, there's no time like the present.

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