John Hancock Investment Management

What were they thinking?: using behavioral finance concepts to help understand and moderate client behavior

Presenter’s name
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A company of Manulife Investment Management

FOR FINANCIAL PROFESSIONALS

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Today's objectives

1	Learn how your decision-making brain works
2	Understand how stress can lead to investment mistakes
3	Recognize and avoid common mistakes

$100 auction

The rules of the game

- Silence is in effect
- This is **REAL** money
- The first bid must be $5, and bids go up in $5 increments
- You can't bid twice in a row
- The highest bidder gets the $100 for his or her bid
- The second-highest bidder pays his or her bid, and gets nothing in return

What just happened?

Felt overconfident

Got excited

Didn't want to lose

Wanted to win at any cost

Lost judgment/didn't plan

Welcome to the real-world implications of behavioral finance!

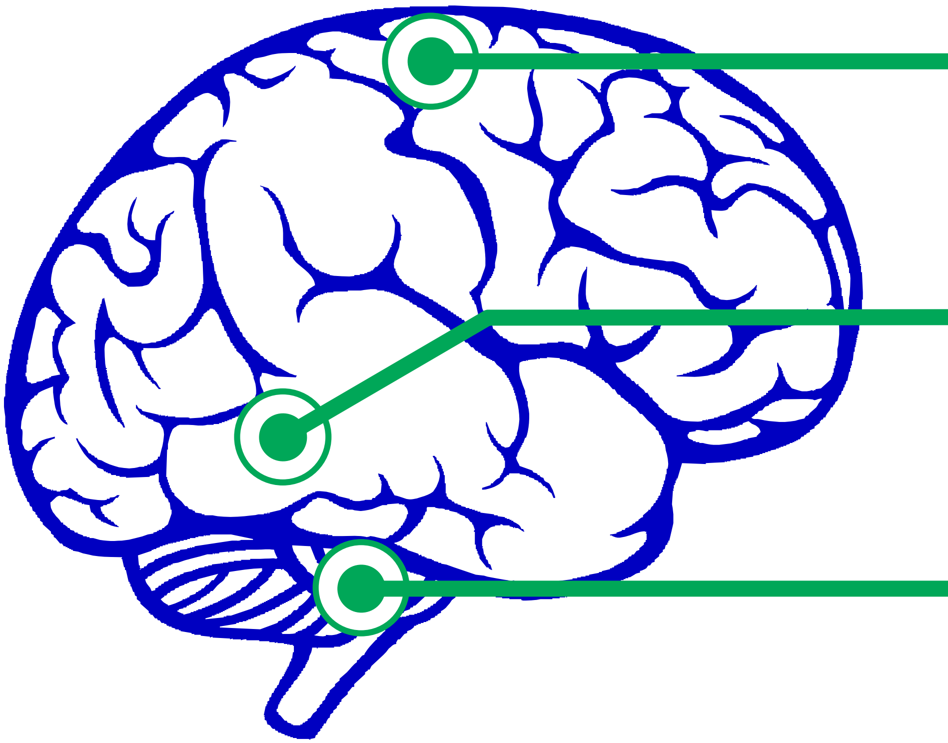
Agenda

What were they thinking?

- The brain, dissected
- Human biases
- Tips and techniques to integrate behavioral finance into your practice

Triune model of the brain

Three brains in one



Neocortex	**Higher** reasoning and language
Limbic system	**Instinct** feelings and emotions
Reptilian complex	**Survival** breathing, heartbeat, etc.

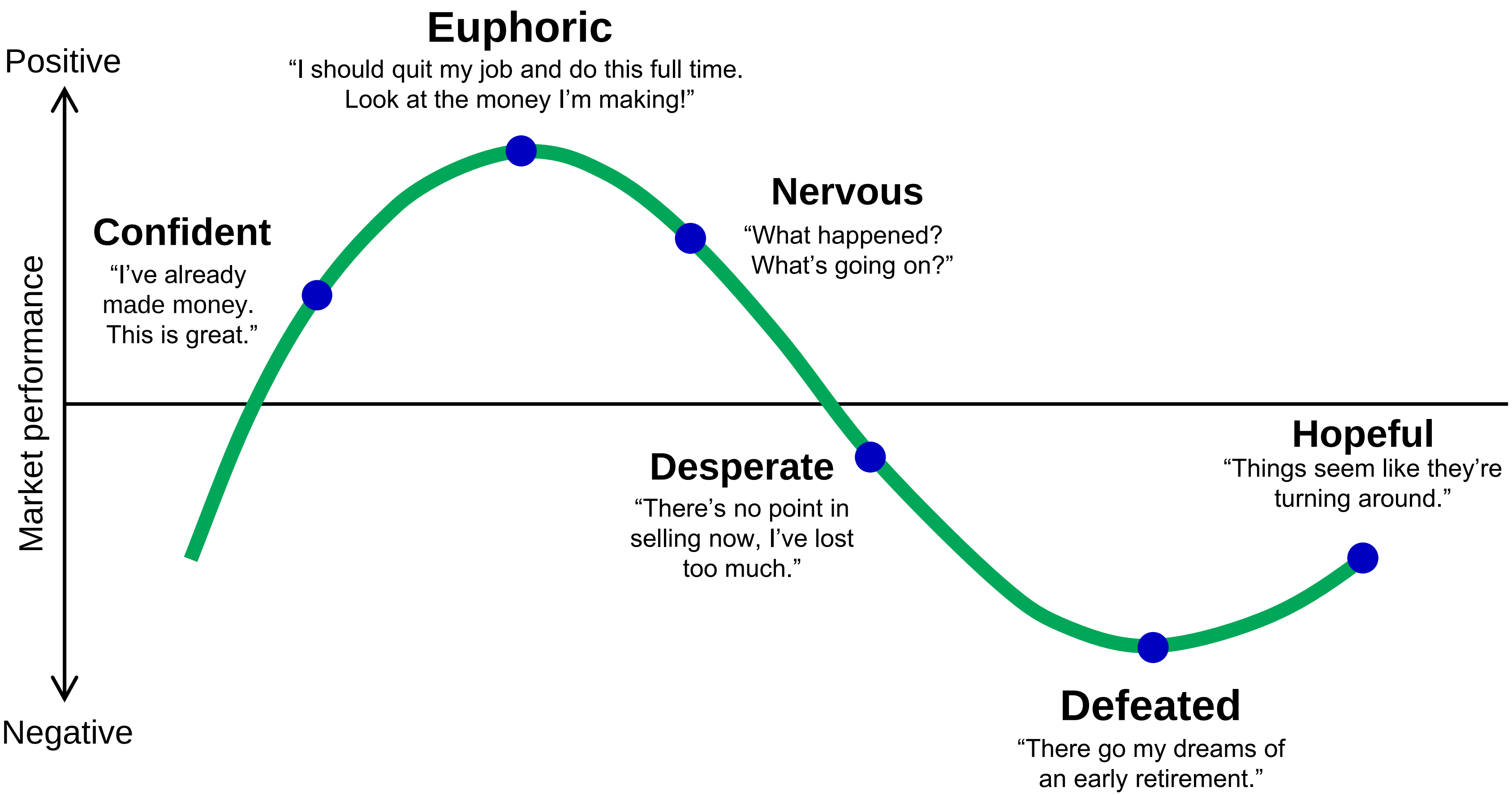
How the brain works

- In a stressful situation, the brain shuts down blood flow to the neocortex
- You really are dumber
- It takes hours to regain reasoning ability in the brain

What happened in 2008 to your clients?

Emotional roller coaster of investing

*When is your **best** opportunity to make money?*



Source: John Hancock Investment Management.
This hypothetical scenario is for illustration purposes only and is not a prediction of future market conditions.

What are heuristics?

Heuristics are rules of thumb or snap judgments that let us process a lot of information quickly

Getting dressed: 5 jackets, 10 pairs of pants, 20 ties, 10 shirts, 10 pairs of socks, 4 pairs of shoes, and 5 belts = **2,000,000 possible outfits!**

Take 1 second to evaluate each outfit, and it would take **23 days** to get dressed

Cognitive bias vs. Emotional bias

Individuals learn and adapt

The example is from "The Adaptive Markets Hypothesis in Theory and Practice," Dr. Andrew W. Lo, MIT, 2009.

Loss aversion

Emotional bias

People's tendency to
strongly prefer avoiding losses
to acquiring gains

- The psychological impact of a loss can be twice as powerful as the impact of a gain
- Leads to poor investment choices

2008, 2009, anyone?

What you've probably said to clients

The rational approach to moving money off the sidelines from a loss-averse client

"Mr./Ms. Investor, right now your money is earning 0.2% in a checking account and 0.4% in a money market account.

After inflation, you're losing 2% each year. We need to take some of that surplus cash and put it to work for your long-term goals.

Over the long term, stocks have historically outperformed other investments."

Sound familiar?

Frame your ideas differently

The way information is presented (framing) is powerful!

"Mr./Ms. Investor, we had a bad scare in the markets in 2008. Like many investors, you sought safety before profit, and moved to cash. Having a larger emergency fund brought you a lot of comfort the past few years, and that's important. But looking back, if your children were in your circumstances, with the same market conditions, what advice would you give them?"

"Mr./Ms. Investor, you're 50 years old, and you told me you still need to save for retirement. Which would you rather do, take 20% of your funds today and invest it for your long-term, 10-year time horizon, or postpone your retirement and work an extra 5 years?"

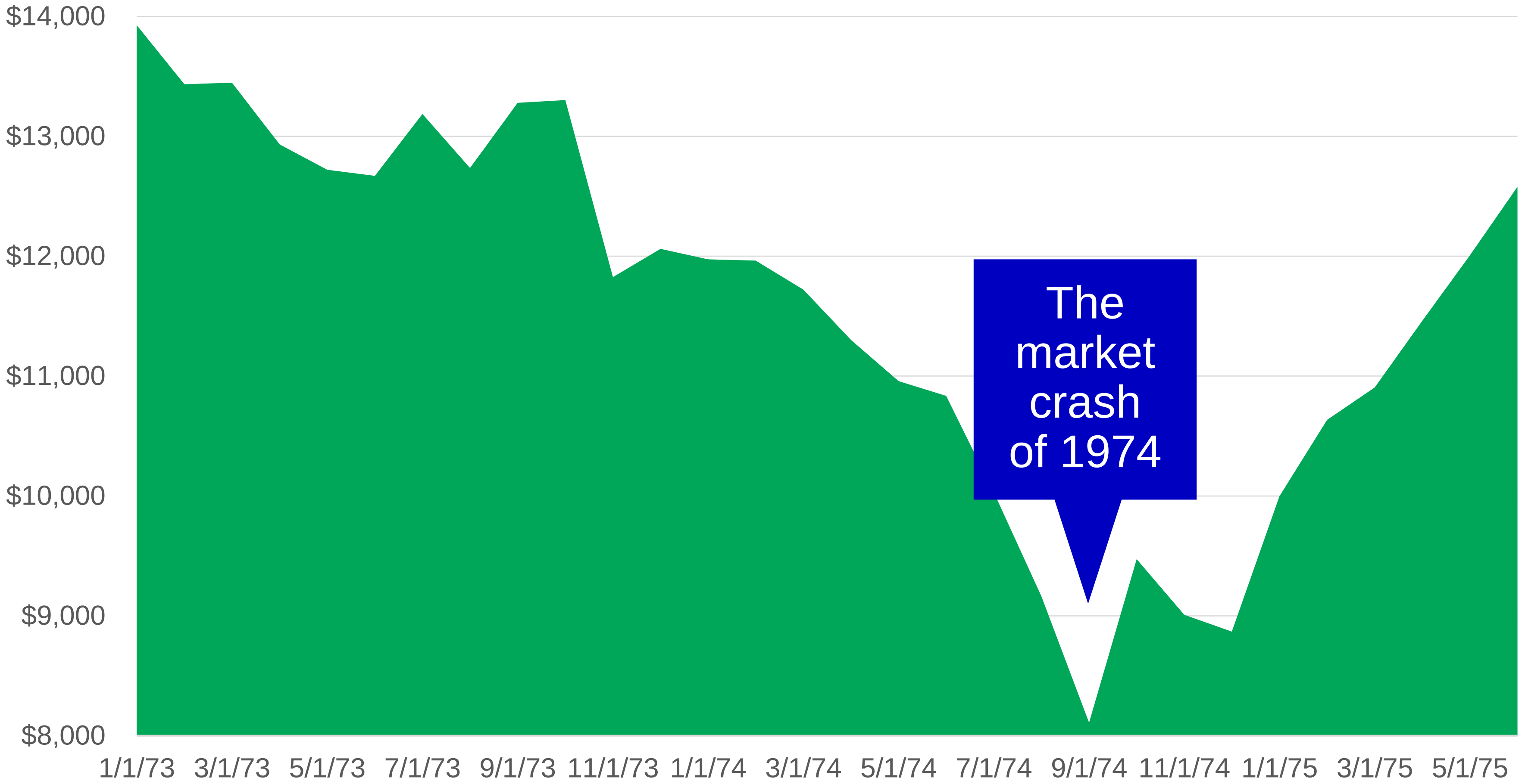
Anchoring

Anchoring is how well you can concentrate and focus

There's a common human tendency to rely too heavily, or anchor, on one trait or piece of information when making decisions

Change your clients' anchors

S&P 500 Index, 1973–1975



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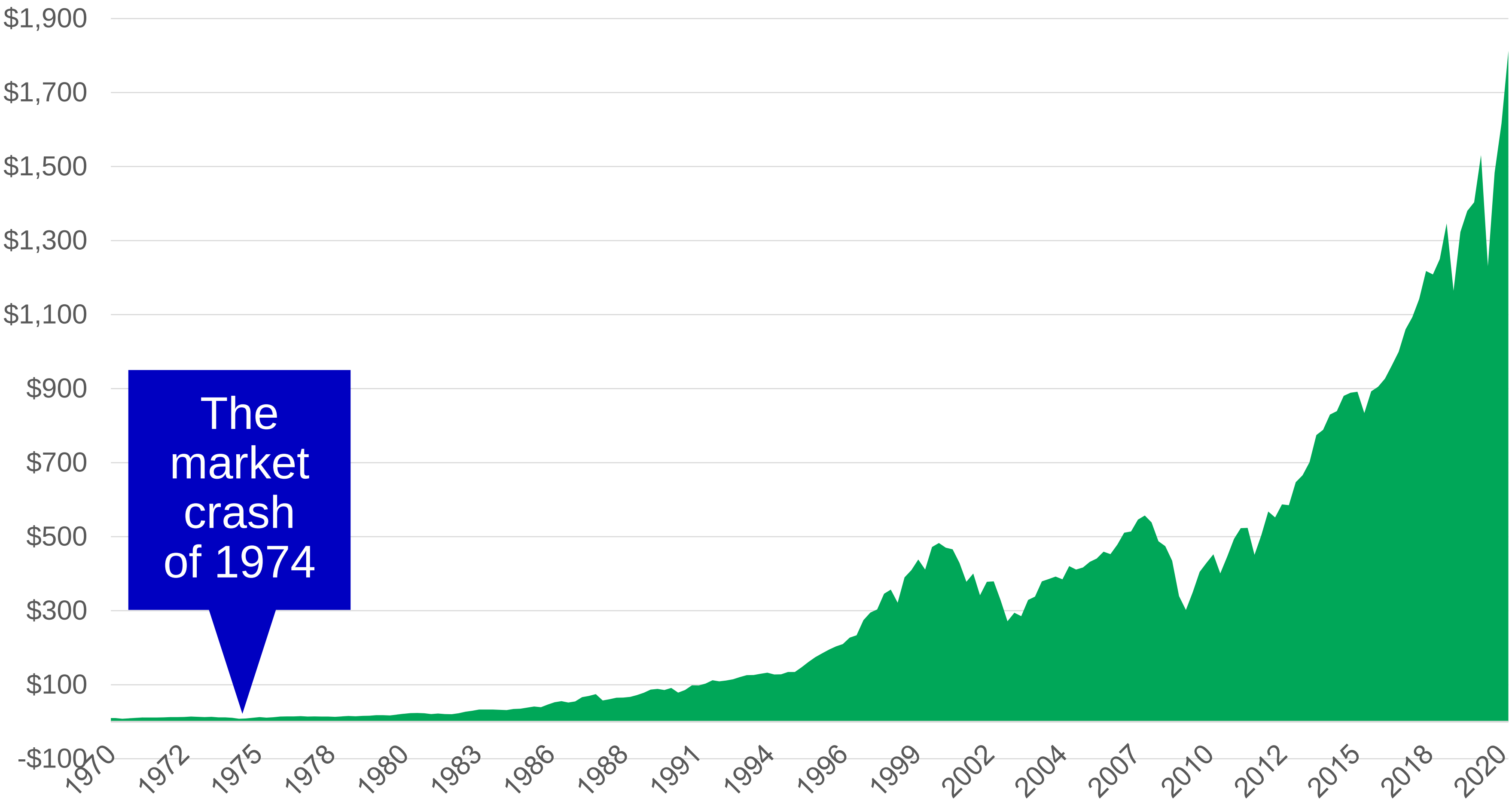
Source: Lipper, 12/31/72–6/30/75. The S&P 500 Index tracks the performance of 500 of the largest publicly traded companies in the United States. It is not possible to invest directly in an index. Past performance does not guarantee future results.

Change your anchors

S&P 500 Index, 1970–2020



Source: John Hancock Investment Management, 2020. The S&P 500 Index tracks the performance of 500 of the largest publicly traded companies in the United States. It is not possible to invest directly in an index. Past performance does not guarantee future results.

What you've probably said

The rational approach to "I lost money in 2008, but I'm almost back to even; should I get out now?"

"Mr./Ms. Investor, historically we've seen that the market moves in cycles, and if you get out now, you may lose out on more potential upside.

You also won't need the money for XX years, and stocks have historically outperformed every other asset class."

Sound familiar?

What you can say instead

Behavioral finance approaches

"Mr./Ms. Investor, our goal isn't to break even; it's to allow you to maintain your lifestyle and enjoy your retirement. You're right on track with our saving and investing plan for your retirement, but we aren't finished. You want to retire in 10 years, but you'll probably live at least 20 or 25 years **in** retirement. Given your 30-year time horizon, your best potential is to stay invested. I think we should continue saving and investing as we have been."

"Mr./Ms. Investor, of course you can take some money out. If you have a tuition bill or a specific need, now might be a good time to raise cash so you can feel secure for your family. But unless you want to radically change your plans for retirement, we need to continue with the plan that we developed to invest and save."

Status quo bias

Cognitive bias

People tend not to change an established behavior unless the **incentive to change** is compelling

- It's easier to do nothing
- Creatures of routine

Your clients' initial portfolio allocation is tremendously important, as it has enduring impact

Procrastination

Emotional bias

- Positive bias toward the present
- Anxiety when starting a complex task
- People want to relax today and invest (or do anything) next week

Fruit or chocolate?

The paradox of choice

Why can't people make decisions?

- Offer a wide range of choices **to attract new clients to your practice**
- Offer fewer choices to make people feel more comfortable with their decision
- When presented with too many options in the market, investors can become overwhelmed by choice overload[1]

Paralysis by analysis

1 "Choice Overload in Investing: Is More Really Better?" morningstar.com/blog, 12/15/17.

"Barn door closing"

Emotional bias

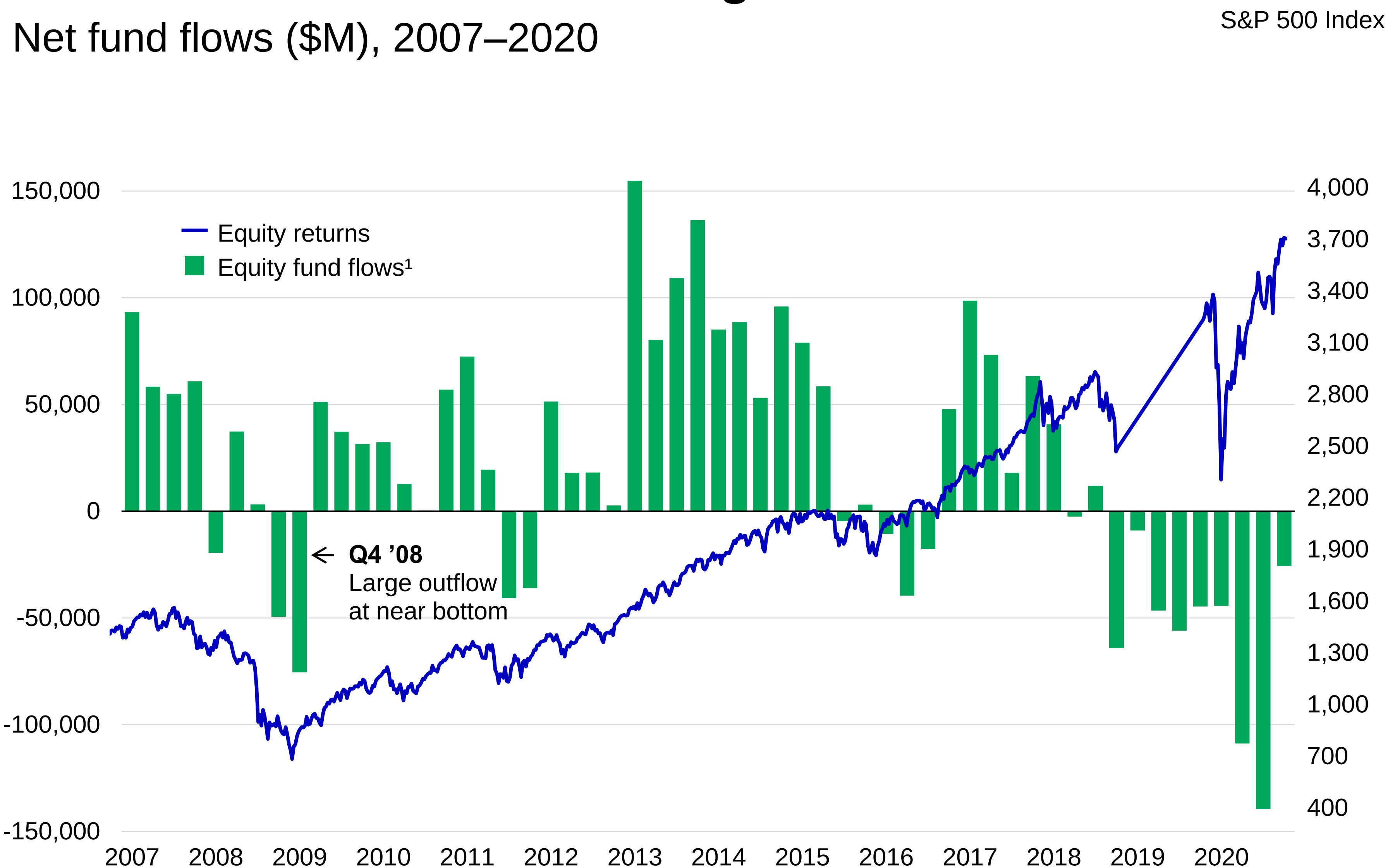
Hindsight—locking the barn door after the horse has run away

- Taking action after it's too late
- The mortgage meltdown, banks tightening credit
- Past performance does not guarantee future results

It's why people start to eat right and exercise after a health scare

The cost of emotional investing—stocks

Net fund flows ($M), 2007–2020



Source: Morningstar, Ibbotson as of 12/31/20. The S&P 500 Index tracks the performance of 500 of the largest publicly traded companies in the United States. It is not possible to invest directly in an index. Past performance does not guarantee future results.

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1 Comprises U.S. equity, sector equity, international equity, and hybrid mutual funds and ETFs.

Eliminating the hindsight bias

Have clients write a letter to themselves

"My financial professional and I have established a long-term plan. Sometime in the future, the market will correct to the point where I feel uncomfortable staying invested. I may feel scared and ask my advisor to get me out of the market.

But I know that my plan is sound and, if anything, now may be a good time to invest more. My long-term goals haven't changed, and I'm committed to sticking to my long-term plan."

Consistency counts

- **Write** an investment policy statement
- **Establish** a communication plan for a crisis when your client isn't in a crisis
- **Require** dollar cost averaging[1] from clients, even high net worth
- **Tell** clients that their portfolios will go down at times
- **Make** inertia work for you. Make client appointments regularly scheduled events, six months in advance (they'd have to overcome status quo bias to cancel!)
- **Work** with diversified investment managers that don't follow one consensus view

1 Dollar cost averaging does not assure a profit or protect against loss in a declining market. Such a plan involves continuous investment in securities regardless of fluctuating price levels. Investors should consider their financial ability to continue purchases through periods of low prices. Most investments generally fluctuate according to market conditions.
Past performance does not guarantee future results.
Diversification does not guarantee a profit or eliminate the risk of a loss.

We learned

1. Clients aren't rational, they're normal
2. The brain becomes emotional in times of crisis
3. Having a plan helps people
4. Advisors are human, too
5. New communication skills are needed to move forward

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"A trusted brand," is based on a survey of 6,651 respondents conducted by Medallia between 3/18/20 and 5/13/20.

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