



## **Behavioral Finance – A Three-Part Model for Client Relationships**

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Behavioral finance can deepen your client relationships during market turmoil, if you recognize your clients' emotional right-brained reactions before you offer insights based on your analytical left-brained analysis. By applying a three-pronged process of Recognize-Reflect-Respond, you can adapt to new information in a thoughtful and effective framework.

Gayle H. Buff, president of Buff Capital Management, proposed this model in "Behavioral Finance: So What?" her June 15 presentation to the Boston Security Analysts Society (BSAS). Buff has 20 years of experience working with individual investors and is a past president of the BSAS. As a member of the CFA Institute's Speaker Retainer Program, she has spoken about behavioral finance to CFA societies around the world.

Buff explained the elements of her Recognize-Reflect-Respond approach and said the best advisors develop instincts to integrate seamlessly the three Rs as they interact with their clients. It's like driving a car with a standard shift. "You have to touch the gas at the same time as you're letting up on the clutch. Someone can't tell you the right amount of gas or the right amount of clutch. It's a matter of practice, getting the right balance," said Buff.

### **Part one: Recognize how brains– both yours and your clients'– work**

Nobody consistently acts with complete rationality or a perfect balance between their left and right brains. Relationships between financial advisors and their clients have similar limitations. Conflicts between emotions and rational thinking can lead to bad investment decisions, when we react only with our emotional right brain and do not incorporate input from our rational, reflective left brain. On the other hand, ignoring client emotions may damage the advisor-client relationship, resulting in clients' losing trust in the advisor and failing to implement their plans.

Buff described how left and right brains differ through an analysis of our ability to multi-task:



### “Why Can’t I Multi-Task?”

Left Brain	Right Brain
Task-oriented	Distracted
Goal-directed	Loss of focus
Detail-oriented	Big picture
Limited perspective	Richness of experience

To make the best decisions, we need to use both sides of our brains, said Buff. She demonstrated this using a classic experiment, by asking her audience to count how many times the white team passed the ball in a video clip. (You can view a [similar video clip](#) on YouTube). Left-brain-dominant members of the audience focused on counting the passes. As a result, they– including this reporter– totally missed the gorilla that passed through the group.

Viewers who saw the gorilla used their right brain more effectively, because it employs parallel processing rather than serial processing. “Parallel processing is the ability of the brain to process simultaneously incoming stimuli... and allow for quick and decisive action,” said Buff.

On the other hand, excessively right-brained individuals are so distracted by the gorilla in the experiment that they lose count. “Don’t let the gorilla distract you,” Buff said. “It’s enough to ‘register’ that it is there and then to return to the original task.”

Advisors should recognize how they process the financial world’s “gorillas” – the disruptive challenges that require processing by both sides of our brains, said Buff. If that’s difficult for advisors, it’s even more challenging for clients whose portfolios are threatened by metaphorical gorillas, such as short-term market volatility.

#### **Part two: Reflect upon your clients’ right-brained reactions**

Clients tend to revert instinctively to defensive behaviors when their emotions are triggered and they feel threatened. Defensiveness impairs their ability to process and adapt to new information, which is the key goal of the Recognize-Reflect-Respond model. Everyone reacts differently to new and disturbing information, but behavioral finance helps you identify some common tendencies. Understanding clients’ emotional reactions– and your own– will help you to respond effectively.

Those reactions are driven by common phenomena that reflect the influence of the right brain, and include loss aversion, uncertainty aversion, and overconfidence.



- Loss aversion means that investors fear losing money so much that they'll hold a stock even when there are good reasons to sell. They feel better because, strictly speaking, they don't realize a loss.
- Uncertainty aversion also drives behavior. Investors may sell stocks to avoid experiencing the anxiety they feel in the face of market volatility or dramatic declines.
- Overconfidence makes investors ignore information that doesn't confirm their beliefs and biases.

These are a few of the most important investor tendencies that behavioral finance has identified.

### **Part three: Respond to your clients' left-brained emotions**

It isn't enough to identify your clients' right-brained reactions. You've got to acknowledge their emotions, so they can move beyond them.

For example, during the past year's financial crisis, Buff observed many instances where fear of uncertainty trumped fear of loss. Some of her clients wanted to sell their investments—including securities well-positioned to bounce back over the next couple years. Behavioral finance helped Buff respond effectively to those clients. First, she recognized that those clients' sell requests were intensely emotional. Many of them were struggling with uncertainty aversion, unable to tolerate the markets' volatility.

"I don't take it personally or as them telling me I've done something bad," she said. Instead of arguing with them, Buff listened to her clients' fears. If a client said, "I've got to get out of the market now," Buff probed to learn why. If the client admitted, "I'm afraid I might lose all my money," they typically became less defensive and more open to Buff's advice.

The concept of defensiveness is important to behavioral finance and comes from biology. Like an animal reacting to a predator, a client in the throes of uncertainty aversion can't be distracted from the perceived threat. Different individuals react differently to threats—much as one dog may run away, while another may bark—presenting what Buff refers to as characteristic defensive postures. Clients can relax their defensive postures if advisors acknowledge their fears. "Talking about what makes us afraid makes us less fearful," she said.

It isn't easy for most advisors to follow Buff's strategy of first probing emotions. "We often want to rush in with facts," she said. However, advisors who first acknowledge their clients' feelings will find their clients more receptive to the advisor's left-brained reasoning.



Advisors and clients who can use behavioral finance to work through a financial crisis will develop a much deeper relationship from learning what lies underneath clients' instinctive reactions. Buff believes that most advisors will learn that clients overestimated their risk tolerance prior to the past year's financial crisis. This is a very valuable thing to learn, said Buff.

"Two heads are better than one. Or, more accurately, four brains are better than two," said Buff. It's time to take advantage of insights from the left and right brains of both clients and advisors.

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