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EXECUTION GUIDE

How to Tell the Story of a Great Investment Idea

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When faced with a complicated or challenging decision for which we cannot find an immediate and satisfying answer, people use heuristics. Heuristics are mental shortcuts that allow us to answer a simpler question instead. People inadvertently use heuristics such as loss aversion and anchoring when making decisions. These shortcuts often disrupt rational decision-making and prevent investors from taking action.

This guide explores how these kinds of dynamics interfere with good decision-making and offers direction on managing the effects of heuristics and natural biases. The guide concludes with a six-step approach designed to help clients maintain a logical mindset toward investing.

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How Humans Make Decisions

Investors often rely on simple and familiar solutions to complicated decisions. Understanding why and how this happens enables Financial Advisors (FAs) to make more impactful recommendations.

Heuristics and Their Role in Decision-Making

The human brain is an amazing machine. The dynamic ways in which language, thoughts and emotions are deeply connected and how the brain perceives and reacts to information have been widely studied. Daniel Kahneman won the Nobel Prize for delineating and describing the vulnerabilities of the central nervous system. In his book *Thinking, Fast and Slow*, he catalogs the natural heuristics that cloud investment decisions: "The technical definition of *heuristic* is a simple procedure that helps find adequate, though often imperfect, answers to difficult questions."[1] Unfortunately, natural heuristics can befuddle investment decisions. By understanding the ways humans make decisions and how heuristics work, advisors can improve the quality of the recommendations they make to clients, and those recommendations may have greater influence. Let's focus on how loss aversion and anchoring influence financial decision-making.

Loss Aversion Colors Our World

The first few lines of Charles Dickens' novel *A Tale of Two Cities* provide an example of how the human mind alters the information it receives according to built-in patterns. The famous lines "It was the best of times, it was the worst of times" are intended to present the emotional tension of the era in which the novel is set—the good and bad experiences of everyday life. This is where one of the peculiarities of human nature kicks in. Humans experience the pain of losses significantly more than the pleasure of gains. This heuristic, loss aversion, has revealed that most of us require more than twice the upside of an investment for the positive feeling to equal the negative feeling experienced when we lose money.

In fact, loss aversion colors all of our experiences: we react to "worst of times" much more strongly than "best of times." Imagine being told in advance that there will be some good times and some bad times on your vacation. How would you feel as you anticipated the trip? This heuristic has significant implications for an FA's work with existing and prospective clients.

With the loss aversion heuristic in mind, it becomes clear why investors often become negatively affected by news reports and market commentary. Rarely is *all* the news positive. Instead, investors are exposed to one or more issues of concern, which get magnified and draw focus. As a result, in spite of an advisor's attempt to provide useful information to help with decision-making, client emotions can get activated as soon as a message includes anything negative.

Anchoring Shields Us from Pain

Another heuristic is anchoring. This is the normal tendency to vividly recall negative experiences as a way to learn from the past and protect oneself in the future. The anchoring bias can be difficult to see, but is easy to understand. If a person has a traumatic or painful experience, such as an investment loss or accident, it registers deeply in the brain. This is a normal part of learning about the world and coping with danger. The challenge arises when, once someone has had a painful experience, *she sees the possibility of that experience everywhere she looks*. She creates an anchor to a previous occurrence and feels that the same experience is highly likely to happen in the future.

Anchoring leads investors to make the emotional conclusion that a previously experienced negative event is likely to happen again. When loss aversion is added to the equation, the painful experience is often perceived with even more angst.

1 Daniel Kahneman, *Thinking, Fast and Slow* (2011): 98

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Baby Boomers and the Great Correction

Observers of market behavior since the Great Correction of 2008 have seen heuristics played out in two patterns: investors' aversion to re-risking and deploying assets into equities; and the increased frequency and magnitude of volatility as investors continue to react strongly to market movements, anticipating the painful event they "know" is likely to happen.

Loss aversion and anchoring, combined with actual experiences of investing, have had a deep impact on the Baby Boomer generation. The oldest Baby Boomer turned 35 in 1981. During the 1980s and 1990s, 78 million Baby Boomers entered middle age and started investing. For the most part, they had consistently positive experiences with investing, enjoying bull markets in equities and fixed income.

Unfortunately, markets did not remain benign. Two major corrections within a single decade—one of them the largest in two generations—established a deep, negative anchor of disappointment and anxiety in many investors.

These natural tendencies, combined with the elevated expectations of more than two decades of positive investment experiences, left a generation pessimistic and disappointed. This has profoundly impacted how Baby Boomers respond to messaging: with pessimism and skepticism about positive claims for the future. It's hard for these investors to believe that good things are likely to happen. In fact, it's easier to believe that bad things are likely in the future—that investors are surrounded by dangers that can still hurt them if they are not careful.

Activating the Thinking Part of the Brain

Past negative experiences represent a challenge and an opportunity for the advisor who wants to work more effectively with any pessimistic investor. A closer look at how human beings make decisions will help clarify a strategy. When making a decision to take action, an investor uses two parts of the brain: the rational part (the neo-cortex) and the emotional part (the brain stem). The neo-cortex uses information to understand whether or not something is a good idea; the brain stem and limbic system determine how you feel about the idea. When attempting to motivate a decision about investing, an investor needs to balance the *feelings* that motivate action with *clear thinking* that guides the decision.

As the FA, your job is to activate the thinking, rational part of the brain. Your main tool for helping investors make good decisions is language. Your choice of words and the illustrations you use to accompany those words will determine how the investor becomes motivated. It's important to ensure that the client understands the situation he is in and the likely impact of each investment. It's equally important to use appropriate language when describing a suitable investment. Our guidance is to avoid extreme terms and hyperbolic descriptions. Strike a balance between alerting your client to a potential problem and generating alarm or distress.

Using Language and Information to Motivate Action

There are six steps to moving a client from thinking about an idea to taking the action needed to implement the change. The first three steps are:

1. **Introduce a problem:** Start by introducing a problem or a danger that will potentially impact the investor—a "burning platform" problem that allows the story to achieve relevancy quickly.
2. **Reveal the mechanism:** Next, reveal the mechanism in the capital markets that creates this problem and why it's something to be concerned about.
3. **Explain the implications:** For the investor to respond to the message, he must understand how the problem happens and why it's something he should be personally concerned about.

Most advisors are familiar with the final three steps needed to get a client to take action, but these first three are often overlooked. If the first three steps are accomplished successfully, these last three become less challenging:

4. **Propose a solution:** Describe how your solution solves the problem and protects the client from present and future dangers.
5. **Reveal the mechanism:** Explain how the solution works.
6. **Ask, "Was this helpful?":** Ask if this explanation was useful. If the answer is yes, then close the meeting by asking, "Would it make sense for us to [name the action you want the client to take]?"

Progressing thoughtfully through these steps will help you reach your ultimate goal of getting a client to move from the simple and familiar to the complicated and unfamiliar great investment idea.

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