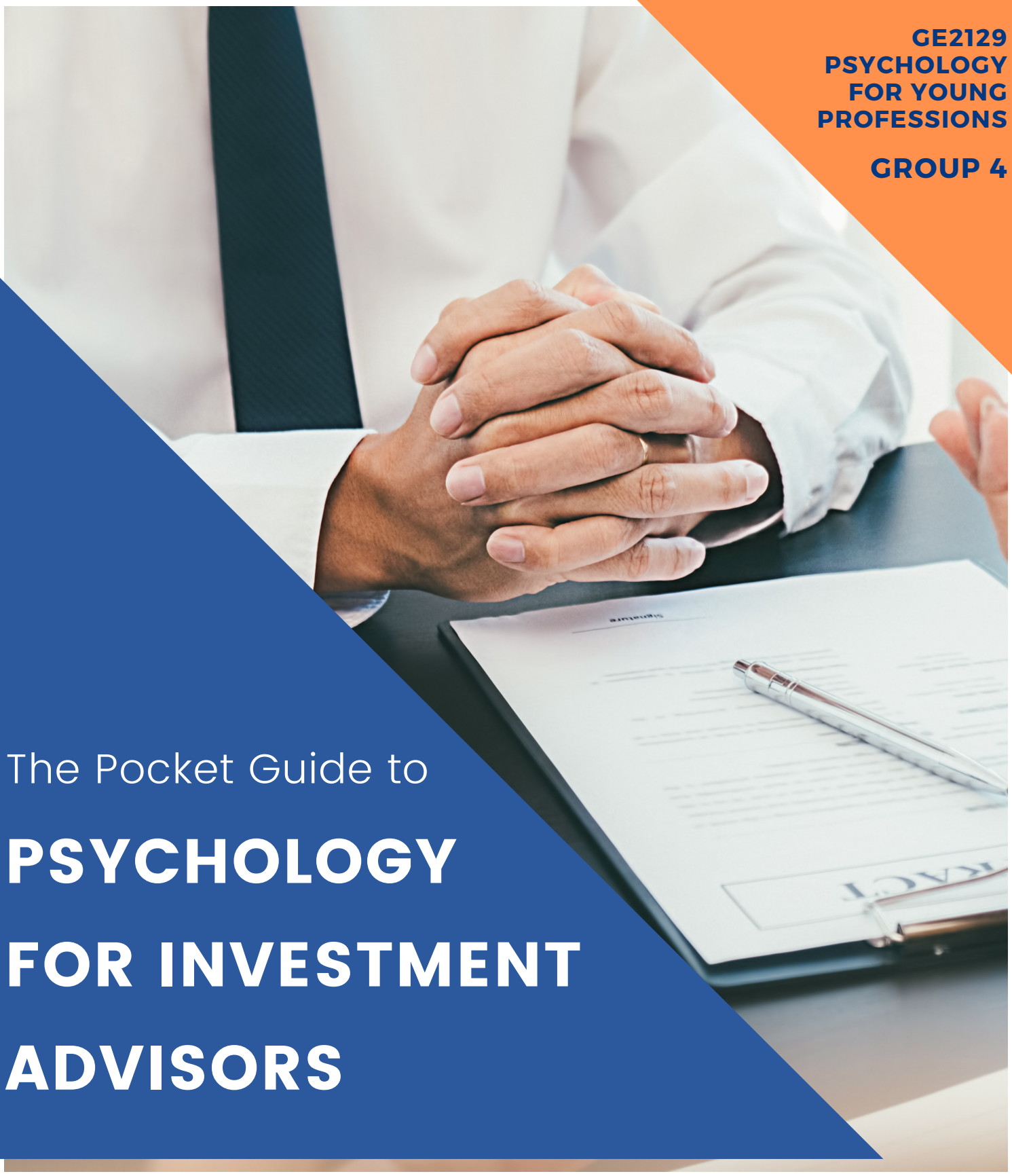
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PSYCHOLOGY
FOR YOUNG
PROFESSIONS

GROUP 4



The Pocket Guide to

PSYCHOLOGY FOR INVESTMENT ADVISORS

PREPARED BY

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JOB PROFILE

FINANCIAL INVESTMENT ADVISOR

"A professional who helps individuals manage their finances by providing advice on money issues"

HOW TO CREATE A SUCCESSFUL ADVISORY RELATIONSHIP ?

No. 01 — Understand Clients' Financial Goals

It is critical to define a client's financial objectives as it helps designing an appropriate investment program. In order to define the best financial goals, advisors have to understand the psychology and feelings that underpin the decisions behind the creation of financial goals. As a result of such insights, the advisor would better be able to strengthen the bond with the client, produce a better investment outcome, and build a stronger advisory relationship.

No. 02 — Delivery What the Client Expects

Addressing the clients' expectations is imperative to a successful relationship. In certain cases, the advisor fails to meet the client's requirements because they don't understand the client's needs. Hence offering a framework in which the advisor can step back and try to comprehend the client's motivations. After getting to the root of the client's needs, the advisor is better positioned to assist their goals.

No. 03 — Ensure Mutual Benefits

Without a doubt, measures that help increase the happiness and satisfaction of clients will improve the advisor's practice and work life. Incorporating behavioral finance insights into the advisory relationship can help strengthen the relationship and contribute to more fruitful outcomes. For example, through the study of behavioral bias, advisors could get into the clients' minds and have a comprehensive understanding of their motivations and fears. Consequently, help clients better understand why the portfolio is structured the way it is and why it suits them the best.

No. 04 — Emotional Engagement

Many financial advisors are objective, critical, and logical thinkers. Yet, on the contrary, clients often make decisions based on their emotions. Therefore, to sustain a successful relationship, advisors have to be able to connect to their clients on an interpersonal basis. This may include describing the emotional implications of a financial or planning decision so that the client understands how it would affect them. Therefore, advisors should have a deep understanding of financial psychology concepts, for example, behavioral bias, informational social influence, etc., which would be discussed further in the following chapter, so as to provide professional advice to clients.

PILLARS OF INVESTMENT SUCCESS





Portfolio Diversification

The first pillar of investment success is helping clients in constructing solid and diversified portfolios. Diversification means building a mixed variety of investments in a portfolio, such as stocks, bonds, alternative investments, and cash. By diversifying investments, the dependence on the performance of any single investment can be reduced. This can mitigate risk and guarantee the user's benefit to a large extent.



Considering Risk Tolerance Level

People with different risk tolerance will have different investment preferences. Conservative investors who have lower tolerance will make conservative investments and include more low-risk investments. Meanwhile, risk seekers are willing to accept more risk in exchange for higher returns. Considering risk tolerance helps investment advisors to allocate assets that suit their clients' needs and drive an investment approach.



Review and Rebalance Portfolio Regularly

An annual review of the investment portfolio with clients is needed to fine-tune and rebalance the portfolio. Investments in the portfolio will grow at different rates over time. As a result, initial asset allocation and diversification will become unbalanced. Coupled with the changes in clients' income, risk tolerance, or family condition. The initial investment portfolio no longer consists of clients' goals. Therefore, the investment portfolio needs to be reviewed and rebalanced regularly to align with the client.



Have a Well-structured Plan

Investment advisors should not let emotions influence their decision-making. When the market becomes volatile, even experienced investment advisors can become too focused on short-term movements. This may lead to hasty decisions, especially when attempting to time the markets. For instance, as the market grows, buyers rush in and buy high. When the market falls, they lose confidence and sell at a loss. The key to avoiding making rushed investment decisions is to make a detailed plan. With a well-structured plan, investment advisors can confidently stick to it. It also helps people to understand that daily market swings are unlikely to impact long-term objectives or the designed investing strategy.

PERSONALITY

The following explained the general personality traits of investment advisors by using the **Five-Factor Model of Personality** (a psychological theory for interpreting personality) and data from the "Kitces Financial Planning Process Survey".



Trait Dimension	Endpoints of the Dimension		
Conscientiousness	Organized Careful Disciplined	⟷ ⟷ ⟷	Disorganized Careless Impulsive
Agreeableness	Soft-hearted Trusting Helpful	⟷ ⟷ ⟷	Ruthless Suspicious Uncooperative
Neuroticism (emotional stability vs. instability)	Calm Secure Self-satisfied	⟷ ⟷ ⟷	Anxious Insecure Self-pitying
Openness	Imaginative Preference for variety Independent	⟷ ⟷ ⟷	Practical Preference for routine Conforming
Extraversion	Sociable Fun-loving Affectionate	⟷ ⟷ ⟷	Retiring Sober Reserved

Conscientiousness

Investment advisors typically scored **higher than the general population** in terms of conscientiousness, scoring 6.10 for males and 6.49 for females, compared to 4.93 and 5.13 respectively in the general population. This implies that they tend to have a strong sense of duty toward others and are always conscientious in carrying out the tasks that have been delegated to them. They prefer deliberate over the alternatives preferable to clients rather than make impulsive decisions.

Openness to experience

Investment advisors show an **average degree of openness** to the norm. This could be explained by the need to expose to new knowledge and information to assist their clients. On the other hand, one of a financial advisor's core value propositions is to respect clients and adhere to time-honored principles that take to accumulate their portfolio's value, rather than helping them to indulge in risky new tactics.

Neuroticism

The majority of advisors are **not overly neurotic**. Depression and other severe mental health issues are linked to extreme anxiety and emotional instability. Financial advisors, like anyone else, are facing a certain level of stress, and as a result, advisors are not prone to these tendencies in general. Nevertheless, it is not surprising that extreme Neuroticism is not common among advisors, given that they have to assist clients to manage their behavior, advisors are supposed to be able to control their own emotions.

Extroversion

Although the traditional perception towards financial advisors should be highly extraverted, the reality is, investment advisors **tend to be more introverted** instead, research shows that they scored an average of 4.19 and 4.55 for males and female advisors respectively, compared to the average of the general population of 3.82 (male) and 4.17 (female). Introverts' innate desire for one-on-one interactions may aid them in bonding with clients even more than extroverts, even if they might have a harder time finding these clients in the first place.

Agreeableness

The score in terms of the agreeableness of investment advisors is **slightly higher than the general public**. From the research, the average score of male and female advisors is 5.21 and 5.91 respectively, while that of the general population is 4.71 and 5.23 respectively. It also suggested that 83% of them agreed about being sympathetic and warm, and 63% of them disagreed that they are quarrelsome and critical, when the client does not agree to their advice. This implies that most of the advisors have managed to strike a balance between being compassionate to customers and still refusing to acquiesce when they are acting irrationally.

CHALLENGES OF INVESTMENT ADVISORS



01. BEHAVIORAL BIAS

REASONS LEADING TO BEHAVIORAL BIAS

"Intuition and emotion play a major role in decision making"

Investment advisors might not always make perfect investment decisions, they sometimes make poor investment choices. Why does this happen? The answer is that they are not able to act rationally. Two premises psychological scientists use to support the argument that investment advisors behave irrationally are Heuristics and Emotions.

Heuristics

In real life, people use decision-making shortcuts, called heuristics. Gigerenzer and Todd (as cited in Baddeley, 2013) explained that the brain has an "adaptive toolbox" for decision making, and heuristics are one of them. Heuristics are simple rules that allow people to make smart decisions by using minimal information and exploiting the information structure of the environment. Heuristics are common-sense rules of thumb derived from previous experience. They do not require careful deliberation. This does not mean heuristics are entirely irrational. They may be procedurally rational as people use them to make quick decisions in uncertain circumstances where a complete evaluation of available information is impossible or time-consuming. Generally, heuristics are reasonable decision-making tools given uncertainty. However, misapplication of heuristics can lead us to mistakes, which refer to behavioral biases. Because judging whether something is sensible can be subjective in heuristics, biases arise with misjudgments of information and events. Therefore, although heuristics are helpful for quick and efficient decision-making, using them does not always lead to the best decision.

Emotions

Decisions involving cognitive evaluation will induce an emotional reaction, and emotional reactions appear to influence the final decision (Lucey & Dowling, 2005). When the brain uses our memories, thoughts, and beliefs to interpret what is happening around us, emotions are created. This triggers how we feel and behave. Different emotions influence decision-making in different ways. The research found that people in a good mood tend to have more optimistic judgments about equities than those in a neutral mood, and people in a bad mood are considered to make more pessimistic judgments (Lucey & Dowling, 2005). Apart from the nature of the decision, emotions can also affect the speed of decision making. Anger can lead to impatience and hasty decisions. When people are excited, they may make quick decisions without thinking about the consequences as they feel confident and optimistic about the future. When they feel afraid, their decisions will be obscured by uncertainty and caution, making people take longer to make a decision. The degree of emotions' influence on decision-making increases with the complexity and uncertainty of choice and the subject matter. These emotions are irrational and lead us to behavioral biases.

Belief Perseverance Biases:
CONSERVATISM BIAS

> ***"To invest successfully over a lifetime does not require a stratospheric IQ, unusual business insight, or inside information. What's needed is a sound intellectual framework for decisions and the ability to keep emotions from corroding that framework."***
>
> *Warren Buffett*

What is Conservatism Bias?

When people cling to their old beliefs or predictions and resist accepting the new information, they are undergoing Conservatism Bias. They favor prior evidence over new evidence or information that has emerged.

Enron is a good example to illustrate. Enron was an energy, merchandise, and service company, which was founded in 1985 in Houston, America. In the 2000s, the total revenues of Enron had attained USD 101 billion. Therefore, most investors take positive views and evaluations of this company. As they hold this impression in mind, after noticing the rumor about the possibility of a scam in Enron, they were confused and even tended to ignore the rumor. At last, they suffered a huge loss after the scam was published.

One of the causes of Conservatism Bias is because the investment advisors fail to re-evaluate complex data. As formulating the company's financial positive is regarded as a complicated task, the investors have to take a complete and detailed analysis of financial information before making a decision. It is considered as a stressful and time-consuming process for investors, so they prefer to hold on the pre-existing beliefs.



"Company A is a good investment."

Company A
Stock Price
$20 ↓ $10 (-50%)

Impacts of Conservatism Bias on Investment Advisor's Decision Making

- **Cling to their previous view or prediction**: When confronted with new facts, the investment advisors may behave inflexibly. In case, a customer buys a stock because he or she knows the firm is to make a big announcement about a new product. However, if the corporation then admits that it has difficulties in getting the product to market, the investors could still stick to the original, positive impression of some imminent, optimistic development of the company, hence, fail to act on the negative news.

- **Slow reaction to new information**: Affected by the above effect, conservatism-biased investment advisors often react to new information very slowly. They only recognize the situation is getting worse after they suffer from great loss, such as losing a lot of money, or there is overwhelming evidence proofing their initial belief is incorrect.

- **Affect investment advisors the ability to process new information**: People suffer mental distress when presented with complicated information so sticking to a previous conviction will be a simple decision. If an investor buys a stock on the assumption that it will rise, and then the company announces a series of difficult-to-understand accounting adjustments that could affect growth, the investor may dismiss the announcement rather than try to decode it. The previous conviction that the business is prospering is more clear-cut and therefore easier to uphold.

WHICH TYPE OF PERSON TENDS TO HAVE CONSERVATISM BIAS?

According to a study on investors' personality characteristics and behavioral biases: Conservatism bias and availability bias in the Tehran Stock Exchange, Moradi, Mostafari, & Meshki (2012) show that the conservatism bias correlates with the personality traits of sensation and intuition, judgment, and perceptual respectively. People who are **confident** and have **high self-esteem** tend to have this bias because they prefer to believe in their prior beliefs. Furthermore, it is found that **neurotic** and **open to experience** are **less prone** to experience Conservatism Bias, so they are more likely to not involve in long-term decisions. They are relatively more sensitive and react faster.



How to avoid Conservatism Bias?

Recommendations and information are useful to correct and lessen the effect of Conservatism Bias. Most importantly, investment advisors should avoid clinging to unreasonable and irrational predictions. Also, they need to respond to new information decisively and resolutely. However, it is not asking them to react without detailed and cautious analysis. After making a complete analysis, adopt the plan as soon as possible in order to reduce potential risks and losses.

Conservatism Bias Test

Part A

Suppose that you live in Seoul, Korea, and you make a prediction: "I think this year will be a snowy winter." Additionally, in late January, you find that no snow has fallen. What is your reaction after you realize the situation?

A. There is still time to get a lot of snow, so my prediction is likely right.

B. There is still time for some snow, but my prediction may get wrong.

C. My past experience tells me I may be wrong this time. Most winter has elapsed, so there is an insignificant cumulative amount of snow.

Part B

When the news implies the price of a stock you owned may decrease, how fast do you react to this information?

A. Wait for the market to announce the importance of the information thereby deciding the following action

B. Sometimes wait for the market announcement, but sometimes will respond immediately

C. Respond without delay

Implication of Answer

Answering "A" or "B" in both questions are more likely to be influenced by conservatism bias

Belief Perseverance Biases:

ILLUSION OF CONTROL BIAS

> ***"I claim not to have controlled events, but confess plainly that events have controlled me.***
>
> *Abraham Lincoln*

What is Illusion of Control Bias?

Illusion of Control, regarded as cognitive bias, refers to the tendency people think they can completely control or at least influence the result where they actually do not. Ellen Langer, the psychology Ph.D. of Harvard University, describes this bias as "a person's anticipation of success probability unsuitably higher than the objective probability would guarantee. Therefore, this bias is determined by the intersection of the want for control and the belief that luck is controllable.

For example, some people believe they are good guessers when they accurately predict the result of a series of coin tosses, but in fact, the results of coin tosses are random and never be affected by human beings.

Impacts of Illusion of Control Bias on Investment Advisor's Decision Making

Become overconfident and subjective: Investment advisors who are successful and experienced in the financial industry or other technical pursuits think that they are victorious and accurate in the investment domain as well.

- **Trade more than is cautious**: Investment advisors think they can control more on the outcomes of security or stock if they trade and process the investment by themselves. Bearing it in mind, they become overconfident and too focus on victory. Gradually, they trade more than is prudent

- **Lack of diversified portfolios**: As the advisors have more confidence and feel more control over specific security or stock, they put too much focus and effort on that investment, but ignore others. Therefore, they are unable to maintain a diversified portfolio, hence, exposed to high risk. The act of "putting all eggs in one basket" may lead them to suffer from great loss.

- **Utilize restrict orders and other techniques**: Limit orders and other similar tactics are used by investment advisors who are with the illusion of control bias, which gives them a false sense of control over their investments. In reality, relying on these mechanisms can lead to missed opportunities or even a costly, needless transaction dependent on an unreasonable price.

WHICH TYPE OF PERSON TENDS TO HAVE ILLUSION OF CONTROL?

According to the journal "Illusion of Control: How We Overestimate Our Personal Influence", Thompson claims that people who **emphasize success rather than failure** and with **strong emotional needs** to control are more likely to experience Illusion of Control. It can be explained by the control heuristics that assesses the causes of intentionality and relation to the outcome for approximating control.

Besides, it also suggests that **overconfident** and **optimistic people** tend to have bias as well, especially those who are successful and professional in specific categories as they have high esteem and hold a positive view of their future.

How to avoid the Illusion of Control?

The most important point is to recognize the reason for successful investment is about probability, but not the control by a human being. Therefore, investment advisors should never trigger susceptibility to Illusions of Control. What they should do is to rely more on the analysis of the external environment and review objective information, such as analyzing the most updated financial information and have a look at the overall general performance of a security. Those can reduce the tendency that people overrate their ability and influence the outcomes of an event.

Illusion of Control Test

Part A

Imagine you are playing board games, e.g. Monopoly, that involve dice, do you think you have more control when you roll the dice yourself?

A. Yes

B. No

Part B

After you bought a lottery ticket, do you think it is more likely to win if you choose the number yourself instead of using a number generator?

A. Yes

B. No

Implication of Answer

Answering "A" in both parts tends to feel more optimistic on individual's control over a random event and are more likely to be affected by illusion of control

Information Processing Biases:

MENTAL ACCOUNTING BIAS

"There's no business like show business, but there's several business like accounting"

David Letterman, Television Personality

What is Mental Accounting Bias?

According to Richard H. Thaler, a Nobel prize-winning economist, mental accounting refers to "the different values people place on money, based on subjective criteria, that often has detrimental results."

It means that investors do not treat money as fungible (mutually interchangeable) and instead relate their spending to specific budgets. For example, if someone receives a $1,000 end-of-year bonus for superior performance, they will believe that the bonus encourages them to spend money on something extravagant such as vacations, meals, and other expenses they can never justify spending normal income on. The theory illustrates that people are more likely to be impulsive with unexpected money, as it wasn't factored into their financial plan.

Mental accounting would appear in investing because investors could select to invest their assets in a speculative and a safe portfolio, they can separate safe and speculative portfolios, hence, negative return from the speculative one won't affect the positive return from the safe one. In other words, investors would have extra capital which they could afford to lose and they would feel comfortable using such money to invest in risky and speculative investments.

Yet, the thought of "extra capital which they could afford to lose" demonstrates the mental accounting bias. As all money is the same, thus, there shouldn't be a distinction between safety capital and assets you can afford to lose, and any such distinction is merely a mental illusion.

Impacts of Mental Accounting Bias on Investment Advisor's Decision Making

Mental accounting bias would lead to irrational investment decisions and financial counterproductive behavior, resulting in inappropriate decision-making:

- **Correlations between investment "buckets"**: It can lead people to believe that their savings are divided into different "buckets" or accounts. It could be, for example, college funds and retirement funds. Creating separate accounts that comply with financial objectives, yet, could lead to investors overlooking positions that offset or correlate across accounts. As a result, the overall output performance of the portfolio would be suboptimal.

- **Irrational return distinguishment**: Investors who suffer from the bias can make irrational distinctions between income and capital appreciation returns. Many people believe that saving capital sums, i.e., the principal is important, hence prefer spending interest. Hence, resulting in investors pursuing revenue streams while unintentionally eroding their principal.

- **Company stock diversification**: If employer stock is concerned, mental accounting bias may lead investors to divide assets differently. When company stock was offered, employees normally put a portion of their contributions into it, with the rest split equally between equity and fixed-income portfolios. Then, total share exposure could be too high, resulting in under-diversified portfolios. Since they do not completely comprehend the risk in their portfolio, this could be a suboptimal situation.

- **House money effect**: The "house money" effect, in which risk-taking behavior increases as wealth rises, may lead to mental accounting bias among investors. Since they refuse to treat all capital as fungible, investors exhibit this rationale and behave irrationally. And such biased financial decision-making will put a portfolio at risk.

- **Clinging to formerly gainful investment:** Investors may be hesitant to sell shares that achieved significant returns in the past but have since declined in value due to mental accounting bias. Investors were used to safe, unrealized returns during the 2000s bull market. But then as the market correction deflated most investors' net worth, they became reluctant to sell their positions at the then-lower profit margin. Many people now still lament not reaping gains when they could and many of the stocks that people clung to since the 1990s boom have now become nearly worthless.

Which Type of Person Tends to Have Mental Accounting Bias?

According to the "Individual Differences in Mental Accounting", it is mentioned that there isn't any research proving the linkage between the mental accounting concept and personality traits. Yet, those traits are being applied in other biases such as anchoring effects, framing effects, overconfidence, etc. Extraversion, agreeableness, neuroticism, and responsiveness were linked to an innate decision style, whereas **emotional stability** and **conscientiousness** were correlated to a conscious decision style. Based on these findings, the study suggested that it is possible to hypothesize that if mental accounting is a byproduct of a conscious decision-making process, it can be associated with emotional stability and conscientiousness.

How to Avoid Mental Accounting Bias?

To prevent suffering from mental accounting bias, investors should consider money to be perfectly fungible, which means all money is the same, regardless of its source or intended use, when allocating funds among various accounts, such as a budget account (daily living expenses), discretionary spending account, or wealth account (investment and saving account).

Information Processing Biases:

FRAMING BIAS

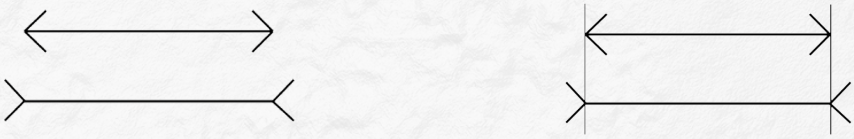
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“You better cut the pizza in four pieces, because I’m not hungry enough to eat six.”

Yogi Berra

What is Framing Bias?

The propensity of decision-makers to react to various circumstances differently depending on the context in which an option is presented is known as framing bias. For example, how word problems are presented, data is portrayed in tables and charts, and figures are illustrated. The following figure has also illustrated the concept.



Which line is longer? **They are actually the same!**

Those that are affected by visual framing bias undergo an optical illusion, leading them to feel that the bottom line is longer. The other figure shows the graphic again, but this time with vertical marks to serve as a reference. The marks have neutralized the framing effect of the head of arrows, hence, it becomes obvious that the length of both lines is the same.

The way how the investment is being “framed” would change our minds on whether or not the investment is a good one. When investors are not aware of all the facts, or when there are several unknown variables, reflexive decision-making is very likely to occur. As a result, the likelihood of being affected by framing bias increases. The following shows another example:

Statement 1

In 2020, the Earnings per Share (EPS) was $1.25, compared to an expectation of $1.27.

Statement2

In 2020, the Earnings per Share (EPS) was $1.25, compared to $2.21 in 2019

Obviously, statement 2 frames the earnings report more effectively. The means it is framed (an improvement over the past year) gives a more optimistic spin on the number.

It could be seen that investors can respond differently to a given opportunity depending on how it is presented to them.

Impacts of Framing Accounting Bias on Investment Advisor's Decision Making

- **Narrow Framing: It is a subset of framing bias, with narrow framing, advisors who hold long-term investments may become obsessed with short-term price fluctuations in a single sector or stock. This would occur in tandem with myopic loss aversion, underlying the risk that concentrating solely on short-term market fluctuations could lead to excessive trading, which is below the optimal level.**

- **Framing and loss aversion: Excessive risk aversion would occur when framing and loss aversion come together. An advisor who has made a net loss is more likely to choose a riskier investment, while a net gainer is more likely to choose less risky options.**

- **Unintended investment choices based on incorrectly framed questions: Framing bias may lead advisors to convey responses to risk tolerance questions that are either unduly conservative or unduly aggressive, subject to how the questions are interpreted. For instance, a risk-averse response is more probable when questions are phrased in a "gain" frame; while the risk-seeking response is more likely when questions are phrased in a "loss" frame.**

- **Positive and negative frames: The way an investment or asset allocation recommendation is interpreted, whether positive or negative, may influence the advisor's willingness or lack of willingness in investment. Usually, questions with positive wordings would probably garner affirmative answers, and answers with optimistic wordings are more likely to be chosen than the negative ones.**

Which Type of Person Tends to Have Mental Accounting Bias?

According to a study "Personality and Cognitive Processing of Affective Information", it suggested that different personal characteristics can be linked to different responses to positively and negatively framed stimuli. The reactions to positive and negative stimulation can be anticipated by the tendency of extraversion and neuroticism. For instance, when **extroverts are more prone to recognize positive terms** from a list of mixed-valence words than introverts. Adding on, it suggested that neuroticism is linked to the understanding of ambiguous emotional terms. For example, those with a **high level of neuroticism are more inclined to recall negative words**.

Another research "A New Look at Framing Effect: Distribution of Effect Sizes, Individual Difference, and Independence of Types of Effects", it was stated that the extent of framing effects (for the cases of attribute framing and risky choice framing) can be predicted by personality traits. It was concluded that people with **low conscientiousness and high agreeableness are more likely to see the projected attribute framing effect of higher favorable scores in the positive situation** than in the negative one. Yet, they are **less likely to see the predicted risky choice framing effect of higher favoritism in risky options** in the negative case than in the positive case.

How to Avoid Framing Bias?

To prevent suffering from mental accounting bias, investors should consider money to be perfectly fungible, which means all money is the same, regardless of its source or intended use, when allocating funds among various accounts, such as a budget account (daily living expenses), discretionary spending account, or wealth account (investment and saving account).



Emotional Biases:

LOSS AVERSION BIAS

> *"Win as if you were used to it, lose as if you enjoyed"*
>
> *Ralph Waldo Emerson*

What is Loss Aversion Bias?

Loss aversion bias refers to a phenomenon under which individuals consider a loss to be psychologically or emotionally more severe than an equivalent gain (Pompian & Pompian, 2012). Generally speaking, losses impact decision-making more than equivalent gains.

Here is a practical example illustrating loss aversion bias.
You're offered a bet on a coin toss, heads, or tails. You will win $1000 if you call heads. You will lose $1000 if you call tails. Are you willing to play this game?



The majority of people are not willing to play this game. This is because the first thing they think of is not the chance to win $1000 but to lose $1000. The pain of losing $1000 cannot be compensated by the joy of winning $1000. In order to persuade people to play the game, the winning amount should be higher than $1000 (i.e., $1500). Hence, the joy of winning can compensate for the pain of losing.

Impacts of Loss Aversion Bias on Investment Advisors' Decision Making

- **Take the money and run**: Loss aversion causes investment advisors less tolerated in financial decision-making. Investment advisors may fear that their profit will evaporate and afraid of experiencing the pain of loss. They thus sell winners too early. This behavior limits the upside potential of the portfolio leading to investment mistakes.

- **Taking on excessive risk**: Since loss aversion makes investment advisors feel a strong impulse to avoid loss, they will refuse to sell a loss-making stock and hold the losing investment too long, hoping that they can get back what they lost. This behavior will lead to investment advisors taking more risk in their portfolios than if they would remove the losing investment and replace it with a better one. Consequently, reduce the return of a portfolio.

- **Unbalanced portfolios**: People are unwilling to sell the stock that is falling on value due to loss aversion bias. The losing investment will increase the portfolio's risk, the risk of the investment portfolio is higher than its return. Therefore, an imbalance occurs. If it lacks proper balancing, the allocation will not fit the long-term goals of the client, leading to suboptimal returns.

Which Type of Person Tend to Have Loss Aversion Bias?

Pessimistic person: Pessimists tend to overestimate the likelihood of negative events while underestimating the likelihood of positive events. Due to the overestimation of such a downside, they focus on trying to avoid a loss more. Many decisions that contain potential risks may be annulled.

How to Avoid Loss Aversion Bias?

Stop-loss rule: To prevent loss from holding a losing position too long and selling a winning stock too early that resulted from loss aversion bias. One effective remedy is the stop-loss rule. A stop-loss rule is a risk management tool that investors predefine the conditions for liquidation of their positions. To be specific, when a stock reaches a specific price, the buy or sell action will be executed automatically. The Stop-loss rule can enable the decision-making of investment advisors free from emotional influence, minimizing the effect of loss aversion bias.

Emotional Biases:

OVERCONFIDENCE BIAS

> *"Too many people overvalue what they are not and undervalue what they are."*
>
> *Malcolm S. Forbes*

What is Overconfidence Bias?

Overconfidence bias refers to decision-making deviation caused by one's overestimation and over-optimism about his ability. In particular, people think they are smarter and have better information than they actually do (Pompian & Pompian, 2012).

There are two types of overconfidence:

- **Prediction overconfidence**: the confidence intervals that investors assign to their investment forecasts are too narrow. In short, people tend to make very narrow predictions when estimating future values of the stock.
- **Certainty overconfidence**: investors are often too certain of their judgments. For example, people often ignore the possibility of a loss after they determine that a company is a good investment and are shocked or frustrated if the investment underperforms.

Overconfidence is one of the most detrimental biases that investment advisors can exhibit in their investing process. Overconfidence may strictly dominate their rationality. The following will show how overconfidence bias leads to making investment mistakes of investment advisors.

Impacts of Overconfidence Bias on Investment Advisors' Decision Making

- **Ignorance to Negative Information**: Overconfidence bias hinders the ability of an investment advisor to factually evaluate an investment. People with overconfidence will overestimate their ability to evaluate a company as a potential investment, they think their judgments are correct and neglect the negative information that indicates either a stock acquisition should be avoided or a stock that has already been bought should be sold. As a result, investment advisors will choose the wrong buy and sold strategies.

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- **Excessive trading**: Overconfidence bias will cause investment advisors to trade excessively which can be detrimental to investment well-being. Since overconfidence makes investment advisors believe that they possess some special knowledge that other investors are not aware of. They think they can get ahead of the game and thus trade excessively. Excessive trading behavior can cause investment advisors to end up picking some wrong stocks. It also can increase transaction costs and lead to poor returns.

- **Underestimating downside risks**: People with overconfidence bias usually do not pay attention to historical investment performance statistics before they invest. These data are important indicators for people to evaluate their portfolios. Thus, investment advisors will underestimate the downside risks and suffer a big loss when the market goes red.

- **Portfolio under-diversification**: Overconfidence makes investment advisors faulty believe that they have identified the "next big stock". This certainty causes investment advisors to invest a lot in one stock and build investment portfolios that are not diversified enough. Holding an under-diversified portfolio can be risky and cause poor portfolio performance.

Which Type of Person Tend to Have Overconfidence Bias?

Over-optimistic person: Overconfidence is generally caused by high levels of optimism. People who possess unrealistic optimism are usually overly optimistic about the outcome of their investment choice, they overlook the potential dangers of their actions and end up making hasty decisions.

How to Avoid Overconfidence Bias?

Review and Reflection: Overconfidence bias can be avoided by review and reflection. Reflection can help people realize their mistakes and how bad their decisions are. Suppose an investment advisor is overconfident in his abilities to forecast the "next hot stock." In that case, he should review trading records of the past two years and calculate the performance of the trades. More often than not, the trading activity will show poor performance. Such review and reflection will demonstrate the detrimental effects of overconfidence, helping investment advisors understand their mistakes and be realistic to their abilities.





CHALLENGES OF INVESTMENT ADVISORS



02. WORKPLACE CHALLENGE

Informational Social Influence

Conforming to the information provided by seniors might lead to an inappropriate investment decision.

Investor advisors might be affected by the informational social influence, which is a type of conformity stem that people make decisions based on data and information provided by others, as they believe that the provider is trustworthy and credible. For example, junior advisors' decision-making might be affected by senior advisors' opinions and thoughts towards the performance of certain hot stocks, believing that these hot stocks could bring a respectable return. This is because they tend to believe that they are experienced and professional, hence their prospect toward the investment is reliable. Yet, in the financial market, there are no guaranteed returns, all investments carry a certain degree of risk. Therefore, conforming to the information provided by seniors simply because they seem to be trustworthy might lead to an inappropriate investment decision.

Solutions

To prevent being irrational due to informational social influence, investment advisors should not rely on information provided by others whom they think are reliable. This could be risky as this information might be subjective and it might not reflect the potential risk behind it. Consequently, advisors should do **more information search** and analyze its impact on the client's portfolio to make sure that it really suits the client and would achieve a better financial return.

Stress

Both environmental factors and tight working schedules can lead to a high level of stress for investment advisors.

Being an investment advisor is challenging and could be stressful as the financial and business world is highly related to the global and local markets, while the economic environment is changing rapidly. During economic downturns, most clients will immediately seek assistance from their advisors. Therefore, investment advisors would have to take care of their clients' emotions regularly. This might make them feel depressed and highly pressured over time.

In the meantime, the competition among investment advisors is competitive as most advisors also work as financial planners, asset managers, psychologists, and even marketers. It means the one who can provide more all-around service and is more knowledgeable will have the advantage. Therefore, in order to hold a place in the fierce, and gain confidence as well as trust from the clients, despite their daily work schedule, they also have to engage in advanced studies or information search to enhance their ability and to keep them up-to-date. This busy work-and-study routine can easily lead to a high level of stress.

Solutions

To cope with stress, **problem-focused** and **emotion-focused** coping strategies could be utilized. Problem-focused means managing the situation that leads to the distressing feeling. It would be effective if the problem is alterable. For example, if an investment advisor finds he/she does not fully understand whether a certain financially engineered investment product could help clients to achieve their financial objective, he/she can spend more time on information search to gain more insights and analyze the risk and expected return of that product. Making a specific plan of action can directly solve the problem, hence, alleviate the level of stress and discomfort. Another strategy is emotion-focused, which is usually adopted when the problem is uncontrollable, i.e. economic downturn. As the problem is inevitable, advisors need to handle their emotional reactions to the situation, so they can keep handling and solving the problem. For instance, when the advisors stress out because of the exhausting schedule as many clients seek assistance during the economic downturn, they can have a walk or exercise to relax.

Teamwork

Cannot proactively collaborate with teammates to design personalized strategies with tangible benefits for clients when handling joint client matters.

Investment advisors might encounter obstacles in terms of teamwork, especially for individual financial advisors. For example, when handling joint client matters, investment advisors would need to work as a team and collaborate with others such as accountants, attorneys, and insurance agents to reach a proper solution for the client. However, having an effective, genuine collaboration could be challenging. Although they do often communicate about particular information or numbers required to complete a legal document or file a tax return, they usually will not proactively collaborate to design personalized strategies with tangible benefits for clients. This is because financial advisors might see each other as rivals, and they would be afraid of losing clients. Besides, the consultation fee is normally charged hourly, hence discouraging clients to make most of the attorneys' and accountants' expertise in consultation, leading to less effective communication.

Solutions

To enhance the level of collaboration between different parties in an advisor team, the role of an investment advisor is of cardinal importance. As the advisor is the one who usually interacts with clients through regular and spontaneous meetings, he/she could better understand the overarching objectives, as well as identify problems where different disciplines overlap. Consequently, the advisor is in the best position in supporting and facilitating the discussion, analysis, and decision-making in the team. Overall, to reach better teamwork, advisors are suggested to take the lead in facilitation in order to obtain the best solution for the clients.





Appendix

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