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In a previous post, we discussed the stark contrast between the traditional economic rationale and bounded rationality. With bounded rationality, consumers can make an optimal choice given a limited amount of time, effort, and information. In this article, we will go more in depth to explain how humans often form heuristics to make financial decisions, and how wealth managers can assist when projected investments go awry.

Using heuristics to problem solve

Heuristics are mental shortcuts developed over time as a way to orchestrate problem-solving techniques to improve performance. People use heuristics to make decisions based on past events or traits that are similar to the current situation.

This technique might not be optimal or rational, but a heuristic is usually sufficient to reach an immediate goal.

Once heuristics develop, without realizing it, our brains utilize these self-educating techniques to make quick decisions. Often, we "misdiagnose" a situation or challenge because it is similar enough to one for which we're familiar with the solution.

For example, think of your daily commute home. You know the optimal departure time and the backed-up streets to avoid after you leave the office. And once you're five minutes from home, you've already planned the first thing you want to do when you walk through the door. Except, in the 100th time of completing this route, a herd of deer is crossing the road as you speed by. You escape the deer, but your brain makes a new mental note – either slow down for deer during this stretch, or to change this part of the route entirely. Despite the fact that the chances of this occurring were always possible.

In this example of accidents, we shouldn't have a tailored set of decision points depending on where we are. Our awareness levels should always be the same, whether we're changing lanes on the expressway or a mile away from putting the key in the door. The same ideology goes for city slickers who are used to one-way streets and neglect to keep their "head on a swivel" for outlier events (i.e. a car going the opposite direction on a one-way).

Just like in daily commutes, information bias from developed heuristics can affect decision-making in financial planning.

Wealth managers provide clients with an unbiased rationale

Unfortunately, heuristics aren't always the best when it comes to making important investment decisions. Think of a stock or bond that features a forecasted chart of earnings. Typically, you will be shown the year-to-date, five-year, and since-inception earnings. All of the numbers show as positive, so one would assume that the past data is representative of the future. However, unfortunately, this is not always the case in the investment world. Extensive research needs to be done since stocks can fall and rise like a roller coaster.

And this is where advisors and wealth managers come in.

Wealth managers can play an important role beyond simple technical expertise. For example, people may be impulsive, emotional, or myopic about their own investments, but usually not about the investments of others. Thus, the wealth manager can bring a more rational, long-term focus during turbulent times. Wealth managers may consider investment options that limit the potential damage caused by the impulsive, emotional side during market downturns by considering alternatives with required delays or penalties for immediate withdraw.

By encouraging a long-term perspective and promoting the understanding that "ups and downs" in returns are a normal and expected part of an ideal long-term portfolio, clients will experience less induced fear from losses. Also, wealth managers may point to the investment policy agreed to in earlier, quieter times, and emphasize the long-term value of sticking with the plan. An advisor may fight against the tendency to sell in a downturn by “reframing” a loss experience as a buying opportunity or characterizing exiting the market as “accepting” a loss instead of benefitting from the long-term positive trends.

Although these client management strategies are not, strictly speaking, portfolio management strategies, they may be vital to helping clients to consistently pursue long-term optimal investment strategies.

The article you’ve just read was adapted from the behavioral finance curriculum in the Wealth Management Certified Professional® (WMCP®) education program developed by The American College of Financial Services.