CASE STUDY
HUMAN BIASES

KNOWLEDGE EXPECTED OF: Both FPSC Level 1® Certificants and CFP® Professionals

Version 1.0.0, Updated 20170907

Ryan, an FPSC Level 1 Certifi cant in Financial Planning, receives two separate referrals from Shae Lynn, a customer service representative. As part of his preparation for the client meetings, Ryan asks Shae-Lynn for a quick description of each client. Shae-Lynn describes them as follows:

Jasper: intelligent, industrious, impulsive, critical, opinionated, doubting.

Louise: doubting, opinionated, critical, impulsive, industrious, intelligent.

Based on Shae-Lynn's descriptions, Ryan looks forward to meeting Jasper more than Louise. He thinks that he will work better with Jasper, given his work ethic and goal-oriented approach. He is more skeptical about meeting Louise, since he may need to choose his language carefully to accommodate her perceived judgmental nature.

Phone Meeting with Jasper

During a recent telephone meeting, Ryan learned that Jasper, a 45-year-old professional, has just returned from a trip across Canada and the United States. Over the course of his trip, he accumulated $40,000 in credit card charges, which are accruing interest at a rate of 20 percent annually.

Jasper has two main goals–to go on a world cruise in six years, and to retire in 20 years. Ryan identifies that Jasper will require $15,000 annually (in today's dollars) before taxes to supplement his government pensions in retirement, and $50,000 (in today's dollars) to cover the cost of the world cruise. Up until recently, Jasper had been saving $670 per month toward these two goals. However, he has temporarily redirected those savings to his credit card payments.

Jasper's investments include a number of mutual funds in his Registered Retirement Savings Plan (RRSP) and publicly traded shares of his employer, held in a non-registered account. His RRSP holdings are currently worth $174,000 with a book value of $152,000. His company shares are worth $50,000 and have a book value of $35,000. Jasper is maximizing his RRSP contributions.

Jasper's investment portfolio is split between 22 percent in fixed-income securities, and 78 percent in equities covering all major sectors of the economy. The average annual management expense ratio for his fixed-income mutual funds is 1.6 percent, and two percent for his equity mutual funds. The RRSP contains an energy mutual fund that has lost half of its value over the last three years. It represents 15 percent of Jasper's total registered portfolio. Most recently, Jasper purchased units in a precious metals fund. He rationalizes the purchase by explaining to Ryan, *"I heard that many of the large investment managers have been flocking to gold to protect their positions, given the market reversal."* His company shares tend to be quite volatile and are currently trading at an all-time high.

Jasper has been self-managing his portfolio since the last market downturn seven years ago because he lost confidence in his advisor. He explained proudly that *"up until recently I was doing great, earning close to six percent per year over the last four years buying and selling periodically. I generally pick funds that have long-standing portfolio managers and have generally performed well."* This year, however, his portfolio is down more than 20 percent. *"I don't know what happened!"* Jasper declared. *"My portfolio was $220,000 and now it's barely exceeding the book value! This is so upsetting to me that I'm starting to pore over my portfolio every night."* Jasper continued, *"I've been so busy lately with decisions at work that I'm not keeping up with the news and current events like I used to. I'm trying to decide whether I should be selling the energy fund or buying more. I've read conflicting news stories. I want to make the right decisions to ensure that I can take another sabbatical in six years."*

When Ryan inquired if Jasper would be open to liquidating any of his investment holdings, he replied that he wants to maintain his company stock. *"The future is looking bright for our company. I've worked for this firm for 15 years, and have great confidence in the CEO and the industry. The stock is worth more than what the market is pricing it at. Plus I've earmarked the value of my shares to cover the cost of my cruise. I work so hard each year that I will not give up that opportunity to travel. On top of that, if I sell any of the shares, I will have to pay tax."*

Ryan has identified that Jasper has a risk profile consistent with a balanced portfolio made up of 60 percent in equities and 40 percent in fixed income. Ryan has calculated that a buy-and-hold strategy over the last four years would have resulted in an average annual return of close to eight percent. Jasper has a marginal tax rate of 35 percent.

Knowledge Expectations – Biases

The FPSC Level 1 Certificant in Financial Planning and CFP Professional should be able to:

- Identify that the way Shae-Lynn characterized Jasper and Louise may influence Ryan's perception of the clients.[1] Ryan should be aware of potential biases that he may have in order to prevent them from influencing his approach with clients.

- Identify that Jasper's motivations include travelling in six years, retiring in 20 years and reducing his anxiety around declines in the value of his portfolio.

- Identify that Jasper's constant scrutiny of his portfolio and news articles may be affecting his ability to make good decisions due to an overload of information.

- Identify that Jasper appears to be under pressure, busy and making a lot of decisions at work, which may affect his investment-planning decisions in a negative way.

- Identify the biases that may affect Jasper's ability to make decisions:
  - A bias of overconfidence, as demonstrated by Jasper's decision to self-manage his investment portfolio.
  - An emotional bias known as the "hot-hand fallacy", as demonstrated by Jasper's sense that historical returns may provide assurance of similar returns in the future.
  - An endowment bias, as demonstrated by Jasper's views that his company shares are being undervalued by the market because he owns them. This may also reflect a familiarity bias.
  - An anchoring bias, as demonstrated by Jasper's comparing of his portfolio's current market value to the recent $220,000 peak value, rather than the amount he has invested.

- Identify that his overconfidence and connection to his company may create some resistance to change.

[1] This example is based on the work of Daniel Kahneman. Note that the only difference in the characteristics is the sequence in which they were presented. Such ordering can affect the perception of the individual receiving the information. Kahneman, Daniel. (2011). *Thinking, fast and slow.* New York: Farrar, Strauss and Giroux. See page 82.

Knowledge Expectations – Relationships

The FPSC Level 1 Certificant in Financial Planning and CFP Professional should be able to:

- Identify the importance of building trust with Jasper given his overconfidence in his abilities, and loss of confidence in his prior advisor.
- Establish a relationship based on trust by avoiding problem-solving, or making recommendations prior to listening and understanding his biases and motivations. *"I must start by saying that you have done a remarkable job of being diligent in saving toward your retirement goal."*
- Normalize Jasper's concerns. *"I can appreciate your concerns over the recent drop in value of your portfolio. Markets have been particularly volatile this year. Feeling anxious about market volatility is something that every investor experiences at some point in their life. Many of my clients have similar reactions."*
- Demonstrate a genuine interest in helping Jasper by offering to meet in person to discuss his goals and potential options in further detail. *"Given your concerns and interest in ensuring that you stay on track to meeting your goals, would you like to meet in person to discuss your situation and options in more detail?"*
- Continue to build a relationship based on trust with Jasper by asking open-ended questions when meeting in person. Ask open-ended questions to understand better his previous experience with a financial advisor relative to his expectations and investment concerns. Ask about his experience with debt, as it appears that his current credit card balance is unusually high.
- Paraphrase Jasper's goals (travelling during his sabbatical in six years and retiring in 20 years) and his concerns (high debt levels, decreasing investment values and the possibility of not meeting his goals).
- Instead of judging Jasper's approach to his finances, focus on his goals and lay out an approach to help meet them, and put him at ease. Doing so would also include creating a financial plan.
- Identify that, in meeting with Ryan, Jasper may be signaling that he is open to change, a characteristic of the contemplation stage of change.
- Encourage Jasper to think about possible alternatives that he may not have considered. Since Jasper may prefer visuals based on his preference to track his investment performance, offer to show Jasper some relevant trade-offs.
- Identify that Jasper is engaging in mental accounting by maintaining his outstanding credit card balance, while also holding non-registered investment assets. Show Jasper that by selling a portion of his company stock and using the proceeds to retire his debt, he could save significant amounts of interest and free up cash flow, while maintaining his net worth.
- Identify that Jasper's connection to his company shares is an emotional one. As a result, he may resist a recommendation to liquidate them.
- Normalize Jasper's connection to his employer, by saying, *"It is quite normal to feel a closer connection and loyalty to your company shares than to other investments you hold. It sounds like you've had a very positive, 15-year-history with the company, and have high confidence in the company's continued success."*
- Explain to Jasper that he may be at risk of falling short of meeting his goals by maintaining the status quo.

- Encourage Jasper to identify possible actions that he may take to achieve his goals.

- Explain to Jasper that he should be able to meet his goal of going on a cruise in six years, but that maintaining his current debt load may delay his scheduled retirement date.

- Identify Jasper's willingness to engage in discussion about using his stock to pay down his debt, by asking a variation of the following: *"Would you be interested in learning how selling your stock to pay down your debt would let you retire when you want to, without giving up your cruise in six years?"* Once Jasper is interested, demonstrate how selling his stock will let him achieve all of his goals (see below). If Jasper declares that he is not interested, respect his decision and do not recommend the option of using his stock to pay down his debt.

- Offer to meet again in a month's time to review financial plan recommendations in detail, based on additional analysis of his current situation and goals.

Knowledge Expectations – Motivation

The FPSC Level 1 Certificant in Financial Planning and CFP Professional should be able to:

- Identify that any recommendations provided to Jasper must be framed in a way that serves his interest. They must help Jasper meet his goals of travelling in six years and retiring in 20. Second, they should include optimistic language focused on the benefits of taking the recommended actions to match Jasper's "promotion focus" attitude. Finally, the recommendations should be easy to implement and relieve his anxieties. Explain the recommendations in a way that helps to ensure the benefits are clear. *"The payments that you are making to your credit cards are being spent on high interest charges. If you continue to make $670 monthly payments to your credit cards, you won't be debt-free for another 27 years. You will also have to work longer than you would like before you can afford to retire. If you were to sell your stock, however, and use it to pay off your credit card, you could save more than $171,000 in interest and free up $670 of cash flow per month. More importantly though, is that, when redirected to a Tax-Free Savings Account, that $670 monthly contribution should enable you to cruise in six years and retire when you want to, without having to adjust your net cash flow."*

- Explain the benefits of asset allocation to Jasper, including the ability to reduce his risk and volatility through diversification, using an appropriate mix of stocks and fixed-income investments. Explain the benefits of implementing a rebalancing strategy, while avoiding the "curse of knowledge" that may affect an FPSC Level 1 Certificant in Financial Planning. In each case, the benefit should focus on the opportunity for Jasper to meet his goals.

- Normalize Jasper's response to the recent volatility in the markets and explore some alternatives. *"It is commonplace for investors to make investment choices based on historical performance, recent economic news or market performance. Our emotions play a key role in these decisions. Many times, they get the best of us, and tend to be the reason individual investors achieve performance below the returns of the market. It's so prevalent that it has become known as the Behavior Gap. I can appreciate your reluctance to sell the energy fund. It's understandable that an investment that has fallen in value may be hard to let go of. I can also understand your motivation to follow the crowd and purchase the precious metals fund."*

- Explore the advantages and disadvantages of professional money management, and Jasper's understanding of an advisor's role, and the advisor's influence on market behaviour.

- Identify that Jasper's anchoring to the $220,000 peak value of his portfolio is a common example of the peak-end rule that occurs frequently because of a bias toward recent events. Explain that, *"While the balance of your portfolio may have fallen from its peak value, your profit may be greater than you think, given that comparing market value to book value is not an appropriate measurement of growth."* Avoid the use of jargon, and educate Jasper on how book value is determined, and why it probably differs from the amount that he has invested. *"The book value of a portfolio is the amount you have purchased, including any original purchases and purchases made using reinvested distributions. As you might expect, that would mean that the amount you invested is lower than the book value. So, your profit is actually higher than you think."* Encourage Jasper to contact the brokerage firm holding his assets to find out the dollar amount that he has invested. Once Jasper has the figure at his disposal, the dollar amount of growth, or annualized rate of return, can be calculated for him.

- Identify ways to encourage Jasper and support his continued progress. For example, congratulate him on his growth so far, and offer to meet again at his convenience to review his future progress.