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The science behind behavioral coaching

- Vanguard research has found that providing discipline and guidance to clients through behavioural coaching can be a significant source of value in the advice process.
- The field of neuroeconomics can help advisers understand what happens in the brain during the investment decision-making process.
- This could expand the toolbox for advisers when coaching their clients, helping them to stay on track.

Introduction

Investing is constantly accompanied by strong emotions: Worry about the future, euphoria, fear – of losses or of missing out on lucrative trends. That is why advisers can add substantial value by helping their clients to maintain a long-term perspective and a disciplined approach[1].

The emotions that can sometimes drive investors to behave to their own disadvantage, such as the temptation to abandon markets when short-term performance has been poor or chase the next 'hot' investment, have been observed and described in investors for decades.

Now the field of neuroeconomics, which bridges the gap between empirical psychology, theory-driven economics and natural science, is helping to map exactly what happens in the brain during such decision-making processes – and could thus provide the basis for more effective methods to systematically counteract behavioral distortions.

Imaging techniques such as fMRI[2] show exactly which areas of the brain are activated during certain decisions, says Rolf Daxhammer, professor of international financial markets at Reutlingen University. "This will expand the toolbox for advisers when it comes to behavioral coaching, make their methods more precise and also increase the appreciation of their work."

One of Daxhammer's key research interests is the field of behavioral finance, or how emotions and behavioural patterns can distort markets and affect investing. We talked to him to explore how neuroeconomics and artificial intelligence (AI) could enhance behavioural coaching.

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Advisers can act as 'emotional circuit breakers'

Advisers need to understand their clients, at best even anticipate their behaviour, and circumvent the tendency for emotions to prevent rational behaviour and cause clients to miss their investment goals. Vanguard's four investment principles – setting goals, taking a balanced investment approach, remaining disciplined and keeping costs low – are designed with this in mind and can support conversations with clients about how to stay on track.

Vanguard research has found that investors derive significant peace of mind from knowing their investments are on track – or the emotional value of advice. Only 24% of human-advised clients would have peace of mind if they were managing their investments on their own. However, three times as many, or 80%, report having peace of mind with the help of their advisers. In absolute terms, therefore, human advisers increase investors' peace of mind by 56 percentage points[3].

Nudges, or incentives in the decision-making process, are an important tool here. Nudges can guide and support investors in making important decisions, but should in no way restrict their freedom of choice. "Some people confuse nudging with manipulation," says Daxhammer. "

1 Vanguard research and other academic studies have concluded that behavioural coaching can add value over a long-term investment horizon. For example, by comparing 58,168 self-directed investor's personal returns for the five years ended 2012 versus hypothetical results using two Vanguard created 'personal rate of return benchmarks' based on single fund alternatives, we found that the average fund investor who made at least one change to their portfolio sacrificed 104 to 150 bps due to poor portfolio adjustments (Weber, 2013). Source: Putting a value on your value: Quantifying Adviser's Alpha, Vanguard Research, June 2020.

"But nudging is more about helping people in emotional situations or situations that are difficult to assess to achieve the goals they themselves have defined in advance."

Every good advice relationship is based on a long-term plan. That is why the first of Vanguard's principles is for the investor, working with their financial adviser, to set measurable and attainable goals and develop a plan for meeting those goals. Nudges can then be designed to help investors overcome unhelpful behavioral patterns so that they can stick to their plan in specific situations. Advisers are therefore acting as a kind of emotional circuit-breaker and preventing wealth destruction – or indeed adding significant value.

Turning impulsive decisions into considered ones

One topic investors struggle with particularly often is retirement planning. "Here, for example, they are dealing with short-term or myopic loss aversion," says Daxhammer. "Even payments into one's own investment or retirement account are perceived as a loss in that moment." Goals for the distant future, in turn, remain abstract.

Meanwhile, turbulent market phases such as those experienced by investors recently often activate flight instincts in the brain. This instantaneous thinking, also called system 1 thinking, has served us well in evolutionary terms, for example when we are exposed to dangers to our own lives and need to make very quick, instinctive decisions. When it comes to investing money, however, a considered decision - so-called system 2 thinking – would usually be better. Such decisions are processed quite differently in the brain. However, these require far more mental effort, so people all too often go with their gut, harming their long-term plans in the process.

Reducing complexity and simplifying decisions

If advisers are aware of how different situations are processed in their clients' brains, they can also provide better incentives. In decisions such as the choice of an investment product, which should be well considered with the help of system 2, advisers can reduce complexity by providing a pre-selection of products and simplifying the decision for clients. This reduces mental effort and increases the willingness to make considered decisions.

AI helps investors get to know themselves better

These exciting developments in neuroeconomics do not mean that observed data now no longer plays a role - on the contrary. "We have data about the markets and investor behaviour in abundance," says Daxhammer. "What's relatively new is how artificial intelligence can help us identify patterns and draw conclusions."

For example, he says, there are attempts to read from the trading behaviour of individual investors whether there is a behavioral bias, or whether behaviour that is not conducive to reaching goals is particularly common in certain market phases, for example. On this basis, it would be conceivable for advisers to develop automated warning signals or nudges.

"We are still a long way from a mature AI solution," says Daxhammer. "But one thing is certain: behavioral coaching is getting a tailwind from many sources right now."

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2 Functional MRI (fMRI) measures brain activity by detecting changes associated with blood flow.

3 Quantifying the investor's view on the value of human and robo-advice, Vanguard Research, February 2022. Paulo Costa, Ph.D.; Jane E. Henshaw. Survey conducted in July 2021. Sample included a total of 1,308 human-advised and 337 digital-advised clients. Clients could rate peace of mind from 0 ("No peace of mind at all") to 10 ("A great deal of peace of mind"). Clients were considered to have peace of mind if their rating was between 8 and 10. Sources: Vanguard and Escalent, 2021.

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