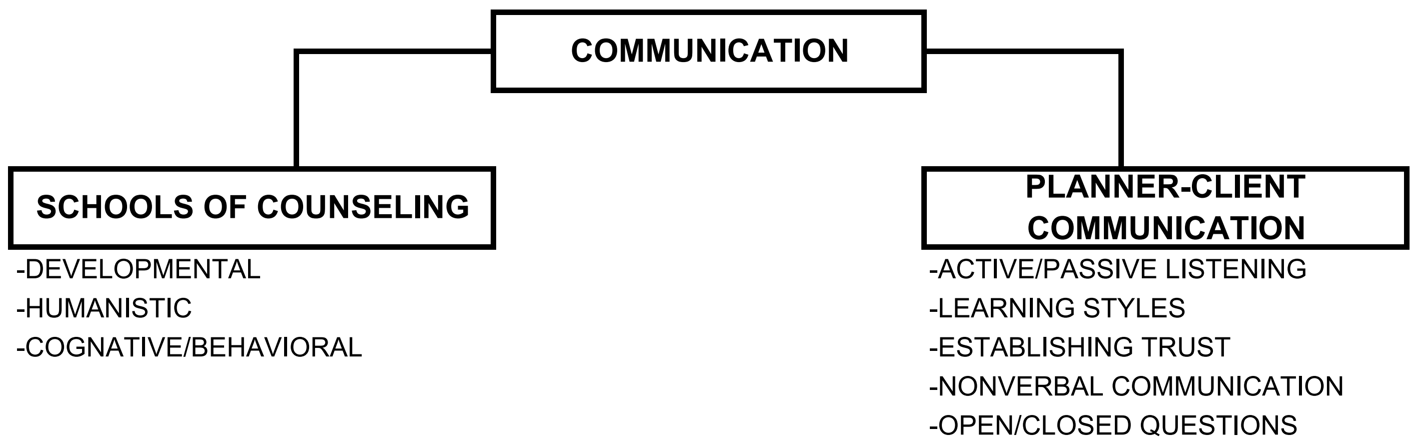
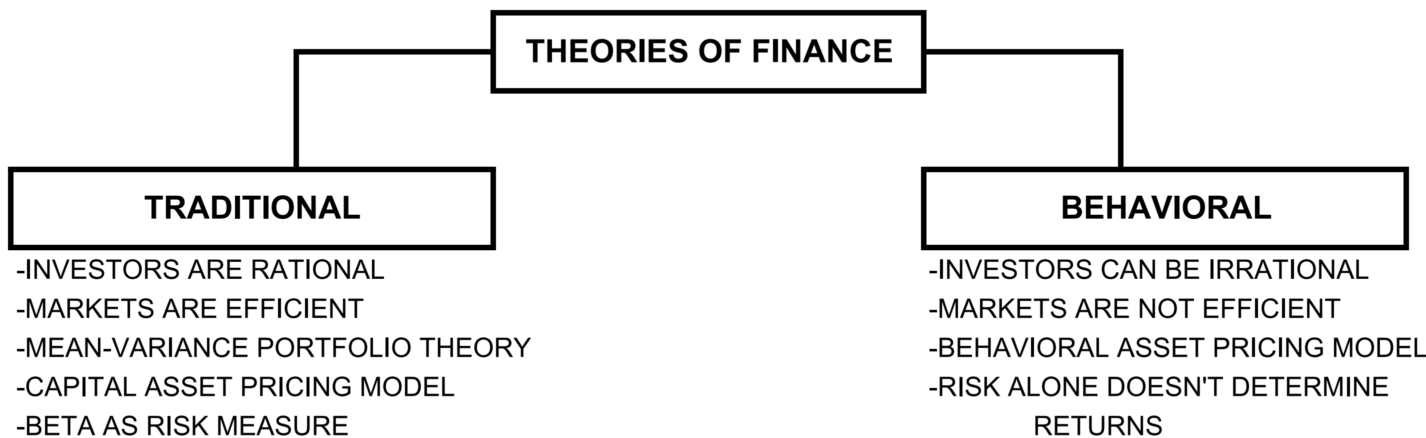
Module 2

Interpersonal Communication



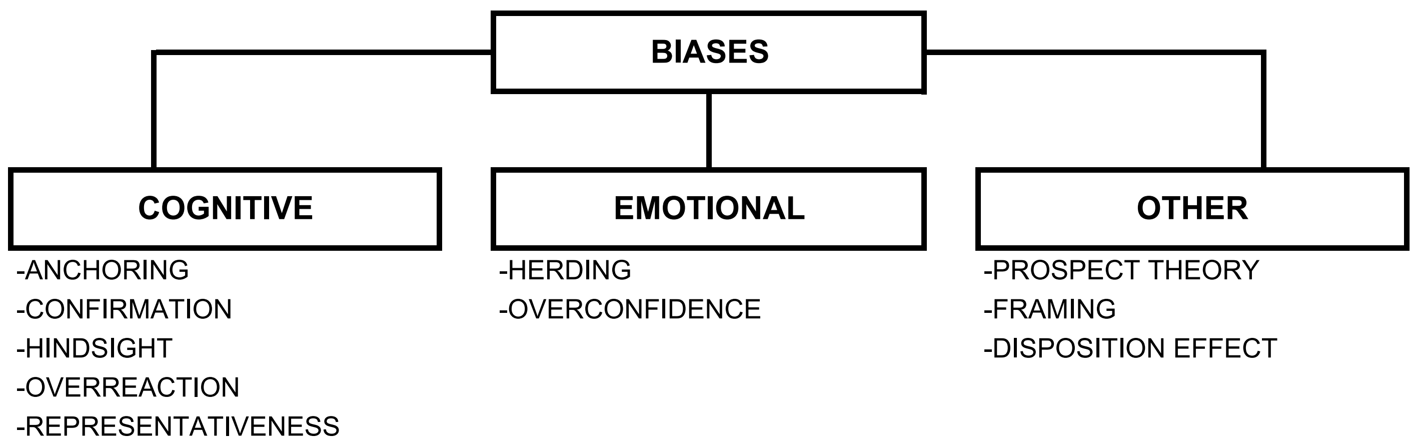
-DEVELOPMENTAL
-HUMANISTIC
-COGNATIVE/BEHAVIORAL

-ACTIVE/PASSIVE LISTENING
-LEARNING STYLES
-ESTABLISHING TRUST
-NONVERBAL COMMUNICATION
-OPEN/CLOSED QUESTIONS



-INVESTORS ARE RATIONAL
-MARKETS ARE EFFICIENT
-MEAN-VARIANCE PORTFOLIO THEORY
-CAPITAL ASSET PRICING MODEL
-BETA AS RISK MEASURE

-INVESTORS CAN BE IRRATIONAL
-MARKETS ARE NOT EFFICIENT
-BEHAVIORAL ASSET PRICING MODEL
-RISK ALONE DOESN'T DETERMINE RETURNS



-ANCHORING
-CONFIRMATION
-HINDSIGHT
-OVERREACTION
-REPRESENTATIVENESS

-HERDING
-OVERCONFIDENCE

-PROSPECT THEORY
-FRAMING
-DISPOSITION EFFECT

© SAW Financial Group, L.L.C. d.b.a. BigDaddy U

Interpersonal Communication

Module 2
Chapter 2

1

1

Objectives

- Obj I: Schools of Counseling
- Obj II: Planner-Client Communication
- Obj III: Behavioral Finance Theory
- Obj IV: Cognitive and Emotional Biases
- Obj V: Risk and Loss Aversion

2

2

Schools of Counseling

3

3

Approaches to Counseling

- Three main approaches to counseling:
  - Developmental approach.
  - Humanistic approach.
  - Cognitive-behavioral approach.

4

4

Developmental Approach

- The developmental approach is based on the theory that human development occurs in predictable stages.
  - Influenced by Freud.
- Suggests that disruptions in normal development result in predictable problems, symptoms, and behaviors.
  - Aspires to correct earlier disrupted development to foster change in client's behavior.

5

5

Humanistic Approach

- The humanistic approach is based on philosophical theory.
  - Humanistic counselors define proper mental health as having congruent and aligned thoughts and behaviors.
- Treatment goals are centered on self-reflection.
  - Focuses on a client's mental health, personal responsibility, and freedom of choice.

6

6

Cognitive-Behavioral Approach

- The cognitive-behavioral approach focuses on identifying aspects of one's surroundings that are unhealthy and could be changed.
  - Initially based on animal research.
- Evaluates the effectiveness of environmental reinforcers when treating problematic behaviors and self-talk.

7

7

Practice

- The idea that treatment goals are centered on the acceptance of personal responsibility, recognizing freedom of choice, and focusing on the present moment follows which school of thought?
  - A. The developmental school of thought.
  - B. The humanistic school of thought.
  - C. The cognitive-behavioral school of thought.
  - D. The traditional school of thought.

8

8

Planner-Client Communication

9

9

Elements of Communication

- Financial planning involves many quantitative and technical processes.
  - Being able to effectively communicate is equally as important.
- Elements of effective communication strategy:
  - Active vs. passive listening.
  - Client learning styles.
  - Establishing trust.
  - Nonverbal communication.
  - Types of questions.

10

10

Active Listening

- The ability to listen is the biggest skill required to be a successful financial advisor.
  - Active listening requires undivided attention and dedicated concentration.
- When practicing active listening, one must:
  - Put aside irrelevant thoughts.
  - Observe body language.
  - Paraphrase what the speaker is saying and ask follow-up questions.

11

11

Passive Listening

- Passive listening requires very little of the listener.
  - Occurs during seminars, educational settings, social gatherings, and sermons.
- Communication rests entirely on the speaker.

12

12

Client Learning Styles

- Two main learning styles:
  - Visual learning.
  - Verbal/auditory learning.
- Clients usually have a preferred learning style.
  - Planners should adapt their communication to each client's needs.
  - Understanding the client's preferred learning style can help planner develop an effective communication plan

13

13

Client Learning Styles

- Visual learners make up 65% of the population.
  - Respond well to charts and graphs.
- Verbal/auditory learners focus attention on every spoken word.
  - Ask for an explanation of words.
  - Learn better when images include phrases and annotations.

14

14

Establishing Trust

- Establishing trust allows the advisor to strengthen their relationship and build rapport with their clients.
  - Can be difficult but is very important.
- Trust is established with empathy, respecting client wishes, and exhibiting discretion.
  - Trust can be damaged if advisor does not maintain confidentiality of clients and lacks empathy.

15

15

Nonverbal Communication

- Clients may use nonverbal cues to communicate.
  - Includes body language, facial expressions, and voice tone or pitch.
- Nonverbal cues can sometimes convey more information than the words that are spoken.

16

16

Types of Questions

- Questions can be open ended or closed ended.
  - Open – key to learning about client's goals.
  - Closed – can pinpoint specific information.
- Open ended questions are a simple strategy to collect data.
  - However, may put the client in a defensive position.
  - "Why do you like working with that planner?"
  - "What is your opinion about…"

17

17

Types of Questions

- Closed questions require a specific response.
  - Commonly answered in one or two words.
  - "Does," "how," "when," etc.
  - "How much income do you receive from your farm?"

18

18

© SAW Financial Group, L.L.C. d.b.a. BigDaddy University

Practice

- Which of the following statements is correct regarding planner-client communication?
  - A. Advisers should passively listen to their clients throughout their meetings.
  - B. Advisers should use both open and closed questions during their client meetings.
  - C. Advisers should avoid using phrases that demonstrate empathy when building trust with their client.
  - D. Advisers should only pay attention to the words their clients are using and ignore all other nonverbal cues.

19

19

Practice

- Which of the following is most likely the beginning of an open-ended question?
  - A. “Is it not true that...?"
  - B. “Would...?"
  - C. “Do...?"
  - D. “How…?”

20

20

Behavioral Finance Theory

21

21

Traditional Finance Theory

- Traditional finance, also known as Modern Portfolio Theory, is based on the theory that:
  - Investors are perfectly rational.
  - Markets are efficient – no way to "beat the market."
  - Mean-Variance Portfolio Theory and the Capital Asset Pricing Model.
  - Beta can be used to judge volatility of an investment.

22

22

Rational Investors

- Traditional finance is based on rational investors.
  - Investors are expected to identify appropriate investments and fund them optimally.
- Rational investors would:
  - Avoid guaranteed payouts and take on more risk if it will result in additional return.
  - Without passion, sell investments that have lost value to claim tax deductions.
  - Avoid panic selling.

23

23

Efficient Markets

- Traditional finance is based on efficient markets.
  - Assets are priced appropriately based on currently available information.
  - Assets will adjust predictably and reasonably to new information.
- Investors cannot consistently outperform an efficient market.

24

24

© SAW Financial Group, L.L.C. d.b.a. BigDaddy University

Mean-Variance Portfolio Theory

- Mean-Variance Portfolio Theory considers investments based on risk and expected return.
  - Variance is the measure of risk.
- Investors should specify either their required rate of return or their preferred level of risk.
  - Portfolio should then be selected that fits their specifications.

25

25

Beta

- Beta is a measure of market risk.
  - Market beta equals 1.
  - Investments with a beta exceeding 1 are more volatile than the market.
- Beta can be used to:
  - Calculate expected return under CAPM.
  - Create a diversified portfolio with a known level of risk.

26

26

Behavioral Finance Theory

- Behavioral finance is relatively new.
  - Does not fully reject traditional finance theory.
- Behavioral finance theory assumes:
  - Investors are sometimes irrational.
  - Markets are not efficient.
  - Behavioral portfolio theory governs.
  - Risk alone does not determine returns.

27

27

© SAW Financial Group, L.L.C. d.b.a. BigDaddy University

Practice

- In accordance with the principles of traditional finance (modern portfolio) theory:
  - A. A rational investor is affected by bias and emotion.
  - B. Markets are inefficient.
  - C. Investment return is commensurate with the risk undertaken by the investor.
  - D. Mean-variance portfolio theory should be ignored as it produces unreliable results over a long-term time horizon.

28

28

Cognitive and Emotional Biases

29

29

Cognitive Biases

- Cognitive biases:
  - Anchoring.
  - Confirmation.
  - Hindsight.
  - Overreaction.
  - Representativeness.
- Emotional biases:
  - Herding.
  - Overconfidence.

30

30

© SAW Financial Group, L.L.C. d.b.a. BigDaddy University

Anchoring

- Anchoring is a type of cognitive bias.
  - Act of attaching one's thoughts to a reference point.
  - Also known as conservatism or perseverance.
  - Common when decisions being made are novel or new to the decision maker.
- Can be mitigated by finding objective measures of value.

31

31

Confirmation Bias

- Confirmation bias is a type of cognitive bias.
  - People tend to filter information and focus on information supporting their opinions.
- Can be mitigated by actively seeking disconfirming evidence and surrounding oneself with diverse viewpoints.

32

32

Hindsight

- Hindsight is a type of cognitive bias.
  - The feeling of "knowing all along" what would happen.
  - May lull investor into believing they can perform better or more efficiently.
- Can be mitigated by keeping records and making small "test runs" of ideas before over-committing.

33

33

Overreaction

- Overreaction is a type of cognitive bias.
  - A larger-than-is-warranted reaction to news or the overweighting of sample information.
- Can be mitigated by taking a pause before acting and seeking objective advice.

34

34

Representativeness

- Representativeness is a type of cognitive bias.
  - Individuals determine the probability of an occurrence based on its apparent relationship with an event existing in their mind.
  - "Past performance does not predict future results" is a warning to investors against representativeness.
- Can be mitigated by conducting fundamental analysis on the investment.

35

35

Herding

- Herding is a type of emotional bias.
  - Stems from people's desire to conform or be accepted by a certain group.
- Can be mitigated by looking for objective measures of value.

36

36

Overconfidence

- Overconfidence is a type of emotional bias.
  - Occurs when an investor over weights their own skills or research capabilities.
  - Overconfident investors trade more than their less confident peers.
- Can be mitigated by recalling failures, seeking objective measures, and keeping performance records.

37

37

Prospect Theory

- Prospect theory is commonly regarded as the first major theory of behavioral finance.
- Suggest people value gains differently from losses.
  - Will base decisions on perceived gains rather than perceived losses.

38

38

Framing

- Investment decisions can be influenced by how the decision is framed.
  - Considering a 75% chance of a gain is more attractive than 25% chance of a loss.
- Framing affects risk-tolerance.
  - Protecting gains vs. recovering losses.
  - Advisors can nudge clients by choosing the proper framing.

39

39

Disposition Effect

- Disposition effect describes behavior of investors who sell assets when prices rise.
  - Hold assets when prices fall.
- A rational investor would focus on total portfolio return.
  - However, someone affected by disposition effect holds on to losers to avoid pain of realizing a loss.
- Can be mitigated by re-framing the situation.

40

40

Practice

- Which of the following statements is/are correct regarding the overconfidence bias?
  - I. It leads investors to reduced trading frequency because they are more confident of their investment decisions.
  - II. It is a type of cognitive bias.

41

41

Practice

- Which one of the following is an example of the disposition effect?
  - A. An investor purchases stock for $100 but refuses to sell it when it drops to $90 because they believe the stock should be valued at $105.
  - B. An investor purchases stock for $100 but refuses to sell when it immediately increases in price to $110 because they believe the stock should be valued at $115.
  - C. An investor purchases stock for $100 and immediately sells it after its price jumps to $110.
  - D. An investor purchases stock for $100 and immediately sells it after its price falls to $90.

42

42

Risk and Loss Aversion

43

43

Capital Asset Pricing Model

- The Capital Asset Pricing Model (CAPM) is a product of traditional finance.
  - Predicts the expected return of an investment based on beta (relative risk to the market).
  - Uses the market risk as a baseline.
- Investors elect to take more (or less) than market risk and expect to receive more (or less) return.

44

44

Behavioral Asset Pricing Model

- The Behavioral Asset Pricing Model (BAPM) is a product of behavioral finance.
- Predicts return based on market risk, as well as:
  - Market capitalization ratios.
  - Stock momentum.
  - Social responsibility factors.
  - Investor emotions.

45

45

© SAW Financial Group, L.L.C. d.b.a. BigDaddy University

Risk Capacity

- Risk capacity is the amount of risk an investor can take.
  - Influenced by cash flow, assets and liabilities, human capital, and dependents.
- People with higher risk capacity tend to have:
  - Higher income.
  - Fewer expenses.
  - Less debt.

46

46

Risk Tolerance

- Risk tolerance is the amount of risk an investor is willing to take.
  - Influenced by emotions, knowledge, attitudes, and general propensity for risky behavior.
- People with higher risk tolerance tend to have:
  - Less stable income.
  - Shorter work history.
  - Riskier investments.

47

47

Practice

- The behavioral asset pricing model considers all of the following risk factors when predicting investment returns, EXCEPT:
  - A. Market capitalization ratios.
  - B. Investor emotions.
  - C. Social responsibility factors.
  - D. Inflation rates.

48

48