APPLETON PARTNERS, INC.

Breaking Through Behavioral Barriers in Personal Financial Planning

Despite a tendency to think of personal finance in quantitative terms, helping clients reach their wealth management goals ought to involve more than data-driven models. At Appleton, we believe the best financial planning advice also considers an element of psychology. Recognizing and adapting to unique emotions and behavior patterns can facilitate better long-term outcomes.

Behavioral finance draws upon cognitive psychology to analyze and explain the thought processes that influence financial decisions. This realm of economics challenges what was once a "rational actor" assumption. Improving our understanding of how information is processed, what risk means to each of us, and what prompts individuals to act can help mitigate that which hinders financial planning.

Communication is Essential but Challenging

Recognizing and adapting to distinct communication styles is an overlooked, yet valuable skill. How one person responds to advice is often very different than another. The same substance and style might be well received by one party yet fall woefully short with another. As wealth managers, our attempt to ensure what we say is received in the manner intended requires awareness of and adaptability to the recipient's communication style. To an analytical, unemotional investor, data may make the case, whereas a less involved investor often makes decisions based primarily on relationship trust. Offering advice in a manner clients can relate to goes a long way towards effective collaboration.

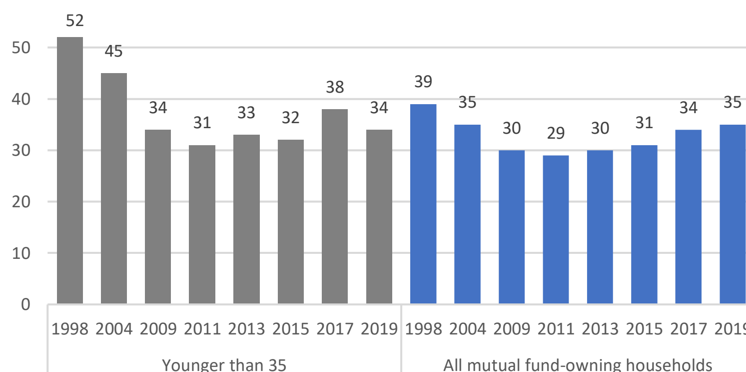
Risk Tolerance: More Complicated Than You May Think

An often-misunderstood reality is that there can be a significant difference between one's *capacity* to take on risk and their emotional *tolerance* for it. The former is means-based, while the latter is a comfort level. While sophisticated models are adept at analyzing risk capacity based on inputs such as wealth, time horizon, and asset/liability modeling, another element lies in risk psychology. We value objective data such as the consistency of positive equity market performance over long periods, yet also recognize that individual risk/reward frameworks differ. For example, studies have consistently demonstrated that most investors feel the pain of loss much more acutely than the pleasure of gain and may react by "anchoring" to the price paid for investments and resist cutting losses. Understanding a client's relative comfort level with prospective upside or downside requires understanding how they internalize risk and reward. Absent such insight, susceptibility to behavioral pitfalls such as selling out of markets at the wrong times can increase.

"Experience Is the Teacher of All Things"[1]

We are all products of our life experiences; the more acute the more likely they are to influence investment behavior. The Great Depression offered an extreme example, as those who lived through that era tended to be highly conservative with their money long afterwards. Recency bias is also a powerful factor. The Investment Company Institute found that willingness to take on risk meaningfully differed depending on the survey year regardless of age cohort. The post-Financial Crisis years of 2009 and 2011 illustrate this point. How a client reacts to an asset allocation plan, and the likelihood they will maintain it long term, may be influenced by the current environment and their past experiences. Although such considerations should not drive a plan's substance, discussing a client's emotional ability to adhere to an asset allocation strategy is as much a part of the process as determining their financial means to do so.

Percentage of all US Households willing to take "above-average" or "substantial" investment risk



Source: ICI Annual Profile of Mutual Fund Shareholders, 1998, 2001, 2004, & 2008-2019

"Don't Stop Thinking About Tomorrow"[2]

Yes, tomorrow will soon be here, so how can advisors address other deep-seated behavioral tendencies that may compromise positive, forward-thinking actions? "Nudge: Improving Decisions About Health, Wealth, and Happiness"[3] argues that subtle incentives and gentle guidance that preserve individual choice are often more helpful than directives or coercive approaches.

A challenge lies in what is known as status quo bias. Inertia, confusion, or other priorities often inhibit individuals from taking beneficial actions. This is particularly the case when benefits are tangible and immediate (e.g., spending), whereas costs are ambiguous and far removed (e.g., retirement security). The authors make a strong case that mechanisms such as default retirement plan options, negative consent agreements, or eye level shelf space placement are highly effective in inducing advantageous personal decisions without taking away choice. For example, the authors reference a study that revealed how rearranging the placement of school cafeteria items alone changed consumption patterns by more than 25%.

Relative to financial planning, we encourage clients to maximize retirement savings, engage in estate plan review and documentation, and proactively manage taxes. By simplifying decision analysis, offering feedback, and making beneficial options readily understandable, we hope to reduce emotional barriers and "nudge" clients towards constructive actions.

The people side of wealth management may in certain respects be more complicated than its analytical elements, yet both are essential. Personalization extends beyond customizing portfolios; it demands a sense of what makes each client unique and influences their financial decisions. Behavioral finance is an inexact science, yet one that warrants our attention.

1. Julius Caesar, 52 B.C. 2. Fleetwood Mac, 1977 3. Richard Thaler and Cass Sunstein, 2021

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MARKET OBSERVATIONS & IMPLICATIONS

Tax-Exempt Investment Grade Municipals

- While a resurgent Delta variant and its economic impact have muddied the economic waters, the Fed has been clear about the likelihood of tapering beginning in late 2021 or early 2022.
- DC policy also remains in flux as Democrats seek consensus on "hard" and "soft" infrastructure. The outcome could impact municipal supply if it prompts a return of Advanced Refundings and Build America Bonds (BABs).
- The 10Yr UST hit a cyclical low of 1.17% in August, before taper concerns lifted yields to 1.49% at the end of Q3.
- Intermediate Municipals followed USTs with 10Yr AAA yields rising 15bps. The front end remains anchored with Fed Funds increases not likely until 2023.

	6/30/21	9/30/21	QTD change
2Yr AAA Muni	0.16%	0.17%	+1 bp change
10Yr AAA Muni	0.99%	1.14%	+15 bps
30Yr AAA Muni	1.50%	1.67%	+17 bps

- YTD issuance of $346.5B is down 2.4% vs. 2020 and lagging Q3 new supply (-20% YoY) has further challenged the market's ability to reach scaled down $460-$515B expectations for 2021.
- $29B flowed into municipal bond funds in Q3, raising YTD net flows to an elevated $88.5B. Long funds attracted over 50% of the Q3 cash flows (Lipper Inc.).
- A late Q3 sell-off raised 10Yr Muni/Treasury ratios to 76.5% from a low to mid-60% range. Expectations for higher personal income tax rates are fueling retail demand, while net negative summer supply has supported the bid-side for munis. We see ratios remaining in the 70s or lower over the course of 2021 and possibly longer.
- Credit spreads tightened slightly in Q3, primarily in lower grades. AAA-BBB spreads fell from 63bps to 57bps, while AAA-AA spreads only tightened 1 bp to 12bps. State GO spreads were mostly static in Q3, aside from IL which tightened 7bps to +58 bps.
- With yields moving higher in Q3, mainly in 6+ year maturities, duration drove performance with credit not a major factor.
- We have adjusted our 10Yr UST trading range to 1.25 – 1.75% and could see some volatility and upward pressure on the high end of that range through the Fall. However, the likelihood of the 10Yr UST trading higher than 2.00% for a sustained period is low.
- Our Intermediate Municipal strategy remains duration neutral at roughly 4.50 years and we are emphasizing high grade issues of 6 to 12-year maturity.

Investment Grade Corporates & Treasuries

- Relative stability of macro factors, favorable market technicals, and strong credit fundamentals are sustaining tight IG credit spreads. After hitting a YTD low of 80 OAS (BB US Corp. Index) in June, spreads traded in a tight band before closing Q3 at 82 OAS.
- With IG spreads range bound, 2021 excess returns have been muted and performance remains largely driven by rate movements. Despite a solid July, Q3 total return was essentially flat.
- The FOMC meeting in September suggested the hawks are scaring away the doves as a more bullish forward narrative took hold. UST yields subsequently moved higher, producing an intermediate curve steepener that pushed 5, 7 and 10Yrs up by 19 to 21bps.
- Looking ahead, moderating issuance and a continuation of the immense support the market has enjoyed could leave room for modest spread tightening, and we expect credit resilience into 2022. We see greater risk of widening from the DC fiscal debates and inflation concerns rather than much anticipated Fed tapering.
- Our portfolios remain cautious about duration management, and we feel intermediate IG maturities offer relative value.

Equities

- Despite receding 4.6% in September, the S&P 500 produced its 6th consecutive positive quarter with a 0.6% gain that raised YTD total return to +15.9%.
- USTs closed Q3 at 1.49% after bottoming at 1.15% in early August. The speed of the yield move, not the magnitude, has unnerved investors already grappling with Fed tapering, the fate of Chairman Powell, the debt ceiling, and supply chain issues.
- Inflation and interest rate concerns pressured "longer duration" growth-oriented equities towards the end of Q3. At a S&P 500 sector level, Technology (-5.78%) and Communication Services (-6.58%) lagged in September, whereas Energy (+9.44%) benefitted from commodity price momentum.
- On a relative basis, the case for equities remains solid with 10Yr USTs of 1.49% only modestly exceeding the S&P 500's 1.36% dividend yield, and cash producing very little income.
- Our portfolios continue to emphasize companies with strong growth characteristics and competitive strengths, although we are also maintaining cyclical exposure. We believe the economy's growth path remains on trend, which should bode well for long-term equity investors as 2022 approaches.

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