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Why So Many People Get Financial Advice That Is Wrong for Them

Advisers too often assume all people have somewhat similar preferences. The result is that outliers—and there are a lot of them—get investments that don't fit their needs.

By Shlomo Benartzi

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ILLUSTRATION: JON KRAUSE

Quick Summary

- Many Americans have financial preferences that deviate from conventional assumptions, such as attitudes toward liquidity and risk.

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The typical American consumes about 10 pounds of chocolate a year. That's a lot of chocolate.

But averages can be misleading. Around 10% of Americans don't like chocolate at all.

So, what does chocolate aversion have to do with financial planning? Quite a bit, actually.

Just as some people reject chocolate despite its popularity, many Americans have financial preferences that deviate from conventional assumptions. Some want their money locked away rather than liquid. Some aren't particularly upset by investment losses. And while it's often assumed that people are present-biased—that they're prone to overspending and undersaving—a meaningful percentage are future-biased and may actually save *too* much. And there are many more examples.

There's nothing wrong, of course, with being different. Not everyone has the same feelings about liquidity, risk or saving.

The problem is that financial advisers tend to overlook these outliers, often relying on "know your client" assessment tools that are too narrow in their measurement of investor preferences. While advisers acknowledge human variation—some people like dark chocolate and others prefer milk chocolate, so to speak—they tend to underestimate the sheer range of this variation.

The result? We end up offering endless varieties of chocolate to people who never wanted dessert in the first place. And, more to the point, it means many people will make investments that don't fit their needs—either psychologically or financially.

Liquidity: Not everyone wants access

It seems obvious that we all prefer liquidity. Who wouldn't want access to their money?

Yet behavioral-economics research shows that some people prefer illiquid accounts. Consider a study where participants were asked to allocate money between two accounts, both offering the same annual return. One account was fully liquid. The other came with a 10% early-withdrawal penalty.

You might assume everyone put all their money into the fully liquid option. But, in fact, 39% of assets were allocated to the semiliquid account.

What happened when the penalty increased to 20%? The semiliquid account became even more attractive, drawing 45% of assets. And when the account became fully illiquid—with no early withdrawals allowed—it attracted 56% of total assets. Remarkably, over a quarter of participants still preferred the less-liquid account even when it offered a *lower* rate of return.

Why would anyone choose to lock up their own money? One possibility is that many people are aware of their limited self-control. They know that easy access to savings might lead to impulsive spending. Illiquidity, for them, is a helpful constraint. It's a regret-prevention tool.

Yet this preference is often ignored.

Financial advisers often rule out less-liquid investments, like private equity, private credit and infrastructure, assuming they're inappropriate for most clients. But the research shows that, for many people, illiquidity is a feature—not a bug. This doesn't mean these investors should suddenly have a portfolio full of private equity. But it does mean they shouldn't be automatically excluded because of old, errant assumptions about illiquidity. Advisers should instead be identifying the clients who want that feature—and why they want it—and tailoring their recommendations accordingly.

ILLUSTRATION: JON KRAUSE

Present bias: Not everyone struggles to save

We assume everyone lives in the present—that we are wired to chase immediate gratification. It turns out, however, that some people are more focused on the future. They prefer to wait.

This future bias may be less common than a preference for illiquidity, but research suggests that 22% of Americans overvalue the future and undervalue the present. (A meta-analysis, or large review, of the present-bias literature also found many examples of future bias.) Still other research finds that approximately 24% of people are tightwads; spending money makes them anxious and stressed.

Some financial advisers are ill-equipped to support tightwads, as they typically don't measure or consider this tendency. We spend enormous resources encouraging people to save more. Rarely do we consider the opposite problem: people who may be saving too much and spending too little.

We should encourage those with a future bias to consider spending a little more today so they can maximize their own enjoyment of life. While they probably can't be talked into splurging on a business-class ticket, they might enjoy a premium-coach seat.

Loss aversion: Not everyone fears losses

Everyone hates losses. Or so we think. Psychologists Daniel Kahneman and Amos Tversky coined the term loss aversion to describe how losses tend to hurt twice as much as equivalent gains feel good. A person must be offered at least $200 to accept a gamble with a potential loss of $100.

But, again, the average masks meaningful differences. Research shows that about 72% of people are loss-averse, though they still differ dramatically in how much they dislike losses.

That means that about 28% of people deviate from this pattern. Around 16% treat losses and gains similarly. And 12% are gain-seeking—they can be more motivated by the potential for gains than they are deterred by the potential for losses, but more research is needed.

For these individuals who feel differently about losses, conventional risk-tolerance questionnaires aren't very helpful. For example, when I reviewed the questionnaires of major financial companies, I found that they were only able to measure people within a narrow loss-aversion range. The preferences of those who treat losses and gains the same, or are drawn to gains, are literally off the charts.

That's why we must reimagine our assessment tools—to capture the full spectrum of human preferences, not just the narrow band defined by traditional tools.

Consider the implications for buffered funds, which are gaining popularity. These investments trade off some upside potential in exchange for downside protection, offering a more stable experience for investors. The level of protection can often be personalized based on individual preferences. Buffered funds are particularly appealing to the estimated 72% of people who are loss-averse, but they're likely not suitable for those who aren't loss-averse. That's because the latter are paying a premium for a level of downside protection that they don't need or even want. Because they aren't loss-averse, these investors likely would prefer the higher potential upside.

Too many in the financial-advisory industry have long overlooked the possibility of such outliers. They fail to realize that for some investors, put simply, atypical is typical.

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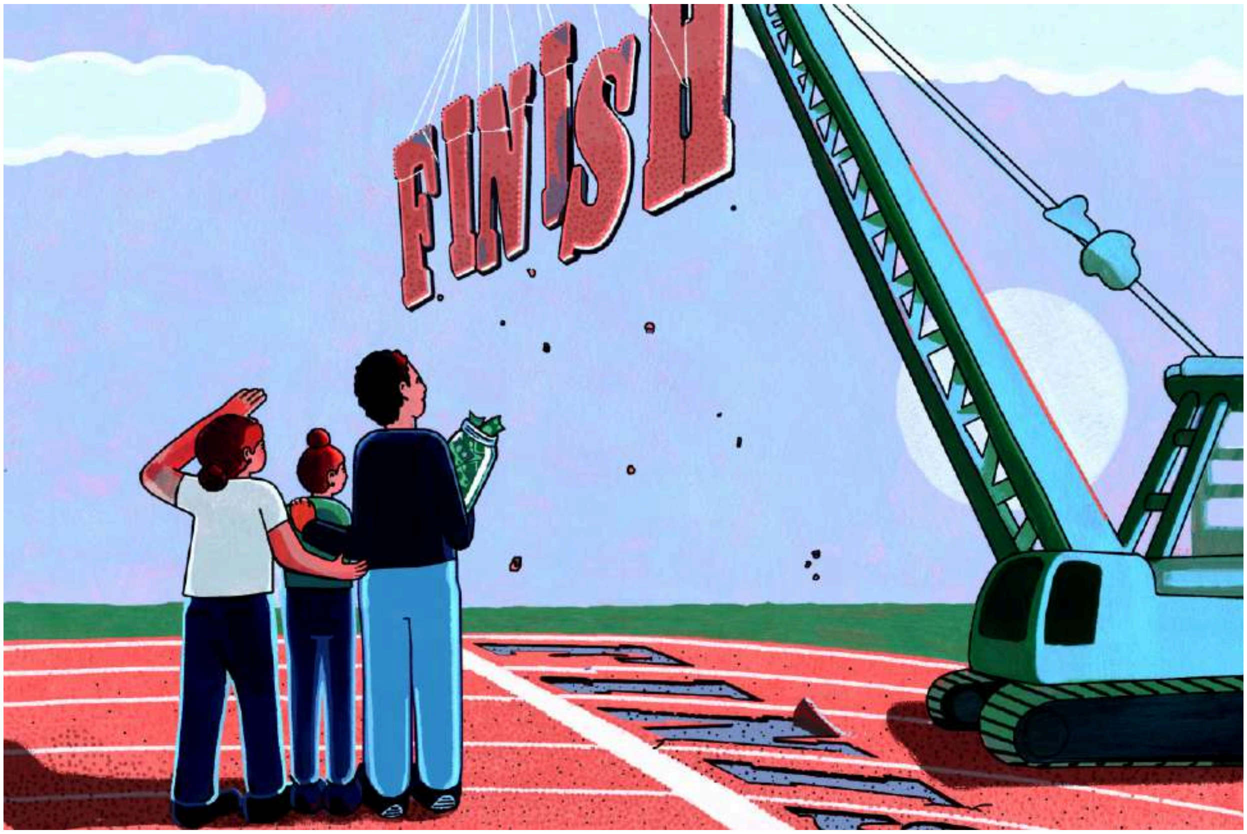

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