

Week 1 Lecture

Financial Planning, Economic Conditions, and Behavioural Biases

The Need for Financial Planning

- Ageing population lead to a shift of retirement funding responsibility to individuals
- Homes in Australian and many capital cities in Asia are not very affordable hence prospective home owners need to save up
- People need to save and do have more wealth to manage and protect
- Complexity in taxation, superannuation, social securities and asset protection laws and regulation

How can a financial planner help?

- Up-to-date, relevant and reliable information
 - Tax and other regulations, e.g. superannuation
 - Financial and insurance products
- Technical expertise to
 - interpret information
 - create appropriate strategies
 - coach individuals be to more rational (less emotional) in making financial decisions
- Specialisation of labour and capital

Consider the Business Cycle

- Economic environment is cyclical in nature
- Planner must be aware of the impact of the economic environment on investment market and client psychology

Data for Economic Conditions

- Interest rate
- Inflation
- Unemployment
- Economic activity

... and the Market Cycle

- Business cycles are about the past and present
 - A recession is typically defined as 2 consecutive quarters of GDP decline, i.e. always need data
- Market cycles are about the future and changes in investor expectations and risk tolerance
 - This is expressed in the buys and sells in the market
 - Risk capital of individuals and institutions is in short supply after major downturn
 - Aggregate risk aversion is likely to be higher after significant market downturn
 - The GFC is a prime example
 - downturn of the U.S housing market and bursting of credit bubble significantly reduced aggregate risk bearing capacity and increased funding needs —> sellers

- dominated markets of risky assets and prices undershoot the “fundamentals”
- The opposite happens in boom phase of a market cycle
 - Fundamentals improves, investor confidence increases, leverage increases, asset price increases, real investment activity increases
- Growth prospects and asset valuation ratios also fluctuate over market cycles
- These cyclical behaviours have implications for asset allocation and security selection strategies

Common Behavioural Biases

- Individuals are potentially susceptible to many other biases in making investment decisions
 - **Propensity to save** (choose suboptimal levels)
 - **Limited attention** (focus on attention grabbing assets)
 - **Overconfidence** (results in excessive trading)
 - **Disposition effect** (ride on losses and cut profit)
- A financial advisor might be able to reduce the impact of these biases on the financial health of clients

Also the Media/Attention Effect

- How do news channel and popular press report as the economy go through the boom-bust cycle?
- How might individual investor behave if they just focus on the press?
- In general it is important to think about whether individual's biases aggregate to the market level and affecting prices

The Financial Planning Process

- Financial planning is the **process of developing strategies** to assist clients in managing their financial affairs **to meet life goals**, which involves reviewing all relevant aspects of a client's situation across a large breadth of financial planning activities, including inter-relationships among often conflicting objectives
1. Collect and assess the financial data of the client
 2. Determine the objectives and goals of the client
 3. Identify any financial problems that may exist
 4. Prepare a written plan which contains alternatives and recommendations
 5. Implement the agreed written plan
 6. Review of the plan
- This process is embodied in the FPA's Code of Professional Practice

Risk Profile and Assessment Tools

- Part of the data collection process
- Portfolio picker (i.e., a questionnaire which directly leads to “prefabricated” investment portfolios) has been heavily criticised
- Good risk profiling should consider
 - Risk tolerance (psychological attribute)