THIRTY-THOUSAND FEET

The Investor's Mind

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A RATIONAL RETHINK

Over the last twenty years, the field of behavioral economics has gained significant traction among financial market practitioners. Economists, market forecasters, and business leaders have increasingly accounted for the presence of behavioral biases in decision-making—perhaps one reason the utilization of financial algorithms has increased. Importantly, human decision-processing is no longer assumed to be rational, as it was decades ago. In fact, a working list of behavioral biases or heuristics has been uncovered, and understanding these tendencies can be beneficial for individual investors and portfolio managers alike.

In the late 1960s and early 1970s, researchers began to question the long-prevailing theory that decision-makers were rational.

In this paper, we address some common behavioral tendencies all investors face, and we offer some thoughts about offsetting their impact on decision-making. While simply identifying these biases could prove interesting, self-awareness as it relates to these factors may indeed help with investment decisions. When it comes to investing, offsetting biases and emotion is not easy. We believe installing a disciplined investment methodology is vital to success— but sticking to that approach may take some mental practice.

BEHAVIORAL BEGINNINGS

The thought that economic decision-makers were not entirely rational perhaps first gained early steam nearly fifty years ago—born from the field of psychology. Preceding that, decades of economic and mathematical research crowned decision-makers, both financial and otherwise, as definitively rational and capable of assessing situations as if all probabilities were known. In the 1940s and 1950s leading thinkers such as John von Neumann and Milton Friedman helped cement the theory of "economic man" - a model of human rational behavior.

Behavioral economics essentially combines economic research with the field of psychology.

Rational economics indeed dominated theoretical thought in the 1950s when Ward Edwards, a psychologist, wrote a seminal article titled "The Theory of Decision Making" (1954). While Edward's work raised some question over rational theory, it was not until Daniel Kahneman and Amos Tversky (both psychologists) embarked on a joint research project in the late 1960s that challenged rational decision underpinnings. Kahneman and Tversky's work inspired Richard Thaler, a young economist, and helped to unite the discipline of psychology and economics in a challenge of rational theory. Kahneman, Tversky, and Thaler have all been awarded Nobel prizes (Tversky posthumously) for their groundbreaking efforts in bringing decision science into a new era.

Today, both behavioral economics and behavioral finance (fathered by Kahneman, Tversky, and Thaler) have firm backing in academia and in business practice. In recent decades, volumes of research dedicated to the disciplines have been written. Behavioral theories are being studied at leading business schools, they have been incorporated in financial modeling, and the theories are being used extensively in investment strategy and portfolio management. Indeed, behavioral factors have helped drive systematic portfolio construction for those seeking to overcome the challenges of human emotion in the investment process.

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KEY BIASES IDENTIFIED BY THE BEHAVIORAL SCIENCES

Knowing that theorists no longer assume we always make rational decisions is one thing, but how do we account for behavioral factors in our day-to-day investing lives? Perhaps the first step is to understand where we may veer off course. Establishing an awareness of behavioral tendencies can help us guard against the often gravitational pull of what may lead us to bad decisions.

Daniel Kahneman, Amos Tversky, and Richard Thaler have been hailed as the fathers of behavioral economics.

In this section, we describe some key heuristics or biases that are now widely known, studied, and ideally mitigated by those steeped in behavioral research and sound investment process building. This is not intended to be comprehensive listing, but rather a short review of the key predispositions we believe are most likely to influence many investors.

Heuristic can be defined as a mental short-cut or a practical but perhaps not optimal path toward a decision.

Anchoring - This bias can cause people to rely too heavily on one piece of information or statistic, perhaps to the detriment of necessary overall analysis. The problem is rooted in the tendency to overweight known information, that which is anchored in your mind, even if the result of that information has little bearing on the outcome of the decision at hand. One good example of this is relying on past investment results as a key component in determining potential future outcomes. In addition, investors may in some cases be predisposed to selecting an investment in an industry they personally know; or an investment type that has performed well for them in the past. For example: a doctor that only buys pharmaceutical stocks or an investor that buys semiconductor stocks because of recent investment success in that space. In these cases, anchoring may lead some to defy the properties of portfolio diversification.

Confirmation Bias - Confirmation bias suggests that investors may look for information that supports an investment idea rather than search out data or theories that contradict it. This is essentially parallel to data mining, or using only data that fits a stated theory, as opposed to analyzing all available information. Confirmation bias can lead to "one-sided" data or information gathering, which can skew analysis of a potential investment. This bias can occur, for example, if investors choose to read only favorable research reports or articles on a stock or company and give little credence to alternate sources of information. We believe asking the question "What can go wrong?" is vital in assessing any investment. The question can mitigate confirmation bias and may improve understanding of investment risks.

Cognitive Dissonance - Cognitive dissonance is a term that identifies the discomfort felt when two conflicting thoughts exist at the same time. Cognitive biases are information processing errors that deter people from reaching rational conclusions. Dissonance results when two conflicting thoughts occur simultaneously. Psychology tells us that humans go to material lengths to reduce cognitive dissonance or that uncomfortable feeling, often by justifying behavior an individual may know is wrong. Take the extreme technology/internet rally of the late 1990s for instance. Common sense told investors that many of the stocks that rallied had little fundamental foundation: no earnings, and perhaps very little revenue. Some may have watched friends and neighbors participate in the rally, while stock valuations served as a personal deterrent. Cognitive dissonance may have caused investors to buy the internet stocks and justify it by thinking "everybody's doing it" - even though valuations acted as a known warning signal. In this case, investors were perhaps conflicted by the high valuations, but did not want to miss out on the rally. In our view, one way to avoid this bias is to have a documented and repeatable investment process.

Recency bias can cause investors to forego sensible risk management during a bull market.

Recency Bias - As the name implies, recency bias is the tendency for investors to more readily recall or place more emphasis on recent events and allow past circumstances to fade from memory. This bias is typical during bull markets as the previous bear market fades from memory. In accordance with recency bias, investors may add to their portfolios' risk profile as they chase the bull market rally. Little attention is paid to the portfolio consequences of a bear market as those consequences fade from memory. This phenomenon helps sustain the buy-high, sell-low negative rollercoaster that is too often present among investors. Simply recalling the cyclical nature of asset class returns may help offset this bias and buffer the emotional toll of both bull and bear markets. A sound asset allocation process is another remedy.

Hindsight Bias - Revisionist history is a bias that permeates financial decisions, causing people to believe an outcome was obvious only after it has been revealed. Realizations, via the benefit of hindsight, often conceal the reality that real-time market analysis is not employed with certainty. Every investment decision has a probability of success or failure. We believe it is often the investor or asset allocator that manages to those probabilities who is most successful over time. In our view, the takeaway from hindsight bias is the understanding that no one can consistently forecast the future and not every holding in your portfolio is going to go up simultaneously. The best investors can do is stick to the probabilities and stay disciplined. Finally, ensure your portfolio is adequately diversified for those intermittent market outcomes that no one sees coming.

Loss Aversion - Loss aversion is based on the observation that people are twice as fearful over losing money as they are joyous over gains. The concept was quantified in Kahneman and Tversky's Prospect Theory, a research work that described how people choose alternatives that involve risk. Said another way, humans find more utility in the avoidance of loss than the realization of gains. We think this bias may be a key determinant of why some investors either intermittently pull out of the market, give up investing, or choose to not invest at all. In our view understanding this bias should prompt investors or their advisors to pay strict attention to portfolio risk, ensure a balanced investment approach, and/or employ a dynamic asset allocation approach that is geared toward protecting against material asset drawdowns.

Groupthink was perhaps evident in all the well-known investment bubbles, from tulip bulbs to real estate.

Groupthink - This bias also answers to such names as herd mentality or following the crowd. The essence: people find comfort in agreeing with decisions of others or engaging in similar activities. Individuals may feel social pressure to conform, endeavor to avoid conflict, or seek to avoid missing out on some potential benefit realized by the masses. In investments, groupthink may provide a false sense of comfort or suppress the necessary critical thinking that may lead to an optimal outcome. An example of this bias is the drive individuals feel to follow the crowd during asset price bubbles. Again, as it regards investing, an answer to this bias may be found in the discipline of a sound investment process and adopting the habit of asking oneself critical suitability questions before engaging in an investment.

CONCLUSION

The field of behavioral economics and finance has helped explain the occasional irrational outcomes peppering decades of asset price history. Self-awareness in the behavioral arena can be an essential aid in avoiding market pitfalls and vital in breaking the merry-go-round of emotionally-based decisions that often plague the everyday investor. Some cognitive biases are more easily remedied than others, but we believe a potential, holistic fix starts with a sound and disciplined investment process. Having a plan and adhering to that plan may indeed raise the likelihood that cognitive biases are overcome and rational decisions are made.

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