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Behavioral bias and the worst common mistakes

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Why DIY investing doesn’t work

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- Numbers - Prove that it doesn’t

- Access - DIY folk lack access
- Industry - Encourages DIY folk to focus on all the wrong things
- Nature of Change - Once every 50 year directional change
- Experience and training - What DIY folk lack
- Behavioral bias - We’re all human
- Retirement years - Facing a different set of powerful issues

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Behavioral bias

- When we . . .

- Allow emotion to interfere with
  - Logic
  - Reasoned judgement
- "Act" instead of "think"
- Allow the animal to decide for us . . . instead of the brain

- We all suffer from behavioral bias . . . we're human
- But . . . successful investing requires that it's kept limited and well under control

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Common behavioral bias - Buy high sell low

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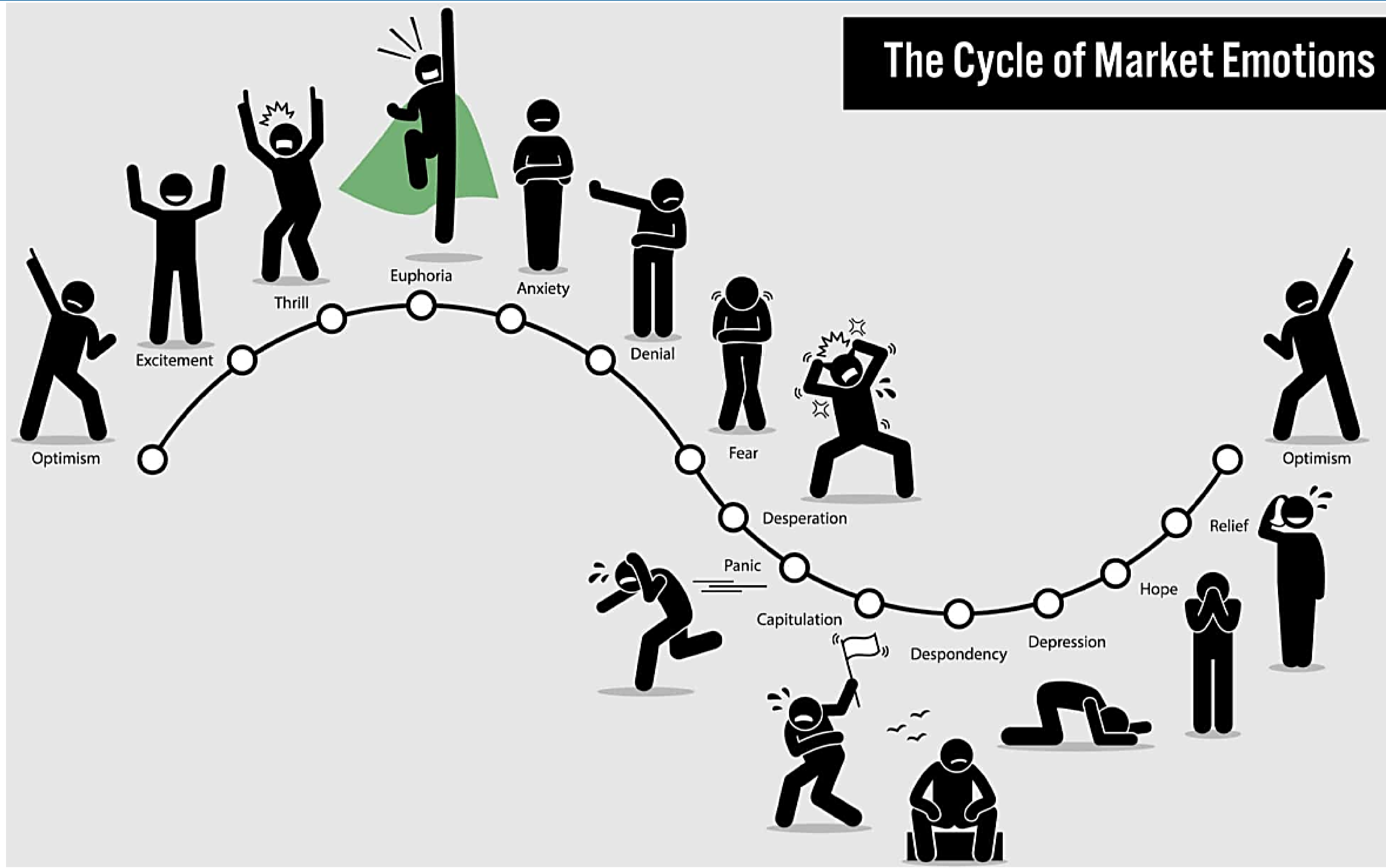

What causes “Buy high sell low”? - Two behavioral biases

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- Trend chasing
- Recency - Hot hand fallacy

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Trend chasing

- Believe past performance indicates future performance

- Believe they can “invest in the past”

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Recency - Hot hand fallacy

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- Because an investment has been climbing higher, you believe that will remain the case
- FOMO - Fear Of Missing Out
- Relying on the latest information and ignoring the greater history
- Feel that winner today will always be a winner
- Your current success becomes the deciding factor for future decisions

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Common behavioral bias - Buy high sell low

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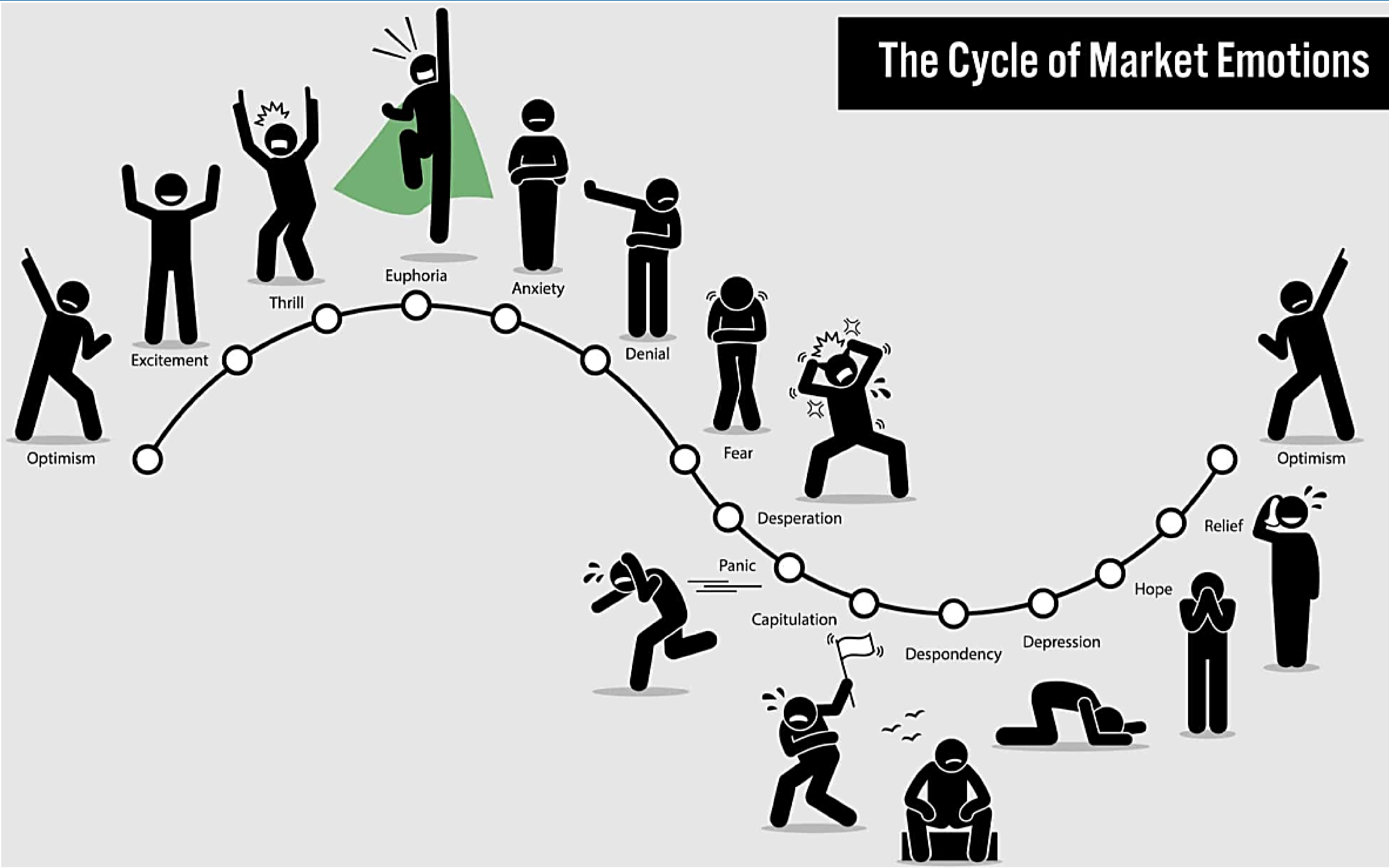

Trend chasing

Believe one can invest in the past

Recency

Recent success decides future decisions

Investing behavioral biases - Nine most common

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Loss aversion

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- Prefer avoiding losses over realizing gains
- Go for low-risk, low-return money market due to stock market volatility
- Feel the pain of loss more than the joy of gains
- Don't want to live in an uncertain world even if embracing uncertainty leads to tremendous gain
- Humans tend to feel the pain of a loss twice as intensely as the joy of an equivalent gain, often leading to panic selling

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Narrow framing

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- Also called confirmation bias
- Seeks information confirming current view while avoiding or rejecting conflicting views
- Buy crypto and only interact with supportive information sources and individuals
- Hear only things which confirm what our existing perception
- Makes decisions without considering all of the information and all of the implications

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Mental accounting

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- Views various sources of money as being different from others (doesn’t realize that money is fungible)
- Example - money earned at a job may be viewed differently than money from an inheritance
- Example - People get emotionally tied to certain stocks. One elderly client wouldn’t part with a large holding of stock in a local bank because it was started by a family member
- Taking undue risk in one account, while avoiding rational sensible risk in another account

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Diversification

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- Seeking to reduce risk . . . but simply using multiple sources of the same risk
- Confusing number of positions (or securities) with actual risk reduction

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Anchoring

- Overreliance on familiar experiences or information
- Use of irrelevant information
- Example - you take the purchase price of a security as an anchor (fixed reference point) for making subsequent decisions regarding that security
- Sticking to an initial piece of information to make judgments and decisions regarding the investment
- Ignoring the new information (and reality) that comes along

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Optimism

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- Also called overconfidence
- Believe that they have more knowledge on a certain topic than they actually have
- Two types of overconfidence
  - Quality of information
  - Ability to act on this information for maximum gain
- Misinterpret beginner's luck . . . and consequently overestimate their skill
- Overconfident people often stop (or slow) learning . . . which undermines future performance . . . investors need to be humble, realizing they need to continuously learn about the markets whatever their experience level

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Media response

- React to news without adequate examination
- Overestimate the importance of the available information, i.e., the news
- Overvalue a new trend or an idea as discussed in the news, e.g., innovation stocks or crypto
- Allow the irrelevant and unimportant to displace the relevant/important
- Lack of a balanced approach

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Regret

- Treating errors of commission more seriously than errors of omission
- Place a higher value on something they own as opposed to something they don’t own
- Won’t selling a bad investment until it regains what it lost
- Not wanting to regret a decision they've made
- Pursue certain behaviors in order to avoid regretting them in the future
  - Dollar cost averaging

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Herding

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- Moving along with the herd/crowd
- Decisions are encouraged by the herd rather than being based on metrics
- Bernie Madoff, Enron, WorldCom, Meme stocks, SPACs, Crypto
- Herd behavior can create massive bubbles that eventually burst because prices are not justified by the asset but the investors’ behavior
- You go with the group because you think the majority cannot be wrong or standing with the majority is a comfortable position

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Loss aversion

Irrational risk avoidance

Diversification

Not understanding the source of risk reduction

Media response

Listening to the news

Narrow framing

Restricting your information

Anchoring

Tying yourself to an initial perspective

Regret

Would of, could of, should of

Mental accounting

Treating different sources differently

Optimism

Overconfidence and lack of humility

Herding

Following the crowd

Conclusions

Best methods for limiting the disastrous effects of behavioral bias

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Successful mitigation

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- Avoid anyone emotional . . . including yourself

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- Describe your investment philosophy and investment process
  - In writing
  - In great detail
  - Make sure you adequately describe
    - The explicit investment objective
    - How you will measure success and failure

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- Identify how it is susceptible to the various forms of behavioral bias
  - It will be . . . no approach can escape these deadly perils
  - Rank order which behavior biases you're most susceptible to

Successful mitigation

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  - Rank order which behavior biases you're most susceptible to
- Determine mitigation steps
  - Including not managing your own money

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Worst commonly made mistakes

That we seem to make again, and again, and again

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Patience

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- Lack of required patience
- Failing to give the investment the time it needs to germinate, sprout, grow, mature, and be successfully harvested

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Home bias

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- Overweighting what's
  - Familiar
  - Comfortable
  - In close proximity

- Irrationally thinking the U.S. offers a superior risk/return ratio
  - Doing so, requires the assumption that markets are inefficient and don't work
  - If this were true . . . why would you invest in markets?

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Investing in the past

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- Pick investment manager based on who did best
- Select asset mix because it did well since Sep 1981
- Wait to buy until after it's gone up . . . then wait to sell until after it's gone down

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Liquid alts

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- Falling for the enticing well-told stories about how you can have it all
- *"All you need to succeed is use our s . . . "*

- The story of liquid alts
  - Full perfect liquidity
  - Zero correlation
  - Return in up markets and return in down markets
  - A new asset category
  - Bringing to your clients what had previously only been available to the Harvard University endowment and the Rockefeller family

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Ignoring price

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- Price does matter

- Classic examples, buying
  - TIPS bonds today because you want inflation protection
  - 10-year U.S. Treasury bond because you want default protection
  - Tech stocks in 2000
  - Housing in 2007

Cost or price

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- One of the criteria to consider when selecting which index fund to use is cost
- Why? . . . because an index fund is a commodity

- Question . . .
  - Is your financial advisor a commodity?
  - Is a successful active investment manager a commodity?

- Price in only relevant in the absence of value

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Taxes

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- Letting the tax-tail wage the dog

- Which is more important to you?
  - Make a profit
  - Minimize your taxes

- In the long-run tax minimization makes a huge difference
- In the short-run . . . it's an irrelevant distraction

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Get rich quick schemes

- Falling for that next get rich quick scheme

- Every era has them

- Florida land - 1920s
- Clicks over bricks - 2000
- Crypto, SPACs, meme stocks, NTFs
- Cathy Wood

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Retirement DIY investing

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- Spousal handoff . . . . when one passes
- Shrinking network . . . . successful investing needs an “expanding network”
- Cognitive decline
- Change is difficult . . . wait too long and can’t pull it off
- Better use of . . . more rewarding use for your time

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Knockout risk

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- Get a seriously bad 12-month return
- Can't withstand the emotional pain of that loss
- You bail out

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Risk/time mismatch

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- Failure to match how much time you've got (or have given the investment)

- With . . .
  - The type of investment you're using
  - The level of risk you've taken

- Old Chinese proverb
  - If you have one year, plant rice. If you have ten years, plant trees. If you have one hundred years, educate children

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The “Age of Disinformation”

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- Today, we’re inundated, buried with data, but mostly just noise
- Failure to ignore
  - Common media
  - Noise
  - Nonsense or irrelevant talk

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Herding

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- Identifying your preferred herd
- Joining them
- Running with the herd

- Doing what's popular

- You just want to gain approval . . . and be one of the cool kids

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Structure of the investment industry

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- Failure to adequately understand how the investment industry works

- It's there to make money from you, not for you

- Industry's two greatest strengths
  - Identifying a mispricing, exploiting it for great gain, and thereby eliminating the mispricing
  - Making up and delivering enticing stories

- Misleading you into DIY investing

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Liquidity

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- Most investors are irrational when it comes to liquidity
- They demand more than they need
  - Sacrificing considerable return
- But the opposite is also not uncommon . . . not maintaining sufficient liquidity
  - Then demanding liquidity at the worst possible instant, and being severely hurt

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Advisor value added

Just how much does the advisor save the client by preventing mistakes and behavioral bias?

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Three sets of studies

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- External . . . Dalbar or Cerulli Associates
- Internal . . . when an organization has the client data
- Survey . . . Vanguard, Envestnet, Dimensional, Morningstar

- My understanding is that the number is solidly between 200bps and 300bps
- And that's actually pretty easy to understand
- Given just how much damage is done by some of these mistakes

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Client hires a financial advisor

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- How do they make their selection

- Who is quoting the lowest fee
- Who is showing me the hottest past performance numbers
- Who will beat the markets by the greatest amount
- Who wines and dines me the best

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Maybe . . . clients would be best served by . . .

- Basing their selection of a financial advisor on . . .

- Which advisor will do the best job of
  - Eliminating behavioral biases (both mine and theirs)
  - Preventing the types of mistakes just mentioned

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Solutions for the short-run, years 0 through 5

Friday

June 10th

11:00 a.m. EASTERN

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