ECHO45 ADVISORS

BeFi Series — Behavioral Finance for Smarter Investing

The Four Pillars of Investor Misbehavior

DR. DANIEL CROSBY'S GUIDE TO BETTER DECISION MAKING

BY DANIEL CROSBY

About the Author

Daniel Crosby is the Chief Behavioral Officer at Brinker Capital Investments. In this role, he is responsible for bringing behavioral tools, training, and technology to financial advisors to allow for the practical application of behavioral science. He is a psychologist and behavioral finance expert who applies his study of market psychology to everything from financial production design to advisor-client engagement. Daniel has more than 10 years of experience in the financial services industry and has published a number of bestselling books that serve as guides to building stronger advisor-client engagement with a focus on achieving better outcomes.

Introduction

As a child I loved reading Rudyard Kipling's Just So Stories, a collection of tales originally crafted as bedtime stories for his daughter who demanded that they be told "just so" (using the same words she was accustomed to). Each story provides a magical take on evolutionary biology and describes how various animals acquired their most distinctive features.

In How the Whale Got His Throat, we learn that whales can eat only plankton as a result of one having swallowed a mariner, who subsequently tied a raft inside its throat to prevent others from meeting his fate.

In How the Camel Got His Hump, we learn that the dromedary's hump is a result of being lazy and subsequently cursed by a genie with a hump that allows for greater work between periods of rest. In each case, the animal endures some hardship, but is ultimately rewarded with a distinctive feature that is evolutionarily adaptive. Just like the stories themselves, the animals are created "just so."

It is satisfying to think of a world where nature conspires to work in our favor, but that is sadly not reflective of our reality when it comes to financial decision-making. Your body and brain were created to do a great many things with remarkable efficiency; investing is not one of them. In fact, if a demigod, evil genie, or vengeful mariner set out to design the worst investor possible, they would have designed you.

When it comes to investing, you were not created "just so."

The flaws in your design quite naturally lead to quirks in your behavior, and creating a system that accounts for these quirks is a foundational element of any sound investment philosophy. Just as good defense wins championships but the quarterback gets the endorsement deal, risk management drives performance but big returns get all of the press.

And so before we answer the question, "How can I become a skilled investor?" we must first answer the less-sexy-but-more-important question, "How can I not suck at investing?" Put more gently, we must learn to manage risk. If you accept this as fact and pick up a textbook on risk management, you are likely to read about two primary types of investment risk: systematic and unsystematic.

Systematic risk, also known as "market risk," is the chance that you will lose money as a result of moves in the broad market as opposed to factors relating to any business in particular.

Unsystematic risk, also referred to as "business risk," is the chance that an investment in an individual security will depreciate in value due to factors pertaining to that business.

What your textbook will likely omit altogether is a third type of risk—behavioral risk—and this is the most important risk of all. Once we embrace the reality of behavioral risk, we must work to codify it and give it form. After all, how can you fight a monster that you can't see?

Decoding Behavioral Risk

So, how do we begin to give shape to something as amorphous as human behavior? As it turns out, you begin by studying how it malfunctions. As Daniel Kahneman says in The Undoing Project, “How do you understand memory? You don’t study memory. You study forgetting.”

Misbehaving, Richard Thaler’s incredible origin story of the field of behavioral economics, recounts the simple but effective way that he set the discipline on its current course. Incredulous about what he was learning about efficient markets, Thaler set out to brainstorm all of the real-life ways in which the people he knew differed from the “Econs” (fictional individuals who optimize utility and always make rational financial decisions) he was learning about in his theory courses. Using nothing more than a simple thought experiment, Thaler created a list of behavioral anomalies that launched a thousand research projects and vastly deepened our understanding of how mere mortals make financial decisions.

While the discovery and documentation of these behavioral anomalies was an important first step, they lack utility to investors inasmuch as there is no broader organizing framework. We now have long lists of the ways in which we are imperfect, but little in the way of practical next steps. As research has shown, bad news without a concrete solution set can actually exacerbate the problem!

Inspired by the simple elegance of Thaler’s approach, I put on my catastrophic thinking cap and set out to brainstorm every possible way someone’s behavior could negatively impact investment decision-making, relying heavily on the existing literature. I found over 117 different biases and heuristics that could lead an aspiring investor from making optimal decisions! Ouch. To make this universe more useful to investors, I looked for common psychological underpinnings among the various modes of error

and grouped them accordingly. I began this process without preconceptions of how the information would shake out. At the end, four consistent types of behavioral risk emerged, they are:

EGO **EMOTION** **ATTENTION** **CONSERVATION**

The number of bad decisions we can make is nearly limitless (have you seen reality TV?), but all behavioral risk has one or more of these four risk factors at its core. I’ll discuss each of them briefly below, with more detailed coverage to come in the weeks to follow.

Ego Risk

Ego risk is made manifest in behaviors that privilege our need for felt personal competency at the expense of clear-eyed decision making. Specific examples might include good old-fashioned overconfidence, a tendency to become defensive when pet ideas are challenged (backfire effect), or a belief that one's mere involvement in a project makes it more likely to succeed (the awesomely named IKEA effect).

Ego risk leaves specific evidence of its presence in overly concentrated positions, churning, failing to plan or work with a professional, and the use of excessive leverage. Whatever the specific manifestation, the source is always the same—an ego that privileges its own care and feeding over making good decisions.

EXAMPLES OF EGO RISK

- **Choice Supportive Bias:** The tendency to ascribe positive attributes to a chosen investment decision and denigrate the road not taken.
- **Overconfidence:** Felt competence or knowledge that exceeds actual competence or knowledge.
- **Confirmation Bias:** The propensity to seek out information that confirms an investment thesis and ignore disconfirmatory information.
- **Endowment Effect:** The tendency to perceive a stock as valuable simply because we own it.
- **Semmelweis Reflex:** The reflexive rejection of information that disagrees with a cherished idea or opinion.
- **Illusion of Control:** Proneness to believe we are more in charge of market outcomes than we truly are.
- **False Consensus:** Overestimating the degree to which others agree with our investment ideas.

Emotion Risk

Emotion risk stems from the fact that our perceptions of risk are colored by both our transitory emotional states and our individual propensity toward positivity or negativity. Emotion leads most of us to underrate the possibility of bad things happening to us (optimism bias), to avoid even thinking about what might go wrong (ostrich effect), and to ignore the important role emotion plays in our decisions (empathy gap). When fear does break through, it can become so powerful that we can be immobilized by trying to avoid pain (negativity bias).

Investors looking for examples of emotion bias in their decision-making should begin with periods of market turbulence. Examine trades for risk taking or safety seeking during periods of elevated sentiment. Also, look for herd following (fearful when others are fearful) versus appropriate contrarianism (greedy when others are fearful) at historical market tops and bottoms.

Research has shown that emotion plays an important role in facilitating choice. In fact, people with damage to the parts of their brain that process emotion are rendered unable to make even everyday decisions, such as what to wear. The key is not to be free of emotion altogether, but to understand our personal susceptibilities to stress, panic and fear of missing out.

EXAMPLES OF EMOTION RISK

- **Affect Heuristic:** The tendency for current emotional state to color risk perception.
- **Empathy Gap:** Underestimating our reliance on emotion and overestimating our use of logic when making decisions.
- **Negativity Effect:** Bias toward negative events and thoughts impacting our risk-perception much more powerfully than positive events.
- **Optimism Bias:** Mistaken belief that we are less likely to experience a negative event than others.
- **Ostrich Effect:** Attempting to avoid risk by pretending it does not exist.
- **Risk Compensation:** Tendency to adjust risk-taking behavior relative to subjective experience of risk (accounts for drivers going faster when wearing a seat belt).
- **Restraint Bias:** Fallacious belief in our ability to control our own impulses in the face of intense emotion.

Attention Risk

Attention risk is born of our disposition to evaluate information in relative terms and let salience trump probability when making investment decisions. “Salience” is the psychological term for prominence, meaning that our attention can be hijacked by low-probability-high-scariness things like shark attacks while ignoring high-probability-low-scariness dangers like eating at Taco Bell. We also tend to rate the unfamiliar as more risky and show a preference for domestic stocks (home bias) and familiar names (mere exposure effect), regardless of their fundamental qualities.

Those looking for concrete evidence of attention risk in their investing should be on the lookout for crowded trades, overreliance on domestic stocks, excessive correlation and high-noise-low-probability investments based on a collective moment of panic (e.g., the Ebola scare). Dr. Bob Nease suggests that of the ten million bits of information our brains process each second, a mere 50 bits are allotted to conscious thought! When so much of what pulls our thoughts and actions happens below the surface, we must be very intentional with how we spend the little attention that is within our power.

EXAMPLES OF ATTENTION RISK

- **Anchoring:** Penchant for relying too heavily on the first piece of information (e.g., price paid for a stock) when making investment decisions.
- **Availability Bias:** Confusing the ease of recalling information with its impact or probability.
- **Attention Bias:** Proneness to confuse our own rumination on a subject with its actual importance.
- **Home Bias:** Bias toward viewing domestic equities as more safe and knowable than their international counterparts.
- **Framing Effect:** The tendency for our perception of risk to vary depending on whether it is framed as a loss or a gain.
- **Mere Exposure Effect:** Phenomenon by which we view stocks as less risky if we are familiar with the company.

Conservation Risk

Conservation risk is a by-product of our asymmetrical preference for gain relative to loss and the status quo relative to change. We like winning much more than losing and the old way much better than the new way, all of which contorts our ability to see the world clearly. This conservation effect can be observed in our resistance to new ways of being (status quo bias), our preference for no risk at all relative to large incremental decreases in risk (zero risk bias) and an aptness to privilege our current self over the needs of our future self (hyperbolic discounting).

Evidence of selling winning stocks too quickly and holding losing stocks too long, a failure to maintain appropriate risk levels when "up" and signs of taking excessive risks when "down" are all good signs that you might have fallen prey to conservation risk. Our aversion to change and loss are primal and can only be unseated by a deliberate process aimed at recognizing and overcoming our behavioral inertia.

EXAMPLES OF CONSERVATION RISK

- **Loss Aversion:** The asymmetrical relationship between gain and loss, whereby the pain of a loss is much greater than the high of a gain.
- **Status Quo Bias:** Human preference for things to remain as they are.
- **Sunk Cost Fallacy:** Reasoning that further risk must be taken in an attempt to recoup past losses.
- **Normalcy Bias:** The belief that all that has been is all that will ever be.
- **Zero Risk Bias:** Preference for the total elimination of specific risks, even when alternative choices offer a greater overall reduction in risk.
- **Disposition Effect:** Behavioral tendency to sell stocks that have appreciated and to hold stocks that have fallen in value.
- **Hyperbolic Discounting:** Tendency to dramatically discount rewards that occur in the future relative to those occurring in the present.

This four-part framework serves as the intellectual scaffolding upon which much of your behavioral finance work can be built. A qualified financial advisor—experienced in investing tools, training and technologies, and able to apply that experience through a behavioral finance lens—can help you identify and overcome these all too common behavioral risk factors and set yourself on a path toward better investment outcomes.

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Contact us today to find out how we can help you avoid common behavioral risk mistakes, and stay on track toward meeting your goals.