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PART ONE

From the Outside Looking In

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Why is it seemingly impossible to take emotions out of making a decision about our finances?

Have you ever noticed how easy it is to know when someone else is making a bad decision—a friend is impulsively quitting her job; a family member is buying a house that seems too expensive; your brother has no retirement account? We find it easier to assess someone else's choices because we all have two views of the world: an outside view and an inside view. When you think about someone else's situation you are able to consider it from the outside, using the rational side of your mind. But when it's a decision affecting your own life, the emotional side often takes over. So why is it seemingly impossible to take emotions out of making a decision about our finances?

This paper is part one in a series that examines how and why we act as we do. We'll use the tenets of behavioral finance* to examine our natural vulnerabilities and tendencies that so often impede good financial decision making. We'll explain some of the common and most powerful biases, help you to assess which biases you're the most prone to, and provide tips for overcoming those portfolio-wrecking tendencies. The goal: help you become a better informed and successful investor. But first, some background information.

How the Brain Works

Our brains enable us to process information and make decisions. The brain is divided into sections that control specific functions. The amygdala is action-oriented; it controls our "fight or flight" instinct and emotions such as anger and fear. In his book, *The Little Book of Behavioral Investing*, James Montier likens this part of the brain to the Dr. McCoy character from the Star Trek series.[1] It operates automatically and quickly. You don't control it. It just happens. It's an automatic system that generates impressions, intuitions, and feelings.

A second system, which includes the neo-cortex, is the rational one. It enables us to come to the logical conclusion and see patterns in the world. It's what the Mr. Spock character from Star Trek used to make rational decisions.[2] This rational, logical system performs complex computation, analysis, and accesses your memory to solve a problem.[3]

Most of the time, the brain uses both systems efficiently, minimizing effort and optimizing performance. The automatic system is reasonably accurate at making short-term predictions and reacting to challenges. However, it has biases, systemic errors or short-cuts it takes in specific situations. Biases are hard to avoid because we cannot shut off our automatic system, and our logical system doesn't recognize the mistake.[4]

For example, when deciding what to eat for lunch, instead of calculating calories already consumed, daily recommended requirements of vitamins, and activity levels - all rationale considerations - the automatic system substitutes a "gut" instinctive or biased answer and says, "I feel like having a roast beef sandwich." In his book *Thinking, Fast and Slow*, Daniel Kahneman calls this operation substitution and defines it as: "A simple procedure that helps find adequate, though often imperfect, answers to difficult questions."[5]

In order to overcome a crippling bias, the first step is to recognize it.

* Behavioral finance attempts to explain actual investor and market behavior. It differs from traditional finance which studies how investors should behave. Traditional finance is modeled on rational behavior while behavioral finance recognizes that people act irrationally.

1 James Montier, *The Little Book of Behavioral Investing: How Not to Be Your Own Worst Enemy* (Hoboken, NJ: John Wiley & Sons, 2010):4-5.

2 IBID

3 Daniel Kahneman, *Thinking, Fast and Slow* (New York, NY: Farrar, Strauss and Giroux, 2011):24.

4 Daniel Kahneman, *Thinking, Fast and Slow* (New York, NY: Farrar, Strauss and Giroux, 2011):25-28.

5 Daniel Kahneman, *Thinking, Fast and Slow* (New York, NY: Farrar, Strauss and Giroux, 2011):98.

Substitution and biases can unintentionally affect the decision making process with unfortunate financial consequences.

To be sure, we don't need to rely on logic all the time, sometimes emotional decisions can yield a better outcome. For example, in an episode of the television program *The Big Bang Theory*, a character named Sheldon removes emotion from many of his daily choices by throwing dice and letting the outcome of the roll make the decision for him. In the program, the outcome of the roll leads Sheldon to make a variety of bad decisions, including a decision to refrain from wearing underwear and another to forego a trip to the bathroom after drinking a lot of buttermilk.

In real life, using emotions to answer questions like, "What should I wear?" usually have only minor consequences. While the result may be that you end up overdressed, or underdressed, or the only one wearing jeans at a party, it's not a catastrophe. But what happens if emotions start to affect more important decisions?

When we use substitution or biases to solve complex problems, especially in the arena of investment decisions, we often find the simple answer isn't the right answer. In order to overcome a crippling bias, the first step is to recognize it. Once that's accomplished, it becomes easier to ignore the bias in the future and opt instead to let the rational side of our brains come to a better and more reasoned "final answer." In other words, we all need to channel our "inner Spock" at times.

Here are four of the most common biases that affect financial decision making.

Loss Aversion

People don't like to lose, especially when money is at stake. Research shows that we are biased against loss so much so that we fear and stress over a loss twice as much as we anticipate the joy of a gain.[6] This bias causes investors to make decisions based on what they think will avoid a loss, over those with the potential for a gain.

Are you biased?

Game A:
You're offered a choice:
1. A sure gain of $500.
2. A 50% chance of gaining $1,000 and a 50% chance of gaining $0.

Game B:
You're offered a different choice:
1. A sure loss of $500.
2. A 50% chance of losing $1,000 and a 50% chance of losing $0.

If you're like most people, in Game A you took option 1, and in Game B you took option 2.

(In Game A, 84% of the people took option 1, and in Game B, 69% took option 2.)[7]

Why do so many of us choose those outcomes? It's because most of us are much more adverse to a loss than we are to the prospect of a gain. In Game A, the fear of a $0 outcome outweighs the potential of a $1,000 outcome. It is perceived as a loss of $500. In Game B, a guaranteed loss of $500 is more frightening than the potential guaranteed loss of $1,000. We hate losing so much that we'll gamble to avoid incurring the sure loss.

How to overcome the bias: If you are managing your own money, you need to develop a strategy for selling poor performers in advance. You have to learn how to "take the loss" and just move on. William O'Neil, founder of Investor's Business Daily, suggests setting the hard rule of selling if a stock drops 7-8% below your purchase price. If you are paying a professional investment advisor, understand his strategy for buying and selling stocks and make sure you're comfortable with the trading disciplines he uses. Look for a manager who has a clearly defined matrix for these types of decisions.

We fear and stress over a loss twice as much as we anticipate the joy of a gain.

6 Daniel Kahneman, *Thinking, Fast and Slow* (New York, NY: Farrar, Strauss and Giroux, 2011):284.

7 Daniel Kahneman and Amos Tversky, "Prospect Theory: An Analysis of Decisions Under Risk," *Econometrica* 47 (1979):313-327.

Conservatism

Conservatism is the mental process in which people cling to their prior views or opinions and reject new information. For example, consider the investor who reads bad news about a company's earnings forecast for a stock he owns and likes. This new information contradicts previous forecasts. A conservatism bias causes the investor to downplay the possibility that the new information is material or credible. Instead, he overvalues the old knowledge and undervalues the new information. The resulting behavior is a failure to act, or maintenance of the previous conviction.

Are you biased?

You read a report that says a company's new product launch is delayed. You own the company's stock. Do you:

A. Ignore the news. You bought the shares because you have faith in the company's fundamentals and management. A delay won't affect overall success.

B. Reevaluate the holding, but probably keep the position anyway.

C. Reevaluate the holding, look at as much current information as is available, and then make a decision.

If you answered A or B, you may be prone to a conservatism bias.[8]

How to overcome the bias: Work to be open to new information and insight. Seek advice from a professional investment advisor and read industry research for the stocks you own. Pose the question to yourself: Would I buy the stock today if I knew what I know now?

8 Michael Pompian, *Behavioral Finance and Wealth Management: How to Build Investment Strategies That Account for Investor Biases*. (Hoboken, NJ. John Wiley & Sons, 2012):69-70.

Hindsight bias gives people a false sense of security about their ability to make financial decisions.

Hindsight Bias

This is the "I knew it all along" effect. People with a hindsight bias believe that, in retrospect, past, unpredictable events were really obvious and predictable. They tend to think their own predictions are better and more accurate than they really were and can get angry when their advisor's forecasts or projections are incorrect. People with this bias can have thoughts like, "You should have known that. That company was obviously going to underperform. "Hindsight bias gives people a false sense of security about their ability to make financial decisions.

Are you biased?

A stock you own goes up in price. Do you:

A. Think, "Great, I chose wisely. No reason to analyze at it any further. I'll keep an eye on it as it goes up. I'm now more confident in my stock picking abilities."

B. Think, "Great, I chose wisely. I'm going to see if I can understand why it went up and use that knowledge when picking my next stock."

If you chose A, you may be prone to hindsight bias.[9]

How to overcome the bias: Work to be objective. Keep track of important facts and beliefs in real time. Write down what you thought, why you thought it, and keep track of what you paid when you bought the shares so you can objectively assess your methods and results later.

Anchoring

Anchoring is the tendency to rely too heavily, or "anchor", on one trait or piece of information when making decisions. In the investment world, this bias is evident when an investor makes a forecast based largely on current levels, current conditions, or original estimates.

Are you biased?

In 2013, you watched as the Russell 1000 Index rose 33% by year-end. On January 1, 2014 you decide to invest predominately in large cap stocks. You expect another great run for large caps and envision an increase of 19% in line with 3 and 5 year annualized performance of the Russell 1000 Index. As of June 30, the index is up "only" 7%. Do you:

A. Keep your expectations in place? Do you think, "It was just a slow start and a harsh winter; things will improve. We'll still hit close to 33% by year-end."

B. Adjust your allocation, but just a little?

C. Adjust your allocation a lot?

9 Michael Pompian, *Behavioral Finance and Wealth Management: How to Build Investment Strategies That Account for Investor Biases.* (Hoboken, NJ. John Wiley & Sons, 2012):112

If you answered A or B, you may be prone to anchoring. You heard a number and are unknowingly fixed on that data point. Your decisions are made based on that data, even though new information is available.

How to overcome the bias: Work to stay open to new information. Review your thinking with a fresh set of eyes and consider data available today. Ask the question, "*Why* do I think X is going to happen?" If the why is based on old information, think again.

Conclusion

It's okay to use your emotional side, especially as a factor in evaluating where you fall on the risk-reward spectrum because your pain threshold plays into where you need to be in terms of overall allocation. If you're trying to dial in on the suitable asset allocation of stocks, bonds and other asset classes that together is the right mix for you, that's an okay place for emotions to play a role. You may feel intuitively more comfortable with a certain composition of higher and lower risk assets.

However, recognize the biases that lurk in your mind. Stop, look, and listen to that inner Spock. He lives inside you. Or better yet, seek out and listen to a professional, trustworthy financial advisor. He can be your outside view. He can help short-circuit the biases that work to cripple your financial decisions.

We hope you found this paper of value. We always welcome your feedback, so feel free to contact Rex Moxley (rmoxley@smithanglin.com) or Weston Pollock (wpollock@smithanglin.com), both members of our Educational Research team, via email or at our toll free number (800-301-8486) with any questions or comments. They can also be reached via our company website, www.smithanglin.com.

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Rex Moxley joined Smith Anglin in 2001. Since then, he's served as a Managing Partner and as a member of the firm's Investment Committee. He regularly meets with prospective clients, counsels existing clients, participates in investment portfolio analysis and develops materials for communicating with the firm's clientele and target markets. He holds a BBA in Finance and Marketing, a graduate degree in Law and numerous securities licenses and designations.

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