Wealth management for life.

PART TWO

From the Outside Looking In

By: Rex Moxley

Ingrained biases can prevent us from making the best financial decisions.

"The investor's chief problem—and even his worst enemy—is likely to be himself."[1] Why is this so? This paper, part two of a series, uses the tenets of behavioral finance* to examine how and why our actions often impede good financial decision making.

1 Benjamin Graham, a British-born American professional investor, who is considered to be the father of value investing.

* 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.

In part one, (Behavioral Finance Part I) we introduced the topic of behavioral finance and how our biases can prevent us from making the best financial decisions. We discussed three common and powerful biases: loss aversion, conservatism, and hindsight. In part two, we will discuss three more biases and show how they can interfere with an important financial objective— investing retirement funds for growth in the face of risk and uncertainty. In addition, we will provide suggestions for overcoming these tendencies. The goal: to help you become a better informed and successful investor.

BACKGROUND

Humans use two systems within their brains to help with decision making. The first system is automatic. We can't start or stop it. This system generates our impressions, intuitions, and feelings, and allows us to make short-term predictions and rapidly react to challenges. However, it has biases, systematic errors or short-cuts it sometimes takes to solve a problem.

We also have a second system which is rational, logical and enables us to perform complex computation, analysis, and access our memory when we try to solve a problem.[2] This system works well, but we actively need to engage it, and it doesn't always overcome biases, mostly because it doesn't always recognize the mistake.[3]

In order to overcome a bias, the first step is to recognize it. Once that's accomplished, it becomes easier to ignore the bias and let the rational side of your brain come to a better and more reasoned "final answer."

Here are three of the common biases that can detrimentally affect saving enough for retirement.

PRESENT BIAS

The percentage of workers who are confident they have enough money for a comfortable retirement increased in 2014 from record lows between 2009-2013. Sounds like great news, right? However a study by the Employee Benefit Research Institute showed that 24% of respondents were not at all confident that they would have enough to retire. In addition, a "sizable percentage of workers report they have

2 Daniel Kahneman, *Thinking, Fast and Slow* (New York, NY: Farrar, Strauss and Giroux, 2011):24.
3 Daniel Kahneman, *Thinking, Fast and Slow* (New York, NY: Farrar, Strauss and Giroux, 2011):25-28.

Are you confident that you have enough money for a comfortable retirement?

virtually no savings or investments." Among those who reported, 36% said they have less than $1,000 set aside for retirement.[4]

The statistics are even worse for younger workers. When asked if they were saving for retirement, 62% said they put away what they can, but doubt it's enough, and 26% say they aren't saving at all.[5]

While these results may be somewhat the consequence of underemployment, much is also due to a behavioral factor known as present bias. Present bias is the tendency to sharply reduce or discount the importance of the future when making decisions today. This is because the value we place on an object or activity falls off rapidly as we project into the future.[6] It leads potential savers to prefer spending now instead of saving for the future now. We imagine that we'll start saving for the future when..... The "when" can be very personal; when I start making more money, when I reach 40, when I've closed on that house I've always wanted. This bias also seduces people into thinking that an unpleasant task will be easier in the future.[7]

4 Ruth Helman, Greenwald & Associates; and Nevin Adams, J.D., Craig Copeland, Ph.D., and Jack VanDerhei, Ph.D., "The 2014 Retirement Confidence Survey: Confidence Rebounds—for Those With Retirement Plans" *Employee Benefit Research Institute* (March 2014, No. 397).

5 NJBIZ survey of 150 respondents in US and Canada aged 21-35 that have held at least one part-time job. *NJBIZ* August 18, 2014:13.

6 Shlomo Benartzi, *Save More Tomorrow* (New York, NY: Penguin Group, 2012):104-108.

7 IBID

When questioned on their decision to put off saving for retirement, employees often replied, “If I could be guaranteed a high rate of return, or if interest rates were higher, I would start saving more now.” However studies in behavioral economics found this line of thinking doesn’t work. One study tested the effectiveness of self-help peer groups versus a high interest account that paid 5% (instead of 0.3%). The study found that peer groups had a strong impact on savings while the higher interest rate had a surprisingly small effect.[8]

Are you biased?

> Would you prefer $150 in 48 weeks or $160 in a year?
>
> Would you prefer $150 today or $160 in four weeks?

In studies of this ilk, participants often chose $160 to the first question, but $150 to the second. However, both options essentially present the same situation, waiting 4 weeks for $10 more.[9]

If you made the same choices, you may be prone to a present bias – it’s hard to put off instant gratification until “tomorrow”, but if you are already waiting, waiting a little longer isn’t so bad.

How to overcome the bias: The simplest way to overcome this bias is to take advantage of your company’s retirement plan as soon as you are able to do so and make a commitment to increasing your savings over time. Also check to see if your company has a matching contribution program which will speed up the pace of your accumulated savings. Shlomo Benartzi developed a program called Save More Tomorrow™ (SMarT) that’s an effective tool for increasing your retirement savings. The program makes it easier for participants to start saving now and gradually increase their savings rate over time.[10]

Another effective way to bolster your savings is to meet regularly with a financial advisor who understands your company’s 401(k) and other retirement savings programs. He or she can help you develop comprehensive savings and investment plans that are based on your specific situation and maximize your chances of securing a financially viable future.

BANDWAGON

We discussed earlier how peer group support or pressure can help employees establish and stick to a savings plan. However, “group think” can lead to poor investment decisions if left unchecked. When we see the masses start to pick

8 Felipe Kast, Stephan Meier, Dina Pomeranz, *Under-Savers Anonymous: Evidence on Self-Help Groups and Peer Pressure as a Savings Commitment Device* (IZA DP No. 6311)

9 Mark Egan, *What is... present bias* (http://www.ezonomics.com/whatis/present_bias)

10 Shlomo Benartzi, Save More Tomorrow (New York, NY: Penguin Group, 2012):13-14.

a winner or a favorite, our individualized and easily influenced brains start to shut down and become less inquisitive. We feel the need to follow the crowd as there is comfort and security in running with the pack. After all, it must be okay if "everyone is doing it", right? However, because your investment objectives are specific to you and since your needs and goals are unique and situation-specific, successful investing requires discipline of purpose and continual re-evaluation.

Following the investing "herd" is prone to serious financial set-backs. For example, during what later became known as The Technology Bubble of 1995-2000, Microsoft stock (MSFT) was a "must own", widely held, outperforming position. It was definitively popular. But in the 14 years since 2000, MSFT plummeted more than sixty percent from its peak in 2000, to a low in 2009, and today still trades well below its all-time high.

The bandwagon bias can affect an investor's choice of money managers as well. How many former clients of Bernard Madoff wish they had done a little more due diligence and asked pertinent questions of Mr. Madoff and his firm rather than just blindly following the crowd?

"Group think" can lead to poor investment decisions if left unchecked.

Are you biased?

Who was the President of the United States in 2008? Did you answer George Bush? What if you were with a group of people you respected and they all said it was Barack Obama? Would you second-guess yourself and maybe change your answer?

You may be surprised to find that many people would. In a classic psychology experiment, Solomon Asch studied the power of conformity in groups. He found that people changed their answer one-third of the time when they recognized they were in the minority. He also found that people were more likely to change their minds when three or more people provided the wrong answer. Asch and other researchers also found that if there was at least one person agreeing with your answer, you were more likely to stick with it. This suggests that having social support is an important tool in combating conformity.[11]

11 Kendra Cherry, *The Asch Conformity Experiments* (http://psychology.about.com/od/classicpsychologystudies/p/conformity.htm)

Having social support is an important tool in combating conformity.

How to overcome the bias: Read and be open to information from a variety of sources. Don't rely on one news channel or program, one newspaper, or one economist's forecasts. If you work with a professional investment advisor, ask to see a variety of industry research on the stock or fund the advisor is recommending you purchase. Pose questions: What are others saying about the stock or fund, its sector, region and growth trends? Also, be disciplined and regularly review your portfolio. Revisit your portfolio's percentage allocations with your financial advisor and establish a regular portfolio rebalancing process which will help minimize the dangers of following the "herd". Rebalancing reduces excessive overweights to specific stocks, bonds, industries and sectors and also increases exposure to positions that have become underweighted.

OVERCONFIDENCE BIAS

Psychologists have confirmed that most people genuinely believe they are superior to others in a number of desirable traits.[12] Studies have also confirmed that overconfidence causes people to overestimate their knowledge, underestimate risks, and exaggerate their ability to control events. This can have a disastrous effect on investing decisions.

Are you biased?

Answer these questions:

1. Are you an above average driver?
2. Are you above average at your job?
3. Are you a better than average friend or companion?

Most people answer yes to these questions. Even when 600 fund managers were surveyed, 74% said they were above average at their jobs.[13] Obviously, this is statistically impossible!

According to Nobel Prize-winner Robert Shiller, "Overconfidence, however generated, appears to be a fundamental factor promoting the high volume of trading we observe in speculative markets." Other researchers, Barber and Odean, took this observation a step further and discovered that individual investors who trade more frequently typically underperform the value-weighted index by more than 1% per year.[14] The reason is simple: the more you trade, the greater the return-dampening trading fees, which cut into your principle before you can even start earning a positive return.

12 Daniel Kahneman, *Thinking, Fast and Slow* (New York, NY: Farrar, Strauss and Giroux, 2011):258.

13 James Montier, *The Little Book of Behavioral Investing: How Not to Be Your Own Worst Enemy* (Hoboken, NJ: John Wiley & Sons, 2010):32-33.

14 Brad M. Barber and Terrance Odean, "Trading Is Hazardous to Your Wealth: The Common Stock Investment Performance of Individual Investors" *The Journal of Finance, VOL. LV, NO. 2 APRIL 2000*: 786

According to Jack Bogle, founder of The Vanguard Group, "The principles of sensible savings and investing are time-tested, perhaps even eternal. The way to wealth, it turns out, is to avoid the high-cost, high-turnover, opportunistic marketing modalities that characterize today's financial service system and [instead to] rely on the magic of compounding returns. While the interests of the [investments] business are served by the aphorism 'Don't just stand there. Do something!', the interests of investors are served by an approach that is its diametrical opposite: Don't do something. Just stand there!"[15] Bogle's right, that excessive trading, which can be caused by overconfidence, means more trading costs which can definitely cut into your net performance.

Overconfidence causes people to overestimate their knowledge, underestimate risks, and exaggerate their abilities.

How to overcome the bias: To overcome the overconfidence bias, work to be objective. Keep track of how often you and your financial advisor are trading, and the impact of trading costs on net returns. Compare the results with your financial objectives, not just a standardized benchmark. This will allow you to objectively assess your performance.

Conclusion

Letting emotions influence how you manage finances can negatively affect financial decision making. Before trading in your accounts, stop and think. Ask yourself, is the decision I'm about to make rational, or is it a reflection of one or more inner biases?

A professional, trustworthy financial advisor can serve as your "outside view", part of an un-emotional support group to help you recognize how one or more biases may be clouding your decision making. A good financial advisor can help you stay on track and keep you focused on achieving your financial and retirement imperatives.

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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15 Jack Bogle, "Jack Bogle's advice for a rocky market: Follow Ben Franklin" http://www.cnbc.com/id/101381010

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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