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A reality self-check for investors

By Cameron Morgan

You stay up-to-date on current economic and financial thinking, and carefully weigh investment choices in comparison to each other. You've scrubbed your monthly budget and have sketched out both short- and long-term spending plans for your household. You're minimizing your income taxes over your lifetime, not just this year. Additionally, you've protected yourself from litigation and unnecessary expense. Last but not least, you've established a legacy plan for college funding, charitable giving, and other long-term financial wishes. All-in-all, you feel capable and competent at managing your family's financial present and future.

But have you considered one of the biggest obstacles to preserving your wealth? Daily, weekly, monthly, and annually, your wealth may be under attack from your own thoughts and ideas. It's investor behavior — one subtle challenge that can be hard to mitigate. After all, it's internal!

What is meant by investor behavior, and its partner, behavioral finance?

The field of behavioral economics blends psychology and microeconomics. The term 'behavioral finance' attracted many investors' attention for the first time in 2002, when Vernon Smith and Daniel Kahneman won the Nobel Memorial Prize in Economic Sciences for their work on the subject.

Humans are emotional beings; some to a greater or lesser degree than their neighbors, but emotions do drive behavior. This has been — and continues to be — an important aspect of what makes us human. Having choice, and the ability to alter our course in response to our environments, is a survival tactic. In the modern day, our ability to adjust our behavior is what sparks entrepreneurship, encourages health, and stretches for goals. In short: We can change!

But malleability has its sinister side as well. Having choice means that once a decision is made, many temptations and distractions will arise to challenge that commitment or decision. You have to choose to commit to your long-term goal again and again, daily, and sometimes adjust your course.

This is explored in an accessible way by longtime behavioral finance academics Richard Thaler and Cass Sunstein in their 2009 book, Nudge: Improving Decisions About Health, Wealth, and Happiness. The premise of behavioral financial is that we are not on autopilot, and can choose behavioral change when circumstances prompt a response. In short, we are not robots, or algorithms, or solely logical. Put another way: Modern Portfolio Theory isn't wrong, just incomplete.

Bringing this to a personal level, what default choices are driving your saving and investing behavior? Put another way, where did you cede the decision, or refuse to make a decision, when you had a choice? And finally: How do you know when emotion has taken the wheel?

The lizard brain

Before you dismiss folks who forget — or 'forget' — to follow beginner investing rules like "rebalance annually" as merely undisciplined, it's important to look at brain science. Decisions are made at the amygdala, offhandedly referred to as the lizard brain. Only later does the logical part of our brain begin looking for evidence to support the decision that our amygdala picked. It's not weighing evidence that leads to the conclusion, rather its conclusion first, supporting facts later. Since the process is so fast, we aren't conscious of it. While that speedy act-don't-think sequence saved the lives of our cave-dwelling ancestors (perhaps), it's rarely best nowadays. At the very least, an investor who doesn't know the way our brains decide can have a dangerous blind spot.

Self-check: Have any of these three thinking behaviors shaped your investment portfolio?

1. Anchoring — the tendency to focus on one piece of information, regardless of its actual priority in your decision making. One example of this is knowing your cost basis in a stock, ETF or mutual fund. Why is this an issue? It's not, unless you are waiting to sell (if it's trading at a price below your cost basis) until you've broken even. Similarly, are you waiting to sell a holding that is up, until you've made a set percentage ('a two-bagger,' 'a 10-bagger')?

The market doesn't know what you paid for your holding. Furthermore, as any candid investment adviser will tell you, the market doesn't care what you paid for your holding. If that stings a bit, you are probably anchoring.

2. Recency bias (an aspect of availability bias) – this pinpoints our tendency to react to fresh news we read or hear. We heavily weight new information and information that arrives in our inbox, mail box, or watch list. We also are more likely to expect that the recent past will repeat, or at least persist, whether the recent past was positive or negative. Related to recency bias is confirmation bias. This describes our very human tendency to search out opinions and facts that echo our own beliefs, and to discount information that challenges our conclusion. Recency bias is a tricky bias to eliminate when we are in pursuit of learning and staying informed.

3. Groupthink — more punitively called herd behavior, groupthink can be a consequence of availability bias. We feel more comfortable, safe, and

‘right’ when we see evidence of other people doing, saying, or thinking as we do. Does it seem that Federal Reserve Chairwoman Janet Yellen’s comments are listened to closely, analyzed for deeper meaning, and have impacted the fixed income markets? Do all investors need to know what Yellen’s intentions and philosophies are, in this great detail? Really? Why?

Finding the solution

Ruthlessly eliminating the emotion from your saving and investing decisions may feel, at first, like taking all the fun out of investing. It’s just that thrill, buzz, or rush that may tip you off to a moment of heightened emotional decision-making. So how do you temper the lizard brain?

The first step to insulating yourself from emotional or behavioral responses when making investment decisions is to establish an investment process. Write it down. This is sometimes referred to as an Investment Policy Statement, or IPS. If you already have one, pat yourself on the back. If you refer to it, then give yourself a high-five. If you don’t have one, or don’t use it, then ask yourself these questions:

What is your buy discipline? How do you identify securities? How do you evaluate bonds, mutual funds, or exchange-traded funds? Which metrics will you look at? For instance, if you will examine four key metrics, and one of them is dividend yield, then what are your parameters? If you have decided that the Sharpe ratio is one of your guides, what is the range for inclusion in your portfolio?

Take a similar approach to documenting your sell discipline. Think broadly when examining the cost built into your process. How long will it take, at an assumed rate of return, to make up for the cost of making a change to your portfolio? With trading expenses nearly zero at many online or discount brokerage firms, you need to consider the tax implications that are unique to your household, before selling. Investing involves trade offs. That said, you must establish a self-check. Otherwise, you risk making a change for only minor improvement in your investment portfolio.

In addition to having an investment policy statement or process, you may want to employ additional behavior measures to counter your hard-wired behavioral instincts. These could include:

1. Add distance – Get a third-party perspective from someone you trust. By stepping outside of yourself and soliciting another person’s opinion, you’ll hear what you’re doing from a less emotional and less vested person. Can you satisfactorily respond to each counterpoint? With that distance, you may hear something that convinces or dissuades you from moving forward. Either way, you can proceed with confidence afterward.

2. Add time — Sleep on your decision overnight. If your decision looks like a sensible one in the clear light of morning, then you have removed any false sense of urgency that may have crept in.

3. Decrease risk (amount of money at risk) — Don’t make a big bet if you think emotion might be involved, but allow that emotion to be expressed with the purchase. Your brain won’t know the difference. Your brokerage account balance will!

4. Reflect — reviewing your past investment decisions may help keep your feet on solid ground, investment-wise. To counter overconfidence, ask yourself if you’ve made a decision before that ended badly. Try to detect any errors you may have made, and log the lessons you need to absorb. To counter hasty thinking, ask yourself if you are anxious. As Carl Richards says in his book The Behavior Gap, “anxious people often screw up. Think about it: ever try doing anything when you’re anxious? Calm is always better.”

Scenario: Avoid

Brain science and behavioral finance teach us that these thinking patterns don’t serve us in the long run. Despite their prevalence, they persist, because our short-term reaction has saved our lives figuratively or literally many times.

One investor was spooked out of the market in late 2008, reacting to her very real financial pain and fear, only to wait on the sidelines for four years before interviewing an investment professional. The path back from fear involved an interview process that took about eight months. All the while this high-earning couple saved and reflected, a sustained bull market was in full swing for equities. Despite having clear goals and an income of more than $300,000 a year, these clients’ dreams were hamstrung by their emotions — specifically, by recency bias. They had healthy savings behavior and didn't struggle with debt, under-earning, excessive frugality, secret funds, harmful giving, or any of the overt behavioral finance challenges. Rather, their response to their recent experience had led them away from a formal investment plan, for years. The consequence will be additional years of working, earning and saving.

Fortunately, working, earning, and saving are feasible solutions for this family and their college-bound kids. Others may not be as fortunate due to career stage or health concerns. Had they realized they needed an investment plan at the point of their greatest fear — instead of years after the fear had subsided — they may have had a smoother road to their goals.

For additional reading

Carl Richards’ The Behavior Gap is a fun starting point, especially for people who are visual learners. The New York Times columnist creates simple black-and-white drawings that illuminate assumptions, challenge old chestnuts, and humorously set investors’ feet back on firm ground.

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