Exposing the blind spots

What your clients can't see is affecting their success

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Dust off and read most financial theories and you'll notice they work under the assumption that investors consider all available information in their financial decision-making process and make informed, rational decisions; i.e. behave how they should behave. Over the last few decades, academic researchers such as Daniel Kahneman, Amos Tversky and Meir Statman have applied their deep knowledge of psychology to those theories, leading to the birth of behavioural finance. As a result, we now have tremendous insight into how investors think and behave, as well as how their actions impact their investing success.

How big of an impact, you ask?

DALBAR's 22nd Annual Quantitative Analysis of Investor Behaviour showed that in 2015, the 20-year annualized return for the S&P 500 Index was 8.19%. The annualized return for an average equity fund investor over the same period was only 4.67% – a gap of 3.52%. For some added context, using a $250,000 initial investment, the average investor earned only 60% of what they could have earned by simply buying and holding an S&P 500 Index fund. This gap can often be explained as investor misbehaviour – i.e. trying to time the market, or making uninformed, irrational decisions based on the fear of missing out (FOMO) and feelings of fear, uncertainty and doubt (FUD).

Many investors' mistakes are the results of their personal biases – the mostly unconscious filters by which they make judgments and decisions about everything, including their money and investments.[1] We refer to these as their "blind spots" when it comes to investor behaviour.

Why is this still an issue in 2018? Aren't we smarter now than we were before? Simply put, we are wired to use our biases to survive.

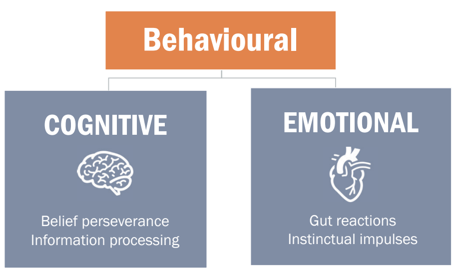
We rely on three basic parts of the brain:

It's how we're wired

- the reptilian brain, the part of the brain that controls our unconscious, reactive, and impulsive actions
- the limbic system, the part of the brain that is comprised of/or introduces emotions
- the prefrontal cortex, the newer, less developed part of our brain responsible for higher-level thinking and reasoning.

Ultimately, our reptilian and limbic brains take control whenever we detect danger or face a challenge. This hijacks our behaviour and prevents us from logical and rational processing. In fact, even when we try to engage the neocortex (our rational brain), we tend to misinterpret the information, or we process it in a way that translates into poor reasoning.

An investor's biases can generally be broken down into two categories: **cognitive** and **emotional**.



Cognitive biases are caused by our belief systems and how we take in and process information – how we edit and evaluate the information around us.

Our cognitive biases stem from "defective thinking," i.e., information processing errors, memory errors, failure to reassess or modify our beliefs when faced with information to the contrary, etc.

The second category of emotional biases stems from gut reactions, or instinctual impulses – acting upon emotions rather than logic. We see this regularly as emotions can overpower an investor's thinking during times of stress, causing irrational decisions.

Regardless of whether our biases are cognitive or emotional, we are essentially opting for mental shortcuts to what would otherwise be a difficult determination. Taking these mental shortcuts makes the task of investing feasible, but also allows the capacity for mistakes that can end up costing investors.

These shortcuts allow an investor to make an approximation without having to conduct exhaustive research. While rules of thumb are useful as general guidelines, they are oversimplified in many situations, which leads to underestimating or overestimating.

There are approximately 20 biases that investors usually exhibit. This article will examine the six most common biases of today's investors and their impacts on investment decisions. They are:

Loss aversion

Having greater sensitivity to loss than risk and return. Roughly speaking, losses hurt investors twice as much as gains make them feel good. This bias can result in investors refusing to sell shares in a losing position with hopes of making their money back, selling winners, locking in their gains and removing their money from the market.

Herding

Aligning with the thoughts and actions, (rational or irrational) of a larger group. It is human nature to feel that there is safety in numbers. We see this behaviour when investors jump on the bandwagon of a hot stock, chasing performance, or trying to get in on a specific market sector. To illustrate this bias, simply recall the number of clients who asked you recently about cannabis stocks (fear of missing out). Regardless of how herding manifests, we know that investors consequently buy high and sell low.

Anchoring

Using an initial/singular piece of information to make subsequent judgments. In our industry, it's easy to be influenced by the numbers. Many investors get stuck on a specific point of reference such as purchase points, or arbitrary price levels. Then they cling to these numbers when deciding to buy or sell a security/fund. If you have been in the industry long enough, you may have witnessed this bias first–hand with telecommunications company Nortel, as clients anchored to the stock's high and refused to sell on the way down. Investors usually believe they know best.

Overconfidence

Being too confident in their own abilities. At best, this bias can be described as an unwarranted faith in one's intuitive reasoning, accuracy or judgments. Think you might be immune to this one? How would you assess your driving skills compared to others? Research show that four of every five drivers believe they are in the top 30%. For investors, overconfidence can result in overactive trading, paying more in fees and generating inferior returns.

Framing

Making decisions based on how information is presented. We make choices daily without knowing we are committing to this cognitive bias – take a closer look at those fat-free and sugar-free products the next time you visit a grocery store. Framing in the investing world means clients end up making decisions without considering the context of the entire portfolio or the bigger picture. It's easy for an investor to get excited about a sector and purchase stocks without recognizing their portfolio or mutual fund is already overweight in that sector. Investors may ignore and therefore squander the potential benefits of diversification with this bias.

Recency

Thinking that what's been happening will continue happening. This bias occurs when people prominently recall and emphasize recent events more than those further in the past. If all that has been witnessed in the recent past are positive and/or bullish events, it is human nature to generalize this experience and expect it in the future. Case in point is what happened with cryptocurrencies. In December 2017, many advisors received instructions from their clients to invest in Bitcoin after it had experienced its amazing run up – it looked like it couldn't lose. Until it did, and it lost more than half of its worth over the next few months.

A **BIG** part of what you do that is invaluable to your clients' financial well-being is coaching to help them mitigate the impact of their blind spots.

Providing solutions and tactics to educate and engage clients is one of the many ways CI's Strategic Business Development Group is committed to helping advisors across Canada. In Part Two of this series, we'll explore how you can tame the investor's brain and shrink the blind spots associated with investing, including three practical steps to help your clients make better decisions.

> ***"The investor's chief problem – and even his worst enemy – is likely to be himself."***
>
> \- Benjamin Graham

[1] Impact of behavioral finance in investment decision making, A. Chaudhary, 2013

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