ADVISOR PERSPECTIVES

Sleeping with the Enemy

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When it comes to investing, our worst enemy may be the one we see in the mirror every morning – ourselves.

Our impulses prompt us to run from danger and chase success, to sell our investments when all seems lost and buy when the future looks bright. We are prone to behavioral biases that can distort our decision-making. Left unchecked, our emotions and biases can wreak havoc on our financial well-being.

Unfortunately, mere awareness of these tendencies is not enough to keep them in check. Our emotions and behavioral biases are a part of us, and while some people are certainly more susceptible than others, these influences affect all of us to some degree. Awareness can, however, teach us to identify the situations in which we are most vulnerable and plan accordingly.

The beast within

Greed and fear are both alive and well on Wall Street today, as they have been throughout history. These emotions drive market prices much lower than seems justified during times of despair and push prices well beyond any realistic measure of fair value during times of plenty. That these patterns of overreaction are so regularly repeated, that we seem incapable of learning from history, is an indication of the power of these emotional forces.

The fact is, we are not well equipped to deal with the daily ups and downs of the marketplace. Most economic theory is built on the assumption that actors behave rationally, and most people would prefer to think of themselves in that way. Unfortunately, the evidence says otherwise. What behavioral finance has to say about our tendencies as investors is frightening.

Far from the rational man of classic economics, studies suggest that when faced with complex economic decisions, people often resort to general rules of thumb and other shortcuts. Furthermore, when we are faced with high uncertainty and anxiety, our emotions and instincts take over. This is particularly true when money – the prospect of making it or losing it – is involved.

During times of severe market turmoil and mounting investment losses, our emotions and their instinctive pull grow ever stronger. In a crisis scenario, the emotion is fear – the impulse is to run away from danger. When markets are rallying and all seems right with the world, greed begins to take hold. Bull markets make all participants look like geniuses – an illusion that always proves temporary – and everyone wants their share.

How we respond

Many factors determine the way we respond to a given situation, including our urgency, the amount and type of information available to us, and the perceived threat to our safety or personal well-being. The gamut of human responses is generally broken down into two broad categories, reflexive and reflective.

The reflexive response system is triggered in urgent situations, such as when imminent danger or a critical, fleeting opportunity is perceived. It can also be activated when we face extremely complex problems or experience information overload. This system is rapid-fire, processing data and drawing conclusions in an instant. Responses are largely driven by emotion or instinct, and occur on a subconscious level. They are automatic. The reflexive response system developed early in man, and is similar to the response systems observed in all animals.

On the other hand, the reflective response system is used to respond to less immediate matters. It is methodical and deliberate, characterized by thought, analysis, and rational decision-making, and occurs in the conscious mind. It allows for the careful weighing of alternatives, as well as the creative expression of the imagination. A much more refined system, it is often said to be what separates man from "beast".

While each response system serves its purpose, we have needed our reflexive systems less and less over time. Gone are the days when our very survival depended upon the ability to avoid predators and quickly seize opportunities for food, shelter, and mating. However, there are still situations in which we depend on our reflexive response systems, and in these situations it is critical. For example, in driving situations where there is literally "no time to think", our survival can depend on our reflexive response systems directing us to slam on the brakes.

The advantage to operating on the subconscious level is the speed of the response time. The stimulus is identified and the programmed action is taken – it kicks in automatically. Unfortunately, the system can misfire, activating in situations that are not urgent and where the response may be undesirable. The reflexive system does not wait for an invitation, and does not particularly care whether it is welcome.

When it comes to managing our investments, many of the decisions involve complex reasoning, with high degrees of uncertainty and stress which can at times seem overwhelming. The emotional and physical responses these conditions evoke are very similar to the symptoms that trigger the reflexive response system. As a result, the system often activates in these situations, bombarding us with all manner of inappropriate and destructive responses. Once triggered, the call to action can be strong and difficult to overcome.

A matter of time

Our emotions also kick in when we perceive rewards or sacrifice, and the desire for immediate gratification can be as strong as the urge to run from perceived danger. One common element that distinguishes the relative strength of these responses is time. Whether the situation involves pain or pleasure, fear or greed, the intensity of our emotional response and our ability to overcome it are heavily influenced by the time frame.

Many studies have examined the influence of time on our decisions. Some studies have pitted one option offering immediate gratification and less appealing long-term consequences against another option with less immediate appeal but superior long-term benefits. For example, one classic study, often repeated in varying forms, looks at the influence of time on the decisions of subjects choosing between chocolate and fruit as a snack. When the snack is to be delivered now, in the present, people overwhelmingly (typically around two-thirds of subjects) choose the chocolate. However, when the treat is to be consumed at a future time, tomorrow or next week, people usually make the healthier choice (again, typically around two-thirds of subjects).

Our penchant for avoiding pain follows the same dynamic. Faced with a situation involving immediate pain or sacrifice and long-term benefits, we tend to look for a way out, even when we know the painful route is best. When the required sacrifice is moved to the future, however, people are much more likely to choose the right course. One classic study compared the choices of exercise today versus exercise in the future. Not surprisingly, study subjects were consistently much more willing to commit to an exercise program when it was to begin at a future date than they were when the program was to begin immediately.

So, what is the psychological difference between chocolate or fruit now, and chocolate or fruit tomorrow? Exercise today versus exercise next week? The answer lies in the strength of our emotional response, and our ability to resist or overcome it. Our emotional response to the prospect for immediate pain or pleasure is very strong. As the event is pushed into the future our emotional response weakens, and our rational, reflective side gains the upper hand. Time weakens the opponent.

Unfortunately, overcoming emotions and reflexive responses are not the only internal challenges investors face. As it turns out, we are influenced by many behavioral biases that provide further obstacles to our investment success.

Our behavioral biases

Recency bias refers to our tendency to give more weight to recent events. When considering the likely future path of the economy or the markets, our minds paint a picture that looks much like the recent past. As the trend continues, we become increasingly comfortable with the current environment. At the same time, stock and other asset prices are marching higher, valuations are being stretched, and markets are becoming increasingly vulnerable. Our bias leads us to become more comfortable with accepting investment risk as the compensation for bearing that risk decreases.

The opposite occurs in times of economic distress. As the bad news mounts and the markets tumble, we find it difficult to conceive of a brighter tomorrow. Our increasing pessimism coincides with the downfall, and our willingness to bear risk bottoms as the compensation for bearing risk peaks. “Buy low, sell high” is not as easy as it sounds.

Time can also have a distorting effect on our memories, causing us to overestimate the accuracy of our foresight. Referred to as hindsight bias, we tend to believe we had, in retrospect, a much more accurate grasp of the way events would unfold than we actually had. Our minds seek harmony, and bend our recollection to more closely correspond to the eventual outcomes. These distortions of reality contribute to another behavioral bias, overconfidence.

Confidence is an admirable and beneficial quality, but overconfidence can be costly, especially in the investment world. Studies consistently demonstrate our tendency to overestimate our knowledge and abilities. One often-used question in these studies asks participants to rate their driving abilities. In classic Lake Wobegon fashion, 70-80% of respondents typically reply that they are above average. When it comes to investing, overconfidence can lead not only to poor individual decisions but also to general behavior that further undermines our chances for success.

Overconfidence can cause investors to take excessive risks by convincing them that they know more about the prospects of a given investment than they actually do. The wealth of online information available to investors today contributes to the illusion. Studies have shown that, among professional investors, the availability of additional information improves decision making, but only up to a point. After that point, the quality of decisions levels off and finally, with the provision of still more information, actually declines. The level of confidence the investors have in their decisions, however, continues to increase as more information is received.

Overconfidence also contributes to excess trading, which is highly correlated with poor relative returns. On average, the more investors trade, the worse their portfolios perform.

Confirmation bias also feeds our overconfidence. Most people prefer to avoid conflict, particularly of the internal variety. We tend to read and listen to those who share our political views, our values, our philosophies and beliefs. Our minds prefer harmony and consistency, so we tend to ignore or discount evidence that conflicts with our views. We seek confirmation and, in the end, we generally find what we are looking for.

Overconfidence may also play a part in loss aversion, another behavioral bias that can hurt long-term investment performance. Most people are reluctant to sell a losing investment. Part of this reluctance can be related to overconfidence or simply the pain of admitting a mistake. However, when it comes to loss aversion, research indicates a much more fundamental characteristic at work.

Prospect theory, another important concept to understand, was introduced in a 1979 paper by two psychologists, Daniel Kahneman and Amos Tversky, in the economics journal *Econometrica*. The beginning of what has come to be known as behavioral economics, prospect theory states that people place much greater emphasis on losses than gains. From a neutral starting position, we tend to place a much higher negative value on the prospect of losing a dollar, than the positive value we place on the prospect of gaining a dollar. However, from a non-neutral starting position, our preferences change.

When faced with a losing starting position, such as when an investment has suffered a decline, people tend to be much more willing to gamble. When presented with the same future prospects, but starting at a position of gain, people become much more conservative. Thus, our evaluation of a given investment or prospect is influenced by the way it is presented. As the fundamental valuation and overall merits of a given investment are in no way affected by whether we happened to purchase the investment at a price above or below the current price, this framing bias presents yet another hurdle for investors to overcome.

Plan your defense

So how do we control this array of emotions and behavioral tendencies? How do we avoid the urge to liquidate our portfolio and bury the money in the back yard when the talking heads on the business networks are preaching Armageddon? How do we resist the temptation to roll the dice at the most inopportune times, when everything seems right with the world, and the neighbor insists on telling us about the killing he is making in commodities (2002-2008), real estate (2000-2005), dot-coms (1990's), biotechs (1980's), gold (1970's), the nifty-fifty (1960's), …tulip bulbs (1630's)..

Emotions are vital to effective decision making, and they are an essential part of many of the finer things in life. If left unchecked, however, our emotions and behavioral biases can make it challenging to achieve our long-term investment goals. In order to succeed, we must first acknowledge and understand the barriers these psychological tendencies present.

Like the legendary werewolf who instructs that he be locked up until sunrise to protect himself and others, investors must plan ahead to effectively prepare for turbulent times. In order to effectively deal with our emotional and behavioral challenges, we must develop a game plan in advance, when our rational minds have the upper hand. Establishing an appropriate, long-term investment strategy designed to meet your financial goals formalizing the plan in a written investment policy statement dramatically increases the odds you will be able to resist the emotional pull when the howling begins.

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