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Controlling the Urges:
How Biases Influence Our Investment Decisions

by Jay Mooreland, CFP®

Warren Buffett, responding to a question about what makes a successful investor, said, "Once you have ordinary intelligence, what you need is the temperament to *control the urges* that get other people into trouble in investing"[1] [emphasis added]. These urges are known as behavioral biases to psychologists and behavioral economists. Behavioral biases are traits or tendencies that influence us to think and act in certain ways. All people have some combination of behavioral biases—they contribute to our individuality, and when it comes to investing, our irrationality.

Biases are either of a cognitive or emotional nature. Cognitive biases influence us to interpret or judge situations inaccurately, while emotional biases distort our decision-making ability because of emotional factors such as fear, greed, and anxiety.

Biases have been shown to influence people regardless of their investment experience, net worth, education, age, employment, or economic incentives.[2] Biases can explain why investors sometimes say one thing and do another, or why investors abandon a long-term investment plan to appease their short-term desires. The good news is, we can identify cognitive errors and set a defense against them.[3] And by doing so, financial advisers can increase the value they provide to clients.

Biases are generally latent, and their influence often is subconscious, usually influencing us in stressful or emotional situations, so we are seldom aware of their influence. However, by asking the right questions, we can proactively identify specific biases that may influence us, and take measures to reduce the influence of those biases.

Because all of us are potentially influenced by biases, financial advisers must first understand how biases influence them and take corrective measures. Advisers will then be in a position to identify and mitigate biases in clients, thus helping clients "control the urges."

Cognitive Biases

Cognitive biases influence the way we think and may be corrected through recognition of the bias, education, and illustration. Financial advisers can help their clients understand their error in thinking by providing evidence of such error and examples of correct thoughts. It is beyond the scope of this article to review every cognitive bias, but here are a few of the more common ones found in the investment realm:

Overconfidence—we are certain that the choices we make are in our best interest. Overconfident investors believe they make better investment decisions than they really do. Abundant evidence demonstrates that the more decisions (for example, trades) investors make, the worse they do. This may be corrected by demonstrating that stock and bond investors significantly underperform their respective benchmark index, according to research from Dalbar Inc.[4] In addition, Morningstar has found that investors underperform the very fund(s) they are invested in.[5] Dalbar and Morningstar conclude that investors' behavior and their decisions of when to purchase and sell securities cause such underperformance.

Myopia—we are influenced by short-term results. Myopic investors, even those with a long time horizon, are influenced to take action based on recent events. It is important that myopic investors evaluate investments with the correct perspective. Advisers should ensure their clients understand that short-term results are heavily influenced by random and unpredictable events, while economic fundamentals tend to prevail over the long term. This perspective will help investors discount the importance of short-term outcomes, and remain focused on their long-term goals.

Representativeness—we believe that past performance is indicative of future results. Investors are influenced to buy yesterday's hot fund because they project that performance will continue, regardless of a disclaimer. The results of this type of behavior also are demonstrated in Dalbar and Morningstar research. The key to reducing this bias is to illustrate examples of funds doing well, and then suddenly not doing well. There are several examples of yesterday's best performer turning into tomorrow's underperformer and vice versa. An understanding of the roles that randomness and luck play in the investment realm also would be of value.

Anchoring—when we are asked to predict a future unknown value, the brain often looks for starting points. We use the anchor as a point of reference and make adjustments until we divine the unknown value. Investors often anchor to the long-term return of securities (for example, 8 percent annualized return) without a proper understanding and/or expectation of volatility inherent in the markets.

To reduce this bias, demonstrate when the market dropped significantly over short periods and subsequently recovered. There also are many years in which the stock market was positive but suffered a significant loss at some point during the year. The key is to help clients recognize that returns—especially over the short term—are random and may be negative. Many investors understand that there are periods when the market will experience losses, but few are willing to anticipate that the next market loss may be this year.

Emotional Biases

Emotional biases often are more difficult to tackle because feelings are complex. The events that trigger emotional responses often are beyond our control.

Snake bite effect—investors experience a negative event, such as an unexpected loss, and revert to a strategy that no longer reflects their goals. Investors who make poor financial decisions may become more averse to risk, thereby reducing the probability of reaching their financial goals. Investors feeling burned by stocks (regardless of fault) may choose to invest only in FDIC-insured accounts, even though they will no longer reach their financial goals. They are driven by the desire to avoid nominal losses.

Pride—feeling of doing something well; having made a correct decision, such as a profitable investment. Pride influences investors to sell "winning" stocks to confirm that they made a good investment decision. This may influence investors to realize gains in stocks quickly and give up on potential growth. Research shows that investors realize gains more often than they realize losses.[6]

Regret aversion—not wanting to admit a mistake, such as an unprofitable investment. Investors may hold "losing" stocks so as not to experience regret for having made a bad investment decision. Holding on to losing positions results in lower investment returns over time.[7] Investors may hold losing stocks even though they acknowledge the prospects are not as good as those of other companies—the desire to avoid regret is that powerful.

Loss aversion—a complex and common bias among investors influenced by feelings of pride and regret. Studies show that loss-averse investors feel the pain of loss more than twice as strongly as the satisfaction from an equal size gain.[8] These investors are risk-seeking when faced with losses, and risk-avoiding when faced with gains. Loss-averse investors tend to sell securities that have a gain (influence of pride) and hold securities that have a loss (regret aversion), resulting in lower investment returns over time.[9]

Identifying Biases

Formulating questions to identify biases can be tricky. You first need to have a firm understanding of the bias and what events may trigger it. Then you need to formulate a question in which one or more of the response choices demonstrates the bias's influence, while other choices would show the bias did not influence the answer.

An example may better illustrate this point. For representativeness (chasing past performance), most investors would agree that chasing past performance is not a good strategy, but advisers want to know if there may be a latent bias that could influence their client to do so in the future. In this case, a possible question to test the bias would be: "A fair coin is tossed five times, each time landing on heads. What is the most likely outcome of the next coin toss?"

Many respondents will say either heads or tails. The unbiased response is "neither." The outcome from a previous coin toss (or series of coin tosses) does not change the probability of the next outcome, yet many people allow future expectations to be influenced by past outcomes.

In this example, advisers could draw a parallel with investments by demonstrating how once-excellent funds subsequently had poor performance and reiterate that past performance does not tell us what will happen tomorrow. While the stock market may not be quite as random as a coin toss, we don't know when trends will change. We don't know if the sell-off is just a correction or the start of a brutal bear market until well after the fact.

Many books have been written on behavioral economics, including popular titles by Dan Ariely and Daniel Kahneman, and some contain sample questions to identify certain biases. Behavioral profilers are also available for purchase/subscription for advisers who prefer to implement an existing profiler, rather than develop their own. Because a variety of questions can be used to identify biases—some short and concise, others longer and more detailed—advisers should adopt the questions that fit their style and overall business philosophy.

—J.M.

Planning Tips

Emotional biases influence the way we feel. It is unwise to tell someone, "Don't feel that way." Instead, emotional biases, such as loss aversion, may be best considered in the portfolio recommendation and investment management phase. One suggestion is to develop a risk policy or a checklist of specific action items to implement should the market go down 15 percent, 25 percent, etc. There is still a chance that emotion may influence clients to abandon the risk policy, but advisers creating a risk policy will have increased the odds of helping clients buy low. The reverse strategy can be used to help clients sell high.

Advisers may also want to consider incorporating non-correlated assets into the portfolio to reduce volatility, thereby moderating the influence of emotional biases.

Lastly, advisers could recommend assets that provide some sort of guarantee or income protection irrespective of future market performance, giving loss-averse clients the security they need to maintain the investment plan.

Understanding Provides Value

The financial industry has been experiencing significant margin compression. Many firms are battling over how low their ETF fees are; Vanguard is currently the largest mutual fund distributor by assets under management. Investors may be tempted to go with the lowest price fund; however, low fees don't make much of a difference if investors cannot "control the urges."

Financial advisers can add tremendous value to their clients by understanding what biases influence them and helping to reduce the influence of such biases. In a highly commoditized industry, understanding who people really are and what makes them tick is a differentiating factor. A deeper understanding of investor behavior will empower financial advisers to help clients achieve their financial goals, despite their biases. ■

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Endnotes

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