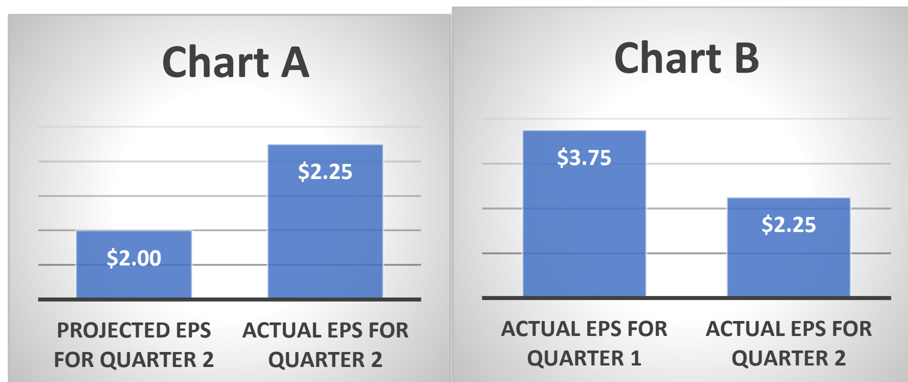
Beware of Bias when Making Financial Decisions Pt.2

In this concluding article, focused on how bias affects our financial decisions, we delve deeper into the psychological aspect of financial decision-making. Last week we introduced the concept of 'cognitive and emotional biases,' and their dangers. We also introduced four different kinds of biases that are commonly exhibited when making financial decisions. If you missed part 1 of this feature, be sure to check it out via our corporate website → https://www.ttsec.org.tt/publications-and-research/?_sft_category=articles.Today,we will look at four more kinds of biases. First, let's start by looking at two more cognitive biases – biases which affect the way individuals process information – framing and mental accounting.

Framing

Framing bias is the tendency for persons to interpret information differently based on the way it is presented/framed to them. It is easy to jump to a premature conclusion when presented with a piece of information tailored to suit a specific agenda. For example, let's observe the two charts below which compare a theoretical company's quarterly earnings per share (EPS).



Consider each chart above separately. Using the same datapoint of $2.25 EPS for quarter 2, Chart A puts a positive spin on the company's performance, while Chart B does the opposite. In viewing Chart A in isolation, one may infer that the company has performed exceedingly well, with an EPS of $2.25, $0.25 higher than its projected EPS of $2.00. Meanwhile, Chart B suggests that the company has badly underperformed, as it generated significantly less EPS than the previous quarter – a decline in EPS of $1.50. In order to gain a more holistic understanding of the company, both charts should be considered collectively.

While the information presented may be factual, we see how the framing of the same information can justify two completely opposite interpretations and thus, lead to different investment decisions being made.

Mental Accounting

Money, by defintion, is fungible in nature – no individual unit of a particular currency is worth intrinsically more than another, which makes money easily interchangeable. Mental accounting bias though is the tendency for persons to favor money based on arbitrary classifications such as its source, location or planned use. Mental accounting bias contradicts rational economic thought because it erodes the fungibility of money and this can have negative implications for one's portfolio of assets.

A person who exhibits mental accounting bias mentally separates his money into 'layers' or 'buckets' and tends not to mix funds among these layers. This is not an inherently bad practice as it may lead to more disciplined spending habits, but if left unchecked, it can result in very poorly constructed portfolios. For example, more tenured individuals may view shares earned via their company's share compensation plan as a distinct layer. As such, they hold excessively large positions in their employer's stock and are exposed to considerable concentration risk. Meanwhile, this same individual maintains a diversified investment portfolio that is separately managed from his employer's shares. If this person were to construct a portfolio which collectively considers his holdings in his employer's shares and his other holdings, the preferred asset allocation would be vastly different and expose the investor to significantly less concentration risk.

Next, let's look at two emotional biases which affect the way people feel – loss-aversion and status-quo.

Loss-aversion

Loss-aversion bias (not to be confused with risk-aversion) is the inclination for investors to disproportionately favor avoiding losses, as opposed to achieving gains. Some studies even suggest that the emotional pain in incurring a loss is twice as large than the pleasure derived in making an equivalent sum of profit.

Loss-aversion bias is detrimental because it can result in the *disposition effect* – the tendency for investors to either hold on too long to losing positions and incur further losses or sell off profitable positions too quickly and miss out on further gains. In the case of losing positions, the loss-averse investor decides to hold the security because the pain associated with 'realizing' the loss is too great. Instead, he opts to hold the security in the hope that its value recovers. For profitable positions, the same investor will be inclined to sell the security shortly after it appreciates to 'lock-in' gains, to avoid the risk of the stock decreasing in value. In both cases, the decision to hold or sell the security is based on the fear of loss, rather than the fundamental characteristics of the security.

Status Quo

How often do you hear the phrase "If it ain't broke, don't fix it"? This expression usually stems from the Status Quo bias – the tendency for persons to favor the current state of affairs thus maintaining the 'status quo.' Change is not inherently 'good' or 'bad,' but persons susceptible to this type of emotional bias tend to have an automatic prejudice against it – a prejudice which is not derived on a rational analysis of pros and cons. Unlike many other biases, this type of bias results in inaction, rather than an explicit action, which makes it easy to leave unchecked. As it relates to portfolio construction, status quo bias results in persons holding their positions indefinitely, until a significantly apparent reason to alter (buy or sell) their holdings emerges. While this may seem like a disciplined approach, the reality is that an investor's optimal portfolio allocation changes over time. With each passing day, share prices fluctuate, bonds are closer to maturity, the investor is closer to retirement and various other circumstances may occur. As a result, the intrinsic value of our portfolio, as well as our own investment preferences, will change. It is not practicable (or profitable, for that matter) to adjust/rebalance one's portfolio on a daily basis. It is imperative though, to keep status quo bias in check by updating one's portfolio on a reasonably periodic basis; in tandem with changes to one's goals, objectives, and preferences.

As you have probably deduced by now, biases are difficult to manage. Even the best investment managers can be subject to their own biases. What is important though is that we keep biases in check and hopefully mitigate their negative effects. Make your investment decisions based on your specific circumstances and the fundamental characteristics of the investment instrument – not emotions and faulty cognitive reasoning.

If you are uncertain, or simply lack the knowledge, on how to choose an appropriate investment, you are not alone. These decisions are certainly challenging to make and biases only makes this process even more difficult. Please ensure that you consult with a registered Investment Adviser or Broker-Dealer who is qualified in assisting persons make these important decisions and remember… *Beware of Bias! Visit www.ttsec.org.tt for a list of registered investment advisers and broker-dealers.*

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