Emotional and cognitive biases affect the investment decisions pension plan fiduciaries make. The author describes these biases and offers tips for avoiding them.

A Crash Course in Behavioral Econo

Bypassing Biases

by | **Kweku Obed**

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In recent years, *behavioral economics*—the study of human bias in the face of financial and economic decisions—has gained more prominence in mainstream discussions. According to Richard Thaler:

> Behavioral economics [is] a field that only exists because regular economics is based on an idealized economic agent, sometimes called Homo Economicus . . . [or Econs]. Econs are creatures that can calculate like a super computer, never get tempted by fatty or sweet foods, never get distracted, and probably aren't a whole lot of fun to be around. In contrast, real people [humans], don't make any appearance in standard economics. Behavioral economics is economics about humans. Humans are busy, can't solve every problem instantaneously, and get tempted by luscious desserts. Sometimes they need some help.

As an investment committee member for a defined benefit pension plan, you are responsible for the oversight of retirement assets. Imagine that you wake up early on a nice summer day and you walk outside to get your paper. You turn to the front page and see these headlines: "Despite international pressure, Country X invades Country Y." "Oil Prices are expected to hit $X per barrel by the winter." "The Fed is expected to raise rates to Z% by the end of 20XX." "ABC is elect-

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ed the leader of Country XYZ—defying pundits and experts."

What do you do? How should you react? How reliable is the information source? Do your equity investments have significant exposures to Countries X and Y? Will your fixed income portfolio be able to weather a Z% rate change? Does the defensive positioning of your portfolio help or hurt you as oil is projected to hit $X per barrel?

Many environmental changes can occur that can positively or negatively affect your investment program. In many instances, these external factors will be unexpected and outside of your control. As a human being, you will be faced with the option to make rational or irrational choices.

When it comes to fulfilling your fiduciary duty in the face of unexpected news and the reintroduction of extreme market volatility after uninterrupted years of "risk-on" bets being consistently rewarded, it is perhaps important to examine some of the more common behavioral traits that can characterize individual decision makers when they are faced with different investment choices.

While we cannot capture every single imperfection the mind is tempted to embrace, the following examples seek to highlight some of the more common pitfalls, or *biases,* that many investors are likely to face.

The table groups these biases into cognitive and emotional biases. *Cognitive biases* are specific views of the world that may or may not be factual that can creep into the decision-making process. *Emotional biases* cause investors to take action based on feelings instead of facts or detailed analysis.

Confirmation Bias

Confirmation bias can occur when a fiduciary has an unflinching investment view. People are tempted to believe the facts that fit a thesis they already agree with and severely discount any facts that do not support those views.

Return-chasing behavior is a negative effect of the confirmation bias. If you were to follow the Investment Company Institute (ICI) or another data source, you would tend to see that many investors increase their allocations to specific areas of the market when they are performing well (i.e., *buying high*). Conversely, you would likely see that many investors reduce their allocations to segments of the market when these segments see poor returns (i.e., *selling low*).

In 2017, emerging market equities returned approximately 30% and saw positive cash inflows of tens of billions of dollars. This contrasts the relatively weaker performance and the tens of billions of dollars of investment outflows that emerging market equities saw in 2011. Similarly, in 2013 and 2014, when emerging market equities saw relatively weaker performance, the asset class experienced large negative outflows from investors. Conversely, in 2012, which was a year of relatively strong performance for the asset class, emerging market equities witnessed positive investor inflows.

The high demand for emerging market equities when they are performing strongly and the weak demand for this asset class when it is not performing so well show that the confirmation bias can lead to performance chasing—buying high and selling low—which ultimately is not a prudent or winning long-term strategy for any investor.

Recency Bias

The recency bias convinces individuals to falsely believe that recent market events will continue to the indefinite future.

With respect to asset allocation decisions, the recency bias seems to be exacerbated by extreme market events. For example, prior to the loud bursting of the dot-com bubble in 2001, many investors remained extremely bullish about the market and were in no hurry to derisk their portfolios.[1]

Conversely, in 2008, some investors impulsively sold off their equity holdings during and shortly after the global financial crisis.[2] These investors effectively locked in their losses and unfortunately missed out on much of the market rally that followed during the first quarter of 2009. When these premature deriskers reentered the equity markets during the onset of the bull market, i.e., rerisked their portfolios, they also added unnecessarily high transaction costs to their investment programs since they were repurchasing equity assets at a higher cost.

Cognitive Dissonance

This negative behavioral trait appears to exist because most human beings have an inner need to ensure that their beliefs and behaviors are consistent, since inconsistent or conflicting beliefs lead to a mental state of disharmony, which most people strive to avoid.[3]

An example of cognitive dissonance could involve committee members' inherent dislike of passive (index fund) investing, yet they take issue with the relatively higher fees that are charged by the incumbent active managers in the fund investment program.

Loss Aversion

Loss aversion exists when someone recalls an investment decline more vividly than an investment gain. For example, the 2% actual loss in the aggregate index in 2013 may have had a more profound impact on some investors, meaning they may have worried about this loss more or reacted to it more strongly, compared with when the index returned a much more respectable 6% the following year.

Loss aversion highlights why investors may rush to "lock in gains" on strategies that are performing well and irrationally hold on to lagging investment managers far longer than necessary, since they are looking to be "made whole" on an investment that is persistently losing money.[4]

Hindsight Bias

This "Monday-morning quarterback" bias can occur if one irrationally dissects an investment decision that was made in the past but with the benefit and clarity of today's information.

Monday-morning quarterbacks would note that if they had been in a fiduciary role during the tech bubble or during the global financial crisis, they "absolutely would have never ridden the tech bubble roller coaster all the way to the top" or that they "would have not trimmed back their equity exposures in response to the global financial crisis."

Hindsight bias gives the Monday-morning quarterback an overconfident and false sense of their predictive powers or an illusion of control. Investors have a subconscious belief that they can accurately make asset class predictions with ease when, in reality, no one can do this with certainty.

Hindsight bias often rears its ugly head when investments are doing well.[5] Investors may be tempted to falsely tie the gains in their investment programs with their ability to connect the dots and make future successful bets. This false sense of security can lead to excessive risk-taking behavior.

Mental Accounting

Under a mental accounting framework, those who come into windfall sums of money are inclined to engage in more impulsive and risky spending as they mentally account the gains as unexpected profits or "playing with house money." Conversely, had they earned the same or similar amounts of money via their day jobs, these individuals would, in theory, be less inclined to spend their hard-earned money as impulsively.[6]

A mental accounting bias may tempt a trustee to focus on the real, tangible gains that the assets are generating or earned within their portfolio. At the same time, they may pay less attention to the liabilities—the obligations that must be paid at a future date—that are being generated by the investment program because, for example, the average life span of retirees has increased as compared with a few decades earlier. This disconnect is also known as a *fungibility violation* because the dollar gained by an asset is treated differently from the dollar obligation that is generated by a long-term liability.

TABLE

Common Behavorial Decision-Making Biases

Cognitive Biases	Emotional Biases
Confirmation bias	Loss aversion
Cognitive dissonance	Herd mentality
Recency bias	Hedonic treadmill
Hindsight bias	Procrastination
Mental accounting	Inertia

takeaways

- *Behavioral economics* is the study of human bias in financial and economic decisions.
- *Cognitive biases* are specific views of the world that may or may not be factual and that can creep into the decision-making process.
- *Emotional biases* cause investors to take action based on feelings instead of facts or detailed analysis.
- Having a multiperson investment committee is one way plan fiduciaries can minimize the impact of behavioral decision-making biases.
- Investment committees also should have an investment policy statement that outlines permissible investments in addition to articulating the roles and responsibilities of all those involved with the management and oversight of retirement plan assets.

Herd Mentality

Savvy marketers are consistently exploiting the human need to be social and the desire to connect and associate with groups that share common values. In the digital age, information is readily available, and we are all part of a collective thought process in which the majority of us do not want to be left out of a trend or a movement for fear of being viewed as obsolete.

It is essential that fiduciaries remember that while the larger herd is stampeding into or out of a particular company that seems innovative (Compaq in 1999), a sector that is doing well (gold in 2011) or a region that is poised for exponential growth (frontier markets in 2005), it does not mean that exposure to the same company, sector or region is ultimately consistent with the long-term objectives of their own investment program.

Hedonic Treadmill or Hedonic Adaptation

This belief or behavior is destructive because it assumes that a steady increase in wealth, status or value should lead to a steady and commensurate increase in happiness.

However, the treadmill effect creates unrealistic goals and ultimately addictive expectations. As people make more money or see more success, their expectations and desires will rise in tandem. In other words, there is actually no permanent gain in happiness, and one's subconscious mind will want more wealth, status or value in order to remain happy. Also, this mind-set ignores the fact that, like any other emotion we can experience as human beings, happiness will have to play a balanced role in someone's life. While it can buy everything else, money cannot buy happiness.

As human beings, our satisfaction will ultimately hit a ceiling. As fiduciaries, this happiness-seeking behavior could create the temptation to unnecessarily tinker with an investment program. A gain will feel good, but the unrealistic need to always feel happy whenever you are reviewing portfolio performance may lead to excessive fiddling with investment options, creating unnecessarily high transaction costs for the investment program while accommodating addictive and unrealistic expectations around the correlation between happiness and portfolio performance.

Procrastination and Inertia

As implied by their names, these related behaviors can lead to the delayed implementation of asset class modifications within an investment program. For example, if the Federal Reserve signals that it will likely raise interest rates for the foreseeable future, investors who are procrastinating may not view analysis of the portfolio's fixed income composite—the segment of the portfolio that will be most sensitive to interest rate changes—as a high priority.

Under these theories, investors might keep "fallen angel" investment managers—entities that were once considered to be best in class but are no longer best in class—in an investment lineup longer than they should.

So What Would You Do?

Armed with the knowledge of common behavioral biases, the author's hope is that investment committee members will be extra diligent, realistically time-sensitive and willing to have their views of the world thoughtfully and respectfully challenged before they make an investment decision. When looking at the effectiveness of various asset classes, an informed and knowledgeable fiduciary will try to assess these investments through a long-term lens. This means, for instance, that the informed trustee will hopefully look to separate "good headline talk" about a geopolitical event from the more mundane facts.

Isolation is not your friend when it comes to effective decision making. You can take comfort in the fact that you have several options to minimize how your individual cognitive and emotional biases can creep into your thoughts. There can be strength in numbers when fulfilling your role as a fiduciary, and lively, constructive debate, diversity of thought and diversity of peers are some of the key ingredients in combating some of the negative behaviors and biases that an individual acting in isolation would be tempted to embrace.[7]

Those who are part of a multiperson committee structure can attest that two heads can be better than one when making investment decisions. Others may argue that having a multiperson committee does not automatically mean that an investment plan is instantly immune from the perils of irrational decision making. Recall, for example, how some institutional investors did not see the need to derisk prior to the end of the dot-com bubble, while some investors impulsively sold off their equity holdings during the financial crisis, locked in their losses and missed out on the early portion of the subsequent market rally.

In the author's opinion, committees that are effective in making sensible strategic decisions have the common denominators of strong governance, a culture of reflection, clearly defined decision protocols, and an openness to review and debate different scenarios.

To foster some of the benefits of strong governance, an investment committee should have at a minimum an investment policy statement for its retirement program. In addition to outlining permissible investments, as an example, the policy statement should clearly articulate the roles and responsibilities of all parties involved with the management and oversight of retirement plan assets.

To encourage a culture of constructive review and discussion, perhaps you can think of ways to nurture a culture of creative brainstorming and a process for decision making. For example, an investment committee could adopt a decision framework like Edward de Bono's Six Thinking Hats, in which the committee reviews an investment topic through a specific lens that looks at the positives, negatives and the simple facts.

Under the Six Thinking Hats framework, when faced with a decision, a committee could consciously deliberate on six keys areas of a topic from the following perspectives:

1. Neutral—What do the facts say?
2. Emotional—Right or wrong, what is your gut feeling?
3. Cautious—What can go wrong?
4. Noncautious—What can go right?
5. Investigative—What haven't we thought of?
6. Managing—What is the key objective of the discussion? What is the bigger picture?

As part of a broader group (committee), you have an opportunity to discuss your thoughts with fellow fiduciaries. We cannot accurately predict the markets or identify which asset classes will perform best or worst at any given point in time. However, we can say with certainty that the absence of a thoughtful decision-making framework, such as a well-crafted policy statement, and the absence of peers or third parties to review and debate investment decisions will be major impediments to a fiduciary's ability to control the destructive biases that seek to enter his or her thought process.

Endnotes

1. For additional reference, please refer to *Irrational Exuberance*, Robert J. Shiller. 2000. Princeton University Press.
2. According to the Investment Company Institute, from 2008 through 2010, mutual fund investors pulled more than $272 billion from U.S. stock funds and poured almost $650 billion into bond funds.
3. *A Theory of Cognitive Dissonance*, Leon Festinger. 1957. Stanford University Press.
4. For additional examples, please refer to *Common Stocks and Uncommon Profits and Other Writings,* Philip Arthur Fisher. 1996. Wiley.
5. In *Irrational Exuberance,* Schiller articulates the link between overconfidence, hindsight bias and how unsustainable market bubbles are created.
6. "Mental Accounting Matters," Richard H. Thaler. July 1999. *Journal of Behavioral Decision Making.*
7. "Why Diverse Teams Are Smarter," David Rock and Heidi Grant. November 2016. *Harvard Business Review.*

bio

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