COGNITIVE BIASES THAT FREQUENTLY LEAD TO INVESTMENT MISTAKES

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AUGUST 2022 CLIENT QUESTION OF THE MONTH

How does investor behavior impact portfolio returns? In our August Client Question of the Month, we thought it would be helpful to discuss the most common cognitive biases that frequently lead to investment mistakes and solutions for mitigating those effects. As a wealth management firm, our goal is to create comprehensive financial planning and follow disciplined investment strategies in order to avoid emotional decisions.

Understanding and overcoming cognitive biases that lead to investment mistakes can lead to better decision making, and ultimately better returns over time.

To invest over the long term, we believe it is critical to understand, and hopefully overcome, common human cognitive or psychological biases that often lead to poor decisions and investment mistakes.

Cognitive biases are 'hard wired' and we are all liable to take shortcuts, oversimplify complex decisions and be overconfident in our decision-making process. Understanding our cognitive biases can lead to better decision making, which we believe is fundamental to lowering risk and improving investment returns over time.

1. Confirmation bias

Definition: Tendency to seek or emphasize information that confirms our existing beliefs

Problem: Overconfidence → investors focus on data that appears to confirm their beliefs

Solution: Try to seek information that makes us question our current investment view

" Rapid destruction of your ideas when the time is right is one of the most valuable qualities you can acquire. You must force yourself to consider arguments on the other side."

– *Charlie Munger, Vice Chairman of Berkshire Hathaway*

We are inundated with information – is someone's opinion an unbiased view? What sources can we use? Who do we trust? In order to avoid the discomfort of reading information that is contradictory to our beliefs, we often seek or emphasize information that confirms our existing beliefs, causing us to be overconfident in our investment decisions.

But It is much more important to ask yourself why you are wrong than why you are right. So instead, we should stop getting news from one source and attempt to challenge the status quo and seek information that causes us to question our investment thesis.

According to a study in the Journal of Economic Psychology, research shows that soccer goalies dive one way or the other 94% of the time*, yet chances of successfully blocking the kick are statistically greater if you simply stay still. So, what compels them to jump rather than standing their ground? It's action bias – the notion that doing something is better than doing nothing.

2. Action bias

Definition: Tendency to favor action over inaction without solid rationale to support the action

Problem: Often times staying grounded leads to better outcomes than taking action

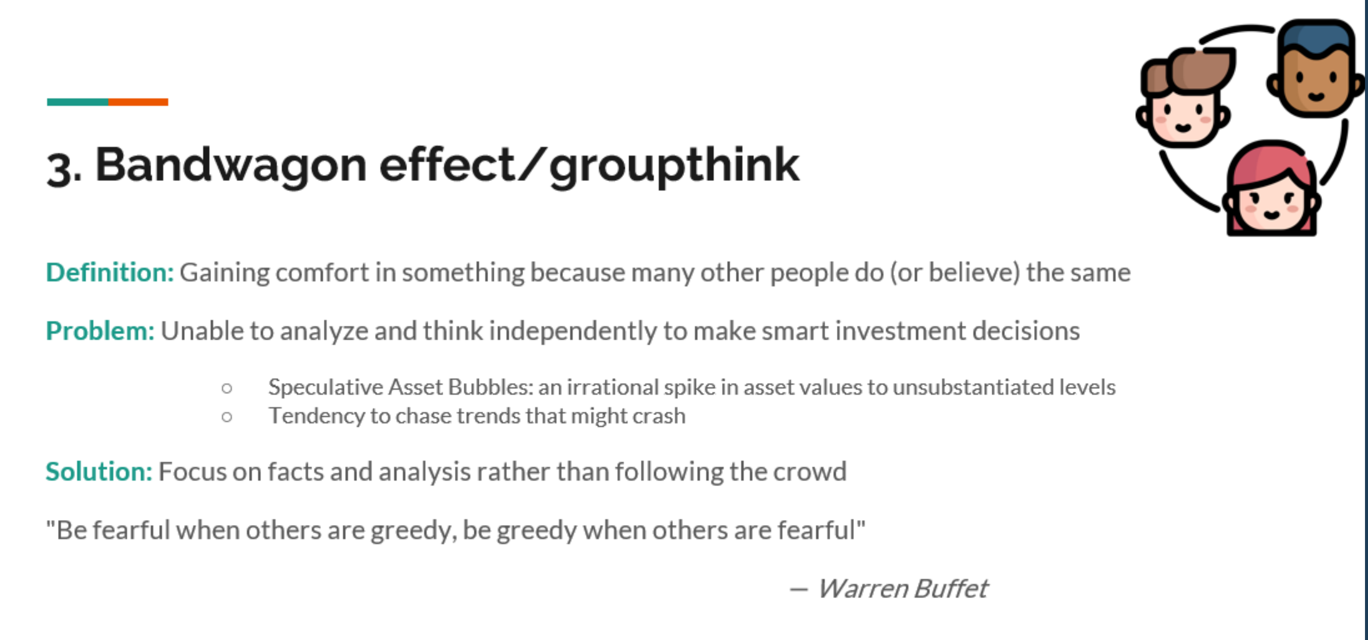
Solution: Rather than reacting automatically, think through consequences and rationalize before taking action

The same concept applies to investors. Many times, you may feel a need to take action in a panic, or buy or sell investments hastily after checking some news. These decisions result from the action bias, as we feel compelled to do something, instead of patiently following our financial plan which is working towards a future goal.

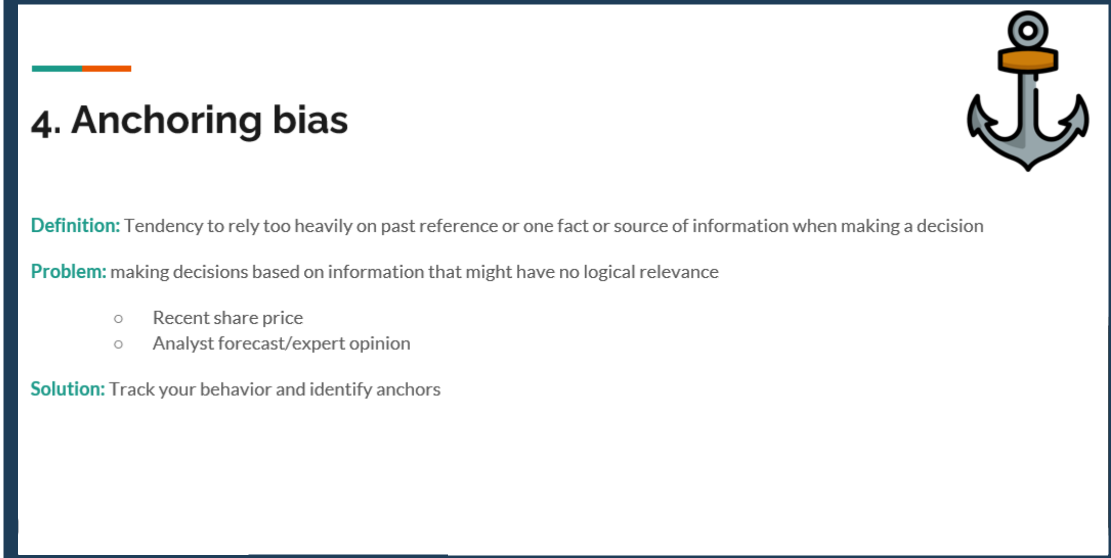
It is important to realize that the market experiences volatility all the time. Whether you react and take action or not, it is important to remember that no investment strategy assures success or protects against loss.

Avoiding the action bias requires us to unlearn our impulse to respond with action in ambiguous situations. So instead of reacting automatically, we should consider the consequences of both action and inaction and compare their effectiveness. Doing so allows us to engage in more informed decision-making. It is also important to not confuse action with progress – just because you are doing more does not mean you are getting more done.

*Bar-Eli, Michael, et al. "Action Bias among Elite Soccer Goalkeepers: The Case of Penalty Kicks." Journal of Economic Psychology, North-Holland, 25 Jan. 2007, https://www.sciencedirect.com/science/article/abs/pii/S0167487006001048?via%3Dihub.



To be a rational investor, you must be able to analyze and think independently. Speculative bubbles – an irrational spike in asset values to unsubstantiated levels – are typically the result of groupthink and herd mentality. If too many investors crowd into one trendy stock, there is a greater chance they'll all rush out at the same time if bad news strikes. So we should find no comfort in the fact that other people are doing certain things or that people agree with us. Rather, we must focus on facts and analysis because the end of the day, we will be right or wrong due to our analysis and judgment being either right or wrong.



Anchoring bias is our tendency to rely too heavily on past reference or one fact or source of information when making a decision. Oftentimes, an average investor will look at analyst forecasts/expert opinions' and become anchored to their information, which may not be correct.

While research analysts are highly paid experts that have a knack for making decisions in the stock market, their opinions often can't be trusted as the basis for objective investing decisions. In the end, it is simply someone else's opinion, not to mention the potential conflict of interest.

For instance, investment firms often make investment recommendations based on the research provided by their analysts, creating a bias where analysts are recommending stocks that are best for their employers rather than the investors their employers serve. Similarly, mutual funds and ETFs employ research analysts, which gives the analyst a vested interest in forming an opinion about a stock that's in the best interest of the fund's portfolio, and not always an unbiased depiction of what to expect from the stock.

Therefore, instead of anchoring to specific sources, one should do a thorough research on their own before investing their hard-earned money. And to avoid anchoring when the price of the shares in your portfolio goes up or down, you must check the company fundamentals before making a call to sell or buy.

The easiest way to overcome the anchoring bias is to track one's behavior and identify the anchors that you are normally prone to be dragged down by. Then, you can overcome anchoring bias with logical thinking, due diligence, and a practical approach driven by research rather than by emotions.

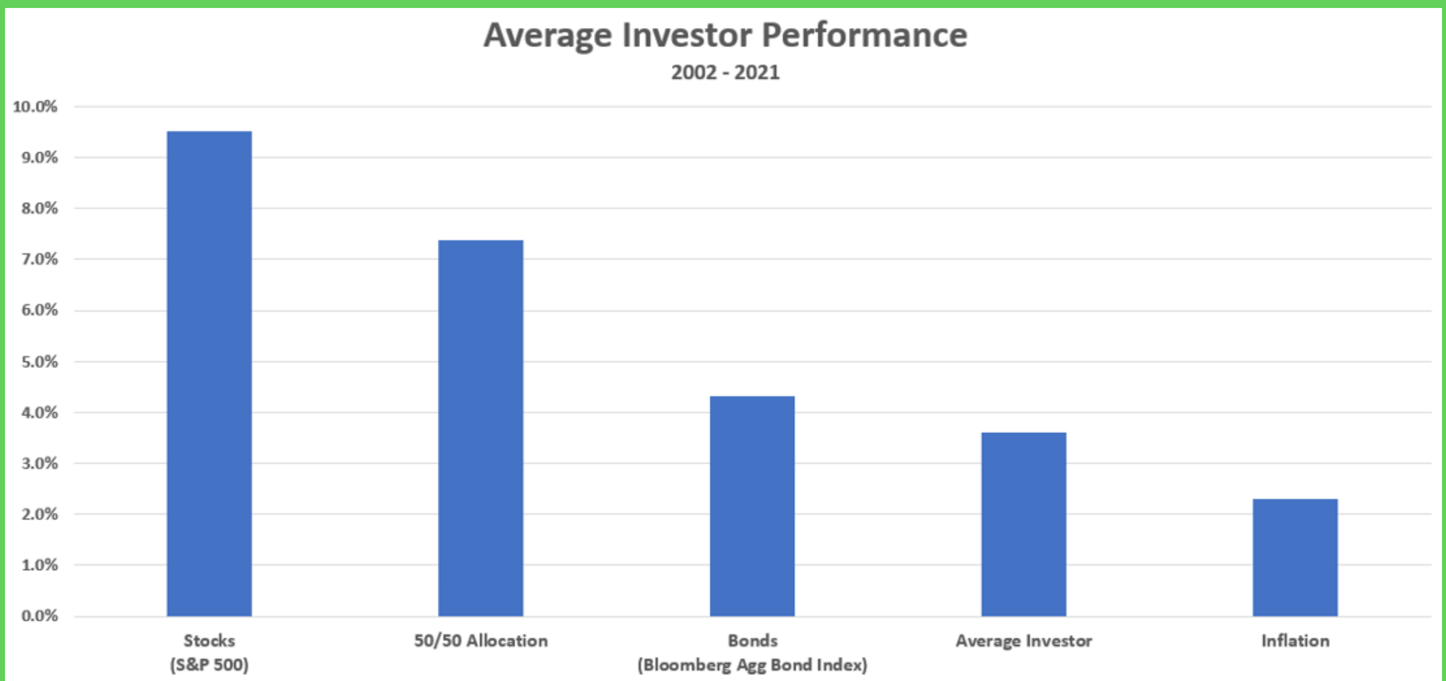
The average investor underperforms due to market timing

The following chart is from a Dalbar study titled "Quantitative Analysis of Investor Behavior" that displays the annualized returns of various asset classes and the average investor for the twenty-year period of 2002 through 2021.

The average asset allocation investor's return is based on an analysis of the net aggregate mutual fund sales, redemptions, and exchanges each month. The study shows that the average investor's return over this period was less than half of stocks and far worse than a bond portfolio.

All indexes mentioned are unmanaged indexes which cannot be invested into directly. Unmanaged index returns do not reflect fees, expenses, or sales charges. Index performance is not indicative of the performance of any investment. Past performance is no guarantee of future results.

Dalbar cites market timing as a main factor for poor investor performance.



Annualized Return	9.5%	7.4%	4.3%	3.6%	2.3%

According to study, the average investor's return over this period was less than half of stocks and far worse than a bond portfolio. This is because most investors make decisions driven by fear or panic rather than fact-based analysis, leading to poor investor returns*.

A financial advisor can help make rational and data driven decisions rather than ones based on emotion. In our experience, a more reasonable course of action is to combine comprehensive financial planning with a globally diversified portfolio constructed by a thorough investment process. The goal is to let the financial plan guide your decision making so you can mitigate biases and seek to avoid emotional decisions.

DALBAR'S year Quantitative Analysis of Investor Behavior (QAIB) study examines real investor returns from equity, fixed income and money market mutual funds from January 2002 through December 2021. The study was originally conducted by DALBAR, Inc. in 1994 and was the first to investigate how mutual fund investors' behavior affects the returns they actually earn.

Summary

- Investors are susceptible to cognitive biases that negatively impact portfolio returns
- Becoming aware of these biases helps us make more informed and rational decisions
    - Confirmation bias
    - Acton bias
    - Bandwagon effect
    - Anchoring bias
- Having a financial plan and disciplined investment process are crucial to avoiding emotional decisions and guides you in the right direction for reaching your long term goals

At Winthrop Wealth, we follow a total net worth approach to wealth management that combines both comprehensive financial planning and investment management. While financial planning and investment management can function successfully on their own, we believe they produce a whole greater than the sum of their parts.

The financial plan defines cash flow needs, seeks to optimize account structures, considers tax mitigation strategies, and helps determine the appropriate asset allocation based on the client's willingness and ability to take risk. Based on the output of the financial plan, our investment management process designs a well-diversified portfolio constructed with a methodology based on prudent risk management, asset allocation, and security selection.

We seek to ensure that our client's short-term cash flow needs are met while stress testing both their financial plan and investment portfolio to help them ultimately pursue their longer-term goals and objectives despite challenging markets.

Without a comprehensive financial plan and investment process, it is very easy to shoot yourself in the foot by making an emotionally based market timing mistake. We believe Investing requires skill and discipline, not reliance on gimmicks like market timing and emotional decision making.

Disclosures

Content in this material is for general information only and not intended to provide specific advice or recommendations for any individual.

The economic forecasts set forth in this material may not develop as predicted and there can be no guarantee that strategies promoted will be successful.

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The Standard & Poor's 500 Index is a capitalization weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

The Bloomberg Barclays U.S. Aggregate Bond Index is an index of the U.S. investment-grade fixed-rate bond market, including both government and corporate bonds.

Financial planning is a tool intended to review your current financial situation, investment objectives and goals, and suggest potential planning ideas and concepts that may be of benefit. There is no guarantee that financial planning will help you reach your goals.

Rebalancing a portfolio may cause you to incur tax liabilities and/or transaction costs and does not assure a profit or protect against a loss.

Likewise, it is important to remember that no investment strategy assures success or protects against loss. Asset allocation does not ensure a profit or protect against loss. There is no guarantee that a diversified portfolio will enhance overall returns or outperform a non-diversified portfolio. Diversification does not protect against market risk. All investing involves risk which you should be prepared to bear.

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