Behavioral Finance Can Teach Investors How To Avoid Mistakes

Introduction

As a scholarly topic, many may have felt tempted to dismiss behavioral finance as only worthy of publication in the Journal of the Obvious, perhaps under the groundbreaking title *Stock Prices Are Determined by People*. By and large, people can be illogical, to which we can all attest. And value managers have been on to behavioral finance for decades: Rob Friedman describes the value approach of Mutual Series funds as seeking "to monetize the mistakes made in other people's overreactions." The expectation is that the endurance of cold factual reason will eventually outlast transient emotion in setting securities prices. But to dismiss behavioral finance because its underlying tenant may be obvious is to ignore the important lessons it can teach us as investors. Behavioral finance is all about decision errors, and you are probably making at least some of them. Most of them will seem obvious, but overcoming them is a much larger challenge than simply understanding them, since many reflect largely unconscious behaviors. Our goal is to help you recognize them, and to suggest strategies to help you avoid them. Remember: investing is a competition, and as your competitors learn to identify and avoid these common errors, you will be increasingly at a disadvantage if you fail to do so. It is also a game of inches, where incremental gains can reap big rewards over time. One of the things behavioral finance teaches us is that there are benefits in framing problems in different ways. In so doing we may gain new insight and understanding. Therefore as we describe the behavioral biases, errors, and remedies, we are going to look at them (where applicable) from the perspectives of both the individual investor and the professional investor (portfolio manager or investment advisor). Not only is the investor interested in learning what pulls them towards a suspect decision, but advisors also commonly make the same mistakes. And advisors, who are faced with "coaching" their clients to maintain discipline and avoid mental mistakes (though sometimes they may defer to the client against their better judgment) are using techniques that individuals would do well to employ on their own.

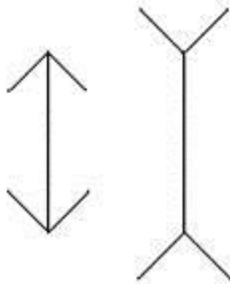
Why Are People So Prone to "Dumb" Mistakes?

In fact, people are amazing at assimilating and acting on tremendous amounts of information. Natural selection rewards traits that improve survival odds. With the constant dangers faced in the battle to survive (and pass on genes) the ability to quickly recognize patterns and take appropriate action was at times hugely rewarded. Recognizing patterns that weren't there generally had less cost than failing to recognize one that was. Avoiding nine of every two tiger attacks was well rewarded, since there was no real cost in the seven false alarms. But recognizing 99 out of 100 with no false alarms, while commendable, resulted in death. It is the human brain's hard-wired propensity for decision making that is based on pattern recognition, risk avoidance and quick, broad generalities that lie behind the decision errors that come up in finance. After all, what could be further from life on the savannahs of Africa than life in the canyons of Wall Street?

In fact, human decision making, when shone under the cold light of logic, reveals errors in all walks of modern life (both teenagers and golfers provide particularly rich sets of examples). And generally it may be easier for us to see them in others and more difficult to see them in ourselves, or even if we do, to avoid them. Consider, for example, the apparent difference in length between the two lines below. Many people have seen this before and know they are the same length, but that doesn't stop the one on the right from appearing longer. Each is

Certain material in this work is proprietary to and copyrighted by Litman/Gregory Analytics and is used by ClearPath Capital Partners with permission. Reproduction or distribution of this material is prohibited and all rights are reserved

distorted by other lines which are irrelevant to determining the length of the line in question. Further, and this is the part you've never heard before, the distortion relates to our hard-wired ability (requirement) to quickly gauge size and distance. The lines on the right are perceived as representing the inside corner of a space, while those on the left are perceived as an outside corner. Perceived as such, our depth perception takes over: the outside wall on the left is close, while the inside corner on the right is far. Clever creatures that we are, we make an automatic adjustment for distance, and see the line on the right as longer.
We all know they're the same length, but there's more to it.



The point is that we take mental shortcuts that enable us to reach conclusions quickly, since in the distant past we may not have had the luxury of time when it came to gathering or processing a lot of information. When humans are "on" they can use this ability to perform amazing feats: Kasparov was beating computers that could process hundreds of millions of chess moves per second. When it's off, we do dumb things, like the head of MENSA (the group of self-proclaimed geniuses) deciding to cool his airplane coffee by turning the air vent up full and holding the coffee above his head up to the vent. (Not only did nearby passengers think he was strange, they also got sprayed with coffee). And just as we use mental shortcuts to deal with the physical world, psychologists can demonstrate that we use them emotionally as well. We seek to avoid pain and find pleasure, and to maintain a sense of control and confidence in our lives. All of this is fine; it is part of being human. But in the situations where our innately human tendencies lead us down the wrong investment path, most of us would be willing to trade a little of our humanity for better returns (as long as it's our decision to do so).

What Are the Common Financial Mistakes, And How Can You Avoid Them?

There has been considerable study in the past decade on the subject of behavioral finance, replete with a new glossary of technical terms and in-depth explanations of the psychological underpinnings. While the subject is genuinely interesting, we will focus instead on describing specific problems, providing an example, and suggesting methods for avoiding them. Many of the examples may apply to more than one of these problems. We have arranged them as we have because many of the examples are strongly interrelated, and we wanted (where possible) related points to be described sequentially.

The Problem: Anchoring

In order to make sense of information, we need a starting point—an anchor. Unfortunately, people have a tendency to attach significance to what may have been an arbitrary or no longer relevant starting point. Car salesman use anchoring by starting with a high price. The buyer then judges the relative value on the basis of how far the price goes below this point. But at least in buying a car the initial price has some reasonable basis—it is the MSRP. People can get really thrown off by anchoring in more extreme cases. In one study, a psychologist asked participants to take the last three digits of their social security number, add 400, and then write the number down. They were then asked whether the Huns' invasion of Europe

Certain material in this work is proprietary to and copyrighted by Litman/Gregory Analytics and is used by ClearPath Capital Partners with permission. Reproduction or distribution of this material is prohibited and all rights are reserved

occurred before or after their "date." Finally, they were asked to estimate the exact date of the invasion. Their answers were correlated to the number that was based on their social security numbers.

Example: You bought a stock at $100 a share. It drops to $50. You believe that the stock's "real" value is around $100, and based on this expectation you are inclined to hang on since it "should" come back. The "real" value of the stock is based on its fundamentals and comparable investments, not on what its price was at some point in the past. It is possible that it "should" be valued at around $100, and that the $50 represents an overreaction on the part of investors. But it is equally possible that the $100 was an overreaction on the part of investors, and that $50 more closely represents the "correct" value. And more likely than both scenarios is that some information has changed: the stock is at $50 because company performance took a turn for the worse. At any rate, the fact that the stock was $100 in the past probably has little or nothing to do with its current value or attractiveness as an investment.

Solutions: Force yourself to evaluate an investment only as if it were a new purchase. If you wouldn't make the purchase now, unless there is a significant tax consequence you shouldn't own it. In the case of the stock you own that's down from $100 to $50, try to imagine how you would view the same stock if you had originally purchased it at $25 (neither is necessarily relevant, but by considering a different angle you might bring your own biases to light). Here's a mental exercise: You take a week's vacation in the Caribbean. Upon your return, you learn that your instructions to your broker were garbled, and every position you own was sold. The broker agrees to cover transaction costs and taxes, and to make any trades you wish. With your entire account sitting in cash, what holdings would you repurchase? How might you think differently about the securities you just held a week ago, now that you no longer are bound by the psychological strings of past ownership?

The Problems: Loss Aversion and Risk Taking

Studies show that while investors are risk averse when it comes to gains (they don't want to give them up), they are risk seekers when it comes to losses (they'll take big risks to avoid realizing them). Researchers have documented that given a choice between a sure gain and a chance to win more, people usually opt for the sure gain. But given a choice between paying a fine and gambling a chance to avoid the fine against a chance at a greater fine, they opt for the gamble. People find losses roughly twice to two-and-a-half times as painful as gains are pleasurable. To avoid the emotional pain of a loss, investors have a strong tendency to hang on to losers (they treat a loss as not real until it's realized). In some cases that may turn out to be a good decision and in some cases it may turn out to be bad. The problem is that the investor faced with a loss is largely leaving it now to "chance" and hope rather than to a sound and rationally informed decision based on a reassessment of the fundamentals. Emotion has clouded the decision. Compounding the problem is that investors view errors of commission as worse than errors of omission. In other words, if you do nothing and you are wrong it doesn't hurt as much as proactively making a bad decision. As a result, investors are biased toward inaction, and seriously underweight the cost of missed opportunities (opportunity cost). Finally, our biases skew our ability to rationally assess probabilities. Given a choice between an $11 gift and a 1% chance of winning $1,000, most people choose the chance at $1,000. And given a 99% chance to win $1,000, people will pay well more than $10 to eliminate the 1% uncertainty (this is the basis for the insurance industry).

Example: An investor sells a strong-performing winner to lock in gains, without considering whether the investment remains attractive or whether a more attractive investment option exists. It turns out that the company is well managed with strong fundamentals, and even after the sale it continues to perform well. Meanwhile, the investor has held on to another

Certain material in this work is proprietary to and copyrighted by Litman/Gregory Analytics and is used by ClearPath Capital Partners with permission. Reproduction or distribution of this material is prohibited and all rights are reserved

loser, and used some of the proceeds from the sale of his winner to add to his holding in the loser in the hopes that even a partial rebound will cover the loss. In fact, UC Davis professor Terrance Odean, in a study of 10,000 discount brokerage accounts, showed that the winning stocks that individuals sell significantly outperform the losers they hang on to over four-month, one- and two-year time periods.

Solutions: Try to consider whether your thinking is influenced by where an investment came from. Are you affected by biases that are unique to your personal experience in the investment? Obviously, if these are unique to you, they have no bearing on the price of the investment (a wise man once said, always remember that the stock doesn't know you own it.) What happens to a security's price is primarily the result of a set of factors that have nothing to do with your ownership. Ask if the reason you made the investment initially is still valid. Compare the position against other potential investments. Consider the position as if you never owned it.

The Problem: Decision Framing

Most investors are heavily influenced in making an investment decision by the way in which the information is presented. Much of the information available is biased in one way or another. Fund companies often market funds on the basis of intuitive appeal and investor biases.

Example: A classic gimmick is to guarantee the principal value of equity investments. Investors will pay higher fees to invest in a fund that guarantees them against loss, even if the cost of the fees (a certainty) is overwhelmingly likely to outweigh any reimbursement of a loss (which is improbable given the typically long time horizons required and typically conservative nature of the investments).

Solution: Question the motivation of the organization that is presenting the information. What do they have to gain and how might that impact the way in which they frame the information? As a mental exercise try to "reverse-frame" the information, making it sound as negative as possible. It may bring to light aspects that might have gone unconsidered.

The Problem: Mental Accounting and Asset Segregation

We all do mental accounting, dividing investments and assets up into neat, manageable compartments. One phenomenon of mental accounting is that people who suffer a loss in one mental account are more sensitive to further losses in that account than they would be to the same loss in another account. We can make bad decisions when we view accounts separately, because we may create independent requirements of these mental accounts that are mutually exclusive, contradictory, or simply make no sense. Researchers asked participants what they would do if they lost a $20 ticket on the way to a show. More than half said they would write off the night and go home. But when asked if they would still purchase a ticket if they lost a $20 bill on the way to the box office, almost 90% said they would. And people are willing to walk six blocks to save $30 on a $100 CD player, but won't walk three blocks to save $30 on a $3,000 vacation, even though the net impact on wealth is identical.

Asset segregation is a result of mental accounting. When investors separate monies or accounts, they make decisions about those accounts in isolation. When aggregated, these decisions are often weaker than decisions that could have been made taking the overall portfolio into account.

Example: An unsophisticated 401(k) participant invests his own contributions in safe investments, while earmarking his employer contributions to risky investments. His thinking is that he had worked hard to earn the money he was contributing and didn't want to risk it, while the money the company contributed was "free" money and could be gambled. Since the majority of money contributed was from the employer, the participant was investing too high a proportion of his assets in highly aggressive investments. Another example is people who

Certain material in this work is proprietary to and copyrighted by Litman/Gregory Analytics and is used by ClearPath Capital Partners with permission. Reproduction or distribution of this material is prohibited and all rights are reserved

borrow money for a car or keep a balance on their credit card, even though the interest rate on these loans is higher than the interest they earn on the money in their savings accounts or returns on their other investments.

Solution: Consider all of your accounts in looking for ways to optimize your wealth. Making decisions that create discomfort in the context of single accounts (but that are beneficial overall) are easier if you consider investments and assets from the perspective of your total financial portfolio. Remember that maintaining an appropriate, diversified portfolio requires that all assets be considered as part of a bigger picture. It's okay to load up your tax-deferred account with higher risk investments as long as the overall percentage of your wealth in higher-risk investments remains appropriate.

Problem: Diversification Errors

While mental accounting and asset segregation can lead to diversification errors, there are several other human tendencies that can lead to poor or illogical decisions about diversification. The "one-over-n heuristic," describes how people tend to diversify evenly across whatever options are presented to them. Consider the style-box mania we talked about in the last issue, where investors feel compelled to own a piece of each box in order to be "diversified." A study by Richard Thaler and Shlomo Benartzi demonstrated that 401(k) participants tend to spread their money across whatever options they have — if they have a choice between one stock fund and one bond fund, they split their investment 50-50; if they have a choice between four stock funds and one bond fund, they put 20% in each stock fund and 20% in the bond fund (certainly not as sound a strategy as basing diversification on time horizon and risk profile).

The timing of decisions also impacts the choices people make. When investors allocate a larger sum of money, they tend to diversify across all options. But when they add to that portfolio, there may be no consideration given to the relationship between the new investment and the rest of the portfolio. This tendency is illustrated in a study where students were asked to choose snacks. When required to choose right then for the next three weekly classes, most students chose three different snacks; when allowed to choose a snack each week in class they tended to pick the same snack every week.

Example: An investor adds funds to his portfolios over time based on the same criteria (namely that the fund is doing well and everyone is recommending it). But because the purchases are made for the same reasons, it results in largely redundant holdings, and higher risk than anticipated.

Solution: Remember that a portfolio can behave very differently than the sum of its parts, and take care to consider the effect that a new holding is likely to have on the overall portfolio. Investors who consider themselves risk-averse may actually be able to add a fund in an asset class that by itself is high risk and still wind up with lower overall portfolio risk than they would have had in choosing a fund that is redundant with existing holdings.

The Problem: OverWeighting the Recent Past

People like patterns, and the recent past represents a nice, easy-to-find pattern that can become the basis for an investment decision. A fund that just had a great year, or a stock that has had a great recent run, can influence investors to pull the trigger based on the assumption that the recent past will repeat itself in the future, but they make this decision with little real research. The same holds true for broader trends. The problem is that while some trends tend to persist, others tend to revert to the mean, and there is no way to gauge which is more likely without doing research. Applying simplistic extrapolations ignores the fact that whether a trend does or doesn't persist is based on underlying, fundamental reasons, not its membership in a "trend class" that was artificially created to describe observed events. The market frequently "overshoots" based on extrapolation errors, creating opportunities for

Certain material in this work is proprietary to and copyrighted by Litman/Gregory Analytics and is used by ClearPath Capital Partners with permission. Reproduction or distribution of this material is prohibited and all rights are reserved

astute investors who are able to think independently. Mason Hawkins (Longleaf Partners Fund) will typically purchase a stock that is viewed negatively by the rest of the market, then liquidate a stock after it has done well and approaches his estimate of its intrinsic value—a time when most investors would take a strongly favorable view of the issue.

Example: An investor reads a study that says short-term mutual fund winners tend to persist. On that basis he decides to invest in several top funds from the prior year, and to revisit his holdings the following year. A few funds do well, but one collapses as its highly specific investment and aggressive style falls way out of favor, leading to poor overall results.

Solution: Try to focus on longer-term decisions, where the ability to make realistic assessments are less affected by shorter-term noise. Effective trend investing requires differentiating between trends that are highly likely to persist, which can only be determined by careful research (not intuition), and those for which there is not real basis for confidence. It also requires a basis for assessing whether or not the trend is so widely recognized that it is already reflected in the investment's price (as perhaps is the case with large growth stocks today). For contrarians, recognizing extrapolation errors on the part of others can result in opportunities, but it requires detailed, careful research and strong conviction and discipline. For fund investors, avoiding extrapolation errors suggests that they shouldn't dump managers just because they hit a rough spot. Instead they should consider the reasons for the underperformance and what they signify (is it a result of how the market is valuing a particular style at that time or a result of loss of discipline or poor stock selection?). Investors should also reexamine the reasons the fund was originally purchased and consider whether those reasons remain valid. Consider that you purchased the fund because you believed your assessments were right. Do you now believe you were in fact wrong? If so, what additional research and information do you now possess that makes you believe you won't be wrong again?

The Problem: Spotting Trends that Aren't There

We suspect that professionals are more prone to this (or maybe they are better at it) than individuals, though for most people pattern seeking comes naturally. It makes sense: recognizing patterns allows us to understand the world and decide what to do. So naturally investors seek patterns that help support decisions — often without adequate confirming research. But with so much information available, there are more and more "trends" that can be coaxed from the noise. It is easy to see that the market rising in years when the NFC wins the super bowl is not a basis for an investment decision. But just as silly examples can be constructed, so can ones that seem reasonable. The media compound the problem. Writers and reporters are always looking for stories. They adopt a thesis that is the basis for a "good" article, with "good" defined as appealing and attractive to the readership. As media commentators, we can attest to many examples of writers who have already reached their conclusions before talking to "experts." When they do, the purpose of the experts is to confirm the conclusion (there's usually one token expert to disagree), and thereby make the story more compelling and a better read. Further, there is no accountability. If a producer or reporter is completely, irresponsibly wrong, there are no consequences whatsoever; the topic just gradually fades into the collective subconscious.

Example: By 1983 small caps had outperformed significantly over most of the prior decade, and experts began to come up with a host of reasons to explain it. The reasons were compelling enough to convince many investors that small-caps represented a clearly better long-term investment opportunity. Small-caps have largely underperformed since then. By the late 1980s experts explained Japan's dominance in terms that included the decline of the U.S., and concluded that foreign investments represented a superior long-term opportunity. In recent years there have been compelling arguments that larger companies have advantages

Certain material in this work is proprietary to and copyrighted by Litman/Gregory Analytics and is used by ClearPath Capital Partners with permission. Reproduction or distribution of this material is prohibited and all rights are reserved

over small (better pricing from suppliers, access to better technology, global distribution, etc.).

Solution: Past experience demonstrates that investors should cast a critical eye on trend arguments that explain the recent past, at least as far as using it as a basis for future decisions. Remember that we seek patterns. Look for alternative patterns and explanations. Play devil's advocate and try to take apart the arguments to see if they hold up. Remember that sometimes what appears in the popular press is determined by factors that are unrelated to whether the thesis of the story is actually correct. There is an awful lot of space and airtime to fill in today's media-saturated culture.

The Problem: Overconfidence

Studies show that people are exceedingly overconfident in assessing their own ability and knowledge, especially relative to others. This is why well over than 50% of drivers rate themselves as above average (and rate most other drivers as poor — though we will concede that they are correct on this one). Or why gamblers misperceive games of chance as games of skill. Confidence provides a sense of control and order. But in investing it leads to shortcuts. Investors react emotionally to a favorable story, knowing full well that in another day they won't feel as positive. They overestimate their own knowledge and rely too heavily on their intuition. With the benefit of hindsight, they exaggerate the talent behind successful decisions, and tend to sweep poor decisions under the rug. As a result they may make inappropriate choices, investing in things they don't really understand in the mistaken belief that their favorable intuition is enough to justify action.

Example: A young fund manager has so much success that he begins to believe that the reason is his own exceptional talent, and that investing just happens to come easy for him. He steadily increases the amount he is willing to bet on his convictions, while at the same time decreasing the amount of research that is behind them. Eventually the manager is wrong, and with his heavy over-weighting, disaster strikes.

Solution: Investing can be too cold-blooded in punishing mistakes to make a short-cut worth the risk. If you have doubts, do more work, or don't invest. Be honest in making a self-assessment as to whether you have the expertise and whether you have done the research to justify the level of confidence you may feel. Take the time to play devil's advocate and approach the conclusion from the opposite direction, with your objective not to come up with reasons that support your conclusion, but reasons to contradict it. Remember and learn from mistakes, without dwelling on them. After all, the best you can do is make rational, informed investment choices and stand by them until something changes. This is also the least you can do: most mistakes are the result of failing to think critically and consider a potential investment from as many angles as possible.

The Problem: Agency Friction

If you use an advisor to help you make investment decisions, there are inherent problems in such a relationship that can contribute to poor performance. Your advisor wants to make you happy, so that you will keep using them as your advisor. A strong desire not to experience regret, coupled with the fact that accounts are reviewed over short time spans, causes many advisors to over-emphasize avoiding short-term losses and controversial investments, even at the expense of long-term gains. In order to outperform, an advisor or manager may be required to make choices that create short-term discomfort. Nevertheless it is common for advisors and portfolio managers to seek short-term praise and avoid regret (or being fired) knowing that this will probably produce mediocre returns in the long run.

Example: An employee accumulates company stock that over time becomes the dominant position in his portfolio. Approaching retirement, the individual seeks the guidance of a financial advisor, who (after considering taxes) recommends reducing the stock position to

Certain material in this work is proprietary to and copyrighted by Litman/Gregory Analytics and is used by ClearPath Capital Partners with permission. Reproduction or distribution of this material is prohibited and all rights are reserved

bring down the overall portfolio risk. After liquidating a portion of the holding, the stock moves up sharply, while the investments that replaced it move little. The individual expresses dissatisfaction, and the advisor agrees to curtail further trimming of the position. As a result, the investor remains heavily overweight in a single holding despite the relatively short time horizon before he will require use of the assets.

Solution: Much of the source of conflict between advisors and clients stems from differing perceptions and definitions of risk. An investor needs to make sure he understands and agrees with the advisor's decision methodology and buys into it. They should agree on an evaluation horizon. An advisor must ensure that the client understands the possible outcomes both of following the recommendations and of not following them. It is helpful to summarize the reasons for and against a decision for later reference.

There is one more problem we will address. But first, we want to acknowledge that much of what we have discussed here appears obvious. In part, that is because the concepts are generally exceedingly simple ones. But even though something may be obvious or simple, it may nevertheless be difficult for many people to sustain an awareness that allows them to do anything about it. Smokers consistently underestimate how much they smoke, because the behavior becomes unconscious. (One of the techniques used by professionals to help smokers quit involves simply keeping written track of how much they smoke.) Another reason the topics here may seem obvious is because there is an innate and well-documented tendency for people who gain new information to believe that they actually knew it all along. This is called hindsight bias, and it too impacts financial decision making.

The Problem: Hindsight Bias

Many events, innovations, or concepts seem obvious after the fact. Individuals regularly forget that something that now seems obvious was not nearly so obvious before it happened; we can't imagine not knowing something once we know it. This is reflected in the common phrases "Monday morning quarterbacking" or "hindsight is always 20-20." However, several studies have indicated that few people are actually able to accurately recall their assessment of an event's probability after the event has happened. The danger is that hindsight can twist a rational, but risky, venture into what appears like a boneheaded mistake, or it can lead investors to overestimate their ability when they have been successful. As such, hindsight can falsely create the belief that the world is a knowable and controllable place (which is often not the case). This unrealistic overconfidence can lead to excessive risk taking when the hindsight creates an illusion of predictive power, and to paralysis when an investor becomes wracked with doubt for his "dumb" mistakes.

Example: After a prolonged period of solid returns, the stock market declines by 15%. Immediately thereafter, all kinds of "experts" appear on television and in the mass media, proclaiming that we were long overdue for a correction, as if the decline were obvious and inevitable. But where were these experts before the event? If it was so obvious, why weren't they speaking up before the market took a dive? If it was so obvious, why didn't investors start cashing out just prior to the sell-off? Hindsight biases also regularly manifest themselves between investment advisors and their clients. Once the reasons why an investment performed poorly are understood, it becomes difficult to understand why it wasn't avoided. A client may complain to his broker or advisor that they should have seen it coming.

Solution: Keep good records of your investment decisions. When considering a purchase or sale, write down the reasons for taking a particular action, making notes on why you're doing what you're doing and what potential events could make your decision turn out poorly. If it turns out that you were wrong, you can return to your notes and remind yourself of what you were thinking before the events became "obvious." This can also help restrain you from making impulsive investment decisions, by creating a sense of accountability for your

Certain material in this work is proprietary to and copyrighted by Litman/Gregory Analytics and is used by ClearPath Capital Partners with permission. Reproduction or distribution of this material is prohibited and all rights are reserved

decisions and by explicitly laying out what you did and didn't know at the time of the decision. It is also good to maintain a healthy amount of humility, since the whims of the market can sometimes make even the smartest investor look like an idiot and the most foolish investor a genius.

Conclusion

All investors face the same biases and emotions that contribute to poorly founded decisions. One of the reasons it is critically important to us to find equity fund managers with clearly defined, consistently applied investment strategies is because they are less likely to be prone to decision errors. Through experience, many great investors have recognized the behavioral biases that affect investment decisions, and have used that knowledge to spot opportunities, as well as to develop strategies to help prevent them from making the same mistakes. On the opportunity side are managers who seek to exploit decision errors that have resulted in unrealistic and unsustainable valuations. The approach is more quantifiable and clearly defined on the value side, though certainly many growth managers are cognizant of valuation distortions and factor that into investment decisions, albeit in a different realm of the market. As for avoiding errors, the techniques employed by many managers are valuable to consider. For example, the team at Brazos Small Cap Growth sells for any of a variety of reasons, including a decline of more than 20% from cost in a flat or rising market. Other techniques we see commonly in successful managers include clear sell disciplines, the challenging of assumptions by other team members, and requiring a sale in order to purchase something new, to name several.

Much of the benefit to be gained from understanding behavioral biases will result simply from remembering to consider them in evaluating investment opportunities and before making final decisions. Few would dispute that most are obvious; the challenge in overcoming them lies in their largely reflexive, unconscious nature. To help, we have included a "checklist" of questions designed to aid investors in avoiding the common behavioral finance decision errors.

Questions That Can Help Avoid Decision Errors

On whether to continue to own an investment:

Think of your portfolio as if you were forced to liquidate all of your holdings. With your portfolio entirely in cash, what would you buy back?

If you own a security that you wouldn't buy back, what would you own instead?

Are you afraid to sell because it might come back?

What would happen if you were wrong, how would it make you feel? Is that impacting your decision?

These considerations help cut through loss aversion and anchoring, where you assess the value of an investment based on what has happened to you specifically.

On whether to purchase an investment:

Ask why you are considering buying it. How does it fit in to your overall portfolio? Are you assessing its risk in a portfolio context or individually?

What reasons do you have to think it will perform well? If you are acting on advice or a tip, how knowledgeable is your source, and how much research have they done? What is their interest in giving you this "information"?

Certain material in this work is proprietary to and copyrighted by Litman/Gregory Analytics and is used by ClearPath Capital Partners with permission. Reproduction or distribution of this material is prohibited and all rights are reserved

If you are acting on your own research, have you given consideration to alternatives? Many investors see a "fat pitch" and swing. As Warren Buffett warns, though, many investors have a tough time laying off a pitch they like even a little. The hard part is being selective. Trying to take advantage of too many opportunities can dilute the benefits of the best of those opportunities.

Is your decision based on a trend?

If so, what is your basis for believing it will continue? Is the trend so widely recognized that it is already reflected in the investment's price? What if the trend doesn't continue? What's your worst case? Many trends tend to revert to the mean. Regardless, whatever happens is going to result from fundamental, underlying factors, not from the prior trend itself.

Write down the reasons behind your decision for later reference. This helps avoid "hindsight bias," which can profoundly impact the accuracy of how you assess your ability to make investment decisions.

Certain material in this work is proprietary to and copyrighted by Litman/Gregory Analytics and is used by ClearPath Capital Partners with permission. Reproduction or distribution of this material is prohibited and all rights are reserved