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Five Wealth-Destroying Biases: Where They Strike in the Investment Process and How to Address Them

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INTRODUCTION

There are scores of biases or "mental traps" that can adversely affect investment decision-making. Creating and following a thoughtful, goal-specific process can help counter them. This paper examines five biases that are among the most common, insidious and destructive.

Heuristics[1]

1. **Anchoring**: Establishing a point of reference that rightly or wrongly influences financial decision-making.
2. **Availability Bias**: The tendency to overrate the likelihood of events that are recent, personal, and emotional, i.e., more psychologically "available" to us.

Prospect Theory[2]

3. **Framing**: The way information is presented to us (e.g., half-empty vs. half-full) can skew how we interpret it.
4. **Extrapolation**: The tendency to become overly focused on present trends and to believe that they will continue or accelerate.

Planning

5. **Planning Fallacy**: The tendency to underestimate the amount of time/money needed to successfully achieve objectives, including long-term financial goals.

The Five Biases

1. Anchoring
2. Availability Bias
3. Framing
4. Extrapolation
5. Planning Fallacy

BIAS ALERT LEVELS

Investors are human. We are always at some risk for biases in our decision-making and analysis. However, some biases are more prevalent at certain times during the investing journey. The bias rating system below is a useful way to classify and counter the threat level at a given point in the investing process.

Yellow: Signifies that bias is more likely to appear above baseline levels. Investors should be aware.
Orange: Signifies biases are *significantly* more prevalent and harmful than baseline levels. Investors should be aware and the biases actively monitored.
Red: Signifies the highest level of danger. Investing biases are at their *most* destructive at these junctures. A concerted effort should be made to recognize and counter investing biases.

[1] Heuristics can be thought of as mental "rules of thumb" or shortcuts people may take in decision-making.
[2] Developed by Daniel Kahneman and Amos Tversky, Prospect Theory states losses hurt at least twice as much as comparable gains feel good.

THE INVESTMENT PROCESS AND BIAS ALERT GUIDE

Stage 1: Asset Inventory

Description: Asset Inventory is the natural first step of an effective planning process. *It is the accounting of all present wealth and other assets, as well as expected streams of income.* This vital stage, when done properly, provides a platform for the destination, the path, and the vehicles that will define the journey. For many people, the Asset Inventory stage will represent the first true step in a strategic, purposeful investing plan with a financial advisor.

Bias Alerts:

Anchoring (Heuristics): Anchoring may creep into the investing process when we establish monetary points of reference. One pivotal investing baseline comes when establishing the monetary value of an investor's investable assets. This figure will become the reference point for all future gains and losses. For example, a net worth that drops below the original asset inventory figure can create a sense of frustration and dismay that sparks impulsive behaviors (e.g., buying, selling or changing advisors). In the long term, such impulsive actions often do more harm than good.

A Typical Investment Process

1. Asset Inventory
2. Setting Goals and Objectives
3. Plan Design and Implementation
4. Monitoring
5. Adjusting/Rebalancing

Stage 2: Setting Goals and Objectives

Description: *Setting Goals and Objectives is where the destination for the investing journey is determined.* A shift occurs at this stage from a focus on the means (the investable assets) to the ends (real-life outcomes). Goals may not be completely envisioned (and can change over time) but an effort should be made to make them as detailed and vivid as possible. Doing so is important financially because it can make prioritizing decisions and tracking progress easier; it is also important psychologically because it can help people focus on "why" they are investing. This often is a healthier question than "how" they are investing.

Bias Alerts:

Planning Fallacy: There is a near universal tendency to underappreciate the cost and length of time necessary to achieve long-term goals. The Planning Fallacy is significant in Stage 2 because many people tend to view the investing journey as being on a path when it is often more like a being on a treadmill. If you are not moving *forward* faster than inflation, you may actually be moving backwards in real world purchasing power. Ironically, the Planning Fallacy is what causes so many investors to *not make a plan*. Clients who underestimate the importance of investing early and often, or believe there is time to play catch up, may be victims of the Planning Fallacy.

Framing (Prospect Theory): It is easier to think about what you want than what you do not. People in general prefer to envision goals as positive things. Yet it is important to factor in the unpleasant things as well. Disability, long-term health care, death—untimely or not—need to be factored into the planning process. When people frame their goals and objectives solely along positive lines (what they want), they risk under planning for the things they *don't* want.

Stage 3: Plan Design and Implementation

Description: The first two stages established a starting point and destinations, respectively. *Stage 3 is when the actual investing journey begins*. It starts with developing an *Investment Policy Statement (IPS)* which provides a documented understanding of investment philosophy, guidelines and restraints. Based on the IPS, a specific portfolio of investments is designed with strategic asset allocation based on both financial factors (e.g., the necessary returns to reach specific goals) and psychological factors (e.g., risk preferences). With the plan agreed upon and in place, the investing—with all its risks and rewards—begins.

Bias Alerts:

Extrapolation (Prospect Theory): Committing money to a plan always requires a leap of faith. Often investors feel a pull to alter an agreed-upon asset allocation strategy or delay its implementation because of the financial and geo-political climate of the day. All investing decisions are made *for* the future but *in* the present. The trends of the present exert a powerful psychological force. At Stage 3, Extrapolation may overrate the importance of those trends, causing the investing journey to get off on the wrong foot.

Availability Bias (Heuristics): Closely related to Extrapolation is Availability Bias. Recent events, particularly those that are relatable and emotionally charged, can have a disproportionate impact on the psyche of the investor. This tendency to overrate the impact of these happenings can turn what is meant to be a lifelong, multi-factor decision into one driven by a single event—for which the risk is incorrectly calibrated. Financial news watchers and followers of current events are at greatest risk. Bad and scary news is, and always will be, part of life. Investors should remember that their goals are designed for the long term.

Stage 4: Monitoring

Description: The destination has been set, a path has been charted and the journey has begun. The overwhelming majority of the investment process takes place in Stage 4, monitoring *where you are on that journey, whether you are on course, and how close you are to your destination(s)*. There are also more chances for biases and emotion to enter our thinking here because this phase typically goes on for many years.

Bias Alerts:

Extrapolation (Prospect Theory): For many investors the problem isn't the lack of a plan, it's an inability to stay with it. Extrapolation during the Monitoring stage is often to blame; this is why so many investors find themselves buying high and selling low. Investors are in a constant psychological battle to pull themselves from a short-term focus on markets back to a long-term focus on goals.

> *"All investing decisions are made* for *the future but* in *the present."*

Availability Bias (Heuristics): The Availability Bias is at an increased level during the monitoring process because emotionally charged events are constantly unfolding with the power to change how investors feel about their portfolios. Even if a single event does not cause an investor to feel uneasy, the relentless barrage of "bad" news can have a cumulative effect that may change the way investors feel about their portfolios or investing in general.

Framing (Prospect Theory): Investors will notice that even strong-performing portfolios fluctuate in value. Often, markets may rise quickly before plateauing or declining over a period. How investors frame these periods – e.g., as longer-term gains vs. shorter-term losses – during Stage 4 can have a profound effect on their psyches. Investors who have the latter response (i.e., a loss frame) will generate emotional reactions more influenced by regret, disappointment and frustration. These emotions make it harder to follow a plan and rarely lead to clearheaded decision-making.

Anchoring (Heuristics): Related to Framing is the Anchoring heuristic. I noted in Stage 1 that the asset inventory provides a powerful anchor. Another powerful anchor emerges in Stage 4, the "all-time high." It typically generates positive emotions and, ideally, should happen on a regular basis. But wealth accumulation is most often a jagged ascent, not a smooth one. Investors often experience the inevitable pullbacks from this figure as stagnation or failure, which may lead to poor, emotion-driven decisions.

Stage 5. Adjusting/Rebalancing

Description: The investing journey can be like any other journey. Even the best-planned ones may still encounter the investing equivalents of traffic, detours or changes in destination. *Stage 5 takes the vigilant monitoring of Stage 4 and translates it into investing actions* (when necessary) to keep investors on track toward their goals. These adjustments may be planned (e.g., at life transitions, yearly reviews, rebalancing) or unplanned (e.g., big market moves, unexpected events.)

Stage 4 and Stage 5 *have a cyclical, reiterative relationship*, but Stage 5 is perhaps the most critical in the investing process. It is where investments may go off track, either by exiting a plan that is working or failing to adjust to new requirements for goals.

Bias Alerts:

Extrapolation (Prospect Theory): We know investors have a tendency to chase trends, but few appreciate how destructive this tendency is. DALBAR's research on individual investor performance vs. market performance shows the damage may cost the typical investor many thousands (sometimes hundreds of thousands) of dollars over a lifetime.[3] In fact, market inflows and outflows can actually represent a negative indicator for market moves. (For example, when investors are selling stocks, it may be a good signal for other, longer-term focused investors to buy.) There are numerous factors at play, but chief among them is Extrapolation. In drawing people into the current trend, Extrapolation creates a framework of short-term thinking. Short-term thinking not only generates emotions—e.g., fear, exhilaration, regret, despair—it gives those emotions a *much larger role in decision-making*. This bias at this stage may be considered the single greatest destroyer of investing wealth.

"Short-term thinking not only generates emotions—e.g., fear, exhilaration, regret, despair—it gives those emotions a much larger role in decision-making."

[3] DALBAR. "DALBAR's 22nd Annual Quantitative Analysis of Investor Behavior." 2016.

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