INVESTMENT INSIGHTS

Analysis, Insights and a Different Perspective February 2022

## KEY POINTS

- Behavioral biases impact our decisions.
- The most common behavioral biases among investors are availability and confirmation.
- A disciplined investment approach can help mitigate behavioral biases.

Cornerstone
WEALTH MANAGEMENT LLC
*A Registered Investment Advisor*

# TWO MOST COMMON BEHAVIORAL BIASES AMONG INVESTORS

**Every day we make many decisions – from easy choices, like what to eat and what to wear, to more important decisions, like adjusting our activities during a pandemic.**

According to research, we make approximately 35,000 decisions each day.[1] For context, assuming a person sleeps for 8 hours per day, a person makes a decision roughly every two seconds.[2] Our brains have evolved to make a large number of decisions very quickly. Some decisions, however, are often made erroneously without slow and deliberate thinking. These error-prone decisions, or behavioral biases, provide us with less-than-ideal outcomes. Investors must understand these errors and how to overcome them to manage potential investment mistakes. In this issue of Investment Insights, we explore the two most common behavioral biases among investors and how investors can mitigate against them.

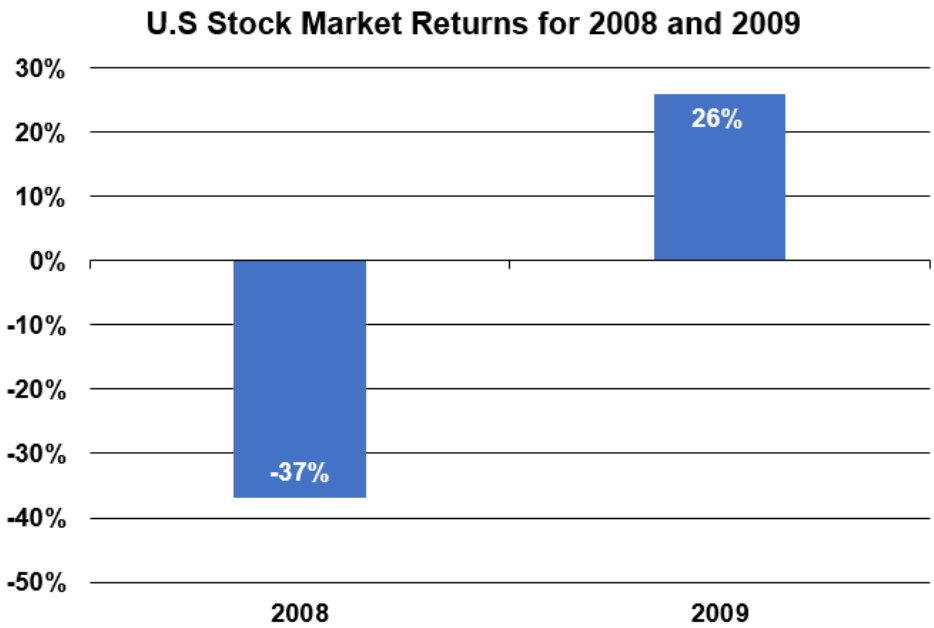
In recent years, the field of behavioral finance has made great strides in the academic literature. Its findings, however, are far from common knowledge. A challenge with discussing behavioral finance for investors is the overwhelming amount of information on this topic. Indeed, a simple search of behavioral biases returns hundreds of lists for "top 10 behavioral biases." Additionally, the order of the list appears to vary study by study, ultimately causing more confusion. Although learning about a dozen behavioral biases can be informative, it's not very practical. Instead, we will focus on the two most common biases among investors: availability and confirmation biases.

1 Hoomans, Dr. Joel. "35,000 Decisions: The Great Choices of Strategic Leaders." Robert's, 20 Mar. 2015.
2 More precisely every 1.62 seconds calculated as 57,000 (16 x 60 x 30) divided by 35,000.

## AVAILABILITY

Availability bias is a mental shortcut used to recall information based on how easily it comes to mind. With this bias, more easily recalled information is considered more important. On the contrary, information that is not as easy to remember is considered less important. For example, most people think the odds of dying from a shark attack are greater than dying from falling airplane parts.[3] This idea is most likely due to more mainstream media coverage of shark attacks compared with falling airplane parts. [4] In reality, more people die from falling airplane parts than from shark attacks.[5]

According to research by Cerulli Associates, more than 90% of investors experience availability bias, making it the most common bias among investors.[6] This bias can potentially influence an investor's view of the financial market based on more recent events. An example of availability bias was on display in 2009 following the 2008-09 market turmoil. As shown in the table below, after a market sell-off in 2008, the markets rallied by more than 25% in 2009. More than two-thirds of participants in a survey, however, believed the market was down or flat in 2009.[7] This disconnect stems largely in part from availability bias. As people recalled the market decline of 2008, they associated it with the market conditions in 2009.



Source: Morningstar. U.S. stocks represented by Standard & Poor's 500 Index.

## CONFIRMATION

Confirmation bias is caused by people searching for information that confirms their opinions while ignoring information that contradicts those opinions. With this bias, investors tend to consider only the positive information about their investments and disregard any negative information. Research has found that investors prefer information that confirms their prior beliefs.[8] Interestingly, this bias influences large professional bodies in addition to individual decision-making. Several studies show many academic papers suffer from confirmation bias. [9] It also impacts a considerable number of investors. Research by Cerulli Associates found that 80% of investors experienced confirmation bias, making it the second most common behavioral bias.[10]

3 Plous, Scott. "THE AVAILABILITY HEURISTIC." The Psychology of Judgment and Decision Making, McGraw-Hill Higher Education, New York, 2007.

4 Ibid.

5 Ibid.

6 Cerulli Associates and National Association of Plan Advisors.

7 "WHAT IS AVAILABILITY BIAS?" AN INVESTOR'S GUIDE TO AVAILABILITY BIAS, Franklin Templeton.

8 Park, JaeHong, et al. "Information Valuation and Confirmation Bias in Virtual Communities: Evidence from Stock Message Boards." Information Systems Research, 25 July 2013.

9 Eric-Jan, Wagenmakers, et al. "An Agenda for Purely Confirmatory Research." SAGE Journals, 7 Mar. 2012; and, Doherty, Michael E. "Confirmation Bias in a Simulated Research Environment: An Experimental Study of Scientific Inference." SAGE Journals, 1 Feb. 1977.

10 Cerulli Associates and National Association of Plan Advisors.

## WHAT CAUSES BEHAVIORAL BIASES?

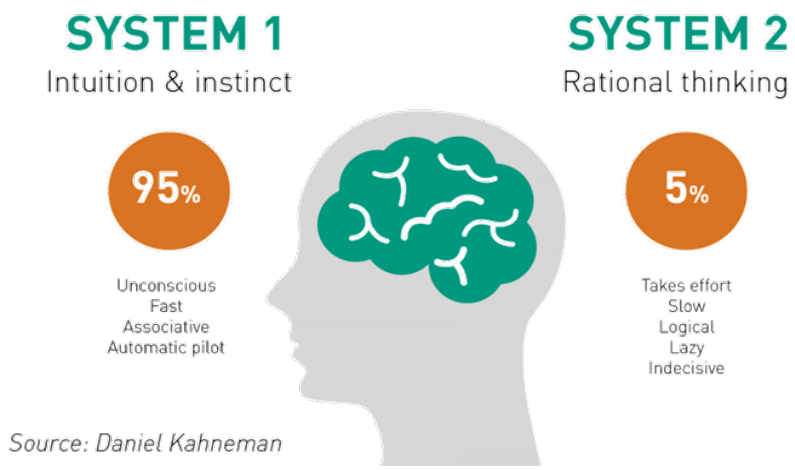
Behavioral biases are caused by how our brain processes information. Our brain processes information using two systems. The following exercise can help us understand how these systems work.

**Answer the following question before reading on:**

"A bat and ball cost $1.10. The bat costs one dollar more than the ball. How much does the ball cost?" [11]

The immediate response to this question for most people is 10 cents. That answer is incorrect. The correct answer is not complicated; it just requires slow and deliberate thinking. If the ball was 10 cents, the total would be $1.20. This is because the cost for the bat is one dollar more than the ball, or $1.10. If the ball was 10 cents, then together, they would cost $1.20 (10 cents for the ball and $1.10 for the bat). The correct answer is 5 cents as $1.05 plus 5 cents equal $1.10, and $1.05 is a dollar more than 5 cents.

While most people answer this question wrong, it has little to do with intelligence. In an experiment, more than 50% of students at some of the most prestigious universities like Harvard, Princeton, and MIT also fail to answer this question correctly.[12] Conversely, the error is caused by how the human brain processes information. According to Nobel laureate Daniel Kahneman, humans use two systems to process information and make decisions: Systems 1 and 2. System 1 is associated with fast decisions, intuition, and instinct. When people answer the question above, they typically use System 1. System 2, on the other hand, is associated with lengthy, thoughtful, and logical decision-making. Upon initially getting the wrong answer, people typically think about the question using their System 2 to answer it correctly. The image below summarizes the two systems.

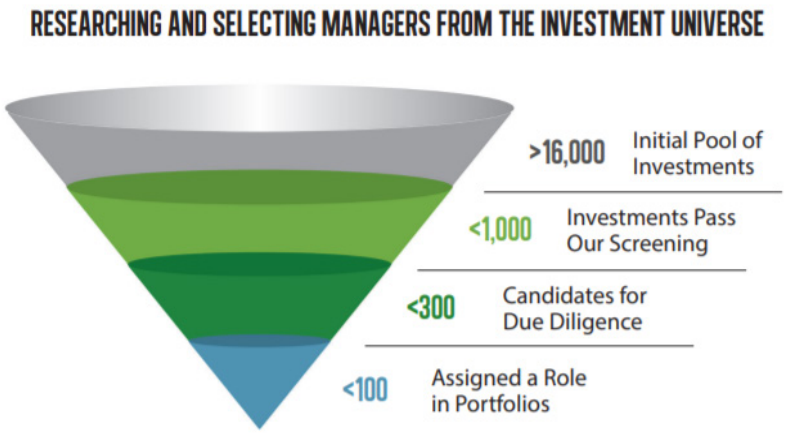



In the bat and ball example above, Kahneman explains that humans tend to accept System 1's proposals without checking them using System 2. Similarly, behavioral biases tend to occur for investors when the fast and automatic System 1 is used to make investment decisions. Decision-making that utilizes slow but logical thinking is less prone to behavioral biases. Thus, a disciplined investment process can help investors mitigate behavioral biases.

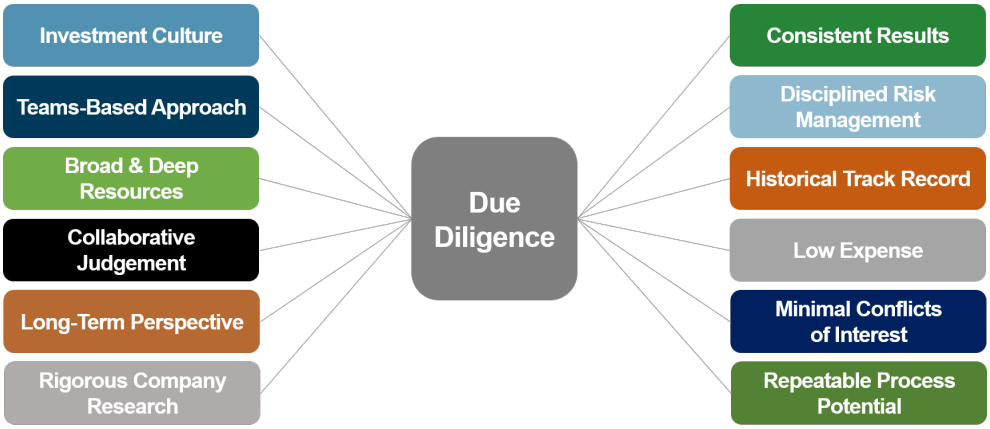
11 Kahneman, Daniel. Thinking, Fast and Slow. Farrar, Straus and Giroux, 2013.
12 Kahneman, Daniel. Thinking, Fast and Slow. Farrar, Straus and Giroux, 2013.

# MITIGATING AVAILABILITY AND CONFIRMATION BIASES

The availability bias occurs when easily recalled information is considered more important, and information that is not easy to remember is considered less important. This bias can cause investors to consider limited investment options based on familiarity.
In an effort to avoid availability bias, our research starts with a proprietary quantitative screening of the full selection of investments. By using the entire universe of managers as our starting point, we aim to mitigate against availability bias. The image to the right shows the quantitative steps involved in narrowing our investment universe.




If a manager passes our performance screens and looks promising on a quantitative basis, the next step is to conduct a due diligence audit by interviewing representatives from the company. This is done to avoid confirmation bias. Rigorous manager due diligence allows us to closely examine characteristics that we believe may help lead to strong performance over the long term. Having a robust list of characteristics that we research results in a more well-rounded picture, mitigating confirmation bias. The image below shows some of the key characteristics we look for in a manager.




As we have seen in previous examples, behavioral biases tend to occur when decisions are made using System 1 rather than System 2. To avoid behavioral biases, it is crucial to use System 2 when making investment decisions. Cornerstone Wealth Portfolios' disciplined investment approach can help mitigate these investment biases. To learn more about Cornerstone Wealth Portfolios, please contact your financial advisor.

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