INVESTMENT INSIGHTS

Analysis, Insights and a Different Perspective March 2021

HOW INVESTORS CAN AVOID BEHAVIORAL BIASES

KEY POINTS

- Our brain uses two systems to process information.
- Behavioral biases are often caused when the wrong system is used to make investment decisions.
- A disciplined investment approach can help mitigate behavioral biases.

Cornerstone WEALTH SERVICES

In the February 2021 Investment Insights, we explored some common behavioral biases that can lead to poor investment decisions. In this issue, we explore what causes behavioral biases and discuss strategies that investors can use to mitigate them.

SYSTEM 1 AND SYSTEM 2

To understand what causes behavioral biases, we first must understand the two systems our brains use to process information. The following exercise can help us understand how these systems work. Answer the following question before reading on:

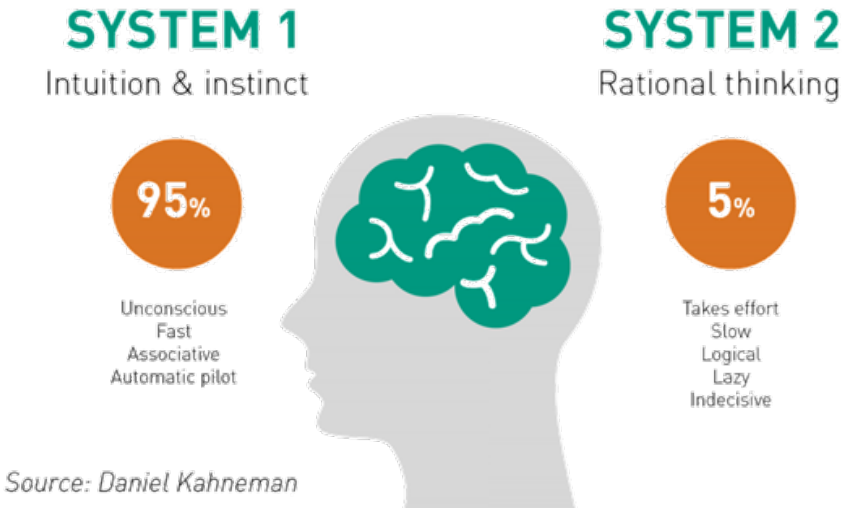
> A bat and ball cost $1.10. The bat costs one dollar more than the ball. How much does the ball cost?[1]

The immediate response to this question for most people is 10 cents, but that is the wrong answer. The correct answer is not complicated; it just requires some slow and deliberate thinking.

If the ball were 10 cents, as people often mistakenly answer, the total would be $1.20 because the cost for the bat is $1 more than the ball – or $1.10. The correct answer is 5 cents, as $1.05 plus 5 cents equals $1.10, and $1.05 is a dollar more than 5 cents.

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

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.[2] Instead, 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: System 1 and System 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 getting the wrong answer initially, people typically think about the question using System 2 to answer the question correctly.

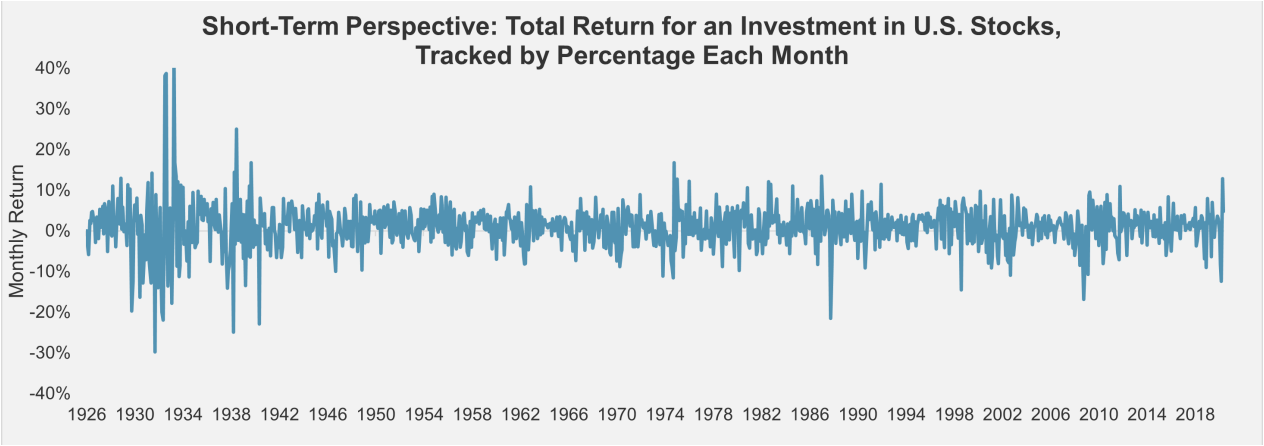


The image above summarizes the two systems. Kahneman discovered that humans spend 95% of their time using System 1 and only spend 5% of their time using System 2. As illustrated by the bat and ball example above, Kahneman explains that humans tend to accept System 1's proposals without checking them using their System 2.

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. A disciplined investment process can help investors mitigate behavioral biases because it employs System 2 for decision-making instead of relying on instinctual or gut reactions.

AVOIDING BEHAVIORAL BIASES

One of our core investment philosophy tenants is maintaining a long-term perspective, which helps alleviate representative and hindsight biases. Many investors have the tendency to believe recent performance will extend into the future, which causes representativeness bias. However, reacting to short-term volatility can often be futile, as many times short-term investment return can best be described as random in nature. The following chart shows the monthly stock returns since 1926. As you can see, over short time periods (monthly), investors try to drive returns in reaction to market noise, which seems random and unpredictable.

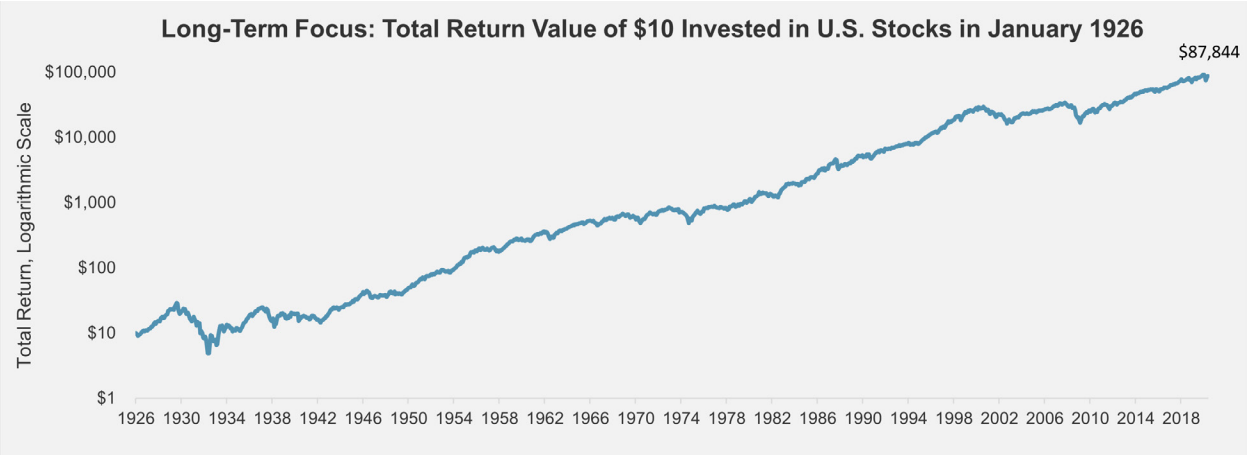


Source: Morningstar as of 6/22/2020. U.S. stocks represented by the IA SBBI US Lrg Cap Index from 1926 to 5/2020.

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

Rather than reacting to short-term market noise, many investors can benefit by making investment decisions from a long-term perspective. The following chart shows the performance of U.S. stocks over the same time period as in the previous chart but shown as a cumulative return over the entire period, instead of monthly.

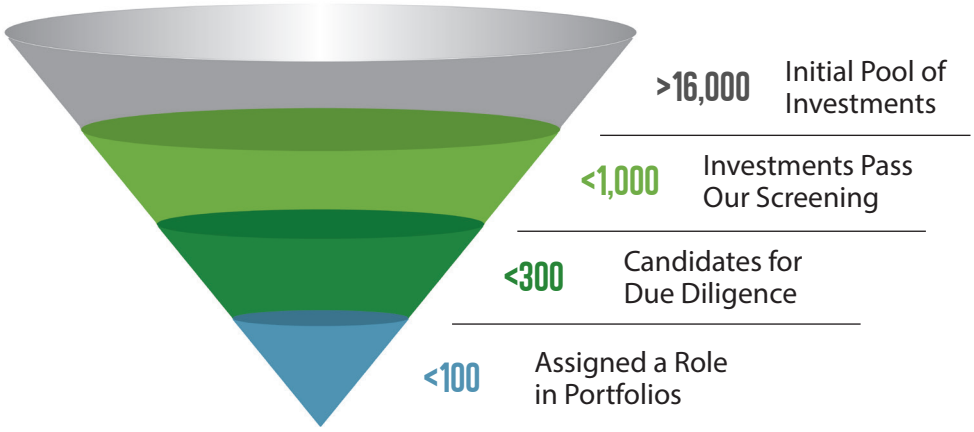
Over long time periods, the stock market is relatively more predictable as it is driven by corporate earnings and growth in the economy. Thus, maintaining a long-term focus gives us the opportunity to ignore short-term noise and avoid representativeness and hindsight biases.



Source: Morningstar as of 6/22/2020. U.S. stocks represented by the IA SBBI US Lrg Cap Index from 1926 to 5/2020.

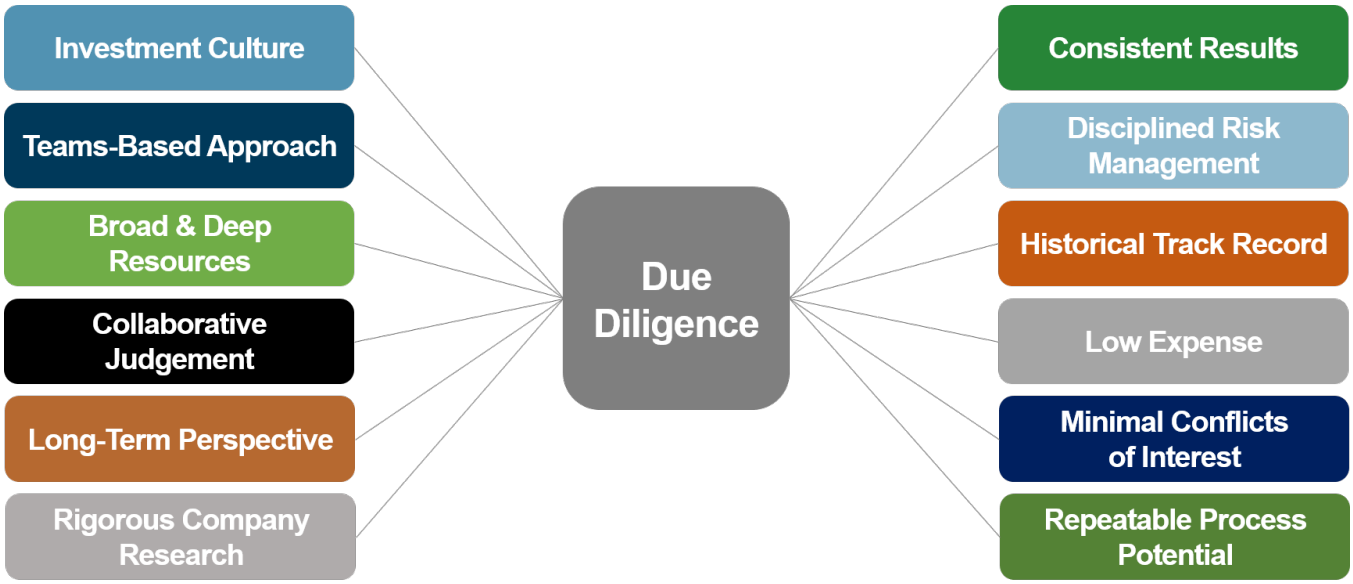
Availability bias occurs when more easily recalled information is considered more important; whereas, information that is not easy to remember is considered not as important. This bias can cause investors to consider limited investment options – only that with which they are most familiar. In an effort to correct for availability bias, our research starts with a proprietary quantitative screening. By using the entire universe of managers as our starting point, we aim to mitigate against availability bias. The image below shows the quantitative steps involved in narrowing our investment universe.

RESEARCHING AND SELECTING MANAGERS FROM THE 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. Recall confirmation bias is caused by people looking for and noticing information that confirms their opinions and ignore information that contradicts their opinions. 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.



Our investment process is developed and executed by a credentialed team, which helps us correct for framing and anchoring biases. Framing bias occurs when people's decisions are influenced based on the way information is presented. For example, the same investment can be presented as "1% risk of loss" or "99% risk of no loss." In an effort to avoid the influence of framing bias, we conduct our own research using data from third-party data providers.

Finally, we aim to correct for anchoring bias by using a team-based approach when making investment decisions. It is common for one team member to request other members intentionally take the opposite viewpoint to highlight any anchoring bias when making investment decisions. For example, when making a change in an investment portfolio, we may assign a team member to list all the reasons against making the change. This process helps reveal any anchoring bias by letting the team view the same decision from a different perspective.

As we have seen in the examples above, 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. A disciplined investment approach can help mitigate these investment biases. To learn more, please contact your financial advisor.

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IA SBBI US Lrg Cap Index is represented by the S&P 500 Composite Index (S&P 500) from 1957 to present, and the S&P 90 from 1926 to 1956. The Standard & Poor's 500 Index is a capitalization-weighted index of 500 stocks designed to measure the performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

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