# How Behavioural Biases Affect Finance Professionals

## A better understanding of Psychology can assist Finance professionals in achieving their clients' long-term financial objectives.

*by H. Kent Baker, Greg Filbeck and Victor Ricciardi*

**THE LITERATURE HAS DOCUMENTED** a wide variety of behavioural biases in financial markets: Individuals are overconfident, they exhibit loss aversion, they demonstrate familiarity bias, and they are driven by mood and sentiment, to name a few. When such biases affect the decision making of finance professionals, they can quickly become their own worst enemies.

It is widely believed that less-sophisticated investors make poorer choices than their professional counterparts. But the fact is, financial professionals are human, too. In this article we will look at which particular biases are most likely to affect three categories of finance professionals: Financial planners and advisors; financial analysts and portfolio managers; and institutional investors. A better understanding of these biases can help finance professionals achieve their clients' long-term financial objectives.

### Key Biases for Financial Planners and Advisors

Financial planners and advisors, along with their clients, reveal a wide array of psychological biases that can result in flawed judgments and decisions. But for this group, being aware of the following biases is particularly important.

**HEURISTICS.** Financial planners often exclude specific information or process information incorrectly when advising clients. That's because they apply heuristics or 'mental shortcuts' when processing large amounts of data or statistics — which often results in errors.

For example, a financial planner may use a heuristic that 'married individuals are less tolerant of risk than singles' and therefore, recommend conservative investment products to married clients. Clearly, not every married investor should be

placed into this risk stereotype. The research shows that many such 'heuristic judgments' result in errors, poor advice, and lower investment performance.

**ANCHORING.** Anchoring is the tendency for an individual to hold a belief and then apply it as a 'reference point' when making future judgments. Planners and advisors often base their decisions on the first piece of information they receive — such as a stock's initial purchase price — and they often have difficulty modifying their assessment of new information. For example, when they 'anchor' on a losing investment as a bad experience, they can become excessively risk- and loss-averse, resulting in underweighting other stocks in a portfolio.

**FAMILIARITY BIAS.** Planners, advisors and their clients often show a preference to own 'familiar' assets. For instance, they show an inclination to invest in local securities with which they are most familiar, thus over-weighting portfolios in domestic assets. They also tend to perceive familiar assets as less risky and earning a higher rate of return, which can result in under-diversification in a portfolio and resulting lower performance.

**TRUST AND CONTROL.** An important characteristic of the client-advisor relationship is developing a balance between trust and control. Clients often place too much trust in planners and advisors or overly allocate control about decisions to them. Conversely, when clients lack trust and are controlling, they are unlikely to listen to financial advice. Financial planners must work to establish a balanced relationship of trust and control with every client.

## The Right (and Wrong) Way to Think About Money

***Leading behavioural economist and best-selling author Dan Ariely gives his two cents to the CFA Institute's Usman Hayat***

**Usman Hayat: What is the 'right way' to think about money?**

**Dan Ariely:** The right way is all about opportunity cost. Every time you buy something — a cup of coffee, a car, a house — you should be asking, 'What am I giving up now, and in the future, for this act of consumption?' Of course, an infinite number of possible other consumption choices exist. Comparing, say, apples to oranges is simple: Nobody has ever stood in front of a fruit bowl saying, 'I have no idea which one I want', because the opportunity cost is so clear: Do you feel like eating an apple or an orange? But with money, you're likely to be thinking, 'Should I buy that new bicycle now, or put the money into my retirement fund?' That is a very difficult decision, because calculating opportunity cost is the key to answering it — and doing so is not humanly possible. Even if you tried to get a computer to simulate all of the various things you could spend your money on, it would be extremely difficult to figure out a true opportunity cost for each purchase you make.

**Is 'short-term vs. long-term' the crux of the issue?**

That is one of the things that makes financial decisions so difficult, because when you think about spending money now vs. saving for later, you're looking at something concrete vs. something abstract. You want that bicycle now; and retirement seems so far away. Even if you could say to yourself, 'This bicycle represents one entire month's rent', it's still about 'now vs. later'. Likewise, with food, we get tempted by what is around us at the moment, because of our *present-focused bias*.

**You have said we think about money in 'multiple wrong ways'. Please describe a few others.**

One of them is *relativity*. Imagine you're going to buy a car. The cost is 30,000 Euros, and the salesperson says, 'Hey, would you like leather seats for an extra 2,000 Euros?' Compare that decision with the following: You're buying a chair for your house, and it costs 500 Euros. The salesperson says, 'For 2,000 Euros more, you can get it in leather'. In the first case, you would likely think it seemed like a good deal; but in the second, you'd think it was a terrible idea — even though you sit down much more at home than you sit in your car. Because of *diminishing marginal returns*, the moment you spend 30,000 Euros, 2,000 looks like a small amount; but when you're paying 500 Euros, 2,000 more seems almost immoral.

Another example is, we tend to not think about decisions from scratch. Instead, we do what is called *anchoring*, which means we consider our past decisions, assume that they were reasonable, and repeat them. Yet another strange bias affects housing. Obviously, buying a house or condo is a huge decision. To get an idea of what they can afford, people often use an online calculator. Then, they use the number generated by this calculator as the true amount they can afford. Just because you've used an online tool, it doesn't mean you should borrow the maximum amount! Yet we have this idea that, 'the calculator said this amount is okay'. As a result, lots of people end up buying a home that they can't truly afford — and that, of course, affects other areas, like saving for the future.

**WORRY.** Both financial planners and their clients commonly suffer from worry, but it doesn't apply to all products equally. One of the authors [**Victor Ricciardi**] found that a large majority of investors associate the term 'worry' with stocks rather than bonds. A higher degree of worry for stocks increases perceived risk, lowers the degree of risk tolerance among investors, and decreases the likelihood of owning the investment.

### Biases for Financial Analysts and Portfolio Managers

Financial analysts and portfolio managers are particularly susceptible to the behavioural biases described below. Left unchecked, these biases can severely damage their reputation.

**OVERCONFIDENCE.** This bias manifests itself as an unwarranted faith in one's own intuitive reasoning, judgment and cognitive abilities and includes both *prediction overconfidence* and *certainty overconfidence*. Prediction overconfidence occurs when professionals assign too narrow a confidence interval around their investment forecasts; while certainty overconfidence occurs when professionals assign too high a probability to their prediction and have too much confidence in the accuracy of their judgments. These biases have been shown to lead to overly-concentrated portfolios, as these individuals may assume that their perceived superior skills warrant including fewer assets for consideration.

**HERDING BEHAVIOUR.** *Herding* refers to disregarding one's own opinion or analysis in order to follow the crowd — which can lead to financial bubbles and crashes. As prices increase from investors capitalizing on momentum, these individuuals may observe their peers investing in these assets and thus be incentivised to

**Is it possible to correct our behaviour and move from irrationality to rationality?**

The question is, What tools can we give people to help them think better about money? If we still believe the human brain is designed to recognize opportunity cost — and that, if we leave people to their own accord, they will do the right thing, that will not happen; but if you admit that people are going to make some predictable mistakes, you can look at how chequing and savings accounts are structured — and come up with mechanisms to help people.

**What would be an example of such a tool?**

One example might be an 'electronic wallet' that nudges you to think about some of the things you want to purchase in the near future. Imagine if — just before you walk into **Starbucks** — it says to you, 'If you keep spending money on lattes, you will not be able to afford that trip to Paris'. That would be one way to get people thinking about opportunity costs.

Or, imagine that your chequing account didn't just include one total pile of money, but was divided into different monthly expenditures. When our salaries come in at the end of each month, we feel like we have a lot of money; but the fact is, rent is due tomorrow and that student loan payment is due the next day; so, you don't really have all that money. Imagine that your account showed you how much money you actually have available to spend on discretionary things each month? Tools like that would be very helpful to people.

**How can behavioural insights help finance professionals make better decisions on behalf of clients?**

Professional investors are human, too, so they are susceptible to some of the same biases as everyone else. In 2008, we saw lots of institutional investors panicking and behaving in terrible ways — it was not limited to individual investors. So, understanding the role of emotions and decisions is centrally important for companies, as well as for individuals.

Think about something like dieting. You know full well that if you have your favourite cookies at home, you will eat too many. So, you might decide, 'No more cookies at home!' You might be willing to limit your freedom to eat cookies by doing that. Imagine if we took a similar approach with investments, and created a rule that 'investors are not allowed to sell things immediately'. Instead, they have to go through a multi-step process that takes one full month — so that they can't act on their emotions. We could apply that to any arena where emotions come into play and get the best of people, and find ways to stop it. The fact is, we will never reach perfect rationality, but we can do much better.

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**Men are consistently more overconfident than women in their predictions, particularly when they relate to finance.**

follow suit. If they fail to follow the herd, they risk trailing behind their peers; however, if they follow the herd, they may get caught on the wrong side of an artificially-attractive opportunity.

**LOSS AVERSION AND THE DISPOSITION EFFECT.** According to **Daniel Kahneman** and the late **Amos Tversky**, investors treat the gains and losses in their portfolio very differently. *Loss aversion*, which comes from Prospect Theory, suggests that managers significantly overweight losses compared to an equivalent gain. This behaviour results in the *disposition effect*, whereby professionals recommend selling securities to lock in gains too quickly, and recommend retaining securities too long in order to recoup losses. These finance professionals may exhibit both behaviours in monitoring a single security in a portfolio.

**GENDER DIFFERENCES.** Although women represent only nine per cent of portfolio fund managers, mutual funds managed by female portfolio managers perform in line with those managed by men. Interestingly, funds with mixed gender teams of both male and female portfolio managers exhibit superior performance. Although both genders can display overconfidence in their abilities, research shows that men are consistently more overconfident than women in their predictions, particularly when related to finance.

**CONFIRMATION BIAS.** This bias causes analysts to *overweight* information that confirms their prior beliefs and to *underweight* information that runs counter to their prior beliefs. The result: Recommendations may be based on previous choices.

**OVER-OPTIMISM.** Empirical research finds that individuals can be excessively optimistic in both their earnings forecasts and stock recommendations. One study found that management actually *prefers* optimistic forecasts, because they increase market valuations and therefore management compensation. In support of this belief, researchers found that sell recommendations comprise only six per cent of their sample of recommendations, whereas buy- and-hold recommendations comprise the remaining 94 per cent.

### Biases for Institutional Investors

Institutional investors are professional investors working for insurance companies, banks, pension funds, endowment funds, mutual funds and hedge funds. Evidence indicates that these sophisticated investors are less subject to some of the more common behavioural biases discussed thus far; however, they can still be affected by the following biases.

**HERDING BEHAVIOUR.** Like analysts and portfolio managers, institutional investors can display a propensity to herd or follow each other's trades. If herding is irrational or driven by behavioural motivations such as fads, greed, fear or reputational concerns, it can de-stabilize asset prices and move them away from their fundamental values. Conversely, herding behaviour can be rational and information-based. If so, it can lead to more efficient markets and/or to higher risk-adjusted returns to investors.

Two reasons largely explain why institutional investors engage in herding behaviour. First, they infer information from each other's trades. Second, they analyze similar information and draw the same conclusions about the fair value of specific securities. Hence, herding by these individuals tends to be unintentional and information-driven. In one study, researchers concluded that herding by institutional investors, in general, appears to be price stabilizing rather than price destabilizing.

**UNDER-DIVERSIFICATION DUE TO OVERCONFIDENCE AND FAMILIARITY BIAS.** Although Portfolio Theory indicates that investors should hold diversified portfolios, institutional investors do not always

**If herding is irrational or driven by behavioural motivations such as greed, it can de-stabilize asset prices.**

do so. Instead, they often exhibit *home bias*, which is the tendency to invest mainly in domestic equities, despite the purported benefits of diversifying into foreign equities. Various behavioural attributes might explain the irrationality of overweighting in domestic markets, including overconfidence, optimism and familiarity. Overconfident investors overestimate the accuracy of their private information, judgment and intuition; those with optimism bias believe that they are less at risk of experiencing a negative event compared to others; and those with familiarity bias trade in the securities with which they are familiar. All three biases can lead to underestimating the amount of risk in the investment and thus not taking the requisite steps to reduce risk, such as diversifying.

However, under-diversification can also be a rational strategy driven by information advantage. If this is the case, under-diversification should not lead to deteriorating performance. One recent study found that under-diversified positions earn higher risk-adjusted returns than globally-diversified portfolios; and another study found that institutional investors, especially in the realm of mutual funds, actually outperform when holding locally-concentrated portfolios. Thus, under-diversification generally tends to be a rational, not a biased choice for institutional investors.

**MOMENTUM TRADING.** This refers to an investment strategy that tries to benefit from the continuance of existing market trends. Although all types of institutions engage in momentum trading, evidence shows that they do not do so because of greed, fear, overconfidence, or representativeness bias, but for fundamental reasons. A 2017 study concluded that using a 'momentum strategy' is actually value-generating, because institutional investors appear to buy past winners. Moreover, they are less subject in general to behavioural biases and generally contribute to making markets more efficient.

## In closing

Behavioural biases can dramatically affect the behaviour of all types of finance professionals. But the evidence reveals that as investor sophistication increases from individual investor through to institutional investor, the biases displayed do in fact decrease — and some even disappear. Regardless of their current role, Finance professionals across the board can benefit from familiarizing themselves with all of the potential biases described herein. ***RM***



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