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RealLifeFinance

Real Topics

Beating Behavioral Biases With Smart Portfolio Structure

The theory of behavioral finance states that investors bring psychological and behavioral biases to their financial decisions that create disparities between the fair value of financial assets and their actual prices. With a disciplined portfolio structure as a blueprint and an informed, objective financial advisor as a partner, it's possible for investors not only to avoid these biases in their own portfolios, but also to profit from the sometimes irrational actions of their fellow investors.

While textbook descriptions of Modern Portfolio Theory seem cut and dried, the body of knowledge referred to as behavioral finance argues that in reality, investors are human beings who are subject to emotions and prone to making systematic errors. Normal behavioral tendencies often cause investors to make decisions on a case-by-case basis rather than within a portfolio decision-making framework, for example. They also can cause investors to be risk-*seeking* rather than risk-averse. These behavioral tendencies often affect the buy and sell decisions of investors in such a way that adversely affects their wealth.

According to Meir Statman, a behavioral finance specialist and professor at the Leavey School of Business at Santa Clara University, investors have never been "rational" as defined by standard finance. Rational investors care only about the risk and expected return of their overall portfolio. Instead, Statman argues, investors are "normal", meaning that they are affected by cognitive biases and emotions.

The good news about behavioral finance is that, if in fact investors tend to make the same mistakes year after year due to certain well understood cognitive biases, we as advisors can both identify these common judgment errors and also help investors avoid making them in the future. In the sections that follow, we will outline some common behavioral biases that can divert investors from their long-term financial goals. We'll then look at what we at Gerstein Fisher do every day on behalf of our clients to design portfolios that are effectively "bias-proof" and can even profit from the errors in judgment made by others in the marketplace.

The Mistakes Every Investor Has Made: Common Behavioral Biases Defined

Overconfidence: Overconfident investors think they have better information than their fellow investors. They are also overly certain of their ability to control outcomes. This often leads to an underestimation of the risks associated with their investments, and also to more frequent trading (and hence commissions and possibly capital gains) because they think the information they have is so good. To understand how prevalent overconfidence is, consider this: how many people, if asked if they were an average or an above-average driver, would answer "average"?

Regret and Pride: We all experience pain or regret after making a bad decision, and often feel joy and pride when we make a good one. Unfortunately, these behavioral tendencies interfere with sound investment judgment more often than not. The fear of regret often leads investors to hold on to a losing stock for too long in the hopes that its price will return to at least its purchase level so it can be sold without regret. Conversely, many investors sell strong performers too early, eager for the "bragging rights" associated with having picked a winner. What they forget is that those bragging rights often bring capital gains along with them, particularly if they are loath to sell any losers to offset those gains. Another manifestation of the regret bias is the "snake bite" effect, where an investor has a bad experience with an investment that leads him to become overly conservative in his investment decisions going forward, negatively impacting his return potential.

Familiarity: It shouldn't be surprising that investors tend to tilt their portfolios in favor of companies with which they are most familiar: it just makes them feel more comfortable. Yet consider the familiar scenario in which investors place their retirement savings almost exclusively in their employer's stock. Suddenly both their salary and their retirement portfolio are entirely dependent on the success of a single company. This outcome is clearly not desirable from a diversification standpoint. We have found that familiarity is often the culprit behind many portfolios that are not sufficiently diversified.

Mental Accounting: Perhaps the most prevalent behavioral bias we come across in working with clients, mental accounting refers to the brain's tendency to classify activities into separate categories or accounts (i.e. winning investments, losing investments, my safe account, my risky account, etc.). Treating each of these components of an overall portfolio independently ignores important interrelationships (particularly correlations) and can reduce an investor's risk-adjusted wealth.

The Endowment Effect: Also referred to as the "do nothing" effect, this refers to investors' tendency to place a higher value on what they own than on what they do not own. Making decisions with a preference to holding on to original investments (regardless of changes in their risk and return characteristics) leads to inertia and eventually, a portfolio that has drifted significantly from its original asset allocation policy.

Cleaning the Lens: Tips for Avoiding the Emotional Pitfalls of Investing

At Gerstein Fisher, we have found a number of strategies and tactics that work to combat the common cognitive biases discussed above:

Acknowledge What Really Matters

We spend a great deal of time with our clients trying to cultivate realistic attitudes about the ability of any investor to consistently earn outsized returns through such activities as searching for improperly valued securities. Instead, we focus our time on more important issues like portfolio structure (asset allocation), diversification, and expense control. Not only are these areas over which we have much greater control, but we have found that they also have a considerably greater impact on portfolio performance in the long run.

Start With Structure

To be successful over time, any investment plan should recognize an investor's financial objectives and constraints, including his or her financial and psychological capacity for assuming risk; the investor's time horizon; and any near- or long-term cash needs. At Gerstein Fisher, we look at all of these pieces before putting in place a portfolio structure to meet these needs. We also take into account the need for appropriate diversification and can provide it when it is lacking, for example due to the familiarity bias discussed earlier. In addition, we will keep an eye on trading and related expenses, ensuring that trades are justified within the context of the client's long-term objectives. This helps combat overconfidence and regret and pride.

Stay the Course

While we recognize that a thoughtfully planned portfolio structure offers the greatest likelihood of meeting an investor's long-term objectives, maintaining this structure often requires selling assets that are performing well and purchasing lower-performing assets – a psychologically difficult thing for many investors to do. By taking ownership of portfolio structure and doing what needs to be done to keep it in line, we as advisors are able to relieve what can be an emotional burden for our clients.

See the Big Picture

Finally, the fact that we take a 360-degree view of each client's total financial picture means we can avoid the mental accounting traps that many investors fall into regularly. By aggregating all of the components of a client's "wealth picture" (portfolio assets, real estate, charitable activities, etc.) in a way that accounts for interrelationships between them, we can create a cohesive whole that is far more likely to meet the investor's overall objectives.

Conclusion

According to behavioral finance, investors are not "rational," as they are presumed to be in standard financial theory, but rather "normal" and therefore subject to normal behavioral biases that can cloud their investment judgment and lead to sub-optimal results. Yet acknowledging and understanding these biases opens the door to overcoming them. At Gerstein Fisher, we believe the best defense against behavioral biases is a disciplined portfolio structure that is continually revisited to ensure its appropriateness for an investor's long-term goals. And as independent financial advisors, we can offer the discipline and objectivity to help our clients "do the rational thing" – at least when it comes to their investments.

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