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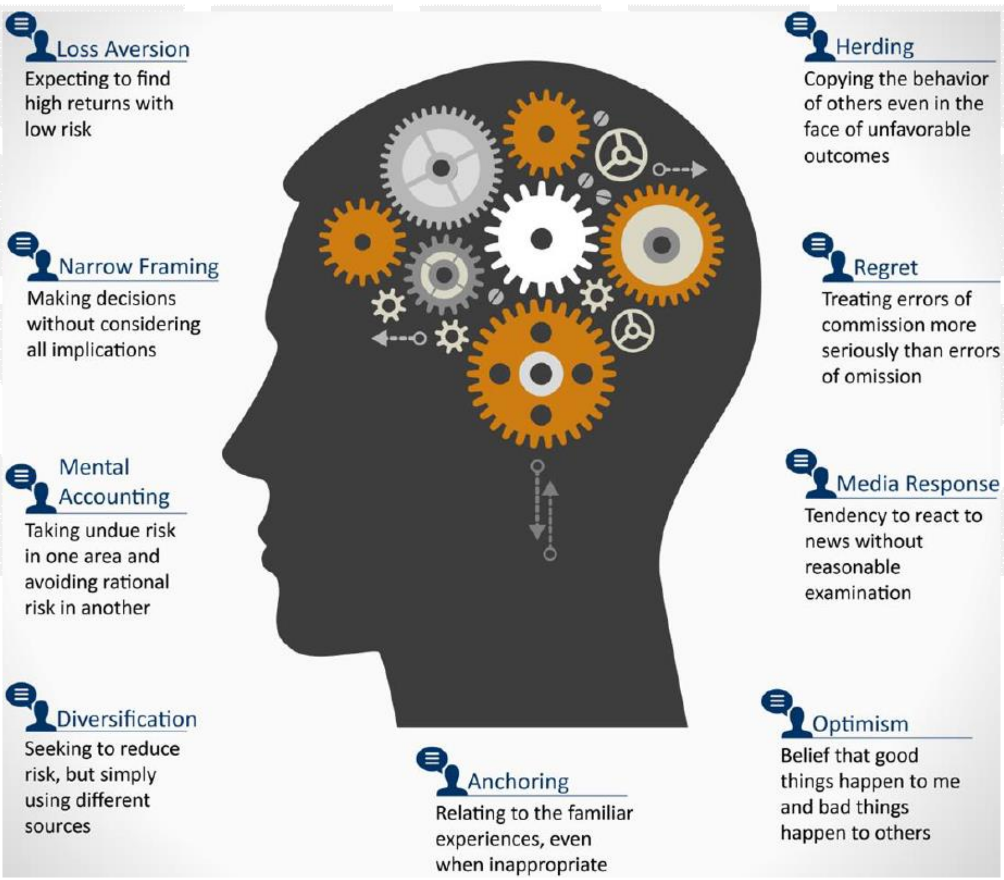
Nine behavioral biases

A satisfying life-long investment journey is far more easily and dependably attained, than is generally appreciated. Comfort, confidence, and peace of mind are all there for the asking. But several ingredients must be brought to the table, and remain there, for those bountiful life-long financial goals to be achieved.

Two ingredients are of particular note . . . as developments over the last year have caused some investors to forget that these ingredients must remain on the table, front and center:

- Understanding the inherent behavior of investment markets . . . so that one is never surprised
- Behavioral biases that serve to undermine and corrupt productive investment decision-making

In this edition of ***Investment Perspectives***, I'm briefly touching upon the second of these two necessary ingredients. Being good human beings, we all suffer from a host of behavior biases. These are the thought-patterns that cause us to make flawed and incorrect decisions. Behavioral bias disrupts all human endeavors, but here I'm restricting my comments to the nine that most frequently destroy a successful investment outcome. The following exhibit identifies the nine.



Today's - three most troublesome biases

All nine of these behavior biases are at times remarkably troublesome. A successful life-long financial journey requires that they're all kept firmly locked up. But occasionally, they escape, and when present, serve to undermine what would otherwise be a dependable results-oriented investment process, one designed to satisfy all future financial needs. Today's events have caused three in particular to become troublesome: Loss aversion, Narrow framing, and Media response.

Loss aversion

Humans don't like living in an uncertain world, even if embracing uncertainty leads to tremendous gain. We feel the pain of loss more than the joy of gains. People tend to feel the pain of a loss twice as intensely as the joy of an equivalent gain. This behavioral bias (dysfunction) often leads to panic selling. Essentially, we prefer avoiding losses over realizing gains and therefore are irrational about the tradeoffs between risk, return, and investment time period.

The loss aversion behavioral bias is often triggered or exacerbated by volatility, a market correction, or general fear of what the future might bring.

Investors who suffer most severely from this behavioral flaw can be seen *"moving to cash"* or just *"reducing their stock allocations"* as news flows in about Ukraine, inflation, societal breakdown, China, and interest rates . . . and as they observe how their investment accounts haven't earned a profit over the last nine or ten months. Such reactions are not rational, and instead are being driven by excessive emphasis on loss avoidance.

Narrow framing

Humans are more comfortable when their existing beliefs are confirmed as opposed to being challenged. Individuals generally don't enjoy considering information or perspectives that would cause them to draw different conclusions and take different actions. This behavioral bias is called *"narrow framing."* At times it is more pronounced than at others, but is today one of the most commonly found destructive behaviors. Of the nine biases noted in the graphic above, it also has the greatest association with ageing. It grows more intense and troublesome as one ages. Thus, the phrase, *"You can't teach an old dog new tricks."*

Those suffering from narrow framing access only a small portion of the available information. They hear only those sources that confirm their already existing fears, perspectives, and recent experiences. But worse yet, they tend to reject or ignore conflicting views. As a result, they make decisions without considering all available information . . . and the associated implications.

The narrow framing behavioral bias is often triggered or exacerbated when the *"nature of change"* experiences a phase-shift . . . from the normal and near-universal ***"speed or pace of change,"*** to the rare and exceptional ***"directional change."*** Something we are experiencing today, as the world around us changes to a degree not experienced since the WWII era.

Investors who suffer most severely from this behavioral flaw can be seen sticking with fixed-weight, Buy & Hold portfolios with a heavy overweight to the U.S., and an orientation towards growth.

Such actions are not rational and result from consideration of only a very narrow slice of the available information - only that information that serves to reconfirm their prior actions and outdated conclusions. They are living in the past and are refusing to consider information that would allow them to evolve in tandem and alignment with the world around them.

Media response

Humans often react to news media without adequate examination. We tend to overestimate the importance and even its veracity. We generally overvalue a new trend or idea as popularized in the news. For example: innovation stocks, crypto currencies, how many times the Fed will raise rates in 2022, or the latest CPI (Consumer Price Inflation) number. People allow the irrelevant and unimportant to displace the relevant and mission critical.

The media response behavioral bias is often triggered or exacerbated by undue attention to popular news sources.

The current era has often been labeled ***"The age of information."*** A more useful and accurate title would be ***"The age of disinformation,"*** as the proportion of *"news"* that is inherently false, misleading, or irrelevant, continues to grow. For example, from that standpoint of you comfortably and confidently achieving all of your life-long financial goals:

- Does it really matter whether the . . . Fed hikes interest rates two times or seven times in 2022?
- Does it really matter that . . . stock market volatility has risen, simply returning to its historical norm?
- Just because inflation is up, the federal budget deficit is growing, supply chains remain broken, and a new COVID variant is about to arrive . . . have investment opportunities really been meaningfully diminished or risks exacerbated?

Investors who suffer most severely from this behavioral flaw can be seen investing in crypto, selling everything and moving into cash if their political party fails to win the election, loading up on commodities or gold, or demanding that their financial advisor buy the latest media-hyped innovation stocks.

Conclusion

Investment professionals understand these issues well . . . and recognize that in today's market, planning, structure, patience, engagement, and humility are the critical building blocks of a successful journey. Or to put it differently, behavioral bias must be securely locked inside the cage, and serious/genuine experience and training must be brought to bear.

Your financial advisor has a menu of possible investment solutions that are directly relevant to these perils. But the solution that is most appropriate to your unique needs and circumstances can only grow out of a meaningful discussion with your advisor. Reach out to them, talk with your advisor.

Rob Brown, CFA, PhD
Chief Investment Officer
Senior Vice President
Integrated Financial Partners, Inc.
Integrated Wealth Concepts, LLC

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Integrated Financial Partners, Inc.
200 Fifth Avenue, Suite 4010 • Waltham, MA 02451
Phone 781-890-3045 • Website https://integrated-partners.com/