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ISSUE 1 | VOLUME 3 | JULY 2014

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Think and Grow Dumb: How Our Prehistoric Brains Sabotage Our Investing

It is impossible to identify a point in history as the moment the human brain started evolving because the process started millions of years ago. It is safe to say, however, that for the majority of the human brain's existence it has been used for very practical purposes. Is that a deer? Throw a spear at it. Is that a bear? Run! It has been estimated the concepts of interest and insurance are about 5,000 years old, and if we accept that the first early human-like brains appeared around 2.4 million years ago, then our brains have been dealing with abstract investment concepts for only about 0.2% of their existence. Is it really surprising, then, that we may be our own worst enemies when it comes to investing some times? We are using very old hardware and software.

What used to be successful in the hunter-gatherer times, like safety in numbers and pattern identification, can get us into trouble when it comes to investing. Consider a few of the tendencies our brains have:

Herd Instinct: A tendency where people feel safer thinking and acting in the same way as the majority of those around them. Herd instinct is the primary cause of bubbles in finance. For example, many look at the dotcom bubble of the late 1990s and runaway real estate prices in the mid 2000s as prime examples of the ramifications of herd instinct in the development of those industries' speculative bubbles. The fear of regret of missing out on a good investment is often a driving force behind herd instinct as well, not just the feeling of safety in numbers.

Familiarity Bias: A mentality where people underestimate the amount of risk present in familiar situations. In investing, this mindset causes people to under-diversify their holdings, either by overweighting investments in their home countries or by causing them to overweight their exposure to their own company's stock. People are under the mistaken impression that because they are familiar with an investment, they will somehow be able to spot trouble in enough time to get out of the way. Being familiar with something does not mean less risk, yet many investors believe it does.

Framing: The tendency to view a scenario differently depending on how it is presented. An example of frame dependence is when presented with a scenario in which a sweater is being offered at its full price of $50 and a scenario in which the same sweater is regularly priced at $75 but on sale for $50, many

consumers would perceive the latter as a better value even though in both situations they are being asked to pay the same price for the same sweater. Thus a real-life application of frame dependence is the use of strategic pricing by retail stores to influence consumers' purchasing behavior. Similarly, investors will frequently assess the value of an investment based purely on how the investment's price compares to that investment's price at a different point in time, completely ignoring the underlying fundamentals of the investment. Apple must be a good deal at $500 per share if it used to be $700 per share, right? When we get investment gains for several years in a row, especially big ones, the natural inclination is to envision how much we'd have after similar or even bigger gains. "What will my portfolio be worth if it grows another 20% this year" can lead investors to stray from their strategies, instead of if they asked themselves what their portfolio would look like if it lost 20% instead. How people frame their "what-if" scenarios has been proven to influence behavior.

Recency Bias: In its simplest form, recency bias presents itself as the belief that what has happened recently is going to continue. In investing terms, recency bias is where investors evaluate their portfolio performance based on recent results or on their perspective of recent results and make conclusions about how financial markets will behave in the future. However, a straight line extrapolation (where a short-term trend is believed to continue far into the future) is fraught with risk because unforeseeable factors almost always intervene.

Frequently after large or long market moves, either up or down, people begin to question their strategies. Some of this questioning could be periodic strategic and tactical analysis like we perform for our clients, but a lot of it is undeniably emotional, knee-jerk and poorly conceptualized due to the tendencies we mentioned previously. Consider some of the questions investors are asking themselves after 5 years of positive S&P 500 returns punctuated by last year's 30% increase:

Did my investments make enough? When the news is ablaze with runaway stock market hysteria, it is difficult to know what your own investments should have done. Moderate and conservative diversified portfolios did not return anywhere near what the stock market did last year, and portfolios with little to no stock market exposure had a bad year. This feeling that you're not keeping up with what other people may be doing is an example of both the herding instinct ("Everyone else seems to be making a killing!") as well as framing ("Why am I only up X when the Market is up 30%?"). It is difficult for your frame of reference to be something other than the stock market given how much that one particular financial market is handled by the media, when instead your frame of reference should be influenced by a multitude of things. How much risk are you willing to take? What would you expect your portfolio to do in bad stock market environments? Are you on track toward achieving your goals? Additionally, it can seem like everyone else in the world is taking advantage of a runaway market when in fact most people with diversified portfolios are performing similarly. Only those risking large losses can be the ones to achieve large short-term gains and it's funny how they never want to talk about their large losses.

Why did my X investment lose money last year when the stock market was up so much? Most investment categories actually lost money in 2013, especially those designed to reduce portfolio risk. This was very difficult for people to see, though, as all the news was about the stock market. This feeling that one particular investment is under-performing based on what completely different investments are doing is another example of framing. Individual investments in a diversified portfolio are frequently going to look good or bad when compared to another individual investment, but their role is to participate in the long-term returns and risk profile of a diversified portfolio. Some investments are in portfolios precisely to do well when the stock market has a bad year, and it is expected they will not have a particularly good year when the stock market goes crazy. They should be judged not by what they return relative to the stock market, but by how their returns compare to similar investments, and by what impact they have on a portfolio's risk level as well as returns.

Should I get more aggressive? One of the most common urges investors have when an investment category, be it the S&P 500, tech stocks, real estate, gold, etc., goes on an impressive multi-year run of eye catching returns is to increase their exposure to that category. There are a number of invest-

ment tendencies at work in this case. One of them is the herding instinct, as it feels like many other people are enjoying the benefits of having a large exposure to that investment and it's easy to feel left out. Another tendency at work is framing, which in the case of big stock market returns makes it easy for investors to focus only on the past returns and ignore that there are risks, and potentially high risks, involved. The last tendency we'll point out is the recency bias. When any investment has increased with little to no major downward moves, investors have a tendency to assume it will keep going up just because it has been going up. Their belief in what will happen in the future is shaped by what has happened in the recent past, making it difficult for them to accurately gauge the risk of committing more assets to that (usually) risky position.

Why should I reduce my exposure to an investment I like/know well/have owned a long time? Investors frequently feel either too safe or believe too much in the earning potential of an investment with which they're familiar, like US as opposed to foreign stocks, or the stock of a company for which they currently or used to work. There are uncountable examples in both the investing and non-investing worlds of the familiarity bias. The problem it causes most often in investing is to overweight an investor's allocation to a specific investment thereby increasing their overall risk. Many people are familiar with the Enron scandal and how more than 60% of the company's 401(k) value was in Enron stock. At that same time, GE's 401(k) was 77% GE stock, and Procter & Gamble's was a whopping 95%! Everyone knows what happened to Enron, but GE stock was down 62% and 83% the past two stock market crashes, and P&G's was down 54% and 38%. Overloading on company stock is an extreme example of familiarity bias, but it can also happen in just about every investment category. It may already seem like ancient history, but the mid 2000s will forever be remembered for the frenzy of real estate activity, from people refinancing second and third properties to come up with down payments to purchase more, to people who moonlighted at night throwing tens of thousands of dollars of Home Depot purchases into fixer uppers just to flip them for a profit before moving on to the next. When it seems like you can't lose money, it's time to get nervous.

Our brains may have been originally designed to help us spear wild boar and worship the moon, but being aware of these tendencies can keep us from systematically reducing our returns over time by accidentally increasing our risks. Investing is inherently risky, which is what gives us the potential for gain. We don't have to let these tendencies increase those risks beyond what we can survive. Investment strategies should be designed to deliver a medium to long term return with a tolerable level of risk, and any changes to those strategies should be rational and uninfluenced by what other people are doing, short term investment performances, or apples to oranges comparisons. We know enough to not look for deer in a bear cave, and when we finally see risk and not safety in runaway investment markets, we'll know we've truly evolved as investors.

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