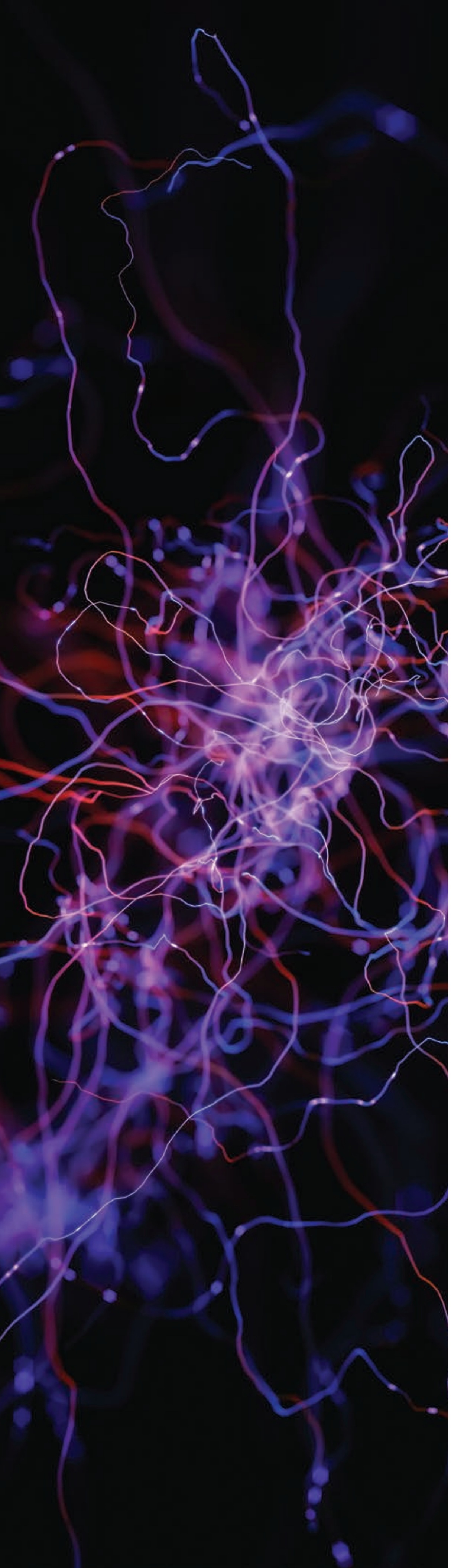

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Understanding Tactics to Overcome Heuristics and Biases

Overconfidence Bias

People often overestimate their ability to predict the market. The client may believe they can accurately predict when to exit the equity market before a major correction.

1. Information Accessibility[1]

Nudge: Make it difficult for investors to think of supporting reasons to sell.

Example: Ask the investor if they can name the top 10 artists of all time or the top 10 movies or the top 10 songs, or if a sports fan, the top 10 athletes. The investor will typically respond that they can. The advisor follows up with the observation that coming up with this list for the investor was not a problem. The advisor then asks, “Name the top 10 market timers of all time.” The typical response is silence. The follow up question, “Well, name the top 5.” Again, the investor does not respond. The advisor concludes with “Name one-top market timer.” With a final no response, the advisor has clearly made their point.[2]

Why it works: When knowledge of a topic is moderately accessible, judgements are based on retrieval ease. The harder it is to think of supporting reasons the less convincing the initial argument. Because the investor will likely draw a complete blank, they are likely to reconsider whether to engage in market timing.

[1] Tybout, Sternthal, Malaviya et al. (2005)
[2] Barker, Filbeck & Ricciardi (2017)

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2. Reframing Positive Outcomes

Nudge: Since the investor is likely to discount what the advisor says, reframe a potential negative result by placing the control in the investors hands.

Example 1: The advisor says to the investor, “That sounds like a very exciting investment, but I am unfamiliar with that investment. Tell me more about it.” This allows the investor to share their excitement of a new investment. The advisor then follows up with, “As I said, I am unfamiliar with that investment, so I was wondering what might go wrong?” The investor is then triggered to think about the investment risk.[2]

Example 2: The advisor says to the investor, “Your idea sounds like a very exciting and potentially rewarding one, so I updated your financial plan to see what an investment might do for you. I found that if successful, you can retire in a few years. However, if it fails, I estimate that you would have to continue working two years past your current planned retirement date.”[2]

Why does it work? People tend to make poor decisions when they are in a ‘hot state.’ They often approach investors anxious to buy an investment recommended by a neighbour, family member, friend or based on a story in the media. Reframing an investor’s focus from the expected positive outcome to the potential negative result, helps investors make rational decisions.

3. Pre-commitment[3]

Nudge: Encourage investors to set goals and make a plan in advance of a market crash, or before they look at their portfolio performance.

Example: The investor writes, “In the event of a market crash, I will sell [X number of S&P shares].”

Why does it work? People feel mental discomfort when they hold two contradictory beliefs. This phenomenon is known in psychology as cognitive dissonance and is triggered by situations where a person’s current belief (like selling now) contradicts with prior evidence (a written statement to not sell). Through reminding investors of a stated or written plan that they committed to earlier on, investors will be more likely to follow through on their plan to avoid this cognitive dissonance.

[2] Barker, Filbeck & Ricciardi (2017)
[3] Benartzi, S., & Thaler, R. (2007)
[4] Thaler (1990)
[5] Ariely, D. (2018) Internal IP
[6] Tversky & Kahneman (1980)

Loss Aversion Bias

People tend to feel market losses as 2x more painful than equivalent market gains.

1. Mental Accounting[4]

Nudge: Before a crisis erupts, create a mental investment account associated with selling during volatile times.

Example: Investors portfolio is divided into 2 mental accounts titled for their function. An emergency account for short-term savings is associated with selling, as it covers 1-2 years of spending, while a growth account is associated with longer-term savings.

Why does it work? People categorize their money into different accounts depending on their intended use. Therefore, if only one account is mentally associated with selling it will be the only account considered during a market downturn.

2.Long-term goal framing[5]

Nudge: Encourage less account checking by using rules of thumb, or by making it more difficult for them to check their account frequently.

Example 1: Tell investors that they should check their accounts as often as they go to the dentist.

Example 2: 3x per day maximum account checking before account lock-out or the client needs to answer some financial education questions each time they log into their account to check the status of their portfolio.

Why does it work? Encouraging investors to look at their portfolio performance less often or in its entirety, reduces the granularity people take in assessing their investments. As such, this encourages investors to look at trends over time, decreasing the anxiety and subsequent poor decisions they would face if they looked daily.

3. Loss framing[6]

Nudge: Discuss foregone gains as lost income

Example: By selling now, you will lose [x] dollars

Why does it work? People do not like to lose things. In fact, often times people will take active steps in order to ensure they avoid a loss. By framing foregone gains as a loss, people are more likely to not sell.

Representativeness Bias

People tend to believe that current performance is representative of future performance.

1. Future-Self

Nudge: Bring investors future-self closer to their present-self.

Example: Ask the investor questions that will prime their future self, including

- Tell me what you will be doing in 10 years with this money
- How would you feel if you sold too early and lost out on market recovery?
- Would you be surprised to learn that people who held their investments during the 2008 crisis saw a 26.5% gain the next year?

Why does it work? When making decisions about money, people are estranged from their future selves. Perceiving someone's future self as closer to their present self, motivates future thinking and decision making. Therefore, investors are more likely to take into consideration their future needs and make investment decisions in the present that will support those needs.

2. Explicit Emotion Priming

Nudge: Ask investors to acknowledge their negative emotions

Example 1: Advisors should profile investors and identify the sub-group of investors that are most likely to be loss averse. Once identifying this group, advisors should send a reassuring email after every significant market move.

Example 2: Advisors should ask investors, "What scares you the most about the economy right now?" The investor will likely start listing off all of the reasons. The advisor should follow up with asking the investor, "How does this make you feel?"

Why does it work? When people acknowledge a negative emotion, or are aware of it, they are better able to inhibit the emotion and therefore their estimates of the likelihood of future negative events are tempered.

3. Balanced Perspective

Nudge: Ask clients to list all the reasons they might hold onto their investments and all the reasons why they might sell.

Example: Advisors should ask investors, "Can you give me 5 reasons why you would sell? Now name 5 reasons why you should hold onto your investments"

Why does it work? When people put effort into considering a contrary view, their effort makes those ideas more available in their memory and they are more likely to consider the contrary position as being true. There is also an element of self-serving bias whereby the investor would consider that the contrary arguments might be true since they were the ones who substantiated support for the contrary viewpoint.

Illusion of Control Bias

1. Enhanced active choice

Nudge: Create the perception of a choice to increase the belief that the investor has taken matters into their own hands.

Example: Advisors should pose a question to investors that subliminally favours one option over another. If an investor expresses a need to sell, the advisor should ask the following question, "How would you like to take advantage of the market? Option 1 is to maintain your investment. Option 2 is to increase it." The investor might ask why they only have two options. The advisor can respond with, "There is a third option, but if you change your investments now, you miss out on your opportunity for future returns."

Why does it work? Questions that are phrased as an enhanced active choice provide investors with a sense of control over their decisions while simultaneously nudging them toward one option over the another. In doing this, investors feel a sense of control over their investments.

2. Priming self-consistency

Nudge: Outline the inconsistency in the investor's current beliefs and prior actions.

Example: The advisor should trigger cognitive dissonance with the investor by saying, "You're such a smart investor and you have made such good decisions up to this point. You put all this effort to plan and create this portfolio, why would you second guess yourself now?"

Why does it work? People like to maintain their self-concept. By highlighting the amount of effort investors have placed in selecting their portfolio and how this decision does not reflect smart investing, they are more likely to reconsider their actions.

3. Control the environment

Nudge: Have investors pick one day per month or one per quarter to review their account.

Example: How about we set [x date] to view your portfolio?

Why does it work? Having investors pre-commit to an action is a mechanism to overcome impulsive actions, like selling, that may be triggered by volatile markets. By setting a goal to only look at one's portfolio on certain dates it is more likely investors will limit the number of times they check their account.

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