STEWARD

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The ABCs of Behavioral Biases: Conclusion

We'll wrap up our series, *The ABCs of Behavioral Biases*, by repeating our initial premise:

Your own behavioral biases are often the greatest threat to your financial well-being.

We hope we've demonstrated the many ways this single statement can play out, and how often our survival-mode brains trick us into making financial calls that foil our own best interests.

Evidence-Based Behavioral Finance

But don't take our word for it. Just as we turn to robust academic evidence to guide our disciplined investment strategy, so too do we turn to the work of behavioral finance scholars, to understand and employ effective defenses against our most aggressive behavioral biases.

If there weren't so much damage done, behavioral finance might be of merely academic interest. But given how often—and in how many ways your fight-or-flight instincts collide with your rational investment plans, it's worth being aware of the tell-tale signs, so you can detect when a behavioral bias may be running roughshod over your higher reasoning. To help with that, we included a summary of the biases we've covered throughout this series on the back of the newsletter.

Next Steps: Think Slow

Even once you're familiar with the behavioral biases that stand between you and clear-headed thinking, you'll probably still be routinely tempted to react to the fear, greed, doubt, recklessness and similar hot emotions they generate.

Nobel laureate Daniel Kahneman helps us understand why in his book, *Thinking, Fast and Slow*, where he describes how we engage in System 1 (fast) and System 2 (slow) thinking: "In the picture that emerges from recent research, the intuitive System 1 is more influential than your experience tells you, and it is the secret author of many of the choices and judgments you make."

In other words, we can't help ourselves. When we think fast, our instincts tend to run the show; for better or worse, they're the first thoughts that come to mind.

This is one reason an objective advisor can be such a critical ally, helping you move past your System 1 thinking into more deliberate decision-making for your long-term goals. On the flip side, financial providers who are themselves fixated on picking hot stocks or timing the market on your behalf are more likely to exacerbate than alleviate your most dangerous biases.

Investors of "Ordinary Intelligence"

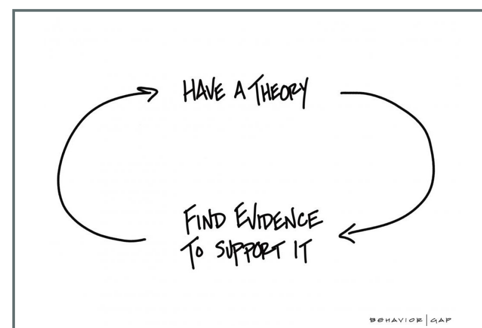
Berkshire Hathaway Chairman and CEO Warren Buffett is a businessman, not a behavioral economist. But he does have a way with words. We'll wrap up with a bit of his timeless wisdom:

"Success in investing doesn't correlate with I.Q. once you're above the level of 25. Once you have ordinary intelligence, what you need is the temperament to control the urges that get other people into trouble in investing."

If you can remember this cool-headed thinking the next time you're tempted to act on your investment instincts, Mr. Buffett's got nothing on you (except perhaps a few billion dollars). But if you could use some help managing the behavioral biases that are likely lurking in your blind spot, give us a call. In combatting that which you cannot see, two views are better than one.

Until then, no regrets!

David Bromelkamp
President and CEO



> *Where returns are concerned, time is your friend. But where costs are concerned, time is your enemy.*
>
> — John C. Bogle, Founder, Vanguard

Headlines

- We had a wonderful time with clients, friends, and colleagues at the Allodium 2019 Wealth Management Workshop called Travel Tips for Money Savvy Adventures. Maria Flynn Conway of Celtic Journeys was the speaker.
- Dave Bromelkamp spoke at the Becketwood Cooperative on April 25. The topic was Socially Responsible Investing (SRI).
- Eric Hutchens was a speaker at the Markets Group 4th Annual Private Wealth Central States Forum on April 2, at the Hyatt Regency.
- Allodium was pleased to welcome six new clients into the firm during the first quarter of 2019.
- Our office will be closed July 4 and September 2 for company holidays.
- ***Note:*** To find out more about Allodium's breaking news, please visit our website: www.allodium.com.

WE APPRECIATE YOUR INTRODUCTIONS

To optimize our objectivity and avoid conflicts of interest, we are a fee-only registered investment advisor that is completely independent from banks, brokerage firms and other financial product providers. If you know someone who may be looking for this type of objective investment advice, please contact Dave Bromelkamp at 612-230-3702 or dbromelkamp@allodium.com to arrange a friendly, no-obligation introduction.

Steward is published quarterly by Allodium Investment Consultants. Please contact Ilona Avraamides at 612-230-3711 or iavraamides@allodium.com if you have any comments about this publication or wish to be added to or removed from our mailing list.

Behavioral Biases Chart

The Bias	Its Symptoms	The Damage Done
Anchoring	Going down with the proverbial ship by fixing on rules of thumb or references that don't serve your best interests.	"I paid $11/share for this stock and now it's only worth $9. I won't sell it until I've broken even."
Blind Spot	The mirror might lie after all. We can assess others' behavioral biases, but we often remain blind to our own.	"We are often confident even when we are wrong, and an objective observer is more likely to detect our errors than we are." (Daniel Kahneman)
Confirmation	This "I thought so" bias causes you to seek news that supports your beliefs and ignore conflicting evidence.	After forming initial reactions, we'll ignore new facts and find false affirmations to justify our chosen course…even if it would be in our best financial interest to consider a change.
Familiarity	Familiarity breeds complacency. We forget that "familiar" doesn't always mean "safer" or "better."	By overconcentrating in familiar assets (domestic vs. foreign, or a company stock) you decrease global diversification and increase your exposure to unnecessary market risks.
Fear	Financial fear is that "Get me out, NOW" panic we feel whenever the markets turn brutal.	"We'd never buy a shirt for full price then be O.K. returning it in exchange for the sale price. 'Scary' markets convince people this unequal exchange makes sense." (Carl Richards)
Framing	Six of one or half a dozen of another? Different ways of considering the same information can lead to illogically different conclusions.	Narrow framing can trick you into chasing or fleeing individual holdings, instead of managing everything you hold within the greater framework of your total portfolio.
Greed	Excitement is an investor's enemy (to paraphrase Warren Buffett.)	You can get burned in high-flying markets if you forget what really counts: managing risks, controlling costs and sticking to your plan.
Herd Mentality	"If everyone jumped off a bridge …" Your mother was right. Even if "everyone is doing it," that doesn't mean you should.	Herd mentality intensifies our greedy or fearful financial reactions to the random events that generated the excitement to begin with.
Hindsight	"I knew it all along" (even if you didn't). When your hindsight isn't 20/20, your brain may subtly shift it until it is.	If you trust your "gut" instead of a disciplined investment strategy, you may be hitching your financial future to a skewed view of the past.
Loss Aversion	No pain is even better than a gain. We humans are hardwired to abhor losing even more than we crave winning.	Loss aversion causes investors to try to dodge bear markets, despite overwhelming evidence that market timing is more likely to increase costs and decrease expected returns.
Mental Accounting	Not all money is created equal. Mental accounting assigns different values to different dollars—such as inherited assets vs. lottery wins.	Reluctant to sell an inherited holding? Want to blow a windfall as "fun money"? Mental accounting can play against you if you let it overrule your best financial interests.
Outcome	Luck or skill? Even when an outcome is just random luck, your biased brain still may attribute it to special skills.	If you misattribute good or bad investment outcomes to a foresight you couldn't possibly have had, it imperils your ability to remain an objective investor for the long haul.
Overconfidence	A "Lake Wobegon effect," overconfidence creates a statistical impossibility: Everyone thinks they're above average.	Overconfidence puffs up your belief that you've got the rare luck or skill required to consistently "beat" the market, instead of patiently participating in its long-term returns.
Pattern Recognition	Looks can deceive. Our survival instincts strongly bias us toward finding predictive patterns, even in a random series.	By being predisposed to mistake random market runs as reliable patterns, investors are often left chasing expensive mirages.
Recency	Out of sight, out of mind. We tend to let recent events most heavily influence us, even for our long-range planning.	If you chase or flee the market's most recent returns, you'll end up piling into high-priced hot holdings and selling low during the downturns.
Sunk Cost Fallacy	Throwing good money after bad. It's harder to lose something if you've already invested time, energy or money into it.	Sunk cost fallacy can stop you from selling a holding at a loss, even when it is otherwise the right thing to do for your total portfolio.
Tracking Error Regret	Shoulda, coulda, woulda. Tracking error regret happens when you compare yourself to external standards and wish you were more like them.	It can be deeply damaging to your investment returns if you compare your own performance against apples-to-oranges measures, and then trade in reaction to the mismatched numbers.

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