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summaries

SIGMA INVESTMENT COUNSELORS

the official newsletter of sigma investment counselors June 2018

# Five Common Behavioral Finance Mistakes

Most of our clients and prospective clients we meet with have at some point in their life done their own investing. They might have chosen which funds to use in their 401k, bought some stocks they liked, or maybe they bought a few CDs at a bank. These clients often come to us with investments that they want to hold on to because they were an inheritance, or because they worked for the company for years and feel an affinity for it. Sometimes they purchased a stock at $80, and it's at $40 now, but they don't want to sell until it gets back to $80. Often, they ask us to be aggressive in one account, but safe in the other for no reason other than where the money originated from.

These are all common behavioral finance mistakes. Sometimes they can end up being a good investment, however more often than not the investor ends up being burned. As professionals, we are trained to identify and hopefully avoid some of the common behavioral finance mistakes known to investors. Here is a selection of five of the most common behavioral finance mistakes that we see:

### Anchoring Bias: Fixed on the past

Investors with an **anchoring bias** tend to hold investments because they have anchored their fair market value to what they paid rather than what the stock is worth today. When company fundamentals change, the valuation of the stock price should be adjusted accordingly. It can be tempting to buy investments that have fallen hoping they get back to where they were, however rigorous analysis is needed to be sure it's a good value. Be careful which benchmarks are being used and look at the investment from different perspectives to help avoid fixating on the past price.

### Mental Accounting: Many pockets, one pair of pants

**Mental accounting** is when people put investments or cash in different "accounts" based on irrelevant criteria like the source of the money, or a specific goal. They may be more speculative with an unexpected windfall than with money they have saved from their job. They might be sentimental about an account inherited from their parents. At the end of the day, you have one portfolio. All the investments have the same effect on your total net worth and should be managed as such. Having a clear picture of your total net worth, defining your goals and objectives, and having a plan to achieve them can help make sure all your money is being invested appropriately.

### Confirmation Bias: Not wanting to be wrong

**Confirmation bias** causes people to seek information that supports their initial investment view rather than information that contradicts it. They look for positive news about an investment and avoid the negative news. Common examples of this involve investors who don't want to be wrong about an investment, allowing their pride to get the better of their decisions. Investors need to be their own devil's advocate and take a skeptic's view of the investment. Make sure to explore different viewpoints and news sources to make the best decisions.

### Hindsight Bias: Knew it all along

**Hindsight Bias** leads investors to believe that an event was more predictable than it was. Following the great recession, a lot of discussion was around how events that at the time seemed inconsequential were indications of doom and gloom to come. Had that actually been the case, and it was that obvious to everyone, the great recession would've likely been avoided entirely. Markets are not predictable and timing when to get in and out is impossible to get right consistently. A long-term outlook, disciplined asset allocation strategy and a diversified portfolio will provide the best outcome for investors.

### Loss Aversion: Can't stomach the pain

**Loss Aversion** refers to people's feeling the pain of a loss more than the reward of a gain. They often would rather sell an investment that has made a profit and hold on to an investment that has a loss, even if selling the loser is a better decision. It also refers to investors who are so fearful of a loss they keep investments in perceived "safe havens" like cash or cash equivalents. While cash may seem safe, the impact of inflation over time can lead to an erosion of purchasing power. Having a clear understanding of all the risks involved, and a long-term outlook can help mitigate some of the fear. Work with an advisor and make sure investments are at least keeping up with inflation to maintain your standard of living.

These are just a sample of the many behavioral finance mistakes we see investors make. Our job as investment advisors is to educate and help the client make the best decisions for their investments. Knowing what is motivating a client can help us to educate and guide the client in the right direction. Having a clear and thoughtful investment plan is at the forefront of all of our client relationships and allows some of the emotion to be removed from investing, allowing us to make what we believe are the best decisions for each client.

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