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Avoid These Five Decision Traps to Improve Your Investing

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Can you separate what you think from what you feel when making decisions? For most everyday decisions, it seldom matters. But relying on facts rather than emotions when making investment decisions is critical to success.

Why? Because your intuition is more likely to get fooled when outcomes are driven by a high degree of randomness. This is clearly the case with markets, where the laws of physics don't apply and there are no reliable cause-and-effect relationships. In such an environment, a probability-based framework for decision-making works best because it can systematically tilt the odds of success in your favor. Plus, this approach has a distinct advantage over an intuition-based approach because it's definable, defensible, and repeatable—an important attribute in a time of heightened regulatory scrutiny.

Our research has identified five common decision traps that investors—both individual and professional—make over and over:

- Trial and error
- Information overload
- Pattern seeking
- Lazy thinking
- Recall

These traps are behavioral and intuition-based but also subtle in nature. Yet understanding and accepting your susceptibility to these pitfalls is

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critical to avoiding them—and potentially profiting from them (see table 1).

THE FIVE DECISION TRAPS

Trial and error. Trial and error can be defined simply as trying something in different ways until it eventually works. It's effective because the process generates a learning curve. From an evolutionary perspective, this is how humans adapted to their environment and created everything from tools to airplanes to the internet. Not surprisingly, trial and error is our default mode for learning. The problem is that it doesn't work with investing because markets lack two critical criteria: stable cues and stable outcomes. In other words, markets don't have reliable cause-and-effect relationships where experimentation eventually can lead to optimization. In fact, a trial-and-error approach to investment decision-making often leads to repeating the same mistakes. Advisors are most susceptible to resorting to trial and error during periods of underperformance, which of course every strategy will experience at times.

Information overload. Advisors are expected to monitor virtually everything in the world that may affect client portfolios, whether it's daily market moves, political events, or economic data. But does absorbing all this information lead to more-informed decisions? Or does it ultimately distract us from focusing on what's most important? "What information consumes is rather obvious: it consumes the attention of its recipients," said Herbert Simon (1971), who received the Nobel Memorial Prize in Economic Sciences for his work in decision theory. "Hence a wealth of information creates a poverty of attention." Research also suggests that the more data we consume, the more confident we become in our ability to predict outcomes. However, we're also more likely to misinterpret the importance of specific data. For example, we often ignore important data and pay too much attention to information that is just noise. The combination of overconfidence and our inability to separate signal from noise increases the danger of poor decisions and more-frequent trading.

Pattern seeking. The human brain is finely tuned to recognize patterns and act

Table
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BEST PRACTICES TO AVOID DECISION TRAPS

Decision Trap	How to Avoid	Best Practices
Trial and error	Be grounded	Create an investment philosophy statement to clarify and codify investment beliefs—building conviction in process to lessen the chances of engaging in trial-and-error decision-making.
Information overload	Be focused	Create a dashboard of market indicators—focusing attention on data with efficacy to affect markets and portfolios and avoiding “drowning in the noise.”
Pattern seeking	Be disciplined	Apply base-rating prior to capital allocations to assess the likelihood of mean reversion and avoid performance chasing.
Lazy thinking	Be skeptical	Structure investment meetings to ensure the broadest participation and evaluation of potential outcomes to avoid groupthink and getting blindsided by the unanticipated.
Recall	Be thorough	Create an effective feedback loop to accurately capture both the rationale for decisions as well as the environment where decisions were made—promoting deliberate process improvement and avoiding a focus on scorecarding results.

on them. Researchers using functional magnetic resonance imaging have shown participants a series of numbers or shapes and, after as few as two or three repetitions, specific regions of the brain activate focusing attention on what to anticipate next. When patterns persist, the “reward” chemical dopamine is released, which improved early humans’ chances of survival by helping them identify everything from weather patterns to the migratory patterns of animals. But when it comes to investing, relying on pattern recognition and instinct may result in chasing performance. For example, some investors have a tendency to buy when stocks have risen and already are expensive. “I argue that our brains are belief engines: evolved pattern-recognition machines that connect the dots and create meaning out of the patterns that we think we see in nature,” said Michael Shermer (2000), a science historian. “Unfortunately, we did not evolve a Baloney Detection Network in the brain to distinguish between true and false patterns.”

Lazy thinking. The term, originally coined by Nobel Memorial Prize winner Daniel Kahneman, refers to the uncritical acceptance of the opinions of others. He notes that the brain loves a good narrative because it connects the dots for us. However, this can lead both individuals and groups to be lazy thinkers and confuse things that are plausible (i.e., believable) with things that are probable (or likely to happen). This is especially true when in the presence of

experts, where research has shown we have a predisposition to give elevated weight to their opinions and advice, especially when they comport with our beliefs. In group settings, this can lead to rapidly coalescing around an initial point of view rather than considering alternative ideas or the full range of potential outcomes.

Recall. Considerable research has been done on memory—specifically our ability to accurately recall events and conversations. Elizabeth Loftus, considered the foremost authority on memory, calls the malleability of memories the “misinformation effect” to describe how they can easily be distorted (or even false memories created) by information introduced after the event being recalled (Loftus 2005). When it comes to investing and process improvement, it’s critical to analyze the decisions that generated the performance as much as the numbers themselves. Unfortunately, most time is spent on the latter because data is easy to generate, while the rationale for decisions isn’t typically documented. This can lead to a cycle of simply scorecarding results, which makes engaging in deliberate process improvement more problematic.

IMPROVE YOUR PRACTICE WITH IMPROVED DECISION-MAKING

Now, more than ever, advisors are faced with increasing scrutiny over how they invest. Having a definable, defendable, and repeatable investment process can help you meet your fiduciary obligations

and grow your business. That means developing a rigorous system and avoiding intuitive thinking and common missteps. Knowing how to avoid these damaging decision traps can help us make better decisions consistently, as well as improve our investing process and overall practice. ●

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