Is Human Behavior Hurting Your Organization's Portfolio?

Natural biases and tendencies can impact how an institution manages its endowment. Recognizing these traits is the first step toward conquering them.

CONFIRMATION (OR FAMILIARITY) BIAS

Traits:

- Tends to ignore new information that is contrary to an existing opinion/belief
- Often looks for evidence of an existing opinion/belief

Considerations:

- Can become less observant of information that challenges their views
- Prone to self-fulfilling prophecies that reinforce existing biases

Example

An investment committee has a long-standing preference of passive low-cost index funds, citing academic research that supports this inclination. Comfortable in its ways, the committee neglects to review new data on active managers that documents strong risk-adjusted returns.

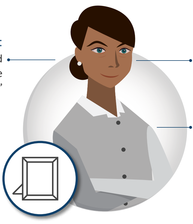
How to overcome

- Seek out and analyze information that is contrary to an existing belief
- Encourage your organization to play devil's advocate and challenge a prevailing belief

FRAMING

Traits:

- Makes decisions based on the way scenarios are described, or "framed"



Considerations:

- The idea of "risky gains" becomes more appealing than the idea of "risky losses"
- Investors who feel they have performed poorly will seek out risks, while those who have been pleased with returns will be conservative

Example

A company may compare its quarterly earnings of $1.10 per share to analysts' expectations ($1.15). It may also compare its earnings to the previous year's results ($1.00). The latter report would "frame" these results in a better light, giving them a more positive spin.

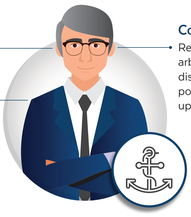
How to overcome

- Focus on the facts, rather than what could be taken with a positive (or negative) spin

ANCHORING

Traits:

- Focuses on a particular price level or reference point
- Uses this point to make decisions, regardless of new information



Considerations:

- Reliance on an arbitrary price level can distract from a possible opportunity to update a portfolio

Example

An investor zeroes in on a particular price point—such as $100 per share—and is reluctant to consider adjustments (up or down) when additional information, such as corporate news or earnings results, comes to light.

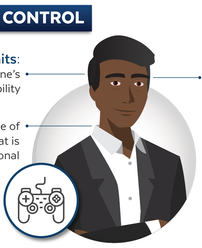
How to overcome

- Reduce the emotional significance of a purchase price or other illogical reference point (such as round numbers). Use all evidence and data available to make informed decisions for your organization's portfolio.

ILLUSION OF CONTROL

Traits:

- Overestimates one's understanding or ability
- Believes in a sense of control beyond what is reasonable or rational



Considerations:

- Failure to recognize risks or shortcomings can lead to mismanagement of risks

Example

An investor who has enjoyed success trading a particular asset class or sector may risk staying undiversified because they feel this narrow success will continue.

How to overcome

- Consider all potential outcomes—including being wrong—and make a plan for each scenario
- Analyze past successes with a financial partner to determine whether external circumstance or luck played a role

These are among the most common challenges individuals (including an organization's board members) can face in terms of their own psychological prejudices. Working with a team of advisors can help ensure your institution is making decisions based on the research and information at hand, not subjective factors.

Learn to focus on the facts

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