BEHAVIORAL FINANCE AND YOUR PORTFOLIO

A NAVIGATION GUIDE FOR BUILDING WEALTH

MICHAEL M. POMPIAN

WILEY

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This book is dedicated to my three sons Nicholas, Alexander, and Spencer.

Preface

If successful, this book will change your idea about what an optimal portfolio is. It is intended to be a guide to both understanding irrational investor behavior and creating portfolios for individual investors that account for these irrational behaviors. In this book, an optimal portfolio lies on the efficient frontier, but may move up or down it depending upon the individual needs and preferences of you as an individual investment decision-maker. When applying behavior finance to real-world investment portfolios, an optimal portfolio is one that an investor can comfortably live with, so that he or she has the ability to adhere to his or her investment program, while at the same time reach long-term financial goals.

Given the run-up in stock prices from 2009, in the wake of the global financial crisis, to 2020, and the bear market brought on by the novel coronavirus, understanding irrational investor behavior is as important as it has ever been. This is true both for the markets in general, but most especially for individual investors. The intended audience for the book is sophisticated individual investors who wish to become more introspective about their own behaviors, and to truly try to understand how to create a portfolio that works for them. The intention is that it is a guidebook, to be used and implemented in the pursuit of building better portfolios. When considering behavioral finance, investors rightly have questions. Some of these are:

- What are the most common investor biases that cause investment mistakes?
- What are the most impactful biases?

- How do I create the best allocation for me, taking into consideration my behavioral tendencies?
- How do I stick to a long-term investment plan?
- Should I buy individual stocks or stick to a diversified portfolio?

This book will answer these questions. There is difference between this book and my prior books. Most of my prior work has been written through the lens of how financial advisors advise: That is, how financial advisors can work better with their clients. This book, however, is written from the point of view of the investor. The only part of the book that has the financial advisor perspective is the case studies at the end. This is intentional. I want you, the investor, to pretend you are an advisor. This way you can implement the lessons in the book, which will drive home the learning.

In the last 25 years, the interest in behavioral finance as a discipline has not simply emerged, but rather exploded onto the scene, with many articles written by very prestigious authors in prestigious publications. We will review some of the key people who have shaped the current body of behavioral finance thinking, and review work done by them. And then the intent is to take the study of behavioral finance to another level: Developing a common understanding (definition) of behavioral biases in terms that advisors and investors can understand, and then demonstrate how they are to be used in practice through the use of case studies—a “how-to” of behavioral finance. We will also explore some of the new frontiers of behavioral finance, things not even discussed now that may be common knowledge in 25 years.

A Challenging Environment

Investors have never had more challenging times to invest in. Many investors thought they had found nirvana in the late 1990s, only to find themselves in quicksand in 2001 and 2002. And then we had the bull market of the 2000s only to get taken down by the 2008–2009 Great Recession. Today, we have had the longest bull market in history interrupted by the novel coronavirus bear market. In today's environment, as well as in the past, investors are continuously asking themselves:

- “Is asset allocation important or should I concentrate my investments?”
- “Should I invest in alternative investments?”
- “Should I have any bonds?”
- “Should I take the same approach to investing in college money as retirement money?”
- “Should I hold cash or stay fully invested?”
- “How should I modify my portfolio allocation based on my behavioral biases?”

To that end, investors need a handbook like this one that can help them deal with the behavioral and emotional side of investing, so that they can help themselves understand why they have trouble sticking to a long-term program of investing. By implementing the lessons in the book, you too can reach financial goals.

Why This Book?

When I began taking an interest in how portfolios might be adjusted for behavioral biases back in the late 1990s, when the technology bubble was in full force, I sought a book like this one, but couldn't find one. I did not set a goal of writing a book at that time, I merely took an interest in the subject, and began reading. It wasn't until my wife, who was going through a job transition and came home one night talking about the Myers-Briggs personality type test she had taken, did I begin to consider the idea of writing about behavioral finance. My thought process at the time was relatively simple: Doesn't it make sense that people of differing personality types would want to invest differently? I couldn't find any literature on this topic. Fast-forward to today and this is my fifth book, and one that brings together a “greatest hits” of my work.

As a wealth manager myself, I have found the value of understanding the behavioral biases that investors have and discovered some ways to adjust investment programs for these biases. You will learn about these methods. By writing this book, I hope to spread the knowledge that I have developed and accumulated, so that other advisors and investors can benefit from these insights. Up until now, there has not been a book available that has served as a guide for the advisor or sophisticated investor to create portfolios that account for biased investor behavior. My fervent hope is that this book changes that.

Who Should Use This Book?

For individual investors who have the ability to look introspectively and assess their behavioral biases, this book is ideal. Many individual investors who choose either to “do it yourself” or rely on a financial advisor only for peripheral advice, often find themselves unable to separate their emotions from the investment decision making process. This does not have to be a permanent condition. By reading this book and delving deep into your behaviors, individual investors can indeed learn to modify behaviors and create portfolios that help them to stick to their long-term investment programs, and thus reach their long-term financial goals. Financial Advisors can also greatly benefit from the book.

When to Use This Book

First and foremost, this book is generally intended for investors who want to apply behavioral finance to the asset allocation process and create better portfolios for themselves. Some suggestions for when to take it off the shelf are:

- *There is an opportunity to create or re-create an asset allocation from scratch*. Having a large amount of cash can be a tricky thing for any investor. When should I put the money to work? At the same time, the lack of "baggage," such as emotional ties to certain investments, tax implications, and a host of other issues that accompany an existing allocation, is ideal. The time to apply the principles learned in this book is at the moment that one has the opportunity to invest only cash or "clean house" on an existing portfolio.
- *A life "trauma" has taken place*. Sometimes investors are faced with a critical investment decision during a traumatic time, such as a divorce, a death in the family, a job loss, or other similar life event. These are the times that this book can add a significant amount of value to this type of situation by using its concepts.
- *A concentrated stock position is held*. When an investor holds a single stock or other concentrated stock position, emotions typically run high. In my practice, I find it incredibly difficult to get people "off the dime" to diversify their holdings in a single stock. The reasons are well known: "I know the company, so I feel comfortable holding the stock"; "I feel disloyal selling the stock"; "My peers will look down on me if I sell any

stock”; “My grandfather owned this stock, so I will not sell it”; the list goes on and on. This is the exact time to employ behavioral finance. Advisors must isolate what biases are being employed by the investor, and then work together with the investor to relieve the stress caused by these biases. This book is essential in these cases.

- *Retirement*. When an investor enters the retirement phase, behavioral finance becomes critically important. This is so because the portfolio structure can mean the difference between living a comfortable retirement and outliving one's assets. Retirement is typically a time of reassessment, reevaluation, and is a great opportunity for the advisor to strengthen and deepen the relationship to include behavioral finance.
- *Wealth Transfer and Legacy is being considered*. Many wealthy investors want to leave a legacy. Is there any more emotional issue than this one? Having a frank discussion about what is possible and what is not, is difficult and often fraught with emotional cross-currents that the advisor would be well advised to stand clear of. However, by bringing behavioral finance into the discussion and setting an objective outside the councilor's viewpoint, the investor may well be able to draw his or her own conclusion about what direction to take when leaving a legacy.
- *Trust Creation*. Creating a trust is also a time of emotion, that may bring psychological biases to the surface. Mental accounting comes to mind. If an investor says to him or herself “OK, I will have this pot of trust money over here to invest, and that pot of spending money over there to invest” the investor may well miss the big picture of overall portfolio

management. The practical application of behavioral finance can be of great assistance at these times.

Naturally, there are many more situations not listed here that can arise where this book will be helpful.

Plan of the Book

The first part of the book is an introduction to the practical application of behavioral finance. These chapters will include an overview of what behavioral finance is at an individual investor level and an introduction to the behavioral biases that will be used when incorporating investor behavior into the asset allocation process. Parts Two, Three, and Four include a comprehensive review, complete with a general description, practical application, implications for investors, a bias diagnostic, and advice. Part Five of the book reviews four Behavioral Investor Types, or BITS, and pulls everything together in the form of case studies that will clearly demonstrate how investors can use behavioral finance in real-world portfolio settings. Part Six covers portfolio implementation: Behavioral Finance Aspects of the Active/Passive Debate, Behaviorally Aware Portfolio Construction, and Behavioral Finance and Market Corrections.

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About the Author

Michael M. Pompian, CFA, CFP, CAIA, is the Founder and Chief Investment Officer of Sunpointe Investments, a multi-family office investment firm in St. Louis, Missouri. He was formerly a Partner at Mercer Investment Consulting for 10 years and was the National Segment Leader for the private wealth business where he consulted to the firm's largest family office clients, overseeing $8 billion. Prior to joining Mercer, Michael was a Wealth Management Advisor with Merrill Lynch and a private banker with PNC Private Bank. Prior to these positions, Michael was on the investment staff of a family office. Michael earned his MBA in Finance from Tulane University and graduated from the University of New Hampshire with a BS degree in Management. Michael has written four books: *Advising Ultra-Affluent Clients and Family Offices* (Wiley 2009), *Behavioral Finance and Wealth Management* (Wiley 2006), *Behavioral Finance and Wealth Management, 2nd Edition* (Wiley 2012) and *Behavioral Investor Types* (Wiley 2015). He writes a monthly column for *Morningstar Advisor* and has been quoted in *Money Magazine*, *The New York Times*, *Bloomberg*, and CNBC, among other media outlets. Michael holds the Chartered Financial Analyst (CFA) designation, Chartered Alternative Investment Analyst (CAIA), Certified Financial Planner (CFP®), and Certified Trust Financial Advisor (CTFA). He is a member of the CFA Institute, the New York Society of Securities Analysts (NYSSA), and the CFA Society of St. Louis. He is a regular speaker at family office conferences globally.

PART I
INTRODUCTION TO BEHAVIORAL FINANCE

In Chapters 1 and 2, Part One of the book, readers will get an introduction to behavioral finance. This will set up Chapters 3 through 22, which review 20 behavioral biases, both cognitive and emotional. Two types of cognitive bias are reviewed in Chapters 3 through 15: Belief Perseverance cognitive biases are covered in Chapters 3 through 8, and Information Processing cognitive biases are covered in Chapters 9 through 15. Emotional biases are then covered in Chapters 16 through 22. After these chapters, the book introduces four Behavioral Investor Types (BITs) and then the BITs are applied in four case studies.

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What Is Behavioral Finance and Why Does It Matter?

> *People in standard finance are rational. People in behavioral finance are normal*.
>
> **—Meir Statman, PhD, Santa Clara University**

If you are reading this book, you have decided that building the best portfolio for you, your family or your organization requires a solid understanding of human behavior. And the most important human behavior to understand is your own! After all, you need to make the best financial decisions possible and this requires understanding how you behave when money is involved. After advising individuals and families for over 25 years on their investment portfolios, and now running my own investment firm, I have found that understanding and applying behavioral finance to the investment process is the absolutely best way to manage portfolios for long term financial success. It may be counter-intuitive, but unless one has super-human capabilities to know which direction the markets are going all the time, the best strategy for managing a portfolio is to choose a comfortable level of risk and stick with that strategy. The less tinkering the better! Does this mean you don't pay attention to it? Of course not! Investors need to pay attention to the value of assets they own, the structural changes in companies or industries that occur, portfolio rebalancing points, etc.—but the core asset allocation framework should remain the same unless personal circumstances have changed. So why is it so hard for investors to stay invested during periods of market volatility? Put simply, many people don't understand how emotions and irrational behaviors creep into the investment process. This book is all about understanding and diagnosing your own behavior so that you can create the best portfolios and have long-term investment success!

At its core, behavioral finance attempts to understand and explain actual investor and market behaviors versus theories of investor behavior. This idea differs from traditional (or standard) finance, which is based on assumptions of how investors and markets should behave. Investors from around the world who want to create better portfolios have begun to realize that they cannot rely solely on theories or mathematical models to explain individual investor and market behavior. As Professor Statman's quote puts it, standard finance people are modeled as “rational,” whereas behavioral finance people are modeled as “normal.” This can be interpreted to mean that “normal” people may behave irrationally—but the reality is that almost no one behaves perfectly rationally when it comes to finances and dealing with normal people is what this book is all about. We will delve into the topic of the irrational market behavior; however, the focus of the book is on individual investor behavior and how to create portfolios that investors can stick with for the long haul.

Fundamentally, behavioral finance is about understanding how people make decisions, both individually and collectively. By understanding how investors and markets behave, it may be possible to modify or adapt to these behaviors in order to improve economic outcomes. In many instances, knowledge of and integration of behavioral finance may lead to superior results for investors.

We will begin this chapter with a review of the prominent researchers in the field of behavioral finance. We will then review the debate between standard finance and behavioral finance. By doing so, we can establish a common understanding of what we mean when we say *behavioral finance,* which will in turn permit us to understand the use of this term as it applies directly to the practice of creating YOUR best portfolio.

Why Behavioral Finance Matters

Market research shows that when investors try to protect their portfolios by moving in and out of the market, they limit gains and increase losses. Taking a long-term view is challenging but it is the most rewarding strategy. This is because staying invested helps fuel long-term portfolio appreciation. The primary evidence linking investor behavior to sub-par investment returns is a study done by a firm called DALBAR in Boston every year. This study compares the returns actually earned by the investor to indexed returns and inflation. Investor returns are calculated by DALBAR using the change in total mutual fund assets after excluding sales, redemptions and exchanges. This method of calculation captures realized and unrealized capital gains, dividends, interest, trading costs, sales charges, fees, expenses and any other costs. The most recently available study as of this writing is 2019.[1] That report found that the average investor took some money off the table in early 2018 as the market went up, but was poorly positioned for the second half of the year. The average investor was a net withdrawer of funds in 2018. Poor timing caused a loss of 9.42% on the year compared to an S&P 500 index that lost only 4.38%. Figure 1.1 illustrates the DALBAR data as of the 2019 report. Note the 30-year difference of 6% per annum!