

INVESTORS AND THEIR DECISIONS (5)

A series of articles, this one being the 5th, addressing investors and their decisions. In particular, whether factors other than rational considerations play a role in the investment decision process, and if so, what the practical consequences and applications are for investors. This article addresses Managing these other factors (biases).

MANAGING BIASES

(1)



In previous articles, I have aimed to familiarize the reader with a range of biases, cognitive as well as emotional ones, which can stand in the way of making sound investment decisions.

The concept of ‘biases’ and their potentially damaging effect on decisions made by investors, belongs to the realm of Behavioural Finance, a theory developed by, among others, Daniel Kahneman.

In his bestseller “Thinking Fast and Slow”, Kahneman covers 40 decades of research on matters to do with the human mind and how it works. His book is not an easy read, and is impossible to summarize. Simply said though, Kahneman attributes the influence of biases in our decision making process to the fact that we are prone to use the Fast Part of our brain (“System 1”) rather than the Slow Part of our brain (“System 2”) (2).

The list of biases is long, ranging from “over confidence” to “risk aversion”, all discussed in my previous articles.

Is there anything investors can do to avoid these biases, stay clear of them or at least manage them? Is there anything investors can do to tap into the Slow Part of their brain rather than the Fast Part?

Daniel Kahneman’s view is quite clear: “little can be achieved without a considerable investment of effort”. Knowing about these biases by itself is certainly no guarantee at all that one is less prone to be subject to them. Kahneman says: “except for some effects that I attribute mostly to my age, my thinking is just as prone to overconfidence, extreme predictions, planning fallacy as it was before I made these studies.” (3).

There is hope though; for while in Kahneman’s words, “our thinking is prone to biases”, whether we act on bias-prone thinking is quite a different matter. Biases play a role in every aspect of life and the journey to discovering our biases and then managing them can be viewed as part of a process of self-awareness. In following articles, I will cover one or two perspectives which may be applicable to investors and their decision making. For now though, there are for investors two practical ways to manage biases when it comes to investment decisions:

- 1) Working with an investment adviser/manager;
- 2) Working with an investment strategy & risk policy.

WORKING WITH AN ADVISER/PORTFOLIO MANAGER

Most investors will not be prepared to put in the “considerable effort” Kahneman is speaking about (4). I advise them to work with an investment adviser/manager who has made it his/her business to do so. The best guarantee to find this kind of quality adviser/manager, is to look for someone with a CFA designation.

Note 1: As I myself am part of a portfolio management firm with a manager at the helm who does have a CFA, I must immediately acknowledge my own bias on the matter;

Note 2: Sourcing Kahneman’s ideas, does not mean that I fully subscribe to his theory or that Kahneman support’s my advice.

My view is that there is a significant benefit in working with a portfolio manager who has discretionary authority, for many reasons. One is that it puts distance between the investor and his investments. So, while the biases may come up in the investor's mind, they are not actionable. If Kahneman is right, it is the impulsive actions in response to bias which does the damage. Working with an adviser can eliminate such impulsive actions, and thus their potentially damaging impact.

The CFA designation (granted by the CFA Institute) earns its reputation mainly due to the grueling process candidates must endure to earn the CFA charter. While the exam is very democratic and open to anyone with a bachelor's degree, the only people with a realistic chance of passing are those who are serious about the field. The three general requirements to earn a CFA charter are to pass three exams, have an undergraduate degree (in any subject) and have three years related work experience in the financial area. (5)

Note: Investors who are not prepared or able to work with an adviser in a cooperative model or one where authority is delegated, are well advised to:

- 1) put the same effort & work in that those do who complete their CFA accreditation;
- 2) guard themselves against any notion that it takes little time to get educated.

INVESTMENT STRATEGY AND RISK POLICY

Central in all efforts, whether working with a portfolio manager, an adviser or making all investment decisions oneself, needs to be a well formulated investment strategy & risk policy. While this kind of policy may not be able to have answers for some of the curveballs financial markets throw from time to time, it will definitely guide investors (and their advisers) with their decisions through most market conditions. And again, perhaps most importantly, such a policy will stimulate the Slow Thinking of our minds, rather than the Fast (impulsive and often bias prone) part of our minds.



Notes:

- 1) "Managing your Mind, the key to everything else" by Jack Speer, 13 Oct 2013, www.delta-associates.com
- 2), 3) and 4) From "Thinking Fast and Slow" by Daniel Kahneman, Penguin Books, 2012
- 5) From www.Investopedia.com



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