6 Pitfalls

Speakers: Jim Armstrong & Leanna Devinney

>> JIM ARMSTRONG: Leanna, there's always something moving the markets, right? So it's easy for us, I think, as investors and savers, to feel like we're getting off track, to feel like something's pulling us off of our goals. And in fact, Fidelity has identified half a dozen investor pitfalls, some of them triggered by the world around us, others by the - I guess, the battles that we fight in our own heads against ourselves. So let's spend a few minutes, if we could, walking through those pitfalls and how we might sidestep them.

>> LEANNA DEVINNEY: Absolutely. So let's start with the first two: loss aversion and confirmation bias. So loss aversion, this stems from the feeling of loss being felt significantly more than gains. So to quantify, we've learned, actually, with working with our clients that the pain of losses are two times. We feel that loss two times more than we would the pleasure of a gain. We saw this even the past few weeks when the market's up 10% or far more that we've seen in this accommodating market through the past few years. It's not felt the same as when we do experience a 10% correction. And that's because we have an emotional relationship with our money and our savings.

So where we help our clients and when we build plans, we want to make sure that we're being proactive. And something we do to help navigate some of the emotions that come with investing and the natural feelings that we have is we assign different roles and responsibilities for our wealth and our investments. We look at it having three critical components to every plan. That's having an emergency fund for those unexpected expenses. It's having protection against some of the market unknowns or life events that can come up. And then it's having a part of your plan in growth to keep pace with inflation.

So this is a way when the loss does happen, clients are able to navigate that easier when they have those three components. But a client once shared with me, "Well, I want all my money in protection. I'd rather keep the money I do have versus risk growing money and dealing with the ups and downs." But where we talk that is there's also a pitfall that can lead you to be too conservative and it can cause you to be emotional when the market may hit a downturn. So we talk about low risk, low return investments, that can hinder your growth over time and can also be as risky as being, sometimes, being too growth-oriented and aggressive - so, again, how we help build that plan, keep it in perspective, and have those three components.

>> JIM ARMSTRONG: Love it - I love the idea, too, that you've mentioned in the past of not necessarily checking your accounts every day. If you're like me and, let's say, you don't need it for 20 to 25 years, checking it three times yesterday isn't good for anybody.

>> LEANNA DEVINNEY: Yes. Checking it a couple times a year causes you not to react and we'll talk about some of the headline risk as another pitfall that we can see later on.

>> JIM ARMSTRONG: Absolutely. But for now, let's stick to confirmation bias, which, as I understand it, is this feeling of sort of not being able to change your mind once you've made a decision.

>> LEANNA DEVINNEY: Yes. I can do this personally, too, I feel. But once we make up our minds, we look for evidence that we did the right thing. So let's say a stock, you buy a company stock, you read up on the firm, and you may come across 10 positive headlines and you also may come across 10 not so positive headlines, more negative, but you may gravitate only towards those positive to support your decision. So we also see this when clients may own their employer stock, a position in their own company.

We'll also talk about firms in history where people felt, oh, that firm is too big to fail. That company will certainly prosper through anything. And we know in the past that that's not always the case. So clients, though, with confirmation bias will say, "No, this is different. My company's different. I know it." So, again, we talk about the power of diversification as a way to help manage risk and, simply, not keep all your eggs in one basket.

>> JIM ARMSTRONG: Perfect, perfect. I can feel that affecting a lot of people for sure. Two other biases in the next: anchoring and recency bias.

>> LEANNA DEVINNEY: Yes. So anchoring, that just means that you're stuck on the first things that you see like an anchor. So our brains latch onto that first information that we get and we act like that may be the most important thing, but it might not be relevant anymore. So a good example, let's say a friend or

family member, they may recommend a mutual fund or an investment that comes with a certain price. And they might state, "Well, I got it for X amount" - let's say $50. But when you check that quote, it's $55. So you decide: I'm not going to do it because it's $55 now.

But where it's important in that anchoring is that that's sometimes not relevant to, actually, the goal of that mutual fund. You want to do your homework and make sure you're looking at: why this fund, what's the price-to-earnings ratio, how does this fit into my overall plan. Sometimes, we get caught up in that first information that we get such as price in this example.

>> JIM ARMSTRONG: I think you're exactly right. And doing that research might seem a little bit onerous to some folks. They might not know how to do it. And I would add that that's probably a good time to consider working with a professional to have some of those decisions made in partnership with you, rather than doing it all yourself. So that said, recency bias - I like this one because it's also called a breaking news problem.

>> LEANNA DEVINNEY: Yes. This is like the headline, breaking news. So most of us do this. We can overemphasize the information that we just received and we can kind of focus on what we're hearing right now. So we see this in the markets. We saw this last week all over the headlines that we were getting fears of market turbulence and volatility. And I think even using a day last week, the average investor would have thought, okay, this day is going to be a significant market downturn. That's what the news is saying. But we saw that that was not the case and there was a sharp rebound in the day.

So recency bias, what we see, it can lead you to invest more on market tops, like when there's good news and good headlines and you want to buy and you kind of are investing on the high or when there's market bottoms, you might be selling at the low, again, based on the recency of what we're hearing. So this happens very often. And I think, again, just a way - we just spoke on this – kind of don't look every day or don't use what you're reading and make actions. Don't be reactive. When you have a plan, it comes from a place then you can be proactive.

>> JIM ARMSTRONG: Yeah, makes perfect sense. All right, the last two potential pitfalls you're going to help us avoid:

ideally, herding bias, which sounds interesting, and then something called ambiguity aversion.

>> LEANNA DEVINNEY: Yes. Herding bias, so this is simply following the crowd and it's how we evolve. And the same thing can go with our money. If we're learning about what others do, we want to do that as well. So something that came up when I was thinking through herding bias that I saw, even as my time as an advisor, sometimes, clients would say, "I want to invest in this specific mutual fund" kind of just to give an example. And they heard from a family member or friend, this was the fund. But it really was maybe that rockstar fund in the '90s or 2000s.

But time passes and maybe that fund manager has changed or that fund strategy has changed, but we follow the crowd and we say – it's almost like FOMO, fear of missing out, when it comes to the herding bias. So I think, again, where we add value is make sure that you have your independent goals, your time, your unique situation, and we build the plan and investments based on that and your comfort level.

>> JIM ARMSTRONG: I will share no stories about times when I heard about the stock that I had to have. It was entirely based on what I was hearing from friends and family. So we'll skip right over that and say that, much like all of these, I've been a potential victim to these pitfalls myself and certainly this last one, too, being a little bit too comfortable with things that feel really predictable.

>> LEANNA DEVINNEY: Yes. So people tend - ambiguity aversion, people tend to prefer the familiar and they shy away from uncertainty. Sometimes, we can stick with our comfort and that can be risky as well. So an example, again, I thought of when we think of cash and the short term investments, my grandfather, he'll always say the same line, "Cash is king. Cash is king." Well, for the bulk of his life – he's 93 years old - interest rates were very different and he would invest in cash and CDs and that provided far more in the banks than they do today.

But now in this interest rate environment and what we talk through, cash can – it's there for emergency fund and having flexibility and liquidity. There's a ton of benefits to it, but from a growth vehicle to invest and keep pace with inflation, we know that's not the case. But, again, our comfort level can feel that more of a security. So just like with every one of these pitfalls, it all comes down to building that plan, having an appropriate mix of investments align with your goal to help you navigate through these pitfalls.

>> JIM ARMSTRONG: Thank you for taking the time to explain that, Leanna.

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