RAYMOND JAMES

Behavioral biases that can keep you from meeting your financial goals

Investors tend to have more difficulty sticking to their investment plans in uncertain or turbulent market environments. Why? Because investors are prone to human behavioral biases that often lead them to make irrational decisions based on emotion or rules of thumb.

These biases can cause you to abandon your investment plan – a mistake that can result in falling short of your financial goals.

Dalbar, a market research firm focused on the financial industry, has studied how such behavior can have a damaging impact on the average investor's long-term portfolio performance. According to its findings (illustrated in the chart below), the average investor often underperforms popular benchmarks across a variety of time horizons.

AVERAGE FUND INVESTOR RETURNS VS. INFLATION AND BROAD MARKET BENCHMARKS

	Average Equity Fund Investor (%)	Average Fixed Income Fund Investor (%)	Average Asset Allocation Fund Investor (%)	Inflation (%)	S&P 500 (%)	Bloomberg-Barclays Aggregate Treasury Index (%)
20 Year	3.88	0.22	1.87	2.17	5.62	4.55
10 Year	9.66	0.70	4.53	1.82	13.12	3.48
5 Year	3.96	-0.40	1.50	1.56	8.49	2.52
3 Year	5.58	-0.11	1.84	2.04	9.26	2.06
12 Month	-9.42	-2.84	-6.97	1.93	-4.38	0.01

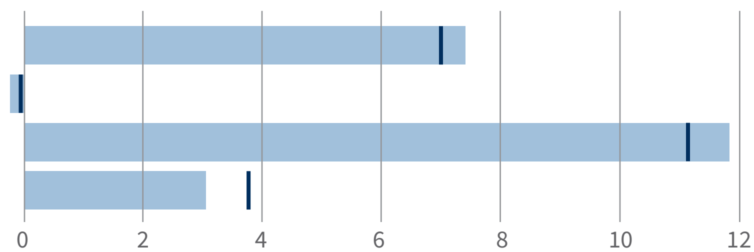
Source: Dalbar 2019 QAIB, data as of December 31, 2019

Global financial services firm Morningstar takes these findings a bit deeper with its investor return calculations. Also known as dollar-weighted returns, investor returns measure how the average investor fared in a fund over a given period compared to the fund's total return, which assumes a buy-and-hold approach.

Unlike Dalbar's findings, Morningstar's data show that investors have mixed performance compared to broad market benchmarks. The chart below shows that, on average over the last 10 years, investors underperformed in alternative and fixed income asset classes, but were able to outperform in equity and asset allocation funds.

THE GAP BY ASSET CLASS (10-YEAR RETURNS)

Broad Category Group	Investor Return	Total Return	Gap
Allocation	7.47	7.08	0.40
Alternative	-0.22	-0.04	-0.18
Equity	11.91	11.61	0.29
Fixed Income	3.02	3.80	-0.78



Source: Morningstar, data as of December 31, 2019

WHAT CAUSES INVESTOR UNDERPERFORMANCE?

The research conducted by Dalbar and Morningstar suggests that investor performance is largely unrelated to market performance and even fund performance. Rather, investor behavior is usually a larger driver of portfolio results. The table below describes the common behavioral biases that can lead investors to make poor investment decisions. See if you recognize yourself in any of these biases.

Behavioral Bias	Description	Example
Anchoring	The tendency for investors to focus on an initial piece of information as the primary reason for a decision	Investors do not adjust expectations for an investment's return based on new information but continue to rely on the information available when they initially made the purchase
Herd Mentality	The tendency of investors to follow what other investors are doing	Investors hear that their peers are making money in tech stocks and therefore decide to purchase tech stocks in their own portfolio to join in the gains
Overconfidence	The tendency for investors to believe that their own judgements are more accurate and reliable than they really are	Investors believe they can consistently beat the market with their investment picks and therefore tend to overtrade their accounts, which ultimately causes them to underperform
Confirmation Bias	The tendency for investors to seek out information and opinions that agree with their own views	Investors believe the market will go up over the next three months and only seek out news stories that support their beliefs and dismiss news stories that challenge their beliefs
Recency Bias	The tendency for investors to more readily recall an event that happened recently rather than one that occurred in the more distant past	Investors are more likely to focus on a recent bull market when making decisions rather than a bear market that occurred several years ago
Loss Aversion	The tendency for investors to be more sensitive to a loss than to a gain of the same amount	Investors are likely to be more upset about a $1,000 loss in their investment portfolio than they are pleased with a $1,000 gain
Endowment Effect	The tendency for investors to value the investments they own more highly than the current market value	Investors expect to sell their shares of a particular stock at a certain price but wouldn't pay the same amount to purchase the same stock on the open market
Representativeness	The tendency for investors to ignore statistical probabilities and instead believe one event or piece of information is representative of future outcomes	Investors forecast future investment results based on the last five years of investment performance and ignore the investment's longer-term track record

The outcome of these biases can lead to irrational decision-making, which often leads to poorly timed trades. It's no wonder investors who let these biases cloud their judgement tend to underperform the market, their investments, and most importantly, their financial goals.

The good news is, once you're aware of these pitfalls, you can implement strategies to help avoid them in the future.

HOW TO NAVIGATE BEHAVIORAL BIASES

Avoiding behavioral biases completely can be difficult. After all, human nature ensures that nearly all investors will succumb to several or all of these biases at some point. However, by following a few simple guidelines, you can reduce the likelihood that these biases will negatively impact your investment performance.

- **Develop and document a financial plan.** A financial plan creates context for your initial asset allocation and all investment decisions that follow. It also provides investors with guidance and clarity regardless of external market conditions.
- **Follow a process.** Following a well-defined, repeatable investment process takes the emotion and subjectivity out of investment decisions. Something as simple as a checklist can help ensure that behavioral biases don't take over when markets disappoint.
- **Stay the course.** The sound thing to do is stick to your plan regardless of the market environment. Work with your financial advisor to develop an investment plan that focuses on your financial goals, and only change it when your circumstances or objectives change. **Your financial advisor can serve as your voice of reason during times of market volatility**.

Behavioral biases can lead to emotionally driven investor action, and detrimental effects on achieving your financial goals. Now that you're a more informed investor, remember to take a pause as you approach future financial decisions.

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