# Behavioral Finance: Pitfalls and Prevention for Plan Sponsors, Part II

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*In the second half of this two-part article, Bob Maynard turns the mirror on plan sponsors and other institutional investors. He highlights certain behavioral factors and relates them to problems that face boards and committees in order to raise our collective consciousness and enhance decision-making.*

## PLAN SPONSORS AND GROUP PSYCHOLOGY

Many plan sponsors are paying increasing attention to behavioral finance, but seem to believe behavioral issues are relevant only to their investment managers. I believe there are "behavioral" lessons to be learned in how we, plan sponsors and other institutional investors, conduct our professional duties.

The findings of behavioral finance and studies of group dynamics suggest natural tendencies of thought or action which, if unchecked, could lead to decisions that may not be in the organization's best interests. As detailed in Part I of this article, there are a variety of behavioral biases that may adversely affect an individual's investment decisions. However, most institutional investors do not act independently. Plan sponsor responsibilities are generally implemented through group structures such as boards or committees. The core concept is that "two heads are better than one." There are good reasons why this structure has become an industry best practice: information sharing and error checking, risk management, involvement of all "interested parties," and improved judgment based on shared knowledge and experience.

But inherent in these group structures are certain counterproductive tendencies, commonly referred to as "groupthink." Groupthink refers to those social and psychological factors that influence group decision-making in undesirable ways. Irving Janis first introduced the topic in 1972 and the concept still has considerable relevance today. According to Janis, the core symptoms of groupthink include pressures toward uniformity, overestimation of the group's ability, and closed-mindedness.[1] Here are some examples in each of these categories.

## PRESSURES TOWARD UNIFORMITY

- **Self-censorship.** People are reluctant to express doubts about an apparent agreement. There is a desire to be a team player and a belief that disagreement will lead to a loss of effectiveness.
- **Illusion of unanimity.** Because of self-censorship and other factors, the group often believes that it is more united than it actually is, leading to potential problems, particularly if the decision appears poor.

[1]Janis, Irving. *Groupthink*. 2nd ed. Boston: Houghton Mifflin Company. 1982.

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- **Direct pressure on dissenters.**
- **Self-appointed "mind guards."** Some members of the group will often take it upon themselves to keep others in line with the supposed consensus.

### OVERESTIMATION OF THE GROUP'S ABILITY

- **Illusion of invulnerability.** This is often generated by past successes.
- **Belief in the inherent morality or rightness of the group.**

### CLOSED – MINDEDNESS

- **Collective rationalization.** Group members can convince themselves that they do not have to go outside the group for additional opinions or information.
- **Stereotypes of others outside the group.** There is a tendency to believe that the group is above average, and those outside the group are below average, weak, or foolish.

Janis asserted that, ". . . the more frequently a group displays the symptoms, the worse will be the quality of its decision, on the average."

John Payne, professor of psychology and research professor of statistics and decision sciences at Duke University, notes that groups tend to be better suited for certain tasks versus others. "Groups can do well, particularly well, when we're talking about intellectual tasks where once you find the right answer, everybody can agree that that's true."[2]

However, in what Payne refers to as "judgment tasks," or tasks where there's no definitive answer (how much risk should the group take when investing, for example), groups are more prone to behavioral biases. For most investment committees, these are precisely the types of tasks for which we are hired – determining an appropriate asset allocation and hiring and firing investment managers, as examples.

Research on group behavior is not as advanced as that of individual decision-making. Nonetheless, Scott Plous, in his book *The Psychology of Judgment and Decision Making*, draws a number of tentative conclusions.[3] Among the benefits of group decision-making:

- Brainstorming is most effective when conducted by several people independently, rather than in a group session.
- Groups usually perform somewhat better than average individuals, particularly if an appointed leader encourages all group members to express an opinion.

[2]Payne, John and Arnold Wood. "Individual Decision Making and Group Decision Processes." *The Journal of Psychology and Financial Markets.* 3.2 (2002): 94-101

[3]Plous, Scott. *The Psychology of Judgment and Decision Making.* Philadelphia: Temple University Press. 1993.

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Despite these advantages, groups have a variety of shortcomings:

- Many individual-level heuristics and biases appear to operate with equal force in groups.
- Group discussion often amplifies preexisting tendencies.
- The best member of a group often outperforms the group.

Research by Hersh Shefrin underscores some of these drawbacks. "Individuals who serve on institutional investment committees exhibit frame dependence and heuristic-driven bias," Shefrin writes in his book, *Beyond Greed and Fear: Understanding Behavioral Finance and the Psychology of Investing.*[4] "When it comes to framing, committee members tend to think of portfolios as a series of mental accounts, with associated reference points known as benchmarks. Therefore, committee members tend to mistake variety in manager 'styles' for true diversification. In addition, reference-point thinking leads people to give opportunity costs less weight than out-of-pocket costs of the same magnitude."

Shefrin adds that because members of institutional investment committees bear responsibility for their portfolios' performance, they are vulnerable to regret. "Choosing active managers enables committee members to shift some of the responsibility for performance onto the managers, thereby reducing their own exposure to regret" (Shefrin 213).

This does not mean that public investment funds would be better off simply turning over their management to experts, or relying on expert opinions exclusively. In fact, another implication of behavioral psychology is that there are real public benefits to adding more general viewpoints to the mix. Pension and endowment fund decisions have large policy and societal interests involved. As Robin Hogarth summarized in his book, *Insights in Decision Making: A Tribute to Hillel J. Einhorn*:[5]

> [P]olicymakers need to take account of public values and perceptions in societal decisions about risk. Failure to do so entails several dangers.
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> First, the people may know something that the experts are missing. For example, one finding from risk-perception studies is that experts tend to assess the risks of a technological option in terms of its expected fatalities and injuries whereas lay people typically use the broader evaluation scheme that includes the voluntariness of exposure to a risk, the degree to which it is understood scientifically, and a number of other psychological factors. It is not hard to argue that such richer, more comprehensive views express important criteria that should be included in the decision process.
>
> Second, the disregard of public opinion may result in a decision that cannot be implemented because of outspoken public opposition. Even if it is possible to force the decision on an unwilling public, the outcomes may be quite different from, and worse than, anticipated. Did politicians in 1917 predict that the adoption of the prohibition amendment to the U.S. Constitution would lead to a law enforcement crisis and the rise of a wealthy, well-armed, and organized underworld? (Hogarth 92)

[4] Shefrin, Hersh. *Beyond Greed and Fear: Understanding Behavioral Finance and the Psychology of Investing.* Oxford: Oxford University Press. 2000.

[5] Hogarth, Robin, Ed. *Insights in Decision Making: A Tribute to Hillel J. Einhorn.* Chicago: University of Chicago Press. 1990.

Both of these rationales apply to public funds, in particular. Nothing is worse than a long-term expert plan that is changed in mid-stream. Very rarely do pension funds fail to meet their long-term liabilities through lack of investment results from a stable, long-term policy. More often, investment disasters or long-term poor performance occurs because of a failure in the ability of a fund to maintain a consistent investment approach through an entire investment cycle. Too often, strategies are abandoned after a poor period just at the point they are about to become successful, and recently successful strategies are implemented just as they are about to become underperformers. Part of the problem is the lack of transparency and complex language in which plans often are written. The more complex and "expert" an operation, the more it is subject to misunderstanding when things go wrong, and to changes at inappropriate moments. This can be seen recently by changes in public funds from the latest equity bear market.

Lack of transparency and difficulty of understanding by relevant constituencies (the retirees, active members, legislature, general public, etc.) have, over the years, turned out to be greater risks, and have caused more harm, than temporary market volatility or most single investment decisions.

I note that, although this article focuses on enhancing decision-making for boards and staffs at institutional funds, this last point raises an equally important issue that is beyond the scope of this article but should be considered: the natural tendencies and biases of the constituencies of the fund (retirees, legislatures, other corporate officers and board members, etc.), and the potential conflicts between the right decision for the fund, and the pressures from those other constituencies.[6] These conflicts, in large part, come from the same biases discussed in this article, and must be dealt with as well.

The solution to the potential problem of bias and "common sense" thinking within the fund itself is not more experts running a fund. Not only are experts subject to these biases, there are also policy and behavioral reasons to discredit this approach. Instead, the solution needs to attack the potential problems directly.

### ADDRESSING BEHAVIORAL BIASES

There is no one right answer or structure to address the impact of behavioral biases on committee or group structures. Even experts are subject to these biases. The only real answer is for people to be constantly aware of these tendencies and to take particular care when a situation or problem arises which could trigger one of the concerns. (Fortunately, all of these tendencies or errors of application in particular situations are correctable when people have those errors pointed out.[7] Remember – they are tendencies, not iron-clad behavioral rules.) Some situations that would require additional care and scrutiny for behavioral influences involve:

[6]For example, see the article, "When Lives are in Your Hands: Dilemmas of the Societal Decision Maker," by Lichetenstein, Gregory, Slovic, and Wagenaar in the book, *Insights in Decision Making: A Tribute to Hillel J. Einhorn,* edited by Robin M. Hogarth, pages 91-96.

[7]For more information on this topic, see E.C. Poulton's book, *Behavioral Decision Theory: A New Approach.* Cambridge: Cambridge University Press. 1994.

- hiring or firing managers based on near-term performance (as opposed to organizational changes)
- adopting strategies or approaches that have had recent success or abandoning strategies that have not worked recently
- looking at portfolio prospects without considering inter-connections with the behavior of liabilities (One key interconnection for pension funds is the relationship between inflation on the asset return side with the impact of inflation on salaries and discount rates on the liability side.)
- potentially confusing skill and better-than-average investment ability with managers' ability to articulate claims of skill and good processes, combined with anecdotes of particular successful efforts
- looking to only high returns without fully understanding the potential risks
- avoiding high risk investments simply because of the volatility
- entering an area that depends on the assumption that one can pick "better than the average manager"

### COMBATING BIASES: GENERAL ACTIONS OR DISCIPLINES

In countering biases, one form of higher scrutiny is requiring explanations of staff or outside experts in plain English. If explanations of problems and solutions are not clear to board or committee members, there are ambiguities into which members can insert prejudice or preconception. Not being afraid to ask "the dumb question" would be essential to this process. Biases and tendencies are only that: inclinations that will operate in the absence of clear insight and full understanding. The primary means of prevention is to eliminate the confusion or unconscious perspectives that allow those tendencies to grow into unsupported decisions.

Another core discipline that assists the group in avoiding biases and groupthink is a commitment and tradition in the group to an interchange of arguments both for and against – and not to a discussion of a decision already tentatively made. Loyalty to the group should be seen as loyalty to the institutional process needed to make good decisions, not to the individual decisions themselves. This means that opposing points of view should be sought out, even if it means going outside the group or immediately available resources.

Another remedy is good, relevant, and understandable statistical and quantitative information. As Fisher and Statman noted, "Regression analysis protects against overconfidence by providing the standard errors of regressions. It protects against the confirmation bias by including all data, confirming as well as disconfirming."[8] But there are a number of pitfalls to using quantitative methods: implied methodological issues, potential interpretive problems, and misunder-

[8]Fisher, Kenneth L. and Meir Statman. "Cognitive Biases in Market Forecasts: The Frailty of Forecasting." *The Journal of Portfolio Management*. 27.1 (2000).

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standing by the audience (they play into the illusion of precision and the Othello Effect). In addition, there are implied assumptions in the use of such materials – namely, that the future will be like the past:

> Statistical tools are very useful; they allow us to extract systematic patterns from the past. But the world does not always regress to its historical mean, and future patterns might well break with the past. Moreover, statistical tools work best with data that can be quantified and traced over long periods of time. This requirement often causes us to exclude potentially relevant data such as changes in the political environment and the state of economic knowledge (Fisher and Statman 78).

### COMBATING BIASES: SPECIFIC ACTIONS AND DISCIPLINES

In "Aspects of Investor Psychology," Daniel Kahneman (one of the founders of behavioral finance) and Mark W. Riepe set out a list of recommendations for individual investment advisors when dealing with clients.[9] Many of the recommendations apply with equal force to institutional investors, and the following actions reflect an adaptation to the institutional setting of those recommendations. In brackets, I've also noted the problems the recommendations combat.

- When adopting an investment policy, follow a top-down process which accounts for all of the fund's objectives simultaneously, and avoid the common bottom-up approach in which a separate policy is set up for each investment objective or asset type in isolation. *[Mental Accounting]*
- Use as broad a frame as possible when making investment decisions, and be aware of the costs of narrow framing, such as separately borrowing on real estate properties while lending to (buying the bonds of) the government and companies in the fixed income portfolio at probably lower rates. *[Mental Accounting]*
- Make sure that the overall health of the organization is included in the policy objetives, such as funding levels and annual impacts on constituencies (profits to a company, COLAs to employees, medical benefits, etc.) *[Mental Accounting]*
- Keep the board's and constituents' attention to the role of "statistical aggregation" (i.e., you win a few and lose a few, but in the long run, you'll come out ahead) as a primary remedy to unreasonable risk aversion. *[Prospect Theory, Myopia]*
- Remember that risk of loss is important for most people, but that loss is a relative term. Determine the reference point from which a gain or loss will be calculated and compared (funding levels, assets only, time periods to determine success or failure, etc.). *[Framing]*
- Constantly remind everyone of the importance of taking a long-term view, and remember that people like to talk long term and act short term. *[Myopia]*

[9]Kahneman, Daniel and Mark W. Riepe. "Aspects of Investor Psychology." *The Journal of Portfolio Management.* 24.4 (1998).

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- Recognize which board members and parts of the constituencies (legislators, retiree groups, etc.) will find it most difficult to stay the course and to live with a long-term commitment. *[Prospect Theory, Myopia, Mr. Jones Effect]*

- If a board is particularly prone to regret errors of commission, radical changes in investment policy, or decisions that are out of character should be taken with special caution, since they may not be able to stay the course when bad things happen. *[Prospect Theory, Mr. Jones Effect]*

- Make sure that the board or committee is not simply mechanically following the staff's or consultant's advice, so that the decision is truly a collective and understood action. *[Quasi-magical thinking, Groupthink, Othello Effect]*

- When adopting a strategy that is different than simple market weighting (e.g., adopting a small cap or growth bias), ask yourself whether you have real reasons to believe that you know more than the market, or that the approach is grounded in real relationships to funding the particular liabilities of the organization. *[Lake Wobegon Effect]*

- Resist the natural urge to be overoptimistic about the courses of action that are being considered for adoption, and think, for example, of things that could go wrong. Make sure that you have considered the realistic odds of success (such as what would happen if one picked simply the median manager). When looking at historical data, resist the tendency to focus on the upside. *[Lake Wobegon Effect, Wishful Vision]*

- Because one is more likely to remember successes, keep a list of past courses of actions or decisions that were not successful. *[Wishful Vision]*

- Make sure that you are constantly aware of the uncertainty of all investment decisions. For example, make sure that there are not unreasonably high standards of performance that would lead to early and repeated terminations and turnover (such as asking bond managers to beat the benchmark by 1% - 2% or more, when the difference between a top quartile and median fixed income manager over ten years is less than 50 basis points). *[Lake Wobegon Effect, Mr. Jones Effect]*

- Make sure that the current long-term approach is sufficiently articulated, and that there are procedures in place so that they cannot be changed due to hunches or knee-jerk reactions to recent events. *[Myopia, Wishful Vision, Mr. Jones Effect, Lake Wobegon Effect]*

- Since the disposition effect is a powerful bias, provide the board with specific real-life examples of where it was better to let winning managers run, and cut losses with losing managers. *[Prospect Theory]*

- Before a decision to try a new asset type or strategy, or hiring a new manager, discuss the conditions under which the manager would be let go, or the strategy would be considered a failure and thus abandoned (return objective, time periods, etc.) *[Mr. Jones Effect, Wishful Vision, Othello Effect, Myopia]*

### QUESTIONS TO CONTINUALLY ASK

Biases and tendencies are only that: inclinations that will operate in the absence of clear insight and full understanding. The primary method for preventing these biases is to eliminate the confusion or unconscious perspectives that allow those tendencies to grow into unsupported decisions. Therefore, some questions that should be regularly asked are:

- How does this activity fit within the entire portfolio? Does it add, or reduce risk, or does it cancel or offset another position (for example, leverage in real estate can help offset a bond investment in the fixed income portfolio)?

- Is there another way of looking at the problem, or framing the problem, that suggests a different approach or solution? Has the "other side" been presented with as much detail? Have you looked for contrary or disconfirming evidence?

- Are you looking at information that will actually help you reach a decision, or are you simply gathering information for information's sake? Is your decision something that affects future returns or risks, or are you simply reacting to past losses or events?

- Is a potential short-term loss from an approach overriding the consideration of either long-term gains or portfolio risk reduction (e.g., currency hedging losses viewed in isolation)? Is one reacting to recovery of recent losses or prevention of past pain, rather than to expected future or long-term developments?

- Could recently successful or unsuccessful strategies have been due to "luck" rather than skill? Is it statistically supported as being likely to persist? (In fact, very few strategies meet longer term statistical tests.)

- Will the strategy succeed if one is only the "average" participant (e.g., private equity and hedge fund activity)?

- Is there an objective check or support for a particular decision?

### UNDERSTANDING THE SUSCEPTIBILITY OF A GROUP TO BIASES

Of course, the investment group making these decisions must be open to these sorts of inquiries. One very interesting approach on this point comes out of the work done by Karen Strohm Kitchener, Patricia King, and their colleagues pertaining to stages of thinking and reasoning, which appears to track people's experience in moving from naïve to sophisticated investment reasoning.[10]

[10]In his book, *Thinking and Deciding*, published by Cambridge University Press in 1994, Jonathan Baron summarizes the work of Patricia M. King and Karen Strohm Kitchener, co-authors of *Developing Reflective Judgment,* published by Jossey-Bass in 1994.

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There appear to be seven developmental stages in thinking:

- **Stage 1.** There is no question about what is true: it is known either through direct experience or through authorities. This stage tends to dissolve when it is found that authorities often disagree with each other, and what is "common knowledge" to one person is false to another.

- **Stage 2.** There is an objective, knowable reality, but it is not known to everyone; it is only known to legitimate authorities. True disagreements between authorities are therefore impossible, and actual differences in interpretation of the underlying evidence is not acknowledged.

- **Stage 3.** Objective reality is there, but may not be known even to legitimate authorities. Until it is known, people are free to believe what they choose to believe, but there is no other basis than "what feels right" for particular beliefs, and alternative points of view among experts are understood as areas of uncertainty, where any point of view is as good as any other.

- **Stage 4.** People dispense with the idea of objective truth. One person's belief about anything is as good as another's and no evaluation is possible.

- **Stage 5.** People hold a similar view as in stage 4, but allow that there are methods for justifying beliefs within certain frameworks. For example, for a nuclear physicist, there are acceptable risks for nuclear-power plants that would be unacceptable to an environmentalist. Each belief is justified within the particular framework, and no comparison is possible across frameworks.

- **Stage 6.** People continue to hold that truth is ultimately subjective, such as in the statement, "There's no such thing as objective, unbiased reporting." There is, though, a belief that some justifications are better than others, that the principles of good justification hold across frameworks, and that the attempt should be made to bring beliefs into line with the best justifications.

- **Stage 7.** People believe that there is an objective reality, which is known imperfectly through perceptions and interpretations, and that it is possible to determine, through critical inquiry, that some judgments are more correct than others. Knowledge is the result of a process of critical inquiry and must always be open to criticism and improvement, and beliefs are justified by passing through the "gauntlet of inquiry." Specific criteria for evaluation may vary from area to area, but there are always ways of judging which of two approaches or ideas is a better approximation to reality.

These stages have clear applicability to the stages observed by most investment professionals at both the retail and institutional level in bringing naïve but intelligent clients or board members through the investment learning process – from the idea that there is an answer known by the right “experts” to more realistic, and probabilistic, thinking about complicated investment issues. It also suggests an inquiry or self-examination process for investment committees to see where they are in this process, both collectively and individually. The reason for this need can be seen in the summary of the research in this area by Jonathan Baron:[11]

> The first four stages involve a gradual break with the idea that truth is absolute and known to all. The breakdown of this idea is what leads to subjectivism or relativism. The last (higher) . . . stages involve a gradual recognition of the possibility of general standards of justification. . . . The research done so far does not deter mine whether the developmental sequence observed is inevitable or whether it [is the result of other causes such as the educational system]. There is little reason to think that stages cannot be skipped. It is also possible that general standards can be acquired earlier, so that the middle stage of relativism can be avoided.
>
> What is clear is that the higher stages encourage actively open-minded thinking and the lower stages discour age it. The higher stages imply that thinking is worthwhile, that progress can be made. The lowest stages imply that thinking is futile because only authority or direct experience can lead to truth, and the middle stages imply that thinking is futile because no answer is better than any other. In addition, the highest stages imply that beliefs can always be improved; this encourages openness to alternatives and to counterevidence (Baron 292).

This approach suggests that a necessary prerequisite to combating irrational behavioral tendencies in investment is that the committee members must be in the later stages of thinking about investment matters. It is only the openness to alternatives and to counter-evidence, and the merit of thinking through issues, that allows the behavioral tendencies to disappear. To the extent that a committee is in the earlier stages of understanding, where experts and systems have the true and only answer, or that any view is as good as another, then that committee will be unable to rise above its “natural” tendencies, and will then allow itself to be dominated by inclinations counter to basic, modern investment principles.

As an example, for committees in the “lower” stages of investment thinking, there may be a tendency to confuse relying on apparent expertise with understanding a problem, or to slavishly follow strongly expressed opinions of others in the group (or advisors). As Baron surmises, “[t]his confusion of expertise with good thinking may reinforce the institutional pressures. Those who are considered wise and respected members of the institution or group may talk like experts, encouraging their followers to ‘know’ rather than to think. And how are the followers supposed to ‘know’? By listening to the experts, of course” (294). An example or a signal of a purely relativistic point of view would be a naïve commitment to strong efficient market theory, where no action is better or worse than any other (on a risk-adjusted basis), because all prices are believed to accurately reflect all relevant information.

[11] Baron, Jonathan. *Thinking and Deciding.* Cambridge: Cambridge University Press. 1994.

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In any event, groups or staffs should examine their own dynamics to see whether their groups are, in fact, open to the critical and open inquiry needed to combat the natural "illogical" investment tendencies of common sense thought. If the group exhibits any of the group barriers to that ability to conduct an open inquiry (namely groupthink or "lower" stages of thinking), then the effort should be first to change the group dynamic before proceeding to resolving individual issues.

In closing, group-decision making can indeed pose behavioral traps for the unwary. Recognizing some of the behavioral biases we may exhibit when making group decisions is the first step in overcoming them. Just as important is maintaining awareness and making a commitment to continually address these issues with the goal of improving our approach, our results, and better executing our duties on behalf of our constituents.

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