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A Trusted Advisor Can Keep You from Cheating

We've all cheated on a diet. We reason, "It's the weekend, so it doesnt count." Or, we factor in the calories for a serving size when we know we've had two. Or, we cut our run short to get back home in time to watch the big game. The list goes on...We may know the smaller portion or the longer run is better for us, but since we alone are monitoring our behavior, we convince ourselves that cheating is okay— that we are not doing ourselves any harm in the long run.

Investors cheat, too. I'm not talking about the criminal behavior of Bernie Madoff, but rather what behavioral economist Dan Ariely describes as "fudging." As is the case with dieting, investors attempt to convince themselves that straying from their investment discipline won't cause any problems if they do it just once. In his recent article *Why Don't Investors Stay True to Their Principles?* Think Self-Deception, Morningstar's Head of Behavioral Science Stephen Wendel explores Ariely's theories, stating, "It can be remarkably difficult for investors—and advisors—to stay true to their stated investment principles over time. Whether an investor focuses on momentum investing, minimizing fees or using a valuation-driven approach, there are many pressures to stray—from the urge to chase returns, to getting caught up in fads, to running scared when the markets turn rough." He goes on to posit that investors succumb to temptation because of the power of self-deception. That is, like sneaking a dessert while

dieting, investors simply excuse themselves from breaking their own rules.

The urge to cheat is particularly strong in volatile markets. As Wendel writes, "When an investor, or anyone, commits to a virtuous course of action there's usually a temptation to cheat, too. For example, for a die-hard value investor, there's a temptation to pick up a few overvalued but hot stocks, just in case. When markets are bumpy, the temptation to break from one's strategy is particularly intense. When people are faced with conflicting incentives like this, they try to follow both sets of incentives at the same time. They balance their self-image as an honest person (following their stated course of action) with the temptation to cheat (chasing returns) by fudging things a bit."

Most interesting to me, Wendel offers a personal example that illustrates that even someone so skilled in behavioral science and investing can be sway by these powerful behavioral tendencies. He writes, "I recently moved to Chicago to be at Morningstar's home office. Due to the particular timing of the move, I needed to liquidate some investments last year, and have been sitting on cash ever since the purchase. While I'm a valuation-driven investor who researches common investor mistakes...I've basically been trying to time the market. I've been avoiding my advisor and dragging my feet about reinvesting the money. It's a really, really stupid thing to do."

Here's the truth: Wendel is avoiding his advisor because even though he was not self-aware enough to stop from making a bad investment decision, he knows his advisor will insist that his actions correspond to his investment plan. Sometimes that requires a real intervention. Like, Circe who advises Odysseus to plug his men's ears with beeswax and have them bind him to the mast of his ship in order not to be drawn off course by the beautiful—but ultimately destructive—songs of the Sirens, trusted advisors can ensure their clients are able to navigate choppy markets and stay on course to meet their short- and long-term goals.

How do we accomplish that? Behavioral finance teaches us that when facing uncertainty, we are hardwired to react with fear and often make snap, ill-advised decisions. I think here of a recent Caltech study that imaged subjects' brains as they made decisions with increasingly less information. You might figure that sparse data would lead the subjects to hesitate and to carefully evaluate what little information they were provided with. Yet, the reverse was true. The less data the subjects had to evaluate, the more irrational and erratic their decision-making became. Of course, there's a scientific root to this behavior. As the uncertainty of the scenarios increased, the subjects' brains shifted over to the limbic system, the place where emotions, such as anxiety and fear, overpower reason.

Of course, in uncertain markets like we are currently experiencing, it's critically important to hang onto reason and follow your plan. And that can be difficult. For example, individual investors who don't work with advisors are often hurt when they make investment decisions in response to news headlines. Generally, that means buying high and selling low. I caution our clients not to respond to the fearful urge to "do something" or to disengage with their plan. That's because we build diversified portfolios to withstand market swings. We emphasize the importance of broad diversification, efficient portfolio design and execution, and consistent

asset class exposure as the most reliable means of capturing market premiums that can offer investors higher expected returns and minimizing downside risk.

As with any relationship, consistency always provides comfort in times of major stress. And our investment approach has not changed as a result of increased market volatility. We keep you from "cheating" yourself—and make changes to your portfolios when your goals, time horizons or risk tolerance change, not in response to market fluctuations.

Stay Diversified, Stay the Course!

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