



The Human Factor in Evidence-Based Investing

This quarter we turn to the final and arguably most significant factor in your evidence-based investment strategy: the human factor. In short, your own impulsive reactions to market events can easily trump any other market challenges you face.

Exploring the Human Factor

Despite everything we know about efficient capital markets and all the solid evidence available to guide our rational decisions . . . we're still human. We've got things going on in our heads that have nothing to do with solid evidence and rational decisions – a brew of chemically generated instincts and emotions that spur us to leap long before we have time to look.

Rapid reflexes often serve us well. Our prehistoric ancestors depended on snap decisions when responding to predator and prey. Today, our child's cry still brings us running without pause to think; his or her laughter elicits an instant outpouring of love (and oxytocin).

But in finance, where the coolest heads prevail, many of our base instincts cause more harm than good. If you don't know that they're happening or don't manage them when they do, your brain signals can trick you into believing you're making entirely rational decisions when you are in fact being overpowered by ill-placed, "survival of the fittest" reactions.

Put another way by neurologist and financial theorist William J. Bernstein, MD, PhD, "Human nature turns out to be a virtual Petrie dish of financially pathologic behavior."

Behavioral Finance, Human Finance

To study the relationships between our heads and our financial health, there is another field of evidence-based inquiry known as **behavioral finance**. *What happens when we stir up that Petrie dish of financial pathogens?*

Wall Street Journal columnist Jason Zweig's "Your Money and Your Brain" provides a good guided tour of the findings, describing both the behaviors themselves as well as what is happening inside our heads to generate them. To name a couple of the most obvious examples:

- **When markets tumble** – Your brain's amygdala floods your bloodstream with corticosterone. Fear clutches at your stomach and every instinct points the needle to "Sell!"
- **When markets unexpectedly soar** – Your brain's reflexive nucleus accumbens fires up within the nether regions of your frontal lobe. Greed grabs you by the collar, convincing you that you had best act soon if you want to seize the day. "Buy!"

An Advisor's Greatest Role: Managing the Human Factor

Beyond such market-timing instincts that lead you astray, your brain cooks up plenty of other insidious biases to overly influence your investment activities. To name a few, there's confirmation bias, hindsight bias, recency, overconfidence, loss aversion, sunken costs and herd mentality.

Your Take-Home

Managing the human factor in investing is another way an evidence-based financial practitioner can add value. Zweig observes, "Neuroeconomics shows that you will get the best results when you harness your emotions, not when you strangle them." By spotting when investors are falling prey to a behavioral bias, we can hold up an evidence-based mirror for them, so they can see it too. In our next quarterly newsletter, we'll explore some of the more potent behavioral foibles investors face.

David Bromelkamp
President and CEO

HUMANS ARE NOT WIRED FOR DISCIPLINED INVESTING

When people follow their natural instincts, they tend to apply faulty reasoning to investing.

The market tanked, and I should have seen it coming.

I wasn't wrong about that stock – just unlucky.

I work in that industry, so I know where it's going.

The trend looks good and should continue for a long time.

I have a proven system for picking winning managers.

My research confirms this is a great stock to own.

I knew this stock was going up.

It was a bad idea, but I don't want to sell at a loss.

MENTAL ERRORS



NEW EMPLOYEE SPOTLIGHT: Ilona Avraamides

Role at Allodium: Marketing and Administrative Assistant

Joined firm on: November 1, 2016

Hometown: Cleveland, OH and Ames, IA. I was born in Cleveland, and then my family moved to Iowa when I was almost 12.

Favorite movie: Life is Beautiful

Favorite book: My favorite novel is Pride and Prejudice by Jane Austen.

Favorite TV show: MI-5

Favorite food(s): Greek and Chinese food

Favorite news source: BBC World News

Favorite place in Twin Cities: I love to go out to eat in quirky restaurants in Northeast Minneapolis.

Favorite gadget/technology: My smartphone and my iPad.

Favorite activity: Hanging out with my family, cooking, reading and working on my cooking blog.

Favorite music: Blues, Jazz, Rock and Classical.

Person I admire most: Mother Theresa and Margaret Thatcher. Two great female role models!

What I'm most thankful for: My children, my husband, my friends and my health.

Headlines

- Dave Bromelkamp attended the Second Convening of the Twin Cities Impact Investing Ecosystem to learn more about impact investing opportunities.
- We had a great time with clients at our client education event in October about navigating the nonfinancial side of retirement.
- Dave Bromelkamp attended the 2016 AQR Investment Symposium to learn more about their evidence-based investment strategies.
- Allodium was pleased to welcome five new clients in the third quarter of 2016.
- Our office will be closed on December 26, January 2 and January 16 for company holidays.

Note: To find out more about Allodium's breaking news, please visit our website: www.aicria.com.



S P O T L I G H T

WE APPRECIATE YOUR INTRODUCTIONS

To optimize our objectivity and avoid conflicts of interest, we are a fee-only registered investment advisor that is completely independent from banks, brokerage firms and other financial product providers. If you know someone who may be looking for this type of objective investment advice, please contact Dave Bromelkamp at 612-230-3702 or dbromelkamp@aicria.com to arrange a friendly, no-obligation introduction.

Mark Your Calendars

ALLODIUM INVESTMENT FORUM: Wednesday, January 25, 2017, 3:30pm

Allodium will hold an educational workshop at Golden Valley Country Club for clients and their friends about "Allodium's Investment Philosophy." More details will be sent out in the near future!

For more information on events or to RSVP, please contact Victoria Simpson at 612-230-3704 or vsimpson@aicria.com.

Steward is published quarterly by Allodium Investment Consultants. Please contact Ilona Avraamides at 612-230-3711 or iavraamides@aicria.com if you have any comments about this publication or wish to be added to or removed from our mailing list.



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