

What Makes Your Brain Tick?

In our article last quarter, “The Human Factor in Evidence-Based Investing,” we explored how our deep-seated “fight or flight” instincts generate an array of behavioral biases that trick us into making significant money-management mistakes. In this installment, we’ll familiarize you with five of these more potent biases, and how you can avoid sabotaging your own best-laid investment plans by recognizing the signs of a behavioral bias.

BEHAVIORAL BIAS #1: Herd Mentality

Herd mentality is what happens to you when you see a market movement afoot and you conclude that you had best join the stampede. The herd may be hurtling toward what seems like a hot buying opportunity, such as a run on a stock or stock market sector. Or it may be fleeing a widely perceived risk, such as a country in economic turmoil. Either way, following the herd puts you on a dangerous path toward buying high, selling low and incurring unnecessary expenses en route.

BEHAVIORAL BIAS #2: Recency

Even without a herd to speed your way, your long-term plans are at risk when you succumb to the tendency to give recent information greater weight than the long-term evidence warrants. We know that stocks have historically delivered premium returns over bonds. And yet, whenever stock markets dip downward, we typically see recency at play, as droves of investors sell their stocks to seek “safe harbor” (or vice-versa when bull markets are on a tear).

BEHAVIORAL BIAS #3: Confirmation Bias

Confirmation bias is the tendency to favor evidence that supports our beliefs and gloss over that which refutes it. We’ll notice and watch news shows that support our belief structure; we’ll skip over those that would require us to radically change our views if we are proven wrong. Of all the behavioral biases on this and other lists, confirmation bias may be the greatest reason why the rigorous, evidence-based investing approach becomes so critical to objective decision-making. Without it, our minds want us to be right so badly, that they will rig the game for us, but against our best interests as investors.

BEHAVIORAL BIAS #4: Overconfidence

Garrison Keillor made overconfidence famous in his monologue about Lake Wobegon, “where all the women are strong, all the men are good looking, and all the children are above average.” Keillor’s gentle jab actually reflects reams of data indicating that most people believe that their acumen is above average. On a homespun radio show, impossible overconfidence is quaint. In investing, it’s dangerous. It tricks us into losing sight of the fact that investors cannot expect to

consistently outsmart the collective wisdom of the market, especially after the costs involved.

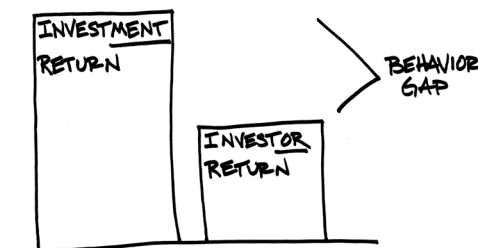
BEHAVIORAL BIAS #5: Loss Aversion

As a flip side to overconfidence, we also are endowed with an over-sized dose of loss aversion, which means we are significantly more pained by the thought of losing wealth than we are excited by the prospect of gaining it. One way that loss aversion plays out is when investors prefer to sit in cash or bonds during bear markets — or even when stocks are going up, but a correction seems overdue. The evidence clearly demonstrates that you are likely to end up with higher long-term returns by staying fully invested in your long-term strategy. And yet, even the *potential* for future loss can be a more compelling emotional stimulus than the *likelihood* of long-term returns.

Your Take-Home

So there you have it. Five behavioral biases, with many more worth exploring in the area of behavioral finance. We recommend you do take the time to learn more as it can help you become a more confident investor. But be forewarned. Even once you are aware of your behavioral stumbling blocks, it can still be devilishly difficult to avoid tripping on them as they fire off lightning-fast reactions in your brain well before your logic has any say. That’s why we suggest working with an objective advisor, to help you see and avoid collisions with yourself that your own myopic vision might miss.

David Bromelkamp
President and CEO



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FINANCIAL PLANNING TIP:

Advice from a Financial Advisor or Salesperson?

You work hard to invest and grow your money for your future. How do you find a financial advisor whose interests are aligned with yours and can provide you with advice to address your financial goals?

For this quarter's financial planning tip, we recommend that you be selective about where you get your advice. We are often asked how investors can know which advisors are working in their best interests. Can you tell by the advisors' titles or marketing materials? What about their websites?

As the report *Financial Advisor or Investment Salesperson? Brokers and Insurers Want to Have it Both Ways* by Micah Hauptman and Barbara Roper, Consumer Federation of America (2017) finds, many firms create an illusion that they are advice driven and client oriented in the way they present themselves to the public. They use titles such as "Financial Advisor" or "Retirement Counselor" and their websites encourage investors to believe they are entering into trustworthy and reliable relationships. Yet the dirty little secret in the industry is that many of these same firms are fighting a law that requires that their recommendations be held to the fiduciary standard of accountability. The fiduciary standard requires that they are bound to act legally and ethically in the best interests of their clients. This means that they may not make recommendations that benefit the investment firm or advisor more than the investor. The standard presently governing these firms is the suitability standard. The suitability standard allows them to recommend investments that are more profitable for the firm or advisor than the client, as long as the investment is generally "suitable." The report shows these very firms that claim they are putting the client first are arguing in court that they are really investment "salespeople" who are not to be relied on as trusted advisors by their clients and thus should not fall under the fiduciary standard.

We believe one of the most important tips we can provide is to select an advisor who is a fiduciary under the law, required to act in your best interest. Please contact [David Bromelkamp](#) if you would like to learn more about selecting a fiduciary advisor.

Hauptman, M., & Roper, B. (2017). *Financial advisor or investment salesperson? Brokers and insurers want to have it both ways*. Retrieved from <http://consumerfed.org/reports/financial-advisor-or-investment-salesperson-brokers-and-insurers-want-to-have-it-both-ways/>

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.



Headlines

- We had a wonderful time with clients at our 2017 Investment Forum on January 25th where we shared Allodium's investment philosophy.
- Allodium was pleased to welcome two new clients in the last quarter of 2016.
- Our office will be closed on April 14th and May 29th for company holidays.

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



Allodium Has Moved

Allodium is pleased to announce that we have moved to the 4th floor of our same building. We are continuing to grow as investors learn more about the benefits of fee-only investment advisory firms. This has created the need for more office space to accommodate our growing team.

Below is our new address effective February 24th:

Allodium Investment Consultants
500 Washington Avenue South, Suite 4400
Minneapolis, MN 55415

We look forward to serving you at our new location!

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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