STEWARD

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The ABCs of Behavioral Biases: H-O

There are so many investment-impacting behavioral biases, we could probably identify at least one for nearly every letter in the alphabet. Today, we'll continue with the most significant ones by looking at: hindsight, loss aversion, mental accounting and outcome bias.

Hindsight

What is it? In "Thinking, Fast and Slow," Nobel laureate Daniel Kahneman credits Baruch Fischhoff for demonstrating hindsight bias – the "I knew it all along" effect – when he was still a student. Kahneman describes hindsight bias as a "robust cognitive illusion" that causes us to believe our memory is correct when it is not. For example, say you expected a candidate to lose, but she ended up winning. When asked afterward how strongly you predicted the actual outcome, you're likely to recall giving it higher odds than you originally did. This seems like something straight out of a science fiction novel, but it really does happen!

When is it helpful? Similar to blind spot bias (one of the first biases we covered) hindsight bias helps us assume a more comforting, upbeat outlook in life. As "Why Smart People Make Big Money Mistakes" authors Gary Belsky and Thomas Gilovich describe it, "We humans have developed sneaky habits to look back on ourselves in pride." Sometimes, this causes no harm, and may even help us move past prior setbacks.

When is it harmful? Hindsight bias is hazardous to investors, since your best financial decisions come from realistic assessments of market risks and rewards. As Kahneman explains, hindsight bias "leads observers to assess the quality of a decision not by whether the process was sound but by whether its outcome was good or bad." If a high-risk investment happens to outperform, but you conveniently forget how risky it truly was, you may load up on too much of it and not be so lucky moving forward. On the flip side, you may too quickly abandon an underperforming holding, deceiving yourself into dismissing it as a bad bet to begin with.

Loss Aversion

What is it? "Loss aversion" is a fancy way of saying we often fear losing more than we crave winning, which leads to some interesting results when balancing risks and rewards. For example, in "Stumbling on Happiness," Daniel Gilbert describes: "[M]ost of us would refuse a bet that gives us an 85 percent chance of doubling our life savings and a 15 percent chance of losing it." Even though the odds favor a big win, imagining that slight chance that you might go broke leads most people to decide it's just not worth the risk.

When is it helpful? To cite one illustration of when loss aversion plays in your favor, consider the home and auto insurance you buy every year. It's unlikely your house will burn to the ground, your car will be stolen, or an act of negligence will cost you your life's savings in court. But loss aversion reminds us that unlikely does not mean impossible. It still makes good sense to protect against worst-case scenarios when we know the recovery would be very painful indeed.

When is it harmful? One way loss aversion plays against you is if you decide to sit in cash or bonds during bear markets – or even when all is well, but a correction feels overdue. The evidence demonstrates that you are expected to end up with higher long-term returns by at least staying put, if not bulking up on stocks when they are "cheap." And yet, the potential for future loss can frighten us into abandoning our carefully planned course toward the likelihood of long-term returns.

Mental Accounting

What is it? If you've ever treated one dollar differently from another when assessing its worth, that's mental accounting at play. For example, if you assume inherited money must be more responsibly managed than money you've won in a raffle, you're engaging in mental accounting.

When is it helpful? In his early paper, "Mental Accounting Matters," Nobel laureate Richard Thaler (who is credited for having coined the term), describes how people use mental accounting "to keep track of where their money is going, and to keep spending under control." For example, say you set aside $250/month for a fun family outing. This does not actually obligate you to spend the money as planned or to stick to your budget. But by effectively assigning this function to that money, you're better positioned to enjoy your leisure time, without overdoing it.

When is it harmful? While mental accounting can foster good saving and spending habits, it plays against you if you instead let it undermine your rational investing. Say, for example, you're emotionally attached to a stock you inherited from a beloved aunt. You may be unwilling to unload it, even if reason dictates that you should. You've just mentally accounted your aunt's bequest into a place that detracts from rather than contributes to your best financial interests.

Outcome Bias

What is it? Sometimes, good or bad outcomes are the result of good or bad decisions; other times (such as when you try to forecast future market movements), it's just random luck. Outcome bias is when you mistake that luck as skill.

When is it helpful? This may be one bias that is never really helpful in the long run. If you've just experienced good or bad luck rather than made a smart or dumb decision, when wouldn't you want to know the difference, so you can live and learn?

When is it harmful? As Kahneman describes in "Thinking, Fast and Slow," outcome bias "makes it almost impossible to evaluate a decision properly – in terms of the beliefs that were reasonable when the decision was made." It causes us to be overly critical of sound decisions if the results happen to disappoint. Conversely, it generates a "halo effect," assigning undeserved credit "to irresponsible risk seekers . . . who took a crazy gamble and won." In short, especially when it's paired with hindsight bias, this is dangerous stuff in largely efficient markets. The more an individual happens to come out ahead on lucky bets, the more they may mistakenly believe there's more than just luck at play.

You're now more than halfway through our alphabetic series of behavioral biases. Look for our next piece soon.

David Bromelkamp

President and CEO

Headlines

- Allodium was named as one of the Minnesota Registered Investment Advisory (RIA) firms in RIA Survey and Ranking 2018, as published by *Financial Advisor Magazine* in the July 2018 issue.
- The Centre for Fiduciary Excellence (CEFEX) has recertified Allodium again in August 2018. The CEFEX assessment process is based on rigorous ISO 19011 standards for quality management system auditing.
- Allodium was pleased to welcome two new clients in the second quarter of 2018.
- Our office will be closed November 22 and 23 for company holidays.
- Just a reminder that we are gradually transitioning to the domain name of *allodium.com* for both our website and employee email addresses over the next year. Please update your records.

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

PLANNING

FINANCIAL PLANNING TIP:

Keep Safe From Identity Theft

According to Minnesota's attorney general, Lori Swanson, the U.S. Department of Justice estimates that over 17 million Americans become victims of identity theft each year, resulting in billions of dollars in losses. We have all experienced swindlers attempting to obtain confidential information or money from us through fraudulent emails and phone calls. The Nigerian prince and fake "IRS" are two examples of these cons. There are numerous forms of identity theft and one must be vigilant about protecting accounts and information from getting into the wrong hands. Criminals can hack into your accounts from miles away and steal your social security, credit card and bank information.

Freeze or Monitor Your Accounts

One simple and effective solution to protect yourself from the time, hassle and cost of identity theft is to place a security freeze on your credit file. According to the Federal Trade Commission, a security freeze allows you to restrict access to your credit report, which makes it more difficult for identity thieves to open new accounts in your name. Most creditors require seeing your credit report before they approve a new account. If creditors can't see your file, they may not extend the credit.

There are three credit bureaus—Experian, Equifax and TransUnion. It is important to place a freeze at all three bureaus. Find detailed information on freezing your credit here. There is no longer a fee to freeze your credit. Also, starting on September 21, 2018, parents and guardians are able to freeze the credit file of a child under age 16, a service previously only offered to adults.

If you do not want to pursue a security freeze, consider monitoring your credit report using www.annualcreditreport.com, or sign up for one of the many credit monitoring services that will monitor your credit report for you and alert you to any new activity.

Contact us if you would like to discuss other ways to protect against identity theft.

Upcoming Events

September 12, 2018:
Dave Bromelkamp will speak on a panel at the *Markets Group 5th Annual Great Plains Institutional Forum* at the Hyatt Regency in Minneapolis. The topic of his panel will be **"Environmental, Social, and Corporate Governance (ESG) Integration."**

September 13, 2018:
Dave Bromelkamp will speak on a panel at the *Markets Group 3rd Annual Private Wealth Great Plains Forum* at the Hyatt Regency in Minneapolis. The panel's topic will be **"The Future of Wealth Management."**

September 27, 2018:
Join us at Allodium's *2018 Fall Wealth Management Workshop* titled **"Passion to Impact: Generous and Powerful Charitable Giving."** Mary Karen Lynn-Klimenko, Alice Hill and Joni Boucher from Private Philanthropy Services will present. The event will be held at the Golden Valley Country Club.

October 23, 2018:
Eric Hutchens will speak at the *2018 Minnesota Elder Law Institute* at the Minnesota CLE Conference Center. His topic will be **"Social Security: What's Changed and What You Need to Know."**

EVENTS

For more information about these events, please contact Ilona Avraamides at (612) 230-3711 or iavraamides@allodium.com.

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@allodium.com to arrange a friendly, no-obligation introduction.

Steward is published quarterly by Allodium Investment Consultants. Please contact Ilona Avraamides at 612-230-3711 or iavraamides@allodium.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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