Surviving Our Own Instincts

financial fitness

By **Erik Ford**

Last month, I wrote about the importance and value of putting a financial plan together with the assistance and guidance of a professional. Once that plan is in place and implemented, either at a general level or at great detail, what is the greatest risk we face to failure? Ourselves and our human nature. Of course, there are bumps in the road of life that may interfere (illness, job loss, divorce, etc.), but it is our human nature that is most likely to trip us up by driving our behavior against our own best interests. So, how does this happen? This article will present some of the most common self-defeating traits, although it is certainly not an exhaustive list.

Recency bias is our tendency to believe that events or results that have happened most recently in the past will continue in the future. If we experience a sharp decline in our portfolio due to a market sell-off, we expect this trend to continue. We don't step back and console ourselves with how markets have performed over longer periods, but instead have an urgent need to do something before it gets worse. We sell low only to finally buy back in at higher levels. Not a recipe for financial success.

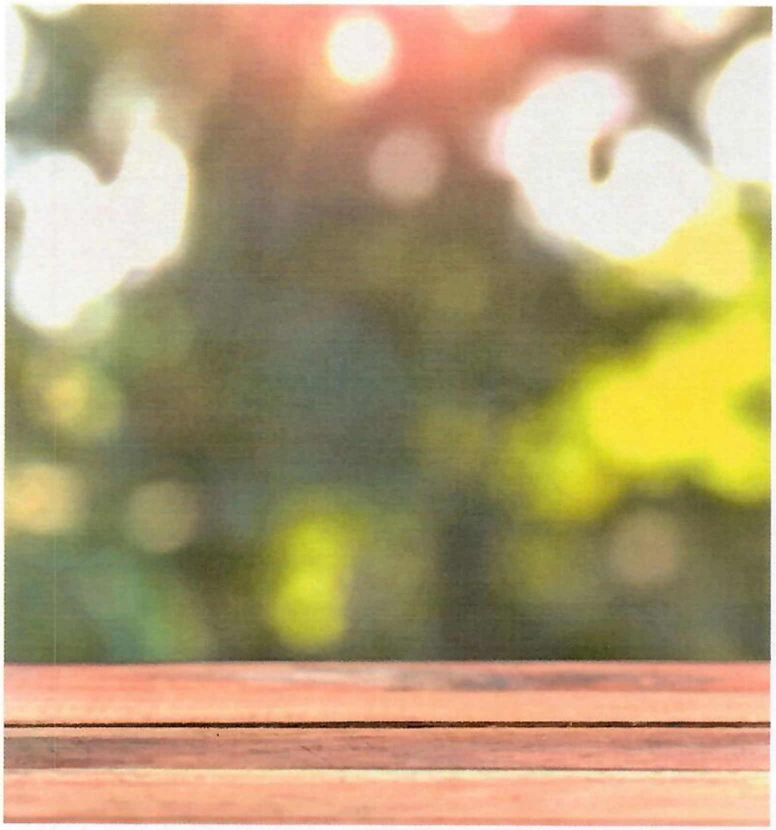
Overconfidence is another bias that can work to our detriment. We believe we know more than the average bear and act accordingly on what is likely scant data. What is even worse, and compounds our overconfidence, is that we seek out evidence that we were right all along even though we weren't. This is called confirmation bias. Together it can be a deadly combination.

We look for patterns where there are none. Our overconfidence and desire for confirmation lead us to seek out telling patterns where true randomness may prevail. And if we experience an outcome we expected, or convinced ourselves in hindsight that we expected, it will feed into our overconfidence and self-confirmation. We use hindsight to bolster our biases selectively.

Availability bias is our tendency to rely on the most accessible information, even if it may not be the most critical. Anchoring bias is what may cause us to stubbornly rely on these easily available facts rather than seeking out additional data that may contradict our predisposition.

In some respects, these tendencies can all compound on each other, even though they are also individually harmful. In short, we over-confidently anchor ourselves to available data to seek patterns that we falsely confirm to ourselves with hindsight. Being human is challenging, isn't it?

While the above biases may relate to humans as sophisticated (even though misguided) actors, underlying all of this is our



most primitive nature often referred to as our "lizard brain." It is referred to as such because it is the most primitive part of our brains from an evolutionary standpoint. It is our survival instincts, our instinct to "fight or flight." How does this affect our investing behavior? It drives us to fear loss to a much greater degree than we value an equal gain. We react much differently and perhaps suddenly to a 10% decline in our portfolio ("sell!") than a 10% gain. This short-termism can be very harmful over the long-term and the long-term is what is critical to any financial plan succeeding. A sharp decline in our portfolio is not the same as rounding a corner to face a hungry bear. In the first case, we are better to stay in the game and be contemplative; in the latter, it is best to take immediate action. Not all bears are the same.

While the basis for this article comes from innumerable readings and experience over the years, I would like to give credit to two pieces that I directly referenced while preparing the above. The first is a piece put out by Virtus Investment Partners called "Minds over Markets, a Behavioral Guide to Investing" and the second is an opinion piece by Lance Roberts published by Marketwatch.com dated October 21, 2017.

Erik Ford is the owner of Ford Wealth Management LLC in Glen Ellyn, IL. He is a CFP® certificate holder as well as an Accredited Investment Fiduciary®.

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