CLEARPOINT

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ET TU, BRUTE?

BY ANNA RATHBUN, CFA, CAIA, DIRECTOR, RESEARCH

In the Shakespearean tragedy *Julius Caesar*, the title character ignores two warnings about an impending personal doom. The first one is from a soothsayer, where he utters the famous phrase "Beware the Ides of March." The second warning comes from Caesar's wife Calpurnia, who upon having a bad dream begs Caesar not to go to the senate: "you shall not stir out of your house today." Driven by vanity, ambition, and overconfidence, Caesar goes to the senate anyway, and instead of receiving the crown, he is betrayed by his friend Brutus. In addition to its indisputable place in world literature, Shakespeare's *Julius Caesar* can also be useful for our "tongue-in-cheek" analytical exercise in behavioral biases. Caesar's biases may have led to the eventual misfortune, and our own biases may betray our investing acumen and lead us to less than optimal portfolio outcomes.

NEW INFORMATION: "BEWARE THE IDES OF MARCH" AND "YOU SHALL NOT STIR OUT OF YOUR HOUSE TODAY"

Making investment decisions, among many other daily choices, is often about what we do with the information we receive. Caesar received new information about his future, and how he processed it led to the fateful decision. We receive new information all the time about the economy, the markets, and portfolio advice through the 24-hour news feed. How does information shape the way we think and believe about our financial future? In this section, we walk through a select few behavioral biases that have been widely discussed in academic literature.

CLEARSTEAD ROUNDTABLE FOSTERS INSIGHTFUL DISCUSSION ON WEALTH TRANSITION

Clearstead was honored to host our Third ClearPoint Roundtable, *Investing in the Future: Preparing the Next Generation to Sustain Family Wealth*.

We had a great panel of six professionals, moderated by Dave Osborne, President DAO Advisors, Former President CYMI, Ltd., that touched on a range of topics from how best to communicate with future generations on inheriting and sustaining family wealth, encouraging family mission statements and values, how current generations are approaching their wealth management, and governance issues and techniques, to name a few.

Our esteemed panel was comprised the following individuals:

- Mr. Joe Verciglio, Partner, Baker Hostetler
- Mr. Bill Karnatz, President, Western Reserve Trust Company

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Confirmation Bias is when we look for confirmation of our already held beliefs. For example, if a person believes that our economy is heading into a recession, he/she may be biased towards evidence to support this thesis, while ignoring information that supports a growing economy. In the case of Caesar, it was easy for him to ignore the two warnings because they did not confirm his vain belief about himself and his future. In fact, when Calpurnia originally objects to Caesar's trip to the senate, Caesar reluctantly concedes. Upon hearing Decius's (one of Brutus' conspirators) more rosy interpretation of Calpurnia's dream, Caesar is quick to accept the explanation that confirms his own views.

Representativeness Bias refers to our tendency to categorize new experiences. Sometimes, we try to categorize new information to our existing categorization scheme, even if it does not fit. For example, when we see negative news headlines about hedge funds, we might want to believe that all hedge funds have bad performance, when in fact, the hedge fund universe is diverse and manager selection determines the outcome for the investor.

Availability and Recency Biases refer to our tendency to gravitate toward what is readily available, or at arms-length. Specifically in *Recency Bias*, we place more emphasis on events that just occurred. In another example, if I favor a certain asset class, say U.S. large cap stocks for no other reason than that it has done well recently, I would be looking at my investment choices with recency bias.

But, if I am wary of the asset class U.S. large cap equities for no other reason than that it has done well, and I am afraid it might fall soon, I would be exhibiting *loss-aversion bias*, where I am so against losing any money that I do not consider the prospect that large cap stocks might continue to do well. Only if Caesar had some *loss-aversion bias*…

Self-Control Bias is as it sounds: difficulty with self-discipline. The most widespread problem of this bias is happening in the retirement planning world, where those who are able may not save enough for retirement.

Status-quo bias and *regret aversion bias* are similar since they both deal with anxiety around having to make decisions. One might relate the two in the following way: because I am afraid of regretting my choice, I would rather do nothing and make no decision. In this way, regret aversion leads to the status quo. In some ways, the creation of large positions could be viewed as a result of regret aversion bias. If a stock has risen considerably, and the owner has "fear of missing out" on future gains, it may lead to holding the position for longer than advisable while the position grows.

In the following pages, we will see how these select few biases can work dynamically in specific situations: making asset allocation decisions, manager decisions, and personal finance decisions.

MAKING ASSET ALLOCATION DECISIONS

If you have been investing for a while, I am sure that you have heard of the benefits of portfolio diversification. Our clients are familiar with what we call the "quilt chart" on the following page, where we show the performance of various asset classes over time, ranked from highest performing to the lowest, top to bottom.

- Mr. Jeff Wasserman, Managing Director and Executive Vice President, Oswald Companies
- Mr. Joe Juster, Partner, Calfee Halter
- Mrs. Kate Biggar, Vice President, KeyBanc Capital Markets Public Finance Group
- Mr. Greg Althans, CPA/PFS, CFP®, Senior Managing Director and Chief Wealth Strategist, Clearstead

We are grateful for those who participated in and attended our Roundtable Event. Please look to our Blog where we will have a full write-up of the key insights from the discussion available.

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2010	2011	2012	2013	2014	2015	2016	2017	2018	Q1 2019	Q2 2019	2019
REITs 27.6%	US Bonds 7.8%	REITs 20.1%	Sm/Mid 36.8%	REITs 27.2%	REITs 2.3%	Sm/Mid 17.6%	Em Mkt 37.3%	Cash 1.9%	REITs 16.7%	Large Cap 4.3%	Sm/Mid 19.3%
Sm/Mid 26.7%	REITs 7.3%	Em Mkt 18.2%	Large Cap 32.4%	Large Cap 13.7%	Large Cap 1.4%	Hi Yld 17.5%	Dev Intl 25.0%	US Bonds 0.0%	Sm/Mid 15.8%	Dev Intl 3.7%	REITs 18.8%
Em Mkt 18.9%	Glb Bond 5.2%	Dev Intl 17.3%	Dev Intl 22.8%	Sm/Mid 7.1%	US Bonds 0.6%	Large Cap 12.0%	Large Cap 21.8%	Glb Bond -0.9%	Large Cap 13.7%	Glb Bond 3.6%	Large Cap 18.5%
Hi Yld 15.2%	Hi Yld 4.4%	Sm/Mid 17.9%	Hdg Fnds 9.0%	US Bonds 6.0%	Cash 0.1%	Em Mkt 11.2%	Sm/Mid 16.8%	Hi Yld -2.3%	Dev Intl 10.0%	US Bonds 3.1%	Dev Intl 14.0%
Large Cap 15.1%	Large Cap 2.1%	Large Cap 16.0%	Hi Yld 7.4%	Hdg Fnds 3.4%	Hdg Fnds -0.3%	REITs 9.3%	Glb Bond 9.3%	Hdg Fnds -4.0%	Em Mkt 9.9%	Sm/Mid 3.0%	Em Mkt 10.6%
Dev Intl 7.8%	Cash 0.1%	Hi Yld 15.6%	REITs 3.2%	Hi Yld 2.5%	Dev Intl -0.8%	US Bonds 2.7%	REITs 9.3%	Large Cap -4.4%	Hi Yld 7.4%	Hi Yld 2.6%	Hi Yld 10.2%
US Bonds 6.6%	Sm/Mid -2.5%	Hdg Fnds 4.8%	Cash 0.1%	Cash 0.0%	Sm/Mid -2.9%	Glb Bond 1.9%	Hdg Fnds 7.8%	REITs -4.4%	Hdg Fnds 5.0%	REITs 1.8%	Hdg Fnds 6.3%
Glb Bond 6.1%	Hdg Fnds -5.7%	US Bonds 4.2%	US Bonds -2.0%	Em Mkt -2.2%	Hi Yld -4.6%	Dev Intl 1.0%	Hi Yld 7.5%	Sm/Mid -10.0%	US Bonds 2.9%	Hdg Fnds 1.6%	US Bonds 6.1%
Hdg Fnds 5.7%	Dev Intl -12.1%	Glb Bond 1.8%	Em Mkt -2.6%	Glb Bond -2.8%	Glb Bond -4.8%	Hdg Fnds 0.5%	US Bonds 3.5%	Dev Intl -13.8%	Glb Bond 1.4%	Cash 0.6%	Glb Bond 5.0%
Cash 0.1%	Em Mkt -18.4%	Cash 0.1%	Glb Bond -4.9%	Dev Intl -4.5%	Em Mkt -14.9%	Cash 0.3%	Cash 0.9%	Em Mkt -14.6%	Cash 0.6%	Em Mkt 0.6%	Cash 1.2%

Past performance is no guarantee of future results. Asset classes represented by: Large Cap – S&P 500 Index; Sm/Mid – Russell 2500 Index; Dev Intl – MSCI EAFE Index; Em Mkt – MSCI Emerging Markets Index; Hi Yld – Bank of America Merrill Lynch U.S. High Yield Master II; US Bonds – Barclays Capital U.S. Aggregate; Glb Bond – Barclays Capital Global Treasury ex US; REITs – NAREIT ALL REITs; Hdg Fnds – HFRI FOF: Diversified Index; Cash – Merrill Lynch 91-day Tbill . Data as of 6/30/2019. Source: Zephyr Associates.

This chart reveals two things about the benefits of diversification: 1. There is no asset class that sits consistently at the top or the bottom; 2. It is impossible to know in advance which asset class will be at top (or at the bottom). The general idea behind diversifying is that you populate your portfolio with asset classes that serve various functions (some growth, some hedging), and that you can participate in the upside of the asset classes as they climb up. The more technical idea behind diversifying is that, through rebalancing your portfolio as the various asset classes out/underperform relative to one another, you reduce your total portfolio volatility and improve your risk-adjusted performance over the long run.

As much as the above paragraph makes sense, our biases may come into play when we begin to consider the discipline of diversification and rebalancing. It is especially difficult to stay diversified when certain asset classes lag others over a long period of time. Take, for example, the S&P 500 Index. Over the last several years, it has been difficult for other equity indices to beat this index ("Large Cap" in our quilt chart above). It has also been difficult for investors to stay diversified because our biases may encourage us to chase returns. Being influenced by the most recent return information in our portfolio construction is recency bias in action. We may even begin to think that U.S. large caps is safer than other equity categories because its outperformance has been consistent, a frame of mind that misrepresents the risk profile of the asset class (representativeness bias).

Think back to 2008, which seems so distant now but still serves as a good example of investor recency and representativeness biases. Many investors fled to cash after the market crash, as equities and credit instruments were deemed "too risky." Years later, investors have exhibited "fear of missing out," especially with certain areas of the stock market (e.g. technology) being framed as the only place where one might find growth.

The task of diversifying a portfolio is not to predict the winner and pile on; the task is to accept the unpredictability of the future, as the quilt chart would indicate, and to increase the likelihood of long-term success. Recency bias would only make us chase the winners, and representativeness bias could leave us with the wrong impression of the risk associated with an asset class. Neither of these approaches is a long-term solution.

MAKING DECISIONS ABOUT MANAGERS

How many of our readers would feel comfortable investing with a manager whose performance has been mediocre for the last few years? Probably not many. Often, investors choose managers who have a good performance track record because managers who have proven themselves with good past performance provide comfort to investors regarding their skills set. Investors may expect future persistence of excess returns by knowing only one fact: past performance.

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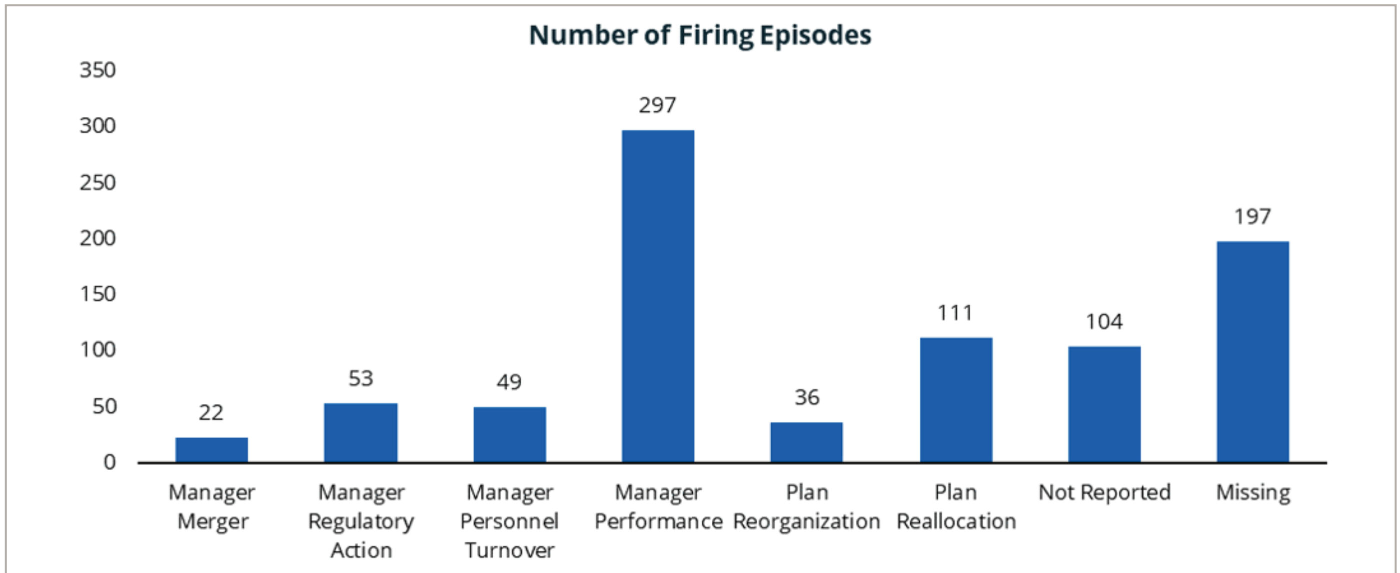
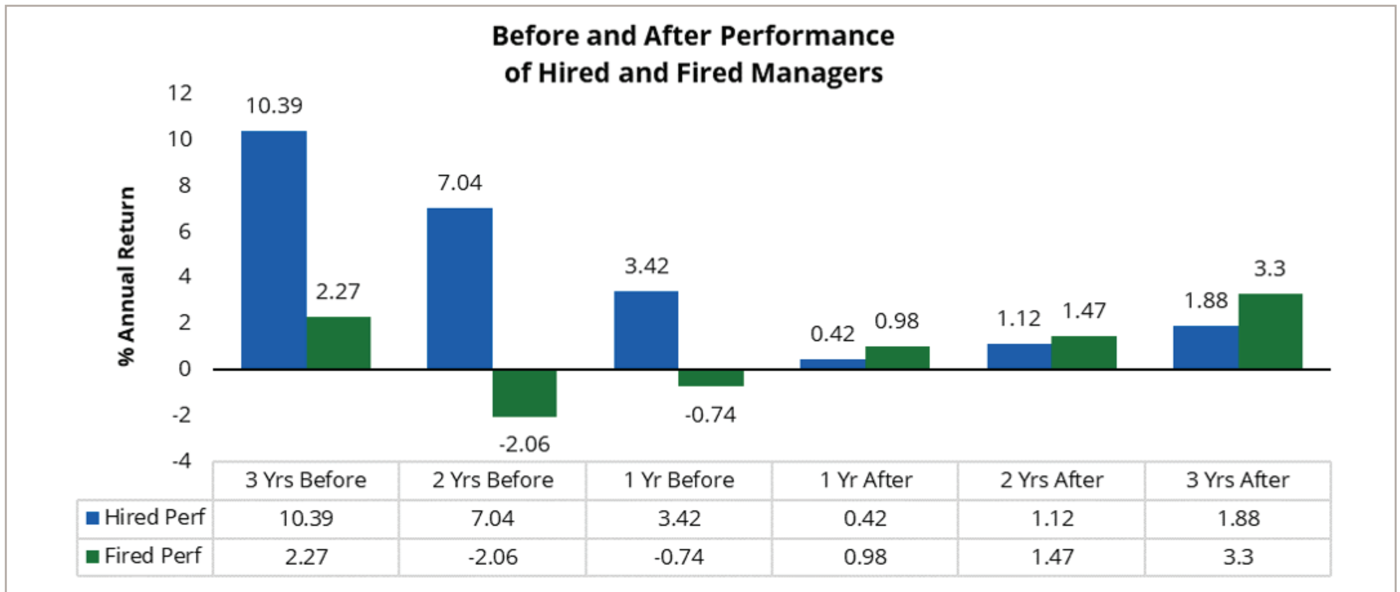
But basing an investment decision solely on recent performance is another form of recency and representativeness biases at play, which leads investors to categorize the strategy as a "good investment" in their minds. However, when the manager underperforms (which will happen to most managers), the same biases will quickly influence investors to fire the manager, resulting in suboptimal performance for the duration of the investment. Perhaps they will be swayed by availability bias and invest in the next hot fund that everyone is talking about.

This investor pattern is all too familiar in the industry and was well demonstrated in the study on plan sponsor behavior[1]. In the 2006 paper[2], Goyal and Wahal tracked manager hiring and firing decisions of 3,417 plan sponsors and tracked their performance before and after the decisions. In the survey, manager performance was by far the most frequent trigger for a manager change, as indicated in the chart below.



It was also clear that the decision makers in the aggregate made their decisions based on past performance (hired managers who had past outperformance; fired managers with past underperformance). According to their study, the managers that were fired ended up outperforming the managers who were hired.



	3 Yrs Before	2 Yrs Before	1 Yr Before	1 Yr After	2 Yrs After	3 Yrs After
Hired Perf	10.39	7.04	3.42	0.42	1.12	1.88
Fired Perf	2.27	-2.06	-0.74	0.98	1.47	3.3

Past performance is no guarantee of future results.

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The truth is that nearly all winning managers underperform at some point in their history, whether it is because they were unlucky, there was a stylistic headwind, or the market environment changed. Making decisions about investing with a manager requires a holistic perspective that expands beyond past performance considerations. Clearstead's Research Team and its "6 pillars" (aka, 6P's) incorporate our understanding of the marketplace, assessment of the managers' competitive edge in their space, and other qualitative evaluations. These elements help to provide confidence in the durability and persistence of good performance from the manager over a market cycle.

MAKING DECISIONS ABOUT MANAGERS

We all must make daily decisions, whether saving for our future versus spending today, or abstaining from the extra piece of cake in the office and choosing fruit instead. These dilemmas involve tilting away from or toward delayed gratification, and we read about their effects time and time again in reputable publications, where articles bemoan the lack of retirement preparedness in America. The two biases that are prominently shown through the retirement savings shortage are self-control bias and status-quo bias.

Self-control bias is self-explanatory and permeates through all parts of our lives. Saving for the future, when the present needs and wants take precedence is a difficult task for anyone. The current general thought seems to be a contribution ratio of about 10% to 15% in retirement savings. Unfortunately, the average contribution rate overall in the industry today is roughly 6-7%, which falls short of the recommended average, and this statistic does not address the distribution of savings rates among Americans. In other words, if the average is 6-7%, then we have the super savers that save more, but we also have plan participants who are not saving nearly enough.

Exacerbating the retirement conundrum in America is also status-quo bias, where eligible employees do not participate actively in the retirement program. Either they do not elect to save into the plan or take the steps to make sure that their assets are invested appropriately (e.g. rebalancing periodically, adjusting exposure to risk assets as they get older, etc.). Sometimes, this bias stems from lack of interest, and sometimes, the participants are overwhelmed by the choices they are required to make. The status-quo leads to no action at all, resulting in savings shortfall as well as inappropriate asset allocation.

In order to help mitigate the effects of these biases, retirement plan sponsors have utilized creative plan designs to help. Features such as auto-enroll and auto-increase help participants combat self-control and status-quo biases to start saving and to get closer to a general recommended savings rate. Corporate/institutional matching programs also encourage eligible employees to save. Finally, target date funds, which are often designated as Qualified Default Investment Alternative (QDIA), help to decrease the pressure of decision making for participants, and to become automatically invested in a diversified and professionally managed option that adjusts risk over time.

CONCLUSION

It was ultimately confirmation bias that led Caesar to be cavalier about the two direct warnings regarding his future. While our study on Caesar was playful, the financial realities of behavioral biases can have a significant impact on our clients. Although *Julius Caesar* was not intended to comment on human reactions to the capital markets, it does provide enduring lessons on the importance of humility, objectivity, and situational awareness. At Clearstead, we are mindful of these qualities as we search for skilled investment managers, distill market intelligence, and advise our clients. Behavioral biases are a normal part of our lives, but Clearstead can help navigate our clients toward more optimal outcomes.

Sources:

(1) The term "plan sponsors" is used generally to represent institutions with asset pools, including endowments and foundations, and is not specific to retirement plans.

(2) Goyal, Amit and Sunil Wahal. "The Selection and Termination of Investment Management Firms by Plan Sponsors," The Journal of Finance Vol. LXIII, No. 4, August 2008, pages 1805–1847.

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MARKET BENCHMARK RETURNS

August 31, 2019		1M	3M	12M	YTD
US Large Cap	S&P 500	-1.6%	6.9%	2.9%	18.3%
US Small Cap	Russell 2000	-4.9%	2.4%	-12.9%	11.8%
Developed Intl	MSCI EAFE	-2.6%	1.9%	-3.3%	9.7%
Emerging Intl	MSCI Em Mkt	-4.9%	-0.2%	-4.4%	3.9%
Real Estate	NAREIT	3.4%	6.0%	13.6%	23.9%
Core Fixed	BarCap Agg	2.6%	4.1%	10.2%	9.1%
Short Fixed	BarCap 1-3Yr	0.8%	1.3%	4.6%	3.5%
Long Fixed	BarCap LT G/C	7.9%	11.7%	22.3%	23.3%
Corp Debt	BarCap Corp	3.1%	6.0%	13.0%	13.4%

Source: Bloomberg

The performance data shown represent past performance. Past performance is not indicative of future results. Current performance data may be lower or higher than the performance data presented.