# Limiting Behavioral Biases in 2017 and Beyond: Q&A with Dr. Wai Mun Fong

*According to the Chinese zodiac, 2017 is the year of the rooster. But Dr. Wai Mun Fong, Associate Professor at National University of Singapore (NUS), member of the Brandes Institute's Asia-Pacific Advisory Board and winner of the 2015 Brandes Institute Prize, urges investors to be more like foxes this year. Fong offers practical tips in this exclusive Q&A.*

**Q: What biases or tendencies do you think investors should be most aware of?**

**Fong**: In his classic book, *The Hedgehog and the Fox*[1], philosopher Isaiah Berlin uses the hedgehog as a metaphor for someone who is overconfident of his abilities, holds one world view, and who dismisses anyone who disagrees with that view. In contrast, Berlin uses the fox to describe a person who acknowledges that the world is complex. To understand our world, one must be like the fox—humble and willing to incorporate different viewpoints.

Overconfident investors do not believe in the benefits of risk diversification. They exhibit a home country bias in their asset allocation, trade excessively in the belief that they can beat the market and make predictions with too much confidence. I believe that all of these behaviors are detrimental to one's wealth.

**Q: You summarize these beliefs and many others in your book, *The Lottery Mindset: Investors, Gambling and the Stock Market*.[2] Would you explain that phrase, "the lottery mindset?"**

**Fong:** I use "lottery mindset" as a catch-all phrase to describe an investment attitude which causes an investor to seek stocks that have poor returns on average, but offer the hope of occasional out-sized gains. Such stocks include those with high betas, high volatility (total and idiosyncratic) and high daily returns in the prior month. In my opinion, growth stocks also could be characterized as "lottery mindset" investments given that they have tended to be more volatile, have had distinctly higher betas than value stocks and their high past earnings growth has rarely been sustainable.

**<u>Dr. Fong's 3 Keys to Combat Behavioral Bias</u>**

**1. Stay aware.** *Bias can creep into decision making at any time.*

**2. Manage loss aversion.** *Risk should be controlled, not avoided.*

**3. Avoid trend chasing.** *Stay focused on long-term goals.*

**Q: What do you see for value stocks in 2017 and looking forward?**

With a new U.S. President and his highly idiosyncratic policy-making style, global financial markets are likely to be highly alert to news coming out of the United States during 2017, especially news related to monetary, fiscal and trade policies. Meanwhile, I believe the world will continue to fret over China's economic growth, oil and numerous unresolved geo-political issues in the Middle East, North Korea and the South China Sea. Uncertainty will again be a byword in financial markets, as it was in 2016. Active investors will see this as presenting opportunities to trade. However, some of the big events that will unfold this year, notably the U.S. Federal Reserve's decision to bump up short-term interest rates, are largely discounted in asset prices.

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[1] Berlin, Isaiah. *The Hedgehog and the Fox: An Essay on Tolstoy's View of History*. New York: Simon & Schuster, 1953.
[2] Fong, Wai Mun. *The Lottery Mindset: Investors, Gambling and the Stock Market*. New York: Palgrave Macmillan, 2014.

While impossible to forecast, value stocks may do better than growth if we continue to see economic strengthening. Having said that, value has *under*performed growth during periods of volatility. There were a number of unnerving events in 2016, but actual volatility, as measured by the VIX [CBOE Volatility Index], declined to an average of about 16 in 2016 vs. its average of about 20 between 1990 and 2016. It averaged 31 in 2009.[3] If volatility reverts to its historical average this year, growth stocks could outperform in the short term. Value investors, as always, could fasten their seat belts, look for bargains and ride through it. Markets have sometimes overreacted, so short-term setbacks can present opportunities for long-term investors to add undervalued assets to their portfolios.

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**Q: The last line in your book is so powerful: "…investors have much to gain by keeping behavioral biases in check." What are three good ways for investors to do this?**

**Fong:** 1) Awareness. Remind yourself constantly you are human and thus vulnerable to all types of cognitive biases. Noted psychologist and behavioral finance pioneer Daniel Kahneman once said that most of the time he acts intuitively when he should slow down and think more carefully about things.[4] This is from a man who has spent a large part of a distinguished career studying behavioral biases! That gives me some comfort when *I* fall prey to biases! One thing I have learned to do is slow down and give more thought before making a decision. This approach is very much inspired by Kahneman's book, *Thinking Fast and Slow*.[5] Also, owning stocks that consistently pay good dividends helps me focus on the stability of quarterly income rather than day-to-day price fluctuations.

2) Manage loss aversion. The central message of Prospect Theory is that investors experience more pain from a dollar lost than the pleasure of a dollar gained. Loss aversion increases when investors look at stock prices frequently because they will see prices go up or down and will weigh the "downs" much more than the "ups."

This can be detrimental in many ways, depending on one's investment experience. A new equity investor may freak out after experiencing short-term losses and sell positions, thus foregoing the benefits of harvesting the equity risk premium (which is a long-term concept). A seasoned investor may think he can capture the gains and mitigate his losses (perhaps by delaying realizing any paper losses). This is a form of mental accounting that reduces investment to a short-term game of cat and mouse by viewing investments as a series of gambles.

The bottom line? Risk should be managed carefully, not avoided nor speculated upon. I believe one way to take controlled risk is through asset allocation focused on long-term goals. For example, lifecycle or target date funds follow a long-term plan by gliding the asset allocation from one that is heavily weighted toward equities when the investor is young to one that has more bonds when the investor nears retirement. Lifecycle funds certainly have their critics and flaws, but I accept the underlying notion that people's risk tolerance tends to decline with age.

3) Avoid trend chasing. If you toss an unbiased coin consecutively, you may get nice "patterns," such as six heads out of eight throws. However, it would be foolish to bet your house that the next coin throw would be another head (extrapolation bias) or tails (the gambler's fallacy). While most people understand the unpredictable nature of coin

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[3] Daily VIX historical price data between 1990 and 2016 from the CBOE website: http://www.cboe.com/micro/vix/historical.aspx
[4] To listen to the interview with Daniel Kahneman at the Singularity Summit in 2012 where he talked about his tendency to act intuitively, please use this link: https://vimeo.com/54714729
[5] Kahneman, Daniel. *Thinking, Fast and Slow*. New York: Farrar, Straus and Giroux, 2011.

tosses, they have a much harder time applying the same logic to the stock market. The result is that investors read too much into stock price fluctuations and trade on this "information" to their detriment.

I believe trend chasers tend to lose money compared to buy-and-hold investors because they often invest in the market *after* superior past returns, but *before* inferior subsequent returns. Indeed, it seems the more bullish the market, the stronger is the tendency to chase trends as investors become more overconfident of their ability to forecast the future. Similar to under-diversification, overconfidence is a major contributor to what I think is the false belief that one can successfully time the market. (Separately, for more details on the hazards of market timing, see the Brandes Institute paper, "Market Timing: Opportunities and Risks.")

**Q: Based on your experience or research, do individuals experience investing biases similar to those afflicting institutional investors?**

**Fong:** Individual investors are subject to more behavioral biases than institutions are. First, the average individual investor is less informed; he tends to lack financial literacy and has less access to information that facilitates rational decision making, e.g. timely research reports, company visits, etc. In addition, institutions must comply with the "prudent man rule" requiring them to diversify risks, conduct due diligence, practice good risk management and so on.

That being said, institutions also may exhibit poor decision making at times due to their role as agents or intermediaries. One could argue whether some decisions reflect biases or stem from the principal-agent relationship, but consider active investment managers who may behave like "closet indexers" (holding equity portfolios highly correlated with broad market indices). Closet indexing may mitigate reputation risk because, as John Maynard Keynes wisely observed long ago, "…it is better for reputation to fail conventionally than to succeed unconventionally."[6] Regardless of whether it's a rational *business* decision given the risks for the agent or an actual behavioral bias—or perhaps even a rational approach that ultimately *biases* a decision—closet indexing remains a problem for investors who inadvertently send money to what they perceive as "active" fund managers that charge active fees for an essentially market portfolio.

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Also, the relationship between short-term performance and reputation and related fund flows also may explain the reluctance of institutional investors to take large arbitrage positions to exploit market anomalies. This is because it may take a while before anomalies get corrected. In the interim, open arbitrage positions are exposed to "arbitrage risks" (i.e., the anomaly may get worse). This, together with the well-known cost of short selling, could be a key reason why many seemingly simple anomalies like the beta anomaly (where portfolios of low-beta stocks have tended to deliver better volatility-adjusted returns than high-beta stocks) have persisted for so long.

[6] www.goodreads.com

**Appendix**

For more information on the connection between lower returns and less undiversified portfolios, see:

- Goetzmann, W., and A. Kumar. “Equity Portfolio Diversification.” *Review of Finance*, 12, pages 433-463. 2008.
- Dorn, D. and G. Huberman. “Preferred risk habitat of individual investors.” *Journal of Financial Economics*, 97, pages 155-173. 2010.

The following article describes the home-country bias, which leads to an over-concentration of one’s portfolio in domestic securities and lower returns relative to more globally diversified portfolios:

- Coval, J.D., and T.J. Moskowitz. “Home Bias at Home: Local Equity Preference in Domestic Portfolios.” *Journal of Finance*, 54, pages 2045-2073. 1999.

Additional details on the benefits of global diversification may be found here:

- Asness, C.S., R. Israelov, and J.M. Liew. “International Diversification Works (Eventually).” *Financial Analysts’ Journal*, 67, pages 24-38. 2011.
- Fong, W.M. “International Diversification: A Bootstrap Approach.” *Journal of Wealth Management*, 18, pages 110-120. 2015.

For more information on the correlation between excessive trading and poor performance, see:

- Barber, B., and T. Odean. “Trading is Hazardous to Your Wealth: the Common Stock Investment Performance of Individual Investors.” *Journal of Finance*, 55, pages 773-806. 2000.

For a detailed discussion on the difficulty of sustaining high earnings growth, see:

- Chan, Louis K.C., Jason Karceski and Josef Lakonishok. “The Level and Persistence of Growth Rates.” *The Journal of Finance*, LVIII, No. 2, pages 643-684. April 2003.

## Disclosures

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The CBOE Volatility Index (VIX) is an index designed to track market volatility with high values implying pessimism and low values implying optimism.

Beta: A stock's (or a portfolio's) beta measures its volatility vs. an index. A stock (or portfolio) with a beta higher than one has tended to exhibit more volatility than the index, while a stock (or portfolio) with a beta between zero and one has tended to exhibit less volatility than the index.

Arbitrage: A reflection of market inefficiency, arbitrage is the practice of buying and selling the same or similar securities simultaneously, but in different markets or forms, to profit from price discrepancies.

Equity Risk Premium: The additional return that equity investments may provide over a risk-free security.