INVESTOR'S BUSINESS DAILY

FINANCIAL ADVISOR BRIEFING

Conquering Your Investment Biases Can Deliver Better Results

Successful advisors learn how to expand their investment views beyond their natural biases.(©oneinchpunch - Fotolia/stock.adobe.com)

MOREY STETTNER | 7/29/2016

Reprints

Financial advisors often help clients manage the mental game of investing. They urge investors to set aside emotional impulses to make calm, rational decisions.

But advisors can fall into mental traps as well. Investment-related biases can undermine their judgment and lead them astray.

"As an advisor, you've got to understand where your biases might lie," said John Fowler, a Dallas-based certified financial planner. "To recognize your biases, you need to have an introspective nature" in assessing how you think and draw conclusions.

Over his 10-year career as an advisor, Fowler has formed a deeply held belief that gold is a poor investment. Yet he strives to keep an open mind.

Fowler's firm uses what he calls "a structured, analytical approach" in choosing its portfolio. Thanks to the defined set of rules that govern investment decisions, Fowler can look past his anti-gold bias and follow the firm's number-crunching guidance.

"Our models selected gold as a holding in January (2016), and we've learned to trust our models because they've been right more than they've been wrong since we started using them in 2004," he said. "So I held my nose and hit the 'buy' button. If I had held on to my sector bias (against gold), our clients would have missed out on the run up."

Overcoming investment biases gets trickier when they're not entirely irrational. Fowler notes that the inflation-adjusted returns for gold over long periods "aren't that great."

Even though his lack of enthusiasm for the precious metal is rooted in data, his commitment to follow his firm's models comes first. He has found that establishing a specific set of reliable rules that dictate buying and selling decisions helps tamp down biases.

A Mentor's Wisdom

Adopting a detailed set of rules to manage investment transactions produces other benefits. You're less apt to get caught up in market trends -- or follow the herd in a sudden stampede -- if you stick to structured analysis.

When Fowler engaged in options trading years ago, he recalls a mentor who told him to pay attention to implied volatility and reversion to the mean. He took the advice to heart.

"Those two things matter in options trading, not reacting with your biases or your day-to-day emotional response to the market," he said.

From that experience, Fowler has learned one of the best ways advisors can conquer their biases is to find a mentor who understands the psychology that drives investment beliefs. He says that taking a class on psychological biases -- and how they affect decision-making -- can also help.

In many cases, advisors' biases reflect their life experience. They may favor certain investments (and disdain others) based on their most vivid memories of what worked and didn't work.

Mike Desepoli teams with his father at their wealth management firm in Port Jefferson Station, N.Y. He says that they see investing through different eyes.

"We have different biases based on the world we grew up in," he said. "I tend to gravitate to companies in the tech sector, because I've lived it. My father prefers companies that pay long-standing dividends. We discuss these biases all the time" and take steps to ensure they don't interfere with what's best for clients.

Smart Questions

When scrutinizing potential investments, Desepoli says he and his father like to ask each other, "Why do you feel so strongly about this company?" Their answers help clarify their reasoning -- and expose their biases. They may bring in a few colleagues to enrich the discussion.

"It keeps us more grounded," Desepoli said. "The more people in the room, the better. If I'm in a room by myself, who's going to challenge me?"

Group discussions also promote more rigorous analysis. When Desepoli proposes a stock for consideration, his father or other team members might ask, "Is this a passion play?" or "Are you going on intuition or is it really undervalued?"

One of the toughest pitfalls in weighing potential investments is confronting confirmation bias. Fowler says it's easy for advisors to find market mavens providing commentary "that confirms your thinking." But pouncing on information that confirms what you believe while disregarding data that upends your preconceived notions can cause trouble.

Both Fowler and Desepoli acknowledge a bias against utility stocks. But they know that under certain market conditions, these companies have proven sound investments for a segment of their clients.

"You have to get over what you don't like," Desepoli said. "I tend to be a bit squeamish about the energy sector, but it has worked out."