ALTERNATIVES

When Do You Ignore Your Gut?

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admin

Anyone who took an introductory psychology class probably remembers the classic study in which different people witnessing the same crime each report a different take on what happened. Though each presumably sane, sober person witnessed the events with his or her own two eyes, individual expectations and biases influenced how they perceived what happened. Sure, you say, but what does this have to do with investing? Well, it turns out that our individual expectations and biases influence how we view investments, too.

- Our thinking is often strongly influenced by what is personally most relevant, recent or dramatic.
- Fear may be driving investor decisions more right now than reality.
- As the yield environment has shifted, many investors are faced with a choice of either changing their goals or changing their approach.

If you've been underwhelmed by your so-called "safe" but low yielding investments over the past couple of years, you're not alone. The low-rate, slow-growth environment we're in right now has investors facing a dilemma: relative safety feels comfortable, but it isn't getting them much traction towards their goals. Meanwhile, riskier investments, which could offer greater potential to help them reach their growth goals, are just plain scary given the market tumult of the last few years. While investment goals like retirement haven't changed for most of us, suddenly the path to reach those goals has. What availability bias tells us is that investors' lingering perceptions of a dire market environment may be causing them to view investment opportunities through an overly negative lens, making it less appealing to consider taking on investment risk, no matter how small the returns on perceived "safe" investments.

To shed further light on how our individual biases affect our decision-making processes, we had the opportunity to speak with Dan Ariely, James B. Duke Professor of Psychology and Behavioral Economics at Duke University and author of *The New York Times* bestseller, "Predictably Irrational: The Hidden Forces That Shape our Decisions." Much of Ariely's work builds on the idea that we don't really know our preferences as well as we think we do, or why we have them. In many cases, the environment—and other people—can sway us to a large degree. This applies to nearly every aspect of our lives. In the world of finance, he provides an example of how a financial advisor could create different biases, depending on how he or she might frame a discussion about risk.

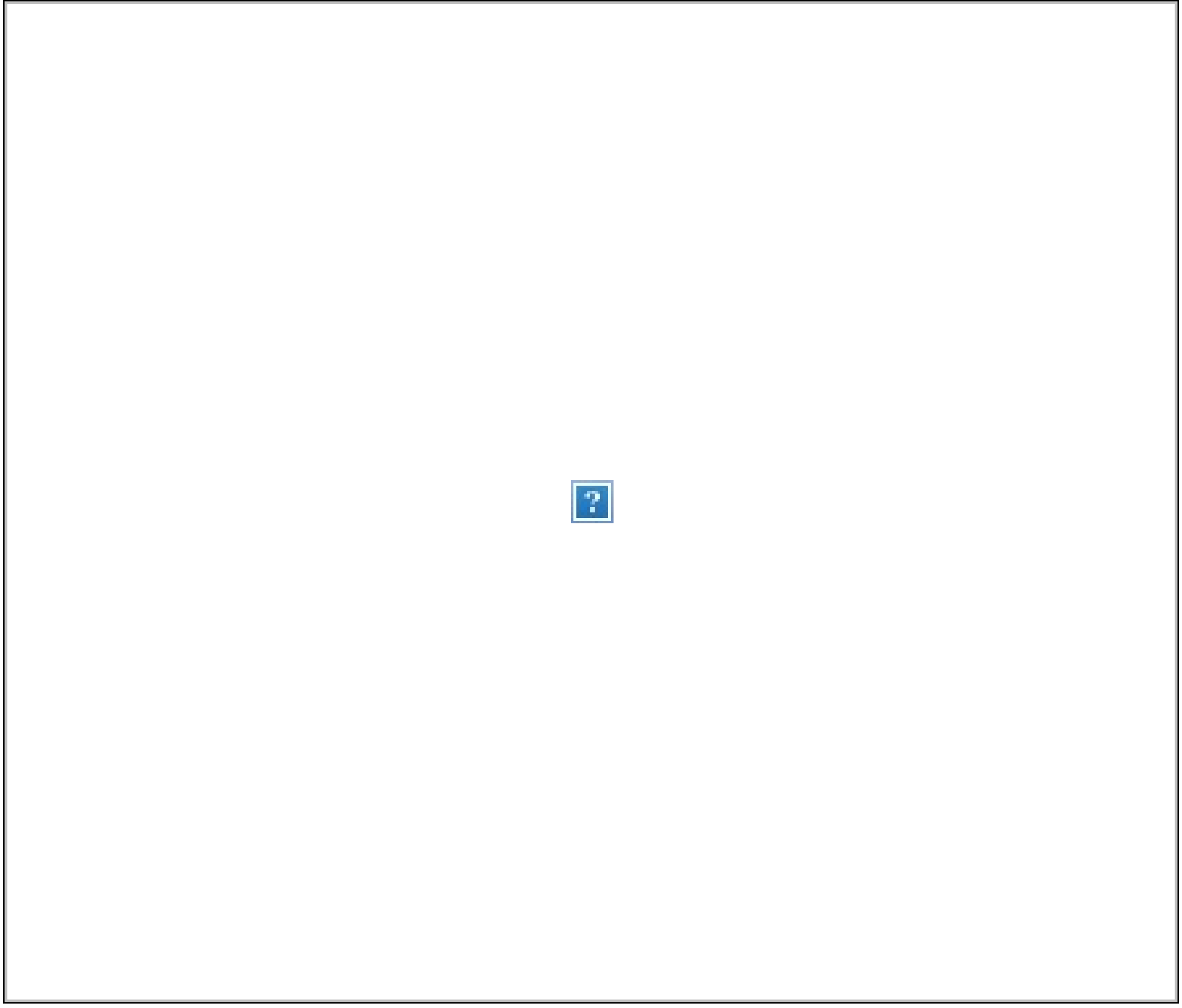
"*Imagine if I was a financial advisor and you came to talk to me about your risk attitude, and I started the discussion by asking you to describe how you felt in the last three years on the days when your portfolio lost 5% of its value. Then I asked you what your risk attitude was. Most people would say they don't want to ever experience days like that again. On the other hand, what if instead I talked about people I knew who were retired and living in the Bahamas, fishing and golfing. Now your risk attitude would probably be different.*"

Availability Bias definition

Availability Bias

"Availability bias" is a behavioral concept which describes how our environment can shape our perceptions. As humans, our thinking is strongly influenced by what is personally most relevant, recent or dramatic. As investors, this can translate into perceptions colored by personal experiences that likely represent only a fraction of the complete economic picture. As an example: availability bias means that a person whose home has lost 20% of its market value and whose spouse endured a long period of unemployment is less likely to see or feel an economic recovery even while housing markets show signs of recovery and unemployment ticks down. Conversely, someone who just landed a great job would be inclined to see that as proof the economy is recovering. Either way, the experiences of a single person aren't likely to reflect a national norm, let alone a global one, which is why investors' perceptions of market performance can easily slip out of line with reality.

Underscoring this point was an interesting response to Franklin Templeton's annual Global Investor Sentiment Survey[1] in which individuals were asked how they believed the S&P 500 Index performed in 2009, 2010 and 2011. Large numbers of survey respondents indicated they thought the benchmark was either down or flat, but in reality, in 2009 and 2010 the S&P 500 Index saw double-digit gains and a modest gain in 2011.[2] Again, this means lingering perceptions based on dramatic, painful events are impacting decision-making even when those events are over.



And, when asked if they could invest in only one region next year, more than half of the survey respondents globally (56%) said they would choose their home country, even if the outlook might look better elsewhere.[1] Clearly, some of these investment decisions were driven by a related concept, a “home country bias.” Ariely said a home country investment bias might be generated by two perceptual factors.

“The first is an overly optimistic belief about one’s own economy; an expectation of performance in their country that is higher than what would be statistically realistic. The second reason is most likely due to procedural difficulties in investing outside the country – such as less knowledge about how to access these markets.”

Theory into Practice

So what does that mean in investment terms? It means investors may be making decisions driven more by personal bias or irrational belief than by reality and, in doing so, they may be hindering their own investment success. An investor whose retirement nest egg took a hit in 2008 may be inclined to avoid another roller coaster run by sitting on the sidelines with their cash stashed in low-yielding savings vehicles. Or, they might fail to diversify into global markets where the economic outlook might be better than at home. The problem? These decisions may hinder their ability to reach their desired retirement or savings goals. The choice is between changing the goal—or changing the means of reaching it.

Being aware of how emotions can impact decisions is one thing; taking action to make a change is another.

Markets tend to move in cycles, and the only thing anyone can be certain about is that change is inevitable. That doesn’t mean investors should remain frozen, losing out on potential opportunities while sitting on cash and other low-yielding investments that fail to generate needed income, let alone keep up with inflation.[3]

Will the chart lines always point up? Of course not! But a savvy investor is one who knows the difference between reaction and research. As Sir John Templeton famously said: *“Avoid the popular. When any method for selecting stocks becomes popular, then switch to unpopular methods.”*

Learn more about how to overcome what may be irrational fears and market biases, and take actions to help you reach your long-term investment goals. Visit our 2020 Vision: Time to Take Stock website.

Find out what other investors think. Read about the 2012 Franklin Templeton Global Investor Sentiment Survey.

Get more insights from Franklin Templeton delivered to your inbox. Subscribe to our Beyond Bulls & Bears blog.

Join the discussion on Facebook.

What are the Risks?

All investments involve risks, including possible loss of principal. Stock prices fluctuate, sometimes rapidly and dramatically, due to factors affecting individual companies, particular industries or sectors, or general market conditions.

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1. Source: 2010 Franklin Templeton Global Investor Sentiment Survey designed in partnership with ORC International included 1,010 telephone responses from participants age 18 and older in the U.S. from March 25, 2010 to March 28, 2010; 2011 Franklin Templeton Global Investor Sentiment Survey designed in partnership with ORC International included 1,049 responses from participants age 18 and older in the U.S. from January 6, 2011 to January 7, 2011; 2012 Franklin Templeton Investor Sentiment Survey designed in partnership with Duke University professor Dan Ariely and Qualtics included 1,142 online responses from participants age 18 or older in the U.S. from January 30, 2012 to February 13, 2012.

2. Standard & Poor's. S&P 500 Index: STANDARD & POOR'S®, S&P® and S&P 500® are registered trademarks of Standard & Poor's Financial Services LLC. Standard & Poor's does not sponsor, endorse, sell or promote any S&P index-based product. Indexes are unmanaged, and one cannot invest directly in an index.

3. It is important to note that money market accounts and CDs are insured by the Federal Deposit Insurance Corporation (FDIC) for up to $250,000 and CDs offer a fixed rate of return.