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The ABCs of Behavioral Biases: O-R

There are so many financial behavioral biases and so little time! Today, let's take a few minutes to cover our next batch of biases: overconfidence, pattern recognition and recency.

Overconfidence

What is it? No sooner do we recover from one debilitating bias, our brain can whipsaw us in an equal but opposite direction. For example, we've already seen how fear on the one hand and greed on the other can knock investors off course either way. Similarly, overconfidence is the flip side of loss aversion. Once we've got something, we don't want to lose it and will overvalue it compared to its going rate. But when we are pursuing fame or fortune, or even going about our daily lives, we tend to be overconfident about our odds of success.

When is it helpful? In "Your Money & Your Brain," Jason Zweig cites several sources that describe overconfidence in action and why it's the norm rather than the exception in our lives. "How else could we ever get up the nerve to ask somebody out on a date, go on a job interview, or compete in a sport?" asks Zweig, and adds: "There is only one major group whose members do not consistently believe they are above average: people who are clinically depressed."

When is it harmful? While overconfidence can be generally beneficial, it becomes dangerous when you're investing. Interacting with a host of other biases (such as greed, confirmation bias and familiarity bias) overconfidence puffs up our belief that we can consistently beat the market by being smarter or luckier than average. In reality, when it's you, betting against the trillions and trillions of other dollars at play in our global markets, it's best to be brutally realistic about how to patiently participate in the market's expected returns, instead of trying to go for broke—potentially literally.

Pattern Recognition

What is it? "Is that a zebra, a cheetah or a light breeze moving through the grass? Since prehistoric times when our ancestors depended on getting the right answer, right away, evolution has been conditioning our brains to find and interpret patterns—or else. That's why, our pattern-seeking impulses tend to treat even random events (like 10 coin flips, all heads) as if they're orderly outcomes suggesting a predictive pattern. "Just as nature abhors a vacuum, people hate randomness," says Zweig, as a result of our brain's dopamine-induced "prediction addiction."

When is it helpful? Had our ancestors failed at pattern recognition, we wouldn't be here to speak of it, and we still make good use of it today. For example, we stop at red lights and go when they're green. Is your spouse or partner giving you "that look"? You know just what it means before they've said a single word. And whether you enjoy a good jigsaw puzzle, Sudoku, or Rubik's Cube, you're giving your pattern recognition skills a healthy workout.

When is it harmful? Speaking of seeing red, Zweig recently published a fascinating piece on how simply presenting financial numbers in red instead of black can make investors more fearful and risk-averse. That's a powerful illustration of how pattern recognition can influence us—even if the so-called pattern (red = danger) is a red herring. Is any given stream of breaking financial news a predictive pattern worth pursuing? Or is it simply a deceptive mirage? Given how hard it is to tell the difference (until hindsight reveals the truth), investors are best off ignoring the market's many glittering distractions and focusing instead on their long-term goals.

Recency

What is it? Recency causes you to pay more attention to your most recent experiences, and to downplay the significance of long-term conditions. For example, in "Nudge," Nobel laureate Richard Thaler and co-author Cass Sunstein observe: "If floods have not occurred in the immediate past, people who live on floodplains are far less likely to purchase insurance." That's recency, tricking people into ascribing more importance to the lack of recent flooding than to the bigger context of being located on a flood plain.

When is it helpful? In "Stumbling on Happiness," Daniel Gilbert describes how we humans employ recency to accurately interpret otherwise ambiguous situations. Say, for example, someone says to you, "Don't run into the bank!" Whether your most recent experience has been floating down a river or driving toward the commerce district helps you quickly decide whether to paddle harder or walk more carefully through the door.

When is it harmful? Of course buying high and selling low is exactly the opposite of investors' actual aspirations. And yet, no matter how many times our capital markets have moved through their bear-and-bull cycles, recency causes droves of investors to stumble every time. By reacting to the most recent jolts instead of remaining positioned as planned for long-term expected growth, they end up piling into high-priced hot holdings and locking in losses by selling low during the downturns. They allow recency to get the better of them . . . and their most rational, evidence-based investment decisions.

We're on the home stretch of our series on behavioral biases. Look for the rest of the alphabet soon.

David Bromelkamp
President and CEO

FINANCIAL PLANNING TIP:

Build Tax-free Savings for Healthcare

Healthcare has been a common topic of conversation in Allodium client meetings lately. Between rising health insurance premium costs and the recent elimination of some healthcare plans from the marketplace, many people are turning to High Deductible Health Plans (HDHP). HDHPs have lower monthly insurance premiums, but those insured with this type of plan are required to cover more of their healthcare costs if healthcare is needed. If you are relatively healthy, an HDHP can work in your favor if the monthly premiums paid during the year are lower than your out-of-pocket expenses incurred when you seek medical care.

Health Savings Account (HSA)

A tax-efficient strategy to capture those monthly savings and set them aside for future healthcare costs is to fund a Health Savings Account (HSA). HealthCare.Gov describes HSAs as a special type of account that allows you to set aside money on a pre-tax basis to pay for qualified medical expenses. Anyone not enrolled in Medicare can open and fund an HSA as long as your health plan is "HSA-eligible" as a High Deductible Health Plan (HDHP).

HSA plans provide a triple tax benefit:

1. They allow for tax-deductible (pre-tax) contributions,
2. Withdrawals are tax-free when used for Qualifying Medical Expenses, and
3. Interest income and growth of investments earned within the plan are free from tax.

Any funds not used in the current year can remain invested to grow for your future health care needs.

The IRS limitations on contributions into your HSA for 2019 are: $3,500 (individuals), $7,000 (families) and an extra $1,000 more for anyone age 55 or older.

HSAs and HDHPs are not for everyone. People who anticipate having significant healthcare costs in the near future should likely seek a health plan with a lower out-of-pocket risk. Talk to your financial advisor about whether an HSA plan makes sense for you.

PLANNING

Headlines

- Dave Bromelkamp will be heading to the MarketCounsel Summit 2018 this December in Las Vegas. Al Gore, former Vice President of the United States, Jack Bogle, Founder and former CEO of Vanguard, and Jason Zweig, personal finance columnist for The Wall Street Journal will be featured speakers. Dave is excited to be in the company of such thought leaders.
- Kari Cedergren has earned the Accredited Investment Fiduciary® (AIF®) designation from the Center for Fiduciary Studies, the training center of Fi360.
- Allodium was pleased to welcome six new clients into the firm the third quarter of 2018.
- Our office will be closed December 25, 2018 and January 1, 2019 for company holidays.
- Reminder: we are continuing to transition to the domain name of *allodium.com* for both our website and employee email addresses over the next year.

Note: To find out more about Allodium's breaking news, please visit our website: www.allodium.com.

"In the business world, the rearview mirror is always clearer than the windshield."

–Warren Buffett, CEO & Investor

Upcoming Events

January 31, 2019:

Attend Allodium's Investment Forum at Golden Valley Country Club. Our topic is managing investment risk in volatile markets. We hope to see you there. Details coming soon.

For more information about these events, please contact Ilona Avraamides at (612) 230-3711 or iavraamides@allodium.com.

EVENTS

WE APPRECIATE YOUR INTRODUCTIONS

To optimize our objectivity and avoid conflicts of interest, we are a fee-only registered investment advisor that is completely independent from banks, brokerage firms and other financial product providers. If you know someone who may be looking for this type of objective investment advice, please contact Dave Bromelkamp at 612-230-3702 or dbromelkamp@allodium.com to arrange a friendly, no-obligation introduction.

Steward is published quarterly by Allodium Investment Consultants. Please contact Ilona Avraamides at 612-230-3711 or iavraamides@allodium.com if you have any comments about this publication or wish to be added to or removed from our mailing list.

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