KEEN ON RETIREMENT

The Best Investors Rarely Make These Behavioral Mistakes

Welcome to Keen on Retirement
With Bill Keen and Steve Sanduski

Steve Sanduski: Have you ever noticed how all of us have behavioral biases that can impact the way that we make decisions and not always in a positive direction. Today we're going to talk about behavioral biases and how they affect investors in the decisions that investors can make and not always cause them to make good decisions. Welcome back everybody to "Keen on Retirement", I'm your host Steve Sanduski and joining me, of course is Bill Keen. Bill, great to have you here.

Bill Keen: Well, great to be here Steve. It's an honor to be here in the studio with you today.

Steve Sanduski: Yeah, it's great. Here we are, live in person. I get to see you right next to me. You're here with me just outside of the great city of Milwaukee. A little cold out there today but we're staying nice and warm here.

Bill Keen: That's right and learned a little bit about the snow that comes in out of Lake Michigan here. What did you call that today?

Steve Sanduski: Lake effect snow.

Bill Keen: Lake effect snow, okay.

Steve Sanduski: Yes. Not quiet like the people in Buffalo who might be listening to this but we get a little lake effect snow here.

Bill Keen: I'll tell you what. Carissa and I, my wife are just grateful to be here with you and shared some time with you and Linda and able to record an episode here in your studio, so thank you.

Steve Sanduski: Thank you. It's been great. Linda and I loved having you as hosts and maybe you'll get snowed in tonight. It looks like we might have some weather that might cause some plane cancellations.

Bill Keen: I'm actually hoping so, actually, now that we think about it. Well, great.

Steve Sanduski: All right Bill, we've got some good stuff to talk about here. Important issue. behavioral biases that we as humans have.

Bill Keen: That's right.

Steve Sanduski: We are emotional creatures and oftentimes we make emotional decisions and we've certain had some market volatility here in the early days of the new year.

Bill Keen: That's right.

Steve Sanduski: Upside volatility, downside volatility and we thought this would be a timely topic to talk about. How do our emotions affect the decisions that we make. So Bill, why don't you tell us a little bit about what are some of the biases that you come across in working with your clients?

Bill Keen: The purpose of our podcast is to bring awareness to our listeners of the things that create success in this long-term retirement thinking and planning endeavor and then also to bring awareness to the things that can throw people off track. I think it was just good timing for this episode, like you said. One of the first biases that we see is the recency bias. The recency bias means that what's recently happened, we tend to think, will continue to happen in the future and not only in the future but possibly forever. We can forecast things or project things into the future forever. Let me give you an example. Kind of an obvious one. If the market has gone down for a few weeks or a few months or maybe a year, we will tend to run the numbers and think that that might continue indefinitely into the future. Likewise if things have gone up and gone higher over the recent period, we then can also get kind of lulled into a false sense of security and think things might never go down again.

Steve Sanduski: We tend to have a short term memory, we tend to extrapolate. What's going on here lately? Well that's just going to continue.

Bill Keen: That's right.

Steve Sanduski: Really probably the way we should look at it is more like a rubber-band that when things get stretched in one direction, it's just building up some power here or energy that it may snap back in the other direction at some point.

Bill Keen: We talked in prior episodes about things moving around a mean. When things go higher they typically will trade back to their mean, when things are lower they come back to a mean as well. Exactly what you're talking about with the rubber-band effect, yes that's correct.

Steve Sanduski: How do we overcome this recency bias if we're aware of it that we tend to extrapolate, we tend to think well well what's just happened here recently is going to continue in that direction. You, as an advisor, how do you advise your clients to overcome this potential bias.

Bill Keen: First of all you got to get aware of it and be conscious that it's something that we have to deal with. It all goes back to having a plan in place, first of all in getting clarity on how history has played out. Getting clarity on the fact that there will be times that things are not so well and there will be times that things are going very well like we mentioned. Having a plan in place and being prepared for these things, understanding that we have these biases is the starting point, Steve.

Steve Sanduski: Okay. You were showing me some charts earlier about bull and bear markets. I don't know if you've got those numbers handy or not but it showed that historically the length of bull markets versus the lengths of bear markets. Again, maybe that ties into this whole recency effect where we think what's happened here recently is going to continue. I think you've some numbers here in front of you that talk about the average lengths of bull markets and bear markets.

Bill Keen: Yes. Let me share this with you. We've got since 1929 the average bull market has lasted nearly 9 years. The average cumulative return, get this is 461% in that nearly 9 year period. Now here's the catch. There's always a catch, Steve, right? The catch is we go through bear markets or times where the market does pull back and the average has lasted about 1.3 years and the cumulative average loss, and I hate because it's not a loss unless you sell.

Steve Sanduski: Temporary versus a permanent loss.

Bill Keen: That's correct. The average cumulative, let's say temporary loss has been 41%. Think of the numbers. This speaks to another one of our biases that we can talk about in a moment, but let's just think of these numbers. The average bull market has lasted nearly 9 years and been up just shy of 500%. The average bear market has only lasted 1.3 years and the average cumulative short term lost has been 41%. Those odds are massively in our favor as long term investors as long as we don't mistake one of those bear markets as a permanent loss and sell.

Steve Sanduski: We're talking about US financial markets, correct?

Bill Keen: Yes.

Steve Sanduski: Just to be sure we're all familiar, this date is coming from where and it's measuring what?

Bill Keen: That's right, this data is coming from a firm called First Trust who we do like the information that they've put out. They've put out some good information. It's based on the US S&P 500 in Dallas.

Steve Sanduski: So US common stocks.

Bill Keen: That's right.

Steve Sanduski: If we can withstand these tough times in the market, at least historically, of course past performance is no guarantee of future results.

Bill Keen: That's right.

Steve Sanduski: Historically the numbers have been in your favor if you have a relatively long time horizon.

Bill Keen: That is correct and to say in your favor, I would say massively in your favor, Steve.

Steve Sanduski: Right. It's like you're the house, here.

Bill Keen: Well, it is. It is if you have the wherewithal to make it through those downturns. Even, we've said in past episodes, don't have money in the market that you're going to need back and I always say within a minimum of 5 years. Don't be surprised by these corrections and make an emotion decision. Most of it boils down to that.

Steve Sanduski: The good thing is that you've been an advisor for over 20 years. You know these things happen. We know markets go down and you take that into consideration as you work with your clients and you put portfolios together.

Bill Keen: That's right.

Steve Sanduski: Down markets, volatility, is no surprise to solid, experienced advisors.

Bill Keen: But going through these things, no matter how much you study it and how much you think about it and how much you've experienced it, going through down markets is never fun for anybody. We have to keep the perspective and we talk a lot about this, a lot about having money in the market and our podcast is about retirement planning and I would just say if there are certain people that just should not have money in the market at all. That's okay too. I'm not saying that you have to have money in the market to make this work. I am saying with rates of the banks, call it 1-2% if that and inflation over the time period leveraging close to 3. If you decided to settle for those types of returns then your plan is probably, unless you just have a super large pool of capital, you're plan is going to have to be from day one to know you're going to eat your principal up. That can be a plan. It can be an okay plan. I'm okay with that. I'm not saying that everybody needs to have some money in the market. I believe that most people probably should have some portion of their assets in the market and go through these things.

Steve Sanduski: Good. Let's take a look at another bias. What would be another one that you come across often?

Bill Keen: Confirmation bias is one that I think of. Confirmation bias is where we have our opinions. We know what we believe. We look to confirm what we believe by going to sources that we know will confirm what we believe, that will agree with us. The example that I can think of most obviously is what news station do we watch?

Steve Sanduski: Oh sure.

Bill Keen: Do you watch MSNBC? You don't have to tell me Steve, I won't put you on the spot there. You know what I mean?

Steve Sanduski: For sure, yeah. Fox typically conservative. MSNBC historically, although I think they've changed since, has typically been more liberal. CNN I think has tried to present both sides of the story.

Bill Keen: That's right. That's an obvious one though, isn't it?

Steve Sanduski: Right.

Bill Keen: For confirmation bias. Can you think of any?

Steve Sanduski: I personally, this is one I work on, that I have opinions on things and I know that I'm drawn toward sources, toward writers, toward headlines that confirm what I believe. What I already believe.

Bill Keen: Yes.

Steve Sanduski: That's a bad way to do things.

Bill Keen: Yes.

Steve Sanduski: You really need to get the other side of the story. How do you overcome this confirmation bias? As an advisor how do you overcome that? How do you help clients overcome that if they may have a already formed opinion on a particular topic?

Bill Keen: What we try to do is get the data out there and objectively look at the data. Really look at the research. The other thing that we do as a firm as well is buy research from people that don't agree. That don't agree with me and don't agree with each other from a fundamental and technical standpoint. I so believe it's good to have people arguing and looking at all the points and then we can step back, like we said, and look at the data and come up with what we believe is an appropriate observation. If there's action to be taken, good, we really looked at it from all fronts.

There's another bias, it's called the blind spot bias. The blind spot bias goes right along with confirmation. Most of us have cognitive blind spots that we can't see ourselves. You can't see the blind with the blind spot. That's why, you know Steve, I'm so big on getting guidance and council and having coaches. I have coaches in a lot of areas. In fact, you're one of my coaches. I believe you have to have people help you think through things. I obviously believe in financial coaching as well. I think it's super important. Those blind spots can be devastating if you don't have somebody to help you see them.

Steve Sanduski: Right. A lot of these biases are interrelated. The confirmation bias, blind spot bias. There's another one that I think is also very interesting and that is that we prefer stories to analysis and I think you just touched on this a second ago where you said we tend to overlook the data.

Bill Keen: Yes.

Steve Sanduski: As humans we love stories. We love narratives. Of course, we grew up as a kid. Mom or dad are telling us bedtime stories and we love that, can relate.

Bill Keen: Of course.

Steve Sanduski: If we look at something like the financial markets which can be very data oriented, how do we make sense of the data. We tend to try and connect the dots and we try and create a story around that that we think interprets the data, but I think oftentimes we have a mistake in there because the story is more shorthand and not always right.

Bill Keen: Some of the greatest teachers probably ever, are people who can take complicated concepts and make them simple and make them understandable. It's almost always with stories. Still you have to look through those things and make sure that you're looking at the data and not just being overwhelmed or memorized by the story itself.

Steve Sanduski: Right. Oftentimes we get enamored of great speakers because they tell such great stories and gosh that sounds great.

Bill Keen: That's right.

Steve Sanduski: Then, when you unpeel the onion a little bit, maybe you're being sold a bill of goods. No pun intended.

Bill Keen: That's right. Well, thank you. It's true. I know right now especially we all need leaders, the world needs real leaders and to be able to step up and take a look at who the people are that really we need to be paying attention to, it's important. That's part of what we do at our firm. We try to make heads or tails of the news, the real news and the real information from the nose that's out there.

Steve Sanduski: Right. I think stories are very, very important. I don't want to suggest that we should not be telling stories because as you just touched on, you said that we can use stories to help us interpret very complicated topics. In fact, a recent movie "The Big Short".

Bill Keen: That's right.

Steve Sanduski: I think one of the reasons why that's popular is because they took a very potentially complicated topic and were able to tell a story about it and use metaphors and analogies that lay people could understand.

Bill Keen: They did a great job with that movie. If our listeners out there have not watched that movie I would highly recommend it. Wouldn't you Steve?

Steve Sanduski: Oh, for sure.

Bill Keen: Some of the movies that come out, especially on the financial industry, I'm not real sure of but that was a good one, I liked that one.

Steve Sanduski: It was. Bill, what are some other biases that you come across?

Bill Keen: One of the things that I look at, I call it the "Found Money Affect", I think it has the official title as the "House Money Effect". Can you guess what that actually would mean?

Steve Sanduski: Has something to do with gambling or Las Vegas.

Bill Keen: I'll tell you, it's hard to put you on the spot here in person, Steve. We're talking on the phone over these episodes; we're putting each other on the spot. You can't reach over and hit me or anything, but here you kind of can.

Steve Sanduski: I can, yeah.

Bill Keen: I don't know, I better watch out today. The "House Money Effect" or the "Found Money Effect" is how people, we tend to treat money differently if we didn't have to work for it. If you're walking down the street and you found a $20 bill on the ground, you would treat that money differently than you would had you had to work for it, pay taxes, all those things on it. Like you just mentioned, the casino. I try not to mention the casino when we're talking about investing, you know.

Steve Sanduski: We don't want to equate the two.

Bill Keen: I really would prefer not to.

Steve Sanduski: Maybe we'll let it get out.

Bill Keen: Okay, excellent. It's true. For people to go in and gamble, if you will and they have a profit. They think that that is the house money and the reality is at that moment, it is their money. It's their resources. It does not matter how you obtained it.

Steve Sanduski: A dollar is a dollar.

Bill Keen: A dollar is a dollar.

Steve Sanduski: Whether you earned it or whether you got it because your investment went out.

Bill Keen: That's right. You should treat it no differently. I can give you the example I wanted to share with you is the credit card example on this. It's when you're spending money on a credit card this effect kind of sneaks in there because it doesn't feel like it's your hard earned money. It's so easy to spend money when you're spending it on a credit card and you can just worry about it later. That's a problem in our society right now.

Steve Sanduski: From an investor's standpoint, what have you found that you have a client, they make an investment, the investment goes up in value, now they've got this extra money that they "didn't work for" although one could argue that they worked for it.

Bill Keen: Right.

Steve Sanduski: Did they behave differently with the profit? Do you find that they tend to be riskier because this is money that is a profit or how does that change their behavior with this house money?

Bill Keen: The "House Money Effect" would say that it does change their behavior, that it makes them feel like that they now can be more risky with that capital as if they lost it, it wouldn't be a big deal because it was again, found money. I can tell you when things are going well and we're out ahead of plan, which happens, you cannot look at that gain as something that's just can be gambled with or squandered. There will be times where the markets are down temporarily and that extra money that was made in the good years needs to average itself out.

Steve Sanduski: Do you find that when you have clients that are ahead in the market, do they look and say "okay well, we've got this money to play with because say we bought this investment at $20 and now it's at $30 so gosh it could go all the way back down to $20 before we 'lose any money'". Do you find that they start anchoring on a price where now they say oh I'm not going to worry about it until it gets to 20 because that's what I paid for but if it gets below 20 then I might sell because I don't want to lose money. Is there anything in terms of anchoring based on this idea of "House of Money" effect.

Bill Keen: Yes there is. I see this quite often. A lot of people will talk about or set price targets, especially when they've left a company that they had a good portion of their capital in one security. I've seen many times over the years folks set arbitrary price targets on getting out of a security, diversify themselves. In essence, when you have all your money in one security, it doesn't matter how much you might know the firm or how long you worked at a firm or you think you know what's happening inside of a firm. With all do respect, I can tell you that most of the people at Enron had no idea what was going on inside the company. I've seen people set arbitrary price targets; they're really meaningless. Then the stock never get there. They never, never get a chance to diversify.

Steve Sanduski: Instead of an arbitrary price target, then what do you suggest. How do you come up with, I suppose this varies with each person or each investment but if it's not arbitrary then what is it?

Bill Keen: It's interesting because a lot of what we do in our industry is very to the detail, it's very to the decimal point. Other things are common sense. If someone has a large pool of capital and they're having a hard time, emotionally, cause it's kind of what we're talking about here.

Steve Sanduski: It's all emotion.

Bill Keen: Yeah, absolutely. We know, they know they have enough resources based on their asset base as of that moment, If they were to sell the security at that time, diversify the holdings, appropriate asset allocation and bonds and fixed income and diversity portfolio of equities, they would in essence be set based on their plan and their needs. There's a strong argument to diversify before the sun goes down. No reason to hold out and speculate because when you have all your money in one security or a good portion and you're holding out for a price, this goes kind of with I think a Stockdale Principal we're going to talk about here in a minute. It's the facts, you are a speculator. You are choosing to be a speculator. If you have your assets in one security and you have the option to diversify and you are not, you now become a speculator. Hopefully it works and it works in your favor. Just call it what it is. Once you diversify, take that action and make that up and you've now become an investor. There's a huge difference. Maybe that's another episode for us but it does make a big difference.

Steve Sanduski: Would it be fair to say that the best time to make a decision or take an action is to intentionally make it when you can as apposed to when you have to?

Bill Keen: I think that makes total sense. Get out in front of it beforehand. Start to think about it beforehand so the emotion of stepping out of something that you've been involved for so many years isn't quite as difficult when you've been thinking about it for a while. Another common sense issue that I would throw in there though is that we've had people average out of positions. If you can't decide to sell all or nothing and diversify then maybe you sell half and you walk out or maybe some portion that you walk out of retirement or cost average out over time. These are strategies. These are legitimate, real strategies to help people take action that's in their best interest and overcome these biases that we're talking about today. I hope that makes sense

Steve Sanduski: Right. I think related to the "House Money Effect" is this idea of the pain that we feel when we lost money versus the pleasure we feel when we gain money. I know there's a lot of research in that area. What have you found in that area in terms of how that affects our behavior?

Bill Keen: I think most people would probably agree, and I always ask folks no matter what we're talking about to listen to us and others but then examine their own lives. Think about this in their own situations and evaluate what their experience has been. We call it the "Loss Aversion" bias. We definitely tend to feel the pain of a loss more than the pleasure of a gain. There's no question about it. Have you had some experience with that?

Steve Sanduski: Oh yeah. I think this is one that is very difficult to overcome for most people. We tend to panic if you're in the market and it looks like we're "losing some money". Of course that maybe just temporary, it becomes permanent if we actually make a transaction to make it a permanent loss. If we see something going down we tend to feel that pain, I think the studies show as much as 2 times as much as the pleasure of an equivalent gain. I know you talked earlier about the importance of awareness, self-awareness of these biases I think is really the first step to overcoming these.

Bill Keen: If you have a long-term plan in place and you realize that you have to go through a little bit of short term discomfort to obtain a long-term dignified life and you can see it and it's planned for and it's real, you're way more likely to overcome these biases. That's why we talk a lot about having a plan and thinking through these things and making sure that we're set emotionally. One thing I was sharing with you, I think offline earlier, is just the concept of if I'm making a presentation and there's 30 people in the room and 28 people like what I said and 2 people said they didn't care for it much, I'm going to be focused on the two people. It's going to be more painful to me than the 28 people that liked what we said that day. I'm not sure if that plays into this ""Loss of Version" at all but it's an interesting concept.

Steve Sanduski: It's a great story, Bill.

Bill Keen: Yes.

Steve Sanduski: We were talking about stories and narratives.

Bill Keen: Can you understand that though, how we would tend to focus on the negative even if the data comes in and shows that 28 out of 30 really enjoyed the presentation. Two people didn't. I'm wired to take away what was wrong. Why didn't those two people enjoy it? The two negatives are going to have more impact on me than the 28 positives. That's kind of my point here on this "Loss Aversion'.

Steve Sanduski: I think you also touched earlier that ties into what you just said there and that is the confirmation bias. We tend to seek our information that is the same opinion of what we believe but you said one way to overcome that is to look at the opposite opinion. What are the people saying that believe the opposite if what you believe. I think that's the case here when you just talked about the 28 agree and 2 don't.

Bill Keen: Right.

Steve Sanduski: It's worth finding out why the two don't agree with you.

Bill Keen: That's right.

Steve Sanduski: Sometimes it's the people on the fringe that see things earlier. Now I'm really talking more in the investing side.

Bill Keen: Right.

Steve Sanduski: Sometimes it's the people in the minority that see things prior to and that was in the movie "The Big Short."

Bill Keen: Yes, that's right.

Steve Sanduski: People who ended up seeing what was happening, they were early. They didn't make money early on because they were too soon before these things started to turn.

Bill Keen: That's right.

Steve Sanduski: Then they were eventually proven. That's not always the case.

Bill Keen: That's right.

Steve Sanduski: Just because the minority has an opinion doesn't mean that they're eventually going to be proved right. I think it's usually worth listening to just to make sure you're not missing something and see what validity there might be to their side of the story.

Bill Keen: Not to get overwhelmed by it and just to have this obsession with that.

Steve Sanduski: Right.

Bill Keen: There's always probably going to be some folks that disagree and that's okay too.

Steve Sanduski: Right. I think in the coaching business we often say that if you're coaching someone and they have a weakness, you don't necessarily want to spend a lot of time trying to improve that person's weakness. You want to figure out is there someone else we can have in the organization that can handle that particular piece because the person I'm working with is not necessarily strong. You want to make their strengths stronger as opposed to trying to make their weaknesses a little bit better.

Bill Keen: I was involved with an organization, we talk about operating in our unique ability whether it's with our staff, making sure their operating what they love to do and what they're best at. I apply that to even my kids. I'm so grateful, all my kids get great grades and they're good kids. Very blessed and grateful for that. They all have their favorite classes and they all have their classes they don't like as much. After I was kind of armed with that information about the unique ability, the concept you just mentioned, I said look guys, if you don't like a class don't worry. Take it, do your best but when you get out into the world and you're operating, you may not be operating in that particular field. You'll be doing things in the field that you love and that is your unique ability.

There's probably one other that I'd like to at least touch on today before we close if we're getting close. That is the "Optimism Bias". I know probably a lot of people think financial advisors - we're just always optimistic, Steve. I believe optimism is the only long-term realism. If you really look at history that would be what you come up with. I do believe there's serious issues that have to be looked at and considered on the way to the long-term optimism. I do believe you also have got to be a realist when it comes to the facts of the current situation. So optimistic long-term, yes. Realist about the facts, absolutely I believe or you'll get blindsided. I saw a piece that you put out recently about the Stockdale Principle and I wondered if maybe you could share a little bit about that.

Steve Sanduski: Some of the listeners are probably familiar with Admiral James Stockdale. He was if not, the highest ranking, certainly one of the highest ranking officers that was a prisoner of war during the Vietnam War. He was a prisoner of war for seven and a half years. He was brutally mistreated and then he was asked years later by Jim Collins who is a prominent business book author; he was asked how did he survive during that time. Stockdale said that among things that enabled him to survive were, he said, that you must never confuse faith that you will prevail in the end, which you can never afford to lose, with the discipline to confront the most brutal facts of your current reality, whatever they may be.

Bill Keen: That's right.

Steve Sanduski: It's that paradox in terms of have confidence, have ultimate faith that things are going to work out but on the other hand also you have to face the reality of your current situation and you can't just blindly say oh it's going to work out in the end, everything's fine, don't worry about it cause that may cause you to not take any action.

Bill Keen: That's such a great story. It's so true and again, it speaks to why we're doing this podcast series and really kind of the mission our firm. I want people to get conscious of the facts, conscious of reality and look up and say what's the why around what we're doing. Where do we want to be 1, 3, 5, 10, 20 years from now; what do we want things to look like and let's step back and develop a plan and get clarity on the things that we need to be focusing on. If there's things that need to be addressed, we have to tell that to our clients. People get focused on those things.

Gosh, in this world where you turn on the news and I know you probably get tired of hearing me say this, but it's true. It's 24/7, it's in our face and it's nearly all negative. It's just the way it works. The news, they're selling advertising and that's the business that they're in and fear sells. When we live in a world like that and then we go through things like we're going through with the market here at the beginning of 2016 and boy it's just kind of they're really going to grab on to that and create hysteria, if you will, on it. Having a plan and being educated and armed with this information, to me, it's priceless. I'm grateful to be able to do it and take time to have our conversation, Steve. I hope that some of our listeners are getting something from what we're saying and it's sparking their interest and sparking their thought and making a difference, you know.

Steve Sanduski: Yeah.

Bill Keen: I really do.

Steve Sanduski: Excellent. Great, Bill. As we wrap up here, Bill, is there anything else that you want to share before we close?

Bill Keen: I think that what we've done today is just briefly brought some light to some of these biases that are pretty common and if it can help our listeners to avoid this or at least get conscious of it when they come up, I think we've been successful today, Steve.

Steve Sanduski: Yes. I think awareness like you're talking about. Just awareness of these issues and keeping them front and center and working with a trusted advisor like you and your team at Keen Wealth Advisors, can go a long way toward overcoming these and not letting them cause you to make a bad, emotional-based decision.

Bill Keen: That's right.

Steve Sanduski: Bill, as always, great to talk to you. Great to have you alive here in person. We're going to have to do this more often.

Bill Keen: Yes, very good. You didn't give me too hard of a time.

Steve Sanduski: Well, we'll save that for the next episode.

Bill Keen: All right, very good.

Steve Sanduski: Thanks Bill.