J. F. Williams Co. INC.

Jim Williams

We've been publishing some pieces on behavioral finance and cognitive biases in recent weeks. This is a look at a laundry list of known biases and priors that affect the financial decisions that individuals make. This is an area of inquiry that has become more prominent in recent years. A recent book, The Undoing Project by Michael Lewis tells the story of two of the pioneers in this research. Daniel Kahneman and Amos Tversky, two Israeli psychologists, who started some 40-odd years ago to identify, evaluate, and document behavioral biases that show up in decision-making. Their work was the inception of Behavioral Finance.

Another source in this area is Kahneman's own book Thinking Fast and Slow. In his book, Kahneman describes much of research that forms the basis of his life's work. Most interesting, I think, is the tour of the two decision-making systems we all operate with as a part of our original equipment. System 1 is the fast, intuitive and emotional system. System 2 is the slower, more deliberate and more logical system. System 1 is hardwired and hotwired to effortlessly guide our behavior and decision-making whereas System 2 is somewhat disconnected and requires a good bit of energy and effort to get working and engaged. It is easier and quicker to use System 1. System 1 is great for avoiding snakes, spiders and predators. It is not so good for making sound investment decisions. System 2 is inconvenient and time-consuming, but in the end System 2 gives us a chance to make decent financial decisions.

We have long held that emotions and intuition are unreliable and perverse bases for decision making in investment management in particular and personal finance in general.

This recitation of decision-making biases can lead one to conclude that markets cannot be efficient. But we believe that an efficient market does not require that each and every participant in the market be fully rational. We believe that when markets aggregate the individual decisions of many, many participants, the result is pretty efficient. (See The Wisdom of Crowds by James Surowiecki.)

While we think that it makes sense to try to understand our own biases, we believe that it is also true that simply knowing about bias is not sufficient to overcome it. One needs some strategies.

Our approach to avoiding the corrosive effects of bias in financial decisions consists of several parts. Among them are these:

Separate the decision point from the point where the emotions arise.

- In the case of investment decisions, we design a personal risk profile that explicitly accepts an amount of downside risk (short-term volatility) as the cost of the expectation of the corresponding level of long term total return. We help our clients make this decision in the calm, cool and collected comfort of our conference room. We try to make the decision memorable without making it too painful. Then we reinforce the decision whenever we get the chance so that when the downturn hits (and we emphasize that it is when, not if or might or maybe, because downturns will happen), the client has some mental preparation through rehearsal for the difficult period. Our experience is that this works pretty well.
- In the case of financial planning decisions, we try to provide the proper framing for the decisions through construction of careful planning models. We use these models to illustrate "what if's" and gauge the impact of certain levels of saving, spending, gifting, charitable giving, etc. In the spending realm, our modeling is designed to help the client translate the differences between macro-scenarios down to the day-to-day decisions about whether to buy that $5.00 latte.

The connection is weaker in the spending area, and that effect is compounded by the fact that we have no real presence in the spending decisions, whereas we may have the chance to influence the client in investment decisions due to our management position with respect to investment assets.

Reduce the worry.

- In his great book "How to Stop Worrying and Start Living" Dale Carnegie proposed a simple method to eliminate worry:

- Ask yourself, "What is the worst that can possibly happen?"
- Prepare yourself mentally to accept the worst.
- Then calmly try to improve upon the worst which you have already mentally accepted.

- We think this an excellent formula, particularly when you realize "the worst" that you have to accept is really only a transitory downside that will inevitably be followed by a recovery. "The Worst" is simply the willingness to endure short term volatility in exchange for long term returns.

Focus on the things you can control.

- You cannot control the rate of return that is systematically produced by the financial markets.
- You cannot time the markets (indeed we believe no one can). This holy grail of investment illusions is so persistent and so pervasive that it may never go away, despite all the evidence to the contrary.
  - You can manage costs,
  - You can manage tax effects,
  - You can manage your level of risk.
  - You can manage your own behavior.

Let go of the noise.

Ignore the constant and unending din of market commentary and market predictions that make up most of the content of the financial (and non-financial) press. Most of what the financial media has on offer is designed to instill either fear or greed. Neither of which is a sound basis for decision-making. The objective of these folks is to capture your attention (eyeballs). It is not to improve your investment performance.

When we think about Behavioral Finance and Cognitive Biases, we don't harbor the delusion that this knowledge will help us beat the market. We look at this information as a useful caution against acting on emotion or intuition and a tonic against overconfidence.

ⓘ Reminder to get your quarterly Credit Report from: ***TransUnion*** ***https://www.transunion.com/annual-credit-report***

The table below shows the returns through March 31, 2018 for selected investment asset classes. In most cases, the results below are appropriate benchmarks for the related mutual funds in your investment portfolio.

Asset Class	Data Series	YTD	1 Yr.	3 Yrs.	5 Yrs.
Ultrashort Bonds	ICE BofAML US 6-Month Treasury Bill Index	0.32	1.15	0.71	0.48
Short Term Municipal Bonds	ICE BofAML 1-3 Year US Municipal Securities Index	0.29	0.46	0.70	0.74
Short Term Corporate Bonds	ICE BofAML 1-5 Year US Corporate & Government Index	-0.49	0.22	0.81	0.99
Short Term Global Bonds	FTSE World Government Bond Index 1-2 Years (hedged to USD)	0.30	0.95	0.82	0.76
Intermediate Term Municipal Bonds	Bloomberg Barclays Municipal Bond Index 7 Years	-1.20	1.26	1.62	2.10
Intermediate Corporate Bonds	Bloomberg Barclays U.S. Credit Bond Index	-2.13	2.59	2.16	2.83
Intermediate Global Bonds	FTSE World Government Bond Index 1-5 Years (hedged to USD)	0.17	1.01	1.06	1.21
US Marketwide Core 1 & 2; Vector	Russell 3000 Index	-0.64	13.81	10.22	13.03
US Large Cap Market	S&P 500 Index	-0.76	13.99	10.78	13.31
US Large Cap Value	Russell 1000 Value Index	-2.83	6.95	7.88	10.78
US Small Cap Market	Russell 2000 Index	-0.08	11.79	8.39	11.47
US Small Cap Value	Russell 2000 Value Index	-2.64	5.13	7.87	9.96
Real Estate Investment Trusts	Dow Jones U.S. Select REIT Index	-7.43	-3.68	0.74	5.97
International Marketwide Core & Vector International Large Cap Market	MSCI World ex USA Index (net div.)	-2.04	13.92	5.30	6.04
International Large Cap Value	MSCI World ex USA Value Index (net div.)	-2.52	11.66	4.46	5.44
International Small Cap Market International Small Cap Value	MSCI World ex USA Small Cap Index (net div.)	-0.50	21.16	11.30	9.71
Emerging Markets	MSCI Emerging Markets Index (net div.)	1.42	24.93	8.81	4.99

April 16, 2018