UNDERSTANDING BEHAVIORAL SCIENCE

How Behavioral Science Can Help Make You A Better Investor

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Before you make another decision today, read this.

DECISIONS, DECISIONS – ARE YOU CHOOSING THE BEST OPTIONS?

Consider all the decisions you make each day, like how much to pay for a cup of coffee, whether to buy or bring your lunch, or go to the gym. These daily choices may seem small, but they can actually have a cumulative effect. Take the "latte factor," popularized by author David Bach. It's a simple concept: Spending small amounts of money on a regular basis costs us far more in the long run than we can imagine.

Now consider the potential impact of the more complex decisions we make throughout our lives, like whether to buy a home or rent, how to fund college expenses and how much to save for retirement, and ask yourself: Do I approach big decisions rationally; do I weigh the benefits and drawbacks and then choose the best possible option?

Classical economic theories of decision-making, such as rational choice theory, assume that we make decisions in a rational manner — that we weigh the costs and benefits of different outcomes, consider the future, and get the information we need to choose the best options. But, behavioral science — the collective study of human behavior across disciplines, like economics, psychology, social psychology and neurosciences — tells us that when it comes to making decisions, humans are actually much less rational than we think. Our decisions are influenced by a myriad of factors that we may not even be aware of.

Most of us have a sense that our past life experiences often frame how we respond to events. But, what you may not realize is that 95% of us use heuristics, or mental shortcuts, such as a rule of thumb (general guidelines say this is the right thing to do), an educated guess (this seems like the right thing to do) or intuitive judgment (it feels right) to make complex decisions. To compound matters, we're at the mercy of a host of biases that influence our behavior and the decisions we make. In challenging times, we tend to rely more on metal shortcuts and biases to make decisions, which can lead to less than ideal outcomes.

By examining the biases that affect the decisions we make, behavioral science and its investment-related subsets, behavioral economics and behavioral finance, examines the biases that inform our decisions and helps us understand that achieving successful outcomes hinges on our ability to make rational decisions.

RECOGNIZING YOUR BIASES

There are well over 100 cognitive and emotional biases, an umbrella term that refers to the systematic ways in which the context and framing of information influence our judgment and decision-making. Importantly, not all biases influence us in the same way, but their common characteristic is that they lead to judgments and decision-making that deviates from rational objectivity. Here are some of the most common cognitive biases that can lead you to make less than optimal investment decisions:

- **Confirmation bias**. Humans have a tendency to search for, interpret, focus on and remember information in a way that confirms our preconceptions. Investors might inadvertently look for information that supports their beliefs about an investment and fail to see information that presents different ideas. Having a one-sided view can lead to poor investment decisions.
- **Overconfidence effect**. Humans tend to overestimate or exaggerate their ability to successfully perform a given task. Overconfident investors feel that they are better than others at picking the best stocks and times to enter or exit a position – a behavior that can lead to more frequent trades and market timing, which will impact returns.
- **Loss aversion**. Humans feel the pain of loss more severely than they feel the joys associated with gains. This aversion to loss can cause investors to sell winning investments too early, hold losing investments too long, or possibly assume additional risk in an attempt to make up for potential losses.
- **Bandwagon effect / herd instinct**. Humans are frequently compelled to take a particular action primarily because other people are doing it, regardless of their own beliefs, which they may ignore or override. In investing, we see this phenomenon can play out during bull markets and in asset bubbles, when price spikes occur when investors all flock to a particular asset class.
- **Familiarity bias**. Humans tend to stick with what they know, which can have a strong impact on what they buy. However, investing only in stocks that we're familiar with can result in over allocations to certain companies, industries and countries, which can negatively impact portfolio diversification. One common example is "home country bias," which is the tendency to favor companies in one's own country over those from other regions and countries.
- **Hindsight bias**. Humans have a tendency to perceive events that have already occurred as having been more predictable than they actually were before the events took place — the "knew-it-all-along effect" — which can result in an oversimplification in cause and effect. An investor who believes that they knew everything about every situation has a strong inclination to become overconfident.

BEATING YOUR BIASES FOR MORE RATIONAL INVESTMENT DECISIONS

Here are some tips for helping beat the cognitive biases that can derail your long-term financial goals:

- **Keep emotions in check**: Market volatility combined with a 24/7 news cycle can unnerve even the most seasoned investors. But, decisions that are driven by emotion are often not the wisest. Rather than worrying about short-term market fluctuations, stay focused on your long-term financial goals.
- **Stay diversified**: Periods of significant volatility often lead to emotional decision-making and behaviors. Appropriate portfolio diversification, consistent with your return objectives and risk

tolerance, may help mitigate volatility, calm your fears and potentially produce more consistent and successful investment outcomes.

- **Avoid being overconfident**: Before you act on a "can't lose" investment decision, it can be useful to step back and consider that even professional fund managers, analysts and traders with access to the best information and models still struggle to achieve market-beating returns.
- **Consider the other side**: To avoid having a one-sided view of an investment and acting on it, search out reliable information that presents different perspectives. This will help give you a holistic picture and lead to a more informed decision.
- **Rebalance regularly**: Regular portfolio rebalancing instills a disciplined approach to decision-making, forcing investors to take actions that may be emotionally uncomfortable, but have the potential to be financially productive.

BEHAVIORAL SCIENCE IN ACTION

PIMCO has long understood that behavioral science can make us better investors. That's why we've partnered with the best minds in the field at the Center for Decision Research at The University of Chicago Booth School of Business, under the leadership of faculty director Nicholas Epley, and CDR governing board member Richard Thaler, recipient of the 2017 Nobel Prize in economics. Learn more about our partnership and how behavioral science can make you a better investor.

DISCLOSURES

All investments contain risk and may lose value. **Diversification** does not ensure against loss. There is no guarantee that **rebalancing regularly** will result in financial gains. Investors should consult their investment professional prior to making an investment decision.

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