SHARPER GRANITE LLC

Letter on the Economy

Misperceptions of Risk – Where Are Your Pitfalls?

Individuals perceive risk differently. Some enjoy the high stakes of Vegas, while others find comfort in stashing cash in a bank account. Although these examples sit at opposite ends of the risk-tolerance spectrum, they share a common trait. Both are rooted in the misperception of risk. Misperception of risk can damage the health of investment portfolios as well as the health of investors by creating unnecessary stress.

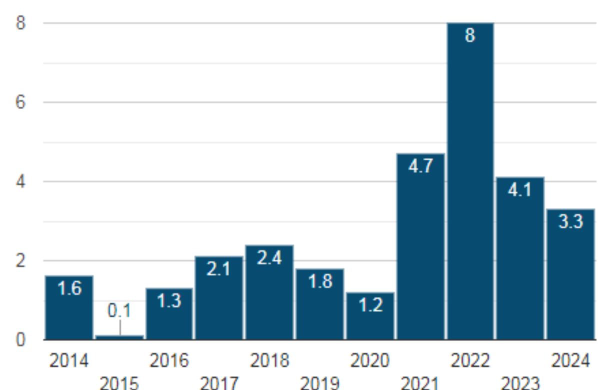
In DALBAR's 30th annual investor behavior study, the average equity investor earned 5.5% less than the S&P 500 Index in 2023. While investors generally trail the S&P 500 Index, this is the third-largest gap in the past ten years.[1] How is this possible? The return deficit was mainly due to poor investment behavior – buying when markets were strong and selling when markets were weak. Mountains of research show that most investors hurt themselves with bad investing behavior. Here, we discuss five behavioral pitfalls that result from *misperception of risk*.

Fixation on a Key Past Event

For some investors, a defining moment in their life – the Great Depression, hyper-inflation of the 1970s, Tech Bubble, Financial Crisis of 2008 – drives their perception of market performance and risk. Some will remember a parent or grandparent stashing money in a coffee can. Those who watched banks fail during the Great Depression developed a mistrust of the banking system and federal government. Despite FDIC insurance and other measures instituted since then, some over-estimate the modern-day risk of U.S. banks and government-backed securities such as treasuries. Their perception of risk is anchored by a past event which guides their future financial decisions.

Others remember the period of 10% average annual inflation from 1979 to 1981.[2] Investors impacted by this time period may overly-focus on inflation risk; however, Federal Reserve officials now have a much better understanding of inflation, along with stronger tools for controlling it.

Inflation averaged close to 2% over the past thirty years.[2] Even with the recent inflation spike, inflation averaged 2.8% over the past ten years (see chart at right).[2] By over-loading a portfolio with inflation-hedges such as gold, commodities and inflation-adjusted treasuries, these investors have lost the "inflation bet" more often than they have won and hurt their long-term returns as a result.



Paralyzed by Uncertainty

When presented with too much data, too many decisions and too many unknowns, some investors' inclination is to do nothing. They fear uncertainty. This fear is similar to that which may strike someone planning a wedding or renovating a home. Faced with choosing between 19 flower arrangements or faucet styles, many feel overwhelmed, afraid of making the wrong choice. Similarly, in a dynamic economy each day may bring another set of investment decisions.

This is decision fatigue, and the research behind it is discussed in the book, *Willpower*.[3] For this investor, doing nothing is the least-risky option. Nobel laureate Richard Kahneman refers to this as "status quo bias." [4] Doing nothing, however, can lead to missed opportunities or portfolios that are inconsistent with financial objectives.

"If you choose not to decide, you still have made a choice."
- "Freewill" by Canadian rock band, Rush, 1980

This paralysis can explain why an investor may sit on cash for years, with inflation gradually eroding its spending power. And consider those whose portfolios became over-allocated with tech stocks in 2000 or real estate in 2007 as these asset classes ballooned but were never rebalanced. They lost far more than necessary when the bubbles popped.

Resistant to Change

In anchoring behavior investors can have expectations which no longer apply to current market conditions. They rely too heavily on past performance as justification for their strategy. For example, in 2007 some investors may have thought, "leveraged real estate has always done well," and did not realize they were over-allocating to a risky asset class. The following year, a global financial crisis centered on real estate led to home prices falling an unprecedented 18%, the largest annual decline since 1987. [5] An investor who resists making changes and over-invests in one asset class risks the possibility of large losses and missed opportunities.

Overreact to Recent Information

This behavior relies on an exaggerated emotional response to new information, regardless of risk, known as recency bias. A positive-reaction example is the investor who chases a hot stock pick regardless of whether it fits her investment strategy. She believes she knows something that will give her an advantage. She ignores that she is competing with highly-trained experts at scores of financial institutions whose job is to analyze that stock. These experts likely have deeper access to company information and sophisticated analytic tools. She misperceives the risk of placing this bet and exuberantly chases the lead.

A negative-reaction example is the investor who hears a financial-news sound byte and abandons a sound strategy because the "sky is falling." He does not assess all possibilities and weigh them appropriately. He over-emphasizes the worst-case scenario based on limited recent data and acts. In each of these examples, impulsive decision making based on a misperception of risk could sabotage a well-planned investment strategy.

Further research shows that investors tend to focus on information that confirms their opinions, and discount information that counters their viewpoint. This is confirmation bias. We often cling to messages that resonate with our past experiences while ignoring contradictory viewpoints and data. This can exacerbate an overreaction to recent information.

Attached to Cash

These investors tend to be overweight in cash as they hold a false sense of security with cash. This behavior results from the misperception that cash holds no risk. This is known in economics as the money illusion or price illusion – the tendency to think of currency in nominal rather than real (after-inflation) terms.[6] Individuals tend to overlook inflation effects on their cash. Holding too much cash results in inflation risk, which leads to a loss of real portfolio value and the lost opportunity from investing in other asset classes.

Many of these misperceptions of risk are fear based. University of Chicago behavioral economist Dr. James Grubman finds that investors experience the pain of losses two-and-a-half times more strongly than they experience the joy of gains. Multiply that pain across years of market ups and downs, and we see how investing can generate significant stress for investors.[7]

“Scientists have discovered why we experience losses much more powerfully than gains,” Grubman explains, “Our frontal lobes, the areas that put together and understand data, process and analyze most of the information related to gains. However, the limbic system, the emotional system of the brain, comes into play in processing losses.”[7]

As humans, we all have these natural biases and are subject to these pitfalls. According to Grubman, “We have a finite store of mental energy for exerting self-control. Sticking with a plan requires energy. When mentally depleted, we lose willpower and become susceptible to impulsive decisions, becoming paralyzed, or letting go of the plan. Whatever feels easy becomes attractive.”[7]

Fortunately, we can overcome these biases and exhibit healthier investor behaviors. The first step is identifying and confronting our investment-behavior imperfections. Self-awareness is key to perceiving risk more accurately, gaining confidence and moving forward. The second step is clearly identifying your goals. This provides a reliable decision-making framework for you and your financial advisor.

Finally, communicating concerns and biases with your financial advisor is an important strategy for improving investment behavior. Your advisor can help you better understand risk, gain historical perspective, determine the best course and create an investment balance that pursues your goals while reducing worry.

Notes and Acknowledgements:

1. DALBAR 30th Annual Quantitative Analysis of Investor Behavior (QAIB) report, April 2024
2. U.S. Bureau of Labor Statistics as of May 2024
3. *Willpower*, Baumeister and Tierney, 2014
4. "Anomalies: The Endowment Effect, Loss Aversion, and Status Quo Bias,“ Daniel Kahneman, Jack Knetsch, Richard Thaler, Journal of Economic Perspectives 5 (1): 193–206, 1991
5. Case Schiller Home price indices
6. “The Money Illusion,” Irving Fisher, New York: Adelphi Company, 1928
7. Dr. James Grubman, University of Michigan and University of Vermont; State Street Global Advisors, September 2014

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