



# DON'T BUST YOUR BRACKET THIS MARCH

## Take Some Cues From Behavioral Investing

### IT'S BRACKET TIME AGAIN

Between Selection Sunday and the tip-off of Friday's games, Americans will fill out roughly 70 million March Madness brackets, guided by some mix of faith, hope, intuition, knowledge and ... a few behavioral biases that inevitably creep into our decisions.

If those biases point you in the wrong direction, don't worry. The stakes in your March Madness office pool are probably low. But the behavioral biases lurking behind bracket picks are nevertheless instructive, as they are the same mistakes many people make with investing.

In the spirit of the season, this paper shares some of the common behavioral biases that affect decision making, with examples of how they affect your March Madness choices and your investments.

### RECOGNIZING COGNITIVE LIMITS AND EMOTIONAL BIAS

There are two main types of bias that affect our decisions: cognitive and emotional. Cognitive errors result from faulty reasoning. Some of the most common cognitive errors include:

- **Representative Bias:** Assessing new information based on past experiences.

**Examples:** When filling out your March Madness bracket, perhaps you avoid picking a top-seeded team because they let you down in the past. (Here in Seattle, Gonzaga has broken our hearts plenty of times.) But last year's tournament has no real bearing on future results.

When investing, representative bias may steer you away from an asset class or style box that has underperformed in recent years. For example, value stocks have underperformed growth stocks since the financial crisis, so it might be tempting to steer your allocation more heavily toward growth investments. This bias can keep you from being diversified and cause you to miss out on an asset class that may be the next top performer.

- **Confirmation Bias:** Looking for and/or utilizing only the information that confirms your view while disregarding conflicting data.

**Examples:** When it comes to the tournament, maybe you have a hunch that a particular 12 seed will upset a 5. But how are you making your choice? Are you only focusing on that 12 seed's one or two impressive wins in the regular season, and completely ignoring its embarrassing losses? If so, you may be falling victim to confirmation bias.

It's easy for the same bias to affect your investment choices too. There is no shortage of financial resources, from the Wall Street Journal to Reddit. If you are only reading the positive articles you want to believe and ignoring the warning signs from others, confirmation bias may steer you toward a riskier investment than you realize.




- **Anchoring and Adjustment Bias:** Focusing on a single data point and actively discounting new information that counters it.

**Examples:** If you only have time to watch a handful of basketball games in a season and weight your March Madness decisions solely around those, you're falling victim to anchoring.

In the investment world, anchoring occurs when someone piles into an investment or asset class after seeing one news article or video. This may be in stark contrast to what the data actually says, and could lead to poor financial outcomes.

- **Recency Bias:** Placing greater importance on the most recent event.

**Examples:** A common mistake in March Madness brackets, recency bias occurs when we weight too much significance on a team's performance in the conference tournament preceding the big dance. Perhaps a middling team in conference play skated through their conference tournament due to some good fortune and upsets of other teams in the bracket. That success does not necessarily portend a long run in the next tournament.

For investors, recency bias occurs when we favor, and overweight, an asset class based on the most recent results. For example, you may think you only need exposure to U.S. stocks, since they have significantly outperformed emerging market and international stocks over the past decade. This overlooks the fact that U.S. stocks returned nothing from 2000 to 2010. 

## EMOTIONAL ERRORS

Cognitive errors aren't the only ones that can bust your bracket. Emotional errors arise from personal feelings and are manifested subconsciously, making them the hardest to realize and combat. Some of the most challenging emotional errors are:

- **Loss Aversion:** Focus on avoiding losses, regardless of true cost.

**Examples:** Our fear of avoiding a loss causes some basketball fans to favor the top seeds in the bracket too much. It's not always the worst strategy – those teams are a top seed for a reason – but to win your bracket competition, you'll likely have to go out on a limb and predict that a few top teams get upset.

Loss aversion can also undermine an investment portfolio. If you are unable to accept the risk that comes with the stock market, you may invest only in less-risky bonds. While those bonds are not likely to experience losses, you are probably sacrificing the portfolio growth needed to achieve some of your long-term retirement objectives.

- **Overconfidence (Illusion of Knowledge):** Thinking you know more than you do.

**Examples:** When making March Madness selections, overconfidence may manifest itself in your belief in a select conference. Perhaps you went to an ACC school, and are of the belief that it is a superior basketball conference, so you predominantly pick schools from that conference to win games.



For investors, overconfidence can manifest itself in many ways. Perhaps you've inherited company stock options from your employer. Given your confidence in the business, you simply keep collecting those options without diversifying into other opportunities or assessing whether the value of those options alone are enough to fund your retirement needs.

- **Status Quo:** Getting complacent about what you currently own.

**Examples:** The March Madness equivalent to status quo is sticking with those "blue blood" basketball schools that are traditional stalwarts, even though the current team may not be as strong. This year, status quo could be particularly perilous, as some traditional power houses are having poor seasons relative to their recent histories.

When managing wealth, status quo means sticking to what's already worked. For instance, after U.S. stocks experienced the strongest gains over the past decade, it may be tempting to leave yourself overexposed to that market, instead of rebalancing the portfolio toward international or emerging markets. The decision to stay put could leave you underexposed to other markets at precisely the wrong time.

- **Halo Effect:** The tendency for positive impressions of a person, brand or company to positively influence one's opinion in other areas.

**Examples:** For basketball, if you read a touching story about a particular player, it may influence your opinion of the player's entire team, creating the belief they are a Cinderella story destined for the Final Four despite a middling record.

The technology stocks that have outperformed since the pandemic serve as a potential example of the halo effect in markets. Many of these are quality businesses, but valuations have been pushed up in part because people appreciate the role these companies played in helping us through a stay-at-home environment, and have thus heavily invested in the stocks.

- **Herd Mentality Bias:** The tendency to follow what other investors are doing.

**Examples:** If you are picking the same number one seed to win the championship that every pundit is talking about, you're probably herding. And while there is a decent chance that team may win, your bracket likely won't be differentiated enough to take home your bracket contest prize.

In the investment world, examples of herding run the gamut. An investor may see friends buying properties to take advantage of a hot real estate market, then purchase their own second home even though it may be out of their means or the market is overheated.

**The Takeaway:** As the examples highlight, behavioral biases can easily influence your decisions. It's our job to help you filter them out. At Laird Norton Wealth Management, we build portfolios that are designed to get you the highest net return based on your personal risk tolerance and tax situation. But that is only the beginning of the relationship. We stand by as an objective partner, removing bias and emotion from investing, so your portfolio stays on that pre-designed path.



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