

Overcoming Behavioral Biases: The Importance of Our Proprietary Portfolio Exercises

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- Behavioral biases are inherent in human decision-making. Even experts are prone to blind spots that can distort judgment.
- As investment managers, we recognize that both individuals and teams are subject to biases that may affect company evaluation and portfolio decisions.
- Since 2014, Eaton Vance Equity teams have incorporated Portfolio Exercises into our investment process to systematically counter behavioral biases—a key differentiator in how we manage money.

All humans have behavioral biases—blind spots that can affect decision-making. Some people are overconfident; others overvalue what they own or place undue weight on irrelevant information. Behavioral biases have been well documented. Daniel Kahneman won a Nobel Prize in Economics on behavioral economics, the only economics winner who was not an economist (he holds a Ph.D. in psychology).

Research shows these biases affect decision-making across professions: Judges tend to be more severe before lunch and more lenient afterward, while doctors have been known to make mistakes by relying too heavily on prior experience and overlooking new data at their fingertips.¹

Behavioral biases arise when people fail to act “rationally” and process all available information objectively. As investment managers, we recognize that individually, and as a team, we are susceptible to biases in evaluating companies and selecting portfolio stocks. Understanding that we have these biases is the first step, but what can we do to proactively overcome them?

Eaton Vance Equity teams believe that deep, company-specific knowledge, rigorous financial analysis, and decades of collective experience are essential—but alone, insufficient—to achieve strong investment results. Since 2014, we have integrated Portfolio Exercises into our investment process to counter behavioral bias, a differentiator in how we manage money and an important contributor to our success.

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¹ Diagnostic Errors in Medicine, Mark Garber, February 2007.



Behavioral Biases and Their Impact on Investing

We have learned that human beings are not always rational and don't process all the information available to them when making decisions. There are over 150 documented behavioral biases that can impact decision-making in life—and in the investing world. *Below are some examples.*

OVERCONFIDENCE BIAS

Overconfidence is the tendency to overestimate one's abilities and judgment. It shows up in everyday behavior—how well people think they drive, how funny they think they are, or their certainty of being “absolutely right.”

In investing, overconfidence is particularly dangerous.

While conviction matters, we find that overconfidence can impair decision-making. Money managers have to understand that sometimes they will be wrong about assumptions and projections—and ultimately the stocks they pick. In one survey, 74% of fund managers described themselves as “above average” investors, with the remaining 26% calling themselves average.² Of course, no one identified as below average, a statistical impossibility, but not at all surprising.

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LOSS AVERSION

People don't like to lose, and loss aversion is the tendency of people to prefer *avoiding* losses, as opposed to achieving equivalent gains. Kahneman's research suggests that losses are psychologically twice as powerful as gains: The pain of losing \$100 is double the satisfaction of gaining \$100, i.e., a person would have to gain \$200 for their feelings to equalize.³

In the case of investing, loss aversion can lead individuals and investment teams to hold on to positions despite clear reasons to sell.

The notion that losses are avoided by not selling is not necessarily rational when processing all available information. In the words of Kenny Rogers, sometimes “you gotta know when to fold ‘em.”

² “Behaving Badly,” James Montier, 2006.

³ Prospect Theory, Daniel Kahneman and Amos Tversky, 1981.

RECENCY BIAS

Studies show that people tend to overweight recent events when making decisions. A lawyer's closing argument may carry more weight than evidence presented earlier in the trial. Employee evaluations are sometimes based on the past month's work, rather than the full year's achievements. And despite being in first place all season, if a baseball team then loses eight out of nine games, the fans may insist that the manager be fired.

In investing, recent market events often carry more weight than a longer-term view. For example, investors may buy near the top during market rallies and sell at the bottom during downturns. Money management requires filtering a constant flow of short- and long-term information when making investment decisions. While many money managers talk about the need to "tune out the short-term noise," that's often easier said than done. And the media doesn't help, as headline "fears" may serve to grab attention for their content.

ANCHORING

People often become fixated on an "anchor," which can irrationally impact their decision-making. In a famous study, people were asked to take the last three digits of their phone number, add 400, and then estimate the year Attila the Hun was defeated (a fact few knew, which was the point). Their answers formed a perfect regression, even though the phone number plus 400 had absolutely nothing to do with Attila. The fabricated number had become an irrational anchor.⁴

In the world of investing, there are many real-life anchors. Individual investors may anchor performance expectations around headlines ("market at a new high!"), investment news ("our expert says now is the time to buy gold") or even conversations with their neighbors ("I've quadrupled my money on X stock"). For investment managers, anchors could be the price they paid for a stock, its 52-week high or a recent earnings estimate. Although it's important to analyze these data points, managers shouldn't let their decisions get weighed down by them.

ENDOWMENT EFFECT

The endowment effect describes people's tendency to place a higher value on something they own versus an identical good they do not. Whether it's a band's fan with a concert



ticket or a CEO selling a company, this bias may lead them to assign a higher value to their item than what the market might dictate, *just because they own it*. In these cases, mere possession can impair rational decision-making.

Investors should realize that owning an investment—regardless of how long it has been held—does not necessarily make it more valuable than other alternatives in the market.

HERDING/GROUPTHINK

Herding, or "groupthink," occurs when people follow the crowd instead of their own instincts or analysis. In a well-known study, participants were asked to answer a question by a show of hands (so that each participant could see how everyone else was answering). In the first part of the test, the answer was obvious, and everyone got it right. But in the second part, there were "plants" in the group who intentionally answered incorrectly—and guess what? Many more participants got the answer wrong. This is a classic example of herding, where people might be lazy, indifferent, question their own judgment, or just don't want to "look stupid."⁵

We do not think it's a good idea for investors to follow the crowd—i.e., the markets or other investors. Economist John Maynard Keynes famously observed, "Worldly wisdom teaches that it is better for reputation to fail conventionally than to succeed unconventionally." To achieve success in investing, we believe it is critical for people to think for themselves.

⁴ Russo and Schoemaker, 1989.

⁵ Asch Conformity Study, Solomon Asch, 1951.



Building and Leading an Effective Investment Team

Certain behavioral biases affect us as individuals, while others are more prominent in group settings. To guard against groupthink and conformity, investment teams need to be thoughtfully designed and managed. Debate and disagreement are hallmarks of effective working groups. While it is tempting for a hiring manager to seek out people who are “just like me,” this can result in a lack of cognitive diversity and pressure to “go along to get along,” features that are not conducive to good decision-making.

An alternative approach is for team leaders to identify a list of must-have attributes, such as curiosity, independence of thought, intelligence, honesty and a strong work ethic. On top of that foundation, team members should have diverse skill sets and backgrounds. One person might be especially strong in accounting, another at reading people. One might be eloquent, another shy. One might be from an Ivy League business school, another from the school of hard knocks.

Once the team is built, the leader should take care to conduct group and one-on-one interactions in ways that minimize the pressure to conform or shut down debate. This includes clearly stating that respectful disagreement is encouraged among the team, the leader admitting to mistakes in front of the group, the leader resisting the urge to share personal views on an investment idea before all arguments have been heard. Other valuable tools include blind votes and anonymous submissions, which give individuals the “cover of anonymity” to dissent rather than conform.

Proprietary Portfolio Exercises

Eaton Vance Equity investment teams study behavioral biases and how they might influence investment decisions. To address potential bias risks, we have developed and use more than 50 proprietary Portfolio Exercises designed to help portfolio managers and analysts systematically recognize—and overcome—their personal investment biases. These exercises are an integral part of our investment process and are performed regularly by our portfolio managers and analysts to help overcome bias.

“TWO MISTAKES I MADE LAST YEAR”

Each January, we ask everyone on the team to think about two mistakes they made over the past 12 months. For example, “the stock price hit my target, but I talked myself into holding on just a little bit longer” or “the CFO abruptly left the company, which I know is a red flag, but I dismissed it, and they subsequently had to restate their financial statements.” Everyone in the group then presents their “mistakes” to the rest of the group.

There are a couple important reasons why we do this. One goal is to have people learn from their own and their colleagues’ mistakes. Another is to wipe the slate clean for those coming off a difficult year so they are not hampered by the baggage of history. Likewise, it brings a dose of humility to those who need it.

The behavioral bias we hope to address in this exercise is overconfidence. Good money managers are confident, not arrogant, and confession is good for the soul.

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“ONE UP, ONE OUT”

The assignment is for everyone on the team to look at the portfolio and pick one stock outside their area of direct responsibility that they would add to, and another they would liquidate entirely. The goal is to empower team members and hold colleagues accountable for decisions.

We believe this exercise helps team members come to grips with loss aversion, in the sense that they must exit a stock, even if it is showing a loss at the time. It is also designed to hold sector-specific analysts accountable for “the whole portfolio experience,” to better align them with the perspectives of our clients.

“ROBINSON CRUSOE”

As you might remember from English Lit 101, Robinson Crusoe was a castaway who spent 28 years on a remote, tropical desert island. In this exercise, we ask investment team members to imagine being stranded on a desert island for seven to 10 years, without access to information or the ability to trade. Then, as Robinson Crusoe, they are to identify the ONE stock they would want to own for that time period.

The goal here is for members to overcome any recency bias (or short-termism) they might be experiencing. For example, we do not want team members to be obsessed with the current market environment or to hold out for the perfect entry-point price when buying a stock in a great long-term business. This exercise focuses the team on identifying companies with the qualities of strong, sustainable business models that can compound in value over time. We keep a running list of stocks identified in the exercise, so that when the market drops dramatically, we can consider a potential purchase.

“TIME-TRAVELING REPORTER”

Another exercise to help overcome recency bias or short-term noise is the Time-Traveling Reporter. We ask each team member to think of themselves as a financial journalist with access to a time machine that can leap forward 1, 3 or 5 years into the future. We then ask for a potential newspaper headline from that future date. For example, what might the newspaper say a year from today? Has inflation peaked and dropped? Where is the Fed on interest rates? Is the war in Ukraine over?

One might argue that attempting to predict the future is a fool’s errand. But the point of the exercise is not about predicting the future, but about identifying scenarios that could emerge outside the market’s current narrative. This approach helps us avoid overemphasizing recent events when making long-term decisions for our clients.

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“DESIGNATED BEAR”

Counterargument can be the linchpin of good investment decisions. Whereas everyone on the team might feel confident about an investment thesis, a well-researched counterargument might uncover something the team is missing. In the Designated Bear exercise, we ask a sector analyst to present the case for a particular stock and then assign someone else to be the Bear and make the case that it’s actually a bad investment idea. This approach is borrowed from the military (red team/blue team) and sports (scout team), where it can be helpful to seek out the perspective of your adversary.

We prefer volunteers for this exercise, as research suggests the strongest results occur when the Bear fully believes in what they are presenting, rather than simply playing a role. The goal of the exercise is to systematically break down any herd mentality and complacency that may exist within the group.

In Summary

Behavioral biases are well-documented phenomena that are nonetheless quite prevalent in the investment world. Overconfidence, herding, loss aversion, anchoring and recency bias are all potential blind spots that can undermine the objective decision-making of any investment team.

To address these biases, we have developed proprietary Portfolio Exercises that are fully integrated into our investment process. The exercises have proven to be a great tool for the group, helping both individuals and the team as a whole deliver better client outcomes. We find that some exercises result in immediate changes to our portfolios, and others stimulate new thinking and ideas. We believe these Portfolio Exercises are important differentiators that set us apart from other investment managers in the industry.

Risk Considerations

There is no assurance that a portfolio will achieve its investment objective. Portfolios are subject to market risk, which is the possibility that the market values of securities owned by the fund will decline and that the value of fund shares may therefore be less than what you paid for them. Market values can change daily due to economic and other events (e.g. natural disasters, health crises, terrorism, conflicts and social unrest) that affect markets, countries, companies or governments. It is difficult to predict the timing, duration, and potential adverse effects (e.g. portfolio liquidity) of events. Accordingly, you can lose money investing in this portfolio. Please be aware that this portfolio may be subject to certain additional risks. In general, equities securities' values also fluctuate in response to activities specific to a company. Stocks of small- and medium-capitalization companies entail special risks, such as limited product lines, markets and financial resources, and greater market volatility than securities of larger, more established companies. Illiquid securities may be more difficult to sell and value than publicly traded securities (liquidity risk). Non-diversified portfolios often invest in a more limited number of issuers. As such, changes in the financial condition or market value of a single issuer may cause greater volatility. Derivative instruments may disproportionately increase losses and have a significant impact on performance. They also may be subject to counterparty, liquidity, valuation, correlation and market risks.

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