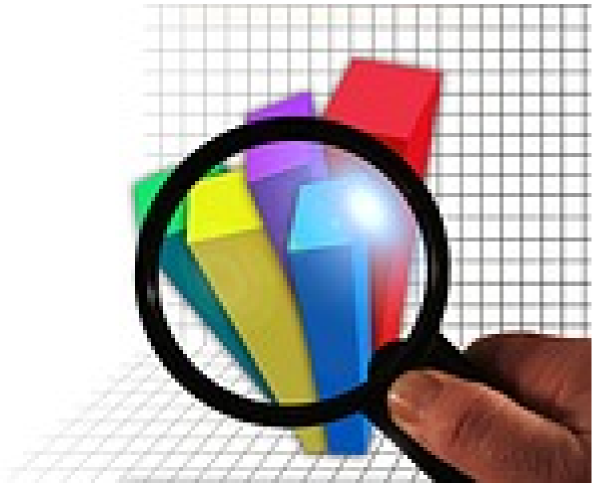
BEHAVIORAL FINANCE 101 - RECENCY BIAS



Recency is a cognitive bias that convinces us that new information – which is more recent – is more valuable and important than older information. Now, this *may* be true, but it is *not necessarily* true. For example, investors tend to base their market expectations on how the market has been performing recently, whether good or bad. Therefore, if the stock market's recent performance has been very strong, while the bond market has been lackluster, they expect these same good or bad returns to continue, pretty much along a straight line into the future. The more rational expectation, of course, would be to look back as far as you can and use long-term averages as a baseline and then judge the more recent performance against those long-term averages.

But, we tend to extrapolate recent returns and use them as an indication of future returns. As a result, investors fall into the trap of*overbuying* the current outperforming asset class and *under owning* the current underperforming asset class.

Investors subject to recency bias may also be affected by other biases, such as hindsight, anchoring, loss aversion, and herding. Recency and outcome biases also go together. People subject to outcome bias focus on the outcome of an event as opposed to the process by which the result was achieved. For example, an investor may think "This manager had a fantastic 5 years, so I am going to invest with him." They jump and invest instead of understanding how such great returns were achieved or why the strategies used by other managers might not have had good results over the past 5 years, but may blossom over the next 5 years.

Putting recency and outcome together, a person may look at a recent outcome, such as the stock market dropping 10% in the last 90 days, and decide it is a lousy time to invest. They may believe this falsely rather than looking at historical valuation information or doing diligent research. When this happens, they may disregard important considerations such as the prospects for the investment or current market valuations, which may be key drivers of future investment successes.

In early 2009, the stock market had suffered severe losses for a couple of years and many investors abandoned it, mentally extrapolating those losses into the future and seeing nothing but red ink going forward. Of course, the market staged a dramatic rebound from that time forward. Today, it is somewhat the opposite, with overall market having moved up substantially and timid investors now thinking about jumping in, based on this recent performance.

Now, this does not mean that it is a bad time to invest. No one has a clear crystal ball and markets are notoriously unpredictable. But, it does mean that investors might want to lower their expectations, as recent returns have been much higher than long-term average returns. In addition, investors might want to look at pockets within the market where recent returns have been lagging, as this might indicate areas of better valuations. For example, international markets have generally lagged the U.S. market recently and hardly anyone likes China or commodities.

In what ways does behavioral finance impact your decisions? We're here to help as you plan for your future.

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