

## Overcoming Behavioral Biases: The Importance of Our Proprietary Portfolio Exercises

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All humans have behavioral biases, those blind spots that can impact decision-making. Some people are overconfident about their abilities; others attribute too much value to things in their possession; some unwittingly attach too much importance to things that are not important at all.

Much has been written on the subject of behavioral biases. 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 has shown that behavioral biases can impact decision-making in a number of fields: judges are inclined to be more severe before eating lunch, more lenient after; doctors have been known to make mistakes based on assumptions about what they have seen in the past, overlooking new data at their fingertips.<sup>1</sup>

Behavioral biases exist when human beings fail to act “rationally” and process all the information available to them when making decisions. As investment managers, we must recognize that individually, and as an investment team, we are likely to have biases about our stock selection process, the sizing of positions, portfolio construction, even risk management. Understanding that we have these biases is the first step, but what can we do to proactively overcome them? The Eaton Vance Equity Group believes that having deep company-specific knowledge, training in financial statement analysis, and decades of collective experience are necessary, but insufficient, to achieve strong investment results. Since 2014, we have integrated the discipline of conducting Portfolio Exercises into our investment process, a differentiator in the way we manage money and an important element to our success.

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<sup>1</sup> 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. Here is a sample.

### OVERCONFIDENCE BIAS

People are overconfident about many things: their ability to drive well, their sense of humor, and their certainty that “they are absolutely right” about specific things. Overconfidence bias is defined as a tendency to have a misleading assessment of ourselves, a belief wrapped in ego that we’re better than we actually are.

Overconfidence in investing can be detrimental. While we want our professionals to be confident, we find that overconfidence tends to be a weakness. Money managers have to understand that sometimes they will be wrong about their assumptions and projections—and ultimately the stocks they pick. In one survey, 74% of fund managers responded they believe they were “above average” at investing, the remaining 26% thought they were average.<sup>2</sup> Of course, no one thought they were 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 acquiring equivalent gains. Kahneman’s research suggested that losses are psychologically twice as powerful as gains, in the sense that someone who loses \$100 will feel twice the pain versus the satisfaction of gaining \$100, i.e. a person would have to gain \$200 for their feelings to equalize.<sup>3</sup>

In the case of investing, individuals and investment teams may stubbornly hold onto investments, in the face of obvious reasons to sell. The thought is that one doesn’t lose money if one doesn’t sell, a behavior that is not necessarily rational when processing all the available information.

<sup>2</sup> “Behaving Badly,” James Montier, 2006

<sup>3</sup> Prospect Theory, Daniel Kahneman and Amos Tversky, 1981

### REGENCY BIAS

Studies have shown that people are prone to make decisions based on recent events. A lawyer's closing argument might have much more weight than evidence offered earlier in the week. Employee evaluations are sometimes based on the past month's work, as opposed to the full year.

In investing, recent events in markets sometimes hold more weight than a longer-term view. It is not uncommon for individual investors to buy near the top during market run-ups and sell at the bottom during downturns. In money management there are reams of data that need to be parsed when making investment decisions—some short-term, some longer-term. Many money managers talk about the need to “tune out the short-term noise,” but that's often easier said than done.

### 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 and add 400, and then asked the year Attila the Hun was defeated (which few know, which was the point). Their answers formed a perfect regression despite the fact that the phone number plus 400 had absolutely nothing to do with Attila. The fabricated number had become an irrational anchor.<sup>4</sup>

There are many real-life anchors in the world of investing. Individual investors create anchors about their investment expectations based on news (“Gold nearing its YTD high”) or talking to colleagues (“I've doubled by money on crypto”). For investment managers, anchors could be the price you paid for a stock, its 52-week high or a recent earnings estimate, and while it's important to analyze these data points, managers shouldn't let their decisions get weighed down by them.

### ENDOWMENT EFFECT

The endowment effect refers to the fact that people will place a higher value on something they own than on an identical good they do not. This bias can influence a fan with a concert ticket or a CEO selling a company, both of whom perceive their item is more valuable than what the market might indicate, *just because they own it*. Mere possession of an asset can impair rational decision-making.



Investors should realize that just because they own a particular investment, regardless for how long, it doesn't necessarily mean it is more valuable than other alternatives in the market.

### HERDING/GROUPTHINK

Herding is when people follow the crowd instead of their own instincts and/or analysis. In a well-known study, participants were asked to answer a question by a show of hands (so that everyone in the group 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, a classic example of herding, where people might be lazy, indifferent or question their own judgment.<sup>5</sup>

We do not think it is a good idea for investors to follow the crowd, i.e., the markets or other investors. Economist John Maynard Keynes once said, “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.

<sup>4</sup> Russo and Schoemaker, 1989

<sup>5</sup> 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. One way to guard against groupthink and conformity is to be thoughtful about the design and management of an investment team. Debate and disagreement are hallmarks of effective working groups and while a hiring manager might seek employees 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 one in which the team leader identifies 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 at 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 be careful to conduct group and one-on-one interactions in a way that minimizes the pressure to conform or shut down debate. Techniques for doing this include regularly reiterating the expectation that respectful disagreement is encouraged from each member of the team; the leader admitting to mistakes in front of the group; the leader resisting the urge to tell others what they think of an investment idea before the discussion is completed and arguments have

been heard. Other valuable tools include giving individuals the “cover of anonymity” by using blind votes and anonymous submissions in order to invite dissent rather than conformity.

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## Eaton Vance Equity – Proprietary Portfolio Exercises

Within Eaton Vance Equity, our investment teams study behavioral biases and how they might impact investment decisions. More specifically, we have developed and use over 30 proprietary Portfolio Exercises that are designed to help portfolio managers and analysts systematically recognize—and overcome—their personal investment biases. In essence, we are trying to define the problem, the biases, and develop a solution, the Portfolio Exercises. These exercises are an integral part of our investment processes, and are performed by our investment teams on a regular basis to help us overcome biases.

### “TWO MISTAKES I MADE LAST YEAR”

At some point early in the year, 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 of important reasons why we do this. One goal is to engender the continuous improvement of our processes by having people learn from their own and their colleagues’ mistakes. Another is to wipe the slate clean for those coming off of 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 is overconfidence. As we see it, good money managers are confident, not arrogant.

**“ONE UP, ONE OUT”**

The assignment is for everyone on the team to review the portfolio and pick one stock outside of their own area of direct responsibility where they would add more to the position, another that they would liquidate entirely. The intention of the exercise is to give every member of the team “a voice” in management of the portfolio, obligating them to take a “holistic view” of the portfolio beyond their individual areas of coverage.

We believe the exercise addresses loss aversion, in the sense that team members have to get rid of something, 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” in order to align them with our clients.

**“ROBINSON CRUSOE”**

Robinson Crusoe was a castaway who spent 28 years on a remote desert island. In this exercise, we ask investment team members to imagine being stranded on a desert island for five years, without access to information or the ability to trade. Then, as Robinson Crusoe, identify the ONE stock you would want to own for those five years.

The goal here is for team 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. We keep a running list of stocks identified in the exercise, so that when the market drops dramatically (as it has this year), we are ready to act.

**“TIME-TRAVELING REPORTER”**

This is another exercise designed to help overcome recency bias. Each team member is asked 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 it’s a fool’s errand to try and predict the future. But the point of the exercise is not about predictions per se, but identifying future scenarios that are not in the current narrative of the market. The intention is to help us to avoid overemphasizing recent events when making long-term decisions for our clients.

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**“DESIGNATED BEAR”**

We believe counterargument can be the linchpin of good investment decisions. Whereas everyone on the team might feel great about a certain investment thesis, a well-researched counterargument might uncover something the team is missing. In this exercise, we ask an analyst to present the case for owning a particular stock in a sector they cover, then name a Designated Bear to present the case for NOT owning the stock. The exercise 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 in this exercise because research shows the best results occur when the Bear fully believes in what they are presenting, rather than going through the motions of acting out the contra case. The goal of the exercise is designed to systematically break down any herd mentality, and complacency, that might have infected the group.

**In summary**

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

### IMPORTANT DISCLOSURES:

There is no guarantee that any investment strategy will work under all market conditions, and each investor should evaluate their ability to invest for the long-term, especially during periods of downturn in the market.

**A separately managed account may not be appropriate for all investors. Separate accounts managed according to the particular Strategy may include securities that may not necessarily track the performance of a particular index. Please consider the investment objectives, risks and fees of the Strategy carefully before investing. A minimum asset level is required.**

**For important information about the investment managers, please refer to Form ADV Part 2.**

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