Battling Behavioural Biases

Understanding how the mind can help or hinder investment success is a cornerstone of successful fund management. Increasingly, investors are using knowledge about investment biases to design better investment solutions and gain an advantage over the rest of the market.

John Roe has been leading LGIM's multi-asset fund management team since 2013. The team manage a range of award- winning macro strategies, working closely with the rest of Asset Allocation.

In this vein, one of the key philosophies driving MATR is the group's emphasis on disciplined investment thinking. The managers don't rely on external research and combat groupthink; to achieve this, they have a 25-strong team of experts that work together within a structured investment framework to develop independent views.

Here, John Roe, Head of Multi-Asset Funds at LGIM, details the actions that the team embeds into the investment process that help to combat behavioural biases and mental shortcuts: a **flexible team, structured decision-making process** and **dedication to improving confidence calibration.**

1 FLEXIBLE FRIENDS

Diversity of thought is central to effective decision making, and as such it is an important argument for greater diversity in investment teams. It is not enough to just hire the right people, however; teams must also make the most of every person, which means ensuring all voices are heard. But that is easier said than done.

Large groups are predisposed to a number of biases: **authority bias**, for instance, whereby decisions are overly impacted by senior individuals; or **shared information bias**, when more time is spent discussing topics with which the group is already familiar, encouraging a narrow focus and consensus views.

Musical chairs

To limit the risk of overemphasising the most senior views and biasing the team towards how those views are framed, we rotate the chair person at our weekly brainstorming meetings and encourage topics from across the team. For similar reasons, we also rotate who contributes to certain parts of our investment process.

The agenda also changes to help combat anchor and adjustment problems, where the first item of the day tends to become overemphasised (the anchor) and insufficiently deviated from (the adjustment).

The stupidity of crowds

The benefit of group decision-making is often lauded as 'the wisdom of crowds'. The average guess from a crowd of people for the number of jelly beans in a jar tends to be close to the correct number, even if many individual guesses are poor.

When it comes to investing, however, market pricing already reflects the average view of thousands of investors. Crowd-based decision-making within the team leads to very similar views and stops us from finding mispriced opportunities. With this in mind, we implement flexible, diverse and small (3-6 people) investment discussion groups that are likely to yield different perspectives on the issue in question.

Legal & General INVESTMENT MANAGEMENT

GUT EXTINCT

Humans are subject to a constant internal battle between logical deliberation and gut instinct when making decisions. Unfortunately, the latter often wins out. Fast, instinctive thinking may be easy, efficient and feel natural – but when it comes to investing, it is not generally conducive to success.

Gut instinct is driven by many biases, but there are two we pay particular attention to. **Availability bias** leans us towards the information that is most widely discussed and readily available. In other words, material that has more profile – notwithstanding its relevance – will have more bearing on decisions. **Recency bias** affects us in a similar way: because we have a tendency to overemphasise whatever has just happened, recent events unduly influence us.

Avoiding survival of the most obvious

When assessing the investment landscape, we have a structured process in place to limit the risk of focusing too much on certain features of an investment opportunity at the exclusion of alternatives or contradicting evidence.

We use scorecards to map pre-agreed criteria such as valuations and investor sentiment across wide range of assets. This forces us to objectively assess new information on existing trades that may otherwise have been subconsciously filtered out. In doing so, we are able to compare investments consistently.

Scorecards also help us tackle **confirmation bias** in the team. People tend to think they are right, and so dismiss information that contradicts their position while using less useful information to justify it.

Surveying the landscape

Our five economists map out their roadmap each month, with an outlook for growth and inflation over the following year or two. While that generally represents our most likely scenario, we need to give due attention to alternatives or else we risk overly focusing on one outcome which in reality we often only see as have a 30-35% chance of occurring.

In addition, the more people discuss a scenario, the more likely they generally believe it to be and the time spent on the full range of alternatives helps counteract that.

3 THE CALIBRATION GAME

Even with a flexible team and structured investment process, we need to ensure our decisions are rooted in evidence. Unfortunately, this is not as simple as it sounds. People are naturally overconfident in their judgement calls and therefore not very good at assessing the likelihood of different outcomes. This is partially due to base rate neglect and it occurs when there is a discrepancy between an event – say, a fund manager outperforming – and how likely people assess said event.

So how do we tackle this predisposition? Calibration training helps us asses individual members of the team in terms of how overconfident they are and ways in which their approach may be flawed. This training is essential to reinforce how difficult it is to beat the average decision-maker, increase self-reflection and, in turn, help the team become more aware of their individual biases.

No silver bullet

We have only highlighted a small handful of biases here. The reality is, there are many more – too many to address individually. That is why we have shaped MATR's investment process to limit their impact. Alongside our tactical investment views, we also allocate risk budget to taking medium-term positions and use market signals to propose trades, so that we can filter out short-term distractions and biases.