EQUITIES

Overcoming Behavioral Biases: The Importance of Our Proprietary Portfolio Exercises

By: Edward J. Perkin, CFA | November 9, 2022

Boston - 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 feel the pain of loss much more so than an equivalent amount of gain.

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 stocks we own and the process for picking those stocks. Understanding that we have these biases is the first step, but what can we do to proactively overcome them?

Since 2014, Eaton Vance Equity has integrated the discipline of conducting Portfolio Exercises into our investment processes. This is a differentiator in the way we manage money and an important element in our success. Here is one example:

The Bias: Recency Bias

Studies have shown that people are prone to make decisions based on recent events. A lawyer's closing argument might carry much more weight with the jury than evidence presented earlier in the trial. Employee evaluations are sometimes based on the past month's work, as opposed to the full year. Despite being in first place all year, if a baseball team then loses eight out of nine games, the fans will insist that the manager needs to be fired.

In investing, recent events in markets often hold more weight than a longer-term view. For example, investors will at times buy near the top during market run-ups and sell at the bottom during downturns. In money management, there is a firehose of information that needs 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. And the press doesn't help, as fear is a motivator designed to grab attention for their content.

Our Portfolio Exercise: Time-Traveling Reporter

An exercise to help overcome ***recency bias*** or short-term noise is the "Time-Traveling Reporter." We ask each investment team member to think of themself as a financial journalist with access to a time machine that can leap forward one, three or five 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 predicting the future, but identifying scenarios that may come to pass that are not in the current narrative of the market. It helps us to avoid overemphasizing recent events when making long-term decisions for our clients.

Co-authors

Aaron Dunn, CFA
Co-Head of Value Equity

Christopher Dyer, CFA
Head of Global Equity

All investing involves risk, including the risk of loss.

Risk Considerations: *The value of investments may increase or decrease in response to economic, and financial events (whether real, expected or perceived) in the U.S. and global markets. The value of equity securities is sensitive to stock market volatility.*

Active management attempts to outperform a passive benchmark through proactive security selection and assumes considerable risk should managers incorrectly anticipate changing conditions. 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.

Edward J. Perkin, CFA
Chief Investment Officer
Eaton Vance Equity

"We have developed and use over 30 proprietary Portfolio Exercises that are designed to help portfolio managers and analysts systematically recognize — and overcome — investment biases."