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# Follow the Leader: A Children's Game, Not an Investment Strategy

A quote from one of the most famous figures in investing offers an effective summary of behavioral finance: "I will tell you the secret of getting rich on Wall Street. You try to be greedy when others are fearful. And you try to be fearful when others are greedy."

The key to investment success is to avoid the common human errors in judgment that most investors make—those built-in vulnerabilities our central nervous system inflicts on most human decisions. In fact, Buffett's repeated success is largely due to his self-training: do the opposite of what most investors feel is a great idea.

Prudent investment decisions should be based on guiding principles—not instincts or intuition. Investors need to train their minds to think probabilistically rather than emotionally: "Look at market fluctuations as your friend rather than your enemy; profit from folly rather than participate in it," as Buffett has put it.

In this paper, we'll consider the practical use of these principles—and how to avoid misleading ones—when making day-to-day investment decisions. We'll explore good and bad investment heuristics and offer a practical example of how they can be applied when considering a specific investment decision point: what to do with bonds in a rising-rate environment. Our intention is to show how human behavior sometimes prevents good decision making. The goal is to help advisors avoid the bad heuristics and follies of others.

## An Unfortunate Fact of Human Nature

Daniel Kahneman is recognized as a "father of behavioral finance" and was awarded the Nobel Prize for delineating and describing the vulnerabilities of the central nervous system. In his book *Thinking, Fast and Slow*, he catalogs the various natural heuristics that befuddle investment decisions: "The technical definition of *heuristic* is a simple procedure that helps find adequate, though often imperfect, answers to difficult questions."[1]

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[1] Daniel Kahneman, *Thinking, Fast and Slow* (2011): 98

We all use heuristics when challenged by complexity. When faced with a complicated or challenging decision for which we can't find an immediate and satisfying answer, our mind decides to answer a simpler question instead. For example, if we're given conflicting advice as to what will happen with interest rates, we choose to believe the most successful person we know, assuming that he or she is successful because of being smart about finances.

This problem affects all of us, because the human brain evolved to cope with a complicated and often threatening world. At any given moment, we're assaulted with more information than we can process. Embedded in the information are threats and opportunities we must respond to in order to survive and prosper. The most basic heuristic of mental hygiene is the ability to filter out almost all of the overwhelming information that washes over us. Our brains constantly generalize, delete or distort information in a frantic effort to simplify this processing and interpretation problem.

Unfortunately, we remain almost completely unaware of most of what goes on around us from moment to moment. Even more important, we are unaware that we're unaware—that's how built-in heuristics are. As a result, the flaws in our thinking are incredibly difficult to see. Kahneman's research has entered the daily lexicon of most Financial Advisors. For example, you're probably familiar with his concept of "loss aversion," the tendency of human beings to experience the pain of loss more intensely than the pleasure of an equal gain. In this paper, we'll focus on understanding how loss aversion and three other closely related heuristics influence investment decisions.

## Social Proof: An Intellectual Autopilot

If Kahneman is a father of behavioral finance, then sociologist Robert Cialdini could be considered its grandfather. In his book *Influence: The Psychology of Persuasion*, Cialdini describes one of the most basic and insidious heuristics, which he calls "social proof": "One means we use to determine what is correct is to find out what other people think is correct.…We view a behavior as more correct in a given situation to the degree we see others performing it."[2] In evolutionary terms, watching what other people do is a useful mental shortcut to making good choices.

Unfortunately, when it comes to investment decisions, social proof is especially insidious. That's because it combines simplification with the mechanism that Cialdini describes as an intellectual "autopilot": "Most of the time, we don't want to guard against the information that social proof provides.… With it we can cruise confidently through a myriad of decisions without personally having to investigate the detailed pros and cons of each."[3] Because of our evolutionary bias, we tend to feel relief and greater confidence in a decision when social proof confirms our decision. Unfortunately, it's our human nature to succumb to new, unfamiliar patterns that social proof and loss aversion activate within us.

[2] Robert B. Cialdini, *Influence: The Psychology of Persuasion* (1984): 117

[3] Ibid: 157

## Narrow Framing and Confirmation Bias

A growing number of researchers have been inspired by Kahneman's research and expanded on his efforts. Chip and Dan Heath published several books describing the implications of heuristics on business decisions and investing. In their recent book, *Decisive: How to Make Better Choices in Life and Work*, the Heaths consider the negative impact of narrow framing and confirmation bias on decisions:

"You encounter a choice. But narrow framing makes you miss options. You analyze your options. But the confirmation bias leads you to gather self-serving information."[4]

Let's consider each of these heuristics separately and then explore the practical implications. Narrow framing is the ultimate appeal to simplification—"the tendency to define our choices too narrowly, to see them in binary terms."[5] When facing a decision, the brain has a preference to narrow the frame of the question to one idea rather than use energy to consider multiple ideas. Instead of exploring and assessing all the available options for action, the question is narrowed to a binary choice: whether or not to take one particular action.

For example, when faced with a concern about the impact of rising interest rates on a fixed-income strategy, the investor may find it difficult and challenging to take the time to explore all the issues involved—and options available—for properly positioning a bond portfolio for rising interest rates. He's likely to opt for the simpler solution: cutting bond exposure because it sounds reasonable and it's what other investors are doing.

In essence, the investor has restricted the actual decision to one immediate and obvious consideration, which is much simpler to work through than exploring several competing options. Having explored how the brain prefers to simplify problems, Kahneman concluded that human beings are naturally "averse to mental effort."[6] This is a trap that's especially easy for investors to fall into: there are so many different investment options available that the problem of choosing the most appropriate one can feel threatening, overwhelming and, at times, even exhausting.

Confirmation bias is different from narrow framing. It's more about comfort than simplification. Confirmation bias is the way we avoid self-doubt about the decisions we've made; according to Chip and Dan Heath, "Deep down, we never really want to hear the negative information."[7] Because we're naturally averse to mental effort and prefer simple and familiar solutions to decision-making problems, we're far more likely to jump to a quick conclusion than to explore and analyze lots of potential options: "Our normal habit in life is to develop a quick belief about a situation and then seek out information that bolsters our belief."[8]

Advisors are especially prone to confirmation bias, because of the intense pace and pressure of decision making they have to cope with every day.

[4] Chip Heath and Dan Heath, *Decisive: How to Make Better Choices in Life and Work* (2013): 19

[5] Ibid: 10

[6] Daniel Kahneman, *Thinking, Fast and Slow* (2011): 336

[7] Chip Heath and Dan Heath, *Decisive: How to Make Better Choices in Life and Work* (2013): 112

[8] Ibid: 113

## The Implications of Simplifications

The list of heuristics involved in human decision making is extensive, but these four will suffice as a starting point for considering how to avoid inappropriately simplifying an important investment decision. As a framework for considering how these ideas apply to real-life decisions, let's shift gears and consider a very real decision-making problem facing investors today: what do we do when faced with rising rates?

Today, markets are poised at an important juncture: 30 years of falling interest rates left rates at or near historic lows. For many years, this trend has benefited investors, but that ride appears to be ending (*Display 1*). Some kind of protection from the impact of rising rates has become an obvious need for investors. We call this need "obvious" because there's evidence of widespread concern: substantial asset flows out of fixed income (*Display 2*). Getting out is a simple, familiar and obvious choice for investors.

Display 1

**Is the Interest-Rate Tailwind Over?**


***Historical analysis does not guarantee future results.***
*Through 30 June 2013*
*Source: Barclays and AllianceBernstein*

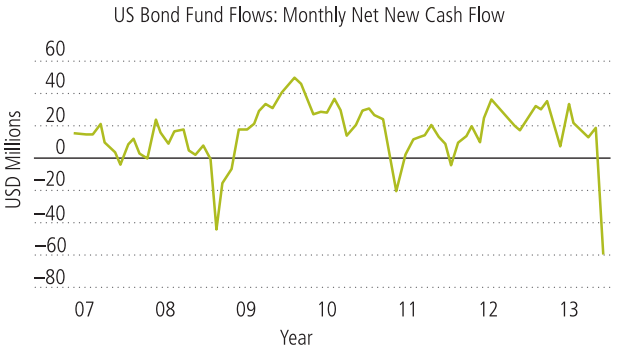
Or is it? Perhaps our understanding of the dangers of simplification and investment heuristics can enrich our analysis. Let's start with the facts:

1. Interest rates are at historical lows.
2. Interest rates are likely to rise.
3. Rising rates will impact fixed income over the short term.
4. Cutting bond allocations reduces or eliminates rate exposure.

All of these observations are simple, true and easy to confirm—even if they're an incomplete assessment of the situation.

Display 2

**Major Outflows from Bond Funds**




***Historical analysis does not guarantee future results.***
*Through 30 June 2013*
*May and June 2013 figures are derived from estimated weekly cash flows adjusted to represent industry totals, based on reporting covering 95% of industry assets.*
*Source: Investment Company Institute and AllianceBernstein*

**Now, let's add the heuristics:**

1. **Loss aversion** kicks in because many investors are worried about losses in the face of rising rates.
2. **Social proof** confirms that reducing fixed-income exposure is an appropriate strategy to achieve interest-rate protection. (More than US$ 60 million flowed out of these funds in June 2013.)
3. **Narrow framing** keeps our attention centered on the "obvious" value of reducing or eliminating bond exposure and simplifies the decision into a binary "stay in or get out" choice.
4. **Confirmation bias** closes the loop by preprogramming investors to seek out information that supports a quick and easy solution and argues against any other options—such as maintaining bond exposure while repositioning it for rising rates.

This example shows how an important decision is ultimately made simple, satisfying and comforting—and it explains the massive outflows from fixed income.

## The Simple Answer May Not Be the Right Answer

Albert Einstein's genius was his ability to think outside the constraints of "proven" scientific thought and to come to conclusions about the natural world that were more accurate and useful than those supplied by conventional wisdom.

This may be the best way to appreciate the importance of understanding how heuristics can muddle clear thinking. Einstein observed what was real in the world, because he was willing to consider that what was commonly and authoritatively accepted as "true" was an illusion based on heuristics. To find the truth, he used a guiding principle: "Everything should be made as simple as possible, but no simpler."

Simplification can be very helpful, unless it's taken too far. Kahneman and the Heaths don't believe simplification helps when making better investment decisions. Kahneman instead suggests practicing "broad framing."[9] Chip and Dan Heath expand by explaining, "When we widen our options, we give ourselves the luxury of a real choice among distinct alternatives….[T]o inform our decision, we'll need to gather more information."[10]

[9] Daniel Kahneman, *Thinking, Fast and Slow* (2011): 339

[10] Chip Heath and Dan Heath, *Decisive: How to Make Better Choices in Life and Work* (2013): 87

If we start by assuming that we're probably oversimplifying an investment decision, and if we understand precisely *how* we're likely to err in our judgment, we can establish our own guiding principle for making more effective decisions.

**Specifically, we can add three additional considerations:**

1. Getting out of bonds protects against rising rates but at a cost: the still meager yields on cash equivalent investments today.
2. Rates are likely to rise but we don't know how soon or how rapidly; if rates rise over a longer period, it puts time on investors' side by allowing income generation to work for them.
3. Massive bond outflows indicate that many investors are concerned, but these flows can also alter long-term portfolio design based on investors' objectives.

Adding these complexities to the decision makes analysis more complicated, but it's necessary so that we can make more effective investment decisions. Why embrace this extra effort? Warren Buffett reminds us that there are often serious consequences for not practicing a thoughtful decision-making discipline: "If you are in a poker game and after 20 minutes you don't know who the patsy is, then you are the patsy."

## Time Is on Bond Investors' Side

Most investors today are sold on the idea that shedding bond exposure is the "best" investment option to protect them in a rising interest-rate environment. It's a deceptively simple construct: less bond exposure, less interest-rate risk. It's not surprising that many investors grasped at this construct, and the result was massive outflows of money from fixed-income funds.

However, the "stay in or get out" choice is needlessly narrow. Panic behavior tosses aside the long-term role that fixed income should be playing in many investors' portfolios—whether it's income generation, stability or a balance of the two.

It also ignores the consideration of time horizon. If bonds are intended as a long-term portfolio component, investors have time on their side when facing rising rates. Income generation and other return factors continue making contributions to total returns, helping offset the impact of rising rates.

A basic hypothetical total-return scenario based on an 18-month time frame bears this out. Let's assume that an investor in the Barclays US Aggregate Bond Index sees an immediate rate increase of 1%. Initially, this could cause a loss of about 4%. However, another return factor such as income-generating ability then goes to work—and is enhanced by the ability to reinvest at much higher rates.

At the end of the 18 months, the cumulative return would be slightly positive. If the 1% rate increase took place gradually over the 18-month period, the total return for the period would also be slightly positive. That income-generating ability would be missing if money retreating from bonds headed to the very thin yields of cash or cash-equivalent investments.

## There Are Meaningful Alternatives to "Just Getting Out"

The bottom line is that investors whose long-term portfolio construction can benefit from fixed income have diverse options available to retool that fixed-income exposure to insulate their portfolios from rising rates. The bond market isn't a monolith.

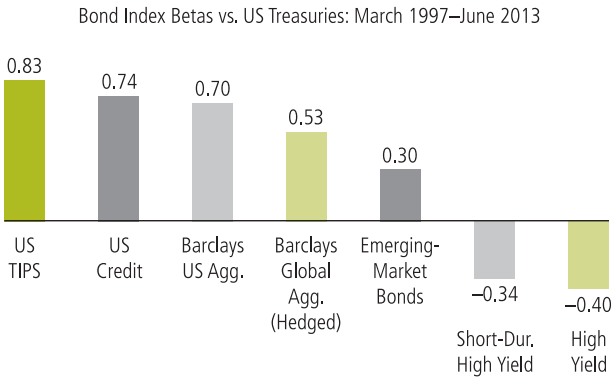
We can see this by looking at the sensitivity, or beta, that different bond sectors have to US Treasury returns, which represent a sector that is extremely interest-rate sensitive. A sector with a beta to Treasuries that's close to 1.00 is also highly sensitive to interest rates. A beta of zero would represent a sector whose returns have no relationship to Treasury returns. The lower the beta, the lower the sensitivity to rising interest rates (*Display 3*).

A broad-market US bond index such as the Barclays US Aggregate is a useful proxy for a broad market–based bond strategy, although not actively managed. It has a historical beta of 0.70, so diversifying beyond Treasuries reduces some of a portfolio's vulnerability to rates. A broad global index, such as the Barclays Global Aggregate (currency hedged), has done even better, with a historical beta of 0.53. We'll explain why this is in a moment.

If we delve deeper into the individual sectors of the bond market, we see that credit quality makes a difference. Investment-grade credit offers some buffering, with a beta of 0.74. High-yield credit, on the other hand, actually has a *negative* beta—its returns have historically moved in the opposite direction from Treasury returns. In periods when rates are rising, that can be a valuable trait indeed.

Display 3

**Not All Bonds Are Created Equal**

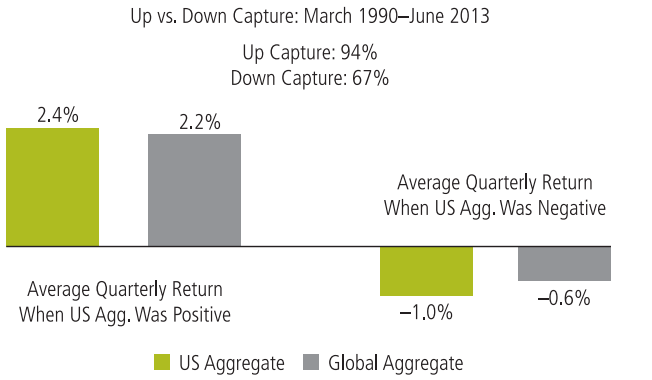



***Historical analysis does not guarantee future results.***
*As of 30 June 2013*
*US Treasuries are represented by the Barclays US Treasury Index (a weighted index of all US Treasuries), US TIPS by the Barclays US TIPS Index, US credit by the Barclays US Credit Index (investment-grade bonds), emerging-market bonds by the J.P. Morgan EMBI Global Diversified Index, high yield by the Barclays High Yield Credit Bond Index and short-duration high yield by the Barclays 1-5 Year BB/B Index. March 1997 is the inception date for the Barclays US TIPS Index.*
*Source: Barclays and J.P. Morgan*

So, contrary to the oversimplified, binary decision many investors followed when interest rates jumped, there are actually many choices for investors worried about protecting their portfolios. Rather than a knee-jerk decision, it's possible to use broad framing to open up an empowering range of possibilities for adapting a fixed-income portfolio to changing times.

Display 4

**Global Bonds Capture Greater Upside, Less Downside**




***Past performance and current analysis do not guarantee future results.***
*As of 30 June 2013*
*Returns are represented by the Barclays US Aggregate Index and the Barclays Global Aggregate Index Hedged to USD.*
*Source: Barclays and AllianceBernstein*

**Go global.**

Country and regional bond markets don't travel in lockstep. Moving from a US-only bond portfolio to a global bond portfolio has historically enhanced risk-adjusted returns even as it expands investors' opportunity set. But not just any global portfolio will do, because currency fluctuations can add a lot of volatility while doing little to increase returns.

To avoid this unintended volatility, a currency-hedged approach is designed to eliminate currency fluctuations, allowing the distinctions between country bond markets to diversify home-country interest-rate risk. Based on historical return experiences, this approach has done a better job than the US bond market of capturing returns in up markets while reducing losses in down markets (*Display 4*).

**Access credit sectors.**

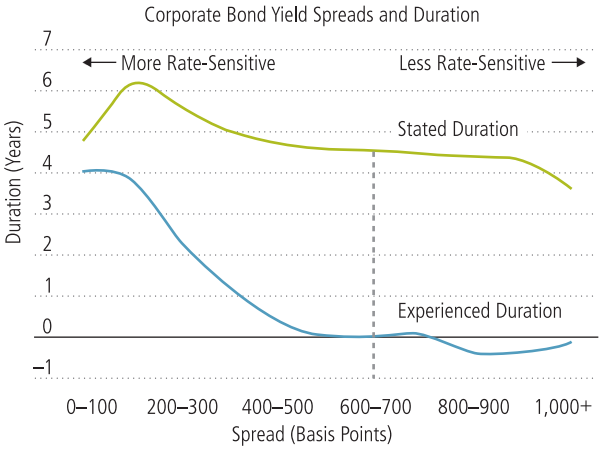
High-yield bonds tend to be driven much more by changing credit conditions than by interest rates, a characteristic that makes them more like equities. Typically, when rates are rising, economic growth is picking up too, which benefits high yield. This helps explain high yield's inverse return relationship with Treasuries. Generally, the higher the credit spread, the lower the sensitivity of a high-yield bond to Treasury rate movements (*Display 5*).

High yield can be a powerful diversifying influence on a fixed-income portfolio, but it's important to set clients' expectations accordingly. On its own, high yield can be a volatile asset class, so investors should be well aware of the trade-off for its higher return potential. High-yield bonds have experienced drawdowns of more than 5% in seven of the last 20 years although, with the exception of 2007, they recovered all the losses in less than one year.

For many investors, high yield functions best as a portion of their overall portfolio—and can be effective in that role. For investors who are particularly volatility-conscious, there are short-duration high-yield bonds, which are even less interest-rate sensitive.

Display 5

**Credit Sectors Can Reduce Rate Exposure**



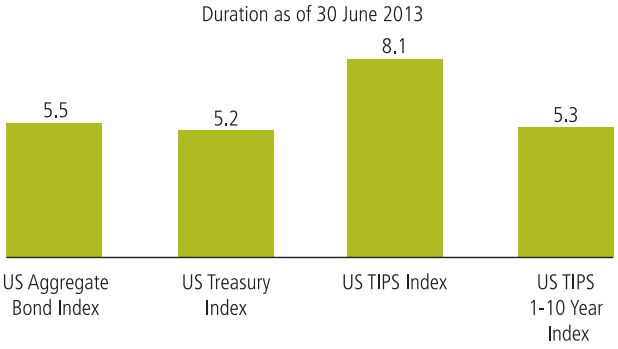

***Past performance and current analysis do not guarantee future results.***
***For illustrative purposes only***
*Corporate bond data shown are for US investment-grade and high-yield bonds issued by corporations. Duration is a measure of the sensitivity of an asset's or portfolio's price to interest-rate movements.*
*Source: Barclays and AllianceBernstein*

**Add inflation protection.**
Rising rates are often accompanied by rising inflation expectations, which can hurt bond returns. TIPS (Treasury Inflation-Protected Securities) have been a popular investment and have produced strong returns. However, our research reveals that the driver of that performance also presents an unexpected risk: higher duration (*Display 6*). As interest rates rise, this is likely to work against longer-duration TIPS. A shorter-duration TIPS index has a duration that's much more aligned with that of the Barclays US Aggregate Bond Index, which may reduce that risk.

Investors should be looking to inflation-protection strategies with lower duration. Perhaps the simplest way to do this is to move into shorter-maturity TIPS, which offer the same degree of inflation protection as longer TIPS with modestly lower coupon income and potentially less volatile returns. Investors seeking a more tax-efficient approach may want to consider a strategy that combines intermediate municipal bonds with an inflation swap based on the Consumer Price Index.

Display 6

**TIPS Duration: Once a Benefit, Now a Risk**




***Historical analysis does not guarantee future results.***
*Duration for US TIPS Index and US TIPS 1-10 Year Index is represented by the real duration as of 30 June 2013.*
*Source: Barclays and AllianceBernstein*

**Leave the index behind.**

Staying close to a broad-market benchmark such as the Barclays US Aggregate may limit a portfolio's ability to reduce duration or increase sector diversification. In addition to tying investors to a single-country benchmark tied to one interest-rate cycle and one credit cycle, there are other risks.

For example, in 2007, when Treasury valuations were much more favorable, Treasuries accounted for 22% of the Barclays US Aggregate. Fast-forward to 30 June of this year, with Treasuries extremely expensive, and they now make up more than 36% of the index. Tracking that changing composition wouldn't be wise. Interest-rate risk has grown for the index as well: in December 2007, the Barclays US Aggregate had a duration of 4.4 years; today, it's 5.5 years.

To increase flexibility, strategies that emphasize total return and don't track a specific benchmark have the freedom to create and manage their exposures independent of the benchmark, in an effort to maximize the risk/return balance of a portfolio. With interest rates likely to continue rising, this flexibility can be critical.

## A Final Word

Given the many diversifying strategies that are available to address the risk of rising interest rates, the "stay in or get out" oversimplification of the fixed-income decision is unfortunate. It's important to be aware—and to make clients aware—of how day-to-day investment decisions can be short-circuited by bad investment heuristics.

We'd all be better off avoiding the common human errors in judgment that most investors make. The built-in vulnerabilities that our central nervous system inflicts on most human decisions pale in comparison to the effectiveness of making investment decisions by following guiding principles rather than instincts or intuition. When we use broad framing to help clients understand the full array of choices they have in responding to rising rates, they'll be much more likely to make a decision that's in line with their long-term interests.

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