Behavioral Biases

By Mano Mahadeva, CPA, MBA | Column Editor

Finance professionals make significant daily decisions for their companies, so it is important that individuals become aware of personal biases that may affect the reliability of the decision-making process. In an ideal situation, all decisions are made as the result of deliberate thought, analyses and research. However, due to various reasons – personal biases, earnings pressure, anxiety and limited resources among many others – we make errors. Minimizing the impact of these biases is crucial!

Here is where both behavioral science and behavioral finance offer many nuggets of insight to us that will help strengthen the relevance and reliability of our decision-making process.

Behavioral science involves the research on how people make judgments and decisions and how they interact with one another. Research in this area draws on theory and methods from areas such as cognitive and social psychology, sociology and economics, and offers a wealth of knowledge in understanding behavior in the workplace.

A subset of such studies is related to finance – known as behavioral finance. Behavioral finance suggests that not all economic decisions can be described by the equilibrium conditions in markets. It focuses not on economic theory, but on how people behave in the real world when faced with financial decisions. Controversial as this subject may be, resulting takeaways on various calamities in financial events over the last 20 years have offered this area more credibility.

An employee is given a rating of five based on likeability and not on performance. Investors bid up stocks sold in initial public offerings when they hear a hot story about a new opportunity. A very conservative financial forecast is prepared for the next 12 months without regard for the positive outlook in its business sector. A controller makes a snap judgment during an interview on a potential accounting candidate, all based on superficial cues without any substantive information. At retail outlets, shoppers fall for the "buy four for the price of $4" instead of when each item is priced at $1.

Even though these actions are very common, it is possible that the actors are not aware of the reasons underlying them. These reasons, or biases, are a result of a person's view of the world due to the lifetime accumulation of judgments, beliefs and prejudices that get unconsciously drawn into most decisions normal people make. And being unaware of these biases might mean incorrect judgments, missed opportunities or ending up on a land mine.

We interact with professionals who do the following: are slow to update a forecast because less value is placed on more recent information; support their analyses with parts of information while ignoring contradicting elements; draw conclusions incorrectly due to a smaller than required sample size; think they are in control but *believe* they can control outcomes by individual effort; prefer to stay the course without change because of a previous bad experience; place a smart, hard worker who does not have people skills in charge of a team.

What steps can we can take to discover and mitigate our irrational side? Education is a must – this will require attending a workshop on the basics of modern portfolio theory and one on behavioral science pertaining to people and organizations. Any projects, proposals and initiatives (PPI) brought forth need to be supported by information – supportive and contradictory – with past, present and future data. They also need to be compared jointly, with a long term in mind, rather than in isolation. If any PPI is being planned, ask decision makers to bring their objectives with them prior to discussion to avoid group think. It is *critical* to keep notes and assumptions made on PPIs completed so that we can look back on them in the future to learn from them. Did we succeed? Did we fail and if so, why?

Come up with different ways to look at projects and use fundamental analysis or relative value methods or any other reasonable and suitable way. Flip it on its head and see if we're biased one way. Ask for insights and opinions from buy- or sell-side analysts. Ask for outside help, such as an independent party, to assist. Or possibly reward people when intentions and efforts are sound.

By nature, biases create problems for us. Even the smartest of us exhibit biases in our choices. Quick decisions save time and energy, but sometimes those knee-jerk reactions lead to poor choices. Instead of exploring uncertainties, we rely heavily on intuitive, heuristics to get work done. This logic only narrows our vision for the future and the way we get there. But given the knowledge and their nature, we can broaden our awareness, work diligently to mitigate them and make better choices.

Mano Mahadeva, CPA is CFO with Solis Health in Addison, Texas. He serves on the editorial board for TSCPA. Mahadeva can be reached at mmahadeva@solishealth.com.