Quick Reference Card (QRC)

Best Practices for Eliminating Psychological Biases

Bias	Manifestation	Example	Increasing Self-Awareness Tactic
Fear of Failure			
Sunk Cost Fallacy	Investing considerable time or capital into a given stock prevents you from looking at it objectively	When analysts initiate coverage on an entire sector, they may mistakenly recommend many of the names, when in reality only one or two are likely to substantially outperform the market	• When conducting extensive research on a topic, periodically ask, "What will I do if I discover nothing new?" It reduces the amount of time sunk into any one effort • Resist the temptation to make changes to your financial forecasts or valuation multiples to "make it work," in an effort to show more upside/downside than you previously expected • Be willing to reverse your recommendation when you've made a mistake, or your thesis failed to play out • Set aside time (once a month or quarter), and ask yourself, "If I switched firms tomorrow, would my initial stock recommendations at the new firm match my current ones?" If not, understand why.
Loss-Aversion	Avoiding selling a stock at a loss	An analyst finds a new rationale to keep recommending a stock that hasn't been performing as well as originally expected	• Document your thesis for recommending a stock and the price target specifics before you make your recommendation. If key tenets to the thesis fail to play out, strongly consider reversing recommendation. • When faced with an underperforming stock, ask yourself, "If I switched firms tomorrow, would my initial stock recommendations at the new firm match my current ones?" If not, understand why. • After beating yourself up over a mistake, embrace it as a valuable lesson learned that will make you a better analyst
Anxiety	Allowing high levels of anxiety to lead to investment decisions that are not based on sound analysis and research	Feeling the need to change your view toward a stock on a weekly or monthly basis, even though fundamentals haven't changed	• It's important to watch the daily movements in your stocks to understand investor sentiment, but don't let stock price movements alter your view about the fundamentals • When uncertainty arises around a key stock call, do more work to either reduce anxiety or lead to a better decision • Conduct scenario analysis to put limitations around the "worst-case" • When considering a recommendation change, if possible, think about it overnight

Snakebite Effect	Categorically dismissing a stock as a bad investment due to bad performance in the past	Telling someone, "I can never own that stock"	• Resist drawing quick, sweeping generalizations about a troubled company's past, and instead research if their problems were:
			  o Within or outside of management's control;
			  o Industrywide or company-specific
			• Utilize the company's weakness as providing tremendous upside potential in its stock if you can identify and forecast the catalyst for change (e.g. examine changes in management or management's behavior)

Costly Psychological Shortcuts			
Familiarity or Availability Bias	Preferring stocks you're familiar with over those you're less familiar with	When asked for your favorite stock, you reply with the one you're most familiar with rather than the one that may have the most upside	• Don't make recommendations of stocks you're unfamiliar with, but conversely don't make a suboptimal recommendation, just because you know the stock better than the proposed alternatives • Ensure there are no "forgotten" stocks in your assigned universe, by setting aside time to ensure you are well-versed on all of them (even the more complicated ones)

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Recency Bias (related to Familiarity/ Availability Bias)	Over-emphasizing recent information, with little regard for older information	Having a more positive bias toward a company you've recently met with, compared to one you haven't seen for months	• Avoid making recommendations where the stimulus is primarily based on a recent meeting or call with company management, especially if it's initiated by the company • Don't ignore (or fail to research) a stock's critical factors of the past as they often come back and become the critical factors that move the stock in the future
Rules of Thumb (Heuristics)	Blindly relying on or over-using mental shortcuts or heuristics to make investment decisions without checking to ensure they are reliably accurate	Recommending a stock or a sector every time its P/E ratio drops below 12x forward earnings, and selling every time it moves above 15x	• Ensure heuristics are derived from facts or historical trends that can be substantiated. When a heuristic is key to your investment recommendation, ensure its backed up with sound logic (and evidence, if applicable) • When someone tells you to follow a "simple rule" in forecasting or valuation, validate it with historical analysis before using (if the rule always works, a computer would likely have arbitraged it away)
Following the Herd (social psychology)			
Overreaction	Selling or buying at irrational prices with the herd, which in hindsight, was among the worst possible times	An analyst downgrades a stock in response to bad news even though his research suggests the concern is being overblown	• Before making a recommendation, document your thesis, price target and exit thresholds in an effort to remain disciplined in the face of market hype • If the media or sell-side appear to be overreacting, update your scenario analysis to identify realistic worst-case and best-case scenarios • Resist changing a stock recommendation mid-day or immediately after a company reports results (always try to "sleep on it" when it comes to major recommendation changes)
Momentum Bias	Assuming recent trends will continue, even if historical evidence and metrics suggest they are unsustainable	After a recommended stock has rallied to a realistic price target, the analyst raises the valuation multiple or financial forecast to unrealistic levels to justify an even higher price target that ultimately isn't achieved	• If you've missed a substantial move in a stock, be hesitant to chase it such as jumping on the bandwagon. If you're in the same trade as everyone else, ask "Who's going to take the other side of the trade when I want to get out?" • Research history for your companies and industries, specifically, the growth rates and valuation multiples. If your price target relies on one or both being well outside historical trends, make sure you have a sound reason for doing so. • When making a change to your thesis, ask where you are in the "greed vs. fear" spectrum compared with consensus. If you're in the same place, you may be following the herd. • When markets appear to be moving too far too fast for irrational reasons (not based on fundamentals), consider the contrarian view

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Pollyannaish or Hopeful Thinking			
Confirmation Bias	Seeking out information that supports your view and rejecting, distorting, or ignoring information that conflicts with it	While conducting research on a stock you're recommending, you come across a new competitive threat but choose to downplay it as insignificant	• In making recommendations, wait until you've done all of the research before considering the rating. Deciding your rating early in the process will bias you toward finding insights that support your view and rejecting those that conflict with it. • Approach all new information with an open mind, regardless of your current view toward the stock • Build your upside and downside scenarios while conducting the research, documenting as you go along, which should be reviewed before changing a recommendation • If you're serious about making a recommendation, ensure that you know the opposing view
Over-confidence	Assuming you're smarter than everyone else, which prevents you from exploring the real risks or reasons that a stock is not currently at your price target	After a few good stock calls, you begin to let down your guard in terms of assessing risks for future recommendations	• Be humble by realizing that no professional investor is right 100% of the time • Fully understand the "other side of the trade" before making a recommendation • Ask a trusted colleague or investment committee to put your thesis under scrutiny • Any time you think *"I can't lose",* think through the downside or risks of the investment

Self-Attribution Bias	Taking full credit for wins and placing blame on others for losses	After a recommended stock goes the wrong way, blaming a colleague (or the sell-side) for conducting shoddy research. (Remember, part of your job is to validate your information sources.)	• When you have a big win, go back to the documents you wrote when you recommend the stock, and see if your thesis really played out. (Or was it some other factor?)
			• Before placing blame on others, or saying, "The surprise couldn't have been foreseen," ask yourself these questions:
			  o Did anyone else see this coming (sell-side or buy-side)?
			  o What could have been done to know about this surprise earlier?
			• Examine constructive or negative feedback provided by others. (Don't just internalize the positive praise.)

Optimism Bias	Being too optimistic about your stock's valuation and future earnings potential	Modeling a company's EPS growth at a 12% CAGR over the next 2 years, even though it has grown EPS at an 8% CAGR for the past 10 years	• Research history for your companies and industries, specifically the growth rates and valuation multiples. If you settle on a price target based on factors running well outside historical trends, make sure you have a sound reason for doing so. • Spend as much time identifying risks as catalysts • Ask a trusted colleague or investment committee to put your thesis under scrutiny

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Falling in Love With a Stock	Becoming so emotionally attached to a stock that it can't be analyzed objectively	An analyst is hesitant to downgrade a stock that's hit its price target because it's a franchise name that the analyst is associated with	• Periodically review your universe of stocks to ask if you're less likely to change the status of any stock recommendation other than for risk and return considerations (such as concern over upsetting company management or disappointing those who rely on your research) • When reviewing your comp table, hide the company names and tickers and look only at only the numbers to see if you have the same view when the names are revealed