Our Periodic Review Exploring Multiple Topics Related to Behavioral Finance
• Market Driven • Economic • Psychological • Probabilistic • Investable •

Perception is Everything!
Frame Dependence and its Impact on Human Decision Making

"The whole of science is nothing more than a refinement of everyday thinking."
-- Albert Einstein

Perception often trumps reality. It has been said that the best financial advisors are the ones who can most successfully manage to their clients' sense of perception rather than to reality. The key to this is developing an understanding as to how people take in news, events, and market conditions and in turn predict how that information will be interpreted. In other words, how will my client "frame" or view current events, and, based on that framing, how will he or she react next?

Frame dependence is a cognitive bias in which people show a tendency to react to a certain choice in varying ways all depending on how the choice is presented or framed. For example, research has shown that individuals will avoid risk when something is presented in a positive or profitable light, and conversely, they will tend to seek risk when something is presented or framed in a negative or unprofitable manner. Framing is about form and style and it reflects a blend of the cognition of our minds as well as a range of our prevailing emotions at the time of a decision.

The dictionary defines perception as "to become aware of through the senses," and also as "an immediate or intuitive recognition or appreciation, as of moral, psychological, or aesthetic qualities." So much of what we decide to do or how we feel in any given situation is largely impacted by how we perceive the circumstances. At times, the impact of our perceptions (and the framing that results from our perceptions) can be huge. Advertising executives are keenly aware of this principle. The goal of any successful marketing campaign is to take a product or service and present it in a slightly different light in order to change the public's perception about it. The Coca-Cola Company figured this out over 100 years ago. A carbonated and sweetened beverage widely offered at a reasonable price is not too much of a remarkable thing on its own physical merits. What Coke figured out from its earliest days is that its product needed to be consistently pictured alongside and associated with all activities and settings the public defined as good, fun and desirable (gatherings, sporting events, days at the beach, etc.). Coke's marketing has always equated fun and enjoyment in life with their product. What is the result of this strategy that launched in the year 1886? In 2014, Coca-Cola provided over 693 billion individual servings of its products worldwide.

Marketers are also aware that due to the framing that goes on in the mind of a consumer that a sweater on display at full price for $50 will not sell as many units as the identical sweater on display for $50 marked down from $75. For better or for worse, shoppers routinely perceive that a product that is marked down on sale is inherently a better value proposition than a product that is not marked down. Numerous other examples exist related to how successful marketing campaigns shift our perceptions which in turn alter our decision making. However advertising is not the sole domain as perception shifting is alive and well in government, public policy and charitable endeavors. In the last five years, municipal governments around the globe have learned that a simple low cost measure can greatly enhance the riding experience of daily commuters on subways and trains. They have installed countdown clocks on platforms to indicate exactly when the next train will arrive. Knowing your train will arrive in 7 minutes is a much preferable experience to not knowing if your train is arriving in 4 minutes or 15 minutes, particularly if you are frantically running late. Removing a big chunk of anxiety for most riders by creating an element of certainty enhances the experience for all. Thus the train operators have been successful in re-framing a negative experience (waiting anxiously on the platform) to at least a neutral or positive experience.

In Spain, after medical shortages of organs and tissues, the government shifted the policy for those seeking a driver's license or government ID card. For decades the policy had been that people seeking a new card had to choose to opt-in for organ donation. The government changed the policy so that the default option indicated organ donation. If a person feels strongly about not having their organs donated they must take an active role to check the opt-out box on their application form. As a result of this shift and re-framing, the shortages have ceased.

What about in the world of investing? The manner in which people perceive investment opportunities and the manner in which many people trade is largely a function of our psychology and how our brain perceives and frames. People hate to lose things. We hate it when our favorite sports team loses. We hate to lose arguments. We hate to lose our place in line. And we really hate it when we lose money. Sometimes when we lose things, we work hard (sometimes too hard) to either make it up or to prevent it from happening again. In particular as it relates to losing money there is a tendency in the majority of people to take on unwarranted risk for the sake of reversing the situation. Behavioral economist Hersh Shefrin coined the term "get-even-itis" to describe the tendency many people have in taking on excessive levels of risk all for the goal of getting back to a position of break-even after sustaining losses.

An extreme example of get-even-itus can be observed in the case of Nicholas Leeson. Leeson worked for Barings, PLC and through a series of events he became a rogue trader. His intense desire to "get back to break even" single handedly caused the failure of the 232 year old financial institution. In the span of 1992-1995 he began to engage in rogue trades in order to hide trade errors made by himself and his subordinates. The strategy initially worked.

Eventually, the sum total of the losses of the trades made to cover up other trades compounded. Leeson took on more risk and engaged in more rogue trades. In the end he lost over $1.4 billion of his employer's capital.

Things are not what they really are. Rather, they are what we think they are. Ultimately, we are all prisoners of how our minds perceive and frame investment situations. At Sterling, we recognize the difficulty involved with separating the biases that enter into the appraisal of a situation or portfolio opportunity at the moment of perceiving it from what it might actually be in reality. As a result all of our behaviorally driven portfolios are designed to intentionally remove the portfolio managers personal bias or opinion from the decision making process. We seek to intentionally remove the bias that can be inherent in our own framing and instead rely on the strength of our behavioral stock ranking investment process.