

Quality Asset Management

Grow Your Wealth with Peace of Mind

Are you Subject to the Status Quo Bias?

By Gil Hanoch, December 2011

Imagine the following: You are a retiree with \$10M in a diversified stock portfolio. You sell \$50k each quarter (\$200k per year) to generate current income. Your portfolio declined by 50% in the recent quarter. Please answer the following questions with likelihood between 1 and 10 (ignore the time spent on acting on your decision):

1. You need \$50,000 to cover quarterly expenses. How likely are you to sell an extra \$50,000 to lock-in the current value given the potential for further declines?
2. You have an old employee retirement account that has \$50,000 invested in bonds. How likely are you to keep the bonds in place (as opposed to selling and reinvesting in stocks)?

STOP. Make sure you have a response in place, before reading further...

People have a tendency to keep their current behavior in place, even when the change would improve their lives. This Status Quo Bias is seen in various domains of life, including investing. The rest of this article will help you recognize and avoid it.

If your answer to #2 is higher than #1, meaning you are more likely to do #2, you are probably subject to the Status Quo Bias. In both scenarios, the difference between agreeing with the statement and not, is having \$50,000 extra outside of the stock portfolio. Your preference for financial security may affect your responses, but is likely to keep them similar to each other. Specifically:

1. If you are looking to maximize your short-term security, you would want to sell the extra \$50,000, as much as you would want to keep the bonds in the retirement account in place.
2. If you are looking to maximize your long-term security, you would want to avoid an additional sale from stocks, to avoid locking in a 50% loss on the additional \$50,000, and let the amount recover with the stock portfolio. By the same token, you would want to move the bonds in your retirement account to your stock portfolio, so they can grow with its recovery.

To clarify further, taking action #1 and not #2 is very similar to taking action #2 and not #1. Phrased differently taking either action would yield similar results (keeping \$50,000 away from the stock portfolio).

There is one financial difference, though: #2 refers to a retirement account. Given the tax benefit, you would want to consume money from that account last (under most scenarios), making its time horizon longer than the taxable account. Therefore, cash is more valuable in the taxable account, since the stock investment has less time to recover from any further potential decline. This means that you should have a preference to do #1 over #2, meaning your answer to #1 should be higher than #2.

Why would you prefer #2, if it goes against your financial interests?

Because #2 does not require any action, while #1 requires taking an action. People have more regret as a result of actions than inactions.

How can you limit the impact of the Status Quo Bias?

In every financial decision, focus on the end result, not the process. Imagine reality after you implemented the decision. Picture all changes that result from the decision. This will remove the focus on the action/inaction. Only after picking the best financial result, evaluate whether any effort required would outweigh the financial benefit.

How would you follow these ideas in the example above?

In the example above, if you desire to keep your cash/bond allocation unchanged, it may be best to take the following two actions: (1) invest the bonds in the retirement account in stocks, while (2) selling the equivalent amount from your taxable stock portfolio (assuming you can do so without realizing gains – likely given the recent 50% decline).

Given the low withdrawal rate for ongoing expenses, it seems that the short-term risk is small, making it smart to try to maximize the long-term security. If that is your preference, you would choose to transition the bonds to stocks, and not sell extra stocks from the taxable portfolio.

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