

# The Cost of Ignoring Behavioral Biases

By Jay Mooreland, MS, CFP®

**B**ehavioral biases influence us to think and act in certain ways. Biases are often subconscious and therefore may influence us without our knowledge. We all have some combination of biases; they contribute to our development and personality. Research has shown that biases influence people regardless of age, wealth, education, employment, investment experience, and even economic incentives (Menkhoff and Nikiforow 2009). In other words, if you are a human being, you are influenced by these biases, and they may lead to costly errors.

This article evaluates the recent problems at the national retailer J.C. Penney and how behavioral biases may have influenced poor decisions that led to the problems. Ron Johnson, the former chief executive officer (CEO) of J.C. Penney, came in with great fanfare to turn around the company. Yet his brief tenure resulted in costly mistakes that left Penney's very existence in question. These decisions were influenced by three basic behavioral biases. If biases can influence wealthy, successful executives such as Mr. Johnson, they can influence any of us.

This article reviews the biases that influenced Mr. Johnson's executive decisions and demonstrates how those same biases influence investors. These biases are cognitive in nature, meaning they influence how we think and analyze situations. The good news is the influence of these biases can be reduced, or perhaps eliminated, through recognition and education. I encourage financial consultants to share this article with clients—it is a modern, true tale of how biases subconsciously influence us and can have dire consequences.

## J.C. Penney Overview

In November 2011, J.C. Penney was a bland retailing business that relied heavily on promotions. Stores were old and cluttered, sales were relatively flat, and the stock was underperforming. This was the scene when Ron Johnson hired on as CEO to improve Penney's image and financial performance. Mr. Johnson was educated at Stanford (BA in economics) and Harvard (MBA), and he had extensive experience in retail. He'd been vice president of merchandising for Target and, most recently, senior vice president of retail operations at Apple during the launch of Apple's retail stores.

Mr. Johnson had the education, experience, and track record that made him a perfect candidate to turn around Penney. He implemented strategies similar to those at Apple, which appeared sound on the surface. But we now see the strategies resulted in a lot of pain—for everyone. Sales decreased by more than 25 percent, the stock price plummeted more than 50 percent, and more than 30,000 employees lost their jobs. What went wrong? It boils down to three specific behavioral biases.

## Overconfidence

Confidence is a desirable quality that enhances character; overconfidence feels good but often leads to undesirable outcomes. Overconfidence is the belief that we make decisions that are always in our best interest and usually correct. Overconfidence is often the root of most arguments, as each side digs into pre-existing beliefs and opinions without understanding how we may be wrong. Prior success, whether in winning an argument, creating a project, or having an investment gain, can fuel (over)confidence.

Mr. Johnson came into a company that relied heavily on promotional discounts and immediately instituted a "fair and square" pricing strategy. He abolished the "high-low" pricing strategy (artificially marking things up, then putting them on sale). He instituted an everyday low price strategy—no more sales, just all-around lower prices. This looks like a good strategy until you look at the typical J.C. Penney shopper. Penney shoppers live for sales and discounts; in fact, 72 percent of Penney's revenue came from items discounted at least 50 percent (Lahart 2013). Unfortunately, Mr. Johnson chose not to test the new pricing strategy, despite Penney's culture of offering discounted items. He could have piloted his pricing strategy in a few stores, or he could have heeded the fact that a competitor (Sears) tried everyday low pricing in 1989 and failed miserably. (Ironically, Sears' CEO in 1989, Mike Bozic, lasted the same amount of time as Mr. Johnson at J.C. Penney—17 months [Jenkins 2013]). Mr. Johnson was overconfident in his pricing strategy. His overconfidence was a costly mistake.

## Overconfidence: Investor Application

Investors often are overconfident. We believe we make better investment decisions than we actually do. We are influenced by prior investment success and more information often leads to increased confidence but not accuracy (Tsai et al. 2008). Dalbar, Inc. has found that investors, both stock and bond, significantly underperform their benchmark index and Morningstar® has found that investors sometimes underperform the very mutual fund in which they are invested. Many factors, including other behavioral biases, go into this underper-



formance, but it is important to understand that we may not be as good as we think we are.

So how do investors overcome or reduce the influence of overconfidence? The key is to understand that there are a lot of moving parts in the stock market. No one knows what the stock market will do tomorrow, next month, or even next year. Information we have may be incorrect or simply not relevant. We often confuse correlation with causation. As Warren Buffet has said, “What counts for people in investing is not how much they know, but rather how realistically they define what they don’t know” (Zweig 2007, 118).

### Representativeness

Representativeness encourages us to look to the past to divine future outcomes. While learning from history is important, past outcomes are not always indicative of the future. The saying, “The game is the same, only the players have changed” rings true much of the time—we are faced with similar problems over the course of human history, but the players are different. They may have different attitudes, perceptions, or beliefs than the past players. So the game may be the same, but the outcome may be very different.

Mr. Johnson had a successful and profitable experience in retail sales at Apple. His goal was to transform Penney into a hip store with a modern layout, with high-margin “mini-stores” inside such as Sephora, Levi, and Joe Fresh. His plan was to eliminate cash registers and have employees walk the store with “registers” in hand, the way Apple’s retail employees do. He did away with the “high-low” pricing strategy. Mr. Johnson wanted Penney to be like Apple and expected that the results at Penney would be similar—after all, the game (strategy) was the same. Unfortunately, the players were different.

The Apple consumer is not representative of the Penney consumer. Apple consumers rarely, if ever, receive

a discount. They pay top dollar for high-quality goods and are willing to stand in long lines (sometimes overnight) to purchase desired goods. About the only time Penney consumers stand in line is on Black Friday waiting to get “Doorbuster” deals. Penney consumers live on discounts. As stated above, more than 72 percent of Penney revenue came from items on sale by at least 50 percent.

Mr. Johnson did not realize the strategy at Apple worked so well because it was right for the consumer. Mr. Johnson ignored the bias of representativeness. He did not realize that Apple customers are much different than those that shop at Penney. He assumed something that worked well in the past certainly would work well in the future, which was a very costly mistake for Mr. Johnson and Penney shareholders.

### Representativeness: Investor Application

The bias of representativeness often causes investors to believe that past performance *is* indicative of future results. Investors, analysts, and economists alike all tend to look to the past to guide their future expectations. This is the primary reason why investors perform so poorly—we buy after good results and sell after experiencing poor performance. We tend to miss out on much of the gains, only to participate in most of the losses.

The key with this bias is to understand that the future is unpredictable and that stock markets are mostly random movements in the short term. Is the inability to correctly predict which roulette number will come up next a sign of ignorance? Of course not—the game is simply unpredictable in nature. So is the stock market, especially in the short term.

### Anchoring

The bias of anchoring occurs when we need to define a future unknown value and we look to something as a start-

ing point, or reference point, to better predict the value. All retailers know that everyone loves getting a deal. If we perceive we are getting a deal, we are much more likely to purchase goods or services before the deal goes away. A retailer ensures that we perceive a deal in two primary ways: (1) place an item the retailer desires to sell next to items that are more expensive, so the price is relatively cheaper and (2) the “high-low” sales strategy. Penney would mark up the price of goods (sometimes as much as five times the wholesale price) and immediately discount by one-half or more (Jenkins 2013). It was a very successful strategy.

Mr. Johnson came in and eliminated the promotions; he switched the sales strategy from “high-low” to everyday lower prices or “fair and square.” Penney shoppers, who relied on discounts to tell them whether something was a good value, couldn’t discern a deal anymore—and that alienated them. Which is a better value, a \$30 pair of jeans or a \$60 pair marked 50-percent off? The result is the same, a \$30 pair of jeans, but the latter appears to be a better deal. Mr. Johnson did not understand the need to have a reference, or anchor price, to help people discern whether they were getting a good deal. He did not understand the bias of anchoring, and it was a costly mistake.

### Anchoring: Investor Application

Many investors, when trying to determine what future investment returns may be like, often anchor to past returns. Many times we anchor to the long-term return of a portfolio of commensurate securities. But we fail to see that (1) we compare short-term performance to an historical average over a very long period of time, and (2) long-term returns most likely are positive, while short-term returns often include periods of negative performance. A long-term historical return of 8 percent (the anchor) may entice investors to

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expect a similar portfolio will perform in some range around 8 percent (i.e., 4 percent to 12 percent). But long-term average returns do not show the volatility inherent with investing. A sudden sell-off could encourage investors who are expecting an 8-percent return to abandon their strategy simply because they never considered losses possible. Anchoring to long-term performance masks the significant losses that occur on the way.

Anchoring can be reduced by understanding the historical volatility of a similar portfolio. The key is to expand the possible outcomes. If a portfolio averages 8 percent over the short term, expand the range of anticipated short-term outcomes to include double-digit losses. When market losses occur, investors who have expanded the acceptable range of returns will be more likely to stick with the investment strategy.

## Conclusion

Mr. Johnson's experience and his role as CEO of J.C. Penney are rich with les-

sons. He was so confident in his strategy that he didn't test it before running with it. He viewed Penney shoppers the same as Apple shoppers, and he believed the success of his strategy at Apple was representative of the success it would have at Penney. And he did not understand how important reference points were to the Penney shopper.

These experiences are evidence that behavioral biases exist and subconsciously influence us, many times at a significant cost. The good news is that tools exist that financial consultants can use to identify and reduce the impact of biases for themselves and for their clients. 

*Jay Mooreland, MS, CFP®, is a behavioral economist, investment advisor representative, and owner of The Emotional Investor. He developed Understanding My Client™, a profiler designed to help consultants identify and solve several common biases. He earned an MS in applied economics from the University of Minnesota.*

Contact him at [jay@theemotionalinvestor.org](mailto:jay@theemotionalinvestor.org).

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