DISPATCHES

Investors Allocate More Into Funds According to the ABCs

Investors as well as financial professionals are more likely to invest in fund names that appear higher in the alphabet or higher in retirement plan menus (a list of available fund options), according to a recent study.

Using a 13-fund option as an example, the researchers found that changing an "R"-named fund to an "A"-named fund increased the number of dollars invested by roughly 20%. All other factors being equal, the change led to an additional $653,000 being allocated to this "R" fund in an average plan with assets of $32.5 million. This so-called alphabeticity bias explains why individuals satisfy their preference toward the first "acceptable" option when making fund allocation decisions within a 401(k) plan, even if more searching could result in a better choice. The bias is more evident when there are a large number of fund choices available.

The study also found that a fund's position on a retirement plan menu was more important than the fund's alphabetical location. If a 401(k) plan offers only Vanguard funds (which start with the word "Vanguard"), then the Vanguard 500 Index fund (VFINX) would likely be listed first. If the plan offers Vanguard funds as well as options from other fund companies, then the Vanguard 500 Index fund would likely be listed toward the end of the offerings. The same fund appearing in multiple plans received a significantly higher allocation when listed closer to the top of the plan menu, according to the study's authors.

If plan sponsors and administrators change the order in which funds are listed, plan participants would benefit. For example, the researchers found that ordering funds based on expense ratio (lowest to highest) would lower the average expense ratio of the top four equity funds in the study's sample plan menu from 0.90% (with alphabetical listing) to 0.62%. The study calculated that over a 30-year period, an investor who contributes $5,000 annually and realizes a fixed 7% annual gross rate of return would save the equivalent of $20,440 in investment income due to the change.

Source: "Alphabeticity Bias in 401(k) Investing," by Thomas Doellman, Jennifer Itzkowitz, Jesse Itzkowitz and Sabuhi Sardarli; The Financial Review, December 2018.

Knowledge of Social Security Spousal Benefits Is Low

Knowledge about spousal and survivor benefits is low among those who have yet to start receiving Social Security benefits. The lack of knowledge can put even otherwise financially literate individuals at risk for making suboptimal claiming decisions.

Social Security offers two types of benefits that spouses can be eligible for beyond claiming on their own earnings record. The spousal benefit allows a married individual to claim Social Security benefits based on their spouse's earnings record if higher than their own earnings record. The survivor benefit is equal to the full amount of the deceased spouse's benefit, if it is larger. The amount of the survivor benefit that the spouse with the lower benefit can receive is affected by the higher-benefit spouse's age at the time of the death. (Divorcees can receive spousal and survivor benefits if certain requirements are met.)

Representatives from the University of Michigan Research Center conducted a study to test knowledge of spousal and survivor benefits. The team created two focus groups based on whether the participant was the household's primary or secondary earner. Awareness of Social Security benefits was low in both groups. Compared to the primary earner group, the secondary earner group was more familiar with spousal benefits. Also, participants in the secondary earner group said that they only had some knowledge about Social Security.

Based on the focus group discussions, a survey was constructed and sent out. Knowledge about eligibility or how benefits are calculated was low among the approximate 1,400 eligible respondents. For example, just 27% of study participants correctly said that spousal benefits are available to couples married for a year or more. Less than 40% knew that claiming spousal benefits doesn't affect the primary beneficiary's benefits or were aware that spouses cannot claim benefits before the primary beneficiary does. Out of five questions designed to test participants' knowledge about spousal benefits, the average respondent answered 1.65 questions correctly. The study's authors suggest, "this result is driven by those with low financial literacy, low familiarity with the Social Security retirement program, in general, or low confidence in the Social Security system."

Source: "Social Security Household Benefits: Measuring Program Knowledge," Katherine G. Carman and Angela A. Hung; Michigan Retirement Research Center Working Paper, September 2018.

Mobile Trading Apps Lead to More Frequent Transactions

Along with the rise of technology portability through the use of smartphones over the past decade, financial applications such as trading securities have become more prevalent. Active investors taking advantage of these advances have changed their behavior, according to a recent study. Convenience and the illusion of knowledge control increased investor attention and trading frequency.

The study consisted of 13,354 app adopters (investors who switched from using a trading website to a mobile trading app) and 11,482 nonadopters (investors who continued trading via a website even after mobile trading became available). Sixty-one percent of the study's subjects were male, and the average age was 36.

Using a number of statistical analyses, the author found that after adopting the mobile trading app, investor attention (measured by app logins) rose by 146% and trading volume, subsequently, rose by 86%, indicating higher trading intensity. The researcher also concluded that some app adopters are prone to mistake their alpha (excess returns to the market) as investment skill and disproportionately continue to increase their trading volume.

Separately, the study examined flow (cash inflows or cash outflows) for a mutual fund used by the app adopters. Using a regression analysis, the researcher found that higher flow due to app adopter trading largely contributed to a decline of 4% annually in the performance of the mutual fund.

In addition, the researcher examined whether mutual funds with a greater exposure to app adopters would have a lower return relative to the other funds. Comparing retail-oriented and institutional-oriented funds, the data showed that the former's return would "deteriorate" faster with higher exposure than the latter.

The study concluded that a change in trading method (website to mobile) impacts investor behavior biases by increasing attention, increasing trading volume and frequency and subsequently negatively impacting mutual fund performance.

Source: "Going Mobile, Investor Behavior, and Financial Fragility," Xiao Cen; SSRN, January 2018.

Not Giving Sufficient Consideration to Sell Decisions Is Costly

Institutional investors tend to pay more attention to which stocks they are buying than the stocks they are choosing to sell, to the detriment of their portfolios' returns. A study looked at portfolio managers with an average portfolio value of $573 million. It was discovered that "selling decisions not only fail to beat a no-skill strategy of selling another randomly chosen asset from the portfolio, they consistently underperform it by substantial amounts." It was found that managers using hands-on selling techniques are giving up between 0.5% and 1.0% of returns per year.

However, if the managers had chosen to sell a stock at random, they would not have missed out on these returns. The study also found that when a stock shows "extreme returns" (either worst- or best-performing), it is sold at a rate over 50% higher than a stock with minor under- or overperformance.

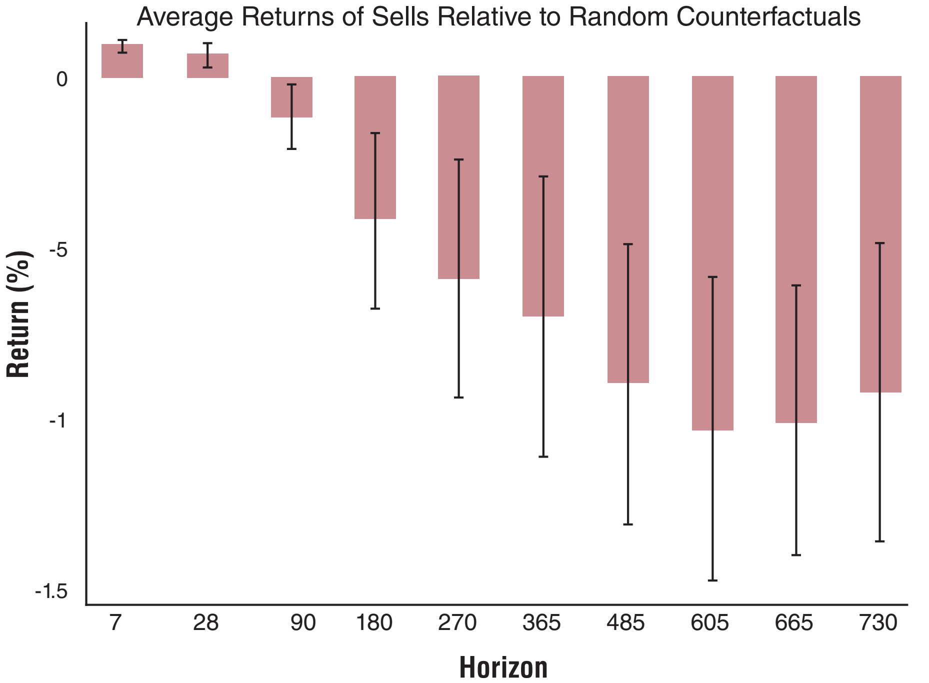
Research has found that the decision to buy a stock and the decision to sell require different ways of thinking. One such study by Brad Barber and Terrance Odean (interviewed in the November 2014 *AAII Journal,* "Trading More Frequently Leads to Worse Returns") purports that buying decisions are forward-looking and selling is backward-looking. When asked, some portfolio managers described selling as "simply a cash raising exercise for the next buying idea." Another sees buying as "an investment decision, selling is something else."

Many institutional investors focus on finding a new profitable position for their portfolios. Many make sell decisions only when they find their next buys, leaving the sell decision to the last minute but still using a specific method for removal. Especially in these instances, it would be more profitable to choose a random stock to sell.

The one exception to this data is the incorporation of earnings announcements into sell decisions. When a company has announced earnings, institutional investors who use this information when removing a stock from their portfolio outperform a random selling strategy.

Source: "Selling Fast and Buying Slow: Heuristics and Trading Performance of Institutional Investors," by Klakow Akepanidtaworm, Rick Di Mascio, Alex Imas and Lawrence Schmidt; SSRN, December 2018.

The Cost of Stock Sell Decisions



The bars represent the average counterfactual return with the range reflecting the confidence interval. The average sell causes a loss of 1.0% at the one-year horizon relative to randomly selling other stocks.
Source: "Selling Fast and Buying Slow: Heuristics and Trading Performance of Institutional Investors," by Klakow Akepanidtaworm, Rick Di Mascio, Alex Imas and Lawrence Schmidt; SSRN, December 2018.