QUARTERLY MARKET INSIGHTS – FIRST QUARTER 2024

To the Clients and Friends of Hilltop Bank Wealth Management:

We entered 2024 with easing concerns about the possibility of a recession and solid progress in returning inflation to its 2% target. In the first quarter, economic growth has moderated as expected, payroll growth has remained strong, and falling job openings and rising unemployment suggest a labor market in better balance. Disappointing inflation data over the first two months have calmed some of the markets' exuberance, decreased expectations of early interest rate cuts, and pushed up yields across the curve. Stockholders, unfazed by any of this, have pushed the broad market up 10% - its best first quarter since 2019.

While it's our job to monitor these day-to-day fluctuations in the markets, we do so in the broader context of what we think we know about investing as a discipline. Transparently, in addition to keeping you up to date on what's happening in the economy, one of my goals in these letters is to relate to you some of that knowledge. First, because I believe the more knowledge we share between us, the better the outcomes we can achieve. Second, because I believe most of what you can find to read about investing (especially online) ranges from useless to actively harmful.

In that spirit, the recent passing of a Nobel Prize winner in economics provides a timely opportunity to pass along some of what he taught. He was one of those rare people who seems to come along every once in a while, with a certain imagination and intelligence, that allows them to redefine their field and advance all of our understandings. He, and those who came after him, have provided some of the most readily applicable lessons in finance to individual investors. Lessons from which we can all benefit.

If you ever took an economics class, you may recall the omnipresence of a character called the "rational economic man". If not, they are a person who always makes the optimal decision based on perfect rationality. They are the underlying basis for many economic theories dating back to Adam Smith. They are also a construct developed to make neat theories applicable to real life. We would all agree, of course, no such person exists in the real world. Real people make decisions every day that are neither optimal nor rational.

Starting in the 1970s, a psychologist named Daniel Kahneman, recognizing that humans are flawed, revealed that we are in fact flawed in predictable ways. This spawned a whole new field of study, called behavioral economics, which represented a great leap forward in our understanding of both markets and ourselves.

What behavioral economics shows us, is that even if we were able to build a perfect portfolio, the execution of it is still limited by our ability to follow through. We are, all of us, beset by ways of thinking and methods of reasoning that reduce our ability to be that rational economic man.

Luckily, once we are aware of our biases, we can at least be diligent in not following them too far. With that goal in mind, I'd like to take the opportunity of Kahneman's passing to reintroduce us to some interesting features of ourselves.

I present here a list of the most common and widely studied ways in which we repeatedly and predictably trick ourselves into making suboptimal decisions. Some you will have heard of before, while others may be new (or seem to only apply to your in-laws). I encourage you, as you read, to try to think of a time you (or someone else) may have exhibited them. They pop up constantly in our work here, and to make sure I am the best investor I can be for all of you, I keep a similar list in mind in order to test whether any particular decision I have made might be implicated.

First, **loss aversion** is the most common bias that you, our clients, will experience. Markets are volatile, and it turns out, we are predisposed to experience between two and two-and-a-half times more pain from losses than utility from gains. Often, this takes the form of an investor moving their portfolios to cash after a period of negative returns. For others, it may lead to investing too conservatively given their time horizon and risk tolerance. Perhaps more tangibly, I would offer an experiment – Would you take a bet that would pay you $10,000 if you could flip a coin and get tails twice in a row, but if you fail you would have to pay $2,000?

I imagine most would at least hesitate at the prospect, despite probability telling us we should be willing to wager up to $2,500 on such an outcome. Instead, our predisposition to avoiding losses means that the more probable outcome of paying $2,000 feels more painful to us than the more remote chance of winning $10,000. We are disproportionately averse to losses.

The second is **confirmation bias**. That is, we have a natural tendency to seek out and internalize only information that supports our own opinions and prior beliefs. While whole media organizations seem to have built a business model on this idea, failing to seek out opinions contradictory to our own means any decision we make will be based on incomplete information. For example, I tend to believe cryptocurrencies are not investments, but rather a form of speculation more akin to gambling. I have a hard time seeing a value in them that would justify their current prices outside the premise that holders are simply hoping to offload them later to someone else at an even higher price. While this greater-fool theory may prove correct, I ought to at least seek out arguments in the opposite. (I have yet to be convinced by any).

Next, and relatedly, **hindsight bias**. Hindsight bias prevents us from recognizing past mistakes by convincing us that whatever actually transpired is what we predicted. Failing to recognize when we were wrong inhibits our ability to learn from our mistakes. To combat it, try writing down your prediction somewhere and revisit it periodically. This keeps us honest about what we previously believed and may prove to be quite humbling. For me, this newsletter provides just such an opportunity.

Anchoring bias is the name of a phenomenon in which we assign outsized weight to the first piece of information we encounter. If you're shopping for a car and the salesman offers you a 10% discount, you may think you are getting a great deal, when perhaps the dealership just increased the original cost of the car by more than 10% before applying the discount.

In any subject you engage with deeply, you should be aware of the **Illusion of knowledge**. If we discuss markets, you are likely to hear me admit that I don't have a crystal ball predicting where they are heading in the next week, month, or year. This is despite the fact that I spend hours each day thinking about just this subject and will continue to do so. While this study makes me a more informed investor, it's important to recognize that the accuracy of our forecasts does not grow linearly with the amount of information we take in. In contrast, the illusion of knowledge suggests to us that if we just collect enough data, we can, in fact, predict the future. Relatedly, the **illusion of control** is the propensity to overestimate our ability to control uncontrollable events, perhaps based on our accumulation of additional information. If you were a long-term sports gambler, the likely outcome is that you would have lost money overall throughout your endeavor. However, the more games you watch, and the more bets you place, the more likely you are to convince yourself that some system you have devised provides special control over the outcome of the contests. In reality, lucky socks will not help your March Madness bracket.

Attribution bias is the name for our inclination to attribute any good outcomes to our skill and any bad outcomes to sheer luck. Reflectively, it also applies when we witness someone else do something wrong and attribute it to the quality of their character rather than some situational factor they are responding to. If I cut you off in traffic, you are likely to think I am rude, arrogant, or aggressive, whereas if you are the one cutting, you are more likely to rationalize it as a response to being late, or a superior ability to judge the distance between cars. We internalize the positive and externalize the negative.

Finally, **framing bias**, which is a cognitive bias that leads people to decide between options based on the light in which those options are framed. For example, which sounds riskier, a surgery with a 95% survival rate, or a surgery in which one out of every twenty patients died? Put another way, would you rather buy a package of beef that's labeled 90% lean, or one labeled 10% fat? Our decision between options is easily impacted by how the options are framed.

In conclusion, if you find that any of these seem to resonate, please keep in mind that they are not flaws of character, but rather flaws in reasoning. The world is too complicated for us to be constantly rational. Therefore, we often resort to rules of thumb, or heuristics, to shorten our path to a conclusion. However, by considering them in the context of our own decision-making, we can all strive to be better decision-makers, and ultimately, investors.

Best,

Christian Jorgensen, JD, CFA
Vice President, Investment Strategist
HILLTOP BANK WEALTH MANAGEMENT