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Once Bitten, Twice Shy

On a windy Sunday morning at the 2012 British Open, Adam Scott prepared to play his final round of golf with a four-stroke lead over his nearest competitor. At 32 years old, Scott was widely regarded as one of the best golfers in the world, even though he'd never won a major tournament. Today, it seemed his drought would finally end.

But, with only four holes to go, Scott played disastrously, ultimately losing to Ernie Els by a single stroke in what is widely considered one of the greatest chokes in professional sports history.

The loss had a profound effect on Scott. With his confidence wounded, he began playing much more cautiously. In subsequent tournaments, he fell further and further behind, even finishing 45th at the World Golf Championships.

He hadn't lost his skill, of course, but he stopped taking the necessary amount of risk that was required to push ahead of the pack.

The Snake-Bite Effect

Losing confidence and making overly conservative decisions in the wake of a negative experience is common and normal. Psychologists call this *the snake-bite effect,* and it's deeply rooted in human evolution. Before venom antidotes were invented, a knee-jerk and overly cautious reaction was an important survival instinct.

But it may not serve us well in modern times, when unnecessarily cautious decision-making can stifle our experiences and opportunities for success. For instance, someone who gave up flying after just one turbulent flight would have limited chances to see the world.

Similarly, someone who refused to invest in technology stocks in the decade after the dot-com bubble burst would have missed out on the best-performing sector, thereby limiting their portfolio's growth.

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"The hard part about cognitive biases is that they are often unconscious and automatic," says CAPTRUST Chief Investment Officer Mike Vogelzang. "To make prudent decisions, we have to retrain our thinking to mitigate these knee-jerk responses and be more thoughtful instead."

Automatic Thinking

The snake-bite effect is a combination of two emotional responses: *recency bias* and *loss aversion*. Recency bias weights our decisions more heavily toward events of the recent past, while loss aversion, simply put, is the idea that people hate losing about twice as much as they like winning. Psychologist Daniel Kahneman, who coined the term, said that people feel the negative impact of a loss twice as deeply as they feel the positive impact of an equal gain. This makes people avoid losing by avoiding risk.

Put recency bias and loss aversion together and investors are primed to be overly cautious following a market downturn, such as the one experienced in 2022, or an unexpected banking event, like the one the country witnessed in March 2023.

But this type of thinking could cause investors to miss out on opportunities for growth and potentially hinder their ability to achieve long-term financial goals.

Usually, cognitive biases are buried deep in our mental mapping—a legacy from our cave-dwelling days when quick decisions and mental shortcuts could mean the difference between survival and extinction. While useful in a historic context, these biases create more problems than solutions when it comes to successful investing. Nevertheless, academic research repeatedly shows that they impact our financial decisions regardless of investment experience, age, employment history, or net worth.

Homo Economicus vs. Real People

Economic models are built on the assumption that *Homo economicus*—that is, the average person—will absolutely always act rationally and make decisions based on perfect information, not emotion or past experience.

Do you know anyone like that? Probably not.

In fact, *Homo economicus* doesn't exist. It is merely a stylized representation of how investors should make decisions. And when we base economic models around this theoretical person, we are ignoring the behavior of real people, who almost always allow past experiences to influence future decisions.

Homo economicus is immune to the snake-bite effect—and hundreds of other behavioral biases. But the rest of us are not.

"I see the snake-bite effect most often when establishing an initial risk tolerance with a client," says CAPTRUST Senior Director and Portfolio Manager Jim Underwood. "If a person is beginning their investment journey in the depths of a bear market, they are much more likely to enter cautiously, just when the market is most likely to reward those who take risks."

Underwood says snake-bitten investors can be overly concerned about the potential for short-term corrections and therefore lose sight of the long-term potential wealth generation that comes from compound growth in stocks. "This bias could permanently lower the investor's long-term wealth ceiling," he says.

This is a critical point. While short-term investment results are somewhat random, the probability of

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compounding wealth in stock investments is skewed heavily in our favor if we stay invested for at least five years.

In fact, when we look at probabilities of investment success, using the S&P 500 Index as a measure, we find that trailing one-year returns have been down only a handful of times. Five-year returns have been down even less. And if we zoom out to investigate the 15-year trailing average, the S&P 500 has never been down in its history: a reminder of why time in the market is better than timing the market.

Winning the Game

Although we cannot change our past experiences, we can take actions today to overcome biases like the snake-bite effect and make better investment decisions.

One effective method is to keep a record of your major investment decisions, including rationales. By tracking the investment's performance and your reasons for choosing that investment, you can learn to separate emotion from investing.

Remember: Every asset class goes through periods of poor performance and periods of great performance. Don't let one bad experience limit your investment options.

Diversification is also a powerful tool. Creating a portfolio that contains assets from many different classes, industries, and geographies can help reduce the impact of negative events in any one area. While a diversified portfolio will never perform as well as the best-performing sector, more important for long-term investors is that it will likely never decline as much as the worst-performing sector.

Another antidote to the snake-bite effect is staying focused on your long-term investment goals by sticking to your personal financial plan. Financial markets move around, sometimes in unexpected and extreme ways, but a financial plan can provide comfort during those uncertain periods and help you stay focused on future goals.

Finally, you can get outside help, which is what Adam Scott did. Within a few months of his British Open meltdown, Scott began working with a sports psychologist on the mental aspect of his game. That work paid off when, less than a year later, he became the first Australian to win the tournament in a dramatic playoff.

When it comes to financial issues, we often find ourselves in the role of money coach for clients. As Vogelzang says, "It's the advisor's responsibility—and often, the advisor's highest calling—to help clients manage emotional reactions and stay focused on long-term goals." Blunting a client's worst instincts, however they've been formed, and helping them avoid impulsive mistakes is one of the most important ways advisors can add value.

Unlike *Homo economicus*, no real person is immune from emotional biases like the snake-bite effect. As Warren Buffet said, "Once you have ordinary intelligence, what you need is the temperament to control the urges that get other people into trouble in investing."

Using the tips above will help you avoid the negative implications of the snake-bite effect. It can also help improve the odds of winning your personal version of the game, whatever that may be.

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