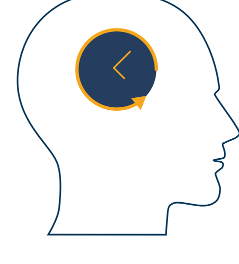
Fundamentals of behavioral finance: Recency bias

Why clients put too much emphasis on recent events, and what you can do help them shift their perspectives

Key takeaways

- With recency bias, people tend to put too much emphasis on recent events.
- This bias may lead investors to think that a current stock market downturn or rally will extend into the future.
- Recency bias can lead clients to make short-term decisions that deviate from their financial plans.
- Advisors can use several strategies to help clients reduce the negative impacts of recency bias.
- Educating clients about recency bias now may help them better cope with future periods of market volatility.



In this series, we explore some of the most common biases exhibited by investors, and discuss how advisors can help their clients overcome them. This article focuses on **recency bias**, a cognitive bias that can lead clients to make ill-informed decisions.

What is recency bias?

Recency bias is the tendency to place too much emphasis on experiences that are freshest in your memory—even if they're not the most relevant or reliable. Would you want to go for a long ocean swim after watching *Jaws*? Probably not, even though the actual risk of being attacked by a shark is infinitesimally small.

In the investing world, recency bias can be hard to avoid. Clients display recency bias when they make decisions based on recent events, expecting that those events will continue into the future. It can lead them to make irrational decisions, such as following a hot investment trend or selling securities during a market downturn.

In fact, the BeFi Barometer 2020 study, conducted by Cerulli Associates and sponsored by Charles Schwab Investment Management in collaboration with the Investments & Wealth Institute, found that recency bias is the most common behavior bias that advisors believe is affecting clients' investment decisions.[1]

At a glance: Recency bias

Head or Heart?
Recency bias is cognitive. It describes the tendency to overemphasize the importance of recent events.

Who has recency bias?
Advisors say...*

Generation	%
Millennials	26%
Generation X	22%
Baby Boomers	17%
Silent Generation	11%

The big problem:
The recent past is a poor indicator of the future.

February-March 2020	March-April 2020	April-May 2020
S&P 500 -19.9%	>$1 Trillion flows into money funds**	S&P 500 +17.8%

How advisors can help:
Advisors can educate investors about how markets move over time.

* Cerulli Associates, "BeFi Barometer 2020." Survey. July 2020.
** "Morningstar Reports U.S. Mutual Fund and ETF Fund Flows for April 2020." Morningstar, Inc. May 18, 2020. Press release; "Morningstar Reports U.S. Mutual Fund and ETF Fund Flows for March 2020." Morningstar, Inc. April 15, 2020. Press release.

Recency bias can lead clients to deviate from their carefully laid investment plans, which can have damaging long-term consequences.

Consider the cost of chasing hot investment trends: In 2016, energy was the best-performing sector in the S&P 500® Index, delivering an annual return of 27%. A client who subsequently loaded up on energy stocks may have been disappointed that the sector returned -1% in 2017, when the S&P 500 Index returned nearly 19%.

The takeaway: short-term market moves caused by recency bias can sap long-term results, making it more difficult for clients to reach their financial goals.

What can you do about it?

To combat recency bias, advisors can help their clients take a broader view of how markets tend to move over time, and the larger trends that may have the biggest impact on their investment returns. During the rebalancing process, consider illustrating to clients which investments have fared well or poorly recently, and use that information to initiate a larger discussion about how markets tend to move over time.

It's also important to find ways to curb clients' impulses to make decisions influenced by recent events. For instance, you might discuss limiting their daily news intake, or you might create a mutually agreed-upon waiting period before making investment decisions. Another strategy: discuss portfolio performance in terms of progress toward a client's goals rather than focusing on individual return figures.

Working with clients to avoid the effects of recency bias can help keep them from making irrational investment decisions and manage their expectations during the next period of market volatility. In turn, that work will demonstrate the value of your services, potentially leading to greater client trust.

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Home bias | Overconfidence bias | Loss aversion bias

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[1] Cerulli Associates, "BeFi Barometer 2020." Survey. July 2020.

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The 2020 BeFi Barometer surveys approximately 300 financial advisors to learn how advisors view and use behavioral finance when working with clients. Conducted by Cerulli Associates in May and June 2020. Respondents were members of the Investments & Wealth Institute® and diversified among business models, including wirehouse, registered investment advisor (RIA), and national/regional broker dealers. All data is self-reported by survey participants and is not verified or validated.

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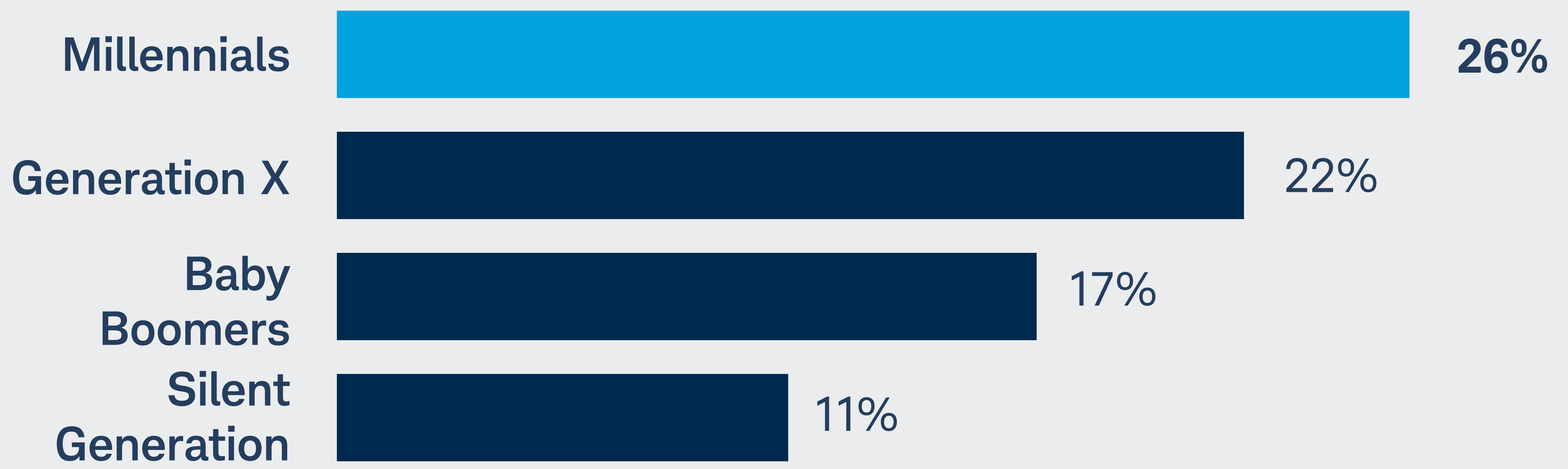

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