Stock-Based Compensation: Part 2

Drinking the Kool-Aid

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In the first installment of this series, we explained why you need to deliberately manage your stock-based compensation. Without a plan, people tend to deal with their vested shares in one of two ways: (1) delay decision-making, hoping that somehow it will get easier to figure out what they should do, or (2) take inconsistent action, mostly based on feeling and instinct, rather than data. Either approach can lead to an erosion of wealth and even a permanent loss of money.[1]

Why do we make decisions like this? Because we're human and our brains can only handle so much. Remember the packed daily schedule and lengthy to-do list we discussed in the first installment? Given how busy we are, our brains tend to short-circuit when confronted with complicated problems, particularly when the stakes are high and our brain is tired. Overloaded with responsibilities, we rely on our "gut instinct" or "rules of thumb" to help decide, however flawed this approach may be.

The truth is, we all have a tendency to make decisions this way. It's a normal, human thing to do. However, to better understand these decision-making inefficiencies we look to a field of study known as behavioral economics for answers.

According to a behavioral economics article from the University of Chicago, a thought leader in this space, "Behavioral economics combines elements of economics and psychology to understand how and why people behave the way they do in the real world."[2] Further, "behavioral economics examines the differences between what people "should" do and what they actually do and the consequences of those actions."[2]

Therefore, an educational series on the topic of stock compensation would not be complete without an introduction to behavioral economics and the influence psychology has on managing this very valuable form of compensation. In the sections ahead we are going to highlight two distinct categories within the study of behavioral economics, 1.) emotional biases and 2.) cognitive errors (aka, "thinking errors").

Why We Use Emotions to Make Financial Decisions

Stock compensation has the very real tendency to make us more vulnerable to emotional decision-making than other complex situations. Why? Naturally, when you devote significant hours to a company—particularly one that is growing rapidly--you want to believe the good things you're seeing, hearing, and reading about it. Every day, you welcome new employees, get updates on innovative products, and enjoy the hum of a lively workplace. When you live and breathe a company's ethos, it's very hard to give the correct amount of weight to information that doesn't correspond with your experience. This is all normal, but it can lead to some poor—and costly—decisions.

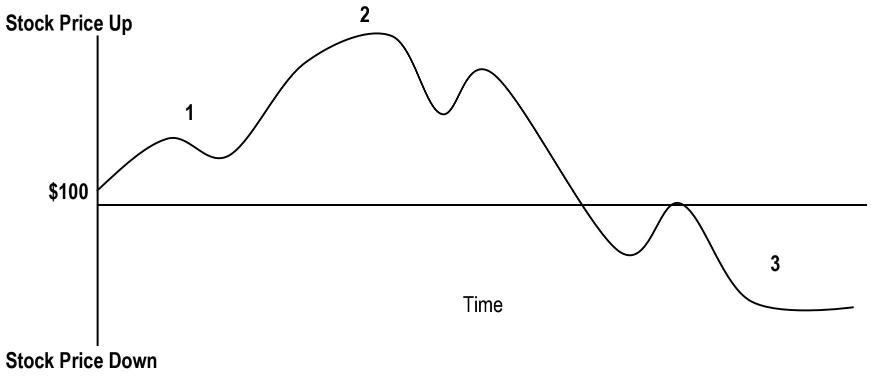
Plus, it's always difficult to stay rational when it comes to large sums of money, which tends to be how stock compensation is awarded, often equaling tens of thousands and even hundreds of thousands of dollars. And, of course, you always feel an inevitable thrill whenever the company stock price rises. Ka-ching!

Looking at the research, we can identify several emotional biases that come into play when dealing with stock compensation.

Ask yourself if you've ever been vulnerable to any of the following:

1. Overconfidence: An unjustified faith in someone's, or a group of people's, knowledge or abilities.[3]
   - Have you ever overestimated the likelihood of an outcome because you believed someone had superior knowledge or capabilities—and it became difficult for you to consider conflicting facts?
   - Have you ever had a "gut feeling" that made you feel just certain that something would work out?
2. Status Quo: Deciding it is easier to do nothing than to take action.[3]
   - This particular bias was briefly highlighted in Part 1 of our series when we addressed kicking the can down the road; You think, "I'll have more time another day. This can wait. The stock is fine for now; it's not going anywhere." Simply doing nothing is often easiest.
   - Our brains function like this because when they're bombarded with analyzing lots of different choices, they get tired. And, like any other muscle in our body that's overworked and tired, the brain wants to shut down and rest.[5]
   - Choosing to do nothing is sub-optimal, but to our brains it's a much-needed nap!
3. Loss Aversion: The strong behavioral preference to avoid loss rather than achieve gains.[3]
   - The pain of losing is about twice as powerful as the pleasure of gaining.[4] When a position we hold goes down in value, we hope the price will recover and go on to generate gains.
   - We seek to avoid the pain of actually locking in the outcome of losing money, even if doing so could generate better results for our portfolio.

Here's an illustration of how emotional biases can override our brain's ability to make well-reasoned decisions.



(1) As the stock moves up from $100, you become overly confident that the people leading this company are the best around. Any blip is just a mild bump in the road. **(2)** As the stock hits a new high every day, you're ecstatic with your account balance, but confronted with big financial decisions and a variety of choices. Overwhelmed with which one is the best, you decide to do nothing and tackle the task another day. **(3)** The shares have now fallen well below your original price of $100 because of new entrants to the industry and a change in the economic landscape. You hate the idea of selling your company stock at a price below $100 because you can't stand the idea of losing money; instead, you think the stock is the lowest it can go, and you have high hopes it's going to fully recover.

While the above example is overly simplified, it gives you a general understanding of the emotional rollercoaster employees with company stock ride every day. Through the ebbs and flows, our brains are confronted with obstacles that make it difficult to make timely, well-reasoned decisions. Remember: Nearly 40% of individual company stocks in the Russell 3000® Index fail to fully recover after they lose 75% or more in value.[1] These are the potential outcomes we spend a lot of time talking about when helping our clients plan their long-term future. One way we do this is by coaching our clients to understand the trade-offs arising from emotional biases; the use of visual illustrations and scenario comparisons can help individuals see more clearly the impact of sticking to long-held feelings and beliefs.

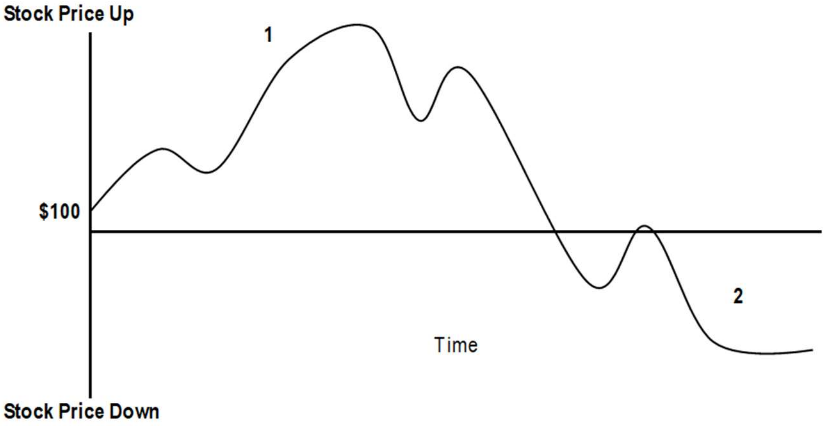
Thinking Errors Can Also Trip Us Up

Unlike emotional biases, which arise from our feelings or instincts, cognitive errors result from "faulty reasoning and analysis".[3] As we mentioned earlier, our brains can only handle so much. The good news is that cognitive errors aren't a reflection of your ability to execute complicated math processes. Instead, they arise from your inability to recognize that your initial approach to a problem was incorrect. You can think of these errors as "blind spots".

Let's look at a few tendencies that can lead to cognitive errors.

1. Availability: This bias is associated with how easily an outcome comes to mind.[3]
   - The more recent an event, the more heavily it factors into how we evaluate the likelihood of the next outcome.
   - Here's an example. You flip a coin four times, and it comes up tails after each flip. If I were to ask you, "What's the likelihood on the next flip that it will also be tails?" Quickly, you might start to think, "What are the chances it could be tails again?" Tails never fails, right? But in fact, the previous coin tosses have no bearing on the next toss. It's always equally likely to be heads or tails. But our recent experiences affect our beliefs about what will happen next. (By the way, the expected probability of flipping a coin that lands on tails four straight times is very low; in fact, the likelihood is only 6.25%!)
2. Anchoring and adjustment: When we fail to take into account new information, we can fall victim to an anchoring error.
   - When this happens, a statistical, information-processing error is committed.
   - For example, an investor can get anchored to the original price they bought a stock for, even though new information has subsequently hurt the stock and clobbered its value. The investor remains anchored to the previously higher price simply because it was their initial point of reference, whereas they should reset their point of reference to the current share price and evaluate the likelihood that the stock will recover.

On the following page we'll look at how cognitive errors can create blind spots.



(1) The company has had a consistent string of better-than-expected earnings reports. The stock price rises as investors flock to buy more in a wave of excitement. Then, on the heels of some notable new names entering the industry and a weakening economic environment, the stock experiences some trouble; however, you're convinced the upcoming report will be just as good as the last several and maybe better still leading to a rebound in the stock price. **(2)** The stock hits a new low, but you still think the stock will recover to its earlier high level. An objective analysis, however, would take into account the entrance of new competitors, as well as the less favorable economic environment, and it might conclude that the stock could go lower still, given the new headwinds the company is facing. In situations like this, the anchoring effect is often amplified by the emotional bias of loss aversion, the tendency to avoid locking in a loss in hopes of generating gains once more.

Fortunately, cognitive errors are easier to manage than emotional biases because they aren't rooted in our instincts or feelings, but only in our information processing. Once you learn the correct approach to solving the problem, you'll use it.

Emotional biases, on the other hand, involve changing what you believe to be true—a much trickier proposition. Strong emotional biases are hard to modify. In fact, some won't ever be changed. When you're working for a company that pays you a lot of money in company stock, it's hard not to get emotional. The right financial planning tools, however, can help you visualize the impact of emotional biases and cognitive errors so that you can see how they could undermine your long-term goals.

Crunching Numbers Isn't Enough When It Comes to Stock Compensation

"Wait a minute," you might be thinking. "Surely, there must be a set of straightforward, quantitative rules that can tell me how to handle my stock compensation, and once I know those rules, I can just follow them from now until I retire. How I 'feel' doesn't matter, right?"

Wrong.

Time and again, we find that stock compensation generates powerful feelings for our clients. When it comes to this issue in particular, it is hard to put emotional biases aside.

This is why a good financial planner must know more than the quantitative aspects of investing. It is simply not enough to admonish clients about what the math says they "ought to do." In part, that's because no singular path will work for every individual; every client has unique and important considerations, such as family composition, health concerns, and retirement timelines, to name just a few.

More importantly, though, rather than taking into account what you "ought" to do, we must also take into account what you are likely to do. This is a hallmark trait of a good behavioral coach. Even when quantitative analysis seems to offer a definitive answer, if that answer doesn't fit your temperament or your goals, you are unlikely to follow it.

Or, as often happens, you will choose to do nothing instead and hope that the status quo will protect you from experiencing the losses we are all so afraid of.

You might be wondering: How much value is derived from behavioral coaching? According to Vanguard research, behavioral coaching can add between 0% to 2% to a client's net returns.[6] Although everyone's experience will be different, the main takeaway is that behavioral biases can take a toll on long-term outcomes, which can meaningfully impact an individual's ability to effectively build wealth.

In the next installment, we'll discuss how you can ward off some of the emotional biases and cognitive errors that might trip you up. We'll also explain how you can assess risk in your investment portfolio and walk you through how specific tax rules can impact your stock compensation.

For those who would like more information on any of the topics covered in this series, please give us a call at 312-736-8567 or email jmariscalco@103advisory.com. When you're ready, we're here to help.

P.S. Do you have friends or colleagues who also wrestle with how to handle their stock compensation? If so, please share this series with them. Below is a link to our website that you can copy and paste.
https://103advisory.com/our-thinking/

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Citations

1. FactSet, Goldman Sachs Asset Management as of 12/31/2022
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