The Different Faces of Familiarity Bias

by Dr. Vicki Bogan

Millions of Americans own stock in their employer through various employee stock ownership plans and 401(k) plans.[1] While there can be discounted prices and specific tax benefits to buying employer stock, many investors hold much too much stock of their employer. There are estimates that five million Americans have more than 60 percent of their retirement savings in company stock, over 2 million Americans hold 40 – 60 percent of their retirement savings in company stock, and more than 3 million Americans hold 20 – 40 percent of their retirement savings in company stock.[2]

Certainly, investors hear alarming investment nightmare stories about people who held a large proportion of their personal wealth in their employer’s stock and lost everything.[3] [4] While your client may think that, “I know this company. I have inside information because I work here.” That thinking, sometimes, can get them into trouble. Think WorldCom and Lehman Brothers. These firms, in particular, encouraged employees to hold company stock inside and outside of their retirement accounts. Beyond the risks of having a large amount of one’s portfolio in a single stock, holding a large amount of employer stock means both their “day job” and their financial fortunes are tied to only one corporation. If something happens to the firm, your clients could lose their jobs and a large percentage of their financial wealth at the same time. That, my friends, is a very risky investment strategy.

So why do investors continue to do just that, despite the horror stories we hear when a frim like Lehman Brothers gets into trouble? The short answer is something called ***familiarity bias***. Familiarity bias is the tendency for individuals to be more comfortable with the familiar, dislike ambiguity, and look for ways to avoid the unknown. There are several types of familiarity biases, some of which can influence your clients’ investment preferences and some of which can affect you and how you may manage your clients’ portfolios. Every financial advisor understands the need and benefit of portfolio diversification. Familiarity biases can have a significant negative affect on portfolio diversification.

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[1] https://www.nceo.org/articles/statistical-profile-employee-ownership
[2] Mitchell, Olivia S. and Utkus, Stephen P. (2003). “The Role of Company Stock in Defined Contribution Plans.” in The Pension Challenge: Risk Transfers and Retirement Income Security. Mitchell, Olivia S. and Kent Smetters (eds.) Oxford, UK: Oxford University Press.
[3] Woolley, Suzanne. (October 13, 2016). “Wells Fargo Is Your Last Warning: Check Your 401(k)” Bloomberg.com
[4] Lieber, Ron. (March 20, 2015). “A Scary Movie: Filling Your 401(k) with Company Stock” nytimes.com

Despite the risks, employees often invest a significant portion of wealth in employer stock because their employer is a company which is very familiar to them. There is a belief that working at a company gives them certain informational advantages. However, that inside perspective generally does not translate into higher portfolio returns, nor does it compensate for the risk of limited diversification. This type of familiarity bias also can be manifested as a general “local” investing bias. You probably have clients who prefer to invest in the stock of companies that are in their local area/state. Again, they are favoring local market companies because they ‘feel’ that they have informational advantages about them because they are more familiar with them, when that is not necessarily the case (Huberman, 2001).

Familiarity Biases and Advisors

Unfortunately, clients are not the only ones that can be influenced by familiarity biases. As advisors, various types of familiarity biases can affect you, too. Researchers Coval & Moskowitz (1999) show that U.S. investment managers also have a strong preference for locally headquartered firms. Additionally, home bias can influence advisors. Home bias is the propensity to favor domestic financial investments over international ones. While there is a rich academic literature that documents the benefits of international diversification (e.g., DeSantis & Gerard, 1997), home bias is very persistent (Ahearne et al., 2004; French & Poterba, 1991). This bias strongly influences portfolio manager investment decisions, even when greater diversification outside of domestic markets might yield greater return and lessen risk.

The reason these biases cause problems is that they limit portfolio diversification. While certain familiarity biases are more likely to affect your clients’ investment preferences, other familiarity biases can influence you as an advisor. Some familiarity biases cause clients to invest too heavily in a particular security while other types of familiarity biases can cause investors to avoid certain types of securities. Your job is to be aware of these influences when trying to appropriately diversify a client’s portfolio.

Key Take-Aways

- There are several types of familiarity biases – some that are more likely to affect your client and some that can also influence you, the advisor.
- While certain familiarity biases can cause clients to invest too heavily in a particular security, other types of familiarity biases can cause investors to avoid certain securities.
- Familiarity biases can be an enemy to portfolio diversification.

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