

Del Mar Times

The psychology of investing



Financial Thoughts

by John Schooler

Studies show that 15 percent of the time when we feel that we are absolutely, positively right about something, we're actually wrong. (Our teenagers will tell us that we are wrong 100 percent of the time, however that is for a different article.) That's overconfidence, one of many behavioral flaws that can be financially dangerous for investors.

The emerging field of behavioral finance studies our irrational investment decisions. Ultimately it may give us insight into "irrational" market swings.

One example of financial decision-making swayed by emotion is the "disposition effect": When investors sell stocks from their portfolio, they tend to sell winners and hang on to losers.

"It's very natural why people do that," says Daniel Kahneman, who received the Nobel Laureate in Economics for his pioneering work in behavioral finance. "If you sell a stock that is currently worth more than you paid for it, then you pat yourself on the shoulder for a successful investment. When you cut your losses on the stock, in contrast, you have to accept punishment right now for having made a choice that didn't turn out well. It is not surprising that people prefer rewarding themselves than punishing themselves."

According to Kahneman, one of investors' biggest mistakes is "narrow framing," or looking at investment problems in isolation from the whole portfolio. "People should be educated to ask for advice about the big picture and always consider a particular decision in the context of their overall situation and objectives," says Kahneman.

John Nofsinger, author of "Investment Madness: How Psychology Affects Your Investing and What to Do About It" and "Investment Blunders of the Rich and Famous," says investors' missteps fall into three categories.

Overconfidence. Nofsinger agrees with Kahneman that many people exaggerate their ability to pick winners and their control over the market. They hang onto losing stocks or funds because they can't admit mistakes. "The overconfidence bias causes you to trade too much and take too much risk," says Nofsinger. "As a consequence, you pay too much in commissions and taxes, and you're susceptible to big losses."

Terrance Odean, associate professor at the University of California, found that men are particularly prone to overconfidence, which hurts their returns. Men trade 45 percent more often than women but earn returns that are 1.4 percent less. Among single people, men trade 67 percent more often but earn returns that are 2.3 percent less than women.

Emotion. Fear and greed, rather than rational facts, rule many investment decisions. Worse, says Nofsinger, is an "attachment bias" that can make investors emotional about their holdings. "You are emotionally attached to your family and friends, and so you focus on their good traits and deeds and discount their bad ones," he explains. "When you become emotionally attached to a stock, you may fail to recognize bad news about a company."

Oversimplification. Many investors tend to see patterns in random events, such as stock price movements, and make investment decisions based on these false patterns. Also harmful, says Nofsinger, are the shortcuts people make to reduce complexity. "For example, we assume things sharing similar qualities are quite alike," he says. "You may put too much faith in familiar stocks."

To avoid these tendencies, you need to recognize them and understand the impact they can have on your decisions. Nofsinger proposes several strategies.

Know why you're investing. Many people have only vague notions of their investment goals, such as "I want a lot of money so I can travel abroad when I retire," or "I don't want to be poor when I retire." Says Nofsinger: "These do little to give you direction. Nor do they help you avoid psychological biases that inhibit good decision-making. So be specific." Examine your progress toward your specific goals during annual portfolio reviews.

Establish quantitative investment criteria. These can help you avoid basing decisions on emotion, rumor or other psychological biases. Instead, your investments should measure up in terms of price-to-earnings ratios, sales growth and other quantifiable benchmarks.

Control your investing environment. "Limit activities that magnify your biases," suggests Nofsinger. That may mean avoiding Internet chat rooms and message boards, checking your investments just once a quarter rather than minute to minute, and relying on a professional financial adviser to help make objective decisions.

December 3 - December 9, 2004 issue

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