

Be a Better Investor

Outsmart your emotions, cut your fees, keep it simple -- and reap higher returns.

By Bob Frick

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Damn, it happened again. Ten years after the internet bubble ballooned, then burst, we're left to pick up our shattered portfolios from another cycle of hope, anxiety and regret. To make matters worse, our own actions added insult to the injury inflicted by the catastrophic bear market that ended last March.

By buying high and selling low, mutual fund investors, for instance, lost \$42 billion more than they should have during the 12-month period that ended last May, estimates *The Hulbert Financial Digest*. (In a similar vein, columnist [Russel Kinnel tells us](#) that the typical investor earns far less than funds' reported returns.)

How could this have happened? The simple answer is that emotion, not logic, usually rules our investing habits. In many ways we're predisposed not just to buy high and sell low, but to cling to losing investments we should sell, ignore threats to our wealth and follow the investing herd off a cliff again and again.

These tendencies are now well documented in the burgeoning fields of investor psychology and behavioral finance. Scholars in both disciplines are arriving at a new understanding of how humans make decisions. For instance, in the bestseller *Nudge: Improving Decisions About Health, Wealth and Happiness*, authors Richard Thaler and Cass Sunstein say long-held assumptions that people "think like Albert Einstein, store as much memory as IBM's Big Blue and exercise the willpower of Mahatma Gandhi" are falling by the wayside. To help people, including investors, make better choices, we have to understand and embrace our emotions and predilections, say the authors, and figure out how to avoid becoming our own worst enemy.

Teachable moments

But just recognizing our mental kinks won't help us undo them, experts say. "I don't believe it's possible to change behavior that's really hard-wired into our biology," says Andrew Lo, director of the Massachusetts Institute of Technology Laboratory for Financial Engineering. But "Homo sapiens can do what we've always done: adapt. We don't have wings, but we can fly. So we develop tools to protect ourselves from these emotional shortcomings."

The silver lining to the recent bear market is that painful experiences remain in our memories for a long time and provide lessons for the future. So let's review the past few years through the eyes of experts in investor psychology and behavioral finance, studying events not as a financial roller coaster, but rather as an emotional one.

Humans are wired to organize facts around **stories**. The Internet bubble was fueled by a fable that the Web would lead to an unending explosion of commerce. The explosion in real estate speculation that began in the early 2000s was firmly built on the same kind of fiction. Stories of people getting rich as property prices rose year after year "replicated

and spread like thought viruses," says Robert Shiller, the Yale economist who warned of the Internet and real estate bubbles in different editions of his book *Irrational Exuberance*. Such tales instill confidence in people and inspire them to move fast to get rich themselves.

These stories proliferate even when they fly in the face of facts. That's because we tend to look only for facts that support our story, something called **confirmation bias**. So, for instance, real estate prices in Las Vegas and Phoenix rose at double-digit rates, as if land in those Sun Belt cities was a scarce commodity. The desire to cash in on the property boom ignored "obvious facts," says Thaler, such as a virtually "infinite supply of land" that facilitated an abundant supply of homes.

So think back to 2006. Real estate is on fire, the stock market is doing pretty well, and both investments look like sure bets. That's about the time the dangerous psychological juju started kicking in. Greg Davies, head of behavioral finance for Barclays Wealth, the London-based financial-services giant, says investors fell victim to the **recency effect** and began to lose their sense of caution because they'd known nothing but gains for several years.

As a result of the recency effect, says Davies, "what's most recent in our minds stands out." For instance, "if investments have been going up for a while, I start seeing them as less risky. I start thinking, Well, my budget for risky investments isn't full -- I can put more in there."

Buying stimuli

As investors pile in and the markets continue to rise, herd behavior and regret drive our actions. One consequence of herd behavior is that it makes us think something is safe because it seems safe if everyone is doing it. And regret causes those who can't stand being left out to jump in.

Then, as our portfolios swell, we start to feel a collective buzz courtesy of dopamine, a feel-good chemical that the brain produces at the mere thought of making money (or driving a sports car or having sex). The more dopamine produced, the more decision-making is kicked to the primitive, emotional parts of our brain, making it harder for us to think logically. As the reward system gets excited, the fear centers in the brain are deactivated, says Richard Peterson, a psychiatrist who runs a hedge fund that aims to make money by taking advantage of investors' overreactions. "We're no longer able to observe the threats," says Peterson. "We observe only what we want to."

Now recall the mood in September 2008. The real estate sector is crumbling, and the stock market has been slipping for nearly a year. Uncle Sam has taken over Fannie Mae and Freddie Mac, and Bear Stearns and Lehman Brothers have failed. Investors, who couldn't wait to check their account balances when the market was rising, monitor them much less frequently now. They are suffering from the **ostrich effect**, a term coined by George Loewenstein, a professor of economics and psychology at Carnegie Mellon University.

Many investors who know intellectually that they're overloaded in stocks can't pull back, even if they're suffering steep losses. The reason is something called the disposition effect. On some level we feel that if we don't actually *sell* a stock that's underwater, we're not actually realizing the loss and the pain that goes with it.

Then, from mid September to mid October, the sum of our suppressed financial fears came to fruition. Stocks tumbled 30%. Do you remember that as an especially painful period? If you do, you're not imagining that pain. When we lose money, our brain reacts in the same way that it processes physical pain. Losing money hurts.

For many people, plunging portfolio values became too much to bear, and they just wanted the pain to end. So they sold. According to the Investment Company Institute, the greatest net monthly outflow from stock funds in the past two years -- \$25 billion -- came in February 2009. The timing couldn't have been much worse for those who sold then. As it

turned out, stocks bottomed on March 9 and surged about 50% over the ensuing six months.

As stocks have recovered, our emotions have begun to heal. Lo, the MIT professor, thinks most investors have already dealt with three of the five stages of grief-the denial, anger and bargaining phases-and are now working through the last two: depression and acceptance.

Now is a perfect time, while the trauma is still fresh in our minds, to figure out how to prevent similar mistakes in the future. Unfortunately, says Peterson, the psychiatrist and hedge-fund manager, the bear market was so painful that many investors don't want to think about it. As a result, he says, "five years from now they'll make the same mistakes."

So, if you recognize yourself in some of the actions (or lack thereof) we've just described, now's the time to take steps to make sure you don't suffer the same mental miscues in the future. You may not be able to change your behavior in trying times, but you can change your investing strategy to neutralize negative impulses.

One bold idea: If you handle your own investments and you find that emotions are tripping you up, hire an adviser. A good adviser should help you avoid those impulses-which typically stem from short-term fluctuations in the value of your investments-and keep you focused on meeting long-term goals. The extra cost could be worth the money.

You can also use a psychological quirk, called **mental accounting**, to your advantage. Mental accounting holds that even though a dollar is a dollar, we often mentally separate our wealth into different accounts. Consider opening a separate account to house your "safe" money-cash-type investments and other low-risk stuff that should hold up even during a stock-market crash. The size of your safe account depends on your risk tolerance and other factors. But while the pain of the bear market is fresh in your mind, determine how much of a cushion you need so that another 40% drop in the rest of your investments won't lead to poorly conceived actions that are driven by panic.

You may also want to tone down the risk in your other accounts as an antidote for increasing volatility in all sorts of markets. A more stable portfolio will leave you calmer and better able to make decisions based on logic rather than emotion.

Beware of merely mixing stocks and bonds, which Lo says creates "diversification deficit disorder." You need other assets, such as real estate, commodities and other alternative investments. For instance, even if you're not rich enough to buy into a hedge fund, you could buy a mutual fund that serves the same purpose. One of our favorite hedge fund-like mutual funds is **Hussman Strategic Growth** (symbol [HSGFX](#)). From its inception in July 2000 through September 4, it returned 8.7% annualized, beating Standard & Poor's 500-stock index by an average of 11 percentage points per year.

One of the best vaccines against emotional decision-making is the tried-and-true technique of dollar-cost averaging. By investing a fixed amount of money on a regular basis-the practice of just about anyone who participates in a 401(k) or similar retirement plan-you're conceding that you can't time the market. You avoid the temptation to buy high, or to pull out precipitously if the market sours. Plus, you'll continue to invest when markets decline, so -- *voilà* -- you're buying low. Who knew that controlling emotions could be so easy?

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