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FINANCES

Are You Your Own Worst Investing Enemy?

by David Blanchett

June 13, 2008

Theodore Roosevelt, the twenty-sixth President of the United States, once said, “The only man who makes no mistakes is the man who never does anything. Do not be afraid to make mistakes providing you do not make the same one twice.” Winston Churchill had a similar take on mistakes, saying “All men make mistakes, but only wise men learn from their mistakes.” Young children often learn things through trial and error. For example, the concept of a hot pan is often difficult to explain to a child… that is until one tries to pick one up and the concept of “extremely hot” becomes far easier to understand.

Unlike children, though, we adults often are not as willing to recognize errors when we’ve made them. This is especially true when it comes to investing. In fact, a field known as behavioral finance has been created to study the investing mistakes we humans make. Behavioral finance combines behavioral and cognitive psychological theory with conventional economics and finance in order to provide explanations for why people make irrational financial decisions. Traditional economics is based on the rational man theory (homo economicus), which contends that each of us only acts in a rational manner in order to maximize our utility (or happiness). However, humans do not always act rationally, and these irrational decisions can be very expensive.

Noted behavioral finance researchers Barber and Odean have observed that, “Behavioral finance relaxes the traditional assumptions of financial economics by incorporating these observable, systematic, and very human departures from rationality into standard models of financial markets.”

Here are some of the more common mistakes people make from a behavioral finance perspective:

Framing: The way a problem or decision is presented can have a tremendous impact on the decision maker. For example, research has shown that participation among employees in a company-sponsored 401(k) plan changes based on how the decision is framed. Plans that automatically enroll employees in the 401(k) plan (where employees must elect out by filling out a form) tend to have higher participation rates than those where employees must elect to join the plan. The outcome of either action is the same (either being in the plan or not) but the way the decision is framed (either you’re automatically in the plan or you have to elect to join the plan) impacts the likelihood of participating in the 401(k) plan.

Hyperbolic discounting: Refers to the empirical finding that people do not use a consistent discounting rate when presented with a variety of payoffs. For example, people generally prefer smaller, sooner payoffs opposed to larger, later payoffs when the smaller payoffs are imminent; but when the same payoffs are distant in time, people tend to prefer the larger, even though the time lag from the smaller to the larger would be the same as before. Viewed differently, if offered $70 now or $100 a year from now, many people will choose the immediate payoff of $70. However, given the choice between $70 in five years or $100 in six years even those who selected the original $70 would now likely select the $100, even though that is the same choice seen at five years' greater distance.

Herd behavior: Describes how individuals in a group can act together without planned direction. Large stock market trends often begin and end with periods of frenzied buying (bubbles) or frantic selling (crashes). Many observers cite these episodes as clear examples of herding behavior that is irrational and driven by the emotions of greed in the bubbles and fear in the crashes. Individual investors join the crowd of others in a rush to get in or out of the market. Just because everyone else is buying or selling doesn't make it the right thing to do. This investing mistake reminds the leader of common parenting cliché, "if all the other kids were going to jump off a bridge would you?" Just because everyone is buying in the stock market doesn't mean it's a good time to invest, in fact the opposite may be true.

Snake Bite Effect: Where an investor has had a bad experience with an investment that leads to becoming overly conservative in investment decisions going forward, negatively impacting the return potential. Investing in the stock market is a risky endeavor, especially when viewed over short periods (weeks) versus longer periods (years). If an investor exits the market during a bear market, or after they've seen their account drop significantly, they are essentially exiting near the bottom of the market, eliminating the possibility of capturing gains when the market finally recovers. Those investors who tend to exit the market during a bear market often reenter after prolonged periods of good performance. This is essentially buying high (after the markets have done well) after they've already sold low, which is not a good investing behavior.

House Money Effect: The premise that people are more willing to take risks with money they obtained easily or unexpectedly. When people have gained a profit, they segregate that profit and feel that the profit is "house money" and not their money, when in fact, it is their money. People will take more risk with "house money" than their own money. For example, an investor who has done very well investing may feel more inclined to take more risk with the gains than the original investment. This was common during the Tech bubble in the late 1990s when many investors saw their accounts double or triple and ended up taking more risk than they should have, only to give back most or all of their gains in the following bear market.

Anchoring: During normal decision making, individuals anchor their decisions, or overly rely on specific information or a specific value, and then adjust to that value to account for other elements of the circumstance. Usually once the "anchor" is set, there is a bias toward that value. For example, investors who purchase individual securities will often use the original purchase price as an "anchor" when determining whether or not to sell the security. Despite the fact that new information may become available that substantially affects the value the security, it is the initial purchase price that continues to drive the buy or sell decisions of the investor.

James Joyce once described mistakes as "portals of discovery." While most of us would prefer to avoid making mistakes, as humans we're entitled to our fair share. The key, though, is learning from your mistakes, and learning how not to repeat them again in the future.

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