ADVISOR PERSPECTIVES

Behavioral Finance Traps En Route to Investment Success

By Dan Richards*
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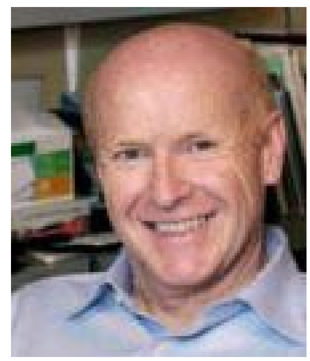

Recently, a money manager told me his investing motto comes from the words of Polish composer Frederic Chopin:

"*Simplicity is the final achievement. After one has played a vast quantity of notes and more notes, it is simplicity that emerges as the crowning achievement."*

It's easy to make investing complicated. By contrast, Warren Buffett has said that all it takes to invest successfully is having a sound plan and sticking to it – and it's the "sticking to it" part that investors struggle with the most.

To understand why investors fail to stick to their plans, economists and academics are studying the rapidly growing field of "behavioral finance," analyzing the patterns of behavior that cost investors serious money. In fact, an entire branch of economics has sprung up around this issue. Israeli psychologist Daniel Kahneman was awarded the 2002 Nobel Prize in economics for his contributions to this movement,. (As an aside, one commentator said at the time that a psychologist winning the Nobel price in economics was akin to a history professor winning the prize in physics.)

Lisa Kramer, my colleague at the University of Toronto's Rotman School of Management, has written extensively on this topic. She's now doing research at Stanford University while on sabbatical, and she spoke with me about some costly behaviors that can trap your clients.

Overconfidence

When it comes to long-term investing success, perhaps the biggest problem stems from overconfidence in our investing knowledge and ability. This isn't true just of investing – overestimating ability can be costly in many aspects of our lives.

Ask an audience if their driving ability is above or below average – typically 95% will say they're in the top 50%. As a result, people believe that talking on a cell phone or texting while driving might be dangerous for others, but their outstanding driving skills mean they can get away with this.

Research by Terrance Odean and Brad Barber of the University of California shows a natural tendency to overestimate our investment knowledge as well – particularly among men. And just as overconfidence leads to car crashes, it causes investor portfolios to go on the rocks.

Many do-it-yourself investors believe that by nimbly jumping in and out of stocks, they can beat the market. Odean and Barber dug deep into the records of heavy traders at a discount brokerage firm. They discovered there's an inverse correlation between the amount of trading and investor returns – the more trading you do, the lower your chances of success. And even if investors do show a paper profit, commission costs often turns that into a loss.

Their conclusion: "Excessive trading is dangerous to your wealth."

Along the same lines, it's not uncommon to see corporate executives with the bulk of their net worth in the shares of their company and other companies in their industry. They believe their unique vantage point and industry knowledge give them an advantage – to the point that their firm or the whole industry go off a cliff.

Herding

A second trap is "herding," also known as the "lemming effect."

It's hard to stand on the sidelines while everyone around us is making money – or conversely to be in the market losing money while people we talk to are safely on the sidelines.

Classic examples of this include the housing market at its frothy peak and the internet bubble in late 1999 and early 2000. We all hate to miss out – among Warren Buffett's claims to fame was his stolid resistance to investing in tech stocks during their mania.

It can be incredibly hard to avoid being sucked into investment fads that everyone you talk to seems to be profiting from. At the height of the internet frenzy, I interviewed one investor whose advisor had kept him out of the tech darlings. I vividly recall his words: "It's like there's this unbelievable party next door. There's music, dancing, great food, everyone's having a fantastic time – and I'm in my kitchen eating a salad."

It can be equally difficult for clients to hang in during markets such as we've seen of late. "The buy part is easy" says Lisa Kramer. "It's the hold part in tough markets that's the challenge."

Anchoring and regret

There are many other behavioral traps that cost us money.

Anchoring makes clients fixate on the price we paid, regardless of whether that price is still relevant. Some have a tendency to latch on to what they paid or what something was worth at its peak, even after the world has changed; some investors held internet highfliers like Nortel and Webvan all the way down, waiting for them to return to their purchase price.

And this isn't just true of investments – early in the housing decline, think about people clinging to houses whose prices dropped saying "I'm going to wait for my house to get back to what it was worth and then sell."

Another issue is *regret.* Research shows that investors experience more pain when they lose money than satisfaction when they make it; that's one of the drivers of risk aversion.

"That's why people hang on to investments that are underwater, avoiding the pain of selling them" says Kramer. "When they do finally sell, they often do it all at once to get it over with. On the other hand, research shows a tendency to sell winners over time, to savor the sense of accomplishment."

Perhaps the best insight into the behavioral finance traps that cost clients money comes from cartoonist Walt Kelly's famous line from the cartoon strip Pogo: "We have seen the enemy and he is us."

The good news is that awareness is the first step to overcoming these dangerous traps. Help clients understand the behaviors that undermine investment success and you and they will be better positioned to avoid them going forward.

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