

The Psychology of Investing*

(What drives our personal investment decision process?)

"We have met the enemy and it is us."**

Q. How can one be rational in an irrational world?

A. Know thyself . . . Above all else to thine own self be true.

We are who we are. As investors our decisions are controlled by simplistic, heuristic-driven biases:

- We ignore the "base rate" or normal pattern of experience. (Even though we know the odds are against us, and the potential pain of loss or risk overpowers the pleasure of gain, we gamble at casinos).
- We believe in "hot hands" and winning streaks and believe that recent events matter, even if flipping coins. (Reversion to the mean)
- We are impressed by short-term success, as in mutual fund performance. (Recency)
- We are "confirmation-biased," looking for and overweighting the significance of data that support our initial impressions. (Personal data-mining)
- We allow ourselves to use the initial idea or fact as a reference point for future decisions, even when we know it is "just a number." (Anchoring)
- We distort our perceptions of our decisions - almost always in our favor - so that we believe we are better than we really are at making decisions. And we don't learn--we stay *overconfident*. (Do we know what we don't know?)
- We confuse familiarity with knowledge and understanding. (Media-fed "intelligence")
- We overreact to good news - and to bad news. (Information without context)

We think we know more relative to others than we really do. (We also think we are "above average" as car drivers, in evaluating other people, as parents, and as investors.)

As human beings we are endowed with certain inalienable characteristics of mind and behavior that compel us to make imperfect decisions - even dreadfully serious mistakes - as investors. For example, we are:

- *Impatient* . . . If your investments went up 10% per year, that would be less than 1% a month. On a daily basis, that rate of change would be anything but "interesting," but you would double your investment every 7 years! (Test yourself: How often do you check the prices of your stocks or funds in your retirement accounts? If you check more than once

a quarter, you are curious more than you need to be for useful price information.) During times of adversity, we suffer from “activity bias,” the need to do something in an extreme situation, the tendency to abandon thoughtful and established disciplines.

- *Optimistic* . . . Being hopeful is almost always helpful, but in investing it's much better to be objective and realistic.
- *Proud* . . . Over and over again studies show that we substantially overestimate our own investment performance relative to the market. Do you understand how to calculate your investment return? And we don't like to recognize and acknowledge our mistakes, even to ourselves.***
- *Impressionable* . . . Hounded continually by media “expert” talking heads and print-generated “accepted wisdom,” our investment decisions are dominated by short-term concerns, generally crowding out longer-term, more rational strategies.
- *Emotional* . . . We smile when our stocks go up and frown or kick the cat when our stocks go down. And our feelings get stronger and stronger the more - and the faster - the prices of stocks rise or fall. There is an addictive, seemingly toxic linkage in the brain to continuing the pleasure of a rising market and a resistance to managing pleasurable behavioral patterns which would require a break-out of the cycle of dependency.

Our internal demons and enemies are pride, hubris, fear, greed, exuberance, anxiety, hope, and sometimes, if we lack the confidence to act, inertia.

References:

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Ellis, Charles D. and Burton G. Malkiel The Elements of Investing. Hoboken: John Wiley & Sons, Inc., 2010.

Goldie, Daniel C., CFP and Gordon S. Murray. The Investment Answer. Hachette Book Group, Inc., 2011.

Mackay, Charles. Extraordinary Popular Delusions and the Madness of Crowds. Andrew Tobias ed. New York: Three Rivers Press, 1980.

Notes:

*Ellis, Charles D. Winning the Loser's Game: Timeless Strategies for Successful Investing. New York: McGraw Hill, 2002 and 2010.

**Kelly, Walt. The Best of Pogo: Pogo's Lament. Simon & Schuster, 1982.

*** We also do not understand the math underlying accurate, time-weighted investment performance calculation. Adjustment for cash flows and time of entry and exit are essential. If our investment declines by 50%, what % return must be earned to rebuild the capital to its original starting value?