

# HOW INVESTORS THINK OFTEN GETS IN THE WAY OF THEIR RESULTS

FORWARD • THINKING



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## About Nxt Funds

Wellington West Asset Management Inc., a division of Wellington West Holdings Inc., actively manages the Nxt Funds portfolios. Chief Investment Officer, Sam Pellettieri, and the team focus on employing an active-analytical investment method that combines a study of behavioural finance with strong quantitative research. [www.nxtfunds.ca](http://www.nxtfunds.ca)

*The Wall Street Journal*, September 2009

THE MISTAKES WE MAKE—AND WHY WE MAKE THEM.

HOW INVESTORS THINK OFTEN GETS IN THE WAY OF THEIR RESULTS.

MEIR STATMAN LOOKS INTO OUR HEADS AND TELLS US WHAT WE'RE DOING WRONG.

By Meir Statman

## What was I thinking?

If there's one question that investors have asked themselves over the past year and a half, it's that one. If only I had acted differently, they say. If only, if only, if only.


Yet here's the problem: While we know that we made investment mistakes, and vow not to repeat them, most people have only the vaguest sense of what those mistakes were, or, more important, why they made them. Why did we think and feel and behave as we did? Why did we act in a way that today, in hindsight, seems so obviously stupid? Only by understanding the answer to these questions can we begin to improve our financial future.

This is where behavioral finance comes in. Most investors are intelligent people, neither irrational nor insane. But

behavioral finance tells us we are also normal, with brains that are often full and emotions that are often overflowing. And that means we are normal smart at times, and normal stupid at others.

The trick, therefore, is to learn to increase our ratio of smart behavior to stupid. And since we cannot (thank goodness) turn ourselves into computer-like people, we need to find tools to help us act smart even when our thinking and feelings tempt us to be stupid.

Let me give you one example. Investors tend to think about each stock we purchase in a vacuum, distinct from other stocks in our portfolio. We are happy to realize "paper" gains in each stock quickly, but procrastinate when it comes to realizing losses. Why? Because while



regret over a paper loss stings, we can console ourselves in the hope that, in time, the stock will roar back into a gain. By contrast, all hope would be extinguished if we sold the stock and realized our loss. We would feel the searing pain of regret. So we do pretty much anything to avoid that pain—including holding on to the stock long after we should have sold it. Indeed, I've recently encountered an investor who procrastinated in realizing his losses on WorldCom stock until a letter from his broker informed him that the stock was worthless.

Successful professional traders are subject to the same emotions as the rest of us. But they counter it in two ways. First, they know their weakness, placing them on guard against it. Second, they establish "sell disciplines" that force them to realize losses even when they know that the pain of regret is sure to follow.

So in what other ways do our misguided thoughts and feelings get in the way of successful investing—not to mention increasing our stress levels? And what are the lessons we should learn, once we recognize those cognitive and emotional errors? Here are eight of them.

### **No. 1: Goldman Sachs is faster than you.**

There is an old story about two hikers who encounter a tiger. One says: There is no point in running because the tiger is faster than either of us. The other says: It is not about whether the tiger is faster than either of us. It is about whether I'm faster than you. And with that he runs away. The speed of the Goldman Sachs of the world has been boosted most recently by computerized high-frequency trading. Can you really outrun them?

It is normal for us, the individual investors, to frame the market race as a race against the market. We hope to win by buying and selling investments at the right time. That doesn't seem so hard. But we are much too slow in our race with the Goldman Sachs.

So what does this mean in practical terms? The most obvious lesson is that individual investors should never enter a race against faster runners by trading frequently on every little bit of news (or rumors).

Instead, simply buy and hold a diversified portfolio. Banal? Yes. Obvious? Yes. Typically followed? Sadly, no. Too often cognitive errors and emotions get in our way.

### **No. 2: The future is not the past, and hindsight is not foresight.**

Wasn't it obvious in 2007 that financial institutions and financial markets were about to collapse? Well, it was not obvious to me, and it was probably not obvious to you, either. Hindsight error leads us to think that we could have seen in foresight what we see only in hindsight. And it makes us overconfident in our certainty about what's going to happen.

Want to check the quality of your foresight? Write down in permanent ink your forecast of tomorrow's stock prices. Do that each day for a year and check the accuracy of your predictions. You are likely to find that your foresight is not nearly as good as your hindsight.

Some prognosticators say that we are now in a new bull market and others say that this is only a bull bounce in a bear market. We will know in hindsight which prognostication was right, but we don't know it in foresight.


When I hear in my mind's ear a voice that says that the stock market is sure to zoom or plunge, I activate my "noise-canceling" device rather than go online and trade. You might wish to install this device in your mind as well.

### **No. 3: Take the pain of regret today and feel the joy of pride tomorrow.**

Emotions are useful, even when they sting. The pain of regret over stupid comments teaches presidents and the rest of us to calibrate our words more carefully. But sometimes emotions mislead us into stupid behavior. We feel the pain of regret when we find, in hindsight, that our portfolios would have been overflowing if only we had sold all the stocks in 2007. The pain of regret is especially searing when we bear responsibility for the decision not to sell our stocks in 2007. We are tempted to alleviate our pain by shifting responsibility to our financial advisers. "I am not stupid," we say. "My financial adviser is stupid." Financial advisers are sorely tempted to reciprocate, as the adviser in the cartoon who says: "If we're being honest, it was your decision to follow my recommendation that cost you money."

In truth, responsibility belongs to bad luck. Follow your mother's good advice, "Don't cry over spilled milk."

Where am I leading you? Stop focusing on blame and regret and yesterday and start thinking about today and



tomorrow. Don't let regret lead you to hold on to stocks you should be selling. Instead, consider getting rid of your 2007 losing stocks and using the money immediately to buy similar stocks. You'll feel the pain of regret today. But you'll feel the joy of pride next April when the realized losses turn into tax deductions.

#### **No. 4: Investment success stories are as misleading as lottery success stories.**

Have you ever seen a lottery commercial showing a man muttering "lost again" as he tears his ticket in disgust? Of course not. What you see instead are smiling winners holding giant checks.

Lottery promoters tilt the scales by making the handful of winners available to our memory while obscuring the many millions of losers. Then, once we have settled on a belief, such as "I'm going to win the lottery," we tend to look for evidence that confirms our belief rather than evidence that might refute it. So we figure our favorite lottery number is due for a win because it has not won in years. Or we try to divine—through dreams, horoscopes, fortune cookies—the next winning numbers. But we neglect to note evidence that hardly anybody ever wins the lottery, and that lottery numbers can go for decades without winning. This is the work of the "confirmation" error.

What is true for lottery tickets is true for investments as well. Investment companies tilt the scales by touting how well they have done over a pre-selected period. Then, confirmation error misleads us into focusing on investments that have done well in 2008.

Lottery players who overcome the confirmation error conclude that winning lottery numbers are random. Investors who overcome the confirmation error conclude that winning investments are almost as random. Don't chase last year's investment winners. Your ability to predict next year's investment winner is no better than your ability to predict next week's lottery winner. A diversified portfolio of many investments might make you a loser during a year or even a decade, but a concentrated portfolio of few investments might ruin you forever.

#### **No. 5: Neither fear nor exuberance are good investment guides.**

A Gallup Poll asked: "Do you think that now is a good time to invest in the financial markets?" February 2000 was a time of exuberance, and 78% of investors agreed

that "now is a good time to invest." It turned out to be a bad time to invest. March 2003 was a time of fear, and only 41% agreed that "now is a good time to invest." It turned out to be a good time to invest. I would guess that few investors thought that March 2009, another time of great fear, was a good time to invest. So far, so wrong. It is good to learn the lesson of fear and exuberance, and use reason to resist their pull.

#### **No. 6: Wealth makes us happy, but wealth increases make us even happier.**

John found out today that his wealth fell from \$5 million to \$3 million. Jane found out that her wealth increased from \$1 million to \$2 million. John has more wealth than Jane, but Jane is likely to be happier. This simple insight underlies Prospect Theory, developed by Daniel Kahneman and Amos Tversky. Happiness from wealth comes from gains of wealth more than it comes from levels of wealth. While gains of wealth bring happiness, losses of wealth bring misery. This is misery we feel today, whether our wealth declined from \$5 million to \$3 million or from \$50,000 to \$30,000.

We'll have to wait a while before we recoup our recent investment losses, but we can recoup our loss of happiness much faster, simply by framing things differently. John thinks he's a loser now that he has only \$3 million of his original \$5 million. But John is likely a winner if he compares his \$3 million to the mountain of debt he had when he left college. And he is a winner if he compares himself to his poor neighbor, the one with only \$2 million.

In other words, it's all relative, and it doesn't hurt to keep that in mind, for the sake of your mental well-being. Standing next to people who have lost more than you and counting your blessings would not add a penny to your portfolio, but it would remind you that you are not a loser.

#### **No. 7: I've only lost my children's inheritance.**

Another lesson here in happiness. Mental accounting—the adding and subtracting you do in your head about your gains and losses—is a cognitive operation that regularly misleads us. But you can also use your mental accounting in a way that steers you right.

Say your portfolio is down 30% from its 2007 high, even after the recent stock-market bounce. You feel like a loser. But money is worth nothing when it is not attached to a

goal, whether buying a new TV, funding retirement, or leaving an inheritance to your children or favorite charity.

A stock-market crash is akin to an automobile crash. We check ourselves. Is anyone bleeding? Can we drive the car to a garage, or do we need a tow truck? We must check ourselves after a market crash as well. Suppose that you divide your portfolio into mental accounts: one for your retirement income, one for college education of your grandchildren, and one for bequests to your children. Now you can see that the terrible market has wrecked your bequest mental account and dented your education mental account, but left your retirement mental account without a scratch. You still have all the money you need for food and shelter, and you even have the money for a trip around the country in a new RV. You might want to affix to it a new version of the old bumper sticker: "I've only lost my children's inheritance."

So here's my advice: Ask yourself whether the market damaged your retirement prospects or only deflated your ego. If the market has damaged your retirement prospects, then you'll have to save more, spend less or retire later. But don't worry about your ego. In time it will inflate to its former size.

### **No. 8: Dollar-cost averaging is not rational, but it is pretty smart.**

Suppose that you were wise or lucky enough to sell all your stocks at the top of the market in October 2007.

Now what? Today it seems so clear that you should not have missed the opportunity to get back into the market in mid-March, but you missed that opportunity. Hindsight messes with your mind and regret adds its sting. Perhaps you should get back in. But what if the market falls below its March lows as soon as you get back in? Won't the sting of regret be even more painful?

Dollar-cost averaging is a good way to reduce regret—and make your head clearer for smart investing. Say you have \$100,000 that you want to put back into stocks. Divide it into 10 pieces of \$10,000 each and invest each on the first Monday of each of the next 10 months. You'll minimize regret. If the stock market declined as soon as you have invested the first \$10,000 you'll take comfort in the \$90,000 you have not invested yet. If the market increases you'll take comfort in the \$10,000 you have invested. Moreover, the strict "first Monday" rule removes responsibility, mitigating further the pain of regret. You did not make the decision to invest \$10,000 in the sixth month, just before the big crash. You only followed a rule. The money is lost, but your mind is almost intact.

Things could be a lot worse.



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