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Behavioral Finance and You: Portfolio Management Lessons

GREG FORSYTHE, CFA, senior vice president, Schwab Equity Ratings,® discusses how behavioral finance can help you become a better investor.

We are often our own worst enemies when it comes to investing. The emotions of fear and greed can easily cloud our judgment. Biases in how we process information can lead to sub-optimal decisions. In recent years the psychology of investing has become better understood through the emergence of a fascinating new field called behavioral finance.

Fortunately, understanding how psychology can influence investment decisions is half the battle in preventing judgment errors. This issue, we're going to draw lessons from behavioral finance to help you be a better portfolio manager.

Portfolio management is basically a three-step process:

1. Articulate your investment goals and risk tolerance.
2. Construct a portfolio of assets consistent with your objectives.
3. Monitor and adjust the portfolio as prices (and objectives) evolve through time.

Sounds simple, but behavioral finance experts have categorized several types of common mistakes that can distort decisions and harm portfolio results.

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Overconfidence

Investors tend to be overconfident in their ability to make decisions in an uncertain world. We often set unrealistic investment goals. For example, most investors believe their portfolios will perform better than market averages—a statistical impossibility since the market is the average of all investors. This is sometimes referred to as the "**Lake Wobegon Effect**," or the tendency to overestimate one's achievements and capabilities in relation to others.

Another example of overconfidence, known as **myopic loss aversion**, is believing a portfolio can be managed to avoid annual losses in any market environment. Historically, no fixed blend of investable assets has provided short-term security while delivering after-tax returns above inflation. Other investors think they can avoid losses through tactical asset allocation, despite the overwhelming evidence that market timers are more likely to buy high and sell low.

Overconfidence is also demonstrated by investors' difficulty in distinguishing between luck and skill. The tendency to remember our good decisions and forget our bad ones, also known as **hindsight bias**, affects all of us. We also tend to believe that if our last

decision or two was correct, then we possess special market-beating capabilities. Market history is full of strategists and portfolio managers labeled as geniuses after one good market call or a few years of beating the market that have been unable to sustain their superior performance in the long run.

Mental accounting

The term **mental accounting** is used to label another category of behavioral finance mistakes: the tendency to compartmentalize money into buckets rather than treating assets as an integrated whole. For example, investors often manage their retirement accounts more conservatively than their other accounts. They often have large, low yielding cash balances in their bank or brokerage accounts while simultaneously paying high, non-deductible interest rates on auto loans or credit card balances. Also, investors sometimes manage money they have saved from their paychecks completely differently from money perceived as coming from a windfall such as a tax return, bonus or inheritance.

Another potentially harmful mental accounting concept is known as **narrow framing**: the tendency to focus too much on a portfolio's components rather than the portfolio as a whole. When reviewing their portfolios, investors typically focus on assets that have recently performed poorly, often deciding to "fix" the problem by selling underperformers and buying more of "what's working." More often than not, investors are being fooled by random fluctuations and are falling into a pattern of selling low and buying high—forgetting that a well-diversified portfolio will always have leaders and laggards over any short-term evaluation period.

Disposition effect

Behavioral researchers have noted that investors often fixate on the price paid for an investment, and particularly dislike realizing losses. Mental **anchoring** on cost basis, coupled with loss aversion, results in a pattern called the **disposition effect**—the tendency for investors to sell winners too soon and hold losers too long. Hanging on to a losing position hoping it rebounds lets investors postpone the psychological pain of regret, but can have disastrous consequences—just ask Enron and WorldCom shareholders. Losing investments with deteriorating future prospects should be sold immediately. The general strategy of letting winners run and cutting losers short maximizes returns and minimizes capital gains taxes.

Considerations

Even experienced investors are vulnerable to making the judgment errors identified by behavioral finance researchers. The only real cure is discipline. Consider all of your assets and liabilities, regardless of their source or location, when creating or updating an investment plan. Set realistic goals for your portfolio's long-term return, put them into writing and consider following these five suggestions:

1. Recognize that your portfolio will decline from time to time, but take solace in knowing that short-term pain is required for long-term gain.
2. Rebalance your asset allocation periodically as an autopilot form of selling high and buying low.
3. Diversify widely and consider using mutual funds, or asking for expert advice.
4. Monitor your portfolio carefully, but infrequently, and ignore the short-term price fluctuations of your holdings.
5. Don't sell investments just because they dropped in price—but do sell losers with future prospects that look weak, and hang on to winners with prospects that remain solid.

I hope that following these suggestions not only helps improve your portfolio's performance, but also helps reduce stress and makes investing more fun!

QUICK TIP

>>To learn more about behavioral finance, read *Why Smart People Make Big Money Mistakes and How to Correct Them,* by Gary Belsky and Thomas Gilovich. For more depth and technical coverage on behavioral finance, read *Beyond Fear and Greed,* by Hersh Shefrin.

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