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Behavioral Finance and You: **Security Selection Lessons**

GREG FORSYTHE, CFA, senior vice president, Schwab Equity Ratings,® discusses common mistakes that can distort fund selection decisions.

In this article, we'll focus on how human psychology can adversely influence the selection of specific securities such as stocks and equity mutual funds. The challenge of deciding what and when to buy and sell stems from one source: uncertainty. There are no "sure things" in investing, which means that all investors must deal with risk while seeking returns. Unfortunately, our risk and return perceptions often trigger emotions of fear and greed that may cloud our judgment.

To raise the odds for success, investors should exercise consistent discipline for making all buy/sell decisions. Investors must develop a process to rationally gather the facts, weigh the evidence and draw a sound conclusion—and then humbly accept that they will be right 50%–60% of the time, at best. Sounds hard, and it is. But behavioral

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finance experts have categorized several types of common mistakes that can distort our security selection decisions. Recognizing and avoiding these mistakes is a significant step toward becoming a better investor.

Optimism

Any investor who seeks to outperform the stock market—whether acting independently, with guidance or through delegating to a money manager—is behaving optimistically. Why? Because few investors have been able to beat the market consistently over time. Hope is not an investment strategy. While employing an investment strategy that has been effective historically doesn't guarantee future success, utilizing an unproven strategy is likely to fail. If you don't know which security selection strategies have historically offered a market-beating edge, then stock or fund-picking on your own is unwise.

One way optimism in security selection is evidenced is by the **lottery effect**. Investors seem drawn to investments perceived as having the potential for large gains, such as biotech companies working on cancer cures or mutual funds investing in developing countries. Behavioral researchers have found that decision-makers tend to overweight the strength of information signals (i.e., return potential) and underweight

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their probability of occurrence (i.e., likelihood of success). Simply stated, investments perceived as having high return potential tend to be overvalued.

Brokerage analysts' five-year earnings per share (EPS) growth forecasts also reflect excessive optimism. Over the last 30 years, forecasted EPS growth rates have averaged about 14% annually, while actual EPS growth has averaged only about 8%. Furthermore, companies with the highest growth forecasts have been the most likely to report actual growth below estimates.

Exploiting investor optimism, security salespeople often employ analogies to entice investors. How often have you heard a hot new stock labeled as the "next Microsoft"? The **representativeness heuristic** describes our tendency to evaluate new situations by noting similarities to past situations, and then often inappropriately assuming similar appearances will lead to similar outcomes.

Long-term overreaction

Investor expectations of a company's future earnings growth tend to be highly correlated to its past growth. Yet researchers have found that historical earnings growth rates have little ability to predict future earnings growth. Nonetheless, analyst forecasts reflect excessive **extrapolation** of past growth trends and influence investors to award high (low) price-to-earning (P/E) multiples to stocks with high (low) EPS growth forecasts. Reflecting this overreaction tendency, research has shown that high P/E stocks tend to underperform as actual results fall short of optimistic forecasts, while low P/E stocks tend to outperform as actual results exceed pessimistic forecasts.

Mutual fund flows also often reflect investor overreaction. For example, technology fund inflows peaked in early 2000—right in time for investors extrapolating huge prior returns to experience the full brunt of the technology stock crash. Confirming the tendency for fund investors to buy high and sell low, dollar-weighted fund returns (which reflect when investors purchased or sold fund shares) that Morningstar® recently began publishing are almost always lower than time-weighted fund returns.

Short-term underreaction

While investors often overreact to long-term trends, they tend to underreact to new information—especially if it runs counter to existing beliefs. For example, research has shown that companies reporting positive (negative) earnings surprises one quarter are likely to report further positive (negative) earnings surprises in subsequent quarters. This indicates that EPS forecasts don't fully incorporate the information contained in prior earnings reports. Brokerage analysts appear to follow an **anchoring-and-adjustment** process of making only incremental directional revisions to their earnings forecasts in reaction to recent news. Analyst underreaction reflects both **status quo bias**—the tendency for people to prefer things to stay the same—and **confirmation bias**—the tendency to interpret information in a way that confirms one's preconceptions. The fact that stocks and mutual funds tend to display price momentum (i.e., recent past winners and losers tend to repeat in the immediate future) is further evidence of pervasive investor underreaction effects.

Considerations

Behavioral finance research suggests you can often be your own worst enemy when it comes to making sound investment decisions. Here are three tips to help you make knowledgeable and disciplined decisions:

1. Be realistic about your success prospects for selecting stocks, funds, or advisors with the goal of outperforming the market.

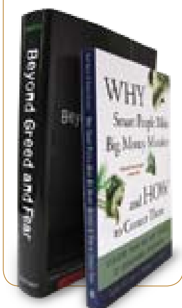
2. Avoid "story stocks" or over-hyped investment opportunities, as their future potential will tend to be more than reflected in their current prices.

3. Use a "surprise anticipation" strategy to try to get the overreaction and underreaction effects working jointly in your favor. Look for stocks where low EPS growth forecasts and P/E ratios indicate long-term pessimism, but recent positive news may get the upward forecast revision bandwagon started.

We hope these suggestions not only improve your portfolio's performance, but also help make 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 Greed and Fear*, by Hersh Shefrin.



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