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Neurofinance: Think, Don't Blink

GREG FORSYTHE, CFA, senior vice president, Schwab Equity Ratings®, explains what neurofinance can teach us about making investment decisions.

The reason people often make bad investment decisions is rooted deep inside our heads. Brain scans reveal that when we invest, we tend to use our inner, reflexive brain—which involves emotions and reactive, impulsive behavior—much more than our outer, reflective brain—which controls our thoughtful, conscious actions.

The best-selling book *Blink* touts the benefits of making intuitive decisions. But with investing, research shows that approach usually fails, as people overreact and become emotional when faced with potential financial gains or losses. In the Summer 2009 issue of *On Investing*, we highlighted ways to recognize and dampen the emotional triggers that can hamper your investment success. In this article, we'll show how you can become an even better investor by bringing your reflective brain into investment decisions.

Save first, then invest

Saving is a far more reliable way to increase your wealth than the rate of return you get on your investments. Saving $2,000 per year and investing it conservatively to earn a hypothetical 6% annual return creates the same wealth as saving $1,000 per year and investing it aggressively to (hopefully) earn a 12% annual return. Although it's possible for people to figure out ways to save more, there are limits to a diversified portfolio's potential return. See "The Benefits of Regular Saving" below.

Set a realistic investment plan

A written investment plan may be the most important tool to protect you from your reflexive, emotional brain. As you determine your investment goals and develop a strategy to attain them, the reflective mind is engaged. Talk to an advisor or use some of the tools available on **schwab.com** to make sure your goals are achievable and your investment strategy is reasonable.

Of course, no amount of reflective thinking can achieve the impossible, such as earning 20% annual returns with no down years. Unrealistic expectations are particularly dangerous, as they often trigger dysfunctional behaviors. For example, if your return goals are too high, you will be vulnerable to messages touting "home run" investments. You will likely invest too aggressively and trade too often. You may feel like there's no room for error, leading to strong feelings of regret when an investment doesn't pan out or when inaction leads to forgone profits.

Better to take a humble approach to investment planning. Avoid relying on grandiose return predictions, know what you don't know, expect the unexpected and don't beat yourself up over mistakes. These principles will help keep your reflective mind in control and your reflexive brain at bay.

Evaluate opportunities mindfully

One challenging aspect of investing is evaluating the constant flow of information without letting your reflexive brain take over. A first step is to simply ignore information that is irrelevant to your investment plan. If market timing isn't part of your strategy, ignore the pundits who tell you to get in and out of the stock market. If you rebalance your portfolio every six months, then there's no need to follow the market on television every day.

The Benefits of Regular Saving

Focusing on savings has several advantages:

- **You can control how much you save.**
- If you save more, you **may need a lower rate of return** to achieve your goals.
- By investing regularly, you can turn a down market into an **opportunity to buy more shares when prices are low**.

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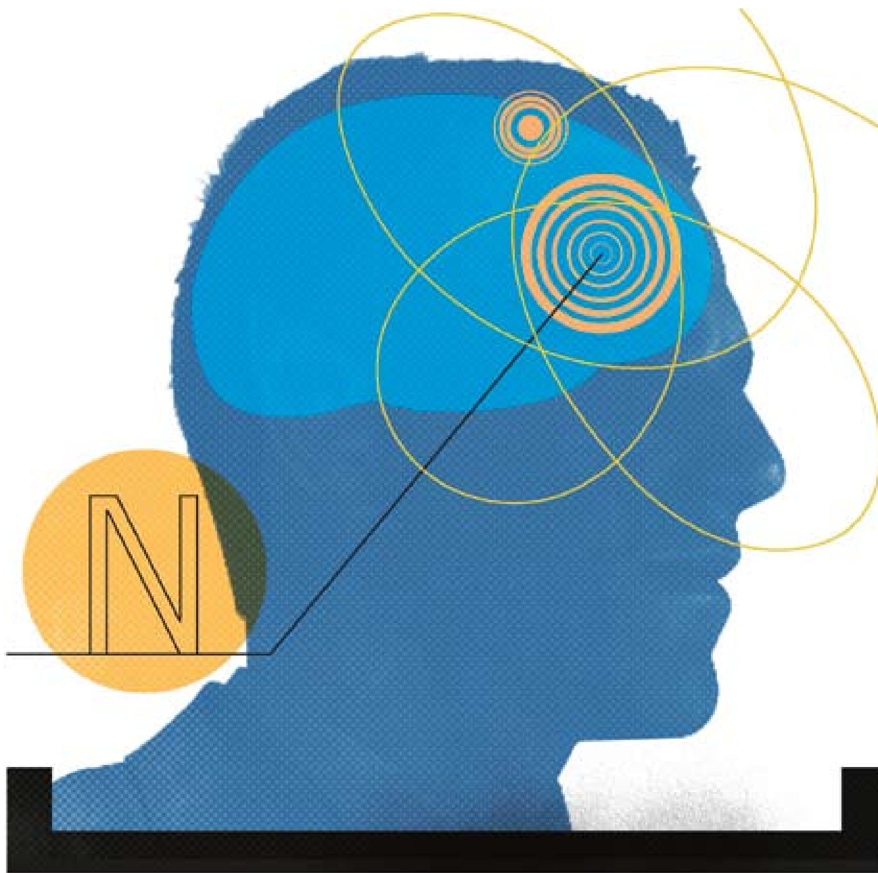

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If an interesting investment idea is presented to you, ask several "why?" questions to gain a deeper understanding of it. Before making any big decisions, wait and see if you feel the same way tomorrow. Don't be shy about seeking an independent opinion. Then if your gut tells you an investment sounds too good to be true, move on as fast as you can. (This is one time to use your intuition.)

Remember that money isn't everything

Investing can bring some degree of fulfillment, but the inherent uncertainty of capital markets prevents them from ever being a source of peace of mind. To help put money in perspective, remember that happiness comes from relationships, experiences and being part of something bigger than yourself—not from material things.

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Investment Guidelines Provide Control

Neurofinance research suggests that following sensible investment rules—developed by thoughtful research—can help you keep a sense of control when volatile markets trigger fear and greed. Here are some guidelines to consider:

Stick to your target asset allocation. Invest in a fixed mix of stocks, bonds and cash that is appropriate for your goals and risk tolerance. Rebalance back to your target allocation at set intervals.

Select securities in a disciplined manner. Establish strict buy-and-sell rules and employ them with unwavering discipline. (For example, buy stocks with Schwab Equity Ratings of A or B and sell stocks if their ratings fall to D or F.)

Check your progress. Compare your portfolio returns annually to an appropriate benchmark index to assess your investment success.

Hold yourself accountable. To help you adhere to your investment strategy and prevent you from letting yourself off the hook for undisciplined decisions, consider holding yourself accountable to your spouse or a trusted friend. Keeping a written diary of your investment decisions is a useful way to evaluate your thought processes and learn from your successes and failures.