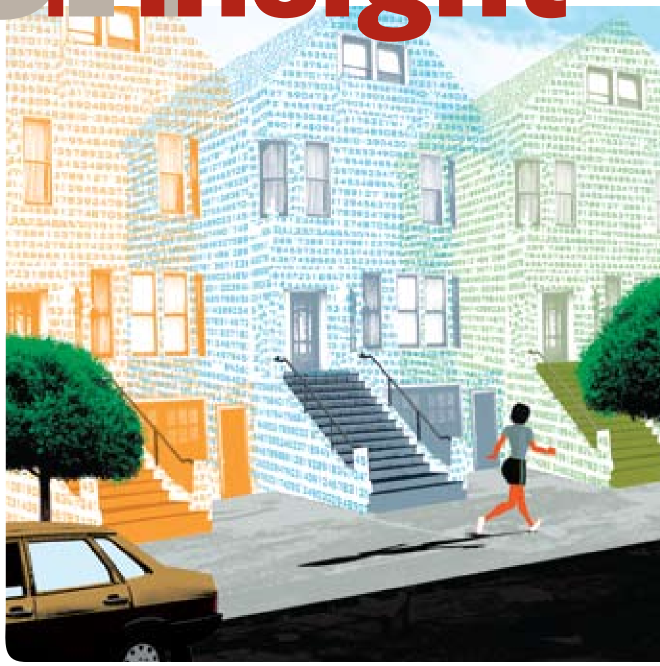
# research+insight



**A well-thought-out investment plan includes establishing goals, implementing a strategy and monitoring your portfolio.** This section offers ideas, insights, lists and tools from Schwab and third-party experts to help you create and maintain a diversified portfolio, including:

- **Financial Perspective:** Greg Forsythe provides his views on an investment-related topic.
- **Investment Insight:** John Eade of Argus Research Co. provides commentary and the latest Argus Model Portfolios.
- **Schwab's Mutual Fund OneSource® Select List:** This is a quarterly list of funds, plus analysis and commentary, from the Schwab Center for Financial Research.

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*For more information about mutual funds that participate in the Mutual Fund OneSource® Service, please refer to "Additional Important Information" on page 47.*

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FINANCIAL PERSPECTIVE

# Neurofinance: To Be a Better Investor, Tame "the Animal in You"

**GREG FORSYTHE,** CFA,
senior vice president,
Schwab Equity Ratings®

Neuroscientists have long known that humans have two different types of brain functions. The limbic system, located deep inside the brain, controls our instinctive, reactive and impulsive behavior. The prefrontal cortex, in the outer part of the brain, controls our conscious, thoughtful and methodical behavior. Recently, scientists studying the brain activity of people making economic decisions were surprised to see that the inner, reflexive brain was much more in use than the outer, reflective brain. Apparently the financial rewards and risks inherent in investment decisions often cause us to behave more like ravenous wolves or skittish deer than cerebral human beings!

### Harness your survival instincts

Our inner brains instinctively push us to seek reward, avoid risk and be alert to change—behaviors that were critical to basic survival in ancient times. Making financial decisions activates that same inner-brain circuitry. Investing engages our emotions, and we've learned that emotion-driven investment decisions are not consistently profitable. However, learning to recognize common emotional triggers can help us prevent our reflexive brains from undermining our investment success.

JOHN RITTER (TOP); KEVIN MIYAZAKI

## Be realistic

Perceptions of opportunity or risk compel human beings to act. But perceptions based on unrealistic expectations can mislead us into adopting risky strategies that promise high returns or abandoning sound long-term strategies when they lose money. To counter that tendency, we suggest looking at market history to better understand what kinds of investment returns are likely or unlikely.

For example, U.S. stocks returned about 10% annually from 1957 to 2008.[1] So you shouldn't expect 20% returns from a diversified stock portfolio. Stock market investing alone is unlikely to make you wealthy. At 10% annually, it would take more than 48 years to turn $10,000 into $1,000,000. You also shouldn't expect steady, positive yearly returns from your stock portfolio. The market is too volatile to meet those unrealistic expectations. If stocks are down 30%, your portfolio is also almost sure to be down—even if you are guided by the smartest advisor. Bearing short-term market risk is the price you pay for the opportunity to earn higher long-term returns.

Similarly, don't expect every stock you buy to go up or beat the market. Historically, only about 45% of individual stocks beat market averages in a given year (a few big winners cause the market's mean return to exceed the median stock's return). With good advice, careful research and tools such as Schwab Equity Ratings, you may be able to do better. But I've never seen any person or strategy pick stocks that outperform even 60% of the time.

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### Using the inner, reflexive brain

The limbic system, shown in blue, controls our instinctive, reactive and impulsive behavior. The prefrontal cortex, shown in gold, controls our conscious, thoughtful and methodical behavior. Scientists studying people making economic decisions observed that they use the inner, reflexive brain much more than the outer, reflective brain.

## Beware the big opportunity

Nothing triggers the reflexive brain like anticipating large gains or losses. When large payoffs seem to be at stake, greed and fear are subconsciously activated. Headlines such as "XYZ is the next Google" or "Markets plunge on depression fears" convey a sense of urgency to act now to get rich instantly or to avoid catastrophic losses. Try to avoid reacting to such sensationalistic headlines or being lured by "can't miss" investment opportunities. Large payoffs are very rare and big bets leave you vulnerable to large losses. A diversified portfolio provides the best balance of risk vs. return.

You also shouldn't expect to be able to buy in at market bottoms and sell at the top. While the payoff would be huge, short-term market timing is rarely more successful than coin flipping. Ever notice how new gurus emerge after major market moves, claiming to have called the bottom or top? Where were they before the event? Doing it once doesn't mean it can be done again.

Whenever you feel excited or fearful about an investment opportunity, pause and let your reflective brain calculate the odds of a large payoff actually occurring. Consider the credibility, track record and motives of the information source. Is the hot idea really so unique that it isn't already reflected in market prices? How much could you lose by acting or not acting? Why do you have to act right now?

### Tune out the noise

Don't expect to get much help from the mainstream financial media that encourage short-term reflexive thinking with expert predictions, real-time market updates and scrolling tickers. You worry about missing something if you don't stay tuned in, and that's what they want—to keep viewers watching. Even if you could absorb all the stimuli, there's little money to be made by acting on such public information.

Another inadvertent trigger for your reflexive brain is frequent price changes. Our brains seek order out of chaos, often tricking us into seeing patterns when they don't exist. Three positive price changes becomes an uptrend. Our brains are so alert to change that every price tick becomes a lost opportunity or a potential risk.

Studies have shown that the more we check up on our portfolios, the more we trade and the worse our returns become. Take a step back. While a stock's price may change constantly, its fair value doesn't. Concentrate on your portfolio's total value, which fluctuates much less than your individual holdings.

In the next issue of *On Investing*, we'll show how you can become a better investor by bringing the reflective brain into your investment decisions.

[1]*The S&P 500 return from 1957 to 2008.*

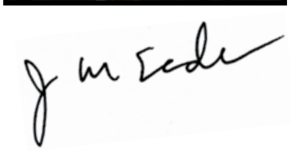
*The information provided here is for general informational purposes only and should not be considered an individualized recommendation, a personalized investment strategy or advice. Each investor needs to review an investment strategy for his or her own particular situation before making any investment decision.*

**INVESTMENT** INSIGHT

# Which Sectors Will Benefit Most

## **JOHN M. EADE**, president and director of research, Argus Research Co., talks about which areas of the economy will benefit most from the American Recovery and Reinvestment Act.

GIL VAKNIN



President Obama's $787 billion fiscal stimulus plan is designed to put people back to work. It may also offer an opportunity to put your portfolio back to work. The plan resembles an investment policy statement, which some investors adopt to help them reach their financial goals. For example:

- The time horizon for the infrastructure plan is long-term.
- The expected beneficiaries are diversified throughout the economy.
- Because not all of the money will be spent at once, a portfolio designed to take advantage of the plan may benefit from dollar-cost averaging, where funds are allocated to the market over time.

### But where should you allocate them?

The analysts at Argus Research forecast that these areas stand to benefit from the stimulus plan and recommend you include them in your portfolio:

**Basic materials.** The plan may be the single largest new investment in the nation's infrastructure—roads, dams, bridges—since construction of the Interstate System began in the