Taking the emotions out of investing

Market observers long have detected that investment decisions have an emotional component. *Behavioral finance* scholars have produced a series of studies that point out mistakes that investors tend to make in managing their portfolios. Because it is basic human psychology that is behind their actions, even experienced investors are likely to make these mistakes.

The pain of loss

Research by behavioral psychologists suggests that most individuals feel twice the pain over a financial loss as they do the pleasure of an equivalent gain. A classic 1979 study ("Prospect Theory: An Analysis of Decision Making Under Risk" by Daniel Kahneman and Amos Tversky in *Econometria*) found that people make different choices in equivalent situations, depending upon whether the choices are framed within the context of gain or of loss.

To illustrate this phenomenon, Kahneman and Tversky gave two groups a set of choices: Group 1 was told that in addition to what they owned, they had been given $1,000. They then were asked to choose between (a) a sure gain of $500 or (b) a 50% chance to gain $1,000 and a 50% chance to gain nothing. Some 84% of the group chose (a). Group 2 was told that in addition to what they owned, they had been given $2,000. They were asked to choose between (a) a sure loss of $500 or (b) a 50% chance to lose $1,000 and a 50% chance to lose nothing. Here, 69% chose (b). But the fact is that the choices that are offered to each Group are identical in terms of the net cash amounts that the individual could receive. Yet the phrasing of the questions caused the choices to be interpreted differently.

An evolutionary twist

This *loss aversion* concept was tested again recently by M. Keith Chen, assistant professor at Yale School of Organization and Management, in a study under review by the *Journal of Political Economy*. Chen and his associates gave capuchin monkeys small disks to trade for rewards—apples, grapes or gelatin cubes. Capuchins, noted the researchers, are well-suited subjects for study because they are relatively large-brained primates, skilled problem solvers and a close evolutionary neighbor to humans.

In one experiment the monkeys were asked to choose between spending a token on one visible piece of food that one-half of the time gave a return of two pieces, or two pieces of visible food that one-half of the time gave a return of only one piece. The capuchins vastly preferred the first gamble, which is essentially one-half of a chance at a bonus, than the second gamble, which is essentially one-half of a chance at a loss.

"The economic view," Chen reports, "says that people are aware, rational and in control of their major decisions. Social psychology cuts in the opposite direction, maintaining that people are often unaware of the forces that dictate their behavior. We wanted to understand the interactions of these two things. What we've shown is that capuchin monkeys look remarkably like us; making rational decisions in many of the same settings that humans get right, but also make many of the same mistakes we make."

"We are fighting tendencies [loss aversion] that may be biologically hard-wired," concludes Chen.

Common conflicts

Most people don't have the time or inclination to delve deeply into the field of behavioral finance. But they can look inward and examine how they have reacted to recent events. Here are the more common emotional reactions:

• *Failing to act or procrastinating* does allow one to avoid unpleasant thoughts, but, ultimately, it provides no solutions.

• *Hitting the panic button* can lead an investor to follow dubious advice or to chase the latest trend without any sound reason.

• *Holding on too long* to one's investments, even when it seems logical to let go, is such a common emotion that psychotherapists have given it a name—"divestiture anxiety."

• *Loss of self-esteem*, says John Jacobs, a New York psychologist with expertise in wealth issues, makes it possible for an individual's feelings of worth to "rise and fall with the Nasdaq or Dow."

Taking a rational approach to investing

If you see your own reactions in any of those described above, it's time for us to spend some time together reviewing your portfolio to turn some of the negative emotions into positive action.

1. Be clear about what you are doing. Can you easily summarize your investment strategy on paper? It's the foundation upon which your portfolio will be built. Your portfolio should reflect who you are—your goals, investing time frame and tolerance for risk. Developing and articulating your strategy will help keep you from making changes to it solely based upon how the market rises and fall.

2. Use the right tools to help you find success. *Asset allocation*—spreading your dollars among the basic investment categories, among stocks, bonds and cash equivalents—is an organized, systematic approach to building and maintaining a portfolio. Diversifying your holding within each asset class is important as well. For instance, within the equity portion of your portfolio, you may want to consider large-, mid- or small-capitalization stocks; choose a mix of stocks that yield dividends and those that are growth stocks with little likelihood of significant dividends. You may want to take a look at investing in the equities of companies outside of the U.S.

3. Be vigilant. Review your investment choices regularly and make the necessary adjustments accordingly. You may need to rebalance your portfolio, when your holdings in a particular portion of your portfolio exceed the original allocation target that you have set. Family and personal circumstances also may dictate that you review your investment strategy.

4. Don't go it alone. The daily market reports that you read or hear notwithstanding, there are opportunities to be found out there. We can help you find them. Think of us as a valuable resource for unbiased, objective financial advice. As a partner who can help you to formulate an investment strategy that incorporates both your long- and short-term goals, tailored specifically to your needs and concerns. Contact us now to find out more.