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The Irrational Investor – Why We Act That Way

The markets now seem to be heading in the right direction (up) based on the performance of the past two months. After taking a deep sigh of relief, we're asking ourselves why we didn't invest more while the markets were low. We all have been drilled over and over again to buy low and sell high, so why is it so hard to actually do that?

Anyone who has tackled financial economics in college will certainly recall many serious professors filling blackboards with algebraic symbols and models that purported to explain precisely how financial markets work. The capital asset pricing model, the efficient-market hypothesis—that information, however, had one flaw. While these models explained things generally, they assumed that people make financial decisions with the rationality and precision of an astrophysicist calculating a moon launch. But “rational” does not always describe the way we approach our finances. After all, if we are so rational, *why are we not all rich?*

Common Approaches to Personal Finances

When it comes to sorting out complicated material like our financial affairs, we tend to be foolish, sentimental, illogical and, in short, badly flawed. At least that's the premise of a new academic discipline called Behavioural Economics.

As we emerge from one of the worst markets many of us have seen, let's sit back and look at some of the classic ways investors fool themselves. Don't be alarmed if you recognize yourself in any of these; it would be surprising if you didn't.

The Gambler

Suppose you brought \$1,000 with you to Las Vegas and won \$2,000 on your first bet. Chances are you will mentally divide the money into two portions: the hard-earned cash you squeezed from your pay cheque and took to Vegas, and the easy money you won at the roulette table. The first wad you will continue to spend relatively cautiously, but the second you will throw around the room with abandon. If we were

economically rational, we would value the gambling win as much as the money we work for. But in reality that is not how we react.

A form of mental accounting known as “framing”, which applies arbitrary yardsticks and time periods to assess whether you are winning or losing, may influence how individual investors will respond to a correction or a high-performing investment. Instead of using logic and depositing money in an investment that is low risk, the gambler in us wants to put the money into the investment with the best short-term performance, considering it to be “found” money.

Asymmetric Loss Aversion

A stranger comes up to you on the street and offers to flip a coin. Heads, you have to pay him \$500; tails, he'll pay you an agreed-upon amount. How much would that amount have to be to make the game attractive? Assuming the person is trustworthy, common sense says that any offer over \$500 tilts the wager your way. Yet you still balk. If you're like most people, you're not tempted by anything under \$1,000.

You may be suffering from a condition known as “Asymmetric Loss Aversion”. Its cause is simple: Losing money seems twice as bad as making money feels good. In other words, the value of a win in a fifty-fifty game of chance has to double the cost of a loss before we feel comfortable with the gamble. This phenomenon prevents some investors from ever taking money from safe investments because they simply cannot envisage the risk/reward opportunity of another type of investment. This way of thinking can cause even greater losses in the long run. Over the last six months many investors poured money into money markets, GICs and other safe harbours, when in the previous year they poured money into the equity markets at twice the price.

Clueless Anchors

Smart investors understand how little they really know about the future of the market. The rest of us find the uncertainty so hard to tolerate that we impose patterns where none exist. And we create anchors—apparently logical rules of thumb—to help resolve issues about which we have no clue.

Random anchoring has long been a favourite pastime among Wall Street analysts. Without it, how could they fix a proper price for those Internet stocks with no earnings or any imminent hope of success? Their thinking went this way: “Amazon.com trades at about 20 times sales, so software.net should go public at, say, 14 times...” Left unexamined is whether Amazon at 20 times sales made economic sense. It probably did not.

These anchors pressure investors to value investments based not on prudent investment measures, but on the relative value compared to other investments, which may also be overvalued. Many investors are using these anchors right now. Instead of taking advantage of the great value in many securities, they stick hard and fast to their original investments and refuse to sell until they have broken even when that may take years, while other investment opportunities they could have capitalized on do even better.

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Overconfidence

A key benefit we gain from mental gymnastics such as anchoring is a pleasant, if inappropriate, sense of confidence and feeling of control over our surroundings. For example, in surveys, a whopping 80 percent of people consider themselves to be better-than-average drivers.

Of course, confidence is not entirely a bad thing. It gives us the energy and optimism to deal with challenges, even if it makes us ineffective at estimating the odds that we will succeed. Since investing means putting off the pleasure of today’s wealth in the expectation of gaining more to enjoy tomorrow, optimism is plainly a prerequisite. However, it can be expensive if it gives you the illusion that you can determine the future when you really are unable to do so.

A brand of overconfidence that every investor succumbs to at least once is the “hot hands” fallacy. This is part of that innate human talent for discovering patterns in what may actually be a series of random events.

People tend to think that any mutual fund manager who has had five good years in a row can do no wrong. In reality, given the number of fund managers, a few are bound to have exceptional returns. Statistically, it is impossible to determine whether those returns were due to luck or skill. However, this detail fails to deter investors who are confident that they have discovered a pattern of superior performance and throw billions of dollars into top funds. These managers do not repeat their success any more often than they would by sheer chance.

Investors often follow the trend, which sometimes means unloading good steady investments for a new hot investment, usually to their regret. Choosing a good manager takes much more research than simply analyzing track records. But many investors fail to take the time to determine if a manager is suitable for the mandate of their portfolio.

The Rear-View Visionary

One reason we are convinced of our ability to forecast economic events is that we firmly believe we have done so (or could have done so) in the past. We could not have, of course; we are just not good at recalling risk assessments made months ago, especially once we experience the outcome.

Our inept but overconfident predicting helps explain one of the more profitable loopholes in classic financial economics. Studies have demonstrated that

out-of-favour stocks—those with low prices relative to earnings, sales, and cash flow—tend to perform better over time than high-priced glamorous stocks. One reason for this is that overconfident investors tend to project continued rates of growth for glamour stocks indefinitely. Expectations for value stocks, on the other hand, are low so that decent earnings tend to be a pleasant surprise.

As we have repeatedly advised, the best way to invest is simply to:

- take a long-term approach
- diversify based on time frames and objectives
- rebalance on a regular basis

If you think behavioural economics may have affected you over the last eight months, perhaps you should review your portfolio.



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