NORTHSTAR
FINANCIAL
PLANNING INC

Volume V, Issue I

INDEPENDENCE INTEGRITY INTELLIGENCE

Are You an Emotional Investor?

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It may seem like a question from left field, but if you were to sit down and really think about the types of decisions you make every day about your money, would they be logically based and unaffected by emotions?

At first you may think to yourself, '*No, I am definitely objective about my financial planning. Really, I am*.'

But scientific study reveals an opposing camp of theorists whose entire careers focus on the study of how and more importantly, why investors behave illogically with regard to their financial future. The study of Behavioral Finance was brought to the forefront by 2002 Nobel Prize winning psychology professor Daniel Kahneman's observations exploring the emotional biases that govern our financial decision making. The research "reveals repeated patterns of irrationality, inconsistency, and incompetence in the ways human beings arrive at decisions and choices when faced with uncertainty," says Peter Bernstein in his book *Against the Gods*.

If you agree that sometimes you make financial decisions that are not in your best interest, what can you do as a serious investor? "*Seek the advice of an unbiased advisor,*" says Sam Hull, CFP who is a principal with Northstar Financial Planning, Inc. in Londonderry, NH. "*The only way to be sure that you're making sound decisions is to work in concert with an unbiased third party who can point out when your choices are more emotionally based than you may want to believe.*"

Consider for a moment that you are the CEO of your own company. You would have learned the hard way that a good leader always works with a team of trusted advisors. The President of the U.S. works with a cabinet and a staff of trusted colleagues to make policy decisions. Shouldn't potentially life changing choices about your own financial future deserve the same careful consideration and perspective?

Several theories combine into the study of Behavioral Finance, but the main points can be summed into seven areas of observation about how investors respond when faced with financial decisions.

Loss aversion – Investors are more prone to feelings of loss than to pleasure feelings of a gain. Roughly translated, the good feelings generated by a $2 gain on an investment are exceeded by the negative feelings prompted by a $1 loss on a similar investment.

Overconfidence – People are overconfident about their own abilities to make sound investment decisions, especially in the case of entrepreneurs because they are by their nature risk takers. This overconfidence spurs too little diversification in a portfolio, leaving the individual at greater risk should the investments perform badly. Men also tend to be more overconfident than women and prone to higher risk taking behavior. For example, Charlie, a mid-level manager at SuperTech believes that he knows a solid line of new products will be hitting the market in the next 12 months. He tells his advisor that he wishes to increase his percentage of profit sharing contributions rather than more equally balance his portfolio. His advisor warns Charlie of analyst reports stating that Super Tech stock is way overpriced and advises against additional purchase of company stock. Charlie ignores this and continues with his plan, confident in his special knowledge. SuperTech stock remains flat for over a year. Charlie now faces the reality that he not only needs to diversify his portfolio, but also needs to sell of some of his recently purchased SuperTech stock to accomplish the task.

Procrastination / Inaction – Optimism leads to the belief that no matter what our troubles are today, it will all work out in the end. This anchoring behavior pushes the individual into denial that a bad investing decision needs to be terminated. Investors avoid selling or rebalancing a portfolio after having made a bad investment decision due to embarrassment and fear of admitting that they were wrong. When looking at the future, it is always easier to hang on to a known assumption rather than make the clean break and move on. The real question for Charlie to ask is '*If I were going to make an investment today, would Super Tech be my choice?*' If your answer in a similar situation is no, ask yourself why you are still hanging on and hoping. A decision to cut your losses and sell may be hard for your ego to swallow but will usually be the right choice.

Herd Mentality – People tend to give too much weight to what the other people are doing believing that they possess an 'insight' or additional knowledge that makes their decision more accurate and should therefore be followed. Behavioral finance experts also found that investors tend to place too much worth on judgments derived from a small sample or a single "expert" source.

Mental Accounting – Investors sometimes separate decisions that should, in principle, be combined. This concept, first named by Richard Thaler in 1980, states that people tend to segment their money into separate accounts for different goals, when in fact the funds derive from the same source. The best way to avoid the impact of mental accounting is to concentrate on the total return of your portfolio and not fixate on what happens to a single stock or mutual fund (even if it is your favorite!).

Framing - How investors tend to look at a problem results in how they perceive, or frame, the issue mentally. For instance, hospitals can either report 'survival rates' or 'morbidity rates' when reviewing successes or failures in a clinical trial. However you look at the numbers, they are still the same basic facts. The framing constitutes how optimistically or pessimistically the situation is viewed.

Representativeness – Investors tend to look only at short term performance and not at long range results when selecting a purchase. Representativeness leads to a knee-jerk reaction to short term fluctuations in the markets and performance of a fund or stock causing multiple trades and eventual financial loss. This attitude is what prompts the gambler to pump quarter after quarter into the slot machine when the odds are incredibly stacked against him in ever compensating the financial loss. The single win intermingled with several losses also reinforces the belief that to make the big payout, a few losses are to be expected.

It is easy to recognize irrational behaviors after the fact. It is much more difficult to recognize the emotions behind your behavior *before* making a decision. The duty of financial advisors is to help you focus on future goals by helping you create a meaningful vision of your future, a sound strategic investment plan and then implement that plan with investment decisions based on unbiased facts and research. Often times, investors will exhibit one or more of the behavioral traits listed above and a financial advisor will need to weigh the effects of each behavior in order to make recommendations that will meet the investor's emotional *and* financial needs. Investor A may have had a bad investing experience and be extremely loss averse but also be faced with the possibility that she will outlive her income if her portfolio isn't properly rebalanced. The advisor will need to consider the previous bad experience and marry that loss aversion with a lengthy explanation and ongoing education about the risks of outliving her income if the funds aren't reallocated.

With both personality and money profiling as part of a holistic life planning program, a financial advisor should work to help each client to better understand the behaviors that can harm investment performance.