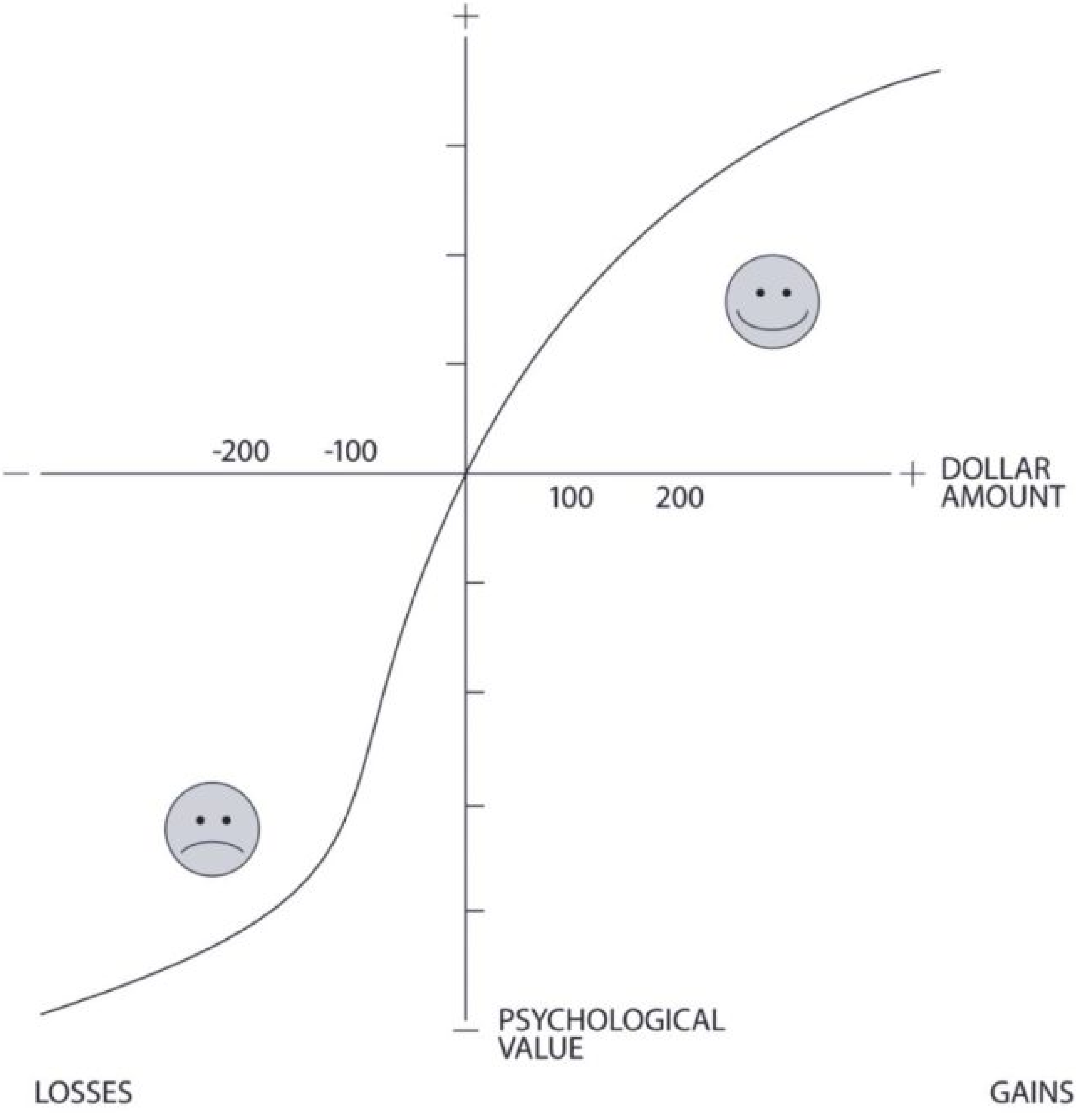
Strategies for the Irrational Investor

If you are like the typical investor, cognitive biases, emotions and reactive thinking inevitably influence your decisions to some extent. The result can often be subpar portfolio returns.

Some of the most obvious examples of behavioral errors are lotteries. Why do we play when the odds of winning are low? Ironically, part of the reason is that we are loss-averse. By not buying a lottery ticket, people feel they are missing out on a chance to win the big jackpot. Even though the odds are absolutely awful, they are still above zero. And our brains are programmed to avoid the pain of losses.

Nobel laureate Daniel Kahneman and his late colleague Amos Tversky described this as prospect theory. Prospect theory says humans feel greater pain from losses than pleasure from gains. Figure 1 demonstrates this: The slope of the line steepens as it moves from the upper right-hand quadrant (gains) to the lower left-hand quadrant (losses). The psychological impact of losses is far greater than those of gains.

Take a look at the slope of the line in the chart below. It steepens as the line moves down from the upper right-hand quadrant into and through the lower left-hand quadrant. This is because prospect theory holds that the aggravation associated with losing a sum of money is greater than the pleasure associated with gaining the same amount of money.



Source: "Prospect Theory: An Analysis of Decision Under Risk," Daniel Kahneman and Amos Tversky, Econometrica, March 1979.

Figure 1

Then there are the limits on our abilities to make good decisions. Due to constraints on cognitive abilities, time and access to information as well as the interplay of emotions, humans operate under what is known as bounded rationality. This holds that even though we may want to make the best possible decision, we lack the ability to do so.

Behavioral economists have found that humans often rely on mental shortcuts and heuristics. The default setting in our brain is to use the information and knowledge immediately available to make a decision. For example, a person may view a certain point move in the Dow Jones industrial average (e.g., 200 points) as significant without stopping to consider what the move in percentage terms actually was.

Kahneman and Tversky referred to this as operating on System 1. System 1 is intuitive thinking. It’s reactive. When a person decides to drive to the local grocery store, he or she is operating on System 1. There is little conscious thought about the steps required to get in the car, drive the car or get to the store. Is there cognitive activity occurring? Absolutely, but our conscious thoughts are generally focused on other subjects (e.g., traffic, the radio, what needs to get done later in the day, etc.)

When a person acts emotionally to a move in a stock’s price or to macro news, it is System 1 at work. Selling stocks simply because the price has dropped is System 1 at work. Buying a stock with a great story that has run up in price on concern about missing out on the next big thing is System 1 at work.

Analyzing macroeconomic factors, valuations, growth rates and fundamental ratios invokes System 2. System 2 is self-critical, reflective and deliberate thinking. It requires greater cognitive effort and slows us down. If humans were truly rational agents, they would invoke System 2 before making any financial decision. But this is not the case. Rather, as Kahneman explained, “much of what System 2 does is explain and rationalize and apologize for the choices and beliefs of System 1.”

There are various ways we rationalize the decisions we make. Among them is being overconfident. We like to believe our decisions are correct. Part of this comes from simply not wanting to admit we made a mistake. Part of it comes from cognitive dissonance. Cognitive dissonance is downplaying or ignoring facts contrary to our views and beliefs.

This reaction is a common occurrence of the endowment effect. The endowment effect says that we value the things we own more than the things we don’t. In the case of investing, our tendency is to think we’ve made the right decisions and to overestimate our ability to properly analyze the prevailing risks.

Worse yet, we rationalize our viewpoints by engaging in confirmation bias. Confirmation bias is looking for information that backs up our beliefs. Those who think stock prices will rise pay more attention to reports and articles explaining why the outlook is bright. Those who expect stock prices will fall or, worse yet, the economy to collapse pay more attention to reports and articles explaining why the outlook is bleak. Since such information backs up the respective viewpoints, it makes the respective groups of investors more ardent in their viewpoints and more likely to engage in cognitive dissonance.

The problem with confirmation bias is that there is always someone on the other side of a trade. When an investor sells a stock, the buyer thinks it's a bargain. When a bond is purchased on the open market, the seller thinks it's a bad investment. The buyer and seller always have different views. This is why it's useful to ask: What does the investor on the other side of the transaction see that I don't?

Compounding matters is our brain's shortsightedness. We have a tendency to think recent conditions will continue into the future; this is known as recency bias. History is filled with of examples of recency bias occurring. During the late 1990s, investors willingly bought dot-com and technology companies with little to no regard for their current earnings or ridiculously high valuations. During the fourth quarter of 2008 and the first few months of 2009, investors pulled out of stocks even though valuations were extraordinarily low.

It would be great if we could wake up tomorrow with a commitment never to make a behavioral error again. Unfortunately, it won't work in practice. Our brains are programmed to act in a certain manner, and simply being aware of behavioral errors won't stop us from making them. That's the bad news. The good news is that there are strategies you can use to reduce your chances of succumbing to behavioral errors.

Use the Power of the Written Word

One of the simplest and most effective strategies is to use the power of the written word. Write down the rules governing how to manage your portfolio, including your long-term allocation strategy, guidelines for determining if a security or fund should be bought, and the specific circumstances under which you would sell. Simply having these rules in place can make a big difference.

Keep in mind that the simpler and more straightforward the rules are, the more likely you are to follow them. For example, the main purchase rules for **AAII's Model Shadow Stock Portfolio** are a price-to-book-value (P/B) ratio less than or equal to 1.0, positive earnings for the trailing 12-month period and a market capitalization below $300 million—clear, simple and straightforward.

It’s not only important to have the buy and sell rules, but it’s also crucial to have them written down in a format that’s easily accessible. An old-fashioned spiral notebook is ideal. It’s an incredibly effective portfolio management tool because it’s cheap and needs no instruction for use. Once something is written down in it, those words and numbers will never change unless something physically happens to the notebook.

Develop Portfolio Management Guidelines

Included in your rules should be guidelines for your long-term portfolio allocation strategy. Specify how much you want to allocate to each major asset class: stocks, bond, cash, real estate, etc. Then define under what circumstances you will adjust your portfolio when it strays away from these guidelines.

You may decide to adjust your portfolio allocations whenever one of the asset classes moves more than five or 10 percentage points away from its target. Alternatively, you could segment your portfolio by time, such as keeping between one to five years of money needed to cover living expenses in cash and short-term, highly-rated debt instruments.

There are other strategies you could follow as well. The big key is to identify a strategy that you can stick with no matter what the market is doing. What often harms individual investors’ long-term returns isn’t a failure to pick good securities or funds, but rather simply failing to maintain the proper mix of stocks, bonds and cash over the long term.

Having a good long-term portfolio strategy will reduce the impact of behavioral errors and, depending on the strategy, give you a positive outlet to channel your emotional energy through.

Make Use of Sell Rules

Creating and following predefined rules for selling investments is a good strategy that transcends just behavioral finance. Sell rules reduce the guesswork of determining whether to hold onto an investment, reduce the size of the position or get completely out of it.

Going through the exercise of thinking why an investment should be sold before it’s bought will reduce the emotional component of buying. It’s an exercise designed to activate System 2 and to force you to think about why the security is available for purchase.

The other reason for doing this is that after an investment is purchased, the endowment effect kicks in. Once we own the investment, we're more likely to downplay negative news and invent reasons to continue holding onto it (e.g., the price will bounce back). By creating a list of what could go wrong prior to purchase, you will more inclined to recognize potentially negative developments and sell the investment should one of those developments occur.

Find Ways to Slow Down

It may seem paradoxical given Wall Street's focus on speed, but slowing down can lead to higher investment returns. When decisions are made quickly, the brain relies on System 1. Since System 1 is quick and intuitive, it does not fully analyze the potential outcomes of the action about to be taken. Slowing down increases the odds of invoking the brain's System 2 and making more thoughtful decisions.

Slowing down can also reduce the emotional component of investing. When feeling stressed or excited, impose a mandatory 15-minute pause before trading. During that period, go for a walk, meditate, take deep breaths or even just watch funny videos—anything to get your mind off what is tugging at your emotions at the exact moment. Then, when you are feeling calmer, sit down and decide the best course of action. Even if you are not feeling nervous, merely taking a few deep breaths and then carefully reviewing your order can reduce errors.

If these steps are not enough, consider working with a financial planner. The true value of a good planner is not recommending good investments but keeping you from taking actions that will hurt your odds of achieving your long-term goals. Not everyone needs a financial planner, but they can be helpful.

→ **Charles Rotblut, CFA** is a vice president at AAII and editor of the AAII Journal. Follow him on Twitter at **twitter.com/CharlesRAAII**.

This article originally appeared in the ***October 2015*** *issue of the* AAII Journal.