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Smart People: Bad Financial Decisions

By Steven Abernathy and Brian Luster
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Why do smart people make poor decisions? More importantly, why do they keep making poor decisions? Perhaps they study stocks, market fluctuations, or market indicators. Only a fractional percentage of investors, both professional and amateur, manage to "beat" the market. Is their occasional above-average return a fluke? What does it show us? According to neuroeconomics, the field dedicated to explaining what is behind human decision making, our brains seek out patterns. When we discover a pattern, or, sense there might be one, the body's response is to flood the brain with dopamine -- as if an opiate (i.e., heroin) is in our system. And the dopamine-flooded mind is neither objective nor dispassionate. Judith Glaser noted in the Harvard Business Review, dopamine causes one to "...feel good, dominant, even invincible." The irrational appears rational -- and one's investments are affected accordingly. Non-objective thinking can manifest in several ways.

But this overconfidence which is likely to afflict do-it-yourself investors is something they cannot see. The consequences to the overconfident investor's portfolio can wreak havoc worse than greed. An investor may know the stock market has seen an average return of 10 percent over the past century despite market fluctuations and still lose sight of the big picture in the moment. Even when statistics reveal to us we are behaving irrationally, it is in our hardwired biological nature to persevere.

Your Money and Your Brain by Jason Zweig provided an unabashed and comprehensive look at the many ways our "intelligent" decisions are shaped. Decisions, when shaped by our biological responses, are not purely objective -- and often are not so smart. Messengers of financial industry use this to their advantage. The wildly gesturing doom-and-gloom finance pundits understand this well -- as do brokers and financial product salespeople. Our brains quickly react to evocative images of a busy trading floor or the pulsing activity behind the reporter's head, indicating the market's ups and downs -- and we react. Dan Solin writes,

> Those who study finance regard these activities as counter-productive and calculated to enhance the wealth of the securities industry and deplete the assets of investors... Perhaps investors need the equivalent of drug rehabilitation to reprogram their brains so they can rationally assess the overwhelming data indicating that reliance on the traditional securities industry for investment advice is no different than relying on a drug dealer for advice about kicking a drug habit.

Another detriment to our investment health is prediction. "Unlike other animals, humans believe we're smart enough to forecast the future even when we have been explicitly told that it is unpredictable," writes Zweig. Even after a group of people in an experiment, trying to determine a pattern of flashing lights were told it was a random occurrence, they continued in their pursuit of a pattern. Rats and pigeons outscored the humans.

Investors are also prone to self-interest. While that may seem reasonable or advantageous, self-interest is subjective -- so objective analysis becomes marred. This occurs in many instances including clinical trials sponsored by drug companies as well as in politics.
In *Think Again*, Sydney Finkelstein, Jo Whitehead, and Andrew Campbell take a look back at the end of the Cold War where Reagan and Gorbachev demonstrated biases well beyond their different viewpoints. Each one perceived a different occurrence in the room than what had actually taken place. And both leaders were sure their observation and experience was correct. "Reagan and Gorbachev appear not only to have been unconscious of the influence of their own interests; they also believed they were behaving honorably by offering significant concessions -- while the other party was not," write the authors. Investors are equally prone to a self-serving bias where self-interest skews one's view of reality.
So what can investors do to "beat" neuroeconomic factors?

Have a written investment policy statement -- and stick to it.
The investors who successfully keep as well as grow their wealth have a written plan. Its significance prevails over market conditions as those conditions change. This not only offers a road map of investments, strategies, and goals, but offers a stress-management plan of sorts. Action items might be included to describe what steps the investor would take given specific situations. One example might be: "If the assets in the portfolio drop 25 percent, money will be moved from the best-performing investments to purchase underperforming stocks."
Don't forget history -- and the fact that it repeats itself.
Remembering that we've lived through this type of volatility, and much worse, before, may ease nervous investors. Don't forget: Those with a long-term focus who bought into the stock market during the lows of 2008 and 2009 came out ahead over time.
Keep an open mind about the future. "We tend to see one future. We don't tend to see the spectrum of possibilities," Mr. Benartzi says. "When one of those other futures happens, whether it's good or bad, we're totally shocked."

Maintain focus on long-term goals.
The difference between those who have their eye on their goals vs. those who do not can be dramatic. Keeping the focus on the long view could lessen the immediacy of feeling we must respond to our emotional impulses and inclinations based on what happens in any given day.
"It's crucial for investors to train their brains to focus on future goals," says Richard Peterson, managing director of MarketPsych, a research and consulting firm.
Curtail exposure to sensationalistic data and news.
Many people enjoy watching the uptick of their stocks -- the down tick is not as enjoyable.

However, repeatedly seeking out information via websites, apps, or in the news, particularly with so much financial information available at our fingertips 24/7, can skew judgment. Remember that content is designed to capture attention; market news is no different. This does not mean remain in the dark. Check balances on a regular basis to make it easier to handle any short-run volatility and be cognizant of a portfolio's activities. But it's a case for many readers where less may be more.

The best investors habitually stay the course in spite of the setbacks and flood of information they invariably face. And when they encounter a hurdle, they act objectively. Success is not necessarily born from what they know, but, how steady they can be in the storm of market ups and downs. Successful investors expect setbacks and stay in the game anyway.

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