Do We Invest with Our Hearts or Minds?

How Behavioral Finance Can Dramatically Affect Your Wealth

PART TWO

In the second part of this two-part series, we continue to examine how advisors can deliver value to their clients. George Nicola, CFP®, CIMA®, a senior Investment Portfolio Manager at Commerce Trust Company, helps investors understand their underlying motivations in making buy-sell decisions for their portfolios. Today, we look at the four types of behavioral investors, and how they are prone to view the world of investing.

Q. WHAT BEHAVIORAL BIASES ARE INVESTORS PRONE TOWARD?

A. There are four types of behavioral investors: Preservers, Followers, Independents and Accumulators. The four categories are mainly determined by their current stage of life cycle, investable assets and total net worth.

Preservers are typically risk-averse investors who place a much greater importance on the safety of their wealth than taking risks to grow it. Common Preservers gained their wealth through inheritance or saving a large portion of their discretionary income. Some Preservers could be obsessed with short-term losses more than their desire for the potential long-term investment gains.

Followers are passive investors who do not have their own ideas about investing. They follow the leads of others who they trust and seek the most popular investments, at the time, without a defined long-term plan. Followers often overestimate their risk tolerance and maintain high cash levels.

Independents are risk-taking active investors who are involved in their wealth creation by typically risking their own capital to achieve wealth growth objectives. They also want to be involved in the investment decision making and sometimes conduct their own due diligence on considered investments. They are independent thinkers and do their own research. Nevertheless, they may overlook crucial information from other resources that are not available to them.

Accumulators are risk-seeking active investors who are typically entrepreneurs with high wealth levels and are more strong-willed and confident than Independents. Since they have experienced superior control on other non-investment activities outcomes (such as in their businesses), they believe that they can do the same with investing. This could lead to overconfidence bias and ultimately sub-optimal performance outcomes.

Q. WHAT SPECIFIC BIASES FOR THE AVERAGE INVESTOR DO YOU SEE MOST OFTEN?

A. I would say it's the artificial accounting "buckets" we arbitrarily create in our heads to sort various sums of money based on where these funds are mentally categorized (retirement investments, taxable investments, college funds, etc.). These mental buckets can cause investors to neglect allocations that offset, complement, or correlate across your larger holdings and may make overall portfolio performance suffer. For example, in cases where two spouses have 401(k) funds at separate companies, collectively you could have over-concentrated positions in equities because the two spouses treated the funds mentally as two different accounts. In addition, investors tend to invest in an imbalanced fashion when their employer stock is offered in their retirement plans. Investors seem to invest in a much more balanced allocation when their employer stock is not offered. Another bias I observe frequently is investors chasing yield with less regards to the investment's merit. Solely chasing income streams can inadvertently erode principal and ultimately the total return on portfolios.

Q. DON'T YOU AGREE THAT WITH NEW INFORMATION TECHNOLOGY, INVESTORS ARE MORE INFORMED AND CAN MAKE RATIONAL DECISIONS?

A. Technology has certainly helped in a tremendous fashion. However, some might argue that it also contributes to irrational behavioral of some investors. A recent study showed that people are still easily overwhelmed with information, which leads them to attempt to find shortcuts to arrive at a decision, which can lead to a less optimal outcome. Also, the same study found that when people are offered too many options, they tend to do nothing and leave things as is, which could pose tremendous unnecessary risk.

Q. WHAT ADVICE WOULD YOU GIVE INVESTORS TO HELP MITIGATE THEIR BIASES?

A. First, and more than anything else, just try to acknowledge them. Recognize that confusion or frustration naturally arises when an individual receives new information that conflicts with pre-existing beliefs or experiences about an investment they hold. Investors may often hold losing positions to avoid the mental discomfort associated with admitting they made a bad decision.

Clinging to prior views or forecasts at the expense of acknowledging new information is another form of bias. But if you recognize it, you can adjust for it.

Q. CAN YOU GIVE ME A SPECIFIC EXAMPLE?

A. Investors who have an emotional attachment to an inherited stock can learn to treat it as equally as another stock that was recently bought. Second, seeking professional investment advice is an effective way to invest based on fundamental facts and analysis and will tremendously lessen the effect of the behavioral biases that could influence investment and ultimately future financial goals. Finally, investments are meant for the long-term in general, and the reality is that even top investment managers experience periods of underperformance when their investment style or philosophy is temporarily out of favor. Nevertheless, these periods of underperformance typically represent golden opportunities to savvy investors to allocate their un-invested excess cash into temporarily undervalued (attractive) investments for the long-term growth they pursue.

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George is a senior portfolio manager for Commerce Trust Company. Upon gaining a thorough understanding of a client's needs and goals as well as assessing the client's entire financial situation, he works with our investment research team to construct a portfolio to help clients achieve their long-term goals. George comprehensively represents our research- and goals-based investment process, starting with the initial assessment and creation of an investment objective to ongoing evaluation and adjustments based on changing market and life circumstances. With a deep knowledge of the market and experience in investment management, he serves clients with thought leadership, insight, and consulting services. In addition to his responsibility, George served as an Equity Strategy Committee voting member in 2015 and 2016. George has more than 15 years of experience in portfolio management, investment analysis and banking. He earned his bachelor of science degree in Finance and Accounting from Cairo University and a Certificate in Investment Management Theory and Practice from Yale School of Management. George holds the CERTIFIED FINANCIAL PLANNER™ designation as well as the Certified Investment Management Analyst® designation. George is a member of CFP Board, Investment Management Consultants Association®, the CFA Society of Kansas City, and the CFA Institute.

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