# *Do We Invest with Our Hearts or Minds?*

## *How Behavioral Finance Can Dramatically Affect Your Wealth*

### PART ONE

*In the first part of a two-part series on how advisors can deliver value to their clients, George Nicola, CFP®, CIMA®, a senior Investment Portfolio Manager at Commerce Trust Company, helps investors re-examine their underlying motivations in making buy-sell decisions for their portfolios. This deeper dive into the topic reveals what research tells us about our core investing habits and biases that may keep us from reaching our goals.*

## Q. WHY PAY ATTENTION TO AN ACADEMIC TOPIC LIKE BEHAVIORAL FINANCE?

A. One reason is that it can help you determine your own tendencies and biases in making investment decisions. There is, in fact, much research behind what your portfolio manager may have been advising you on over the years. Making better decisions at any pursuit, especially one involving investments, can add up over time.

## Q. SO HOW DOES THE RESEARCH HELP PROFESSIONAL MANAGERS MAKE BETTER DECISIONS FOR MY PORTFOLIO?

A. It helps to have some historical context first. For decades, investment professionals and investors have been trained in university-level finance classes and professional accreditation programs on "Modern Portfolio Theory." This approach is considered the foundation of sound investment principles, the bible for the investment community.

Modern Portfolio Theory (MPT) was developed by American economist Dr. Harry Markowitz in 1952, but it did not start gaining traction with mainstream investment advisors until the 1980s. Today, its principles are used by professional money managers worldwide to help investors assess the risks and rewards in portfolio management. Markowitz's work eventually led to a Nobel Prize in 1980.

## Q. WHAT IS SO SPECIAL ABOUT MODERN PORTFOLIO THEORY?

A. Modern Portfolio Theory (MPT) is a predictive model that can help investors build portfolios to maximize expected return based on a given level of market risk. According to the theory, it's possible to build an "efficient frontier" of optimal portfolios offering the maximum possible expected return for a given level of risk. Given that no two people are alike, the level of risk people are willing to take is variable. Just like forecasters have weather models, financial advisors have their own financial models as well to build portfolios and help predict portfolio risk and returns.

## Q. HOW HAS THIS HELPED INVESTORS?

A. Adhering to MPT principles can help investors, for example, from selling too late in a downward trending market, which is a typical textbook mistake investors make over time. Or following a herd mentality when the market is trending upward. Or holding losing positions to avoid the mental pain associated with admitting they made a bad decision.

### Q. WHY DO INVESTORS MAKE THOSE KINDS OF MISTAKES?

A. As an evolutionary quirk, human beings have learned to take mental shortcuts toward an answer when overwhelmed by a lot of data or choices in a short time frame. It's a trait that has served all of us well in many situations. That's why "rules of thumb" are so beneficial when trying to sift through complicated situations quickly. However, investing is not one of these situations where shortcuts work over time.

### Q. SHOULD INVESTORS RELY MOSTLY ON FUNDAMENTALS, FACTS AND FIGURES WHEN INVESTING?

A. If the market was only populated with rational investors who are always willing to accept a higher degree of risk for a potential higher return, one could say yes. These are some of the tenets of Traditional Finance. Behavioral Finance, however, assumes that investors do not always act based on raw facts and analysis alone. Moreover, based on studies conducted in the late 1970s, researchers found that people normally feel losses twice as bad as they feel the joy of gains. Therefore Behavioral Finance argues that investors are irrational and do not always choose or make an optimal decision when given the information due to either an information processing issue or certain biases they possess.

### Q. WHY IS IT IMPORTANT TO UNDERSTAND THE DIFFERENCE?

A. Well, since 2008/2009, we have experienced one of the most extended bull market equity cycles (now 90 months) ever. It is important to revisit how most investors normally tend to react, not only in different market conditions and phases of their lives, but also according to their different behavioral biases. This should help investors not to repeat some costly mistakes, especially if they are in, or close to entering, the retirement phase. If one recognizes bias, investors can try to accommodate for it.

*The second part of this series will cover the four types of behavioral investors, and how these four categories are prone to view their investment world.*

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# ABOUT THE AUTHOR

## GEORGE NICOLA, CFP®, CIMA®

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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.