Economic and Market Insights

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Behavioral finance: Why do savvy people often make big investing mistakes?

As part of a series on how advisors can deliver value to their clients, Nick Fafoglia, CFA®, a senior Investment Portfolio Manager at The Commerce Trust Company, helps investors re-examine their underlying motivations in making buy-sell decisions for their portfolios.

Q. What is behavioral finance and why should I care about it?

A. In traditional financial theory, most people are rational and attempt to maximize their wealth. However, there are many instances where emotions and psychology influence our decisions, causing us to behave in unpredictable or irrational ways. That's the quick basis for what behavioral finance is all about.

Q. What sort of behavioral influences are we up against?

A. An interesting psychological quirk in our brains is the fact that many people *detest losing money* more than they *enjoy making it*. That may sound counterintuitive, but it truly describes why, for example, people find it hard to cut losses and often throw good money after bad. As one market observer put it, profits bring pride while losses inflict regret. So we are programmed to realize gains quickly and procrastinate in the realization of losses.

Q. Can you give some examples of common investing mistakes that may occur because of this?

A. Probably the most common is what is referred to as the “herd mentality” behavior. It’s simply the tendency for individuals to follow the actions of a larger group. Investors that employ a herd-mentality strategy constantly look to buy and sell in pursuit of the newest and hottest investment trends. The thought is that if everyone is buying, it must be a good decision. However, as the dotcom bubble and many others illustrate, it is usually not a very profitable investment strategy.

A second common example is that investors often overreact and base their opinions on new information, either for individual stocks or the market in general. This happens all the time. For example, investors quickly look to sell – the “sky is falling” – at the first hint of bad news, when in reality nothing long term has changed. Studies have shown that the overreaction is often greater than the actual impact of the news.

Perhaps the most important lesson to be learned here is to retain perspective. While it’s easy to get caught up in the latest news – and news is everywhere these days – these short-term approaches don’t usually yield the best investment results. Remember to stay focused on the long term.

Q. How much can these poor decision-making traits cost investors?

A. The behaviors these traits trigger were part of the reason why individual investors have underperformed the S&P 500 by nearly four percentage points, on average, over the past 20 years. (Source: DALBAR 2015, see http://www.dalbar.com/ProductsServices/AdvisorSolutions/QAIB/tabid/214/Default.aspx.)

Just focusing on the last five years, if you missed the five best performance days from March 31, 2010, through March 31, 2015 in the S&P 500, your total return would be 59.1% versus 96.5% had you remained fully invested for the duration. (Source: The Commerce Trust Company analysis.)

Q. What can investors do to change these behaviors?

A. Understanding the motivation behind our biases and how we analyze information to reach decisions is key to making significant improvements. In these situations, as well as some of the other common biases, the best solution is to find someone – and we suggest a professional – who can act as an alternative "voice of reason." That way, you'll have someone to bounce ideas off of who can provide a contrarian viewpoint before a decision is made.

Also, be consistent with your goals. As Warren Buffett has said, "Beating yourself is half the problem." Remember that beating an investment index is not really a goal. Your goals are those activities and dreams that are the focal point of your financial plan – what you want to do in retirement, helping your children or grandchildren, or making a difference in the community. That's the end game to really keep in mind.