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Financial Briefs

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7 Psychological Traps That Make You a Worse Investor

Sometimes when it comes to investing, volatile markets aren't your worst enemy. It's actually you. That's because money and logic don't always go hand in hand. Unfortunately, our brain often plays tricks on us, causing even the savviest of investors to make decisions that don't really make a lot of sense, from panic selling to ignoring opportunities.

In fact, the problem of psychological investing traps is so pervasive, there's a whole field dedicated to studying it called behavioral finance. Researchers in this discipline look at the way psychology affects how we make financial decisions, and some of what they've discovered is pretty interesting. Knowing about these traps can help you avoid them and make you a better investor.

Here are seven psychological traps to keep in mind.

Sunk Cost Bias

The sunk cost bias has to do with the all-too-common tendency to stick with something, whether a bad boyfriend or bad investment, long after it's clear that it's not worth it anymore. Still, because you've invested a certain amount of time or money, you're reluctant to give it up. In investing, you might end up hanging on to a stock long after you should sell it in the hope that you'll eventually come out ahead. But in these cases, it's better to cut your losses rather than to hang on to a loser.

Familiarity Bias

Most of us are biased toward those things that are familiar to us. We head to restaurants we've been to before and follow the same roads to work, because we know what to expect. With investing, familiarity bias involves favoring investments that are familiar to you. You might prefer to invest in the company you work for or big-name businesses that are in the news. This could

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Reevaluate Your Portfolio

Periodically, you should thoroughly review your portfolio to ensure it is still helping you work toward your investment goals. Follow these steps during that review:

Review your current portfolio mix. List the current value of all your investments. Determine what percentage of your portfolio is held in stocks, bonds, cash, and other investments; but don't stop there. Take a closer look at where the stock portion of your portfolio is invested. Break down investments by market capitalization (small-, mid-, and large-cap), by style (growth and value), and by area (domestic and international).

Analyze each investment. Determine whether it still makes sense to own each investment. Don't let emotions get in the way. Review why you purchased each investment and whether those reasons are still valid. Emotionally, it is difficult to sell an investment at a loss, but holding on until you get back to breakeven may not be the best strategy. The investment may never get back to that price or may take an excessively long time to do so. You may want to sell the investment and reinvest in another with better prospects. Instead of worrying about what you paid for the investment, decide whether you would buy it today at its current price.

Determine if changes are needed to your current allocation. If we've learned anything over the past few years, it's that a portfolio should not be highly concentrated in one area or sector. Instead, look to broadly diversify your portfolio. Some points to consider include:

- **Decide how much to allocate to stocks and bonds.** Your stock and bond mix is a major factor in

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7 Psychological Traps

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cause you to overlook important opportunities you don't know that much about.

Anchoring

Anchoring is the process of getting attached to a particular reference point — such as the price you paid for a stock — and using that to guide future decisions. Or you might fixate on a stock's previous high, even though that price was an anomaly. Anchoring is why you think you got a great deal when buying a $60,000 car for $50,000, even though the car's really worth closer to $40,000.

Whether you're buying stocks or cars, anchoring involves using a single piece of information to determine what a stock or other investment should be worth while also discounting more relevant information, such as a company's fundamentals or broader economic trends. Unfortunately, avoiding anchoring is difficult, but considering all available information before choosing an investment can help.

Focusing Too Much on the Recent Past

Recency bias is the tendency to make decisions or judgments based on information that's relatively new or recent. For example, during times when the market is up, people may ignore or discount the possibility of a market decline. Or, if a certain category of stocks has done poorly recently, people may conclude that those stocks *always* have negative returns, even if the dip is an anomaly. As with other psychological investing, you can avoid this one by doing your best to consider the entire universe of information at your fingertips, not just what happened yesterday.

Following the Herd

While following trends might be fine for fashionistas, it's not always a smart investing move. Yet herd investing is an all-too-easy trap to fall into. If everyone is telling you that now's the time to get into a certain hot investment, you may feel you need to act fast so you don't miss out. But just because something is popular doesn't make it a good investment. Blindly following the herd without first consulting your own financial goals and plan doesn't make you a smart investor.

Overconfidence

Most of us like to think we're smarter than the average person, but when it comes to investing, you're probably not. Yet if you hit it big with a certain investment, you may attribute that success to your skill rather than what it really is — luck. That can cause you to repeat the same way of thinking.

Panic

Investing isn't for the faint of heart. When the market takes a sudden dip it's easy to panic, which can lead you to make bad decisions, such as selling at a big loss rather than riding out the natural hills and valleys of investing. Making these emotionally driven choices can cost you a lot of money. When making investing decisions, make sure they're based on evidence, not your initial gut reaction to the day's events.

Avoiding psychological investing traps on your own can be difficult. Please call to discuss this in more detail.

4 Reasons for Goal-Focused Investing

The fact is investing isn't just about making your money work for you. It's about making your money work for you for a particular purpose. In other words, you need a goal. Here are four specific reasons why a goal-focused approach to investing is important.

Because It Puts You in Control

When you first start investing, you may feel like you have little control over what happens to your money. No matter how careful you are, you could lose what you invest. But if you take a goal-focused approach to investing, you're not just watching the value of your portfolio rise and fall based on the whims of the market. You are making specific decisions designed to help you reach specific goals. If something's not working, you can change the plan.

Because It Will Be Easier to Save

Saving money just to save money is no fun for most people. Having concrete goals can turn saving from an abstract concept to a specific step needed to achieve a certain aim — like being able to retire one day, take a trip around the world, or send your grandchildren to college. And studies have shown that the better you are at setting goals, the more you're likely to save. You might even do better by focusing on the intermediate steps on the way to your larger goal.

Because You'll Be Less Focused on How Others Are Doing

If your father-in-law is bragging about the great return he got on his investments, it can be tempting to drop your plan and copy his moves. But if you're investing toward a goal with a clear plan, you'll be able to congratulate him on his success while staying focused on your needs.

Because It Will Help You Weather Market Fluctuations

The market goes up and the market goes down. Sometimes, it goes way, way up or way, way down. Just like a roller coaster, these peaks and dips can make your stomach do flip flops, especially when your life savings is on the line. But having a goal-focused approach can help you cope with those ups and downs. If you know that you won't need your money for another 30 years, you can handle some volatility today. But if you're going to need your money in the next couple of years, you can select less-volatile investments, so that the day-to-day movements of the market won't cause more stress. Knowing your specific goals will help you choose the right investments.

If you need help setting your investing goals, please call.

Reevaluate

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determining your expected portfolio return and how much your portfolio will fluctuate with market movements. However, be careful not to let recent events cause you to allocate too much to bonds just to avoid stock market fluctuations. Make this decision based on your financial goals, risk tolerance, and time horizon for investing. If you are investing for the long term, say 10 years or more, you probably still want a major portion of your investments allocated to stocks.

- **Reassess your stock allocation.** Is your stock portfolio too heavily weighted in technology or blue-chip stocks? Have you selected only growth stocks, ignoring value stocks? Do you prefer large-cap stocks and avoid smaller stocks? The stock market moves in cycles, with varying sectors outperforming other sectors at different times. Since no one can predict when one sector will outperform, it is typically best to broadly diversify your stocks over all areas.

Move your allocation closer to your desired allocation. When making changes, first consider the tax ramifications of the transactions. If you can make changes without incurring tax liabilities, you may want to make the changes immediately. But if substantial tax liabilities will be incurred, look for other ways to get your portfolio closer to your desired allocation. For instance, any new investments should be made in areas that are underweighted in your portfolio. Or you may be able to reallocate in your tax-deferred accounts, such as individual retirement accounts and 401(k) plans, where you typically won't incur tax liabilities. However, if you can't get your allocation in line within a year using these approaches, you might want to sell some of the poor performers and reinvest the proceeds.

If you'd like help reevaluating your portfolio, please call.

Stay the Course

By Carol Ringrose Alexander, CFP®, AIF®, CDFA™

It's a common impulse: during turbulent stock market cycles, the initial reaction of many people is to get out of the market. But for most investors, that is the worst action to take. If you have a well-diversified portfolio of mutual funds, you should not sell your investments to invest in cash.

Historically speaking, the long-term risk of stocks to loss of principal does not exist: there isn't a 20-year period (with dividends reinvested) since 1926 with a negative return. "The world does not end; people just fear that it is ending," Nick Murray writes in *Simple Wealth, Inevitable Wealth*. "Volatility isn't risk and temporary decline isn't loss. No panic, no sell. No sell, no lose."

It may seem logical to do something to a portfolio when market conditions change, but in reality, the opposite is true. A study by Brad Barber and Terrance Odean of the University of California showed that the more often investors changed their portfolio, the lower their returns. They also found that the assets investors sold performed better than what they bought with the proceeds.[1] Another study by Richard Thaler and Shlomo Benartzi found that the more often people looked at their portfolios, the lower their returns.[2] By constantly watching a portfolio, investors become more likely to act on emotions rather than logic.

According to Murray, "The two critical things to remember are that 1) Panic is a big mistake, but it's clearly not the only one; and 2) panic always rationalizes itself: "I have to get out until we see who wins the election/we see how the war in Iraq goes/we get past the dot com depression/deflation/inflation/Watergate/Vietnam/Ike's second heart attack/Pearl Harbor..."[3]

"Time in the market, as opposed to timing the market, is not a way of capturing the long-term returns of equities; it is the only predictable way," Murray writes. The problem with trying to time the market is that you have to be right twice, and nobody can consistently do that. If you sell when the market is down, you will lock in your losses. And once you're in cash, you're likely to lose money, because inflation is usually higher than the after-tax returns you earn from a money-market account, reducing your purchasing power and lowering your standard of living...possibly for the rest of your life.

Consider the research on how investors weathered the 1973–74 bear market, compiled by Salomon Smith Barney. Two investors put $100,000 into the S&P 500 at the start of 1973. By September 1974 with the market still sliding, each of their holdings was worth just over $57,000. One of the investors moved his money into a safe haven with a guaranteed return of 5 percent. A decade later, he almost had his original $100,000 back. The other investor stuck with the S&P 500, and 10 years later his portfolio was worth nearly $250,000.

The prudent investor learns from history. You can reach your destination if you stay the course.

1 Barber, B and Odean, T. "Trading is Hazardous to Your Wealth: The Common Stock Investment Performance of Individual Investors." *Journal of Finance.* April 2000, Vol. 55.2 pp. 773–806.

2 Benartzi, S. and Thaler, R. "How Much is Investor Autonomy Worth?" *Journal of Finance*. August 2002. Vol. 57.4, pp. 1593–1616.

3 Murray, N. *Simple Wealth, Inevitable Wealth.* The Nick Murray Company, Inc., 1999.

News and Announcements

From the Thurman Household

Levi is doing well, although he is fighting through a case of strep and chronic tonsillitis. Looks like he will have to get those tonsils removed, probably this summer. Words cannot describe his enthusiasm.

We will see how this impacts his college semester. He has missed a few classes due to illness. I'm worried about his eight-week nutrition class; he may have to retake it.

My dad came through abdominal aortic aneurism surgery. He's still on the mend. He is currently at Grace Living Center in Woodward. I'm very impressed with their care and competence. He is 79, and I'm always amazed with the toughness and tenacity of that generation. Thank you for your thoughts and prayers.

I just returned from the AICPA Advanced Personal Financial Planning conference. Three and a half days of listening to CPAs, economists, political commentators, tax experts, etc. Yes, I know, you wish you were there. But you didn't have to be. I have consolidated the conference into 17 pages of notes. If you would like a copy, please call our office and we'll get them out to you.

Take good care,

Randy Thurman, CFP®, CPA/PFS

From the Rudy Household

Eight years ago, Amy and I were in the middle of a move to a new city. Following the first three rules of real estate (location, location, location), we chose a neighborhood because we loved its location. We felt like Cobb Hill would be a great place to raise our family, but we had no idea what an impact the neighbors would have on our lives.

Within days of moving in, we met other families in the neighborhood. There were little kids everywhere! At the neighborhood park, the kids played while the parents talked. There was (and still is) always at least one other family out at the park, so the kids never lacked playmates.

As the years went by and our girls grew older, we have become close friends with four families in the neighborhood. The kids are best friends and so are the adults. Not only do we still meet at the park, but we carpool to extracurricular activities, celebrate special occasions, take trips together, and help each other in times of need. While we chose our neighborhood for the location, we stay because of the friendships we've made.

Chad Rudy, CFP®

From the Bolander Household

Coffee — on a cold winter's morning, there is nothing quite so inspiring! It calls to me from the kitchen with the promise of a soothing cup to warm my soul as I take a few moments to prepare for my day in quiet reading and devotion. The aroma wakens my mind from its slumber, and the warmth of the cup helps me adjust to the cool temperature of the house and to get me going. If you enjoy coffee too, this excerpt from "Ode to Coffee…" seems to sum it up just right:

A home-brewed confection

Delight to the tongue

A pure taste of heaven

Hosannas are sung!

(*Source: Bunny, B., writing.com*)

I usually take my coffee black; not too strong but definitely not watery. A "morning blend" is just right for me. However, while making hot chocolate for my granddaughter one morning, I discovered that adding a few of teaspoons of instant cocoa mix to my morning cup makes it extraordinary! I know I will have to quit this pretty soon because I certainly don't need the extra calories, but I fear it will be a hard habit to break. Maybe springtime can coax me out of it…

Have a great month!

Brenda C. Bolander,
CFP®, CPA/PFS