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Investing Like Crazy: Managing Your Anxieties for Higher Returns

One of the biggest challenges to being a successful investor is not having the best software, reading the best newsletter, or even doing exactly as your favorite television guru says.

We believe it is managing your emotions – greed and fear.

You can be the best stock picker around, with an uncanny ability to find tomorrow's Apple before anyone else. But if your emotions get ahold of you during the next bear market and you panic and sell, it really won't matter much.

You can be a mathematical genius, with the most sophisticated market-timing program, but if you do not understand your own emotional limits, you probably are doomed to failure.

One of the few iron rules of investing is that no amount of computer power or brains can overcome behavioral mistakes.

Successful investing requires you to understand and manage your emotions. But how do you do this?

Stay in Your Comfort Zone.

First, prepare an investment plan that you can stick to when the markets are turbulent. It is easy to stay the course when everything is going up. It is very hard to do so when your favorite investments are going down. You should design your plan to fit within your "Comfort Zone." If the market falls 10%, how much will your portfolio go down? Can you hold on? Consider having a cash cushion to cover six months or a year of withdrawals, so you do not have to sell at an inopportune time. It is vital that your portfolio react to market moves as you expect it to.

This is a very personal decision. Your comfort zone, or risk tolerance, is unique to you, and your portfolio should be, too. But you must have a written plan. How else will you know if your next great idea fits into your plan?

Get Help.

An astute financial advisor can not only help you design an appropriate financial strategy and investment plan, but he or she can help you manage your emotions.

There is a lot that individual investors can learn from the advice the experts at investment and insurance companies give to financial advisors. So let us see what we can learn and apply to our individual situations.

Crisis Mode.

When the market misbehaves we go into crisis mode – fear fuels our thoughts. Emotions take over.   We worry about the future. We think this time is different. We forget that we have been through this before and survived. We forget about our plan and how we said it would help us not to panic. Our emotions take over and we sell like the last time.

Or on the opposite end of the spectrum, we see the market going up, get greedy, and jump in. And of course we jump into what is the hottest investment of the moment. We don't stop to consider how it fits into our portfolio. Is it an asset class that we already own? Is it too risky? Has it gone up too much already?

Our emotions take over our rational mind. We like to fool ourselves that we are rational beings; that we control our emotions. It's those other people who are emotional traders.

Our emotions are like an elephant. Our rational mind is the driver of the elephant. The driver sits on top of the elephant telling it to go left, right or straight ahead. When the elephant decides to go left, the driver says to go left. When the elephant decides to go right, the driver yells to go right. The driver is not directing the elephant. The driver only thinks that he is giving the orders. The driver is rationalizing where the elephant wants to go. We are brilliant at giving "rational" reasons for what we want to do anyway.

So we buy the latest and greatest investment because it feels good or we do not want to miss the opportunity. Or maybe some guru recommends it. Then our rational minds come up with a brilliant reason why it is a good investment and how it fits into our otherwise carefully laid out portfolio. So what if we already own four other investments just like it? One more won't hurt. And besides, it is not so risky. In fact, let me explain why it is a sure thing. Our rational brains are remarkable at rationalizing our emotional decisions.

Extensive research demonstrates that when we are confronted with tough and complex decisions we take mental shortcuts, also known as a heuristic. We use rules of thumb, for example, rather than taking the time to do the math. Our lives would be impossible if we had to sit down and reason out every little daily decision. And in most cases we are okay with taking these mental shortcuts. With investing, however, shortcuts are more often wrong than right.

So let's look at some typical emotional "challenges" we face as investors, and the shortcuts we take. There are a number of biases and heuristics, or mental short cuts, that we rely on when an optimal solution is impractical or even impossible. We often refer to these as Rules of Thumb, Educated Guesses, Common Sense or Stereotyping.

Because of time constraints, I will cover just a few of my favorites that pertain to investing. I find this a fascinating subject. If you do, too, I have listed a few books at the end for further reading.

Recency Bias.

We put more emphasis on recent events than more distant memories. Recent Stock Market returns influence us more than returns over the last few years. We tend to look at how an investment has done the last quarter, forgetting how it did over the last 3 years. And we forget that past performance is no guarantee of future results.

Media Response.

I think of Media Response as a variation of Recency Bias. Every day we are bombarded with sensational news stories. And we react emotionally. The media know this, so they make every event as sensational as possible. You would not watch if the anchor said, "Ho Hum, this is just like what happened last year and it was no big deal."

If you find yourself concerned that the latest crisis will torpedo your portfolio, call your financial advisor. Discuss what you just heard. Try to analyze rationally how what is happening may impact your portfolio. Then wait a day or two before you do anything. Give yourself the chance for your rational brain to process your emotions.

Loss Aversion.

Humans experience the pain of loss 2.5X more strongly than we experience the joy of gains. Why is this?

- Gains are processed by our brains' frontal lobes, the newest part of our brains. This is our rational brain—where we do our thinking.

- Losses are processed by the most primitive parts of our brains – the Limbic System – that controls emotions. The Limbic System processes fear and signs of danger. And it works a lot faster than the frontal lobes. One economist calls this our lizard brain.

Anchoring.

As investors we often fixate on a number. You hear us say "I bought it at 10, I know it is down to 7 and looking bad, but just let me hold on until it gets back to 9 or 10. Then I will sell." We are anchored to a number. The number has no real meaning other than the one we give it. And while we are waiting for our stock to recover to our number, we lose the opportunity to invest that money in something more promising.

How many of you have done this? Raise your hands.

Mental Accounting

This is when you have more than one account and manage each as a separate entity, not as parts of a whole. For example, say you have one account that is an inheritance from your grandmother who only owned municipal bonds. You continue to own those, even though they only unbalance your portfolio, because that is what your beloved grandmother would have wanted.

I remember meeting with a brother and sister who had inherited dad's portfolio of Canadian Oil Trust stocks. It was a very aggressive portfolio that he must have monitored daily. He had left them a handwritten note to never sell the stocks and never buy bonds. They both were pursuing careers, had young families, that is, no time for careful monitoring of the investments. Nor did they have any investment savvy. At one point in our discussion, the sister said, "Now remind me: what is the difference between a stock and a bond?" But they knew what dad wanted.

Based upon their risk tolerance, we recommended selling the stocks, investing in a diversified portfolio, and taking an annual distribution, which was in line with their lifestyles and financial needs. But it was not what dad said. Rather than seeing their investments as a whole, they kept Dad's portfolio in a separate mental account and chose not to take our advice.

Another typical example is splurging with a tax return, but not with savings. Money is money. Just because it comes from a tax return, does not mean it is a different color or doesn't count.

We also know that we spend more when we put it on a credit card, than when we pay cash. And so do retailers and banks.

False Diversification

While not strictly a behavioral or emotional error, it is a common mistake. This is when you own a variety of investments that you think will provide you with a diversified portfolio. Maybe you own ten stocks. But five of them are high-flying tech stocks. These may move up and down together. They may all zig the same way at the same time.

I would suggest that you or your advisor put your portfolio through a program that can show you how your individual investments are correlated. Will some zig when others zag? Or will they all move the same way at the same time. I can almost guarantee that you will be surprised.

Herding

Perhaps the most famous herd is A Herd of Lemmings. The next most famous herd is Wall Street. This is simply our human habit of subjugating our own thoughts for those of a group. You all remember, "But Dad, everyone else is doing it." And his response, "If everyone else were playing on the freeway, would you?"

It is easy to go along with what everyone else is saying. It is tough to stop, think, and figure out if it really makes sense for you. It is a common mental short cut to go with the herd.

In fact, psychologists have conducted experiments in which all the members of a group except one deliberately give an obviously wrong answer, and the one member not in on the fix, goes along with the others, even when he or she knows the others are wrong. In our early evolution, being part of a group could have meant the difference between life and death, sharing in the hunt or starving. Today, for investors, it can be a quick and easy method to come up with the wrong answer.

Nonetheless, sometimes the herd is right. The point is to be aware of our human tendency to herd.

Optimism

This is a belief that good things happen to me. Bad things happen to others. For example, if I buy a stock, somehow it will know it and go up.

From an evolutionary standpoint, optimism probably is a good thing. And in life today, you have to be optimistic to take risks. If you were not optimistic that an investment was going to grow, why would you buy it?

You invest because you think your investment will go up in value. You're optimistic. But you also need to decide before you invest what you will do if you are wrong. The better you understand why you think your investment will go up, the better you can evaluate what to do if it does not go up. Is it a short-term correction, or were you too far off-base in your assessment of its potential?

Be optimistic, but have a Plan B, if you're wrong. And have the discipline to follow your plan. I would strongly suggest putting the plan in writing.

Overconfidence.

This is a particular trap for investors who have been successful in other areas of life. Among financial professionals, for example, doctors are notorious for being poor investors. They know they are smarter than most other people, and often work much harder. But expertise in one area does not automatically carry over into other non-related areas. They may be god-like in the examining room, but not on the trading floor.

Remember that the institution on the other side of your trade may well be a huge investment bank with an army of MBAs. Are you really smarter? Do you know something that they don't?

A little humility could make you more money than an excess of confidence.

Status Quo Bias

Whatever is happening now, will continue in the future. If the market is going up, it will continue to go up. If it is going down, it will continue to fall. This is particularly tricky, as there actually is a valid investment strategy – momentum investing – that invests on the premise that stocks that are rising in value tend to continue to rise in value. And those that are falling in value tend to continue falling in value. And in many cases this is true. But the trend fades with time, or something unexpected happens to disrupt the trend.

Endowment Effect

What we own is more valuable than the same item we do not own. There is a famous experiment in which participants were given a mug and then offered the chance to sell it or trade it for equally valued pens. They found that the amount participants required as payment for the mug they owned was approximately twice as high as the amount they were willing to pay to acquire the same mug. If I own it, by definition, it is worth more. Makes little sense, but that is what most people believe.

Confirmation Bias

Our brains don't like conflict. They prefer harmony. Our natural instinct is to search out information that confirms what we already think. We, humans, are wired to avoid "cognitive dissonance," that is, holding two ideas that are in conflict. We avoid information that conflicts or undercuts what we believe is true.

If you have invested in a stock, you will unconsciously pay attention to information that confirms your opinion that it is a great buy, or that the sector is on the upswing. And, to make matters worse, you will unconsciously avoid information that questions your decision.

You have to make a conscious effort to seek out information and opinions that contradict you decision, that make you think rationally.

This Time Is Different.

No it isn't. Enough said.

In Sum.

These emotional responses and numerous others lead Rational Investors to make less than optimum investment decisions. Then, instead of using our rational minds to make well-reasoned decisions, we use our rational minds to justify these emotional decisions.

What's an Advisor to Do?

Now let's turn our attention to the other side of the equation, the Advisor.

An astute advisor knows that when investors are stressed, the limbic system takes over. Emotions take control, and it is not easy to shut off. A client simply will not be able to hear what her advisor is saying.

So, advisors must adjust. The advisor may think he or she is talking to the frontal lobes. But the client is listening with her limbic system. The client is not really capable of listening with her rational mind. Her emotions are in control.

Now why does this remind me of talking to a teenager?

So What Should an Advisor Do When the Investor's Limbic System Is in Charge?

- **Invite the client to vent.** Allowing a client time to express her anxieties will help her be able to listen when done. Spend the first several minutes drawing out her anxieties to get a good idea of what she is going through. Do not try to contest any of the points. Simply sympathize and be sure to get a good understanding of what worries her.

- **Mirror a Client's Comments Back to Her.** This will enable the client to hear what she is saying and reassures her you are listening. Simply restate her feelings to validate them.

- **Sympathize and Resist Your Urge to Fix the Problems.** Clients just need to feel heard and accepted. They need to share their pain with someone who is willing to receive it. So just listen.

- **Don't Jump in with Data – Or Jargon.** Clients already feel bombarded with information. Explain in plain English. Do not talk in long paragraphs. An upset client has a shorter attention span.

- **Listen for the Client's Questions so You Can Move Forward.** A Good Transition is: What would be most helpful for us to discuss regarding your concerns? Address what the client wants to discuss, not what you think she needs to hear.

Recognize Decision Fatigue.

A volatile stock market can produce significant stress in investors.

In turn, stress produces Decision Fatigue or Willpower Depletion.

Under stress, making a decision actually becomes exhausting physically and emotionally.

Humans have only a finite store of mental energy for exerting self-control. Sticking with a plan requires energy. When a client is suffering from Willpower Depletion, she becomes susceptible to acting impulsively, letting go of the plan (and pain).

Market volatility means that each day a client must decide to stick with the plan, adjust, or bail out. This can be exhausting.

How Can an Advisor Re-Energize Clients?

- **Remind the Client that You Can Manage, But You Cannot Eliminate Stress.**

- **Listen More than Talk.** Remember the core problem is emotional, not one of investing philosophy or technique. So be a good friend or counselor. Let the client talk-out his or her concerns. Here is a lesson that men can take from women. We tend to try to fix everything, when oftentimes the person just needs to vent to a sympathetic ear.

- **Model Good Decision Making.** By carefully evaluating options, monitoring and measuring results of changes, your behavior can serve as a model for your client's decision making. Review your plan, especially how it should behave under stress. Is it moving as expected? If so, this should help to reassure the client that things are under control.

  Or are there surprises? Can the advisor explain the surprises? What lessons can the advisor and client learn from the surprises? Discuss them.

- **Share His or Her Own Positive Energy.** Be confident, but not a Pollyanna.

- **Make Small Portfolio Adjustments (if appropriate).** This helps the client feel that the advisor is listening to her concerns.

  It reminds me of a former supervisor in the State Department who explained that he was invited to a meeting on a problem in a South American country. He suggested that we did not need to do anything. He said he was never again invited to a meeting on the subject.

  So do something (if appropriate), just not too much.

- **Explain to the client that staying the course is a decision.** It is doing something.

- **Get Back To Basics.** Suggest to your client that she turn off the TV and avoid other negative media.

- **Reassess Risk After Prolonged Volatility.** While the client is stressed is not the time to reassess her risk tolerance. First understand and manage her pain. In crisis mode, clients perceive future risk as greater than it is.

- **Talk It Out.** Consider meeting more frequently. Do less talking and more listening.

- **Concentrate on What You Can Control.** How much you spend, how much you save, and your Asset Allocation. No one can control market or economic performance.

- **Watch less business news.** This is my favorite. The TV is an entertainment medium. We watch shows where people say outrageous things. We want our experts to have strong opinions.

- **Congratulate Clients for Making It through the Volatility.**

- **Discuss lessons learned with the Client.** Let's pay attention to how we performed under fire.

The ultimate solution to managing our anxieties is to have a plan and have the discipline to follow it when the tide goes out.

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