

May 24, 1998

## PSYCHOLOGY OF THE INVESTOR

Behavior of the individual investor has long been the interest of academics and portfolio managers, but not investors themselves. The herd mentality sometimes dominates over reason, but why? Ask Dr. Daniel Kahneman, the Eugene Higgins Professor of Psychology at Princeton University, about investor behavior, however, as it relates to risk or loss aversion and some fascinating concepts emerge.

Investor behavior is part of the academic discipline known as “behavioral finance”. Much of the basic theories of behavioral finance concern irrational or overconfident behavior as it relates to the so-called rational investor.

Dr. Kahneman, who recently spoke in New York City at the Wealth Symposium co-sponsored by the Institute of Certified Financial Planners and Warburg Pincus Investments, is famous for his original works on the concept of “loss aversion”, a phrase he developed that is widely used today in the investment community.

Loss aversion describes the basic concept that, although the average investor carries an optimism bias toward their forecasts (“this stock is sure to go up”), they are less willing to lose money than they are to gain.

An example: Would you accept this gamble? A “50 percent chance to win \$15,000” or a “50 percent chance to lose \$10,000”. Most people would reject this gamble as too risky. The aversion to lose the \$10,000 is greater than the optimism to win the \$15,000.

How does this effect trading? Most investors think they can beat the market (overconfidence) although evidence is overwhelming that they cannot. An associate of Dr. Kahneman, Terry Odean studied the behavior of buying and selling stock. His findings point out that “when an investor sells a stock and immediately buys another, the stock that is sold does better in the following year, by 3.4% on average”.

Selling at the wrong time brings about the concept of “regret”. Feelings of regret also come about in situations of “hindsight”, (“I should have bought

AOL last year”) and “coming close”, (“I was all set to buy AOL last year when I was unexpectedly called out of town”).

How can investors deal with these real psychological issues? Professor Kahneman suggests that regret, optimism, and risk taking can be controlled by;

- **Follow a Routine:** If you have been comfortable with diversifying your assets among various asset classes both domestic and foreign, you should continue on this course. Buying tech stocks or emerging market funds may be out of character for you. Following a routine will provide greater satisfaction as well as a mechanism for controlling regret.
- **Make a Decision Hindsight-Proof:** You can avoid second-guessing by thinking a lot about the decision before acting. The idea that a purchase must be made "now" is usually nonsense. Good stocks are long-term buys and they are, therefore, rarely subject to any short-term decision-making. Again, following a routine is helpful in the decision-making process.

Dr. Kahneman also pointed out that people are prone to “cognitive illusions”, like becoming rich and famous or being able to get out of the market before a bubble breaks. People exaggerate the element of skill and deny the role of chance in their decision-making process. People are often unaware of the risks they take.

Add loss aversion to the mix and it's no wonder the average investor panics in a market downturn, a time perhaps to buy rather than sell.

Reprinted from and with the permission of the *The Times* of Trenton