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Are Your Emotions Costing You Money?

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Traditional finance theory has always assumed that investors make financial decisions that are well-informed, carefully reasoned and consistent with their goals. Further, that investors are never swayed by their emotions nor confused by how information is presented.

Clearly these assumptions do not match reality as investing is highly emotional for most of us. In fact, over the last 20 years a new understanding of investor behavior (i.e. "behavioral finance") has emerged which blends psychology and economics.

It doesn't matter how long you've been investing, how big your portfolio is, or if you have access to the best information… behavioral finance proves we all let harmful decision-making behaviors (or biases) hurt our investment results. These decision-making behaviors are a fundamental part of human nature so the only way to "work around" these biases (to reduce their negative influences and effects) is to understand them.

So what are a few common biases that hurt investors? Overconfidence, Loss Aversion and Regret Avoidance are at the top of the list. So let's explore these biases and how they affect investors.

Overconfidence in investors is manifested in the belief that they exercise more control over their investments than they actually do. In other words, people tend to believe their investment-picking skills are critical to their portfolio performance when in reality the overall market and economy can be more important. This is why proper asset allocation and diversification are often stressed by financial advisors. Overconfidence can also be seen when investors believe that "they have it all taken care of" and therefore there is no need to obtain a second opinion.

Loss Aversion in investors is the tendency to sell winners and keep losers. In 1999 Professors Brad Barber and Terrence Odean found that investors were 50% more likely to sell a winning investment than a losing investment. This is mainly because people have a strong desire to "get back to even" before selling. Interestingly, the U.S. tax code makes it more beneficial to sell losers (and capture a "tax loss" benefit) and hold winners (to defer capital gains taxes). Barber and Odean also found that this tendency to sell winners and hold losers hurts investment returns.

Regret Avoidance plays a key role in failed inertia (or not taking action) even on things that a person wants to do. A related issue (i.e. "having second thoughts") is when emotions sway one away from an agreed upon course of action. The intense human desire to avoid regret drives these behaviors. Unfortunately the tendency to procrastinate (failed inertia) dominates financial decisions. Why? Most investors lack certainty about the specific merits of taking action (whether it be getting a second opinion or just changing investments) and they therefore choose the path of least resistance and do nothing. In other words, although many know they made mistakes in the past and can make improvements; since they are uncertain of what they should do now… they'd rather leave things alone to avoid making another mistake.

Bottom line… your emotions can hurt you when it comes to investing. More importantly, avoiding a second opinion is mostly an emotional response to the uncertainty of finding a qualified advisor you can trust. My advice, when it comes to your money you should never be afraid of new information or differing opinions as new ideas are the engine of growth.

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