FACTORS IN FOCUS

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This Is Your Brain On Investing

by Eric D. Nelson, CFA

How much time have you spent thinking through your long-term goals? What about your effort to understand the science and rationale behind the investment plan that we designed for you with the sole intent of achieving these goals? Do you ever wonder why, despite considerable effort on your part, each time we are faced with a crisis-induced stock market plunge you want to sell out?

Never once, as you read through and signed your investment policy statement, did you look for the section that covered a catastrophe clause—what to do when the headlines turned grim and the stock market headed south. At that time we discussed at length the danger and costliness of rash behavior. You understood and agreed that we would stick to our plan and rebalance when necessary, making adjustments only when *your* circumstances changed But during a downturn, your initial reaction is to panic, to want to flee until it's safe again.

Is there something wrong with you? Are you just not cut out to be a good investor? Maybe you just don't "get" this stuff? I can promise you, none of these things are true. Your time spent with us understanding the markets and your portfolio was not in vain. But how you interpret and process financial information is complex and inefficient. It isn't your fault that you respond this way; it's how we are all wired and it is a byproduct of our environment.

The bad news is, panics and stock market crises will always be with us. We will never be able to predict them in advance and your urge to cut and run may never leave you completely.

But there is good news. If you take the time to better understand how you are influenced psychologically and physically by financial traumas, and the steps you can take to minimize these effects, you can become better prepared to tolerate them. This will help to reduce your anxiety and lead to greater financial success.

Fight or Flight?

Our recent ancestors would have had a hard time imagining how our current living standards have changed. What has not changed much is the brain we use to perform daily tasks, including making smart financial decisions.

Our modern brain looks and acts almost indistinguishably from the one we relied upon to hunt for our food on the African savanna tens of thousands of years ago. The part of the brain that was thrust into "fight or flight" mode when it sensed danger lurking in the brush is the very same part that processes the fears we encounter today.

Few events provoke more fear in us than the potential loss of our financial freedom due to a plunging stock market. As a matter of fact, neurologists who study how our brains react under traumatic circumstances have found that the logical and rational part that normally allows us to thrive in today's complex world becomes temporarily incapacitated and we are driven entirely by the part that drives our emotions.

As this temporary panic subsides, we attempt to rationalize the experience by watching the news or reading the financial media's take on the situation. This only makes matters worse. Our strong sense is still that we need to act. Instead of conducting a thorough and balanced assessment, we fall prey to "confirmation bias," our tendency to go in search of "proof" that confirms our pre-established beliefs. Even if this "proof" is based on faulty logic, we give it credence because it supports a predisposed point of view. We know there's a crisis, we see the declines in our portfolio and we sense that it may continue (remember our discussion of "recency bias" last month?), so we subconsciously search out independent validation for our fears, becoming convinced matters will only get worse.

Even if we weren't programed to search out confirmation, the financial media would bombard us with it. Their take is sensationalized and usually negative. You've heard the saying made famous by *New York* magazine, "if it bleeds it leads." Their use of strong language and graphic images such as plunging stock market charts is intentional. It attracts viewers and readership and helps to sell advertising. Unfortunately, it also helps confirm our greatest fears.

Making matters worse, we often consult with friends and family members about the situation or are exposed to it through dinner talk or chatter at work. Odds are good that the opinions you hear mirror the doom and gloom plastered across television, newspapers and the internet. Because we instinctively follow the herd, we find a sense of safety and sensibility in numbers, even if the consensus rests upon flawed assumptions. What's more, neurologists have found that forming independent opinions and beliefs, going against the crowd, actually impacts the same part of the brain that feels physical pain. In other words, thinking critically for yourself and ignoring "conventional wisdom" can not only be hard for many people, *but it can hurt*!

Unfortunately, this harrowing experience doesn't just have a temporary impact on us. Studies have shown that our brains become branded by these situations and we go to great lengths to protect ourselves from experiencing the same emotions and fears in the future. Studies on cash flows into and out of mutual funds have found that investors were selling their stock funds for almost five consecutive years *after* the 2008 bear market, thus missing out on one of the greatest bull markets in modern history—all in an attempt to avoid another decline like the one they saw a few years earlier, despite the fact that we had not experienced a yearly loss of that magnitude in almost 70 years!

Think Differently

Now that we understand some of the problems and reasons why you are hard wired to react irrationally to traumatic financial events, is there anything you can do to reduce your anxiety? I think there is.

First, give your brain a rest. Feel free to check out. You don't have to inundate yourself with every detail of the current financial situation. If something in your portfolio warrants attention, we will address it and discuss it with you. Chances are, short-term issues will have no material impact on your long-term goals.

Second, don't internalize your frustrations, call us to discuss them. A more grounded and rational perspective can help you cool off and worry less.

Finally, make a conscious effort to minimize your exposure to the financial media and conversations with friends and family regarding money and investments. No one knows your specific plan and portfolio design as we do, so what good could you possibly get from the uninformed majority who don't understand all the facets of your personal situation, let alone the philosophy and principles that you believe in and have committed to? You can turn off your computer and television and skip past the business section of your newspaper. And in response to friends and family, there's nothing more intelligent than simply expressing an "I don't know, don't care" attitude towards the crisis of the moment, knowing you've planned ahead.

Edited by Kathy Walker