Managing the Predictably Irrational Investor

By Jim Coleman

If you're prone to making emotional investment decisions, you should be especially on guard this year. In the wake of the Great Recession, you may still be mourning your 2008 losses, yet simultaneously hopeful over the market's broad gains in 2009. There's no question that this unprecedented combination of fear and greed could significantly impede your rational decision making. In fact, behavioral finance research shows that no matter how long you've been investing -- or however vehemently you insist you will be guided by reason -- you'll likely repeat your past emotionally-driven blunders. You'll follow the crowd and cash out at the wrong time or jump on the bandwagon too late.

Just consider how you behave in rush hour traffic. Your lane comes to a near halt, but it seems the next lane is moving fairly well. Convinced that you have greater insight than the other drivers, you maneuver and switch lanes. Of course, as soon as you do, your original lane starts moving and you find yourself sitting still. It's a futile exercise you repeat day after day, although you know you've failed in the past and have no proof that your current maneuvering will be successful.

You can think of those lanes, of course, as investment strategies or asset classes that move in and out of favor about as predictably as rush hour traffic. In the end, the same emotional instincts that lead to your frustration during a traffic jam can curtail your ability to make rational financial decisions. As a financial advisor, I offer a helpful and comforting bird's eye view of traffic because I'm evaluating the big picture, rather than just comparing your rate of speed with the car next to you. Because I'm evaluating the big picture, rather than just comparing your rate of speed with the car next to you, I can help ensure that the lane you're traveling in will get you to your destination on time. Further, because investors' irrational behavior is at least predictable, I can provide a more rational, and beneficial, framework for your decision-making.

As I meet with clients for year-end planning, I'm offering the following advice to keep their emotions in check:

- **Understand the root of stress.** When you're under stress, your adrenal glands release adrenaline and cortisol hormones that affect your brain and cause a short- term focus, increased pessimism, impaired concentration, a reduced attention span, and decreased patience. Accordingly, with your perspective altered by stress, you are more likely to make impulsive decisions that can negatively impact your finances. Understanding the biology behind your feelings may help you avoid having short-term market volatility play on your emotions and destroy the discipline necessary for successful long-term investing.

- **Stay engaged.** Behavioral finance teaches us that the more complex the problem, the more likely we are to choose the default option, or in the worst case do nothing. Plenty of individual investors still seem frozen, afraid to make financial decisions. However, doing nothing to respond to today's transitioning market is, in fact, a decision -- and one that could result in significant missed opportunities. Focusing on the many things that are right with your life, as well as emerging market opportunities can help you to stay involved with your finances.

- **Return to your plan.** Your investment policy (IP) statement should spell out your short- and long-term goals, the investments to best achieve those dreams, and actions you will take in the event of a market downturn. Collectively, the IP answers the question: Why am I investing?

When a client asks, "Should I move to cash?" my response is to ask, "What are your goals?" and "Is your current investment mix still appropriate for those goals?"

- **Focus on specifics.** Whether you're deciding on 401(k) options or salad dressing at a restaurant, too many choices can make your job more difficult. In an environment where you may be energized by the market's gains, but cautious about how to move forward, be more specific about what you own. Each investment should have a particular role to play in your portfolio, and the more transparency the better.

- **Lengthen your time horizon**. To avoid making a quick fix portfolio move in response to some newspaper headline, lengthen your perspective by reviewing your long-term goals. How will a decision you might make today impact you over a five-, ten-, or 15-year time horizon? Given that timeframe, does your current allocation need tweaking to capitalize on opportunities or mitigate risk?

- **Embrace the process.** If you sail from Point A to Point B, it's impossible to travel in a straight line. In fact, sailing is nothing more than a series of corrections to get you back on course to your ultimate destination. Because the market is as unpredictable as the wind and weather, it's important to look at the need to make a portfolio change as necessary and expected, rather than as an unexpected negative.

Above all, especially in this transitioning market environment, be careful where you turn for investment advice. It never ceases to amaze me how many people follow their neighbor's advice. Think about it. You probably don't drive the same car as your neighbor, spend your leisure time in the same way, or share the same retirement goals. So why would his investments be a good match for you? What's more, he certainly has limited information about your long-term goals and risk tolerance. Instead, seek out a professional advisor whose values center around putting your needs first and committing to ongoing financial planning. That process can help you overcome your emotional biases, think positively, and make rational investment decisions to maintain the long-term investment perspective that is essential to meeting your goals.

About Jim Coleman
Jim Coleman has been in the financial services industry for over 20 years. He founded Coleman Financial Advisory Group, voted "The Best Financial Advisor of Greater Waterbury for 2008 and 2009". Coleman specializes in providing comprehensive financial planning, asset management and estate planning services. He holds a degree from Northeastern University, in Boston, with a double major in finance and marketing. He is a member of the Financial Planning Association and is the President of the Connecticut Chapter of the Society for Financial Awareness.

Coleman's passion is finding solutions to financial problems and further educating his clients and the community. Listeners in Connecticut rely on Coleman to deliver sound, accurate financial advice as host of *All About Money*, a radio talk program. He writes a financial planning column for a local newspaper, the *Prospect Pages*, and recently authored a book titled *Educated Investing: Your Guide to Surviving and Thriving in the Fast-Paced Global Markets of the 21st Century*. Visit www.ColemanAdvisoryGroup.com to learn more.

The "Best of Greater Waterbury" award was determined by survey responses sent in by readers of The Observer newspaper for the months of March and April in 2008 and 2009.

SOURCE: Written by Jim Coleman, Securities America, Inc. Registered Representative, in conjunction with Impact Communications.

AdTrax # 117347