Chicago Tribune
YOUR MONEY

Your own worst enemy

Gut reactions can lead to poor market moves

By Paul Barr
Special to the Tribune

Photo for the Tribune by Erik Unger

"Many people just want to stop the pain," says DePaul University finance professor Werner DeBondt.

With the way stock prices have behaved in recent years, many investors may be wondering if the market is out to get them.

No matter how low stocks go, they always seem to find a way to head lower, leading some people to question the sanity of being invested in the market at all. The natural inclination may be to sell out until the market has settled down.

Relax, say behavioral finance experts, who make it their business to study market psychology and the mental mistakes investors can make. An investor's gut reaction is often the wrong move to make. Rash moves during booming or sinking markets can result in a buy-high, sell-low approach.

Nevertheless, investing with your head instead of your heart isn't easy, when so much can ride on your decisions.

"You don't want to let the fact that we're in a bear market color your investment strategy," says Hersh Shefrin, professor of finance at Santa Clara University and author of the behavioral finance book "Beyond Greed and Fear."

Just as it was unwise to let the bull market cause an overreliance on one asset class, or in some cases a single stock, pulling back too far from equities is likely to be a mistake, Shefrin says.

A look at the past suggests there's no reason to panic, though there are real psychological reasons why investors might have urges to drastically change their investment allocations.

"Right now, many just want to get out, get it over with. This can be very dangerous," says Werner DeBondt, a professor of finance at DePaul University and director of the Richard H. Driehaus Center in Behavioral Finance. "Historically, stock markets have performed pretty well, and there's no reason to think the future will be any different."

The stock market and economy has survived much worse scenarios in the last 100 years—World Wars I and II come to mind—and they're likely to survive the current bleakness.

"In the grand picture of markets ... this is nothing," DeBondt says.

From a behavioral perspective, investors generally should hold tight, assuming they have a proper diversified investment mix.

And it's not just amateurs who are at risk of committing psychological mistakes.

Behavioral finance research has found that even professional investors fall prey to the behavioral traps found in the stock market. Current market conditions are particularly ripe for people to make seriously bad decisions, the experts warn.

In the heyday of the defined benefit pension plan, it wouldn't have mattered so much to non-professional investors.

Corporations took most of the risk of supplying pension benefits to its retirees. If a company suffered investment losses, they had to add more cash to the plan to make good on their promised retirement package.

Today, with the 401(k) plan

PLEASE SEE BEHAVIOR, PAGE 7

BEHAVIOR: Individual investors can affect prices

CONTINUED FROM PAGE 5

and its uncertain future value taking on a greater role in the retirement picture, investor psychology among people with little investing experience could have huge repercussions.

"It's not clear people are prepared for this," DeBondt says.

One bad move now could determine which side of the McDonald's counter you'll be standing on during your retirement years.

And how the general public reacts to the three-year-plus bear market in stocks could affect how much longer the downturn lasts.

"What individual investors do will affect prices," DeBondt says.

There are plenty of ways to make a mental error during a bear market.

One of the more common psychological errors is assuming that what's happened recently will continue, something called recency bias or extrapolation bias.

People can't imagine prices rising in the midst of a bear market, and can't imagine prices falling in a bull market, Shefrin says.

In either case, "it can be disastrous" for investors who get completely out of stocks in a bear market or become too heavily invested in stocks during a bull market, he says.

Supporting the recency bias has been the unusual length of the current bear market, which some say is an overreaction from the years of stock market growth in the 1990s that culminated in the technology bubble. The old buy-on-dips strategy that worked so well for so long failed in the last three years.

"Many people just want to stop the pain," DeBondt says. "The thing to do is not to flinch."

And even as investors try to successfully navigate the market's waters, they may be setting themselves up for additional pain.

A matter of trust

Most individual investors operate with a great degree of trust, says John Nofsinger, professor of finance at Washington State University in Pullman, and author of the new book "Infectious Greed," a prescription for restoring confidence in corporate America. During a bear market, investors want to own investments that make them feel safe.

"Many have looked around and said who can I trust now? The answer is the bond market," Nofsinger says.

Bonds certainly have a place in a diversified portfolio, but plowing huge chunks of long-term savings into that sector could wreak havoc on returns if interest rates ever return to historical levels. With 10-year fixed-income yields hovering near 4 percent, investors aren't being paid a lot to take on the risk of interest rates rising, which reduces the value of fixed-income investments.

But that doesn't mean investors should buy a stock and hold forever, either. Selling a losing stock can make sense from an investment standpoint and have tax benefits.

Unfortunately, too many investors hold on to stocks they own at a loss with the hope that the share price will return to its break-even point, a price target that has no real investment value, other than a psychological one. Selling at a loss is an admission of defeat or lack of skill, and is a leading cause of investment disaster among even professional money managers.

Another psychological mistake that happens when investing directly in stocks is that investors rely on popular valuation methods that in the end don't work. Instead of doing financial research or quantitative analysis, they buy a company because it has a good or exciting product.

"The average investor doesn't know a good company from a good investment," DeBondt says.

Good companies not only can be a lousy investment, but some financial research indicates they are likely to be so, DeBondt says.

The technology stock bubble was a prime example of people investing in companies with good products or services and a poor investment outlook. "People love glamorous companies," and tech firms had plenty, he says. Some research has shown that buying a company at the point when it has become well-known or held up as a model of success has a good chance of being the worst possible moment to do so. Instead, greater value can be found with companies that are out of favor in public opinion.

Furthermore, individual investors tend to forget about the benefits of owning a variety of companies and industries. People might load up on stocks of local companies, companies with strong brand names, or shares of the company they work for, all of which can lead to problems during a downturn.

Look at mutual funds

Given the many ways investors commit mental errors with their investing, perhaps they should give it up and go into a mutual fund.

Shefrin says that may be the best thing to do for most people. Even though professional investors make the same psychological errors individuals do, they have two things individuals don't: a consistent discipline and advanced technology.

Individuals tend to jump willy-nilly from stock to stock, relying on information that is unreliable or has been widely disseminated and priced into a stock.

> *'Right now, many just want to get out, get it over with. This can be very dangerous.'*
>
> —Werner DeBondt, director of the Richard H. Driehaus Center in Behavioral Finance.

Full-time money managers get an edge because they generally stick to a regular investment plan and have better access to information.

Certain types of people might be better off segregating a small portion of their investment savings into a pool they can manage on their own to satisfy their psychological urges. These types of people crave the excitement of the market, Shefrin says.

Lucile Kane, an Aurora investor, takes that very tack. As a Depression-era child, Kane had little interest in the markets and no money to invest until after her daughter graduated from high school and Kane took a job in real estate. A later inheritance added to her stash. She eventually began to dabble in investing.

"I'm a gambler. I like to take chances," Kane says.

Despite that, she keeps the bulk of her money in a professionally managed account, and tries to take a long-term perspective with investments in conservative stocks that pay dividends.

"The good companies are going to rise to the top," she says. "I don't panic."