Emotionality and Investing

In some sense, the financial markets can be viewed as the sum of individuals who participate in them; all of them are emotional beings. If we accept this statement, it is only logical that the market would, at times, behave emotionally. Yet, all of modern finance is built around the premise that each one of us, as economic agent, is a rational being, moved only by utilitarian needs. Although many of us have long known that there was something amiss with this reductive view of economic reality, until recently, there was no solid research to support another theoretical framework.

Over the past twenty years, scientists of a new hue, happily mixing economics and psychology, have started to produce an increasingly persuasive array of research on the influence of emotional behaviors on investment decisions. In doing so, they have made a solid contribution to the field of economics and finance and moved these disciplines beyond the limiting theoretical concepts that had held dominion over them. The totality of this new type of research can help us better understand market behaviors and inform our investment decisions. The purpose of this article is to present briefly two of its most interesting findings and to suggest how an investor might compensate for their effect.

Prospect Theory contends that people value gains and losses of similar magnitude differently. Losses have more of an emotional impact than gains of the same size. On average, a $100 loss upsets us twice as much as a $100 gain will make us happy. Another way of looking at this is to say that it takes a $200 portfolio gain to compensate for a $100 portfolio loss. One of the implications of this "illogical" propensity is the disposition effect. **The disposition effect** is the propensity to hold on to losing stocks and to sell winning stocks too early. We are generally willing to hold on to a losing stock far longer than we should in order to avoid the pain and regret associated with the sale. The sale makes it final and painful. On the other side of the coin, we are often unable to ride a winner as long as we should, simply because the risk of holding on to it past its top is too much for us to bear.

I have found that one of the best ways to fight the disposition effect is simply to "layer in and out" of investment positions. If my rational brain tells me that I need to sell a stock and if my emotional brain does not want to comply, for fear of admitting that I made a bad decision, I sell in stages. I will decide on a selling plan and split the sale in three to five smaller portions and spread it over time. Depending on how

sizeable the position is and how much conviction I have in my decision, it may take me a few days, weeks or months. Once I have decided on the timing, I am committed to the plan and much less emotionality comes to undermine my resolve. I find also that the simple effect of planning the sale is calming. I apply the same process to make new investments. I never do it in one shot, instead always layering it. This has served me well over the years.

Another related concept discovered by financial "behaviorists" is the **anchoring effect**. Anchoring is the tendency to attach or "anchor" our thoughts to a reference point that may or not have any relevance to the decision at hand.

Let's take an example applied to investing.

Let's say that you bought Amazon a few years back at $100. It is now at $300. You have made a nice return. However, it went up to $400 last year and you failed to sell. Now that it is back at $300 you will not sell it until it reaches $400 again. On the face of it, this behavior makes no sense. Either you want to keep the stock and you should be willing to live with the ups and downs or you want to sell it and doing so at $300 should be good enough given where you bought it. Yet it is not. You will not be happy until it reaches $400 and will hold on to it, whether it does or not. You are "anchored".

I do not have an easy remedy with this type of irrationality. Perhaps the best thing to do is to have a plan ahead of time, so that buying and selling becomes much less emotional. In other words, before buying Amazon, try to know 1) what motivates your buying, 2) what would be a good return overall and 3) how much loss you are willing to endure, should it come to that. Then, stick to the plan. This is hard to do but so very valuable.

Applied to a total portfolio, I have found that the systematic layering in and out of positions and the planning of all buys and sales, when rigorously implemented, can make a significant difference in portfolio performance. Perhaps as importantly, it will diminish the angst and emotionality associated with investing in general.

The contribution of behavioral finance to money management is real. Knowing that you are now "anchored" or that you are suffering from the disposition effect, can only help you better understand your decisions or non-decisions. I invite you to read more about these and other related concepts. They will make you a better investor.

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