Behavioral Finance: Investors React Emotionally, Irrationally

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"Wall Street makes its money on activity; you make your money on inactivity."
— Warren Buffet

THE GROUNDBREAKING WORK of psychologists Daniel Kahneman and Amos Tversky in the 1970s to 1980s and follow-up research conducted over the last three decades have revealed striking insights on the complex ways in which the human mind operates. In his 2011 best-seller *Thinking, Fast and Slow*, Kahneman, winner of a Nobel Memorial Prize in Economic Sciences, crystallized those theories, countering traditional economic theory by demonstrating that humans are not always rational in their decisions, that we make financial decisions based on emotions and cognitive biases.

Such behavior results in several tendencies that are counterproductive to our efforts as investors. One of the most common, according to behavioral finance, is loss aversion. Research shows that we feel twice as bad about a financial loss as we feel good about a gain; the pain of losing is twice as intense as the pleasure of gaining. This has a huge impact on us as investors. Our aversion to loss, our anxiety and fear, can stand in the way of investment success. We need look back no further than last March, as the COVID-19 pandemic cratered our economy, to demonstrate the theory at work. Investors dumped stocks as the markets declined, then didn't get back into the markets until June or July. They lost on both sides, selling undervalued equities and paying too much when they bought back.

We make decisions based on emotions and cognitive biases.

Loss aversion plays out in other ways in portfolios. Portfolios can be too conservative; investors fearing volatility hold cash as perceived security. But that security comes at a sneaky cost, as inflation erodes purchasing power. We advise our clients to have enough cash to pay their bills for six months and their mortgage for up to two years, should their income be interrupted. Being too conservative is the main reason investors underperform in the market.

The pain of financial lose is twice as bad and the pleasure of financial gain.

There are ways to outsmart our behavioral tendencies. One is to review your financial goals routinely, to remind yourself why you decided to invest. We got into the market because we want to make money passively. The average annual return of the U.S. stock market over the last 50 years is 10.9 percent; historically, stocks have grown, on average, more than 10 percent a year. Of course, there are ups and downs; markets rise and fall.

Another weapon against loss aversion is a properly diversified portfolio. Work with your advisor to create and maintain a portfolio that balances your goals and your risk profile. Don't let the financial media deter you. Don't change your allocation based on your relatives' or friends' portfolios. Stay the course. Heed Warren Buffet's warning: "Wall Street makes its money on activity; you make your money on inactivity. I mean if everyone in this room trades their portfolio around every day and with every other person, you know, you're all going to end up broke and the intermediary's going to end up with all the money."

Dollar cost averaging is another way to avoid losing money to your emotions. Just as you divide investing a significant sum of money over a period of months, consider the same approach to selling stock. A client who wanted to withdraw $100,000 last March was able to save a substantial amount of money by taking out $20,000 each month over the next five months, instead of all at once.

You have invested money because you want to build wealth for your family or to retire securely. Keeping that at the forefront of your thinking will help you stay your investment course and avoid substantial losses in volatile markets.

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Emerging markets require a higher risk tolerance than the equities of developed nations. But they also offer the potential of greater rewards.