Improve Your Investment Performance by Ditching Your Emotions, Instincts and Overconfidence

Rick Lehman
Adjunct Professor, Behavioral Finance, UC Berkeley Extension
WWW. BehavioralFinance.com

Today's class:

- **Step One: Admitting you have a problem**
- **Coming to grips with the magnitude of this problem (Hint: It's not pretty)**
- **Understanding the cause (Rick's super-condensed lesson in Behavioral Finance)**
- **Zeroing in on the major offenders (emotions, instincts and overconfidence)**
- **What can you do about this?**
- **Homework assignment**

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DALBAR 2016 QAIB: Investors are Still Their Own Worst Enemy

Tom Allen and Mark Hebner

Thursday, May 11, 2017

Opinion: Americans are still terrible at investing, annual study once again shows

Published: Oct 21, 2017 1:17 p.m. ET

It's not about fees or unscrupulous advisers — it's that we lack the patience to hold investments for more than a few years

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Today's Market | Market Outlook

Investor Returns Vs. Market Returns: The Failure Endures

Sep. 21, 2017 5:07 PM ET | 1 Like | Includes: CRF, DDM, DIA, DOG, DXD, EEH, EPS, EQL, FEX, BARRON'S

HOME REAL-TIME MAGAZINE ADVISOR CENTER DATA PENTA NEXT

FUNDS

Investor Returns Lag Fund Performance

Morningstar took a look at investor returns over the past decade and found that investors consistently move in and out of asset classes at the wrong times.

Most investors didn't come close to beating the S&P 500

Tom Anderson | @bytomanderson

Published 9:03 AM ET Thu, 5 Jan 2017 | Updated 11:44 AM ET Fri, 6 Jan 2017

FINANCIAL POST

Let’s face it: You suck at investing

Happy New Year. Try to suck less this year...

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- Coming to grips with the magnitude of this problem (Hint: it's not pretty)
- Understanding the cause (Rick's super-condensed lesson in Behavioral Finance)
- Zeroing in on the major offenders (emotions, instincts and overconfidence) Your problem is even bigger than you think!!!
- What can you do about this?
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How much worse than the market averages do individuals perform ?????

- .50%

- 1.0 %

- 1.5%

- 2.0%

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- 2.0%

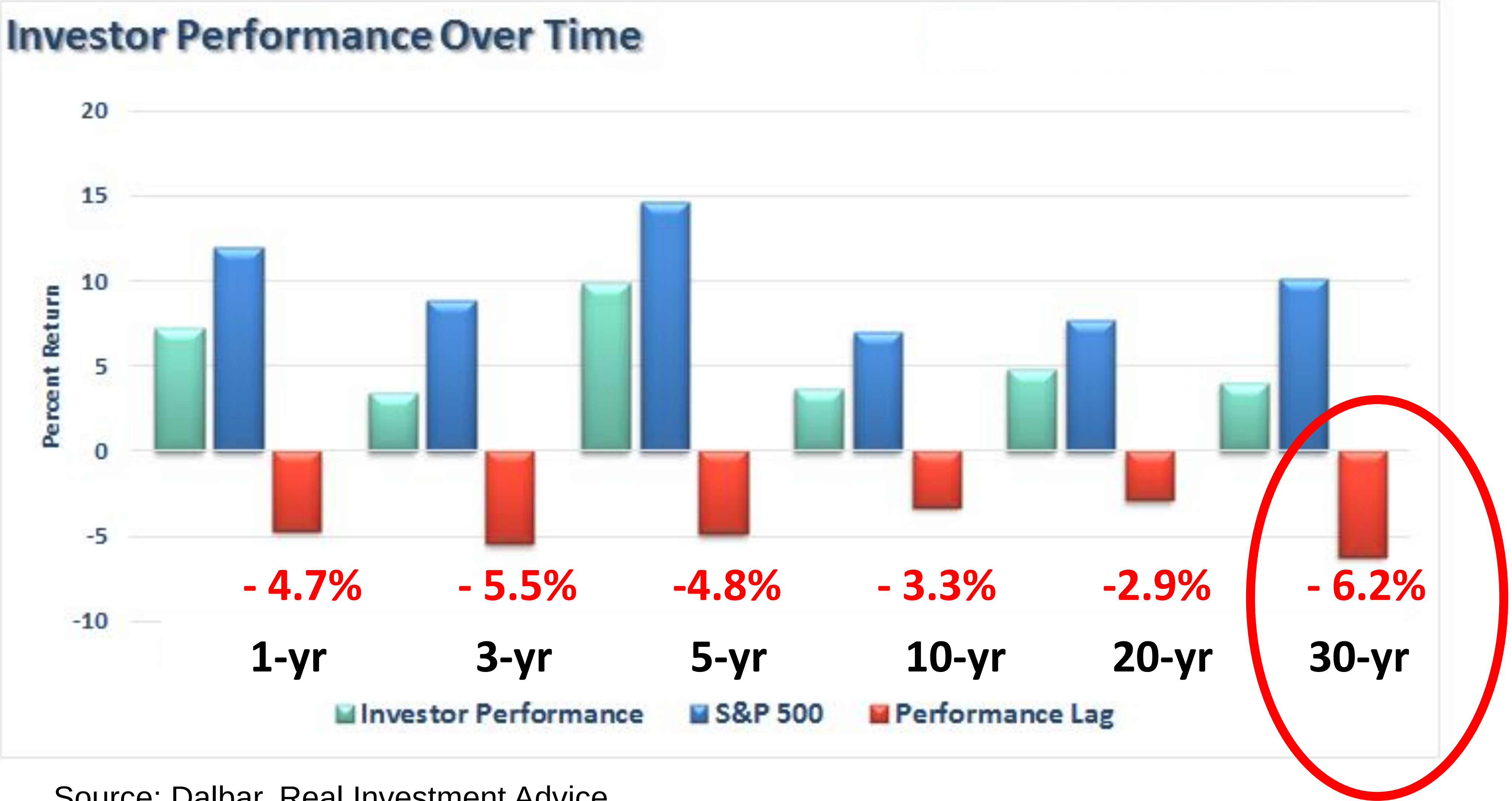
……………………………….Remain calm…

How much worse do individuals perform ?????

– 6.2%

Per year for the last 30 years!

(according to Dalbar)



Source: Dalbar, Real Investment Advice

Let's call it:

3 - 6%

Per year for the last 30 years!

(according to Dalbar)

…………..……………………..but wait, it gets worse…

The Schwab Study
Brad Barber and Terrance Odean
UC Davis, UC Berkeley


1991-1996
66,000 Schwab accounts

- **Net returns for all investors vs. the market: - 2.5% annually**
- **Net returns for the 20% who trade most frequently: - 7.1% annually**
- **The higher the turnover, the lower the return**
- **Men trade 45% more than women, so women outperform men by about +1.0 %**

"The average household …tilts its common stock investment toward high-beta, small-cap, value stocks, and turns over 75 percent of its portfolio annually. *Overconfidence can explain high trading levels and the resulting poor performance of individual investors*."

The Dutch Study
Hersh Shefrin and Arvid Hoffman
Santa Clara University, University of Adelaide

Conducted in 2015 (data from 2000-2006)
Major online broker in the Netherlands (5500 accounts)

All investors: **-1.0 %**

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Traders using TA and options	**(brace yourself…)**

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Investors who use technical analysis:	**-8.6%**
Traders using TA and options	**-20.3%**

Shefrin concludes that individual investors:

- Are disproportionately prone to speculate on short-term stock-market developments
- Hold more concentrated portfolios
- Turn over their portfolios at a higher rate
- Choose higher beta stocks

Fidelity report:

Investor subgroups with the highest returns:

Fidelity report:

Investor subgroups with the highest returns:

1. People who forgot they had an account

and…

Fidelity report:

Investor subgroups with the highest returns:

1. People who forgot they had an account

and…

2. Deceased account holders

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  If you are thinking, "Well, that certainly isn't me"
  Or "Of course the Dutch can't trade, look at what they did with tulips"…

  Then you definitely need to stay for the part on

- Zeroing in on the major offenders (emotions, instincts and overconfidence)
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Why?

Why do individual investors consistently underperform the market (and the pros only slightly less so!)

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Short Answer

Your brain is not ideally suited to this activity

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Short Answer

Your brain is not ideally suited to this activity

(neither are the pros, but computers do most of their thinking)

Why are humans not ideally suited to skillful investing ?

The super-condensed course in Behavioral Finance

“YJHTTMOT”

Why are humans not ideally suited to skillful investing ?

We do not make decisions entirely rationally

(not limited to financial decisions…just easier to measure those)

Behavioral science (now 40 years old) has essentially provided a whole new paradigm for the way humans make decisions

Why are humans not ideally suited to skillful investing ?

Our decisions are subject to a host of biases (which are almost all outside of conscious awareness)

Why are humans not ideally suited to skillful investing ?

Our decisions are subject to a host of biases (which are almost all outside of conscious awareness)

These biases come from three sources:

1. **Emotional influences**
2. **The way the brain deals with information (Heuristics)**
3. **The way the brain handles math and probabilities**

Biases come from three sources

Emotions

<u>**Overconfidence**</u>

Fear

Regret

Doubt

Pain of loss

Familiarity

Biases come from three sources

Emotions

<u>**Overconfidence**</u>

Fear

Regret

Doubt

Pain of loss

Familiarity

Confidence is great!

Overconfidence is hazardous

Biases come from three sources

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Familiarity

Heuristics

Affect heuristic

Recency bias

Hindsight bias

Present bias

Availability bias

Representativeness

Biases come from three sources

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Regret

Doubt

Pain of loss

Overconfidence

Familiarity

Heuristics

Affect heuristic

Recency bias

Hindsight bias

Present bias

Availability bias

Representativeness

Math & Statistics

Probability distortion

Law of chance

Law of large/small numbers

Gamblers Fallacy

Why are humans not ideally suited to skillful investing ?

The biases strongly affect decisions involving risk or uncertainty – making them present in every decision we make about money and investing

They cause people to make consistently bad choices, even when they believe they are acting in their best interests.

Why are humans not ideally suited to skillful investing ?

Biases are not trivial.

They are pervasive (we all experience them)

They are “hard-wired” through evolution

They are almost entirely subliminal

People tend to deny them (Overconfidence)

Biased behavior is extremely difficult to change

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People tend to deny them (Overconfidence)

Biased behavior is extremely difficult to change

…………………………………..Nonetheless……

Why are humans not ideally suited to skillful investing ?

There <u>are</u> ways to mitigate their effects;

work around them;

avoid them;

and actually use them to advantage

A few examples of things we routinely do that hurt our investment performance

1. **We jump to quick conclusions based on too little data**
2. **We naively assume everything we see and hear is factual and unbiased**
3. **We are highly influenced by what others think and do**
4. **We overreact to new information**
5. **We lose our objectivity once we own something**
6. **We mistakenly think we see repeatable patterns in random data**
7. **We rely too much on recent information and too little on older information**
8. **We misinterpret – or simply don’t accept – statistically sound facts**

A few <u>more</u> examples of things we routinely do that hurt our investment performance

9. **We take additional risks to avoid taking a loss**
10. **We exit winners too soon and hold losers too long**
11. **We over concentrate our portfolios and trade too frequently**
12. **We react differently to the same situation depending on things like our mood, how much sleep we got, and even the weather**
13. **We focus too much on upside potential and too little on downside risk**
14. **We are <u>often</u> swayed by irrelevant, biased, or misleading information**
15. **We are not consciously aware of these things while they are happening**
16. **We don’t recognize how detrimental all of these decisions are to us**
17. **We are hugely overconfident, believing that none of this applies to us**

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- ~~Zeroing in on the major offenders (emotions, instincts and overconfidence)~~ What is the industry doing about all this?
- What can you do about this?
- Homework assignment

What is the industry doing about this?

- **The industry is already a leg up because their investment process is far more <u>scientific, disciplined, and computer-driven</u>**

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- **Top global traders are hiring <u>behavioral coaches</u>**

What is the industry doing about this?

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- Top global traders are hiring behavioral coaches
- **Fintech companies are creating software for portfolio managers to monitor their trading behavior**

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- Quantitative (computer-driven) trading is fast replacing human trading
- **Pros and hedge funds are exploiting behavioral factors (“smart beta”, “factor investing”, “quant investing”)**

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What can you do?

1. **Make investing your business, not a hobby**

Your IM Business is Sloppy:

- You don’t track your expenses, your time, or your P&L
- You don’t have a formal, disciplined, repeatable approach to investing (timing, selection, diversification)
- You have no benchmark to use as a baseline for measuring improvement
- You are unable to attribute success or failure in any period to your efforts (vs. chance)
- Your methodology is unscientific (portfolio construction, Sharpe ratios, Volatility, macroeconomic analysis)

What can you do?

1. Make investing your business, not a hobby
2. **Keep a “decision journal”**

The Decision Journal

Action	Item	Date	Rationale	Gain/loss
Bought	BA	10/1	Dropped to target buy-in price	
Bought	AAPL	10/8	News about earnings	
Sold	FB	10/19	Nervous about current price	

What can you do?

1. **Make investing your business, not a hobby**
2. **Keep a “decision journal”**
3. **Get a “trading buddy” for second opinions**

Get a trading buddy (alter ego)

- Solo trading is unchecked
- Someone you can trust for an informed "opinion"
- Make sure they don't already own what you're thinking of buying (objectivity)
- Solicit a dissenting opinion
- …especially when you have a "bet the farm" moment!

What can you do?

1. **Make investing your business, not a hobby**
2. **Keep a “decision journal”**
3. **Get a “trading buddy” for second opinions**
4. **Limit your media exposure!**

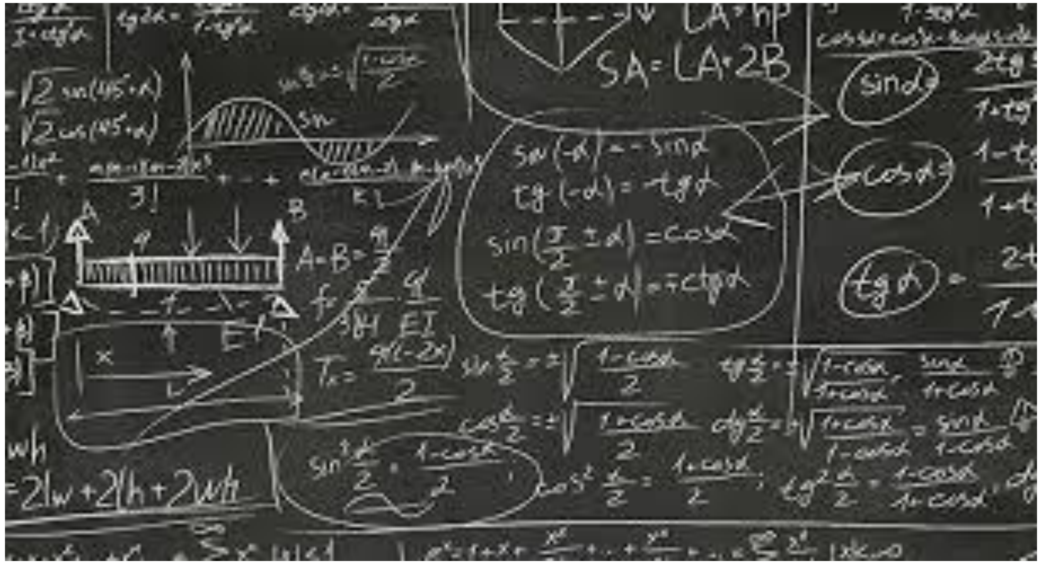
Limit (avoid) the media

- Much of what you see is <u>biased</u> or <u>sponsored</u>
- Much of what you see is <u>old news</u>
- Much of what you see is <u>hyped</u>
- Much of what you see is <u>incorrect</u> or <u>misleading</u>
- There is almost no <u>accountability</u>
- Much of what you see is <u>fake</u>
- Never fill time surfing the web for ideas!

What can you do?

1. Make investing your business, not a hobby
2. Keep a “decision journal”
3. Get a “trading buddy” for second opinions
4. Limit your media exposure!
5. **Add some real math to your decision process**

Add some math (and data) to your investment process



- The more math you use, the less instinct and emotion will be needed
- Investing is a science and the pros all use math rather than intuition
- Diversify, diversify, diversify (20 positions reduce 85% of individual stock risk)
- Basic risk/reward is not rocket science

What can you do?

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4. Limit your media exposure!
5. Add some real math to your decision process
6. **Be especially careful with charts**

Be especially careful with charts

- Charts are very useful, but also <u>very easy to misinterpret</u>
- Your brain <u>automatically searches</u> for patterns
- If you say "well this is an <u>exception</u>", hold back
- You need 180 data points for <u>90% confidence</u>
- Develop a <u>discipline</u>…and track it

What can you do?

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4. Limit your media exposure!
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6. Be especially careful with charts
7. **Do your homework**

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Behavioral homework

1. **Register at BehavioralFinance.com**

BehavioralFinance.com

- Free info and resources
- Curated blog of articles
- List of events and conferences
- List of books (150+)
- List of courses and degree programs
- Sign up for blog (and this presentation)
- Contact me

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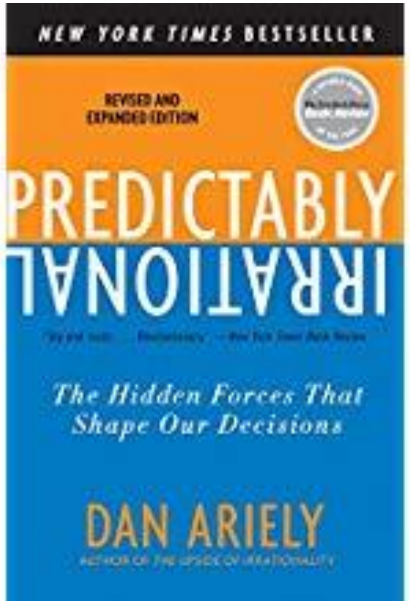
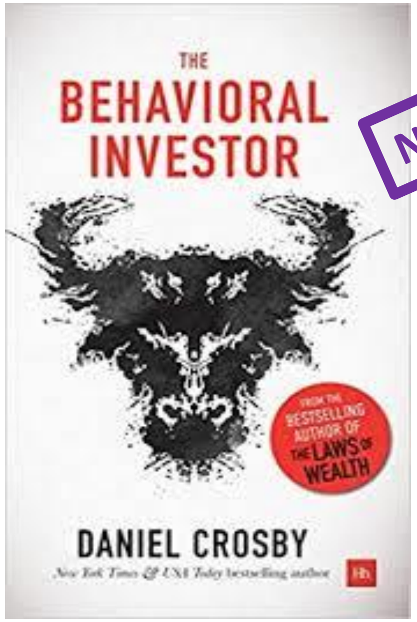
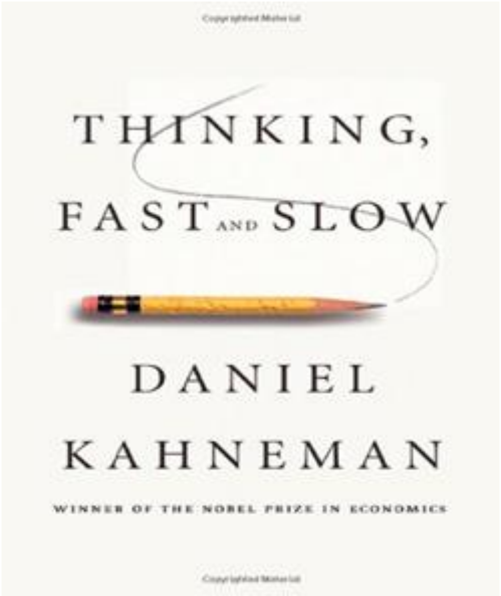
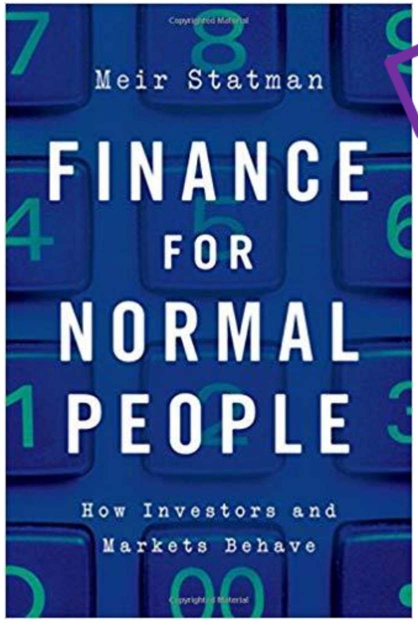

NEW YORK TIMES BESTSELLER
REVISED AND EXPANDED EDITION
PREDICTABLY IRRATIONAL
The Hidden Forces That Shape Our Decisions
DAN ARIELY
AUTHOR OF THE UPSIDE OF IRRATIONALITY

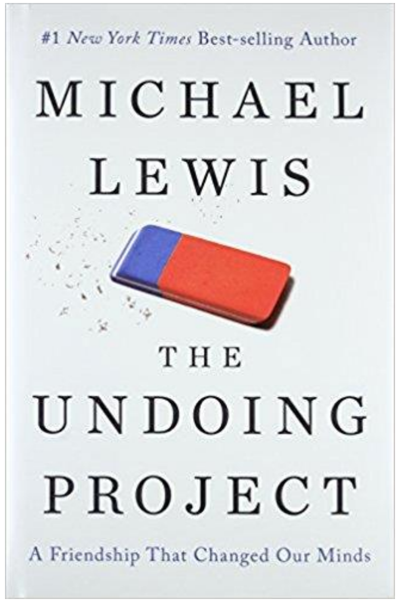

THE BEHAVIORAL INVESTOR
FROM THE BESTSELLING AUTHOR OF THE LAWS OF WEALTH
DANIEL CROSBY

New!

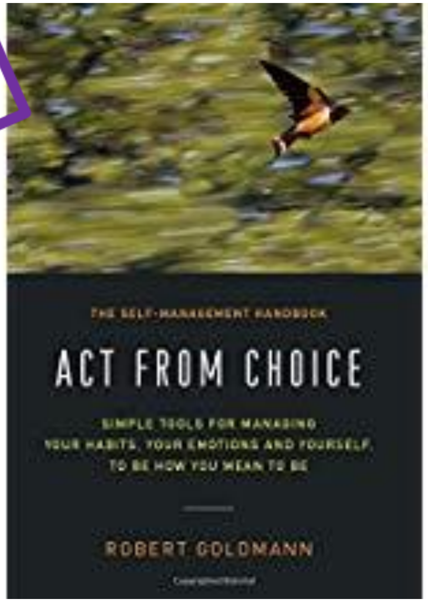

THINKING, FAST AND SLOW
DANIEL KAHNEMAN
WINNER OF THE NOBEL PRIZE IN ECONOMICS


Meir Statman
FINANCE FOR NORMAL PEOPLE
How Investors and Markets Behave

New!


#1 New York Times Best-selling Author
MICHAEL LEWIS
THE UNDOING PROJECT
A Friendship That Changed Our Minds

New!


THE SELF-MANAGEMENT HANDBOOK
ACT FROM CHOICE
SIMPLE TOOLS FOR MANAGING YOUR HABITS, YOUR EMOTIONS AND YOURSELF, TO BE HOW YOU MEAN TO BE
ROBERT GOLDMANN

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3. **Read some basics about risk/reward analysis and portfolio construction**

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Behavioral
Finance.com