Investment Psychology

Following a proven strategy is a key part of investment success, but it is equally important to have the proper psychological make-up to carry out the strategy. Most investors spend lots of time on strategy and completely ignore their own investment psychology. We consistently study the topic of investment psychology because we believe that understanding our own weaknesses will help us avoid some potential mistakes and consequently improve returns for clients.

Investment psychology is far more than simple intelligence. The famous value investor Warren Buffett said:

> "Success in investing doesn't correlate with I.Q. once you're above the level of 25. Once you have ordinary intelligence, what you need is the temperament to control the urges that get other people into trouble in investing."

Unfortunately, very few of us can control these "urges", since they are caused by flaws that seem to be hard-wired into human psychology. These psychological flaws are powerful enough to sabotage perfectly sound investment strategies. They deserve our awareness and attention.

In this Special Edition of the Armstrong Schmidt Perspective, we are going to examine some of the most dangerous psychological flaws that affect investors. We will also propose some remedies that may help improve investment decision-making. It's a challenging topic, and, we hope, an entertaining read.

Excessive Pessimism

Especially in recent years, a "gloom and doom" or "perma-bear" category of the financial media has thrived. These commentators try to instill mistrust of all financial assets in their readers, recommending freeze-dried foods, firearms, ammunition and physical metals as alternative asset classes. While their reasoning is potentially correct if a worst case scenario ever materializes, investors who habitually subscribe to that way of thinking miss countless opportunities to make money and will underperform. For example, during the worst of the financial crisis they were preaching financial collapse instead of recommending shares of high quality companies that subsequently appreciated by hundreds of percent.

Permanent bearishness is bad, but transitory excessive pessimism can be just as bad for returns because it tends to peak at absolutely the wrong time. A person who is consistently pessimistic will probably avoid most of the worst investing risks (while having a miserable life, not to mention low returns). However, a person who is only excessively pessimistic in response to market declines and then becomes optimistic when investments are performing well will almost certainly sabotage their investing results. Many people suffer from transitory excessive pessimism, which is why buying low and selling high is so psychologically difficult.

Remedies

When everyone thinks that the future outlook is terrible, there is often money to be made. That is the counterintuitive logic of financial markets. John Templeton (1912-2008) is considered to be one of the best value investors of all time. He explained the contrarian nature of market sentiment well in the following quotes:

> "Bull markets are born on pessimism, grown on scepticism, mature on optimism and die on euphoria. The time of maximum pessimism is the best time to buy, and the time of maximum optimism is the best time to sell."
>
> "People are always asking me where is the outlook good, but that's the wrong question…. The right question is: where is the outlook the most miserable?" [1]

Following Templeton's advice is easier said than done, but his opinions are very credible, as his career included buying stocks low during the Great Depression and short selling technology stocks near the end of the late 90s stock bubble.

There is another point to remember regarding excessive pessimism. In 2002, various professors from the University of London Business School published a book called *Triumph of the Optimists: 101 years of Global Investment Returns*. They concluded that a random selection of U.S. stocks returned 1,500,000 percent over the 100 years of the 20th century. Adjusted for inflation, this amounted to approximately 6% per year. [2]

The 20th century included two world wars as well as the Cold War and its sustained threat of global nuclear annihilation, so there were plenty of reasons for people to focus on the negative. However, the long-term returns were good, despite these massive problems.

<u>Excessive Optimism</u>

Many investors suffer from excessive optimism and overconfidence. These flaws blind investors to the warning signs that an investment is of poor quality or too risky, because they cannot envision that they may be wrong.

Illusions of superiority often cause people to overestimate their positive qualities and abilities and to underestimate their negative qualities relative to others. The vast majority of individual investors would probably assess their skills as better than average even though that cannot be true.

Excessive optimism and overconfidence bias investors towards hot investments that have outperformed in the recent past or speculative companies that promise huge returns through technological innovation or potential undiscovered resources. When an investor's psychological makeup ignores the downside to a strategy, long-term returns will suffer.

Remedies

To combat these tendencies, the renowned psychologist Amos Tversky suggests that we must acknowledge our limited ability to predict the future:

> "Time and time again, we learn that our confidence is misplaced, and our overconfidence leads to bad decisions, so recognizing our limited ability to predict the future is an important lesson to learn."[3]

David Dreman, a successful American fund manager, suggested that we should expect the worst case scenario for an investment to be much more severe than our initial projection.[4] These experts are saying that humility has to be part of our decision-making process.

Amusingly, the more overconfident an investor is, the harder it will be for that person to follow Tversky's and Dreman's advice. There are no easy corrections for ingrained psychological flaws.

<u>Confirmation Bias</u>

Confirmation bias is the tendency for people to prefer information that confirms their existing beliefs.[5] For example, an investor with a large position in precious metals may only visit websites biased towards precious metals investing and ignore other sources of information. The dogmatic nature of the websites will continually reaffirm the investor's conviction. The danger is that confirmation bias causes investors to ignore emerging evidence that contradicts an investment thesis, leading to unexpected large losses.

Remedies

Charles Darwin (1809-1882) tried to avoid confirmation bias while writing *On the Origin of Species* by immediately making note of any information that contradicted his theories:

> "I had… followed a golden rule, namely, that whenever a published fact, a new observation or thought came across me, which was opposed to my general results, to make a memorandum of it without fail and at once; for I had found by experience that such facts and thoughts were far more apt to escape from the memory than favourable ones. Owing to this habit, very few objections were raised against my views which I had not at least noticed and attempted to answer."[6]

A good strategy, then, to combat confirmation bias is to, at a minimum, take note of any information that contradicts an investment thesis, and ideally, to actively seek out contrary opinions.

The Recency Effect

People have a tendency to overreact to recent events, both positive and negative. For example, after the severe 2005 Atlantic hurricane season, many people believed that severe hurricanes would happen every year. Some investors sold shares of Berkshire Hathaway Inc. that year due to its insurance businesses' exposure to future potentially severe hurricane damage. 2006 and 2007 turned out to be mild years for hurricanes and the stock generated strong returns for investors who bought when the outlook appeared bad.

Remedies

Investors should remember that most recent events will be largely forgotten a few years into the future and new sensationalistic headlines will have taken their place. This means that negative "one-time" events can create huge buying opportunities when they impact the shares of a high quality company.

Social Proof

David Dreman writes that "when reality is complex and the situation is hard to read, "social reality" – the consensus of the group, no matter how far-fetched – can take a grip on the mind, and turn strong, rational, independent people into sheep."[7] In other words, intelligent people occasionally act like herd animals, to the detriment of their investment accounts.

Social proof is an incredibly powerful phenomenon in the investing context. When a particular asset class is generating outsized gains, investment discussions start to permeate everyday life, and the lure of big profits that friends and family are temporarily making is hard to resist.

Remedies

Investors need to be extra vigilant, if not actually nervous, when their investments are trending strongly and everyone shares the same opinion. Warren Buffet has stated that you pay a very high price in the stock market for a cheery consensus. He means that once everyone agrees that a certain sector is a good investment, it may already be overvalued and poised for a fall.

Excessive Impatience

Investors have become more short-term oriented in the past few decades (along with the rest of society). Technology has contributed greatly to this trend. No investment strategy, no matter how sound, perpetually outperforms over all time periods. An impatient investor risks sabotaging a completely sound investment strategy by abandoning it during a temporary period of underperformance to chase a short term fad.

Remedies

Long-term investors should place less emphasis on the short-term results from an asset class and spend more time thinking about how their strategies will fare over 3, 5 and 10 years. For some personalities, an inattention to the daily performance of their investments can be helpful, as long as there are thorough annual reviews.

Loss Aversion

Academic studies suggest that financial losses are twice as psychologically powerful as equivalent financial gains. "Loss aversion" refers to the tendency to strongly prefer avoiding losses to acquiring gains.[8] Investors who held failing technology giant Nortel Networks from the late 90s until its bankruptcy and delisting in 2009 are a good example. They were far better off taking a loss earlier in the process and moving on than suffering a total loss. Their inability to cope with their emotions caused a catastrophic result.

Remedies

Investors should remember that the psychological pain of taking a loss actually fades quickly after it is done. Capital can then be reallocated to a better opportunity. The key question regarding taking a loss is whether the fundamentals of the investment have been impaired, invalidating the original reason for buying. If the fundamentals have been impaired, getting out can be the best option.

Conclusion

We can distill all of the remedies we suggest in this Special Edition down to humility, independence and capacity for critical thought. These traits are excellent traits to improve performance in all facets of life. In investing, they could actually make you rich.

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[1] Traders Log, *Sir John Templeton*, http://www.traderslog.com/templeton/ (March 5, 2011).
[2] Victor Niederhoffer and Laurel Kenner, *Practical Speculation* (John Wiley & Sons Inc., Hoboken, New Jersey: 2003) p. 206.
[3] David Dreman, *Contrarian Investment Strategies – The Next Generation* (Simon & Schuster, New York: 1998) p. 109.
[4] David Dreman, *Contrarian Investment Strategies – The Next Generation* (Simon & Schuster, New York: 1998) p. 115.
[5] Wikipedia, *Confirmation Bias,* http://en.wikipedia.org/wiki/Confirmation_bias (February 9, 2012).
[6] Charles Darwin, *The Autobiography of Charles Darwin,* http://www.darwin-literature.com/The_Autobiography_of_Charles_Darwin/7.html (February 9, 2012).
[7] David Dreman, Contrarian Investment Strategies: The Next Generation (Simon & Schuster, New York: 1998) p. 214.
[8] Wikipedia, *Loss Aversion,* http://en.wikipedia.org/wiki/Loss_aversion (March 5, 2011).

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