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Understanding the pitfalls of behavioral finance - making the difficult choices

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The severe downturn of the financial markets that began in 2007 has led many investors to question their investment strategies and the choices they made in the past. Investment decisions are among the most important life choices a person can make. They may determine where your children will be able to go to college, when you'll be able to retire and the type of lifestyle you'll enjoy after you retire.

For these reasons, many investors are now reevaluating their strategies, reassessing their personal tolerance for risk, revisiting their asset allocation strategy and rethinking their long term financial plans.

In order to make sound decisions in this environment, investors should be aware of their own psychological blind spots. These can lead all of us to make persistently poor financial choices - errors that over time can do significant damage to our portfolios.

Chains of Thought

Traditional financial theory assumes all investment decisions are made rationally, based on the best available information. In theory, the result is an efficient market - one in which prices accurately reflect fundamentals, such as earnings and interest rates.

However, it's not always easy to reconcile financial theory with financial reality. Investors often appear determined to ignore the fundamentals, both in bidding stock prices up and creating "bubbles" only to watch them fall - and often fall dramatically as we have recently witnessed.

"In many important ways, real financial markets do not resemble the ones we would imagine if we only read finance textbooks," notes Richard Thaler, a professor at the University of Chicago and a leading behavioral finance researcher.

It's not that investors are totally irrational, Thaler and other researchers argue, but rather that their thinking can be influenced by mental biases. These quirks can lead them to make choices that appear intuitively correct, but produce poor performance.

This field is known as behavioral finance and it tries to find explanations for these apparent contradictions. It's not that investors are irrational, but that their thinking may be often guided - or in some cases misguided - by subtle biases and mental blind spots.

Some examples include:

* Overconfidence. Investors generally assume they know more than they actually do. They also tend to remember previous investment decisions in ways that exaggerate their own foresight. This can lead to overly aggressive trading and a reluctance to admit - and correct - mistakes.

* Mental Accounting. Financial experts often advise investors to take their entire portfolio into account when making investment decisions. Yet, many investors unconsciously divide their wealth into separate pots. If they have a big gain, for example, they may think of it as essentially "free"

money and take greater risks with it than they would with their "own" money.
* Anchoring. Logically, investors should always base their decisions on current prices and expectations. Instead, they often become fixed on past events, such as the price they paid for a particular stock. Investors will often refuse to sell at a price lower than that - even when it makes more sense to accept their loss and invest their remaining money elsewhere.
* Framing. How people view a decision often depends on how their choices are presented. For example, in one study researchers asked participants how much they would be willing to pay to avoid a one-in-a-thousand chance of being killed. The average answer was $1,000. Participants were then asked how much they would demand to accept the same risk. This time, the answers ranged as high as $200,000. From an economic point of view, the two questions were identical, but subjects saw them very differently.
* Loss Aversion. In a completely rational market, the risk of loss and the possibility of gain should carry equal weight. However, on average investors place twice as much importance on avoiding a loss as they do on making a gain. In other words, to accept a 50% chance of losing $100, most people will demand at least a 50% chance of earning $200.

The Value of Advice

Are investors doomed to repeat these mistakes? Maybe not. Some studies have shown that the more investors know about the investment process, the less likely they are to be misled by behavioral biases.

This is one reason we encourage investors to develop prudent, long-term investment strategies that take into account their goals and tolerance for risk. While this doesn't guarantee investment success, it can at least reduce the risk of being led astray by behavioral blind spots. That's something even the smartest investor may benefit from in today's volatile market environment.

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