



Is Your Investing Brain Working With or Against You?

How the study of neuroeconomics can help you become a smarter investor – really.

An interesting and increasingly popular area of investment research is the subject of neuroeconomics, which combines the study of economics, neuroscience and psychology to better understand how we evaluate choices, categorize risks vs. rewards, and calculate probabilities. Most economic theories and models assume investors are rational decision makers who act in their own best interests. But, in reality, our investment brain often drives us to do things that are quite illogical, but make perfect emotional sense. So, while classical economics tells us what investors should do, neuroeconomics tells us what they really do, and why. The next time you confront an investment decision, pause and ask yourself whether you're making a rational decision or whether your investing brain is making one of the following errors.

Loss Aversion

Recent research has revealed that the pain felt from a loss (either real or perceived) is about twice that of the joy realized from an equal gain. Thus, when faced with a loss we become

more risk-tolerant if there's a possibility we can mitigate the loss; when a possible gain exists we become less risk-tolerant. This loss aversion manifests itself in two distinct investor behaviours. Firstly, many investors elect to not include riskier asset classes such as stocks in their portfolios due to their short-term volatility, even though their long-term performance will probably be superior to safer asset classes such as GICs or bonds.

Secondly, it is common for investors to feel that if they don't sell a security they own at a loss, they haven't actually realized a loss and therefore don't feel the associated pain of the loss. This false perception causes investors to hold on to securities that have fallen in value with the idea of selling them as soon as the price returns to their personal "break-even" purchase price. Often, these investors will ignore fundamental information regarding why the price of these securities is unlikely to return to the level at which they purchased the shares. If you held onto your Nortel shares as they steadily declined, you can probably relate to this point.

Herding


When the markets make significant moves up or down, investors are subject to a fear that others have more information than they do. As a consequence, investors feel a strong impulse to do what others are doing and follow the crowd, to avoid feelings of regret should the crowd's actions be correct. Unfortunately, the crowd is mostly incorrect. Dalbar Inc., a top financial services research firm, conducted a study¹ of U.S. investors in which it tracked the flow of funds into and out of mutual funds between 1984 and 2003. The results showed a common tendency among investors to invest money into sectors that had previously posted strong returns. Whenever you read the fine print beneath any mutual fund advertisement you will see "past performance is not an indication of future performance." But by mistakenly chasing high past performance, the average U.S. investor earned 3.51 percent annually over the course of the study, while the S&P 500 returned 12.98 percent during the same period.

Focus on developing a sound personal investment plan and then make decisions that are best suited to this personalized plan and your own circumstances.

Conservatism Bias and Confirmatory Bias

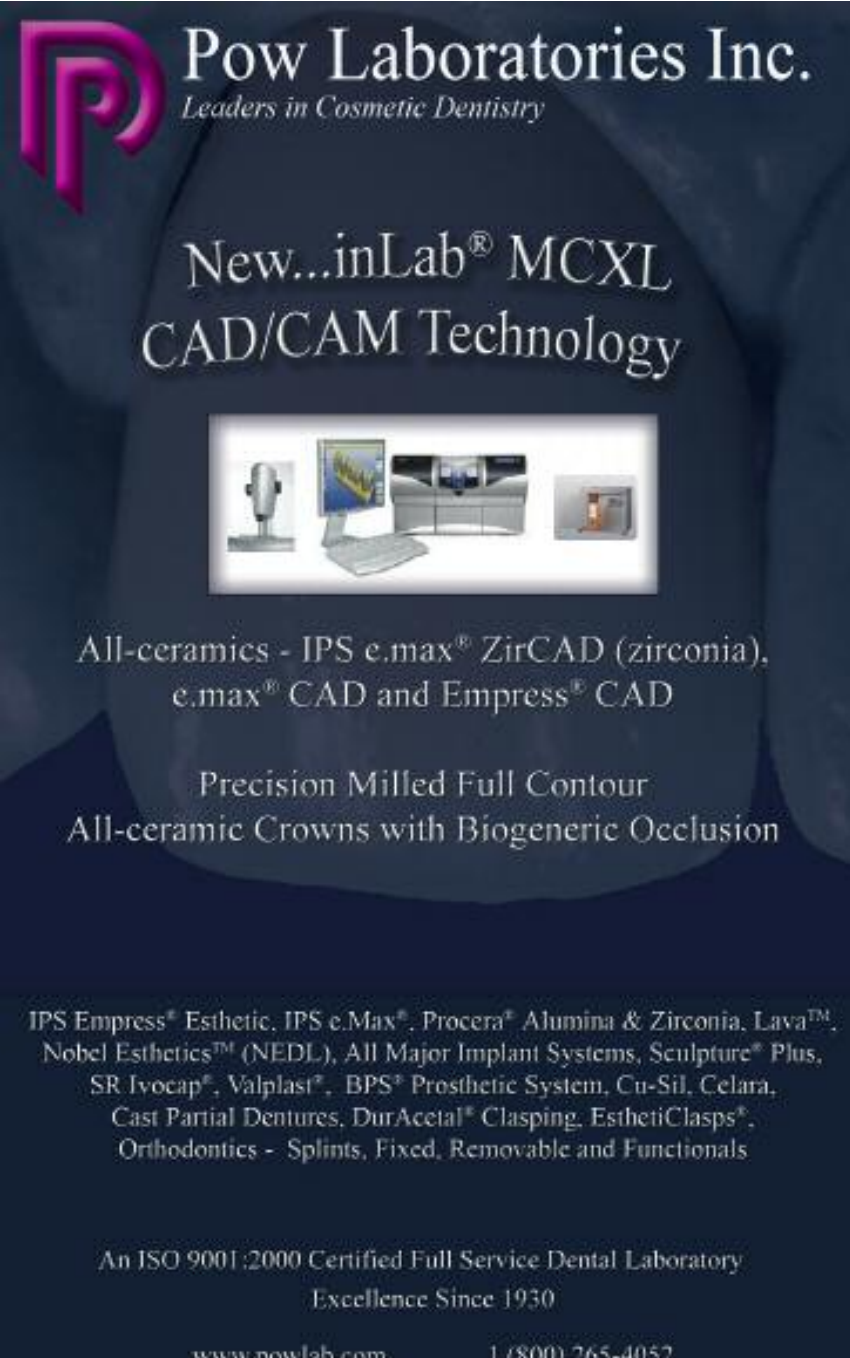
Like Othello, once we form an opinion, we tend to seek out and over-value information that supports our decision (confirmatory bias) and ignore or undervalue information that undermines it (conservatism bias). For example, when news of the Enron scandal and the company's possible bankruptcy began to surface in 2001, many investors focused on, and took comfort in, the fact that *Fortune* had named Enron "America's Most Innovative Company" for the previous six consecutive years, had an investment grade credit rating and was reportedly the seventh-largest company in America by revenue. What these investors should have focused on were the whispers of corporate scandal and suggestions of accounting fraud. Whenever you acquire or sell a stock at what you believe is an attractive price, someone is willing to take the opposite side of that trade, and for each party the information available to you is probably equal. Whenever you are about to make a trade, ask yourself why someone is willing to take the opposite side of it.

What is the Solution?

When it comes to investing, logical thinking and emotional thinking may provide conflicting signals regarding your investment decisions. Remember, to achieve your goals you need to have a long-term investment plan, and this probably means subjecting yourself to near-term market volatility and the associated emotions of potential loss and regret. A good plan is to be clear about how you'll meet your portfolio growth goals while protecting your capital. 

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1. Dalbar Inc. (2004) Quantitative Analysis of Investor Behaviour, p4.



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