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## The Other Nobel Prize

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The returns of the world's capital markets are there for the taking. Yet the average investor fails dramatically in capturing those returns, consequently suffering needlessly in attempting to achieve financial goals.

A recent study by Dalbar, Inc.—a Boston-based investment industry consultant—showed the average equity investor earned just 3.9% annually from 1986 to 2005, compared with the S&P 500 average annual return of 11.9%. Similarly, Morningstar now publishes the dollar-weighted returns of mutual funds—as opposed to just the standard time-weighted returns—which shows investors as a whole don't earn the returns of the managers they hire.

What explains this discrepancy? In my last column, I suggested the biggest mistake investors make is investing in a vacuum—failing to look inside and tether their investments to their most important goals. But, this macro mistake is actually manifested in many smaller errors that subtly reveal our difficulties in making good investment decisions.

As investors, we seek guidance from modern portfolio theory—a model for the relationship between risk and return—that received the Nobel Prize in Economics in 2000. Yet, unraveling the mysteries of our investment blunders requires us to look further inside ourselves, delving into the arena of 2002 Nobel Prize winner, Princeton Professor Daniel Kahneman, and his ground breaking work in the burgeoning field of behavioral finance.

### Summary: The Other Nobel Prize

Well thought out investment planning allows the individual a foundation to draw from when evaluating making changes rather than responding to behavioral mistakes.

The investor's chief problem—and even his worst enemy—is likely to be himself.

—Benjamin Graham, Warren Buffet's mentor



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Your Way to Prosperity

Behavioral finance identifies a laundry list of cognitive and emotional biases—or behavioral mistakes—we all tend to make in our financial decision-making. Think of them as mental traps that, once recognized, we work to avoid in managing our portfolios.

Kahneman and others have categorized these decidedly human traits, some of which you will undoubtedly recognize:

- **Mental Accounting.** Treating interchangeable pools of money as different, depending on their source.
- **Heuristics.** Simplifying—but naïve—guidelines, such as subtracting your age from 100 to calculate the percentage of your portfolio that should be held in stocks.
- **Loss Aversion.** The tendency to view the pain of loss as more significant than the pleasure of gain, causing us to hang on to losers and sell winners.
- **Sunk Cost Fallacy.** Anticipating future prospects according to how much we already have invested, which encourages “throwing good money after bad.”
- **Status Quo Bias.** A form of “anchoring” which ties our decision making to endowed items, such as a dangerously undiversified stock inheritance.
- **Recency Bias.** Another form of anchoring, by which we extrapolate events in the recent past—such as the results of a hot fund manager—into the future.
- **Confirmation Bias.** Relying on irrelevant information, such as the price you paid for a stock that has fallen in deciding whether to sell, rather than making a new and independent analysis to determine whether you would buy it at today’s price.

- **Overconfidence.** Overestimating your ability. You might call this the Lake Wobegon effect, like in the famous survey of Swedish drivers in which 90% of them described themselves as above average. This is the most troublesome problem because correcting or making up for it requires us to be skeptical of our abilities, an evaluation overconfidence is likely to inhibit.

Susceptibility to these pitfalls has curiously little to do with intelligence or education. In a recent experiment among Harvard and Wharton business students ([www.som.yale.edu/faculty/jjc83/fees.pdf](http://www.som.yale.edu/faculty/jjc83/fees.pdf)), fewer than 20% chose costs as the determining factor in selecting from nearly identical S&P 500 index funds—a startling result.

In an even stranger study, reported in the July 21, 2005 *Wall Street Journal*, researchers in the field of neuroeconomics at Carnegie Mellon and Stanford found that participants with certain types of brain damage that interfered with emotional activity made better investment decisions.

These apparently hard-wired tendencies can be difficult to overcome. The idea is not to eliminate our humanity, but rather to acknowledge and manage it by developing a strategy in which you make the really big decisions at the outset and at the same time establish the decision making criteria for subsequent changes.

Such a planning-oriented approach then signals you when a misguided behavior—rather than rational decision-making—is taking over. A temptation to deviate from the plan is your cue to ask yourself if the proposed variation is justifiable.