OLD NORTH STATE TRUST, LLC

Understanding Psychology Helps Investors in a 'Rational' Market

Investing and money management is a science. It deals with hard numbers and the laws of economics. But it is also an art, and the best financial advisors have come to understand this very well.

The influential field of behavioral finance is based on the reality that investing isn't just about markets and securities and money. It's also about people: their hopes, fears, and emotions.

Our firm hosted a luncheon on this topic last summer and it was very interesting, both to our clients and to our staff. Fundamentally, behavioral finance is about why investors do what they do. We know we should buy low and sell high, for example, but entirely too many people do just the opposite, for reasons they may have a hard time explaining even to themselves.

We advisors need to understand the psychology that drives why clients do what they do. Sometimes that psychology can help us understand why a client has a hard time letting us do the job we've been hired to do.

Since the time of Adam Smith in the 1700s, economists have talked about the "invisible hand" of the market. It's a powerful concept and a useful one. But the idea that the marketplace always operates perfectly has some very real limitations.

According to the so-called "efficient market" theory, investors taken as a group are rational, they are always concerned with their own best interests, and they have complete information on which to base their decisions. Well, we all know at least one or two real human beings who don't always operate that way!

Aside from the question of how complete anybody's information can really be—that's a topic for another article!—even the savviest investors aren't purely rational or self-interested.

Two broad categories of bias can distort an investor's thinking. These are cognitive, based on instinctual habits of thinking, and emotional. The faulty reasoning or blind spots that lie behind cognitive bias can often be corrected by good advice or better information. Emotional biases, on the other hand, are harder to overcome, even when an individual recognizes them.

A common example of cognitive bias is giving more weight to recent experiences than to what happened longer ago. This can lead an investor to unrealistically expect the big gains in a rising market to continue indefinitely, discounting the experience of a market downturn that happened years in the past. (This is why you see that common disclaimer, "Past results do not guarantee future performance.")

Other cognitive biases include giving excessive weight to personal experiences over historical data, or giving ourselves credit for all our successes but blaming others or impersonal factors for all our failures.

On the emotional side, one very common pitfall for investors is to fear possible losses more than anticipating possible gains. If somebody's life experiences have primed them to suffer more from a loss than to enjoy a gain, then they may be unwilling to take reasonable risks. That, in turn, can limit their potential to profit when economic conditions are good.

Some people will hold on to an investment that doesn't have good prospects because they have an emotional attachment to it: it might have been inherited from a beloved parent, or be associated with an important milestone in one's life. Others may be unwilling to make any changes, even for the better, if they alter the status quo.

Understanding all these less-than-rational motivations, it's no wonder that we make a point of getting to know each of our clients as a unique human being. That human being has experiences, dreams, and goals that have to be taken seriously.

The sort of advisor who relies solely on questionnaires to try to figure out a client's needs will not truly understand who they are, how they think, and what matters to them. Advising by numbers just doesn't work. No formula can take the place of good, old-fashioned client contact.

One of an advisor's most valuable services is to provide consistency, always focusing on the client's essential financial objectives. That doesn't mean we disregard the client's worries or fears; quite the opposite. Because we understand them, we can help deliver essential peace of mind.

It's a reality in our business that it's not fluctuations in an investment portfolio that cause a client to look for a new advisor. Most often, that happens if the client doesn't feel like their advisor understands, or cares about, their goals. That, in a nutshell, is what behavioral finance is about: Strengthening that bond of rapport and trust between client and advisor.