Teach Yourself to Become a Better Investor
By Christine Benz | 10-15-09 | 06:00 AM | E-mail Article

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The field of behavioral finance examines the intersection between psychology and economic decision-making. In his fascinating recent book, Your Money and Your Brain, Wall Street Journal *columnist Jason Zweig examines a heretofore little-known aspect of behavioral finance: neuroeconomics, or how our brains respond in real-life financial situations. I recently sat down with Jason to discuss investor behavior and his tips for becoming a better investor.*

Christine Benz: People may be familiar with behavioral finance. How is neuroeconomics different?

Jason Zweig: What neuroeconomics does is take the high-technology tools of contemporary neuroscience, which center on the ability to observe activation in the brain at the regional level. So you're able to see which areas of the brain are activated under particular circumstances, and then you correlate that activity to behavior and also to the stimulus that triggered the activity in the first place.

So, for example, if our objective is to learn something about the brain processes that determine risk-seeking behavior, we might present somebody with the option to make a small amount of money or lose a large amount of money, and see what's happening at the level of neurons in that person's brain. The best-established finding is the evidence that Kahneman and Tversky presented roughly 30 years ago, that people feel the intensity of a loss about twice as strongly as they feel the pleasure of an equivalent gain. So losing $100 hurts 2 to 2.5 times more than winning $100 feels good. The neuroeconomic experiments tend to confirm that because they show that losing money activates parts of the brain that are associated with physical pain or disgust, like smelling vomit or stepping in dog doo. So that's the first level that confirms it.

Benz: You went through some of this testing to examine your own brain's response to financial performance--in relation to some of these stimuli. What were some of the interesting things you found out about yourself?

Zweig: The first thing I learned wasn't particularly surprising to me, and certainly was no surprise to my wife, which is that I perform no better than anybody else, and in some cases worse, on the kinds of tasks that you might be presented with in one of these experiments. I think the only unusual thing about me is that I've been shown in at least one experiment to have **an unusual degree of patience**. I'm willing to wait considerably longer than the typical person to get a reward.

Benz: And that's an advantage in investing.

Zweig: It is, but what's interesting about that is that that's not exactly what my brain scan showed. It's what a behavioral test showed. **So it appears that through many years of training and discipline, and studying Benjamin Graham's work, and simply observing the markets and learning about financial history, I seem to have trained myself to become more patient than my genetic and biological makeup would suggest I naturally am.**

The biggest and most surprising lesson to me came in an experiment that I did at Emory University. It was an example of what Gregory Berns, the neuroscientist who did the experiment, calls "learning without awareness." It turns out there are very powerful functions in the brain that enable us to recognize patterns without ever becoming aware we've been exposed to them. This pattern-seeking behavior in the human mind is just an incredibly powerful function. Most of us don't realize how automatic it is, and at what an involuntary level it occurs. So a lot of the trading behavior and what we might call "Cramer-like" behavior, where people see something happen two or three times in a row and just assume it's going to happen again, that sort of thing goes on in your brain whether you want it to or not. And it can drive your behavior even when you're trying to resist it unless you have formal decision structures in place to prevent yourself from acting on it.

In these particular experiments I was being asked to engage in a probability guessing experiment that required a lot of conscious thought, much like playing a game of checkers or backgammon. Simultaneously, I was being presented with a much more basic stimulus, which was that I was getting little sips of sugar water. And there was a pattern to the sips of sugar water that my conscious brain paid no attention to because I was trying to solve the more complicated problem. But the unconscious part of my brain soon detected what was happening with the sugar water. And the next thing I knew, I was pressing madly with my right index finger to indicate that I had solved the problem, even though I had no idea how I had done it. And it was simply that the pattern of sugar water had started to repeat and that part of my brain recognized this repetition, while the conscious part of my brain was still searching for a solution.

That sort of thing goes on all the time in the financial markets. And individual investors do it, and financial advisors too do it, without realizing it. You may end up investing more in a particular stock because you saw the CEO on TV and his necktie was your favorite color. It sounds absurd to think that people would make financial decisions based on irrelevant factors like that but they do. And the reason they do is that things like colors and sounds and smells and tastes and associations with our past and with ourselves increase our comfort and familiarity with a frightening world.

These kinds of effects are everywhere, and they surround investors, and they shape a lot of people's decision-making without their ever realizing it. The reason I harp on this issue again and again is that the single most exciting frontier in contemporary psychology is the exploration of these unconscious biases and the fact that unconscious influences on our behavior can skew our decisions in ways that are incredible to people. No one would ever believe that they married their husband or wife because the person had a last name

that began with the same initial. But if you analyze millions of marriage records, that's exactly what you find.

Obviously you love your spouse, too, but you may well have been more attracted to him or her because of a familiar initial and that may actually be a large part of why you got married. I have no doubt that if we could analyze people's portfolios, we would find that they're overweight companies with tickers that remind them of their own names or their family's names--that they own a disproportionate number of stocks based close to home or where they grew up.

Benz: So as investors, how do we combat our brains' impulses?

Zweig: There's been a real cult in the past few years of intuition and gut feeling and hunches. It kind of started with Malcolm Gladwell's book *Blink*, and now there's a whole cottage industry devoted to helping people tap their inner dartboard. **At least when it comes to financial decision-making, it's hard to imagine a worse way to go about things.** It's not that you should never listen to your gut or that your intuition is always unreliable. It's that intuitions are a good guide only under very specific instances, and it's primarily dependent on the nature of feedback. Think of a professional tennis player, for example. Every decision is consequential. If you make a mistake, you fall behind in the game because your competition is intensely competitive, millions of dollars may hang on the result, and the feedback is instantaneous. If there's a hitch in your swing, the ball goes the wrong way and you know it went the wrong way.

Now think about feedback in the financial markets. You buy ChristineCorp and you pay $10 a share. So by the end of the day it's at $10.05, and you pat yourself on the back and say, "I'm a good stock-picker." And the next day it goes down to $9.50, and suddenly you think you're a bad stock-picker. So you sell it and the next thing you know it goes up to $12. And then what do you decide? Well, you can assume you're a good stock-picker, because it went up 20% above your original purchase price, or you can conclude you don't know what you're doing because you sold at exactly the wrong time. The quality of the feedback varies constantly. **At any given moment, you can look right or wrong because the quality of the feedback depends on the length of the measurement period. So there's lousy feedback in the financial markets. It's noisy, it's delayed, it's ambiguous, and also you can cherry-pick it to lie to yourself, or to present yourself in a better light to other people.**

PROCESS

Because of that, it's especially important to have really good decision structures. **So the first thing is to have a checklist, and to study your past decisions, and to study the decisions of the world's best investors, and learn from your mistakes and theirs and come up with a set of criteria that every investment has to meet in order to be eligible for inclusion in your portfolio.** I suggest a few in my book, but for individual investors, probably the most important rule would be never buy an investment purely

because it has been going up in price, and never sell it purely because it has been going down.

I would put the expense ratio first for mutual funds. I would say, I will never consider a fund with expenses over X. And then I would probably factor in portfolio turnover, I would factor in tax efficiency, I would put in a measure of risk, and I would put performance dead last. In fact, I would also have a decision rule that I can't actually look at the performance of the fund at all until I've determined a short list of funds that passed all the other screens. And only then would I look at performance. Because if you look at performance first, it then becomes an unconscious bias, and it will skew your analysis of everything else you look at. So you have to put performance dead last because otherwise it would be first no matter where you happened to think you're ranking it.

There was a beautiful study that was published in the The Journal of Finance a couple of years ago about the selection of institutional money managers. It basically found that the professionals who pick money managers, in this case it was pension funds, tend to buy high and fire low. They invest in whichever managers have the best trailing three-year performance and then sell whichever have the worst trailing three-year performance. The study showed that if they had flipped their decisions--if they had bought the ones with the worst three-year performance and sold the ones with the best--they actually would have gotten better returns. And of course if they had done nothing--if they had just put the portfolio on ice--they also would have done better. Performance-chasing, despite all the propaganda you hear in the financial industry, is not purely the province of retail investors. It's not the so-called "dumb money" on Main Street that buys high and sells low. Everyone does it.

Frankly I think institutional investors and intermediaries of all kinds, all the way down to financial advisors who have only a handful of clients or brokers who have relatively small accounts, are at least as bad at this as individuals are. There's actually an enormous amount of evidence to suggest that that's true.

And in fact, common sense would tell you that if you're managing money for other people, you're also risk-averse, just as they are with their own money and you are with your own. But you're averse to a different kind of risk. You're averse to the risk of looking bad to the person who's paying you a fee. And that can easily incline you to buy high and sell low. You would want the thing with the best past performance to be going into the portfolio and you would want whatever has the worst past performance to be coming out. Because in real time, at the moment of the decision, it will make you look better.

The problem is that over time, it will not maximize the wealth of your clients. And that's what the economists call an agency problem. And I think it's something that advisors really need to combat. The only effective way I know of doing it is to incorporate a kind of analysis that most advisors to my knowledge don't use, which is to track not just the hold portfolio but also the sold portfolio. You have to keep a continuous record of the performance of the investments you got rid of to see whether after you got rid of them

they did worse. And I know very, very few advisors who actually do this, and in fact some of them are puzzled as to why that's necessary. And the simple answer is that you can't know whether you made a good decision to sell unless you look at the performance of what you sold after you sold it. Because it's quite possible it did better after you sold it than it did before you sold it. And it may have done better after you sold it than the thing you replaced it with, in which case you made a very foolish decision. And you can't evaluate whether you made a foolish decision unless you measure it.

Benz: We've done studies where we've looked at whether turnover was additive. So we've frozen fund portfolios and have said, what would this portfolio have returned versus what the manager actually did. And we've found exactly what you're saying, that had the manager stood still with what he had a year ago or three years ago, that portfolio would have outperformed what the fund actually did.

Zweig: It's a very consistent finding and it really shouldn't surprise anybody. Certainly in the case of stock-picking there are transaction costs to be considered. Often there are some implementation delays, where it takes time after you sell one thing to replace it with another.

But the real reason, the real force that drives that disappointing return, I think, is psychological. The very moment when something is the most painful to own, it's most likely to be a future bargain. So if you sell something that hurts to own, you're very likely to end up getting rid of something you should have held onto.

And whatever feels the best to buy today is likely to be the thing you'll regret owning tomorrow. So people are driven by emotion and psychology to get rid of whatever hurts to own and buy whatever makes them feel good. What they don't really recognize is that they've just laid the groundwork for doing the same thing in the future. Because if it hurts to own it now, it will feel good to own it later. And if it feels good to own it now, it's going to hurt you to own it later.

END

When they invest they are not focused on the profits they expect to make. Indeed, they are not investing for the money.
More focused on not losing money than on making it.
They never diversify.
The do not make predictions about the market or the economy .

Four elements are needed to sustain a mental habit:

A belief that drives your behavior;
A mental strategy—a series of internal conscious and subconscious processes;
A sustaining emotion; and
Associated skills.

Deadly Investment Sins

Believing that you have to predict the market's next move to make big returns.
The "Guru" belief: If I can't predict the market, there is someone somewhere who can—and all I need to do is find him.

Believing that "inside information" is the way to make really big money.

Diversifying

Believing that you have to take big risks to make big profits.

There is a system that will guarantee investment profits. Buffett says, "People are just looking for a formula."

Believing that you know what the future will bring==and being certain that the market must inevitably prove you right.

Winning Habits

PRESERVATION OF CAPITAL IS *ALWAYS* PRIORITY NO. 1

Never lose money
Counting a loss—what that money could have been worth.
High probability Event-gain $1,000 or lose $100.
I am responsible for results.
Can you make it back….
Buffett, "It is much easier to stay out of trouble now than to get out of trouble later."

PASSIONATELY AVOID RISK

The MI is risk-averse.

Risk is contextual. Risk is related to knowledge, understanding, experience, and competence. Unconscious competence.

The Four Stages of Learning

Unconscious incompetence: Admit that you don't know what to do and thus you must begin a long-term process of intensive learning.

Conscious competence is when you are beginning to have mastery of a subject, but your actions have yet to become automatic.

Risk declines with experience. Restricting his investments to those where he has unconscious competence is one way the MI can be risk averse and, at the same time, make above-average profits.

What are you measuring? The Master Investor knows before he invests whether he is likely to make a profit. You are what you measure.

Risk is Manageable:

1. Don't invest. When they can't find an investment that meets their criteria, they don't invest at all. Just sit there.

2. Reduce risk. Buy when you can buy significantly below your estimate of a business's worth. "Margin of safety."

3. Actively manage risk. It is OK to take risks. Never bet the ranch. Always be prepared to beat a hasty retreat.

MI emotionally disconnect their emotions from the market. Buffett doesn't care if the market is open or not. Admit fallibility.

4. Manage risk actuarially. The average expectancy of the event. Las Vegas has been built upon the wealth transfers that occur when people engage in seemingly small disadvantageous capital transactions. A professional bets only when the odds are on his side and there is a positive expectancy over time.

Buying net/nets is an actuarial approach.

Risk and reward are not directly related.

5. DEVELOP YOUR OWN UNIQUE INVESTMENT PHILOSOPHY

The MI has developed his own investment philosophy, which is an expression of his personality, abilities, knowledge, tastes, and objectives. As a result, no two highly successful investors have the same investment philosophy.

An investment philosophy is a set of belief about:

The nature of investment reality: how markets work and why prices move.
A theory of value, including how value can be identified and what causes profits and losses; and
The nature of a good investment.

Van Tharp, You don't trade the market, you trade your beliefs about the market.

Identifying Market Reality. Understanding Mr. Market.

How much is the business selling for? The first question in considering a stock purchase.

Has its business franchise been affected.

Fisher: An intense dislike for losing money.

Intensively understood a business. His investments must have a decided edge over its competition. Outstanding management. A sustainable moat.

First-hand information through scuttlebutt.

Reading the printed financial records about a company is never enough to justify an investment. One of the major steps in prudent investment must be to find out about a company's affairs from those who have some direct familiarity with them.

He owned about 5 to 7 stocks at most—no more than 10.

Sell when a mistake is made, a company didn't meet the criteria after all.