DISSING THE INVESTOR

BY LINDA FERENTCHAK

The dismaying trend of behavioral finance experts and business media of looking down on investors is unwarranted and counterproductive.

Popular financial advice all too often can be summed up with the statement that the average person is incompetent when it comes to investing, either making bad decisions or paying too much for too little—whether professional advice or investment returns. It's all "because of their bad behavior" says one psychologist and behavioral finance expert, sounding like a frustrated parent dealing with a two-year-old.

This attitude is part of what seems to be a growing trend that views the investor as incapable of making the right decision and who therefore requires laws and institutions to impose "correct" behavior. But disrespecting the investor is a corrosive trend that could cause far more damage than the so-called "bad behavior." The reality of behavioral finance is that it helps establish the need for active investment management.

The average investor is not a foolish person. To accumulate the funds to invest, they had to first acquire those funds and then have the discipline to save rather than live for the moment. They had to be able to envision the future consequences of having or not having money and make decisions based on what they perceived as good for their future. To some degree, they had to be cautious, aware that maintaining sufficient financial resources is critical, and that the wrong investment at the wrong time could cost them their savings.

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In choosing to work with a financial advisor, investors acknowledge that they are not experts at investing and that someone else may have a better insight on how to help them reach their financial goals. It's similar to accepting that there is a knowledge base and skill set behind being a good plumber that can't be replaced with guesswork and "do-it-yourselfism." Yet, ironically, working with a financial advisor is viewed by many in the media as foolish because it entails paying fees that could reduce returns.

When one looks at what the behavioral financial crowd has branded as counterproductive investment behaviors, it becomes obvious that these are deeply embedded and common human tendencies, and even survival tactics. Traits that have enabled mankind to prosper as a species can be strengths in the investment process. Instead of denying the value of behavioral traits, it is more effective to acknowledge their reality and put them to work.

Emotional decision-making

Great businesses are generally built by visionaries, the individuals who are emotionally involved in the success of the product and who make decisions based on their emotional involvement—decisions that often make no sense in terms of the numbers. An investor who is not emotionally involved in the success of his or her portfolio would seem to have no reason to invest in the first place. The trick is channeling that emotional commitment to positive outcomes over the long term, rather than spur-of-the-moment decision-making driven by the emotions of fear and greed.

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Loss aversion

Loss aversion is a great investing trait as long as it doesn't paralyze the investor. Bob Maynard, Chief Investment Officer at the Public Retirement System of Idaho, makes the observation that the cockroach has one of the best long-term success rates of any creature. Yet, it has only one defense mechanism: running in the opposite direction from a puff of air. Minimizing losses keeps investors committed to investing and more willing to invest when markets move upward.

Mental accounting

Mental accounting is another trait that makes good sense for individuals. Mental accounting refers to the tendency of people to put their assets in different mental compartments—i.e. the holiday gift fund, the college fund, the vacation fund, the retirement fund, the mad-money fund, etc. The challenge is that it may make it difficult for people to grasp their financial situation as a whole. Yes, all assets are the same in the end, but compartmentalizing makes it easier to make decisions about money and it may help individuals diversify their investments, taking greater risks in accounts with longer time frames, while protecting other funds that are essential to shorter-term needs.

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LINKS OF THE WEEK

The lessons of oil

The "failure of imagination"—the inability of most people to imagine extreme outcomes—has been highlighted again by oil's price drop and its potential second-order consequences.

Arguments for active management get stronger

More financial advisors and market analysts are favoring active management for its ability to navigate risk in 2015, according to an Investment News survey.

10 ways wealth management firms can beat rivals

Mercer identifies the important and manageable things advisors can do to better compete in today's environment.

Dissing

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Framing

Framing refers to the use of anecdotes and stereotypes that become mental emotional filters for individuals to rely on to understand and respond to events. Framing can be a means of making complex concepts and situations easier to understand. However, framing can also be used to mislead investors. The transition in terminology from "junk" bonds to high yield bonds is one of the great "re-framing" stories of the financial world. Eliminating the word "junk" helped reduce the perceived riskiness of the investment.

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Familiarity bias

Familiarity bias is the inclination of individuals to invest in areas that they are familiar with, such as investments centered on specific U.S. sectors, their employer's stock, or a well-known consumer company. One could easily accuse Warren Buffett of familiarity bias. Again, familiarity bias makes perfect sense and can be a much better long-term investing practice than jumping into investments with no information other than the fact that they are currently going up. The downside is that familiarity is not necessarily actionable knowledge of the inner workings of the company.

All of these behavioral finance traits are a reality, not something to be nagged out of investors. They can even be strengths when acknowledged and used correctly. Active management provides the framework to accommodate behavioral finance traits and can focus those traits to investors' advantage.

Active investment management provides a systematic approach to investing that helps remove the need for emotional decisions. It recognizes the individual's need to minimize losses as the tradeoff necessary for a long-term commitment to investing. Mental accounting can actually be used to diversify assets by time frame, strategy, and manager. Framing can help investors understand market cycles and the value of bear markets as both an opportunity for gains and a reality check on why defensive strategies matter. And adding risk management to investments in the "familiar" can provide the balance needed to make those investments work for the individual.

Behavioral finance traits are not always "bad behavior." They can have considerable value when accepted and integrated into the investment approach through active management. pro

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