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FINANCIAL MANAGEMENT



Behavioral Finance and Your Investments

Ever wonder why markets make sudden moves from one extreme to the other, or why markets may decline in the face of good news and rise on bad? Seems crazy, right?

Well, many times stock market movements are based on more than new information such as earnings reports or corporate downgrades... markets are quite often moved by investor sentiment. Psychological factors affect not only the average investor, but also professional money managers who tend to be driven by greed, euphoria and fear!

Behavioral Finance

Believe it or not, there is a legitimate field of study which seeks to quantify the impact of emotions, psychology and behavior on investing and financial decisions – it's called Behavioral Finance.

Behavioral Finance teaches us that just as the stock market operates in up and down cycles, markets also operate on their own "cycle of market emotions". Interestingly these two cycles tend to move in tandem.

For example, when the market is at its peak, most investors are in a state of emotional euphoria. Then as the market trends downward toward a bottom, investors' emotions become darker and more fearful, shifting from slight anxiety to despondency or depression.

This is the shift which can have the greatest impact on your decisions and investment results.

A Little Fun....

Take a short quiz to gauge your investor temperament.

A wager is offered where you **must pick one** of the following choices:

Wager (Investment) A: Gives you a 50% chance of gaining \$1,000, and a 50% chance of gaining \$0.

Or

Wager (Investment) B: Gives you a 100% chance of gaining \$500.

Which do you chose?

If you chose B then you are like most investors who are careful to avoid losses and concentrate on gains.

If you chose A, you are concentrating on the chance of winning \$1,000.

Interestingly, both bets are statistically the same. Wager A has the same statistical outcome as wager B because the average gain is the same. And yet the overwhelming majority chooses Wager B.

Behavioral Finance refers to this as Loss Aversion which refers to people's tendency to strongly prefer avoiding losses to acquiring gains. Some studies even suggest that this aversion is **twice** as powerful as the desire for gains.

Avoiding loss by refusing to sell an investment when it starts to deteriorate can cause permanent destruction of your wealth. Understanding loss aversion as a personal trait can be the difference between investment success and failure.

Key Takeaways-What to do.

Loss Aversion is one of many behaviors to keep in mind when you make investing decisions-here is the summary:

- Emotional and psychological factors impact our decisions.
- People will base decisions on perceived losses more than perceived gains. (That's what our quiz also showed us.)
- Losses have more of an emotional impact than equivalent gains. This reinforces the earlier point that individuals are more loss-averse than gain-driven.
- Investment decisions are usually based on beliefs and feelings and not on facts. So even though you may do a lot of analysis on a stock, ultimately, it's perhaps your emotions that influence how and when you pull the trigger. Unfortunately investing needs to be strictly non-emotional so the impact on your results can be quite devastating.

Things to Remember

So based on all of the above... when investing:

- Remove as much emotion as possible and stick to your game plan.
- Do your research and due diligence, and understand the upsides and risks.
- If your investment is solid, do not deviate from it just to follow the masses or to time the market. Hang tight, ride out the storms, and you will come out better-off in the end. (Remember how Buffet sat out the dot-com boom despite a lot of heavy criticism, but came out a hero.)

Fundamentals impact market moves, but so does investor behavior. So avoid making investment mistakes, and allow professional advisors to manage your investments or guide you through the process.

If you want to know more about your risk tolerance and investor sentiment, contact us at 1-866-Money-01.