

# CHAPTER 1

## Your Investor Identity: And Why You Need One

*The unexplored area is the emotional area. All the charts and breadth indicators and technical palaver are statisticians' attempts to describe an emotional state.*

—Edward Johnson, founder of Fidelity Investments

These words were spoken by Edward Johnson more than 40 years ago, and they ring every bit as true today. So why, after so much time, is the psychological understanding of investing decisions still so widely misunderstood? Given the volatility of the past decade, it stands to reason that merging the lessons of psychology and finance could be wonderfully beneficial to investors.

### Psychology and Finance: Failure to Communicate

*It's not that I can't help these people. It's just I don't want to.*

—Tom Hanks, *Volunteers*

The movie *Volunteers* is an immensely underrated comedy starring Tom Hanks and the late John Candy. In an effort to avoid a gambling debt, Hanks's character poses as a Peace Corps volunteer and boards a plane to a developing country. Shortly after arriving, he seeks to return home. When an incredulous Peace Corps organizer

pleads with him to stay by entreating him, “But you can *help* these people!”, Hanks responds with the classic line quoted above.

This quote is also a fair way to think of the relationship between psychology and finance. These two fields have lived side by side in the same neighborhood for more than a hundred years and have never been properly introduced.

Traditionally the world of psychology has not only been uninterested in finance, but often disdainful of it. There are a number of possible reasons for this disconnection, but one may stem from the fact that the world of finance is full of guys who played on the football team and the world of psychology is made up largely of kids from the drama/science/glee clubs. Of course the primary goals for each profession are different, and that contributes to the problem. But the jock/nerd dynamic is still there.

This is unfortunate because the field of psychology has much to offer the investing world. Few things are as emotional (or stressful) to people as their money. Money is the number one issue mentioned both as a cause of divorce and an instigator of sleepless nights. It is at the heart of what we call “quality of life.” Simply to help individuals invest more effectively and build greater wealth is to make a huge positive impact on their lives.

It has long been accepted that psychology affects investing decisions. Yet scientific inquiries into how it does so are a recent phenomenon. Part of the reason for this inability to connect may be due to the complicated nature of the task; quantifying human thought and behavior is notoriously messy.

But that’s no excuse. The field of psychology has done a poor job of presenting its insights to the financial community in a way it can relate to. Much of the misunderstanding between psychology and finance is due to the language barrier. “Psychobabble”—which has led to such dreadful sentences as “I want to process your affect” and “Let’s reframe your cognitive schema”—not only puts up a wall to financial professionals, it annoys them.

To this day in the work we do, we encounter antiquated stereotypes freely voiced or lying just below the surface. For some reason, there is a popular image of psychologists as being older gentlemen who wear earth-tone sweaters, smoke pipes, and periodically stroke their beards, asking questions like, “And how does that make you *feel*?”

Psychologists aren't altogether to blame for this sour relationship. Financial professionals have been trained to pay so much attention to numbers that they have become utterly mistrustful of fields that focus on words: Can't graph it? Can't express it in an equation? Then it's touchy-feely voodoo.

Fortunately, rigorous scientific disciplines have emerged in the study of decision-making. The goal of applied psychology today, particularly for those in the counseling and consulting fields, is to help clients develop better *habits* for going about their business—that is, to make people more effective at what they do—and that includes investing. As such, applied psychology and decision science are uniquely situated to help the individual investor.

Think of investing as a journey. There is a path you walk down and a destination you are trying to reach. The first steps ought to be the most carefully considered. The earlier you misstep, the farther and more quickly you wander off the path. Yet these first steps are the ones that are most likely to be taken in haste and carelessness. All too often investors plunge ahead to find they have not only wandered off their path, but perhaps chosen the wrong path entirely, or maybe even targeted a destination they will never reach. These initial missteps are most often caused by fundamental flaws in the investors' psychological framework. Beginning with the proper mental approach is essential. Psychologists can help.

## Beginning the Journey

Let's turn to Edward Johnson again:

What is it the good managers have? It's a kind of locked in concentration, an intuition, a feel, nothing that can be schooled. The first thing you have to know is yourself.

His words were referring to professional money managers, but his wisdom is universal; one has to understand oneself in order to be successful as an investor.

However, Johnson was not entirely correct about one thing. The lack of self-knowledge among most investment managers is not due to the fact that it cannot be learned (e.g., in business classes, training, etc.). The problem is that such characteristics have never been properly taught. With all due respect to Mr. Johnson, although

self-knowledge can't be memorized from a book, *skills* for developing self-knowledge can be acquired.

The most cohesive attempt to integrate psychology and investing is a field called *behavioral finance*. This field made its name by demonstrating that traditional economics is based on a false assumption—that human decision making is typically rational, profit-maximizing, and self-interested. Dr. Daniel Kahneman, a psychologist who shared the Nobel Prize for Economics in 2002, won the prize for his research with Amos Tversky demonstrating that financial decisions are systematically biased in non-rational ways.

For all the great research done in behavioral finance identifying irrational investing behavior, the field has had trouble progressing beyond the realm of “investing parlor tricks,” pointing out strange and quirky mistakes investors are prone to make. The findings are interesting, but *what do you do with them?*

While researchers in behavioral finance have identified systematic investor mistakes, they tend to offer these findings as solutions unto themselves, as if to say: “We’ve determined that investors fail to make rational and self-interested decisions. So, now that we established this fact . . . go forth and make rational, self-interested decisions!” [There are some notable exceptions, and one that comes to mind is the Save More for Tomorrow Plan (SMARt Plan) devised by Shlomo Benartzi and Richard Thaler.]

Stopping at identifying mistakes would be enough, of course, if knowledge equaled change. (“You say this is bad for me? Great. I’ll stop doing it, then.”) But knowledge does not equal change. If it did, the world would be a different place. For starters, kids would eat their vegetables. Teenagers wouldn’t smoke cigarettes. And stock market investors would average roughly 10 percent returns annually.

Knowing what to do is only a first step toward success—a necessary but insufficient condition for change. You do not lose money with your mind. You lose money with your actions—namely, buy, sell, and hold decisions that work out poorly.

If the problem isn’t a lack of knowing (and it isn’t), neither is the problem a lack of caring. Most people *don’t want* to make decisions that are bad for them (Freudian notions of self-sabotage be damned!). And yet most investors not only make irrational decisions, they *persistently and reliably* make such decisions. Investors, generally speaking, know what to do and want to do it. The problem is . . . *they can’t bring themselves to do it when they need to.*

It may be useful to think of investing mistakes in terms of an epidemic currently afflicting the United States. Americans have a higher percentage of citizens who are overweight than any other country. We are, simply put, the fattest nation on the planet.

Barring the rare cases of metabolic disorders, the best way to avoid weight problems is to eat a healthy diet and exercise regularly. Everyone knows this—children as well as adults. Every school district in the country drills this message into its students starting in grade school. And it doesn't take long for most people to recognize that the extent to which a food is bad for you is directly correlated with how good it tastes. So a lack of knowledge is not the problem.

The problem isn't even that people don't *care* about being overweight. The United States has an astounding number of joggers and gym-goers relative to its peers. Moreover, we are constantly being inundated with idealized body images in the media (thin for women, buff for men). We do care. We may even care too much. These unrealistic body images are widely blamed for the relatively high rate of eating disorders and steroid abuse in the country.

Nor is there any shortage of advice on ways to help remedy the problem of obesity. If you wanted to lose weight, you could go to the health and nutrition section of any major bookstore and find shelves upon shelves of books with detailed dieting programs. Moreover, most of those programs would work. But that utterly misses the point.

The question remains: What is the right plan *for you*? The right plan for you isn't the one that "would work if you follow it." (All those plans work if you follow them!) The right plan for you is the one *you can best follow*. In other words, the plan for you is one that is most suited to your preferences, values, beliefs, and emotional strengths and weaknesses. This book does not recommend a specific method of investing. There are many right ways for people to invest their money. Choosing one is primarily a matter of fit.

It's important to remember that both financial fitness and physical fitness are long-term goals. Sure, a lot of people like to drop some winter weight, slim down for a wedding, or get into "beach shape." But those are all short-term goals. We don't think you'd be reading this book if you were merely interested in growing your portfolio for the summer. We're talking about lifestyle choices that you can follow forever because they are consistent with who you are.

Again we see that the psychological obstacles that impede getting into better shape physically are the same ones that hamper getting into better shape financially. People attribute the inability to get into better financial shape to ignorance and apathy. This is a common misconception. In fact, a study of 1,115 investors by the Guardian Life Insurance Company demonstrated conclusively that people know they should be saving more money and investing it for the future in vehicles that have shown long-term returns. The survey also found that saving money and investing for the future were consistently rated as top priorities.<sup>1</sup> Yet the same study found that most respondents were woefully underfunding their retirements and risked hardship later in life.

We know what to do. We care. It doesn't matter, because our investing problems lie deeper, in what we call human nature. You cannot change human nature. But it is possible to plan around it. When it comes to your finances, you have to.

## Risky Business

One of the most basic tools used in the investment community is the risk tolerance questionnaire. If you've ever worked with a financial firm or professional, you know one of the first things he or she will do is have you fill out a short survey designed to measure your preferences for investment risk taking. The results are then used to generate an asset allocation model (i.e., a plan made up of different investment vehicles) that matches your inferred investing style.

Matching people's investments to their personalities is a good idea. There is just one small problem with risk tolerance questionnaires. They don't work. They explain only about 20 percent of the variance in the average person's risk tolerance.<sup>2</sup> That's not to say there is no value in taking such a survey. It may lead to insights into one's investing proclivities. It certainly makes a good conversation starter for expectations. But that's about it.

The fact is human beings are lousy at predicting how they will react in future circumstances, especially those they have never encountered. The ability to comfortably handle financial risk is primarily what psychologists call *state dependent* (i.e., how you're feeling at the time), rather than *trait dependent* (i.e., a consistent characteristic that doesn't change).

In addition, there is no way to factor in all the ways in which one's life might change in the future or what the future positive and negative circumstances might be. By the time we encounter the predicted scenarios, we might be very different people in entirely different circumstances.

Additionally, many risk tolerance questionnaires start from false or skewed assumptions. It is sometimes called the Dentist Analogy. Imagine you've gone to see your dentist and the following conversation ensues.

**Dentist:** I got your x-rays back and it looks like you're going to need a root canal.

**You:** Oh wow . . . that's too bad.

**Dentist:** Tell me about it. I have a three o'clock tee time, but there's *no way* I'm going to make that now!

**You:** So, is this a painful procedure?

**Dentist:** No! Of course not! Usually. So tell me . . . what do you think is the most amount of pain you can stand during the procedure?

**You:** What?

**Dentist:** My model is to use as little Novocain as possible, so I need a sense of your pain threshold. What is the absolute most pain you can stand during the procedure?

**You:** Look, I don't think I want to—

**Dentist:** Ah, don't worry about it. How about you just tell me when it hurts, and I'll add more Novocain along the way? Now sit back and relax. Open wide . . .

Of course, it deserves to be said at this point that no dentist would operate this way. But neither should an investment professional! And if you look at the assumptions behind using risk tolerance questionnaires you'll see that the analogy is not far off. Many such measures essentially ask you to rate your various pain thresholds, and then seek to base a plan around the maximum pain you can supposedly tolerate. Most people are asked to rate their pain tolerance while sitting comfortably in their advisor's office. Interestingly, because of a mental trap called the *projection bias*, it's extremely difficult to accurately estimate how we'll respond to pain in the future if we are not in pain in the present. To plan ahead for pain we've got to stay grounded despite changing circumstances.

## Resisting Your “Idiot Friend”

An investing identity is important because it is so easy to get side-tracked along the road to wealth. Here’s a brief anecdote that you may find familiar: I was 16 years old and had just done something stupid but entirely typical for 16-year-olds. It led to the following exchange:

**Mother:** Why did you do that? Are you crazy?

**Me:** But everybody was doing it!

**Mother:** And if everybody were jumping off a bridge, would you do that too?

The preceding conversation has been happening between every generation of mothers and sons in the history of time and, presumably, bridges.

The last question is meant to be rhetorical, but is nonetheless worth answering, because the honest response in most cases is, “Yeah, probably.” What we see others doing around us has a profound impact on the decisions we make.

This exchange can happen between anyone, but it is most typical of teenagers and mothers. Why? Because the primary social developmental task of teenagers is to achieve a sense of “who they are.” This search for an identity leads teenagers to test boundaries, engage in risk-seeking behaviors, and, yes, be more susceptible to peer pressure.

As we begin to grow more secure in our identities, we are better at resisting thoughts and behaviors that seem at odds with our self-image. We say, “I know it seems like everybody is doing X . . . but I don’t like X. I’m not sure I ever did.” And this deeper knowledge and acceptance of who we are allows us to resist the crowd.

Short-term market moves are your “idiot friend.” Don’t know what I mean? Sure you do. You remember your friend back in high school who was always getting you to do dumb stuff. He (or she) used to say things like, “Let’s race that guy!” “Let’s dye our hair green!” and, “They won’t mind if we use their pool!”

These escapades usually started out great, but had a way of ending badly. How did your friend get you to engage in such foolish behaviors? Well, one reason is that the foolish behaviors are often fun—and we like fun. If we didn’t, we wouldn’t have the lottery,

office pools, and the city of Las Vegas. But the second reason is that an underlying insecurity made you susceptible to pressure—usually in the form of such time-tested tactics as “You’re not scared, are you?” “It’ll only take a second,” and the aforementioned, “Everybody’s doing it.”

To a teen these are remarkably effective manipulators. The average adult, however, is more likely to respond, “Of course I’m scared!” “Nothing takes a second,” and “Everybody is NOT doing it and even if they were, I still don’t want to.” Such is the virtue of maturity.

The majority of investors are chronologically adults, but their investor identities are in an earlier developmental stage. They have some knowledge about the financial markets, but sometimes “just enough to be dangerous.” They have some insights into themselves, but lack the realizations born of experience. They are still in the process of learning their investing strengths, weaknesses, values, and pain thresholds. This leaves their decisions vulnerable to the influences of other people in their lives, talking heads on TV, or the greatest pressure group of all, “The Market” itself. Most investors are—and in no way is this meant to be pejorative—the developmental equivalent of adolescents.

There is a consistency of approach that forms with self-insight and allows us to resist such peer pressure. The investing industry is not the fashion industry, but it all too often markets its products that way. Many financial pundits encourage the investing-as-fashion outlook by touting the “hot” investing options of the season as if they are strutting down a runway.

*Spring is here! The leaves are turning green and so is Cyndi’s portfolio! She looks positively verdant in this smart ensemble of solar, green-tech, and renewable energy stocks. Saving the planet never looked so good!*

*Come with Paulina this autumn to the exotic Far East. With the Red Star on the rise, you can’t help but “fall” for these hot infrastructure plays. And with an annual GDP growth of 8 percent and the world’s largest population, you won’t have to be Shanghai’ed into this spicy number!*

*The thermometer is dropping this winter, but Giselle is heating things up with these red-hot selections from the oil sector. An OPEC production freeze will send crude prices—and your temperature—headed to 100 in these oil and gas plays!*

A new fashion is always alluring. But fashion is also capricious. It changes on a whim and without warning.

Most people playing along are behind the curve. They join the trend after it has become the “cool” thing to do, and when they get out, it is usually after the new trend has reversed itself. The result is a wardrobe stuffed with outfits they have no intention of wearing again. Take a look at a picture of you and your friends from 20 years ago. Would you wear the same style of clothes today? Maybe, if you were going to a theme party.

And this would be fine if we were really talking about clothes. But the investing equivalents of leg-warmers, bell-bottoms, and scrunchies not only don’t get sold off in a timely manner, they tend to collect in our closets (read “portfolios”), eroding our net worth in the process. (In later chapters we will discuss why the bad holdings tend to accumulate while the good ones tend to disappear.)

Some of us look back on those pictures of us with our friends 20 years ago and think, “Wow. I can’t believe I wore that. I look like a goofball.” It’s usually good for a laugh. But a trip down memory lane through the wasteland of our investing errors, and the thousands of dollars we squandered in futile and transient pursuits, seldom elicits a chuckle.

When it comes to finding good places to invest our money, the vast majority of us are better off sticking to the classics. The little black dress. The blue blazer. Are they exciting? Well, no. But the goal of investing *shouldn’t be excitement*. That’s an emotional goal in direct competition with our financial ones, and a huge red flag. Nor should the desire to “stay current” be a motivator. The true motivators should always be rooted in our consciously developed goals—how we want our lives to look and what we want our legacies to be.

## Finding Your Investor Identity

*Now, the world don’t move to the beat of just one drum. What might be right for you, may not be right for some.*

—Theme song to *Diff’rent Strokes*

Have you noticed that it’s uncannily common to invest at the wrong time—buy at the tops and sell at the bottoms? (We call it “Whack-a-Mole” syndrome). For most investors, real estate in 2005 and Internet stocks in 1999 appeared to be good buys. For most people it was only in painful hindsight that the tremendous overvaluations were apparent.

If we were to tell you that you can expect to earn an average of 1.87 percent a year in the mutual funds you invest in, would you still invest in mutual funds? Of course not. You'd buy a Treasury bond or something safer (and higher yielding). Yet 1.87 percent is what Americans have annually earned on average in their mutual fund investments over the past 20 years through the end of 2008.<sup>3</sup>

Those numbers are bad enough. But they look even worse when translated into real-life returns. As mentioned in the Preface, Dalbar Inc. found that \$100,000 invested in the S&P 500 index on January 1, 1989, would have grown to a total of \$292,329 by 2009, after accounting for inflation. However, Dalbar Inc. found that the average equities investor who invested that same \$100,000, again accounting for inflation, would now have \$82,288 over the same 20-year period. That is a difference of over \$200,000, not to mention a net loss in actual purchasing power.

How could the average investor underperform so poorly that they can't even match the rate of inflation? Good question. Most of us don't want to arrive at a party before it's hopping or leave while we're having a great time. The same goes for timing our investments. But the inability to do just that is a prescription for underperformance. Thinking counterintuitively about investments is crucial. But it requires tremendous fortitude, confidence, and self-awareness.

Unfortunately, many amateur investors scoff at the idea that psychology matters to their performance. Yet the best investors in history—including Warren Buffett, Peter Lynch, Steve Cohen, Baron Nathan von Rothschild, Bernard Baruch, David Dreman (and the list goes on)—have mentioned the importance of understanding the psychological factors that drive both markets and individuals.

Managing yourself—your moments of greed, panic, and insecurity—can only be achieved once you've obtained the requisite self-understanding. And self-understanding comes from looking within.

In this book we're not endorsing any particular style of investing such as buy-and-hold or market timing. Nor are we endorsing any particular strategies (such as value or momentum) or assets (such as bonds, stocks, or commodities). Your optimal investing style and strategy depend on *who* you are.

If you're going to be investing, you've got to back up and take a good look at yourself. *Why* do I want to invest? *Who* am I trying to be when I invest? *What* are my long-term (and short-term)

objectives? *How* am I likely to deceive myself along the way? Although it's important to answer these questions, they are incredibly challenging to answer honestly.

You may be wondering, "Why is knowing myself more important than knowing the markets?" It's true that you've got to have an elementary understanding of markets, assets, analysis styles, and potential strategies in order to invest well. Yet many investors go further, spending weeks or months learning specific trading strategies, or watching price quotes day after day, and yet never seeming to get ahead (and usually falling further behind). And they wonder, "Why am I trading the best stocks/real estate/commodities, and I'm still not making as much money as I should?"

You might have heard the advice from finance academics who say you can't beat the markets. They recommend you buy and hold low-fee stock index funds and forget the rest. When academics tell you to do this, they make it sound so easy. The more imperious ones seem to suggest you'd be silly not to do it. You may be surprised (if not amused) to know that most finance professors don't follow their own advice. And that raises the question, "If it's so easy to buy-and-hold low-cost stock index funds, why do the majority of mutual fund investors underperform?"

Let's get real about something: You're not designed to be a good investor.

No, we didn't say "destined." We said "designed"—as in anatomy. Investing is not like most other pursuits in life where the advantages can be readily seen. Great long-distance runners tend to be long and lean. Great pianists have long fingers. Great cyclists like to wear form-fitting spandex. And great investors, what are they like? Before looking into the secrets of great investing, let's first look at the causes of bad investing, since in order to be the next Warren Buffett, you've got to avoid being the next Nick Leeson.

On the surface, mutual fund investor underperformance can be attributed to buying at the peaks of the top-performing funds and selling when those funds are at their lows. On a deeper level, such behavior is driven by emotion. Greed and fear are the usual culprits, but there is also a lineup of supporting characters—shame, regret, and excitement to name a few.

Unfortunately financial experts erroneously leave rare events—and the emotions and stress surrounding them—out of their market models. This is insane. It is unexpected, rare events that cause

the emotional reactions, which compel investors to jettison their long-term plans.

Ironically, “rare events” appear to happen on a regular basis in the financial markets. Before the financial paralysis of late 2008, Goldman Sachs’ CFO David Viniar stated of early August 2007, “We were seeing things that were 25 standard deviation moves, several days in a row.”<sup>4</sup> Twenty-five standard deviations implies odds of 1 in  $1.3 \times 10^{135}$  on any given day. That’s one hundred thousand times more than the number of particles in the universe, and it is comparable to winning the UK lottery 21 or 22 times in a row.<sup>5</sup> Clearly, such financial models are based on faulty assumptions about human nature and human-driven markets. Leaving out emotion, uncertainty, and rare events is like forgetting to put flour, milk, and eggs in the cake you’re baking. Is there anything left?

In the end, unexpected events and investors’ accompanying emotional reactions will always be with us. But we have the ability to learn the skills to manage our emotions. It behooves us to do so to the best of our abilities. We’re writing this book because for too long the psychological mistakes of investors have been diagnosed and subsequently ignored, and it’s time for a prescription that goes to the core of the malady and provides a road to recovery. That road starts with a stronger sense of *who you are* as an investor, in other words, by forging an investor identity.

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