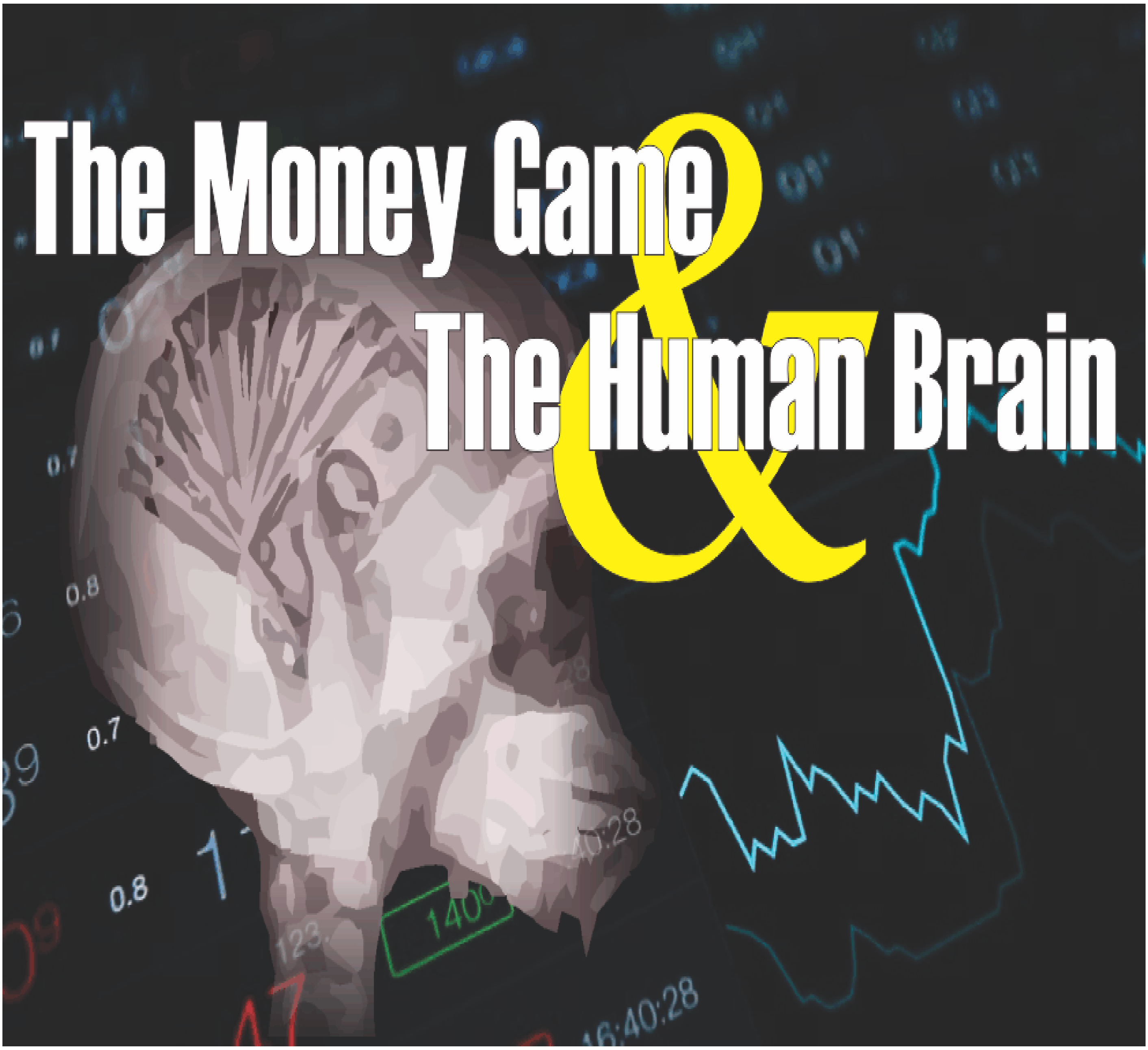
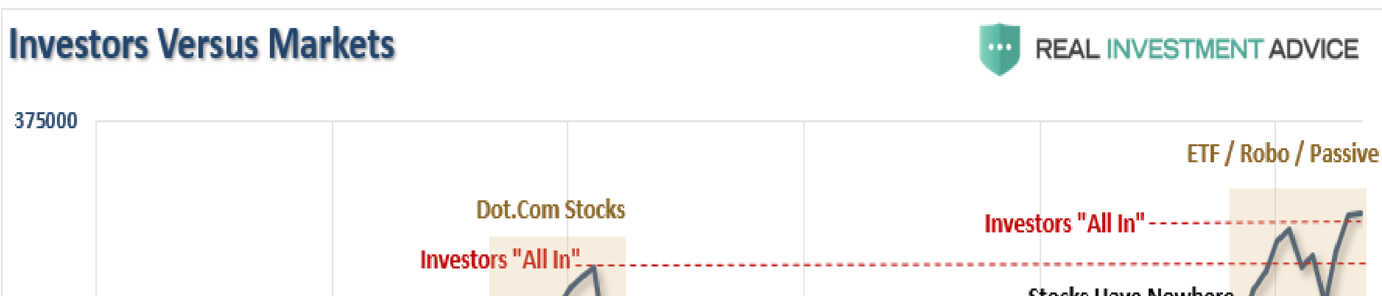


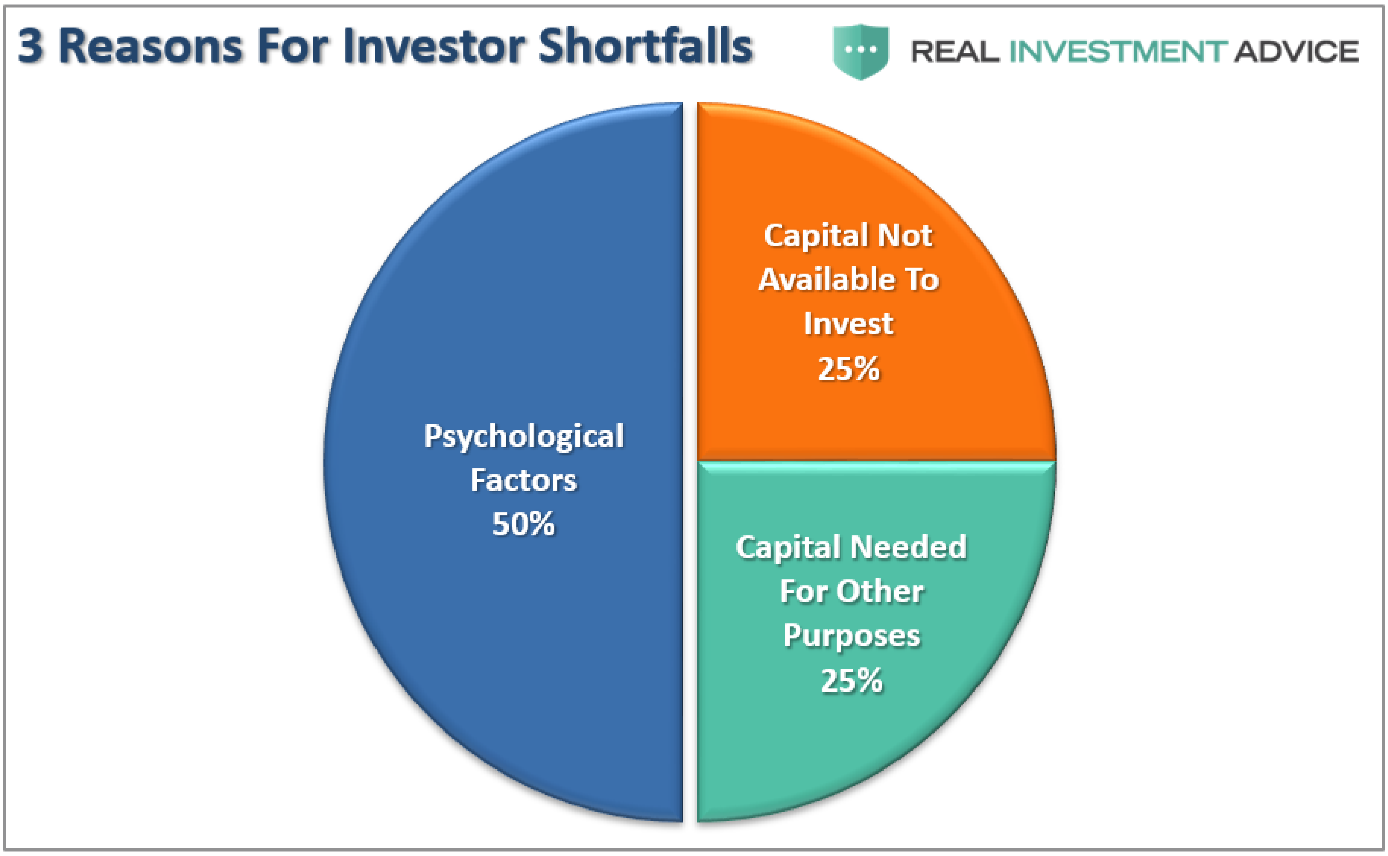
Jason Zweig,•a neuroscience and Benjamin Graham expert, re-published an article last year entitled: ["Ben Graham, The Human Brain, And The Bubble."]•The entire article is a worthy read but there were a few points in particular he made that are just as relevant today as they were when he wrote the original essay in 2003.

> *"At the peak of every boom and in the trough of every bust, Benjamin Graham?s immortal warning is validated yet again: 'The investor?s chief problem ? and even his worst enemy ? is likely to be himself.'"*•

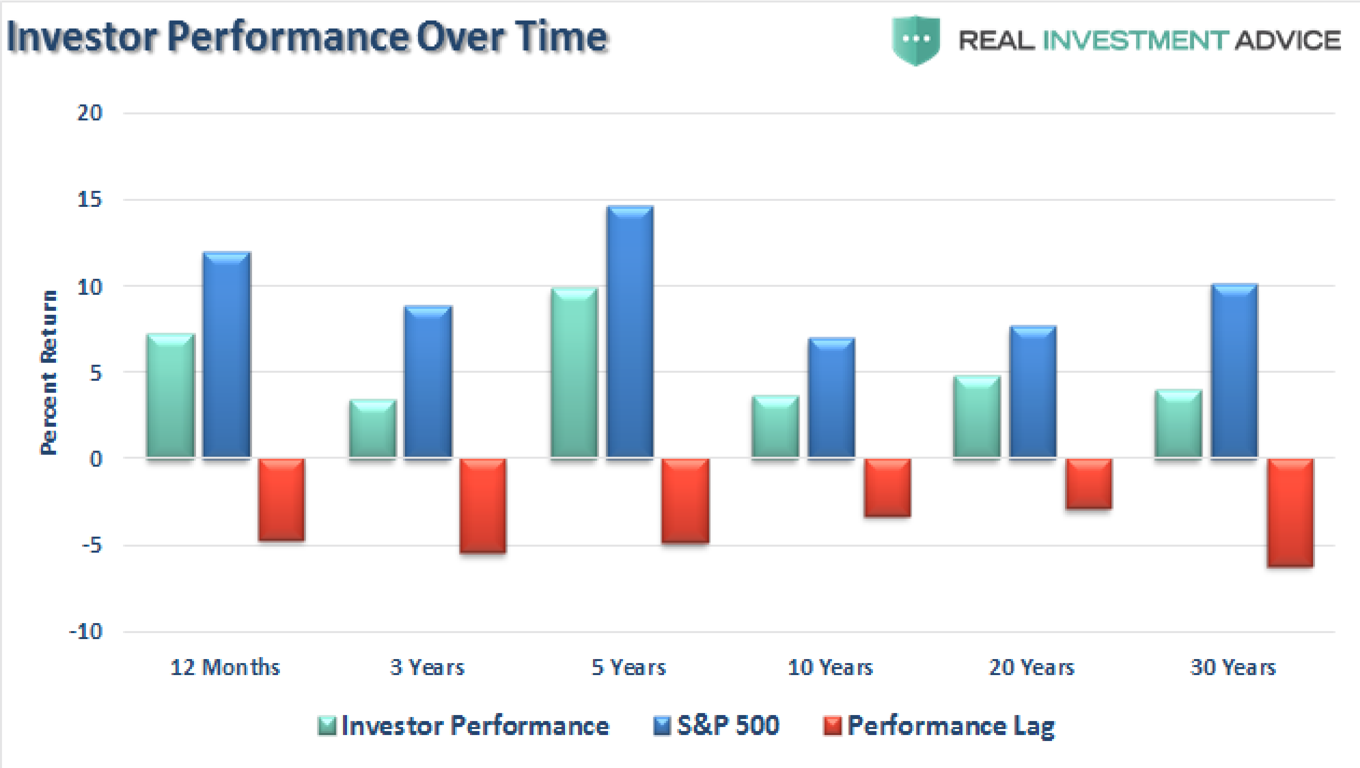


I have written about the psychological issues which impede investors returns over longer-term time frames in the past. They aren't just psychological, but also financial. To wit:

> *"Another common misconception is that everyone MUST be saving in their 401k plans through automated contributions. According to•Vanguard?s recent survey, not so much.*
>
> - *The average account balance is $103,866 which is skewed by a small number of large accounts.*
> - *The median account balance is $26,331*
> - *From 2008 through 2017 the average inflation-adjusted gain was just 28%.•*
>
> *So, what happened?*
>
> - ***Why aren?t those 401k balances brimming over with wealth?***
> - ***Why aren?t those personal E*Trade and Schwab accounts bursting at the seams?***
> - ***Why are so many people over the age of 60 still working?***
>
> *While we previously covered the impact of market cycles, the importance of limiting losses, the role of starting valuations, and the proper way to think about benchmarking your portfolio, the two biggest factors which lead to chronic investor underperformance over time are:*
>
> - *Lack of capital to invest, and;*
> - *Psychological behaviors*
>
> *Psychological factors account for fully 50% of investor shortfalls in the investing process. It is also difficult to 'invest' when the majority of Americans have an inability to 'save.'"*



"These factors, as shown by data from Dalbar, lead to the lag in performance between investors and the markets over all time periods."



While?*buy and hold?*•and?*dollar cost averaging?*•sound great in theory, the actual application is an entirely different matter. Ultimately, as individuals, we do everything backwards. We "*buy"* when market exuberance is at its peak and asset prices are overvalued, and we *"sell"* when valuations are cheap and there is a *"rush for the exits."*•Behavioral biases are an issue which remains little understood and accounted for when individuals begin their investing journey. Dalbar defined (9) nine of these behavioral biases specifically:

- ***Loss Aversion ?•****The fear of loss leads to a withdrawal of capital at the worst possible time.• Also known as ?panic selling.?*
- ***Narrow Framing ?•****Making decisions about on part of the portfolio without considering the effects on the total.*
- ***Anchoring ?•****The process of remaining focused on what happened previously and not adapting to a changing market.*
- ***Mental Accounting ?•****Separating performance of investments mentally to justify success and failure.*
- ***Lack of Diversification ?•****Believing a portfolio is diversified when in fact it is a highly correlated pool of assets.*
- ***Herding?•****Following what everyone else is doing. Leads to ?buy high/sell low.?*
- ***Regret ?•****Not performing a necessary action due to the regret of a previous failure.*
- ***Media Response ?•****The media has a bias to optimism to sell products from advertisers and attract view/readership.*
- ***Optimism ?•****Overly optimistic assumptions tend to lead to rather dramatic reversions when met with reality.*

Cognitive biases impairs our ability to remain emotionally disconnected from our money. But it isn't entirely your fault. The Wall Street marketing machine, through effective use of media, have changed our view of investing from a *"process to grow savings over time"* to a *"get rich quick scheme"* to offset the shortfall in savings. Why "save" money when the market will *"make you rich?"* As I addressed in ["Retirees Face A Pension Crisis Of Their Own:"]

"Using faulty assumptions is the linchpin to•the inability to meet future obligations. ***By over-estimating future returns, future retirement values are artificially inflated which reduces the required saving amounts need by individuals today.*** *Such also•explains why 8-out-of-10 American?s are woefully underfunded for retirement currently."*

The Illusion Of Control

Jason discussed another important psychological barrier to our success.

"Online trading firms went further, blowing the traditional brokerage model to bits. With no physical branch offices, no in-house research, no investment banking, and no brokers, they had only one thing to offer their customers: the ability to trade at will, without the counterweight of any second opinion or expert advice. Once, that degree of freedom might have frightened investors. ***But the new Internet brokerages cleverly fostered what psychologists call 'the illusion of control' ? the belief that you are at your safest in an automobile when you are the driver.*** *Investors were encouraged to believe that the magnitude of their portfolio?s return would be directly proportional to the amount of attention they paid to it ? and that professional advice would reduce their return."*

The *"illusion of control,"* is another behavioral bias that individuals regularly face. When stock prices are rising, especially in a momentum-driven market, individuals believe that have it *"all figured out."*•The inherent problems which arise from this*"over-confidence"*•are the layering of*"risks"* in portfolios which are misunderstood until a correction process begins. As I wrote previously:

"Bull markets hide investing mistakes, bear markets reveal them."•

The reality is that as individuals we are NOT investors, but rather just speculators hoping the share of stock we purchased today, will be able to be sold at a higher price later. **Unfortunately, since individuals are told to *"buy,"* but never *"sell,"*•only one-half of the investment process is completed.** In other words, the illusion we are in *"control"* is simply that. Logically, we know we should *"buy low"* and *"sell high."* Yet it is the entirety of our other behavioral biases that keep us from doing so. But most importantly, it is the consistent message from the mainstream media which *"feeds our greed"* that asset prices will only move higher...**and you surely don't want to miss out on that.** *(Read: Experience Is The Only Cure)*

The Video Game•

Another risk Jason points out is our *"addiction."*

"Psychologist Marvin Zuckerman at the University of Delaware has written about a form of risk called 'sensation-seeking' behavior. This kind of risk ? people daring each other to push past the boundaries of normally acceptable behavior ? is largely a group phenomenon (as anyone who has ever been a teenager knows perfectly well). People will do things in a social group that they would never dream of doing in isolation."

As individuals, we are *"addicted"* to the *"dopamine effect."*•It is why social media has become so ingrained in society today as individuals constantly look to see how many likes, shares, retweets, or comments they have received. That instant gratification and acknowledgment keep us glued to our screens and less involved in the world around us. We are addicted. As Jason notes, a team of researchers have proved this point:

"Wolfram Schultz at Cambridge and Read Montague at Baylor in Houston, Texas, have shown that the release of dopamine, the brain chemical that gives you a 'natural high,' is triggered by financial gains. The less likely or predictable the gain is, the more dopamine is released and the longer it lasts within the brain. Why do investors and gamblers love taking low-probability bets with high potential payoffs? Because, if those bets do *pay off, they produce an actual physiological change ? a massive release of dopamine that floods the brain with a soft euphoria.*

After a few successful predictions of financial gain, speculators literally become addicted to the release of dopamine within their own brains. Once a few trades pay off, they cannot stop the craving for another 'fix' of profits ? any more than an alcoholic or a drug abuser can stop craving the bottle or the needle."

Fortunately, we have support groups to help with most of our addictions from alcohol to gambling. While these groups are there to help us curb our addictive and destructive behaviors for some things, the investing world is full of groups which exist to *"feed"* our investing addiction.

"Until the advent of the Internet, there was simply no such thing as a network or support group for risk-crazed retail traders. Now, quite suddenly, there was ? and with every gain each of them scored, they goaded the other members of the group on to take even more risk. Comments like 'PRICE IS NO OBJECT' and 'BUY THE NEXT MICROSOFT BEFORE IT?S TOO LATE' and 'I?LL BE ABLE TO RETIRE NEXT WEEK' became commonplace. And the public was urged to hurry. 'EVERY SECOND COUNTS,' went the slogan of Fidelity?s discount brokerage ? implying that investors could somehow achieve their long-term goals by engaging in short-term behavior." ***By using technology to turn investing into a video game ? lines snaking up and down a glowing screen, arrows pulsating in garish hues of red and green ? the online brokerages were tapping into fundamental forces at work in the human brain."***

What are the most popular apps on our *"smartphones?"*•Video games and social media. Why, because of the *"dopamine"* our brain releases. This is why apps like *"Robinhood"* and *"Stash"* that allow for online trading straight from our phones have gained in such popularity. The *"immediacy effect"* of instant feedback on success or failure keeps us clicking for next winner. Wall Street has become a full-blown casino with individuals lining up to pull the lever to see if they are the next big winner. But, just as it is in Las Vegas, the *"house usually wins."*•

The Prediction Addiction

Adding to our list of behavioral flaws and biases when it comes to investing, Jason points out another:

*"I*n 1972, Benjamin Graham wrote:•The speculative public is incorrigible. In financial terms it cannot count beyond 3.• It will buy anything, at any price, if there seems to be some ?action? in progress.' -Graham, The Intelligent Investor, pp. 436-437. *In a stunning confirmation of his argument, the latest neuroscientific research has shown that Graham was not just metaphorically but literally correct that speculators 'cannot count beyond 3.'* ***The human brain is, in fact, hard-wired to work in just this way: pattern recognition and prediction are a biological imperative.*** *Scott Huettel, a neuropsychologist at Duke University, recently demonstrated that the anterior cingulate, a region in the central frontal area of the brain,•automatically anticipates another repetition after a stimulus occurs only twice in a row.* ***In other words, when a stock price rises on two consecutive ticks, an investor?s brain will intuitively expect the next trade to be an uptick as well. This process ? which I have christened 'the***

> ***prediction addiction' ? is one of the most basic characteristics of the human condition.***•*Automatic, involuntary, and virtually uncontrollable, it is the underlying neural basis of the old expression, 'Three?s a trend.'* ***Years ago, when most individual investors could obtain stock prices only once daily, it took a minimum of three days for the 'I get it' effect to kick in. But now, with most websites updating stock prices every 20 seconds, investors readily believed that they had spotted sustainable trends as often as once a minute."***

While individuals regularly proclaim to be *"long-term investors,"*•the average holding period for stocks has shrunk from more than 6-years in the 1970's to less than 6-months currently.

The Advisor's Role

These psychological and behavioral issues are exceedingly difficult to control and lead us regularly to making poor investment decisions over time. But this is where the role of an "advisor" should be truly defined and valued. While the performance chase, a by-product of the very behavioral issues we wish to control, leads everyone to seek out last years *"hottest"* performing manager or advisor, this is not really the advisor's main role.•The role of an Advisor is NOT beating some random benchmark index or to promote a *"buy and hold"* strategy. *(There is no sense in paying for a model you can do yourself.)* Jason summed it well:

> *"The only legitimate response of the investment advisory firm, in the face of these facts, is to ensure that it gets no blood on its hands.* ***Asset managers must take a public stand when market valuations go to extremes ? warning their clients against excessive enthusiasm at the top and patiently encouraging clients at the bottom."***

Given that individuals are emotional and subject to emotional swings caused by market volatility, the Advisors role is not only to be a portfolio manager, but also a psychologist.•**Dalbar suggested four successful practices to reduce harmful behaviors:**

1. **Set Expectations below Market Indices:**•*Change the threshold at which the fear of failure causes investors to abandon an investment strategy.•Set reasonable expectations and do not permit expectations to be inferred from historical records, market indexes, personal experiences or media coverage.*•***The average investor cannot be above average.***•*Investors should understand this fact and not judge the performance of their portfolio based on broad market indices.*
2. **Control Exposure to Risk:**•*Include some form of portfolio protection that limits losses during market stresses. Explicit, reasonable expectations are best set by agreeing on a goal that consists of a predetermined level of risk and expected return.*•***Keeping the focus on the goal and the probability of its success will divert attention away from frequent fluctuations that lead to imprudent actions***
3. **Monitor Risk Tolerance:**•*Periodically reevaluate investor?s tolerance for risk, recognizing that the tolerance depends on the prevailing circumstances and that these circumstances are subject to change. Even when presented as alternatives, investors intuitively seek both capital preservation and capital appreciation.*•***Risk tolerance is the proper alignment of an investor?s need for preservation and desire for capital appreciation.***•*Determination of risk tolerance is highly complex and is not rational, homogenous nor stable.*
4. **Present forecasts in terms of probabilities:**•*Simply stating that past performance is not predictive creates a reluctance to embark on an investment program.* ***Provide credible information by specifying probabilities or ranges that create the necessary sense of caution without negative effects.***•*Measuring progress based on a statistical probability enables the investor to make a rational choice among investments based on the probability of*

reward.

The challenge, of course, it understanding that the next major impact event, market reversion, will NOT HAVE the identical characteristics of the previous events. This is why comparing today?s market to that of 2000 or 2007 is pointless. Only the outcome will be the same. **One thing that all the negative behaviors have in common is that they can lead investors to deviate from a sound investment strategy that was narrowly tailored towards their goals, risk tolerance, and time horizon.** The best way to ward off the aforementioned negative behaviors is to employ a strategy that focuses on one?s goals and is not reactive to short-term market conditions.• **The data shows that the average mutual fund investor has not stayed invested for a long enough period of time to reap the rewards that the market can offer more disciplined investors.•The data also shows that when investors react, they generally make the wrong decision. The reality is that the majority of advisors are ill-prepared for an impact event to occur.**•This is particularly the case in late-stage bull market cycles where complacency runs high. When the impact event occurs, advisors who are prepared to handle responses, provide clear messaging, and an action plan for both conserving investment capital and eventual recovery will find success in obtaining new clients. The discussion of why• *?this time is not like the last time?*•is largely irrelevant. Whatever gains that investors garner in the between now and the next impact event by chasing the• *?bullish thesis?*•will be largely wiped away in a swift and brutal downdraft• **Of course, this is the sad history of individual investors in the financial markets as they are always• *?told to buy?* •but never• *?when to sell.?*** You can do better.