

BY KENNETH L. FISHER

Caveman Investment Concepts



Human beings are hard-wired to behave in ways that helped our hunter-gatherer ancestors survive, but hinder our ability to succeed in investing.

WHY DO PEOPLE invest the way they do? What thought processes form investment decisions? Behavioral finance, a new field of finance theory, examines how people use the tools of finance, rather than studying the tools themselves. Many behavioralist discoveries undermine the foundations of standard finance. They also help us to know more about ourselves.

Our Stone Age ancestors' brains were wired for specific tasks. Even in modern society, much of this wiring remains. But some of these cognitive processes that were helpful to our ancestors result in errors in modern-day financial markets. Understanding these errors can lead to

higher returns for investors and a greater understanding of financial market gyrations.

Recently, behavioralists proved that normal people hate losses roughly two and a half times as much as they like gains. People exert more effort to avoid pain than to achieve gain. This is commonly known as "myopic loss aversion" and is a subset of two broader concepts: pride and regret.

Stone Age Man learned to accumulate pride and shun regret to survive. This increased his probability of survival. Behavioralists have learned that the markets, rather than being driven by fear and greed as is generally supposed, are driven by a desire to accumulate pride and shun regret. Pride is a mental process associating success with skill and repeatability. Regret is a process that denies responsibility for failure tied to features other than skill like bad luck or victimization. Accumulating pride and shunning regret motivate people to keep trying when otherwise they would become despondent over failures. Usually this is good for human survival.

Imagine a Stone Age day where two men return to camp — one dragging a gazelle, the other empty-handed. The successful hunter walks proudly into camp bragging of his success. He accumulates pride. The other hunter describes his failure as bad luck. Perhaps a gazelle was just within his grasp when a freak lightning storm scared it away. Maybe his spear wasn't sharp enough. Whatever. He's fabricating excuses to shun regret so he can get up the next morning and try again. It's all about survival. This motivates both the successful and the unsuccessful hunter and the tribe to allow the hunt to continue the next day, when luck may strike differently.

In financial markets, these behaviors cause mistakes. Suppose an investor's portfolio rose 40 percent and then dropped 20 percent. He feels the loss about 2.5 times as much as the gain. The drop causes heightened loss aversion, leading him to consider taking action.

He is sure had he paid attention, this wouldn't have happened. Here another behavioral concept comes into play: overconfidence. He feels certain if he pays attention now, he can figure it out. Human beings are inherently overconfident. If Stone Age hunters weren't almost crazed with confidence they would never try killing huge wild beasts by throwing stone-tipped spears.

The investor's 20 percent loss caused regret. Loss aversion caused him to think about acting. He thinks maybe he

was just unlucky. Overconfidence convinces him he would succeed at whatever he does. Loss aversion minimizes future pain. He concludes stocks will fall further as it minimizes potential pain and shuns the accumulated regret.

Overconfidence and regret-shunning skills lead to other cognitive errors. Our ancestors evolved by focusing on that which would confirm their views of the world. Their biases shaped their beliefs, creating and reinforcing their understanding of the world.

Today this is known as the "illusion of validity." We believe what confirms our prior biases and reject or overlook evidence contradicting it. We see just those fragments of evidence that support our theories. For example, two investors can look at the same set of data and arrive at two completely opposite conclusions, depending on their individual bias. Take high P/Es — most investors believe high P/E markets usually precede market disasters. This stems from our fear of heights — you always react to a puzzle with fear if the puzzle is framed as an issue of heights; it's natural to humans — a bias that allowed our ancestors to survive. However, the data actually argue the opposite conclusion: that high P/E markets are less risky than lower P/E markets. In fact, the S&P 500 has never had a double-digit decline in a year beginning with a P/E over 19. Ever.

If everyone can be wrong about something as simple as high P/E markets not being overly risky, then think how many other things they could be wrong about. The illusion of validity and overconfidence are mutually supportive. Overconfidence breeds the illusion of validity, and vice versa. The two are constantly reinforcing each other, motivating us to see things incorrectly.

Understanding the lessons of behavioral finance can greatly increase your chances of investment success. The key is to reverse the natural way your brain operates and shun pride and accumulate regret — not the other way around. Accumulating regret will reduce overconfidence. You'll know you can be wrong. Understanding the illusion of validity will give you a different view of financial data and investor sentiment. And more importantly, you'll understand a little more about yourself. ■

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