In the relatively new field of behavioral finance, where discovery after discovery undermines the foundations of standard finance while helping you know yourself better and do better.

Few folks are born Warren Buffett or Peter Lynch. If you were, you probably wouldn’t be reading articles like this. Most of us must learn and adapt. Learning the lessons of behavioral finance helps you get higher returns as an investor and do better for clients as an adviser.

Behavioral finance examines how people use the tools of finance, whereas standard finance studies the tools themselves.
In the field of carpentry, standard theory would ask: “Will an increase in a hammer’s carbon steel content create a better hammer?” But behavioralism studies behavior, including unintended consequences like: “Are little kids more likely to bash other kids over the head with a red-handled hammer or a black one?”

Examples of standard finance? Ben Graham endorsing value stocks over growth stocks; Harry Markowitz defining Mean Variance Optimization as the prescriptive basis for portfolio management; active versus passive portfolios; or low P/E versus low P/B stocks.

GETTING LOADED

Now consider load funds versus no-loads. Standard finance has long known that no-loads beat load funds. Its practitioners must envision the 62 percent of fund investors who still buy load funds as very slow to learn. But behavioralists have discovered that load fund buyers do better, on average, than no-load buyers. Huh? How so?

By simply measuring cash flows we see that no-load fund buyers, on average, hold funds too briefly and they enter and exit badly. Load fund buyers hold longer, trade less and maybe better—and those characteristics more than compensate for how much their underlying load funds lag.

Are these buyers trapped by the load like prisoners? Is that good? Or, were they just more patient to begin with? Or both? Behavioral finance is still too new to know.

Should you buy load funds? No. But you should know that normal people, including advisers, hurt themselves trading funds — buying the wrong types and switching among them at bad stylistic times. And you probably do, too. So, if you buy funds, force yourself to hold them very, very much longer than feels right.

GETTING BASIC

Here are the basics: Behavioral finance knows investors are inherently overconfident. They struggle with self-control. They want much more out of investments than just risk and reward. They accumulate pride. They shun regret, hating it. Forget fear and greed — meet pride and regret, of which the former are merely subsets.

Pride is: “I bought it. It went up. I’m smart.”
Regret is: “I bought it. It went down. The stockbroker sold it to me.”

Pride is: “I bought it. It went up. Want to see me do it again?”
Regret is: “All my friends did it, too.”

Pride is: “I’m making a killing. Wanna come meet my soon-to-be trophy wife No. 3?”
Regret is: “I bought it. It went down. I sure hope my ex doesn’t find out and blab to the kids.”

Pride causes people to discount good luck, to imitate past successes and envision successes that never were—all to stay motivated to keep trying to win. If people had not kept trying, our species would have died out eons ago.

Ditto for shunning regret. It makes us feel bad, ashamed and demotivates us — we want to stay in bed and do nothing, which ensures future failure. So we hone excuses linked to bad luck. As time passes, we change time frames to re-cast benchmarks to re-claim success and pride where we would otherwise feel forced to assume failure.

Ancient ancestors used regret-shunning skills to justify continued hunts after long spells of failure. And after good hunts, pride let them assume skill and justify feeding more mouths.

GETTING SEXIST

Human nature is inherently sexist. In a recent study, Brad Barber and Terry Odean of the University of California, Davis, demonstrated that women trade better than men. Using discount brokerage data on 35,000 accounts, they analyzed six years of trades by sex and found men trade 45 percent more than women and annually do 1.4 percent worse. It’s worse for singles. Single men traded 67 percent more than single women and did 2.3 percent worse. Why? Barber and Odean piggy-backed their work on prior psy-
chologists' work showing that men are more overconfident than women.

All human beings are overconfident. But men are worse. This, too, is probably rooted in our hunter-gatherer past. If Stone Age hunters weren't near loony with confidence (and desperation) they would never try killing huge, wild beasts by doing something so stupid as throwing stone-tipped spears.

The lesson? We have no good justification for most trades. We are just throwing spears. We aren't using information (defined as: if you have it, you make money with it). Instead we usually noise trade (defined as: a booby trap disguised as information). So everyone prone to action, especially men, should apply heavy self-restraint on trading. Do you really know more than the unknown guy on the other side of the trade? Why presume you can make smarter moves off the same information everyone else has? Are you more proven as a forecaster and timer? Are you so much smarter? Or, are you just overconfident, driven and lacking self-control?

GETTING IT ALL

Standard finance claims that only risk and reward matter. Risk is defined as volatility. Santa Clara University professor Meir Statman and I have demonstrated that investors want more. Your brain processes investment decisions the way it deals with food. Just as we want taste, nutrition, low cost, appearance, convenience and prestige with our food, so too with investments we crave: high positive returns, prestige (peer superiority), low cost, convenience, attractive packaging, low volatility, a lack of embarrassment and much more. Risk means missing any of these goals, anytime. Missing any goal causes regret.

In an upbeat period you often hear, "All I want is an adviser who beats the S&P 500." So, they hire you. The S&P falls 15 percent. You're down 11 percent. They fire you. Your mistake? Believing any investor has less than six simultaneous goals. You must deal with them all.

GETTING HURT

Richard Thaler and Shlomo Benartzi showed that normal people hate losses roughly two and a half times as much as they like gains. People feel the pain of loss more than the joy of gain and exert more effort to avoid pain than to achieve gain. That function is now commonly called, "myopic loss aversion."

Standard finance assumes a dollar loss equals a dollar gain. Behavioralists perceive someone who loses a dollar in her right pocket while gaining one in her left pocket as probably walking lopsided. Pockets count. People normally fixate on sub-accounting in ways standard finance misses.

Imagine a woman with three sons: a) America's richest man, b) a leading scientist, and c) a drug-addicted gambler. She feels pride for the first two and regret about her third son instead of simply being content that her "portfolio" is above average. In Stone Age times, she fought for her ner-do-well son's survival to maximize the transmission of her genes.

Many people own stocks for a gain and bonds for safety. Say your stocks fall, your bonds rise and your total hasn't changed. Most investors will still be miffed that the parts didn't move as planned. "Order preference" is basic to humans. Investors want each piece to perform relative to its benchmark, as well as the whole. In contrast, all that matters in standard finance is the whole.

Imagine a portfolio containing only an S&P index fund and an EAFE index fund, both with zero costs. Your benchmark is the World Stock Index. Since 1996 you profited on your S&P index, lost money on EAFE, and beat your benchmark.

Standard finance says, "Don't regret the parts: The totality did fine and in every portfolio there are leading and lagging components with co-variant timing."

But any adviser knows a client with that mix will heavily regret the EAFE part and wonder if it makes sense to invest overseas at all.

It would be worse if he owned the underlying stocks in
the indexes. Now your client owns dozens of stocks with huge losses. He asks constantly about those losers, sweats regret and wonders if there isn’t some better way. Should he take tax losses? Shouldn’t you have known to avoid those dogs? You try to get him to focus on the total portfolio. He keeps asking about the losers. What comes next?

GETTING FIRED

When the market free-falls, as in 1998, you can see all the behavioral pieces play together. Every financial adviser has clients who previously wouldn’t have claimed to know where the market would go next, yet after a fall are certain it will fall more. Why?

First, loss aversion: Suppose a client’s investments rose 40 percent and then dropped 20 percent. He feels the loss about 2.5 times as much as the gain. He therefore feels as though he were up 40 percent and then down 50 percent. He feels terrible. He thinks you did it.

Then overconfidence: He is now sure if he had paid attention instead of delegating to you, this wouldn’t have happened. And he feels sure he can figure it out now.

And regret: If he doesn’t do something to make it better soon, the wife may start blaming him.

The drop caused regret. Heightened loss aversion caused him to think about taking some kind of action. Overconfidence allowed him to conclude he would succeed at whatever he does. Loss aversion loops back in again because deciding to avoid further loss minimizes future pain. He will conclude stocks will fall further because this minimizes potential pain and shifts the prior accumulated regret to you.

It always amazes me. I have 26 years as a professional, run billions of dollars, have written three market books (two on market history), been published hundreds of times and have written the Portfolio Strategy column for Forbes for 14 years. Yet clients who were happy to hire my firm to make decisions for them, concluding we knew more about markets than they do, are quite confident—after a fall—about the future direction of the market and easily conclude they know more than we do. They may end up right or wrong. But they will allow themselves to be driven by their pride, regret, overconfidence, lack of self-control and myopic loss aversion.

GETTING AHEAD

How do you use all this? Use behavioral finance’s lessons to get higher returns for you and your clients as well as to manage your clients’ emotions.

Advice is only half about returns. The other half is investor management. Every client has at least six parallel goals at any time. If he harps on one goal, keep bringing him back to all the others.

Advisers must realize that advice is only half about returns. The other half is investor management. Every client has at least six parallel goals at any time. If he harps on one goal where things are falling short right now, keep bringing him back to all the others. It’s for his own good. Accepting this important lesson of behavioralism helps you keep clients longer.

As an investor, learn to manage your own emotions, which in the long run increases your returns. This means:

1) Make fewer decisions.
2) Trade less.
3) Make sure your decisions are grounded in some advantage you have over others.
4) Train yourself not to be proud. Remember the Bible: Pride is a sin.
5) Don’t shun regret: Assume your losses aren’t luck and look for lessons to be learned.

It isn’t normal to be born Warren Buffett. Don’t hold yourself to that standard. If you learn the lessons of behavioral finance, you will get higher returns as an investor and do better for clients as an adviser.

And you’ll keep them longer — particularly if you’re overconfident like me.

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