Improve Your Investment Performance by Ditching Your Emotions, Instincts and Overconfidence

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Today’s topics

I. What causes behavioral biases?

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II. What is their impact on us?

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III. What are the worst things we do as investors?

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II. What is their impact on us?

III. What are the worst things we do as investors?

IV. Is there any hope for us?

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is ill-equipped to do the job

Why?

Because that person is human…

and humans are plagued with behavioral biases

What causes behavioral biases?

Why are humans not ideally suited to skillful investing?

Because our decision process is subject to a host of biases

Biases come from three sources

Emotions

Overconfidence

Fear

Regret

Doubt

Pain of loss

Familiarity

Biases come from three sources

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Regret

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Pain of loss

Familiarity

Heuristics

Affect heuristic

Recency bias

Hindsight bias

Present bias

Availability bias

Representativeness

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Recency bias

Hindsight bias

Present bias

Availability bias

Representativeness

Math & Statistics

Probability distortion

Law of chance

Law of large/small numbers

Gamblers Fallacy

Why are humans <u>not</u> ideally suited to skillful investing ?

<u>All</u> our decisions are subject to biases and heuristics

They are not trivial

They are pervasive (we all experience them)

They are "hard-wired" through evolution

They are subliminal

People tend to deny them (Overconfidence)

Our decision process is extremely difficult to change

…but we <u>can</u> deal with it

Why are humans not ideally suited to skillful investing ?

There <u>are</u> ways to mitigate their effects;

work around them;

avoid them;

and actually use them to advantage

What is their impact on us?

They cause us to make many flawed investment decisions

Over time, this negatively affects our investment performance

…year after year

Opinion: Americans are still terrible at investing, annual study once again shows

Published: Oct 21, 2017 1:17 p.m. ET

It's not about fees or unscrupulous advisers — it's that we lack the patience to hold investments for more than a few years

Today's Market | Market Outlook

Investor Returns Vs. Market Returns: The Failure Endures

Sep. 21, 2017 5:07 PM ET | 1 Like | Includes: CRF, DDM, DIA, DOG, DXD, EEH, EPS, EQL, FEX,

FINANCIAL POST

Let's face it: You suck at investing

Happy New Year. Try to suck less this year...

How much worse than the market averages do individuals perform ?????

- .5%

- 1.0 %

- 1.5%

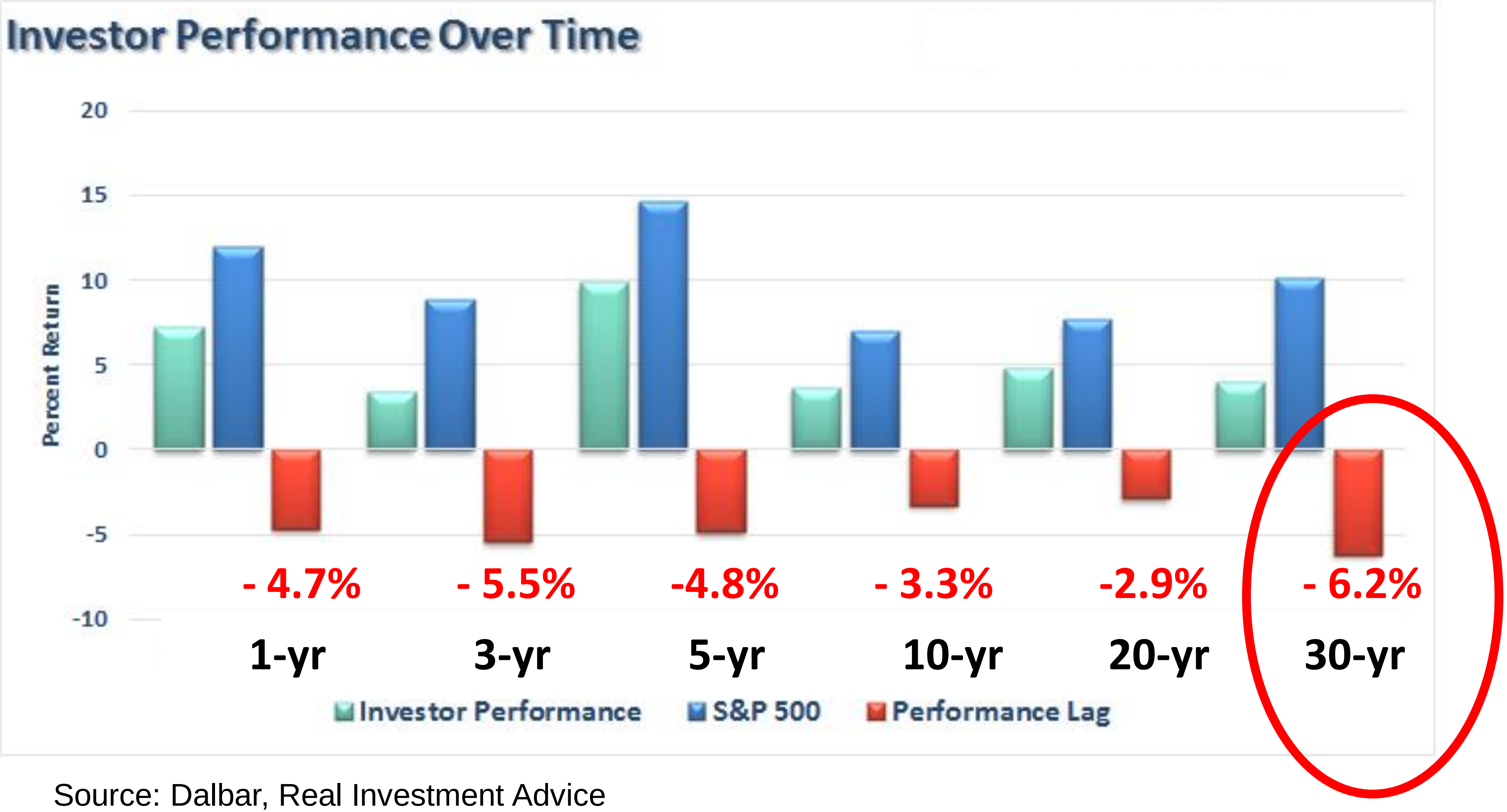
- 2.0%

How much worse do individuals perform ?????

– 6.2%

Per year for the last 30 years!

(according to Dalbar)



Source: Dalbar, Real Investment Advice

Let’s call it:

3 - 6%

Per year for the last 30 years!

(according to Dalbar)

…………..…………………….but wait, it gets worse…

The Schwab Study
Brad Barber and Terrance Odean
UC Davis, UC Berkeley

1991-1996
66,000 Schwab accounts

- **Net returns for all investors vs. the market:** **- 2.5% annually**
- **Net returns for the 20% who trade most frequently:** **- 7.1% annually**
- **The higher the turnover, the lower the return**
- **Men trade 45% more than women, so <u>women outperform men</u> by about +1.0 %**

"The average household …tilts its common stock investment toward high-beta, small-cap, value stocks, and turns over 75 percent of its portfolio annually. *Overconfidence can explain high trading levels and the resulting poor performance of individual investors*."

The Dutch Study
Hersh Shefrin and Arvid Hoffman
Santa Clara University, University of Adelaide

Conducted in 2015 (data from 2000-2006)
Major online broker in the Netherlands (5500 accounts)

All investors: **-1.0 %**

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Investors who use technical analysis:	**-8.6%**

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Traders using TA and options	**(brace yourself…)**


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All investors: **-1.0 %**
Investors who use technical analysis: **-8.6%**

Traders using TA and options **-20.3%**

Shefrin concludes that individual investors:
- Are disproportionately prone to speculate on short-term stock-market developments
- Hold more concentrated portfolios
- Turn over their portfolios at a higher rate
- Choose higher beta stocks

Fidelity report:

Investor subgroups with the highest returns:

Fidelity report:

Investor subgroups with the highest returns:

1. People who forgot they had an account

and…

Fidelity report:

Investor subgroups with the highest returns:

1. **People who forgot they had an account**

and…

2. **Deceased account holders**

What are the worst things we do as investors?

A few examples of things we routinely do that hurt our investment performance

1. **We jump to quick conclusions based on too little data**
2. **We are highly influenced by what others think and do**
3. **We naively assume everything we see and hear is factual and unbiased**
4. **We overreact to new information**
5. **We lose our objectivity once we own something**
6. **We mistakenly think we see repeatable patterns in random data**
7. **We rely too much on recent information and too little on older information**
8. **We misinterpret – or simply don’t accept – statistically sound facts**

Examples continued

9. **We exit winners too soon and hold losers too long**
10. **We take additional risks to avoid booking a loss**
11. **We over-concentrate our portfolios and trade too frequently**
12. **We react differently to the same situation depending on things like our mood, how much sleep we got, and even the weather**
13. **We focus too much on upside potential and too little on downside risk**
14. **We are often swayed by irrelevant, biased, or misleading information**
15. **We rely on our “intuition”**
16. **We are hugely overconfident, believing that none of this applies to us**

Summing up our biggest behavioral flaws about investing:

Using emotion and instinct instead of discipline

Being swayed (by others, by news, by price action…)

Being overconfident

Is there any hope for us?

There are ways to mitigate the effects of biases and heuristics:
Recognize them;
Work around them;
Avoid them;
Use them to advantage

What can you do?

1. **View investing as a business, not a hobby**

View investing as a business

- Track your expenses, your time, and your P&L
- Adopt a formal, disciplined, repeatable approach to investing (timing, selection, diversification)
- Create benchmarks to use as a baseline for measuring improvement
- Distinguish between luck and skill
- Use some science: (portfolio construction, Sharpe ratios, Volatility, macroeconomic analysis)

What can you do?

1. **View investing as a business, not a hobby**
2. **Keep a Decision Journal**

The Decision Journal

Action	Item	Date	Rationale	Gain/loss
Bought	BA	10/1	Dropped to target buy-in price	
Bought	AAPL	10/8	News about earnings	
Sold	FB	10/19	Nervous about current price	

What can you do?

1. **View investing as a business, not a hobby**
2. **Keep a Decision Journal**
3. **Get a “trading buddy” for second opinions**

Get a trading buddy (alter ego)

- Solo trading is <u>unchecked</u>
- Find someone you can trust for an <u>informed</u> "opinion"
- Make sure they <u>don't already own</u> what you're thinking of buying (objectivity)
- Solicit a <u>dissenting</u> opinion (especially when you have a "bet the farm" moment!)

What can you do?

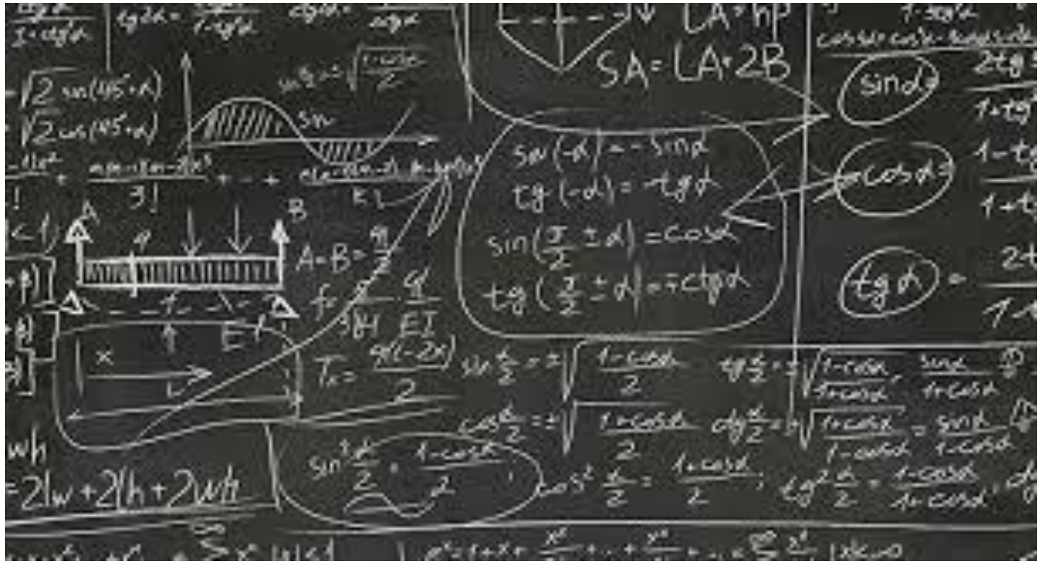
1. **View investing as a business, not a hobby**
2. **Keep a Decision Journal**
3. **Get a “trading buddy” for second opinions**
4. **Limit your media exposure**

Limit (avoid) the media

- Much of what you see is biased or sponsored
- Most of what you see is old news
- Much of what you see is hyped
- Much of what you see is fake, incorrect, or misleading
- There is no accountability
- Never fill time by surfing the web for ideas!

What can you do?

1. **View investing as a business, not a hobby**
2. **Keep a Decision Journal**
3. **Get a “trading buddy” for second opinions**
4. **Limit your media exposure**
5. **Put more science to your process**



Put more science in your process

- The more math you use, the less instinct and emotion will be needed
- Investing is a science and the pros all use math rather than intuition
- Diversify, diversify, diversify (20+ positions reduce 85% of individual stock risk)
- Basic risk/reward is not rocket science

What can you do?

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5. **Put more science to your process**
6. **Be careful with charts**

Be careful with charts

- Charts are very useful, but also very easy to misinterpret
- Your brain automatically searches for patterns
- If you say "well this is an exception", hold back
- You need 180 data points for 90% confidence

My four most important charts for getting the big picture perspective

1. **SPY 15-minute (3-month span)**
2. **SPY Daily (2-year span)**
3. **QQQ 15-minute**
4. **QQQ Daily**

SPY 15-minute
The January uptrend broke here when this line was crossed and a new downtrend began
408.61
403.65
387.41
377.85
374.77
383.39
376.42
377.83
385.88
378.76
393.70
386.27
400.23
387.26
402.64
393.56
408.16
400.28
408.10
416.49
405.01
415.05
401.29
393.64
392.33
407.45
384.32
385.91
MACD(12,26,9) -1.734, -1.899, 0.166

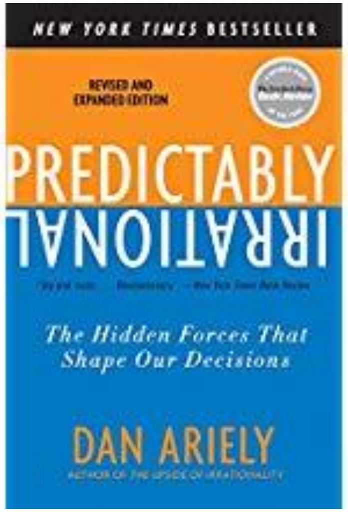

SPY (Daily) 385.91
SPY Daily
The 2022 decline was unusual as it widened while falling. But there were four upper points in perfect alignment and three lower points, indicating the boundaries. Nonetheless, the January breakout says we are in a new uptrend now
Bottom???
MACD(12,26,9) -2.441, -0.798, -1.644
MACD crossed back down in mid-Feb to confirm the new downward move, but the larger uptrend from the October low remains in place
472.32
464.34
456.11
450.81
443.91
440.20
434.07
428.00
418.31
418.08
414.64
412.05
408.61
408.17
404.08
389.76
382.77
377.73
375.63
374.77
367.83
367.10
361.13
359.04
355.41
346.52
2022
2023

QQQ (15 min) 288.55
Volume 5,963,395
QQQ 15-min
MACD(12,26,9) -1.314, -1.435, 0.121


QQQ (Daily) 288.55
Volume 98,590,816
QQQ Daily
MACD(12,26,9) -0.012, 1.241, -1.252
396.76
375.65
374.71
366.61
367.39
331.71
315.93
347.48
315.13
369.87
328.28
304.89
312.64
283.20
278.50
267.64
274.63
295.34
278.63
333.02
309.78
289.65
283.50
266.46
253.65
283.92
258.46
295.04
259.73
313.68
304.00
288.37
288.55
Dec
2022
Feb
Mar
Apr
May
Jun
Jul
Aug
Sep
Oct
Nov
Dec
2023
Feb
Mar
Apr

Where do you go from here

- **Read a book or two on behavioral finance**
- **Start a decision journal**
- **Reposition yourself as a business**
- **Get (and keep) a big-picture perspective**
- **Find a trading buddy for sanity checks**
- **Adopt a discipline**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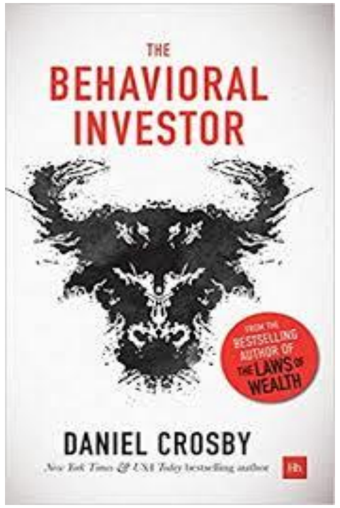
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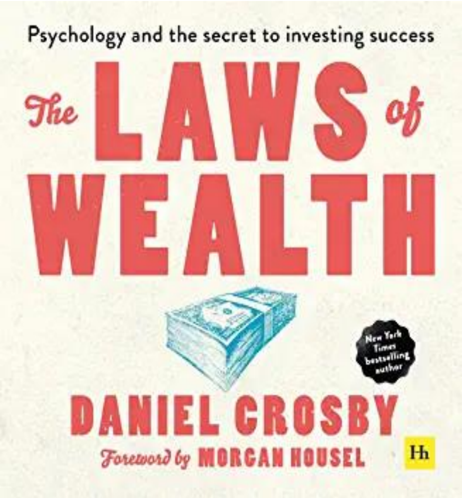
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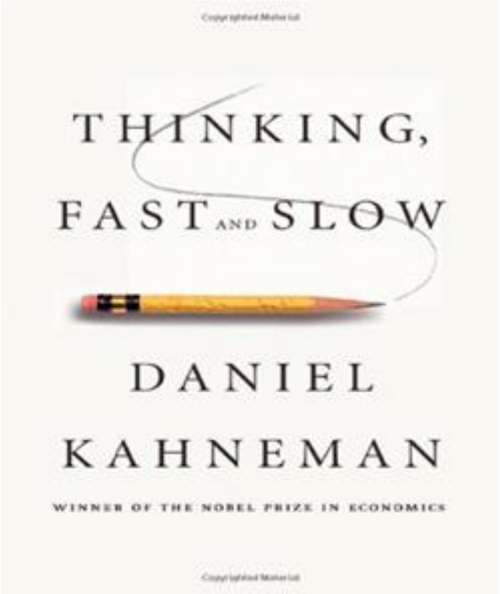
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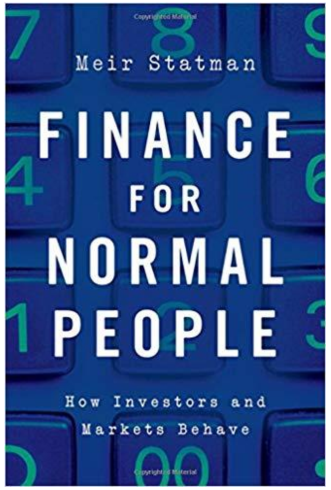
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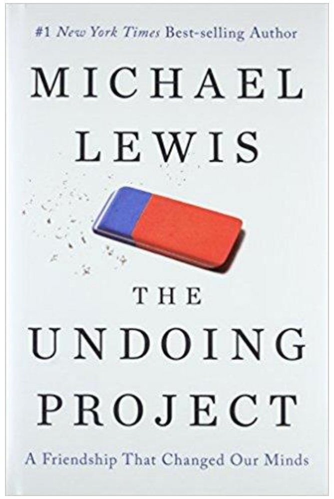
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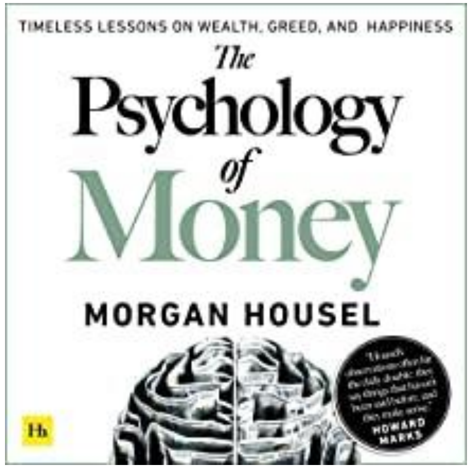
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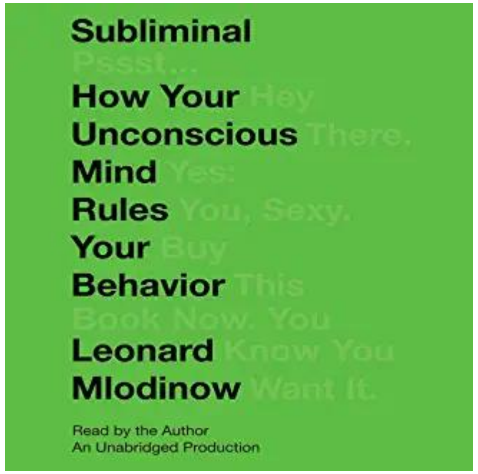
Subliminal
How Your Unconscious Mind Rules Your Behavior
Leonard Mlodinow
Read by the Author
An Unabridged Production

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Book is out of print but I still have copies ($30)