BMO Harris Financial Advisors

Mind Games: What Behavioral Finance Can Teach You About Investing.

Institutional investors long have had an unofficial "rule" they call the "Odd Lot Theory." Its premise is that when small investors (those who purchase investment shares in small lots rather than in multiples of 100) buy, that's a signal for larger investors (those who buy in multiples of 100 or more) to sell.

The reasoning behind this came from Garfield Dow, a young investment manager who, in the 1930s, noted that small investors as a group are often wrong about when and what to buy. In other words, they tend to buy high and sell low.

Does it hold true?

Of course, individual investors can be successful stock pickers. A recent study conducted by Joshua Coval, a professor at Harvard Business School, concluded that one in five individual investors is able to consistently produce aboveaverage equity returns. However, the study also found that the vast majority of investors don't fare as well.[1]

Why do so many individuals underperform the markets over time? That's a question that economists and psychologists have been studying for more than three decades. This field of study is called behavioral finance and its goal is to develop a framework to explain why people make the decisions they do about their money. What they've discovered is that when it comes to investing, rational choices don't always apply. What investors know, and what they actually do are often very different.

Mind over money

According to a 2011 study by leading research firm DALBAR, Inc., "Investment results are more dependent on investor behavior than on fund performance."[2] The report also showed that most of this underperformance is due to psychological factors that translate into poor timing when it comes to buying and selling investment shares.

So what are these behaviors and what can you do to avoid them? Consider the following:

Behavior #1: Overconfidence

Optimism is a great thing to have in life, assuming it's grounded in reality. Yet many investors overestimate their ability to beat the market, even when they have failed to do so in the past. Overconfidence can keep investors from meeting their goals because they may save or invest too little if they overestimate returns. It can also keep them from learning from their mistakes.

Rather than letting overconfidence derail your long-term plans, experts suggest taking a more steady route to building financial security by adopting a consistent monthly investment plan. Although dollar cost averaging doesn't guarantee a profit and can't protect against loss in a declining market, it can help you ease into the market, buying more shares when prices are lower and fewer shares when prices are high. Over time, this can help lower the total average cost per share you pay for your investments.

Behavior #2: Herd behavior

Remember the dotcom bubble of the late 1990s, early 2000s? Like many investing fads, the driving force behind this behavior is the tendency for individuals to mimic the actions (rational or irrational) of a larger group. But as so many investors painfully learned, chasing the herd can be risky. That's because focusing on shortterm performance can hinder your potential long-term success.

The lesson here? Before you jump on the bandwagon, do your homework and remember: Past performance does not guarantee future returns. Understanding what you're buying and why is essential to making the right decisions for your unique circumstances and long-term investment goals.

Behavior #3: Loss aversion

Behavioral finance teaches us that as investors, we tend to value gains and losses differently. In fact, some studies suggest that people feel a decline in the value of their investments twice as keenly as they do an increase of the same value. As a result, many investors are more willing to sell their winners than they are to dump a losing investment.

If you recognize loss aversion as part of your behavior, how do you overcome it? Start by (1) building a broadly diversified mix of investments to help soften the impact of market volatility on your overall portfolio; (2) rebalancing your investments on a regular basis to ensure your portfolio is right for your particular goals, risk tolerance and time frame; and (3) keeping your focus on your overall progress, not the short-term ups and downs of your portfolio.

Behavior #4: Anchoring

Behaviorists have demonstrated that when it comes to making investment decisions, most people are strongly affected by "anchors," or points of reference, that may or may not be relevant to the decision at hand. In other words, they tend to embrace information that supports their view rather than seeking information that contradicts it.

The next time you think you have the market figured out, or you think you've spotted a portfolio manager who is on a winning streak, step back and look more closely. Are you seeing the markets through your own lens of hopes and projections or are you making decisions based on fundamentals and facts? Remember, successful investors base their decisions on a variety of inputs in order to gain the truest picture possible of an investment's prospects.

If you're thinking about making a change in your portfolio, stop and list three reasons why that fund is a good idea, and three reasons why it isn't. This simple exercise will help you consider your decision from more than one angle. By focusing on the pluses and minuses of each investment decision, you may be able to overcome the emotional swings that can keep you from getting the most from your investment decisions.

Your BMO Harris Financial Advisor will provide you with an unbiased recommendation designed to help keep you on track toward your investment goals.

[1] Maccaro, James, An Early Approach to Contrarian Investing, Working Money, The Investors' Magazine, 2011, Working-Money.com.
[2] DALBAR, Inc. 2011 Quantitative Analysis of Investor Behavior (QAIB) – Highlights, March 2011, www.dalbar.com.

BMO Harris Financial Advisors℠ is a trade name of BMO Harris Financial Advisors, Inc., 311 W. Monroe Street, 14th Floor, Chicago, IL 60606.

Securities, investment advisory services and insurance products are offered through BMO Harris Financial Advisors, Inc. Member FINRA/SIPC. SEC-registered investment adviser. BMO Harris Financial Advisors, Inc. and BMO Harris Bank N.A. are affiliated companies. Securities and insurance products offered are: **NOT A DEPOSIT – NOT INSURED BY THE FDIC OR ANY FEDERAL GOVERNMENT AGENCY – NOT GUARANTEED BY ANY BANK – MAY LOSE VALUE.**

© 2013 BMO Financial Corp. (5/13)

BMO | A part of BMO Financial Group

BMO Harris Financial Advisors