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Protect Your Portfolio from Yourself

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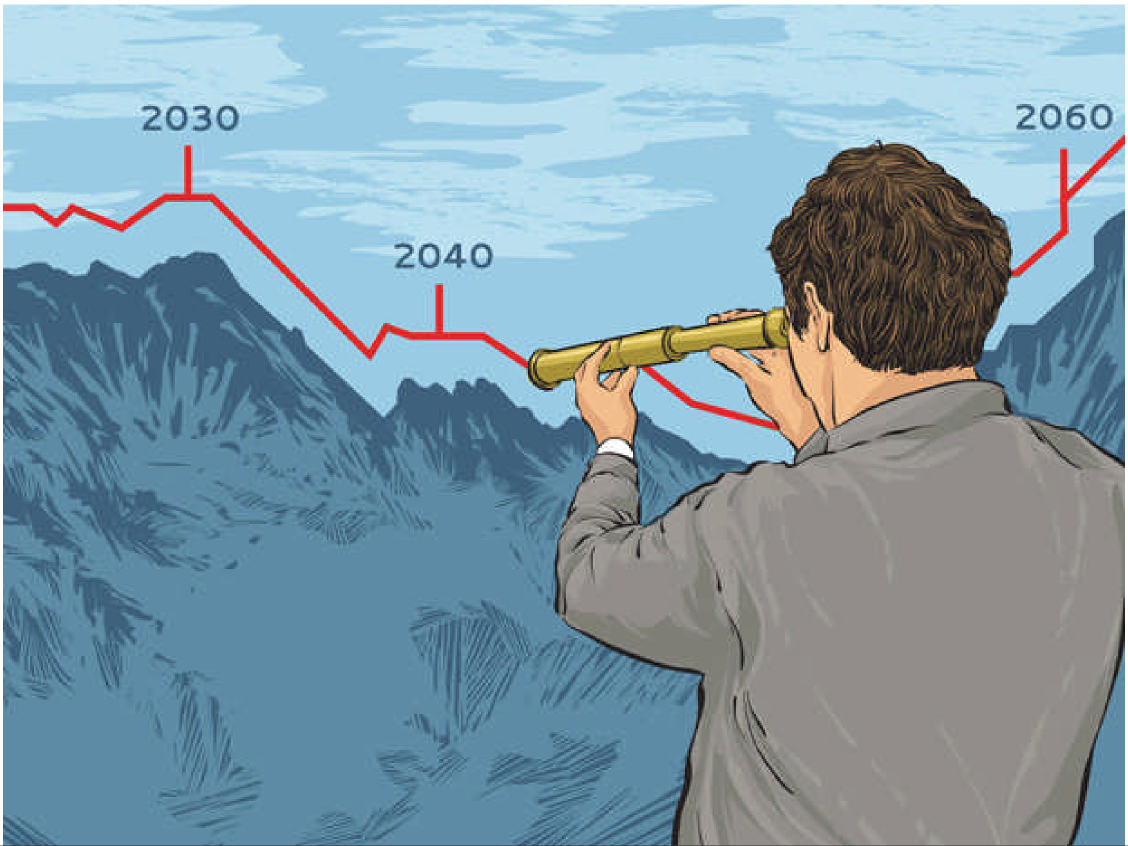

Behavioural finance experts have identified a host of cognitive, emotional and social propensities that impinge upon our ability to make rational economic decisions. Every investor, wealthy or not, confronts these in the course of their decision-making.

By Michael Nairne.

It's easy to blow a hole in a portfolio. Just dump your stocks and head for the hills at the bottom of a nasty bear market. Then wait anxiously on the sidelines only to venture back in once prices have rallied. Or feverishly chase the latest hot manager until both your ardour and capital are swept away when the red ink starts. Or load up enthusiastically on a "no brainer" stock tip, then watch your commitment melt away like an ice cube in August when the price tanks.

The cost of this proverbial “buy high and sell low” behaviour may be greater than any other single investment cost. Morningstar estimated the return shortfall triggered by the poor timing of fund investors’ decisions over the period 2000 to 2009 was 1.5% a year. Other studies have put the cost even higher. For example, John Bogle, the founder of Vanguard Group Inc., found that from 1980 to 2005, poorly timed moves in and out of U.S. equity funds by investors resulted in a forgone return of 2.7% a year.

Behavioural finance experts have identified a host of cognitive, emotional and social propensities that impinge upon our ability to make rational economic decisions. Every investor, wealthy or not, confronts these in the course of their decision-making.

Here are four of the more powerful biases:

Myopic loss aversion This combines our much greater sensitivity to losses over gains with the tendency to evaluate outcomes too frequently over too short a time frame. It’s hard to bear in mind that stocks outperform bonds in the long run when you are watching your portfolio evaporate every week in the midst of a recession.

Overconfidence You don’t become a successful business owner, executive or professional by being a shrinking violet. Hence, one cognitive bias that wealthy investors often possess in spades is overconfidence. Overconfidence contributes to the proclivity to placing big bets on certain asset classes, managers or even single stocks. The consequences of being wrong rarely receive critical reflection.

Confirmation bias We are predisposed to seek out and interpret information in a manner that confirms our preconceptions. For example, many bearish investors follow bearish market strategists. It is much easier to be out of the market, even when it’s rising, when everything you read confirms your gloomy opinion.

Herding Humans are social creatures and herding is a natural instinct. The magnetic grip of the group psyche can be almost irresistible during booms and crashes. Technology stocks soared more than sixfold from 1996 to early 2000. Most investors arrived late to this party, only to suffer a precipitous plunge of more than 80% over the next 2 years.

Many wealthy investors have learned, often at the school of hard knocks, to protect their portfolios from themselves by adhering to a disciplined investment decision-making process.

Here are key aspects:

Commit in writing Investors increase the odds of sticking with their strategy if they first set out clear investment objectives and parameters including a portfolio return goal, risk limitations, a target asset mix and rebalancing requirements in a written plan.

Own your strategy The most important decision in any investment strategy is the tradeoff between potential return and risk. Although an advisor can clarify tradeoff options, benefits and consequences, the choice is fundamentally the investor's. The time spent discussing and reflecting on an optimal trade-off increases the likelihood that the selected strategy will be truly embraced instead of tossed over the side on the next market dive.

Have concentration rules By imposing limits on the exposure to any single manager or position, investors avoid placing an ever-increasing bet on yesterday's winner.

Think in decades, not years Wealthy families typically plan over multiple generations. It is easier to stay the course when your planning horizon dictates that your portfolio will have to endure numerous bear markets.

Be realistic Diversification can enhance risk-adjusted returns but it is not a silver bullet that delivers outstanding returns in sinking stock markets. For example, single-family offices serving the ultra-wealthy reported portfolio losses in 2008 just like retail investors. Realistic expectations lead to realistic appraisals and decisions.

David Swensen, chief investment officer of Yale Endowment, has said, "Casual commitments invite casual reversals." Thoughtful wealthy investors appreciate that serious long-term results require serious commitments.

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