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Market Psych

How to Manage Fear and Build Your Investor Identity

Richard L. Peterson | Frank F. Murtha

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Preface

You may not realize it, but you are on a dangerous journey—the life-long process of wealth accumulation. Your destination is to establish financial freedom and security so that you (and your loved ones) can enjoy the *quality of life* you have always wanted. But make no mistake, you have an enemy that doesn't want you to get there. The enemy is "the market," and it is engaged in a covert psychological war designed to subvert you at every opportunity. The market probes for emotional weak spots and exploits them, scaring you out when the worst is over, luring you in when the gains have been made, baiting you into chasing fool's gold, or convincing you to it 's okay to perpetually "start tomorrow."

Sure, the journey seems easy enough. Buy low, sell high, and all that. The market goes up over time. Just put your money away, and you'll get to where you want to go. If only it were that easy. Investing in the market more closely resembles a crooked carnival game in which you throw a softball at a stack of milk bottles for a dollar. "It's so easy! So simple, a child could do it. Step right up! " The deception is the simplicity. The game is designed for you to lose.

Don't believe us? From 1989 through 2008, the S&P 500 Index had a 5.51 percent average annual return after inflation. Looks fine, you say. But what did the average *equities investor* get as an average annual return, postinflation, during that same 20-year period? *Negative 0.97 percent* per year. (We told you the market was out to get you.) Those are percentages. What about real-life dollars?

A "market" return on $100,000 invested in the U.S. stock market in January of 1989 would yield a postinflation total of $292,329 20 years later—nearly three times as much. Yet the average equities investor would have a total of $82,288 after the same time period. These two returns represent the difference between Ivy League universities for your kids or state schools, between a down payment on a house or not, between vacationing or staying home. In short, this is the difference between leading the life you want to live, and leading the life you're forced to live.

Losses are not only possible, they're predictable. It's the way the game is designed. At the carnival, they get you with physics—the milk bottles are spread out so that it is virtually impossible for a softball to knock them all down with one throw. The market gets you with psychology, baiting you into a reactive paradigm that turns your own fear, greed, hope, and even pride against you. After several go-rounds we find ourselves asking, where's my 9 percent average annual return? And how come I never knock down all the milk bottles?

The investing process even preys on our own biology. The rational, reasoning part of our brain—the prefrontal cortex—evolved about 100,000 years ago. It grew *on top of* the deep brain centers that manage emotion and motivation (the limbic system). In general, the evolution of the prefrontal cortex is an excellent thing—it's essentially what makes us "human." The problem is that the prefrontal cortex evolved *after* the limbic system, and thus while it sits on top of the limbic system and manages and directs our impulses, it can be knocked offline by surges of emotion courtesy of you-know-who.

That is why we wrote this book: to destroy this myth, reset the rules of the game, and to arm and train you for the psychological battle. It all starts with the recognition of a truth that we call the fundamental premise: Investing success appears to be about "the market," but it's not; it's about *you*. The market will do what it has always done—go up, go down, and try to throw you off like a rider on a mechanical bull. The only question that matters is, what will *you* do? Here is where our focus needs to be, on what we can control. And this book outlines what those things are and what it takes to master them.

We know that some of the concepts along the way may be counterintuitive. That's why everything in this book is backed up by scientific research in the fields of neuroscience, behavioral finance, and clinical psychology.

Who is this book for? It's for you. You have hopes and desires for a better life for you and the people you care about. And you invest your money—or should—so that you can achieve this better life. Whether you are a first-time investor who is just beginning the process or a seasoned professional looking to optimize performance, the key to success remains the same—managing emotions and establishing what we call an investor identity. This book serves as a guide for doing just that. It uses a number of different techniques including case studies, exercises, and questionnaires/self-assessments along the way so you can relate these concepts specifically to yourself and begin building the skills to use them.

Chapter 1 gives an overview of the relationship between psychology and investing and provides a context for the book. It also introduces the concept of an investor identity and why it is crucial for long-term investing success.

Chapter 2 lays out the fundamentals of an investor identity. It addresses where to start (what we call frames), and the five questions to ask before investing. Unfortunately, in taking these "first steps" many investors start out on the wrong foot, ensuring problems ahead. The chapter goes on to uncover the real and hidden motivations that underlie our investing decisions, another crucial component of your investor identity. The chapter concludes with a section on goal-setting, outlining a technique we call the Slide Show Method that keeps investors focused on what they want their investing to achieve.

Chapter 3 digs into the concept of your investor personality. It breaks your particular personality down into the "Big Five" traits associated with both investing success and vulnerability. It details how you can identify these traits in yourself and work with them. This chapter also addresses the genetic components that contribute to your investing style.

Chapter 4 is about recognizing the role emotions play in your investing decisions. Most people recognize that investing is an emotional process. What they often fail to appreciate is the extent to which these emotions are hidden, even from ourselves. This chapter addresses how these unconscious emotions often subvert our attempts to make good choices with our money—and what we can do to gain control over them.

Chapter 5 addresses your investing values. In particular, it goes into the root causes of the what, how, and why of your biggest investment beliefs and the ways they affect your choices—for good or ill. This chapter also helps you identify ways you can play to your investing strengths by investing in a way that is in keeping with your values and interests. Last, it addresses financial traumas and what they do to our investing identity going forward.

Chapter 6 addresses your blind spots. It details a number of the most common (and nastiest) traps and how and why investors fall into them. This chapter also contains checklists so you can evaluate your personal susceptibility to these problems and outlines steps you can use to free yourself and avoid them in the future. It concludes with a set of investing archetypes based on recognizable characters.

Chapter 7 addresses the ways in which investing stress takes its toll on your decisions and what you can do to prevent its negative consequences. In particular, it focuses on biological and psychological elements, detailing specific techniques you can use to ameliorate the effects of stress. Subjects include breaking out of slumps, cultivating resilience, and creating internal dialogues to improve performance. The chapter concludes with a method we call the Financial Stress Management Plan and a guide of how you can create one for your investing process.

Chapter 8 pulls it all together. Now that you have a stronger sense of your investor identity, this chapter details how you can preserve that identity, operate as your "best self," and create the optimal environment for success. This chapter details a holistic approach to keep you up and running at maximum efficiency.

Lastly, we strongly encourage all readers to complete a free Investor's Personality Test at www.marketpsych.com/personality_test.php. This test identifies strengths and vulnerabilities in personal investing.

It may feel like the market doesn't want you to reach your rightful destination. Well, we do. Consider *MarketPsych: How to Manage Fear and Build Your Investor Identity* to be your personal travel guide on your investing journey. And while we can't guarantee that you will become rich from reading this book, we can guarantee this—if you read this book and do the work contained herein, you will be part of a select group of investors equipped with the essential psychological tools that lead to great performance.

And the next time the market tries to wage psychological war on your future—it'll be a fair fight.

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We're grateful to Aishwarya Shan and Sharon Liew at Marcus Evans Kuala Lumpur for the opportunities to interact with and learn from private bankers and wealth managers in Asia. We've greatly enjoyed the relationships and friendships that have developed from these annual workshops in Seoul, Singapore, Mumbai, and Sydney. It goes without saying that the past decade has been incredibly tumultuous for investors. We thank those who generously shared their stories, their struggles, and their successes with us, including hundreds of financial advisors and portfolio managers around the world. You are too numerous to name, but without your stories and inspiration this book could not have been written.

We owe a debt to the many scientists and researchers who have advanced the sciences of psychology, experimental economics, behavior change, and neuroscience (all together we will call them neuroeconomics or neurofinance). In particular, we are indebted to the work of Paul Zak, James Montier, Michael Mauboussin, Brian Knutson, Camelia Kuhnen, Colin Camerer, Greg Berns, and John Coates.

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CHAPTER 1

Your Investor Identity: And Why You Need One

The unexplored area is the emotional area. All the charts and breadth indicators and technical palaver are statisticians' attempts to describe an emotional state.

—Edward Johnson, founder of Fidelity Investments

These words were spoken by Edward Johnson more than 40 years ago, and they ring every bit as true today. So why, after so much time, is the psychological understanding of investing decisions still so widely misunderstood? Given the volatility of the past decade, it stands to reason that merging the lessons of psychology and finance could be wonderfully beneficial to investors.

Psychology and Finance: Failure to Communicate

It's not that I can't help these people. It's just I don't want to.

—Tom Hanks, *Volunteers*

The movie *Volunteers* is an immensely underrated comedy starring Tom Hanks and the late John Candy. In an effort to avoid a gambling debt, Hanks's character poses as a Peace Corps volunteer and boards a plane to a developing country. Shortly after arriving, he seeks to return home. When an incredulous Peace Corps organizer pleads with him to stay by entreating him, "But you can *help* these people!", Hanks responds with the classic line quoted above.

This quote is also a fair way to think of the relationship between psychology and finance. These two fields have lived side by side in the same neighborhood for more than a hundred years and have never been properly introduced.

Traditionally the world of psychology has not only been uninterested in finance, but often disdainful of it. There are a number of possible reasons for this disconnection, but one may stem from the fact that the world of finance is full of guys who played on the football team and the world of psychology is made up largely of kids from the drama/science/glee clubs. Of course the primary goals for each profession are different, and that contributes to the problem. But the jock/nerd dynamic is still there.

This is unfortunate because the field of psychology has much to offer the investing world. Few things are as emotional (or stressful) to people as their money. Money is the number one issue mentioned both as a cause of divorce and an instigator of sleepless nights. It is at the heart of what we call "quality of life." Simply to help individuals invest more effectively and build greater wealth is to make a huge positive impact on their lives.

It has long been accepted that psychology affects investing decisions. Yet scientific inquiries into how it does so are a recent phenomenon. Part of the reason for this inability to connect may be due to the complicated nature of the task; quantifying human thought and behavior is notoriously messy.

But that's no excuse. The field of psychology has done a poor job of presenting its insights to the financial community in a way it can relate to. Much of the misunderstanding between psychology and finance is due to the language barrier. "Psychobabble"—which has led to such dreadful sentences as "I want to process your affect" and "Let's reframe your cognitive schema"—not only puts up a wall to financial professionals, it annoys them.

To this day in the work we do, we encounter antiquated stereotypes freely voiced or lying just below the surface. For some reason, there is a popular image of psychologists as being older gentlemen who wear earth-tone sweaters, smoke pipes, and periodically stroke their beards, asking questions like, "And how does that make you *feel*?"

Psychologists aren't altogether to blame for this sour relationship. Financial professionals have been trained to pay so much attention to numbers that they have become utterly mistrustful of fields that focus on words: Can't graph it? Can't express it in an equation? Then it's touchy-feely voodoo.

Fortunately, rigorous scientific disciplines have emerged in the study of decision-making. The goal of applied psychology today, particularly for those in the counseling and consulting fields, is to help clients develop better *habits* for going about their business—that is, to make people more effective at what they do—and that includes investing. As such, applied psychology and decision science are uniquely situated to help the individual investor.

Think of investing as a journey. There is a path you walk down and a destination you are trying to reach. The first steps ought to be the most carefully considered. The earlier you misstep, the farther and more quickly you wander off the path. Yet these first steps are the ones that are most likely to be taken in haste and carelessness. All too often investors plunge ahead to find they have not only wandered off their path, but perhaps chosen the wrong path entirely, or maybe even targeted a destination they will never reach. These initial missteps are most often caused by fundamental flaws in the investors' psychological framework. Beginning with the proper mental approach is essential. Psychologists can help.

Beginning the Journey

Let's turn to Edward Johnson again:

> What is it the good managers have? It's a kind of locked in concentration, an intuition, a feel, nothing that can be schooled. The first thing you have to know is yourself.

His words were referring to professional money managers, but his wisdom is universal; one has to understand oneself in order to be successful as an investor.

However, Johnson was not entirely correct about one thing. The lack of self-knowledge among most investment managers is not due to the fact that it cannot be learned (e.g., in business classes, training, etc.). The problem is that such characteristics have never been properly taught. With all due respect to Mr. Johnson, although self-knowledge can't be memorized from a book, *skills* for developing self-knowledge can be acquired.

The most cohesive attempt to integrate psychology and investing is a field called *behavioral finance.* This field made its name by demonstrating that traditional economics is based on a false assumption—that human decision making is typically rational, profit-maximizing, and self-interested. Dr. Daniel Kahneman, a psychologist who shared the Nobel Prize for Economics in 2002, won the prize for his research with Amos Tversky demonstrating that financial decisions are systematically biased in non-rational ways.

For all the great research done in behavioral finance identifying irrational investing behavior, the field has had trouble progressing beyond the realm of "investing parlor tricks," pointing out strange and quirky mistakes investors are prone to make. The findings are interesting, but *what do you do with them?*

While researchers in behavioral finance have identified systematic investor mistakes, they tend to offer these findings as solutions unto themselves, as if to say: "We've determined that investors fail to make rational and self-interested decisions. So, now that we established this fact . . . go forth and make rational, self-interested decisions!" [There are some notable exceptions, and one that comes to mind is the Save More for Tomorrow Plan (SMaRT Plan) devised by Shlomo Benartzi and Richard Thaler.]

Stopping at identifying mistakes would be enough, of course, if knowledge equaled change. ("You say this is bad for me? Great. I'll stop doing it, then.") But knowledge does not equal change. If it did, the world would be a different place. For starters, kids would eat their vegetables. Teenagers wouldn't smoke cigarettes. And stock market investors would average roughly 10 percent returns annually.

Knowing what to do is only a first step toward success—a necessary but insufficient condition for change. You do not lose money with your mind. You lose money with your actions—namely, buy, sell, and hold decisions that work out poorly.

If the problem isn't a lack of knowing (and it isn't), neither is the problem a lack of caring. Most people *don't want* to make decisions that are bad for them (Freudian notions of self-sabotage be damned!). And yet most investors not only make irrational decisions, they *persistently and reliably* make such decisions. Investors, generally speaking, know what to do and want to do it. The problem is . . . *they can't bring themselves to do it when they need to.*

It may be useful to think of investing mistakes in terms of an epidemic currently afflicting the United States. Americans have a higher percentage of citizens who are overweight than any other country. We are, simply put, the fattest nation on the planet.

Barring the rare cases of metabolic disorders, the best way to avoid weight problems is to eat a healthy diet and exercise regularly. Everyone knows this—children as well as adults. Every school district in the country drills this message into its students starting in grade school. And it doesn't take long for most people to recognize that the extent to which a food is bad for you is directly correlated with how good it tastes. So a lack of knowledge is not the problem.

The problem isn't even that people don't *care* about being overweight. The United States has an astounding number of joggers and gym-goers relative to its peers. Moreover, we are constantly being inundated with idealized body images in the media (thin for women, buff for men). We do care. We may even care too much. These unrealistic body images are widely blamed for the relatively high rate of eating disorders and steroid abuse in the country.

Nor is there any shortage of advice on ways to help remedy the problem of obesity. If you wanted to lose weight, you could go to the health and nutrition section of any major bookstore and find shelves upon shelves of books with detailed dieting programs. Moreover, most of those programs would work. But that utterly misses the point.

The question remains: What is the right plan *for you*? The right plan for you isn't the one that "would work if you follow it." (All those plans work if you follow them!) The right plan for you is the one *you can best follow*. In other words, the plan for you is one that is most suited to your preferences, values, beliefs, and emotional strengths and weaknesses. This book does not recommend a specific method of investing. There are many right ways for people to invest their money. Choosing one is primarily a matter of fit.

It's important to remember that both financial fitness and physical fitness are long-term goals. Sure, a lot of people like to drop some winter weight, slim down for a wedding, or get into "beach shape." But those are all short-term goals. We don't think you'd be reading this book if you were merely interested in growing your portfolio for the summer. We're talking about lifestyle choices that you can follow forever because they are consistent with who you are.