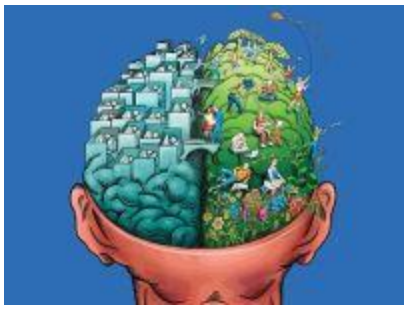
Financial History Repeats Itself: Part I - My Brain Did This?

By Shirley M. Mueller, MD *Published on June 9, 2008* **Physician's Financial News**



"All I ask is the chance to prove that money can't make me happy."
- Spike Milligan

We have a mortgage crisis on our hands. Only a few years ago we experienced the 'tech' wreck. Who hasn't lost money?

History repeats itself. A perpetual question is why people can't learn from recurring financial disasters. Is it stupidity? Is it greed overcoming reason? Is it circumstances beyond our control, or if we understood ourselves better could we soften our own financial blows?

Recent research begins to answer this important question. Our brains do contribute to personal monetary loss. Understanding the reasons why and curbing the culprits can go a long way in making us more prosperous. As a personal testimony, it helped me.

In a nutshell, there are psychological reasons encompassed within the discipline of behavior finance that play into monetary downfalls. These are fueled by underlying brain mechanisms studied in the discipline of Neurofinance. In this post, I'll discuss a behavioral finance perpetrator. In the next post, I'll cover the Neurofinance underpinnings related to it. In a third post, I'll talk about how to use this information to personal advantage.

Behavioral finance is the study of how emotions and human cognitive function affect investor decisions. Emotion is easy to understand. Cognitive function, on the other hand, is a less familiar concept. Put most minimally, it is how we handle information that is presented to us. Not everyone processes the same information identically, and that leads to differences in outcome. For example, the degree of confidence when making a financial decision will influence the result and can do so adversely. This is especially true for doctors who know they are smart because they were accepted into medical school. The self-assurance that results, and adoration by occasional staff and patients, can contribute to unfounded feelings of overconfidence in areas outside the field of medicine, including finance.

Let me elaborate. Barber and Odean from the University of California studied the issue of overconfidence when investing. In their research* they found that people who trade stocks most frequently actually made less money than those who 'buy and hold.' They hypothesized that overconfidence is the reason people trade frequently even though the results are not advantageous to them. In order to examine this, Barber and Odean studied traders who switched from phone-based trading to online trading. ** Their hypothesis was that online investors would become more confident, once online, for three reasons:

1. An illusion of knowledge
2. An illusion of control, and
3. Something called self-attribution bias.

Psychologists tell us that when people are successful, they are prone to believe that success is due to their own abilities, rather than any outside factor. When these same people fail, they tend to believe it is due to chance, rather than their own lack of ability. This characteristic is called self-attribution. The authors of a book called Person Perception (Hastorf, Schneider, and Polefka, 1970) characterize it in this way: "We are prone to attribute success to our own dispositions and failure to external forces."

Barber and Odean hypothesized that traders would buy and sell online more because of overconfidence, and this could decrease their profit. The two researchers studied 1,067 phone traders who went online compared with over another 1,067 phone traders who remained phone traders. That is, the phone traders picked up the phone to make the trade, whereas the online traders used the computer to make the trade. The online traders had a strong investment performance prior to going online, beating the market by more than 2% annually. After going online, they traded more actively and speculatively. In addition, they were less prosperous, lagging the market by three percentage points, a total of 5% down from their phone performance. These results support the researchers' hypothesis that overconfidence leads to more active and less prosperous trading in spite of the fact that it is not beneficial. This research is applicable to the general population as well as to physicians.

What brain mechanisms underlie this behavior? That is covered in part II. Part III is how best to use this information to personal advantage.

* Barber, B. and T. Odean: "Trading is Hazardous to Your Wealth: The Common Stock Investment Performance of Individual Investors", Journal of Finance, Vol. LV, No. 2, April 2000: 773-806.

** Barber, B. and T. Odean: "The Internet and the Investor", The Journal of Economic Perspectives, Winter 2001, Vol. 15, No. 1:. 41-54.