

## Financial History Repeats Itself: Part III: Did My Brain Make Me Do It?

By Shirley M. Mueller, MD

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***“It is optimism that is the enemy of the rational buyer.”***

- Warren Buffet



Some people “double down” when a stock falls precipitously. They assume that whoever is selling in mass quantities knows less than they do; that the stock is still a good stock, even though it’s being sold off. Others buy stock or sector funds on the recommendation of an invited analyst featured on CNBC. They think that person knows the scoop. They must be forgetting Enron; analysts didn’t know that inside story, or if they did, they certainly didn’t let us know.

Well-educated professionals that have financial advisors buy into recommendations for structured products, which are sure to generate a high fee, but may not benefit the investor. Think about the recent collateralized mortgage scandal. All of these investors are on the short end of the stick. Someone else is making money, but they’re not. One way to describe these investors’ actions is “optimism over realism.” As Warren Buffet says, “It is optimism that is the enemy of the rational buyer.” So why aren’t many investors acting in their own best interests—that is, in a rational way? That is the subject of this three part series, “My brain made me do it.”

In Part I, I discussed a scientific study that supports the conclusion that overconfidence in an individual leads to more active and less prosperous stock trading. In Part II, I covered another research study that suggests overconfidence is fed by an inner “spin-doctor” that makes up stories to protect self-image, though its interpretation may be in conflict with reality. That, in turn, can lead to monetary losses.

But, there is good news here, too. People who understand the part their neurobiology plays in detrimental financial decisions can use that information to their benefit. It is important to understand that although overconfidence can be an asset in most areas of life, in money management it is often the reverse. One reason is that hyper-trading due to overconfidence leads to poorer results. Further, because people can fool themselves by constantly telling themselves that their results are due to the market and not anything they are doing, they can continue that behavior. How to curb these tendencies is the subject of Financial History Repeats Itself III: Did my brain make me do it?

Studies show that most people are especially likely to be overconfident early in their trading careers, when they are inexperienced. Therefore, the more seasoned someone is at trading, the less likely he is overconfident. This begs the question: What can an investor,

experienced or not, do to protect himself from overconfidence when buying and selling stock or bonds?

The most important step is understanding and acknowledging the problem. The questions below are helpful in getting started. They help assess if unnecessary risk is being taken, which is a strong indicator of overconfidence.

- First, are you trading more than normal? The average online investor trades about 24 times per year. Therefore, if you buy and sell stocks or funds much more than this, you are likely an active trader, and you may be overconfident.
- Second, are you assuming another's opinion is correct rather than critically evaluating your own stock or mutual fund or asset allocation information? One example is thinking analysts are correct when they make recommendations, when in fact they may have a hidden agenda or they don't have accurate information themselves.
- Third, do you speculate about your investment return rather than accurately calculating your annualized return every year? Setting up a program to be able to figure your annualized investment return can be painstaking. However, without it, you can't objectively verify how you are doing.

If you answered yes to any of the above questions, you are likely engaging in behavior that is damaging to your financial health. The corrections are self evident, but they require work from you. If you don't have time to spend doing the necessary "make-over," seek help. This can be as simple as adopting the strategy of asset allocation in conjunction with broad based index funds and periodic reallocation. It can also entail hiring a reliable money manager who has your best interests at heart. Such a person would most likely put you primarily in broad index funds using asset allocation techniques.

Alternatively, there is professional assistance for investors who want to do more in the way of altering their investment attitudes. These are covered in Richard Peterson's recently published book, *Inside the Investor's Brain*. The author is a physician himself—a psychiatrist. Cognitive-behavioral therapy and coaches are among the many techniques that he covers. Whatever direction your journey takes you, if it results in better investment returns that compound over time and thereby yield real monetary rewards, it is worth it. In addition, it will provide you with the satisfaction that you did the best you could for yourself since you have your best interests at heart more than anyone.

*For more on "Financial History Repeats Itself," see [Part I](#) and [Part II](#).*