Top 10 Tips for Investing Success

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"Success in investing doesn't correlate with I.Q. ...Once you have ordinary intelligence, what you need is the temperament to control the urges that get other people into trouble in investing."
—***Warren Buffett***

Identifying and recognizing your own potential psychological tendencies can help you make better investment decisions.

At Morningstar, we know successful investing is hard, but it doesn't require genius. As much as anything else, successful investing—regardless of whether it is in stocks, options, or for dividend income—requires something perhaps even more rare: the ability to identify and overcome one's own psychological weaknesses.

Behavioral finance has spawned an array of academic papers and learned tomes that attempt to explain why people make financial decisions that are contrary to their own interests. However, much of the field attempts to extrapolate larger, macro trends of influence, such as how human behavior might move the market.

Our 10 Tips report pulls out the most important insights from the field of behavioral finance. Primarily, we're interested in helping you learn how to spot and correct investing mistakes due to human emotion and gut judgment.

Some insights behavioral finance has to offer read like common sense, but the rub with common sense is that it isn't always common practice. We hope that by becoming aware of the most common psychological "blind spots," you'll recognize which traps your investing decisions may fall into and ways to manage those areas.

With that in mind, let's begin.

Overconfidence

Overconfidence refers to our boundless ability as human beings to think that we're smarter or more capable than we really are. It's what leads 82% of people to say that they are in the top 30% of safe drivers, for example. Moreover, when people say that they're 90% sure of something, studies show that they're right only about 70% of the time. Such optimism isn't always bad. Certainly we'd have a difficult time dealing with life's many setbacks if we were die-hard pessimists.

However, overconfidence hurts us as investors when we believe that we're better able to spot the next Google than another investor is. Odds are, we're not. (Nothing personal.)

Studies show that overconfident investors trade more rapidly because they think they know more than the person on the other side of the trade. Trading rapidly costs plenty, and rarely rewards the effort. Trading costs in the form of commissions, taxes, and losses on the bid-ask spread have been shown to be a serious damper on annualized returns. These frictional costs will always drag returns down.

One of the things that drive rapid trading, in addition to overconfidence in our abilities, is the illusion of control. Greater participation in our investments can make us feel more in control of our finances, but there is a degree to which too much involvement can be detrimental, as studies of rapid trading have demonstrated.

Overconfidence can also be caused by spending too much time on any given opportunity. There will be situations in the stock market where you will have all the information you need to make a decision very quickly. In this case, more information may increase your confidence to a dangerously high level, while not necessarily yielding a better decision. Consider how Warren Buffett operates; he can judge the durability of a business in a matter of minutes. He does not use spreadsheets with reams of data to make valuation judgments; he essentially does the math in his head. Of course, none of us has Buffett's skill level, but we can still learn from how he operates. Namely, it's much

Overconfidence can lead to active trading, which hampers returns.

Selective memory, cognitive dissonance, representativeness, and self-handicapping can all cause us to downplay poor-performing investments, squandering the opportunity to learn from mistakes.

better to be approximately right than precisely wrong. We should also know that the future is inherently uncertain, and we will never be precisely right.

To guard against overconfidence, we think it is important to keep one's humility; we all know less than we think we do. Be willing to admit, openly discuss, and analyze mistakes. No investor has ever had anything close to a perfect record, nor do we need a perfect record to achieve good results.

But the most important thing to learn about overconfidence is that we should make sure not to take unreasonable risks. This means keeping an appropriate amount of diversification in a portfolio and not overbetting on any given idea. It also means having an appropriate margin of safety. Moreover, it may be helpful to have checklists and targets in writing for any given opportunity. Sometimes we are right for the wrong reasons, but our overconfidence will cause our minds to rewrite history. In the future, you can look at what was written to get a more honest assessment of what went right or wrong.

In this age of fair disclosure and a nearly ubiquitous Internet, it's almost impossible to gain an informational edge on the market. In other words, getting better results from investing isn't about seeking better information (which is virtually impossible), but rather looking at the available information more rationally. At Morningstar Investor Education, how our clients gain an edge is by having a superior perspective. Being aware of mental biases and inefficiencies is important if one wishes to have this particular edge and generate market-beating returns.

Selective Memory

Another danger that overconfident behavior might lead to is selective memory. Few of us want to remember a painful event or experience in the past, particularly one that was of our own doing. In terms of investments we certainly don't want to remember those stock calls that we missed much less those that proved to be mistakes which ended in losses.

The more confident we are, the more such memories threaten our self-image. How can we be such good investors if we made those mistakes in the past? Instead of remembering the past accurately, in fact, we will remember it selectively so that it suits our needs and preserves our self-image.

Incorporating information in this way is a form of correcting for cognitive dissonance, a well-known theory in psychology. Cognitive dissonance posits that we are uncomfortable holding two seemingly disparate ideas, opinions, beliefs, attitudes, or in this case, behaviors, at once, and our psyche will somehow need to correct for this.

Correcting for a poor investment choice of the past, particularly if we see ourselves as skilled traders now, warrants selectively adjusting our memory of that poor investment choice. "Perhaps it really wasn't such a bad decision selling that stock?" Or, "Perhaps we didn't lose as much money as we thought?" Over time our memory of the event will likely not be accurate but will be well integrated into a whole picture of how we need to see ourselves.

To avoid selective memory—and overconfidence, for that matter—in investing, it's a good idea to document and review investment records on a periodic basis. It's easy to remember the one stock that gained 50% in a single day, but records may reveal that most of your investments are under water for the year. Checking every couple weeks will do, since looking at performance on a daily or hourly basis is not likely to be insightful, and may even spur you to make hasty decisions. Either way, tracking your actual performance will not only help you keep overconfidence in check, but it will also help you identify and learn from your mistakes.

Another type of selective memory is representativeness, which is a mental shortcut that causes us to give too much weight to recent evidence—such as short-term performance numbers—and too little weight to the evidence from the more distant past. As a result, we'll give too little weight to the real odds of an event happening.

Loss aversion may cause us to focus more on our losers than our winners.

Self-Handicapping

Researchers have also observed a behavior that could be considered the opposite of overconfidence. Self-handicapping bias occurs when we try to explain any possible future poor performance with a reason that may or may not be true.

An example of self-handicapping is when we say we're not feeling good prior to a presentation, so if the presentation doesn't go well, we'll have an explanation. Or it's when we confess to our ankle being sore just before running on the field for a big game. If we don't quite play well, maybe it's because our ankle was hurting.

As investors, we may also succumb to self-handicapping, perhaps by admitting that we didn't spend as much time researching a stock as we normally had done in the past, just in case the investment doesn't turn out quite as well as expected. Both overconfidence and self-handicapping behaviors are common among investors, but they aren't the only negative tendencies that can impact our overall investing success.

Loss Aversion

It's no secret, for example, that many investors will focus obsessively on one investment that's losing money, even if the rest of their portfolio is in the black. This behavior is called loss aversion.

Investors have been shown to be more likely to sell winning stocks in an effort to "take some profits," while at the same time not wanting to accept defeat in the case of the losers. Philip Fisher wrote in his excellent book Common Stocks and Uncommon Profits that, "More money has probably been lost by investors holding a stock they really did not want until they could 'at least come out even' than from any other single reason."

Regret also comes into play with loss aversion. It may lead us to be unable to distinguish between a bad decision and a bad outcome. We regret a bad outcome, such as a stretch of weak performance from a given stock, even if we chose the investment for all the right reasons. In this case, regret can lead us to make a bad sell decision, such as selling a solid company at a bottom instead of buying more.

It also doesn't help that we tend to feel the pain of a loss more strongly than we do the pleasure of a gain. It's this unwillingness to accept the pain early that might cause us to "ride losers too long" in the vain hope that they'll turn around and won't make us face the consequences of our decisions.

Sunk Costs

Another factor driving loss aversion is the sunk cost fallacy. This theory states that we are unable to ignore the "sunk costs" of a decision, even when those costs are unlikely to be recovered.

One example of this would be if we purchased expensive theater tickets only to learn prior to attending the performance that the play was terrible. Since we paid for the tickets, we would be far more likely to attend the play than we would if those same tickets had been given to us by a friend. Rational behavior would suggest that regardless of whether or not we purchased the tickets, if we heard the play was terrible, we would choose to go or not go based on our interest. Instead, our inability to ignore the sunk costs of poor investments causes us to fail to evaluate a situation such as this on its own merits. Two tips here. First, if a stock is clearly worth far less than what we originally paid for it, we should be willing to sell if today's price is above our estimate of current value; that we are realizing a loss should be irrelevant to the decision. Second, if we spend several hours to research a given opportunity, we should still be willing to walk away. Our instinct will be to like the opportunity since we just spent time on it, but our goal should be to have rationality outweigh instinct.

Anchoring is when we base our decisions on something we know or believe to be important. Remember, what you paid for a stock or the recent performance of a stock are irrelevant data points when trying to figure the intrinsic value of a company.

Anchoring

Ask New Yorkers to estimate the population of Chicago, and they'll anchor on the number they know—the population of the Big Apple—and adjust down, but not enough. Ask people in Milwaukee to guess the number of people in Chicago and they'll anchor on the number they know and go up, but not enough. When estimating the unknown, we cleave to what we know.

Investors often fall prey to anchoring. They get anchored on their own estimates of a company's earnings, or on last year's earnings. For investors, anchoring behavior manifests itself in placing undue emphasis on recent performance since this may be what instigated the investment decision in the first place.

When an investment is lagging, we may hold on to it because we cling to the price we paid for it, or its strong performance just before its decline, in an effort to "break even" or get back to what we paid for it. We may cling to subpar companies for years, rather than dumping them and getting on with our investment life. It's costly to hold on to losers, though, and we may miss out on putting those invested funds to better use. For instance, Dell was a dominant company with major competitive advantages for the better part of two decades. But those advantages reached the end of the road. Those who saw this shift and acted appropriately fared much better than those of us (ahem) who had an outdated view of the company.

It may be helpful to ask yourself the following questions with your stocks: Would I buy this investment again? And if not, why do I continue to own it? Truthfully answering these questions can help you sever the anchors that may be a drag on your rational decision making.

Confirmation Bias

Another risk that stems from both overconfidence and anchoring involves how we look at information. Too often we extrapolate our own beliefs without realizing it and engage in confirmation bias, or treating information that supports what we already believe, or want to believe, more favorably.

For instance, if we've had luck owning Honda cars, we will likely be more inclined to believe information that supports our own good experience owning them, rather than information to the contrary. If we've purchased a mutual fund concentrated in health-care stocks, we may overemphasize positive information about the sector and discount whatever negative news we hear about how these stocks are expected to perform.

As such, it's helpful to seek out views that actually oppose yours. Actively seek out the evidence that may disconfirm an idea. If you do this you will have a couple of benefits. One, you will not get too tied down to any one idea, maintaining better independent judgment; it will prevent "falling in love with a stock." Second, you will occasionally find that one of your investment theses is wrong. And if you are wrong, it's always good to discover a mistake earlier than later. Finally, if you can successfully rebut the opposing case for an investment, you will have more conviction when making trades and/or holding through market volatility.

Hindsight bias also plays off of overconfidence and anchoring behavior. This is the tendency to re-evaluate our past behavior surrounding an event or decision knowing the actual outcome. Our judgment of a previous decision becomes biased to accommodate the new information. For example, knowing the outcome of a stock's performance, we may adjust our reasoning for purchasing it in the first place. This type of "knowledge updating" can keep us from viewing past decisions as objectively as we should.

Mental Accounting

If you've ever heard friends say that they can't spend a certain pool of money because they're planning to use it for their vacation, you've witnessed mental accounting in action. Most of us separate our money into buckets—this money is for the kids' college education, this money is for our retirement, this money is for the house. Heaven forbid that we spend the house money on a vacation.

Money is money, whether it came from earnings or capital gains.

Investors derive some benefits from this behavior. Earmarking money for retirement may prevent us from spending it frivolously. Mental accounting becomes a problem, though, when we categorize our funds without looking at the bigger picture. One example of this would be how we view a tax refund. While we might diligently place any extra money left over from our regular income into savings, we often view tax refunds as "found money" to be spent more frivolously. Since tax refunds are in fact our earned income, they should not be considered this way.

For gambling aficionados this effect can be referred to as "house money." We're much more likely to take risks with house money than with our own. For example, if we go to the roulette table with $100 and win another $200, we're more likely to take a bigger risk with that $200 in winnings than we would if the money was our own to begin with. There's a perception that the money isn't really ours and wasn't earned, so it's okay to take more risk with it. This is risk we'd be unlikely to take if we'd spent time working for that $200 ourselves.

Similarly, if our taxes were correctly adjusted so that we received that refund in portions all year long as part of our regular paycheck, we might be less inclined to go out and impulsively purchase that Caribbean cruise or flat-screen television.

In investing, just remember that money is money, no matter whether the funds in a brokerage account are derived from hard-earned savings, an inheritance, or realized capital gains.

One other form of mental accounting is worth noting. The framing effect addresses how a reference point, oftentimes a meaningless benchmark, can affect our decision.

Let's assume, for example, that we decide to buy that television after all. But just before paying $500 for it, we realize it's $100 cheaper at a store down the street. In this case, we are quite likely to make that trip down the street and buy the less expensive television. If, however, we're buying a new set of living room furniture and the price tag is $5,000, we are unlikely to go down the street to the store selling it for $4,900. Why? Aren't we still saving $100?

Unfortunately, we tend to view the discount in relative, rather than absolute terms. When we were buying the television, we were saving 20% by going to the second shop, but when we were buying the living room furniture, we were saving only 2%. So it looks like $100 isn't always worth $100 depending on the situation.

The best way to avoid the negative aspects of mental accounting is to concentrate on the total return of your investments, and to take care not to think of your "budget buckets" so discretely that you fail to see how some seemingly small decisions can make a big impact.

Herding is taking comfort in investing with a crowd. Thinking independently and taking advantage of the market's tumultuous ways is a better way to invest.

Herding

There are thousands and thousands of stocks out there. Investors cannot know them all. In fact, it's a major endeavor to really know even a few of them. But people are bombarded with stock ideas from brokers, television, magazines, web sites, and other places. Inevitably, some decide that the latest idea they've heard is a better idea than a stock they own (preferably one that's up, at least), and they make a trade.
Unfortunately, in many cases the stock has come to the public's attention because of its strong previous performance, not because of an improvement in the underlying business. Following a stock tip, under the assumption that others have more information, is a form of herding behavior.

This is not to say that investors should necessarily hold whatever investments they currently own. Some stocks should be sold, whether because the underlying businesses have declined or their stock prices simply exceed their intrinsic value. But it is clear that many individual (and institutional) investors hurt themselves by making too many buy and sell decisions for too many fallacious reasons. We can all be much better investors when we learn to select stocks carefully and

for the right reasons, and then actively block out the noise. Any temporary comfort derived from investing with the crowd or following a market guru can lead to fading performance or inappropriate investments for your particular goals.

Recency Bias

We live in the here and now, and the ability to contemplate things far in the past and/or future is a uniquely human ability that requires higher cognitive functions. Yet our instincts can still get the better of us on occasion. Recency is the tendency to weigh recent events much more heavily into our decision-making than more distant events. It is a sort of mental short-sightedness where we think much more about our current situation than the much broader historical perspective. This can cause us to assume that the current state of the world—good or bad—persists into the future, rather than reverting to a long-run mean.

There are a couple of different ways to overcome this. First, remember that the status quo in any given situation is not likely to persist. The world is constantly changing; don't just take the situation today and assume it will persist in perpetuity. Also, make sure not to just focus on a few years' worth of historical information, but look at data that extends further into the past. Think long and hard about whether something really is "different this time," or if mean-reversion is the most likely path.

This is one of the mental biases that we can easily exploit. By taking a long-term view in a world with an incredibly short-term focus created by short-term incentives, we can engage in "time horizon arbitrage" to create excess returns. Just as an example, say the market is assuming that ugly situations in housing and employment are going to persist essentially forever. We know the cycle will—eventually—turn back around. What if an individual owned shares of Home Depot, Lowe's, Paychex and ADP at that time?

The Bottom Line

We've touched on the psychological mistakes that influence everyday investors. Ideally, you now have some ideas on how to handle the tendencies that are affecting your returns.

But sometimes, awareness is not enough. Turning awareness of a problem into a course of action and then converting that action into a habit is where the real payoff lies. Increasing your awareness—and your ability to do something—about these and other investing "blind spots," is the job of Morningstar Investor Education's coaches. With programs covering stocks, options, and dividends Morningstar Investor Education's specially designed curricula will introduce you to the nuances of investing that, once understood and applied, can make it a lot easier for you to follow these 10 tips and achieve your investing objectives.

To learn more about Morningstar Investor Education, call **1-800-615-6178** Ext. **1300**.