Managing the Mental Aspect of Investing

An Interview with Meir Statman

Article Highlights

- Two common investor errors are not considering who is on the other side of a trade and holding incorrect assumptions about the past.
- Investors do not need to avoid herds, but rather need to distinguish between good herds and bad ones.
- By not taking credit for gains, investors can better cope with the emotions of recognizing a loss.

Meir Statman is the Glenn Klimek Professor of Finance at Santa Clara University, Santa Clara, California, and author of the recently published "What Investors Really Want" (McGraw-Hill, 2011). I spoke to him recently about mental hurdles investors face when making investing decisions.

Charles Rotblut, CFA

Charles Rotblut (CR): *In your book, you talk about how people commit cognitive errors such as confirmation errors and hindsight errors. Can you elaborate on the kinds of cognitive errors that people commit when they make financial decisions?*

Meir Statman (MS): I begin with framing errors. We tend to frame trading stocks, mutual funds, and other investments as tennis played against a practice wall, where we see the ball hit the wall and place ourselves at the right spot to hit it back. But the correct frame of trading is real tennis against a player on the other side of the net. Would you play tennis when Roger Federer might be on the other side of the net if the loser pays $100,000 to the winner? So why are you trading when Goldman Sachs might be on the other side of the net? Remember, there is an idiot in every trade, and if you do not know who it is, it is likely you.

Some investors who frame the trading game correctly as tennis against a player on the other side of the net are often tripped by overconfidence. They know that the better tennis player would win, but surely they are the better player. They know that there is an idiot in every trade, but surely it is the other trader who is the idiot.

Whenever I am tempted to trade, I think about my position relative to that of a likely trader on the other side of the trade. Is my analysis of companies in my spare time better than those of professional analysts who do their work full time? Do I have private information about demand for and supply of stocks available to institutional investors? Is it possible that I'll be trading against insiders who are trading legally or illegally? I conclude that I have no likely advantage over other traders, so I do not trade.

Hindsight is another example of a cognitive error. Investors say, "I knew in 2007 that the market was going to tumble in 2008." Maybe so, but I would like to see their 2007 diary, written in permanent ink. My guess is that in 2007 they wrote something like this: "I've read that the housing market is in a bubble, and this seems to be true as I observe prices in my neighborhood. But are we really in a bubble? And when would the bubble pop?" But when we get into 2008 and 2009 they remember that they have known with clear foresight not only that the housing market would collapse but also that the banking system and the stock market would collapse. And did the people who were smart enough to sell their stocks at their tops in 2007 also buy them back at their bottoms in 2009?

Some months ago I was speaking to a group of very wealthy investors. One said, "I have a friend who just knew in 2007 that the stock market was going to tank, and still he found it hard to pull the trigger. Why is that?" I tried to say, as gently as I could, "I don't think that your friend was as certain in 2007 as he is now. In 2007 he hemmed and hawed, with 'ifs' and 'buts' and 'on-the-other-hands.' It is only in hindsight that all 'ifs' and 'buts' and 'on-the-other-hands' disappear. Now he only remembers that he forgot to pull the trigger and vows not to forget to pull the trigger next time." These are only a few of the cognitive errors that stand between us and good financial decisions.

CR: *What about herd behavior? In your book, you mention it as being both positive and negative.*

MS: Investors often use the language of herding to describe other investors. "These are idiots, members of herds." Investors rarely see themselves as members of herds. "I'm an independent thinker," they say. But whenever you watch CNBC or Bloomberg, you see two professionals, both wearing suits so you know they are experts, yet one says that the market is sure to go up and the other says that it is sure to go down. They cannot both be right. At any moment we have a herd of bulls and a herd of bears. And each herd is splintered into sub-herds: Some bears say that the market is bound to collapse because the Federal Reserve prints too much money; other bears say that it is because government imposes excessive regulations.

We need not avoid herds. We need only to distinguish good herds from bad ones and join good herds.

For example, Consumer Reports tests cars and surveys car owners and concludes that Honda is a reliable car and Mercedes Benz is prone to breakdowns. I join the Honda herd when I buy a Honda, and this is a good herd. I avoid the bad herd of Mercedes Benz. I know that I can trust Consumer Reports because they are experts at evaluating cars. I also know that their surveys are free of bias and that they do not have conflicts of interest because they do not accept advertising from car companies or others.

Compare that with my situation when Joe, my country club buddy, told me Bernie Madoff was a good money manager. I said to myself, "Joe made his money in the junkyard business, what does Joe know about money management? Did he examine the operations of Bernie Madoff? And if he did, does he know what they mean?" The answer was no. Joe decided to invest with Madoff on the recommendation of David, who made his money as a surgeon. The blind who follow the blind form a bad herd, likely to plunge off a cliff.

CR: *For individual investors trying to decide which herd to follow, how do they make a decision?*

MS: Avoiding herds is very easy. Rely on what you know from scientific studies. We know that the "value" herd is more likely to be right than the "growth" herd. So tilt your portfolio toward the value herd, but not too much. Keep a well-diversified portfolio, because sometimes the value herd lags the growth herd. Avoid framing errors, overconfidence errors and hindsight errors. Be aware that the future is uncertain and that black swans are not black swans if we foresee them. Knowing that a major earthquake, tsunami, and nuclear disaster can happen is not the same as knowing where and when they would happen.

CR: *With regard to your book's title, if I were to ask our members what they really want, their answer would be capital gains and portfolio income. However, you think there are other things that investors want as well, correct?*

MS: We want high returns from our investments, but we want much more. We want to nurture hope for riches and banish fear of poverty. We want to be number one and beat the market. We want to feel pride when our investments bring gains and avoid the regret that comes with losses. We want the status and esteem of hedge funds and the warm glow and virtue of socially responsible funds. We want good advice from financial advisors, magazines and the Internet. We want to be free from government regulations yet be protected by regulators. We want financial markets to be fair but search for an edge that would let us win: We want markets that are sometimes fair and at other times not. We want to leave a legacy for our children when we are gone. And we want to leave nothing for the tax man. The sum of our wants and behaviors makes financial markets go up or down as we herd together or go our separate ways, sometimes inflating bubbles and at other times popping them.

CR: *So you think there are emotional gains, in addition to financial gains, that investors seek out?*

MS: Investments are like jobs. The benefits of jobs come in packages and we face trade-offs as we choose among them. A lawyer who wants to earn money but is also passionate about public advocacy can choose a public advocacy package with little money and much passion or a corporate law package with more money but less passion. The benefits of investments, like those of jobs, extend beyond money. Investments express parts of our identity, whether that of a trader, a gold accumulator, or a fan of hedge funds.

Investments are a game to many of us, like tennis. We may not admit it, and we may not even know it, but our actions show that we are willing to pay money for the investment game. We pay the money in trading commissions, mutual fund fees, and software that promises to tell us where the stock market is headed. And investments are about what we would do with the money we make and how it makes us feel. Investments are about a sense of security in retirement, our hope for riches, the joy and pride of raising our children, and paying for the college educations of our grandchildren.

Investments, jobs, products and services have benefits that enhance wealth, well-being, or both. These include utilitarian benefits, expressive benefits, and emotional benefits. Utilitarian benefits are the answer to the question, "What does it do for me and my pocketbook?" The utilitarian benefits of watches include telling time, the utilitarian benefits of restaurants include nutritious calories, and the utilitarian benefits of investments are mostly wealth, enhanced by high investment returns.

Expressive benefits convey to us and to others our values, tastes, and status. They answer the question, "What does it say about me to others and to me?" A stock-picker says, "I am smart, able to pick winning stocks." A Goldman Sachs client says, "My status is high enough to be selected to invest $2 million or more in Facebook shares."

Emotional benefits are the answer to the question, "How does it make me feel?" Insurance policies make us feel safe, lottery tickets give us hope, and an offer to be among the first to own Facebook shares makes us proud.

***CR:** Let's talk about losses. As you know, investors are often reluctant to realize a loss, even when doing so is the smartest move. Any suggestions for how to do cope with the emotional aspect of losing money on an investment?*

MS: The utilitarian benefits of realizing losses are in tax savings. I can write off realized losses against my income or realized gains, but I cannot write off paper losses. So it makes sense to realize losses. But realizing losses detracts from the expressive benefits of investments by exposing me as a loser. And it detracts from emotional benefits by inflicting the emotional pain of regret: You think, why was I so stupid as to buy this stock? If I realize my loss, I will kiss my money goodbye and abandon all hope of recovering my losses.

I have trained myself to realize my losses, suffer the pain of regret, and enjoy the tax benefits. For example, I had losses in my international fund during the crisis, so what did I do? I realized these losses by selling the fund and buying another international fund that was not identical to the one I sold (so I won't have to worry about the problem of wash sales). I said to myself, "Hey, Meir! Stuff like that happens! Get over it, shrug your shoulders and make the best of it." I never take credit for gains, so I can absolve myself of blame for losses.

Now I have a lot of realized losses that I carry forward, yet my new foreign stock fund has accumulated very nice unrealized gains. Earlier this year I deposited money in my charitable account. I took that money from the international fund that has unrealized gains. This way, a dollar donation cost me less than a dollar. (The rest is paid courtesy of the IRS.)

***CR:** And would you say the reason why investors sit on losses is that they just have a hard time "shrugging their shoulders"?*

MS: I think so. I think that investors should make the best decisions they can and shrug their shoulders, whether these good decisions turn out well or badly. I do not pretend that this is easy. I recently returned from the Netherlands, where I serve as a visiting professor at Tilburg University. I spent the weekend before my return in Amsterdam. I put my $250 or so of American money in a pocket of my suitcase, so that my wallet containing euros would not be too bulky. I was checking that pocket on my way to Schiphol airport, ready to replace the euros in my wallet with dollars, but the dollars were not there. "Boy," I said, "it must have been the cleaning woman." I was trying to shrug my shoulders, but it was hard to do. I sent an e-mail to the hotel saying, "This is not right. You'd better investigate and return my money."

I was trying to put it in perspective, saying to myself, "Okay, Meir, in the total scheme of things, a stolen $250 is not a major disaster." Still, I was berating myself about being so stupid as to put the money in a front pocket. But I reminded myself that I'd been doing that on countless trips where all went well.

When I arrived at my New York hotel, I opened the pocket of my laptop case, where I carry the charger and other accessories, and there were my dollars, folded just as I had placed them. I was really embarrassed, and sent the hotel an e-mail saying, "It was my mistake, please forgive me!"

***CR:** In terms of controlling emotions, do you think it's just a matter of trying to keep things in perspective?*

MS: Keeping things in perspective can help a great deal. We feel really bad if we've just lost $250. But ask yourself, "What is $250 relative to my total wealth?" Remind yourself that $250 is nothing relative to real calamities such as earthquakes and tsunamis. Ask yourself, "What could I have done? I cannot carry everything with me. At least my laptop is intact." The same is true in investments. Yes, I lost much more than $250 in 2008 and early 2009, but it could have been worse.

***CR:** To take that a step farther, for those who lost a lot of money during the last bear market and still haven't made it up, does the same kind of thinking apply? Should they remind themselves that there are other people in the same situation?*

MS: Ask yourself, did the losses of 2008 and 2009 injure your retirement prospects or only your ego? The retirement prospects of people with $10 million who have lost $4 million are still pretty good even if their egos are battered. Does the loss of $400,000 of your $1 million portfolio mean that you cannot be retire at 55? What's wrong about retiring at 60 or 65 if you're lucky enough to hold a job or operate a business? And you're still better off than people who've lost their jobs along with big chunks of their portfolios.

Also, remind yourself not to take credit for gains, because this would bring blame for losses. When the market goes up, I remind myself that it's because I was lucky, not because I'm smart. And when it goes down, it is because I was unlucky, not because I'm stupid.

***CR:** Finally, you do talk a little bit in your book about "baskets." Many of our members are retirees, and they are dependent on their portfolios for dividends. How should they view dividends relative to the rest of their portfolios and figure out what "basket" everything fits in to?*

MS: We distinguish capital from income and tend to follow the rule of "spend income, but don't dip into capital." We give ourselves permission to spend dividends and interest income but not to sell stocks to finance consumption. The problem comes when the dividend yield is lower than 2% and interest is close to 0%. A $1 million portfolio yields income lower than $20,000. You'll need a pretty substantial $3 million portfolio to generate a $60,000 income.

Retirees should remind themselves that, sad as it is, we are all destined to die. Running out of money while alive is bad, but so is living like misers only to leave much money when we're dead. People in their 70s and 80s can dip into capital, but such dips must be controlled.

Managed payout funds offered by Fidelity, Vanguard and others are sensible methods of dipping into capital. Investors can choose a 7% payout dip into capital. This is a substantial dip, but a controlled one. They spend $70,000 of their $1 million portfolio and know that they have to wait another year for another payout. Others can choose a more conservative 5% or 4% payout. ➤

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his or her own benefit or the worker's delayed benefit.

The individual who has delayed taking Social Security benefits until his or her full retirement age faces a slight dilemma. Workers who have attained full retirement age can collect benefits and continue working without a payback of any Social Security benefits. (Actually, those wages need not even be reported to the Social Security Administration.) There is no question if the individual simply retires. But if the individual is going to continue to work, the economic consideration is "breakeven."

Breakeven for average- and maximum-wage earners is in the latter half of the 13th year (between ages 78 and 79). Life expectancy at age 66 is approximately 16 more years for a male and 19 more years for a female. Thus, for all wage earners, if an individual is not in good health, taking the benefit is indicated. If he or she is in good health, delaying the benefit is indicated for the maximum-wage earner. Since benefits are automatic at age 70, greater retirement income will be available with reasonably good probabilities of surviving beyond the breakeven age.

It seems reasonable that the average-wage earner would use the Social Security benefit to add to their lifestyle, and so taking the benefit is indicated at age 66. The maximum wage earner may never need the benefit and would simply invest the aftertax amount. At aftertax rates of return between 4% and 10%, the breakeven age is at least the life expectancy of a male and just short of the life expectancy of a female; therefore, taking the benefit at age 66 is indicated. Should the combined worker and spousal benefit be invested, the breakeven age is well beyond both life expectancies and, again, taking the benefit at age 66 is indicated. ➤

Table 6. Breakeven Ages and Accumulation

Aftertax Return (%)	Breakeven Age (Years, Months)	Years to Breakeven	Accumulation ($)
4.00	81, 2	15.2	580,490
5.00	82, 3	16.3	700,490
6.00	83, 7	17.6	873,976
7.00	85, 3	19.3	1,141,171
8.00	87, 6	21.5	1,604,439
9.00	90, 10	24.8	2,578,889
10.00	96, 8	30.7	5,582,487
11.23	Never	Never	N/A

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