

The Good Investor Rule: Focus on How Not to Lose Money

By Steven Sears

Article Highlights

- Bad investors think of ways to make money. Good investors think of ways to not lose money.
- Investors think they make decisions based on facts, but media reports, charts and other stimuli influence behavior.
- Consistent success comes to those who identify and manage risk and then commit money to investments.

Every year, usually in early spring, much of Wall Street pauses for a moment of silent reflection. Heads are not bowed in remembrance of the fallen, or some historical event. Instead, the silence is in reaction to the somber findings of an annual study that shows many individual investors are trapped in boom and bust cycles of their own making.

DALBAR, a financial services market research firm, recently released the results of their annual Quantitative Analysis of Investor Behavior study. It shows that individual investors have, for much of the past 20 years, significantly trailed market benchmarks, including the S&P 500 index. In 2011, when the S&P 500 had a total return of about 2%, the average equity mutual fund investor lost 5.73%. In 2010, when the S&P 500 rose 9.14%, the average equity investor experienced an annual return of 3.83%. Sometimes, investors have trailed the benchmark by as much as 10%.

The study shows individual investors regularly buy high, sell low, and learn little from their experiences. Severe underperformance is troubling enough since so many people rely on the stock market to finance retirements, cover college tuitions, and pay for most big-ticket items. But there is another pernicious finding.

DALBAR found that investors never stay in the stock market long enough to really qualify as long-term investors. They hold stock mutual funds for an average of 3.27 years.



Bond investors and investors who own diversified portfolios are not much steadier. This suggests that individual investors think of themselves as long-term investors, but they actually act like very bad traders. Few people seem aware of the incongruity between their thoughts and actions. Instead, they greed in and panic out of investments. They are often at odds with the natural five-year market cycle, in which a bull market is born, dies, and is born again.

If not for inflation and stock dividends, which historically provide about 45% of stock returns, many investors would have sharply smaller investment portfolios.

History, and Mistakes, Repeat

This disconnect has fascinated me since the Internet bubble burst in 2000, which much of Wall Street likened to the Great Crash of 1929. At the time, I was covering the stock market for Dow Jones Newswires and The Wall Street Journal, and I was in a good position to see if the comparison was valid. I asked our librarian—at the time we still pasted articles into binders or saved them in folders in massive filing cabinets—to pull Wall Street Journal articles that chronicled the Great Crash of 1929.

What was written on those aged pages was eerily familiar. The same logic that described the 1929 market was still being used to describe events in 2000. In fact, if you swapped out the names of investments firms, market pundits, and high-flying stocks, the 1929 article could have been published in 2000. If you read John Kenneth Galbraith's book,

“The Great Crash, 1929” (reprinted by Mariner Books, 2009), or even Charles MacKay’s treatment of Tulip mania in the early 17th century, you can see the similarities yourself.

Yet during the bursting of the Internet bubble, and throughout the credit crisis, I was in contact with a relatively small group of investors who were zigging when others were zagging. In 2000, when the NASDAQ Composite index peaked around 5,000, this group of investors reasoned market conditions could not get much better and they sold, even as many others bought technology stocks in anticipation of greater gains. The same thing happened in October 2007 when the Dow Jones industrial average peaked around 14,000.

Since then, I have been fascinated with why a small group of investors consistently sidesteps much of the investment calamities that ensnare others, and why history so frequently repeats itself in the stock market with so few people seemingly learning anything from what transpired. If you were robbed, or your house caught fire, you would change your behavior. You would get street smart very fast. You would think about risk in meaningful ways. Yet financial calamities often ensnare investors, and they never seem to really evolve their behavior or thinking.

What Separates Successful Investors

If there is a single line of demarcation between consistently successful investors and everyone else, it seems to be captured by a simple idea well known on Wall Street, but not on Main Street: Bad investors think of ways to make money. Good investors think of ways to not lose money.

The “good investor rule” idea seems like common sense, but common sense is often an uncommon virtue. Besides, selling is Wall Street’s essence. Few sales pitches are more attractive than the specter of “buy this and great wealth can be yours.” So before writing my book, “The Indomitable Investor: Why a Few Succeed in the Stock Market When Ev-

eryone Else Fails” (John Wiley & Sons, 2012), I asked many top investors and strategists why the good investor rule was so hard for individual investors to understand and follow. Their response was, as one of Wall Street’s top strategists said, that the masses are stupid.

I have difficulty believing that, as I am sure you have a hard time reading it. I do not believe that anyone who leads a vigorous non-financial life and is capable of making complex decisions based on often fragmented information becomes an idiot when entering the stock market. I ultimately came to believe that the reason so many investors have difficulty is because they have never before been told how to think and act like investors. They bring ideas that work on Main Street or in their respective professions to Wall Street, rarely truly understanding that the market is a distinct culture unto itself. The portrayal of the market as a cantankerous, yet ultimately benevolent, ATM does not help, either.

Because so many individual investors enter the stock market intent on making money, they often seem perpetually off balance and they have a hard-time recovering from their mistakes or learning from their experiences. If they lose money, or buy a stock that goes down, they desperately try to make their money back. At a certain point, the risk of not making money exceeds the risk of losing money. Options dealers, for example, are so confident that individual investors are typically wrong that they sometimes do not even hedge those positions.

In essence, individual investors put profits before process and reward before risk. Seasoned investors do the opposite. Dependent on their investment disciplines, they let their investment processes determine the profits. They sell after making a certain amount of money. One fund manager who has beaten the S&P 500 for more than 20 years says he thinks one reason individual investors have such trouble is because they buy stocks based on intuition—absent any financial analysis or investment thesis. When their hot stocks decline, those investors panic and sell because they

had no real conviction in the first place. They just wanted to make money.

Now, dense textbooks and financial models detail stock analysis. It is serious stuff. The Chartered Financial Analyst Program, for example, takes three years to complete, which is as long as law school and a year less than medical school. Yet many investors enter the market without any meaningful preparation other than a desire to make money. Though salient points for managing risk—and for more smartly buying and selling stocks—are covered in my book, such a discussion is beyond the purview of this article, which focuses on some behavioral factors that commonly trip up many investors. If you know about these pitfalls, you will hopefully avoid them, and make better financial decisions for you and your family.

Your Brain on Money

Science is starting to prove that visual cues heavily influence decision-making. All parents worry that watching too much TV, or incessantly playing video games, will rot their kids’ brains. Well, it turns out investors have similar problems. Risk-based decisions, like buying stock, can be manipulated by positive visual cues—look at how TV covers the market—that stimulate a region of the brain called the nucleus accumbens, part of the brain’s reward circuitry. Although the nucleus accumbens, which is activated by drugs, alcohol and sex, has traditionally been studied to understand addiction, it is at the center of emerging research into investing.

This research suggests one reason people have such trouble with the good investor rule is because they often make decisions in a visual stimulation funhouse. Everyone thinks they make decisions based on cold facts, such as stock trading charts, news stories, corporate earnings reports, and stock analyst research reports. But those reports are clouded by initial perceptions. Investors are cued to be bullish or bearish by media reports, or stock charts that show whether share price rose or fell and if it will turn higher or lower. All of this

Strategies for Avoiding Losses

Are you a trader or an investor?

In a 24/7 news cycle and near-constant market coverage, it is increasingly important for investors to remember that they are investors and not traders. If you remember that you are an investor, do not fret over every single tick up or down in your stock's price. Keep calm, carry on and let time work for you, not against you.

All stocks have an investment thesis. What's yours?

Answer this simple question to understand why you are buying a stock. The answer helps establish investor conviction level. Each stock has an investment thesis. Do you like the dividend? Are earnings growing? Does the company have innovative products? Or are you simply buying a stock because you read about it someplace, or heard someone recommend it on TV? Such analysis should be common sense, but common sense is an uncommon virtue. Identifying an investment thesis, will help you see if you are buying a stock based on intuition, or analysis.

Know your stock.

Determine the price-earnings ratio. What are the key financial metrics relevant to the stock? Read the past eight earnings reports. Seek out news stories and analyst reports published in reaction to each earnings report. Determine if your stock is trading at a sharp premium or discount to its peers. Identify top competitors. Identify the benchmark sector index. Is your stock outperforming, or underperforming, the sector benchmark? How about the broad market? All of these questions will help ensure

you are not overweighting the stock's recent performance and it will counterbalance the recency effect.

Assume your analysis is wrong.

Actively seek contrary opinions to disprove your investment thesis. Look at analyst reports, if any exist, that have the opposite views. Determine what factors would change your investment thesis and be grounds for selling. If you only seek information that proves your point, your analysis is not rigorous.

Risk is a four-letter word.

What is the risk to your investment thesis? At what point would you sell your stock and realize profits? Did you set a stop-loss order 10% below the stock's current price? If so, readjust the stop-loss order as the stock price advances. This is one method for managing risk and protecting profits. It is not ideal in choppy markets, but many investors like its simplicity. Others rebalance their portfolios each quarter, or every six months. They take profits from winning positions and invest those profits in lagging positions; this helps to better balance the risk, and reward, inherent in investing.

Learn from your mistakes.

You will not always win. You will not always know everything. Don't let a mistake go to waste. Study the mistake to find out why you erred, and use the findings to strengthen your investment process so you don't make the same mistake again.

is exacerbated by the popular portrayal of the stock market as some kind of casino culture. Many investors are always excited and eager to make money.

One successful mutual fund manager interviewed in my book says stocks that he sells tend to rise by another 20% once he takes profits and exits. He has already made a profit of anywhere from 50% to more than 100% based on his financial model that led him to buy the stock when it was not on anyone's radar. But after a prolonged gain, he believes his stocks are noticed by technical analysts who will mention how great the chart looks. Soon, media reports, and chat rooms, mention that Stock X has surged, say 100%, and is trading well

above resistance and so forth. Soon, individual investors start buying, and this often attracts seasoned investors and traders to sell—including the mutual fund manager. In essence, individual investors buy near the top, just as prices peak. Then they slide down the slope of hope and often sell low that which they bought high. Such is the power of imagery and the excitement that comes with making money. Some will dispute the role of the nucleus accumbens in investing. But just think of how it feels to look at account balances and see big numbers. It feels good.

If you are still skeptical of the influence of the nucleus accumbens, consider that the FINRA Investor Education

Foundation has awarded more than \$400,000 to the further study of the nucleus accumbens because it is increasingly clear that many investors make financial decisions that have unexpected consequences.

One Brain. Two Minds.

Just as visual cues influence risk-based decisions, it seems the mind is easily tricked into seeing patterns where they do not exist.

Daniel Kahneman, the only psychologist to ever earn the Nobel Memorial Prize in Economic Sciences, believes the mind has two systems. System 1 is intuitive. System 2 is more calculated

and reasoning. Sometimes, System 1 makes decisions that should be made by System 2—and that can create problems for investors.

To illustrate, imagine a medallion with two faces in profile, one facing right and the other facing left. The image is the famous picture of Janus, the Roman god of doors and beginnings. Kahneman says the image of Janus is often used in experiments to show how quickly people see patterns—even if patterns do not exist. In experiments, people are only shown the image of a single face looking right or left. They see it many times: First right, then left, and so on. When people are presented for the first time with the total image of the two faces together, one staring right and one staring left—the first conflict—people think they saw the last image they had just seen, not the total image.

“It takes about three years for people to think they are in a new regime,” Kahneman said at a 2009 conference in Munich. “This turns out to be very important when you are looking at mass phenomenon in the economy, the speed at which people will feel that things will go on forever. They may know it’s a bubble...but this is like System 2 knowledge—it is not System 1 knowledge—and people do act a great deal on System 1 knowledge.” [See the Financial Planning article in this issue on page 25 for an interview with Daniel Kahneman.]

Kahneman did not elaborate on how the three-year phenomenon might impact investing. But it is likely more than coincidence that every five years marks one market cycle and that DALBAR research on stock ownership patterns show people maintain stock investments for an average of 3.27 years—just a smidgeon longer than the time needed to develop ideas of a new regime and far short of a full market cycle. This suggests many stock investors operate on intuition more than generally understood. It also offers more insights into why so many investors are easily rattled when the stock market sharply declines. It suggests too many people invest money based on emotion and

intuition—not analysis.

Put another way: Many people seem to buy securities using System 1 knowledge and sell on System 2. They buy stocks that have advanced for some time and conclude the price will keep rising. After all, the media and stock charts often present compelling evidence that hot stocks will remain hot. Seasoned investors, however, often focus on different facts based on analysis. They may look at how much money they have already made owning the hot stock and decide to take profits. When major investors exit the stock, the stock price often declines, and that can kick-start System 2 knowledge for investors who bought the stock without conducting much of their own research and analysis.

Overconfidence

Many investors are often wrong, but never in doubt.

In essence, the more educated an investor, the more difficult it often is to make good investment decisions. They simply think they know too much or that the skills they use to such great impact in their professional lives translates to the market. This faith in their abilities encourages them to take short cuts.

A study prepared by England’s Office of Fair Trading found that the more people know about an issue, the more likely they were to fall for a scam. This is contrary to the general understanding of scam victims, who are typically thought to be strong contenders for the Darwin Award, which is sarcastically given to those who voluntarily engage in behaviors harmful to themselves.

But when people feel competent in a subject, they tend to seek information that confirms their view. The scientific name of this phenomenon is “confirming information search,” and it causes people to overestimate the quality of information that supports their preferred standpoint. Few mediums make it easier to confirm one’s opinion than the Internet.

The NASD Investor Education Foundation commissioned a study that

found investment fraud victims were more likely than others to rely on their own experience and knowledge to make financial decisions. The study concluded that self-reliance could isolate people and cause them to rely on their own judgment when seeking advice might be more appropriate.

Hindsight Bias

Investing is an endeavor that requires constant gathering of information and updating an investment thesis. If you only focus on what you know, and never update your thesis with what you did not know, the thesis often proves to be incorrect.

Yet a common pitfall in the market is that many people think they know something when they really don’t. Behaviorists call this hindsight bias. When people are presented with new information, they think they knew it all along.

A 2008 study of bankers in London and Frankfurt found that hindsight bias causes people—even professionals—to inaccurately estimate asset returns, which leads to bad trades and hurts portfolio performance. Hindsight bias sufferers underestimate volatility, which leads to ineffective use of risk-reduction strategies. Of 85 bankers surveyed, bankers with the lowest hindsight bias made the most money. So, the inability in the market to be surprised, to learn from the past, and to reject hypotheses—even your own—can be very damaging. The 2008 study found that hindsight-bias traders failed to cut their losses at the optimal time while misinterpreting the informational content of new signals, such as earnings or macro-news.

The study found that hindsight bias kept investors from remembering how little they knew before observing an outcome, or getting an answer. The curious fact about overconfidence and the hindsight bias is that people are often incredibly confident they have no biases.

To circumvent those biases requires concerted effort. Sandy Frucher, vice chairman of NASDAQ OMX (exchange operator), has a simple definition of intelligence that may help: He defines

smart as knowing what you don't know. Whitney Tilson, a hedge fund manager, uses a checklist to battle overconfidence:

- Is this within my circle of competence?
- Is it a good business?
- Do I like management?
- Is the stock incredibly cheap?
- Am I trembling with greed?

Tilson also seeks out contrary opinions to rebut—rather than confirm—his hypotheses.

Simply slowing down is another tactic. Because the stock market is widely perceived through the prism of real-time news—CNBC, the Internet, blogs, websites, etc.—rather than through trading patterns and formulas buttressed by investment disciplines, there is often a sense of urgency to act now or miss out. Investors who make fast decisions often overemphasize recent stock returns. This compulsion is exacerbated by the concept of induced scarcity: Act now, because Hot Stock XYZ will not be available or the price will surge higher. Studies have shown induced scarcity is a tactic scammers use to compel people to buy now.

All of these forces conspire together and cause emotions—not the mind—to start making decisions. The mind should

function like a brake in a car; it should slow down the investment process. But, instead, the mind accelerates much like a car racing down the information highway, collecting fragments of ideas and creating patterns and models that might not really exist.

So much technology exists to animate the market that it is fairly easy to create a private stock market. Larry Summers, a former U.S. Treasury secretary, believes technology misleads investors. “It is like when you build better highways. People tend to drive faster. And actually more people end up dying in auto accidents on these new highways because they make a mistake in estimating how fast they can drive and they end up driving much faster than they should,” Summers said.

Conclusion

A review of key behavioral pitfalls that confront investors admittedly seems dour. But do not conclude that investing is so difficult, financially and psychologically, as to be beyond the knowledge of most people. Instead, conclude that investing is an endeavor of great nuance, worthy of serious study, in which consistent success comes to

those who identify and manage risk and then commit money to investments. This risk-adjusted way of thinking, coupled with a very keen understanding of the psychological influences in the market, will keep you grounded.

Paul Tudor Jones, who will always be counted among the world's great traders, believes most individual investors or traders lose money because they are not focused on making money. “They need to focus on the money they have at risk; how much is at risk in any single investment they have. If everyone spent 90% of their time on that rather than 90% of their time on pie-in-the-sky ideas about how much money they're going to make, then they'd be incredibly successful investors,” Jones said.

The market is so vast and complicated that it defies any one book or investing style. There is room for many ideas and disciplines. Two common denominators, however, span the spectrum. Understand how you react to market pressures, and remember the simple idea that bad investors think of ways to make money and good investors think of ways to not lose money. Do that, and you will inoculate yourself from the many pitfalls Mr. Market sets for investors. ▲

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