

Behavioral Errors Hurt Your Returns

An Interview With Daniel Kahneman

Article Highlights

- The real enemies of good returns are churning and a lack of diversification; individual investors fall for both.
- Misremembering outcomes and misattributing outcomes causes investors to be overconfident and hyperactive in trading.
- In the financial domain, individual investors should take advice from advisers who are realistic, not optimistic.

Daniel Kahneman is a senior scholar at Princeton University's Woodrow Wilson School of Public and International Affairs and the 2002 winner of the Nobel Memorial Prize in Economic Sciences. His book "Thinking, Fast and Slow" (Farrar, Straus and Giroux) was published last fall. I spoke with him recently about the impact of behavioral errors on investment performance.

—Charles Rotblut, CFA

Charles Rotblut (CR): You opined as we sat down that individual investors should use index funds instead of picking their own stocks. Could you explain why?

Daniel Kahneman (DK): Well, there is research for that. The research I have in mind was done by my former student, Terry Odean, who is now a professor of finance at the University of California–Berkeley. He did a study of the decisions of individual investors who sell a stock and buy a stock, which means that they are not selling it for liquidity; they're selling it because they believe the stock they sell is inferior to the stock they buy. There is no other reason.

Now, when you wait a year, and you look at the value, on average, of the stock that individual investors sell and the stock they buy, then you get a difference of 3.5%, roughly, almost 4%. So that means every action the individual investor takes has negative expected value. On average, they lose, and the more ideas they have, the more they lose. Women do better than men because they churn their accounts less. The real enemies of good returns are churning and lack of diversification. Individual investors fall for both of those.



So that would be my advice: Avoid churning and avoid making decisions, because individual investors are really, by and large, not equipped to make the decisions.

CR: Is there a particular behavioral error that you have seen, in terms of what errors investors make or what is causing them to make errors?

DK: Sure. But it's not an error that you can fix. They sell the wrong stock, and they buy the wrong stock.

People tend to sell their winners and hang on to their losers. That is, they sell stocks that have done better than the price they bought them at. Now, this is a really bad idea, and it's a bad idea because, by and large, there is short-term momentum in the market. Because there are large tax consequences, other things being equal, you should sell losers. But the tendency to stick with your losers and sell your winners is a very big deal. So that's one thing.

Then, people buy the wrong stock. They tend to buy stocks when there is news, good news or bad news. And we know that institutions do better than investors because they do not respond in the same way to news. This is other work that Terry Odean and Brad Barber, a professor at the University of California–Davis, have done.

So, by and large, it's unequivocal: If you're an individual investor, you're likely to lose when you buy and likely to lose when you sell. We also know that individual investors who follow funds tend to buy into a fund when it's been doing well and tend to sell it when it's low. So you can have a fund that is doing very well, but of course it fluctuates, and the aver-

age investor in that fund loses money. And there's no contradiction, because the average investor buys at the wrong time and sells at the wrong time. It's not something people should do.

CR: *Do you think investors just want to be part of a herd, or is it that they're overconfident?*

DK: It's mostly overconfidence. People think they can pick stocks, but in fact they can't. They have a subjective feeling of confidence and certainty that is not justified by anything, and that's what drives them to do it.

Investors also misremember their outcomes and misattribute their outcomes. So, in a rising market, individual investors tend to feel that they're geniuses because the results are good. They blame the market when things collapse, but they take credit when things go well. This bias tends to make them overconfident and hyperactive.

CR: *Do you think it's hindsight bias? I know you wrote about that in your book, "Thinking, Fast and Slow." Do you think they're overestimating how well they've done in the past?*

DK: Yes, there clearly is a selective memory of successes and failures so that, in addition to all the other biases, people get the wrong idea about how good they are. And they tend to exaggerate how well they are doing.

CR: *I know you've also talked about overconfidence on the part of CEOs. Do you perceive that as also being a risk?*

DK: Well, it's very clear that highly optimistic CEOs take more risks. Interestingly enough, there is evidence, which I think I cite in the book, that when a CEO who is highly optimistic takes over, the stock market responds negatively. So there is enough knowledge in the stock market to evaluate the fact that optimistic CEOs tend to take risks.

CR: *In your book, you said that overconfidence also plays a role in mergers, correct? That mergers don't tend to be profitable.*

DK: Yes. By and large, mergers are not profitable on average. I think the dominant theory of that is still a theory by Richard Roll, from the University of California—Los Angeles. It's an old theory known as "the hubris hypothesis." You see the other company doing badly, you think that they are very poorly managed, and you are confident that you can manage their company better than they can. Well, it turns out that, on average, that isn't really the case.

CR: *Maybe the core of all these errors is that people think they're better than average?*

DK: Yes. Of course, people do think they're better than average in many domains. Overconfidence has many sources. It keeps us cheerful, so it's a very good thing. Optimists are healthier than pessimists, and they have a better time. But, in the financial domain, I would say, the individual investor has no business being there. And should they have to take professional advice, I would say that they should not take advice from optimists.

CR: *So find an adviser who's more of a pessimist?*

DK: No, a realist! You know, having a CEO who is an optimist has certain benefits, because their enthusiasm is catchy. But having a financial adviser who is an optimist is completely useless.

CR: *In your book, you talked about System 1 and System 2. Could you explain what those are?*

DK: System 1 is intuitive thinking, which is most of what we do, I think. And System 2 is self-critical, reflective, deliberate thinking. And we feel we do a lot of that. But, in fact, much of what System 2 does is explain and rationalize

and apologize for the choices and beliefs of System 1.

CR: *And when people start panicking when the market takes a big drop, that's System 1 taking over?*

DK: Well, System 2 could also, not panic, but decide that if things are going badly, it's time to get out. But, certainly there is an emotional component.

And beyond a certain point, when the world becomes highly uncertain, we tend to act as other people do. Herding tendencies are likely to be enhanced in periods of crisis, and that is going to cause a great deal of volatility.

CR: *Besides indexing, what can people do to avoid making errors? Or, even if they are indexing...*

DK: The real problem that most people have—which wouldn't apply to your individual investors—is that they just don't save enough. So that's a problem. Individual investors are people who are saving. I would say not saving is the biggest problem.

And the errors that individual investors make are, for example, ignoring fees. It looks as if the fees account for so little of the variance. But fees are a sure thing, and they certainly erode your earnings over time.

CR: *In terms of how investors evaluate their performance when they're working with an adviser: I think you wrote about how people blame the leader in charge.*

DK: Hindsight is very pernicious. So whenever something goes wrong, it is very likely you're going to blame your adviser.

Hindsight and regret are something that financial advisers must anticipate. They're really noxious, because hindsight and regret cause people to make mistakes—to overreact when things are going badly, and so on. ▲

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