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Investmental illness: A guide to getting well

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Investing, in theory, is very simple: Buy low and sell high. That means you must sell when others are buying and buy when others are selling. But even simple things can be extremely difficult to do.

Think back to 1999. Imagine that you'd made a lot of money over the past couple of years in tech and Internet stocks. Your friends profited handsomely, too. Positive reinforcement was everywhere. Every time you picked up an investment magazine or flipped on CNBC, financial analysts Henry Blodget and Mary Meeker were touting the very same stocks that you'd discussed with your friends -- and validating your investment decision not to sell. Even to buy more.

If you had expressed skepticism -- or worse, mentioned selling -- you would have had to overcome a good deal of negative reinforcement. Your friends would have pooh-poohed your pessimism. "Doom and gloom!" they would have chanted.

The thing is, you would have been right.

This is the world of investor psychology -- where "investmental health" is a topsy-turvy, Alice-in-Wonderland inversion of popular sentiment. The superior investor must be willing to appear crazy, risking ostracism by his or her friends. And the sanest among us will -- at market tops and bottoms -- appear out of touch, stupid or just plain nuts.

The discipline

At the nexus of psychology and investing lies an obscure academic field known as "behavioral finance." Behavioral patterns of theoretical "rational" investors are well-understood. And much economic theory is predicated on the assumption that markets are rational. But if markets are rational, they are made up of a lot of irrational people! Behavioral financiers try to answer this question: What happens when financial theory intersects with flawed human beings who are motivated not by pure rationality, but by personal and brand-name loyalties and the twin engines of fear and greed?

Behavioral finance experts have studied the problem and have found that, far from being rational, investors in the real world are often wracked by extreme emotional disturbances. Most mental maladies fall into two broad categories: narcissistic delusions and loss-avoidance disorders. These conditions afflict investors just like us. But we can do things to inoculate ourselves against them.

Below are some common afflictions:

- [Testosterus](#)
- [Alfred Hitchcock syndrome](#)
- [I'll-be-darned-itis](#)
- [Allaboutmesis](#)
- [Whatifitis](#)
- [Agoraphobia](#)

Testosterus

An irrational and frequently obnoxious overconfidence in one's own investment prowess, this narcissistic condition is so named because it is far more common among men than women. The ailment has been well-known among women for some time but was first quantified by researchers Brad M. Barber and Terrance Odean.

Looking at data from 45,000 different investors between 1991 and 1997, Barber and Odean found that overconfidence in trading ability caused men to trade more often than women -- a lot more. The men in the sample, all told, traded 45 percent more on average than women. As a result, the increased transaction costs and taxes associated with frequent trading shaved 2.45 percentage points off men's total returns every year, compared with just 1.75 percentage points for women.

The thing is, men and women look at money in different ways, says Nancy Langdon Jones, a financial planner who practices in Rancho Cucamonga and Claremont, Calif. "For women, money means security. For men, it means power."

Matt McGrath, a planner with the Miami area wealth management firm Evensky & Katz, agrees. "Most of our couples seem to fit the stereotype," he says. Men tend to be more aggressive, while women are often more conservative and circumspect -- sometimes to the extent that they separate their accounts completely.

Treatment: Treating testosterus can be tricky. Its victims frequently resent the therapy. Consider channeling the same masculine energy into fee reduction instead. Low-cost investment strategies, such as indexing, also tend to be tax-efficient. Women, be sure to praise your brachiating, bellowing spouse for his scintillating foresight when he takes measures to reduce fees. After all, a reduction in fees is free of risk, and the potential upside is powerful.

Consider the erosive effects of trading costs on the portfolios of a typical male afflicted with testosterus versus that of a woman, using Barber and Odean's numbers. Over 30 years, a \$10,000 investment earning a 7 percent annualized return, minus costs, would be worth about \$38,000 for a man versus roughly \$46,400 for a woman. The \$8,400 difference might be enough to fund a midlife crisis.

Alfred Hitchcock syndrome

Sufferers of Alfred Hitchcock syndrome frequently invest by looking out the (ahem) "rear window" instead of at the road ahead. In advanced stages, sufferers of this syndrome may also exhibit religious delusions, as they begin to worship at the "Church of What's Working Now." This is dangerous, because what's working now has a way of not working for very long. These investors, therefore, run the risk of buying into asset classes after most of the money has already been made.

Case in point: The top mutual funds in 1999 were Internet and Japanese small-cap funds. And investors flocked to them in droves. As the year drew to a close, Jim Callinan, portfolio manager of RS Emerging Growth, won Morningstar's top honors as fund manager of the year, with a stunning 183 percent return on the strength of then red-hot Internet business-to-business plays. Callinan made the cover of investment magazines everywhere, and investors, suffering from the throes of Alfred Hitchcock syndrome in its then-terminal phase, piled into the fund, based solely on his accomplishments of the previous two years. The rear window was enticing, indeed.

Within weeks, the stocks in Callinan's portfolio began to hemorrhage value: The fund lost 25 percent in 2000, 27 percent in 2001 and then 40 percent in 2002. Callinan's returns, relative to aggressive growth peers, were in the bottom 15 percent of his category in each of those three years. The fund has still not caught up to its 1999 peak. Everyone who bought the fund half a decade ago on the strength of short-term results has lost money. Such is the destructive power of Alfred Hitchcock syndrome.

Treatment: To combat Alfred Hitchcock syndrome, ask yourself some questions concerning your portfolio:

- For what reasons will this security or fund outperform the market going forward?
- If I never knew what this investment had returned in the past, would I still buy it today?
- Is the fund manager taking inordinate risks to provide the returns he or she is getting? Can I afford those risks? Is there a way to hedge it away?
- If there is no reason to believe this investment will outperform the market in the future, would I be better off in an index fund?
- (If you hold a position:) Is the reason I bought the fund or security in the first place still valid?

"I usually walk people through market history," says Margaret Starnier, a financial adviser in Coral Gables, Fla.

Her advice: Remember the big picture. Things that looked good last year are unlikely to continue their outperformance. Diversify.

I'll-be-darned-itis

Afflicted investors are unable to sell obviously failed investments -- even after their original investment thesis has collapsed -- because of an irrational aversion to admitting error.

Victims of I'll-be-darned-itis will hang on to investments, confident that they'll be able to break even down the road, even though superior investment alternatives exist, and they could easily sell, take a capital gains loss and reinvest their money more profitably elsewhere.

Treatment: Experts advise investors to accept responsibility for the mistake and move on. "We always ask our clients, "Would you buy the stock today?" says Matt McGrath, financial planner with the Miami area wealth management firm Evensky & Katz. "Every day you own a stock, you are effectively buying it all over again."

Allaboutmesis

Many investors afflicted with economic narcissism disorders succumb to self-attribution bias. They tend to claim credit for successful decisions, while minimizing their own involvement in unsuccessful ones. They may blame others, such as an adviser, a family member or the media for their own poor decisions. (A somewhat related disorder, investment amnesia, is simply the inability to recall bad decisions.)

As a result, investors suffering from allaboutmesis have inflated opinions of their own investment acumen. Symptoms include the following:

Allaboutmesis symptoms:

- Frequent trading.
- Rapid hiring and firing of investment advisers.
- A preference for individual stock investing over mutual fund investing for reasons unrelated to flexibility with realizing capital gains.
- A propensity to file suitability lawsuits against brokers and advisers who may have even warned them about the riskiness of their decisions at the time the poor investment decisions were being made.

"A lot of clients brag about how well they've done," says Matt McGrath, financial planner with the Miami area wealth management firm Evensky & Katz. "We always invite them to bring in their statements so we can help them track their outside investments. Somehow few people actually come up with the goods."

Whatifitis

This loss-avoidance ailment is characterized by an irrational and often paralyzing fear. In Freudian terms, the investor's "id" assails the "ego" and floods his or her mind with images of negative consequences -- drowning out the possibility of investment success.

Those who are afflicted by this condition constantly ask "What if?" and are so fixated by the possibility of loss or underperformance that they take no action, even where action is warranted.

Whatifitis symptoms:

- Lack of participation in 401(k) plans.
- Long-term retirement savings placed in short-term savings vehicles such as money market accounts -- when victims manage to save at all.
- Long-term savings that chronically lag the pace of inflation.

Treatment: Consider carving out your basic needs for the next two years, and putting that into a separate account, says Matt McGrath, financial planner with the Miami area wealth management firm Evensky & Katz. "That way you can take your focus off the short-term impacts and focus on the long-term plan for the rest."

Agoraphobia

This real-world phobia is the fear of going outside. In the investing arena, it typically manifests itself in a debilitating inability to invest outside of one's own employer.

Many investors are intimidated by the countless choices available in their 401(k) plans, for example, and believe -- falsely -- that they are making the safe choice by electing to invest in "what they know." The result: These investors wind up putting all their retirement money in the fortunes of a single company -- the same company upon which they also rely for their salary. It's a high-risk approach.

Treatment: Experts say diversification among various asset classes is the best way to manage risk. For the domestic portion of your portfolio, an investment in a broad index of U.S. stocks is actually a simpler bet to understand than an investment in one's own company, because individual companies sometimes fall on hard times and never recover. But the investor in a broad index fund is betting that the economy will continue to grow and that American business will figure out a way to continue to generate wealth.

Stock markets have ups and downs, to be sure. But when time horizons are still measured in decades, the American economy is still a pretty safe bet. So get your shots, and bring a raincoat. But it's OK to go outside.

These are just a few of the many investmental disorders that sabotage the decisions of millions of investors. It may be tempting to write off behavioral finance as the study of investor stupidity. But this temptation is itself rooted in dysfunction. The reality is that these so-called disorders are simply human nature. And investmental illness, to some

degree, afflicts us all.

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