Investment Psychology

Common Mistakes of Every Investor

Introduction

- Understanding big money blunders
- Lessons from Behavioral Economics
- You are not alone

Introduction

- Some questions to wonder:
  - Why are we willing to spend so much more to purchase products on credit than with cash?
  - Why are we happier with a 10% raise when CPI growth is 12% than a 4% raise when CPI growth is 3%?
  - Why do we buy expensive insurance packages for an improbable event and lottery tickets for an improbable event?

Outline

1. The Sticky Number
2. Confirmation Bias and the Power of Expectation
3. Loss Aversion and Sunk Cost Fallacy
4. Number Overload
5. The Inflated Ego
6. “I Herd About It”
7. Conclusion

The Sticky Number

It was recently discovered that Tutankhamun, the Pharaoh from ancient Egypt died from a disease, not physical assault. Did this happen before or after 3000 BC?

The Sticky Number

People’s “estimates” are noticeably (and dangerously) influenced by the anchors (reference points) they see. Some more examples:

1. Believing Apple is a screaming buy because it “was worth” $200 only a few months ago—it “looks cheap”
2. Refusing to buy a house (or a stock) for more than what it was worth “just recently”

Concrete Studies

1. 1987 study by Gregory B. Northcraft from University of Arizona and Margaret A. Neale from Stanford University
    1. **Experienced** real estate agents appraised a home
    2. $75,190 if the list price is $83,900
    3. $67,811 if the list price is $65,900
2. Researchers conducted an experiment at the Sloan School: Students were instructed to write down the last two digits of their SSN, and asked if they would bid that much for an item

Real World Example

Savador Assael single-handedly created the black-pearl market, which was inexistent in 1973.

1. His original attempts were failures.
2. His friend put black pearls in stores and sold them for outrageous prices, and featured them in glossy magazines next to diamonds and rubies
3. Soon, they were considered precious

Confirmation Bias

- We see what we want to see
  - Positive news regarding stocks we own
  - Negative news regarding stocks we *should* own (but don't)
- More expensive things seem better

Scientific Studies

- Experiment on MIT students: They tasted two beers. The only difference is beer 2 had vinegar
- Expectations altered experiences
  1. Told that beer 2 had vinegar: beer 1 better
  2. Uninformed of the vinegar: beer 2 better
- Another experiment:
  1. Students were told of the vinegar after tasting the beer
  2. They did not change their opinions of taste

Suggestions

1. Broaden your adviser base
2. Research
3. Be realistic and take a long-term view
4. Recognize your mistakes

Loss Aversion

I offer you 1000 dollars and two options:

1. I flip a coin: Heads, you win an additional $1000.

   Tails, you win nothing.

2. $500 guaranteed

Which would you take? 1 or 2?

Loss Aversion

I offer you 2000 dollars and two options:

1. I flip a coin: Heads, you lose $1000. Tails, you lose nothing.
2. You lose $500 guaranteed

Which would you take? 1 or 2?

Loss Aversion

- The two games are the same: Option 1, bet between $2000 and $1000; option 2, $1500 guaranteed
- Prospect Theory
  - People do not consider the effects of losses and gains on their entire wealth
  - Instead they focus on the emotional consequence of the loss or gain itself

Selection vs. Rejection

- You have two stocks A and B, and you can keep only one of them. What you do depends on how you're asked:
  - Which would you like to keep?
  - Which would you like to sell?
- When selecting, you focus on the positives
- When rejecting, you focus on the negatives

Sunk Cost Fallacy

- A group of moviegoers was randomly selected
- Half of them were given random discounts
  - They were informed that the discounts were part of a promotional deal
- Those who paid more for the movies attended more

Suggestions

- Diversify across securities with low covariance
- Make up your price before seeing others’
- Remember the big picture
- Stop dwelling on the past
- Reframe games to be neutral: i.e. the Loss Aversion example will be a toss between \$1000 and \$2000; vs. a sure return of \$1500

Conclusion for Today

- We examined the psychological mistakes everyone makes regarding money
- You are not alone: Smart people aren't immune
- Many flaws are similar
    1. Sticky number
    2. Confirmation bias
    3. Sunk Cost

Goals for Next Time

- More common flaws
  1. Number Overload
  2. Inflated Ego
  3. Herd Mentality
- Examine how to exploit these tendencies
- Study how these mistakes apply to investing