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# You're a worse investor than you think

By Jill Schlesinger

The 2017 Nobel Prize in economics has been awarded to Richard Thaler of the University of Chicago for research showing how our emotions can impact economic decision making. Thaler's body of work has built on that of Israeli psychologists Daniel Kahneman and Amos Tversky, who 40 years ago showed the ways in which the human mind systematically errs when forced to make judgments in uncertain situations.

Thaler's specialty, sometimes called "behavioral finance," can be helpful in explaining why so many of us become our own worst enemies when it comes to investing. The problem is simple: Human beings are not always rational. The Nobel committee said Thaler's work has painted a "more realistic analysis of how people think and behave when making economic decisions ... by exploring the consequences of limited rationality, social preferences and lack of self-control." Here are just four ways our emotions can betray us:

--Confirmation bias: Who doesn't want confirmation that he or she is "correct"? Whether we are articulating a political position or choosing a restaurant or weighing an investment, we seek out experts and information that confirm our beliefs. So if you believe that the stock market is likely to keep rising -- or, conversely, that a crash is imminent -- you are likely to find affirmation of those views as a rationale for continuing to hold them. The best way to fight confirmation bias is to find credible sources that argue the other side, and to resist any urge to outguess the trend by sticking to a diversified portfolio, which you rebalance on a periodic basis.

--Recency bias: We tend to remember recent events more vividly and give recent information more weight than historical information. That can cause us to believe that what's happened recently will continue to occur. Investors are constantly influenced by this bias: When stocks are trading higher, investors erroneously believe that the trend will persist, and when they tumble, they cash out and hide, thinking that stocks will hurtle toward zero. Recency bias is the reason securities law requires that every investment disclosure contain this sentence: "Past performance is no guarantee of future results."

While many gloss over the warning, they do so at their own peril. These investors may chase performance, ultimately causing them to underperform the very indexes into which they're pouring their money. When markets are reaching new highs or lows, fight this bias by returning to the reasons that you are investing, and remind yourself that there is no reason to alter your plan.

--Mental accounting: Thaler has found that "people simplify financial decision-making by creating separate accounts in their minds, focusing on the narrow impact of each individual decision rather than its overall effect." For example, we treat employment income differently than money from a windfall, like an inheritance. Or when someone holds an outsized proportion of her portfolio in a specific stock -- maybe because of a legacy with that company or because it has been a strong performer -- she can get emotionally tied to it and make bad decisions about its disposition. Investors can manage mental accounting by limiting any individual stock position to 5 percent of their total portfolio.

--Illusion of control bias: Some investors want to believe that with time, energy and focus, they -- or some other expert -- can determine which assets will outperform others, and therefore they can control investment outcomes. Sadly, Mr. Market consistently proves them wrong. It is difficult for many to face the fact that the market can be irrational, unpredictable and volatile in the short term. The best way to combat that fact is to accept it and create a plan that accounts for variability.

(Note: there are several other bias's that affect our behavior, including optimism bias (only bad things happen to others); gambler's fallacy (without real evidence a future event has to occur);  hindsight bias (past events were predictable – such as the Tech Bubble of the 1990's or the 2008 crash – which then leads to overconfidence bias; Herding (see the Tech Bubble – if everyone else is investing in the same way, it must work); and so on.