

FINANCIAL FREEDOM PERSPECTIVES



Williams Financial Services Corporation

September 2013

HOW OUR INSTINCTS SHORT-CIRCUIT OUR INVESTMENTS



By Kevin Q. Williams,
Owner, Williams Financial
Services Corporation

Despite the abundance of financial information available to us, we are not always rational human beings. In fact, according to Dan Ariely, author of *Predictably Irrational* and *The Upside of Irrationality*, we are more like “Homer Simpson” than “Spock” or “Data” of Star Trek in the continuum of emotional to rational characters. Ouch! The issue is that we have these natural instincts that can make investing quite challenging. These primary emotional flaws are seeking patterns, repeating our mistakes, and fearing loss.

Many consider how the brain looks for patterns that are not actually patterns one of its more fascinating flaws. It appears that we are incredibly clever about providing causal explanations about random events. According to Daniel Kahneman in his book, *Thinking Fast and Slow*, a research study of schools incorrectly concluded that small schools were more successful than large schools. It was quite simple to provide a plausible explanation that smaller schools can provide more attention and encouragement than larger schools. The flawed explanation made sense to many, including the Gates Foundation which made a substantial investment in creating smaller schools, sometimes splitting larger schools into smaller units. The identification of perceived patterns gives humans the seduction

of certainty. The search for certainty leads to false conclusions and bad decisions. Likewise, for decades, people have explored the use of algorithms to predict the markets. Yet, all the PhDs and technicians using algorithms and charts have failed to accurately predict the market. The natural instincts of looking for patterns actually steers us wrong when making financial decisions.

The second disturbing challenge is, when emotions lead us to make bad decisions, we are likely to repeat those bad decisions. According to Dan Ariely, the emotion that prompted the first decision would not need to be present for a person to continue making the same decisions that were previously made under emotional duress. He provides an example of a couple developing a repertoire of behaviors and decisions as a result of dealing with emotional life issues such as money, kids, and in-laws. These short-term emotions that are left unchecked can lead to a pattern of bad habits such as smoking, over-eating, or drinking. The concept of repetitive behaviors might also help explain why the Dalbar studies show that individual investors working on their own fail to achieve the gains that the stock market provided over twenty year periods. It would seem to reason that these solo investors are making the same mistakes repeatedly. Short-term emotions could also lead to other bad financial habits such as overspending. This bad habit crowds out not only savings, but it also crowds out other critical expenditures such as insurance and estate planning. Moreover,

overspending leads to fewer savings, which in turn makes a person more susceptible to the third emotional challenge, “loss aversion.”

“Loss aversion” is the most recognized flaw of the brain. The emotional part of our brain punishes us more for a loss than rewards us for a gain. Yet, in order to profit, one must take risk. Peter Diamondis in his book, *Abundance*, offers a hypothesis that our fear of loss comes from the idea that early man had to be attuned to danger in order to survive. Today, when the markets trend downward, people sell because of the perceived danger of loss. The investor erroneously equates volatility with loss. Individual investors not only have to deal with the above mentioned cognitive errors, but there may be as many as ten to twelve cognitive biases that challenge the investor decisions, which begs the question how can the individual investor be sure that he is not falling prey to any one of them at any given time?

There is hope for us “Homer Simpsons,” and a different way to go about our investment decisions. We need to work with a team. According to Dan Ariely, we need to test our decisions and assumptions. Hospitals and fighter pilots are two groups that are making split-second, life and death decisions. Yet, these two

groups have decreased errors by implementing programs where the teams go through exhausting debriefing and anyone on the team can express ideas or challenge procedures. In a similar fashion, when it comes to making financial decisions, we need to build a team. A wealth manager is like a team leader. Other members of the team might include a CPA, an attorney, and an insurance professional.

While wealth managers assist clients in maximizing cash flows, minimizing taxes, and transferring wealth to future generations, it is the investment counseling advice that helps in overcoming the emotional obstacles of investing. They can assist investors in weighing all of the alternatives with the goal of creating a customized wealth strategy that reflects the investor’s goals, values, tax perspective, and risk tolerance. Moreover, wealth managers usually offer a second opinion service for investors that are considering significant changes to their portfolio. This service can help investors determine if the changes are prudent or emotionally based. Wise investing recognizes that we are individually impaired in our investment decisions due to the way we are wired. Creating a team headed by a wealth manager can keep our emotions from derailing our investment goals.

Investments will fluctuate and when redeemed may be worth more or less than when originally invested. Past performance is not indicative of future results.

Kevin Q. Williams, MBA, CPA/PFS, CFP® is a financial coach to successful business owners and families in the Baltimore-Washington, D.C. area. For over 20 years, Kevin has been helping clients make smart financial decisions, so that they can leave a legacy to future generations.

*Securities & Investment Advisory Offered Through H. Beck, Inc. Member FINRA, SIPC
Williams Financial Services Corporation and H. Beck, Inc. are unaffiliated.*



Williams Financial Services Corporation

www.kqwcpas.com