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summaries

SIGMA INVESTMENT COUNSELORS

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Emotional Behavior

We believe a large part of our responsibilities to clients is removing emotion from the investment process. Keeping clients invested when it is the most painful can potentially add the most value to our client portfolios. We've survived the toughest of markets with our clients, and are trained to recognize various behaviors and guide our clients away from emotional decisions. We thought we would take the opportunity here to discuss a few of these behaviors with you, so you can have a better understanding of our processes and how we make investment decisions for our clients.

Rational behavior is defined as "a decision making process that is based on making choices that result in the most optimal level of benefit or utility for the individual." In every choice we encounter as human beings, we apply some decision making process while weighing the costs and benefits to achieve the most benefit. Which college should you attend? Should you relocate for a job? Where should you purchase a house? The majority of economic theory is based on the assumption that individuals are rational and decisions are based on receiving the most monetary or material benefit. In the real world humans operate more on emotional benefit than most economists would prefer. College decisions are based not only on tuition costs, but also winning football teams. Job relocation decisions are based not only on salaries, but also proximity to family. Home purchases are based not only on prices, but also style.

When it comes to money and investing, people are not always as rational as we think we are. This is why there is an entire field of study focused on explaining our sometimes odd behaviors and decisions. Behavioral Finance uses social, cognitive and emotional factors to understand the decision making processes of individuals and their effects on market prices and returns. An understanding and awareness of these behaviors can help us identify them in others and avoid them in our own decision making.

There are many different behaviors we could write about. We will touch on the most frequent ones we encounter which are loss aversion/avoidance, mental accounting, anchoring, and overconfidence.

Loss aversion/avoidance - Investors find losses much more painful than they find gains pleasurable. A $10,000 loss hurts more than a $10,000 gain feels good. To avoid the pain of a loss, investors sometimes want to hang on to losers (not treating it as a loss until it's realized). If you do nothing and you are wrong, it doesn't hurt as much as proactively making a bad decision. Sometimes this can work in your favor, but since the decision to remain invested is no longer based on fundamentals and is now based on emotion, it is largely left to chance. In order to avoid this behavior, investors should remember what happens to a stock price has nothing to do with your ownership. The stock price today has no relation to the price you paid for it. You should consider the investment against other possible investments, and realize by holding it you could be losing opportunities.

Mental Accounting - Mental accounting describes the process where people separate their money into accounts for different reasons. As an example of this, a commonly cited study asked participants what they would do if they lost a $20 ticket on the way to a show. More than half said they would write off the night and go home. But when asked if they would still purchase a ticket if they lost a $20 bill on the way to the show, almost 90% said they would. Either way, they are still out $20. While mental accounting can be helpful for budgeting and planning, an example of where it can become a problem is when an investor separates the components of total return (income and capital appreciation). An investor may be inclined to hold a stock because they really like the high dividend yield, even though the price of the stock is declining. Focusing on the total return of the investment is the best way to avoid this behavior.

Anchoring - The concept of anchoring is based on our tendency to "anchor" our thoughts to a reference point, even though it has no relevance to the current decision. People make estimates of value based off a set starting point. When you go to buy a car, the salesman will always start the sales process with a high price, so when he offers you a lower price, you think you are getting a deal. Investors often look at recent high and low prices to determine value. The investment decision should be made based not on historic prices, but on the company fundamentals and prospects going forward.

Overconfidence - Fans of Garrison Keillor might be aware of his fictional boyhood home of Lake Wobegon, Minnesota "where all the women are strong, all the men are good looking, and all the children are above average." The Lake Wobegon effect is a perfect description of overconfidence, or overestimating one's capabilities. Overconfident investors can often be correct. However, they need to remember that as thorough and in depth their research could be, they are typically wrong about as often as they are right. Many different factors beyond their control can impact market prices (including some of the prior behaviors described). Overconfident investors also show a tendency to trade more rapidly, because they think they are smarter than the person on the other side of the trade. Unfortunately, the odds show that half the time the seller is getting the better deal and half the time the buyer is getting the advantage. Even the most impressive investment managers struggle some years keeping up with the market. Smart investors know each day brings a new investment challenge and techniques need constant refining. Investors will get some decisions wrong and some decisions right (hopefully over time the right slightly outweigh the wrong).

Behavioral finance, not only applies to financial planning but also to our stock analysis. Through our research, we can determine a stock price to be overvalued based on fundamentals. However, a beloved brand or product could drive emotional buyers to the stock and drive the price higher. It is nearly impossible to project what investor emotions will be in the future. We are constantly monitoring economic data and projections to make our most educated estimates. Behavioral finance is a soft study and very different than other pure number crunching analysis we do, and it can definitely make the investing process very interesting.

Marisa A. Lenhard, CFA

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Please note that on March 11, 2011 we are moving our offices to The American Center, 27777 Franklin Road, Suite 1100, Southfield Michigan, 48034. This is not too far from where we are presently located. We will be having an open house in the near future to show off our new surroundings, but feel free to drop by sooner if you would like. More importantly, remember this address if you already have a meeting scheduled after March 11th with someone at our firm so you don't end up at the old address. Our phone (248-223-0122) and fax (248-223-0144) number will remain the same.

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