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Don’t let your emotions guide your investment decisions

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We like to think of ourselves as rational decision-makers, yet study after study shows the average 401(k) investor makes a lot of irrational investment decisions.

Too often we chase top-performing funds, sell in a panic after a market downturn, or fail to take advantage of one compelling investment opportunity after another.

Daniel Kahneman, winner of the Nobel Prize in economics for his work in the field of human judgment and decision-making, spoke recently at a conference and offered some compelling explanations for why investors so often make mistakes.

His comments focused on two common mistakes investors make and explained why we are so susceptible to systematic errors in judgment. His findings may surprise you, but more importantly, they may help you become a more successful investor.

Hindsight bias

One of Kahneman's primary areas of research explores the way our brain processes information and the effect this process has on our perceived ability to predict the future.

His studies show that we remember things through the lens of what actually happened, quickly forgetting what could have happened, but did not.

When we look back at recent market activity or fund performance, our brain naturally amplifies the events that led to the result we witnessed and diminishes the events that would have led to the alternate outcomes that did not occur.

Because the events that caused the markets to move are amplified, they are more easily remembered. This creates the illusion that the future is easier to predict than it actually is, causing us to overestimate our ability to predict the future. This illusion it what Kahneman has labeled "hindsight bias."

The problem for investors is that hindsight bias affects our reaction to investment results because the causal factors seem so much more obvious, in hindsight, than at the time the decision was made.

The power of regret

When an investment we make doesn't quickly turn out as planned, the reaction we can experience is the powerful emotion known as regret. Fueled by hindsight bias, feelings of regret can be strong enough to motivate us to act, and in the case of investment decisions, often in an unprofitable manner.

How often have you felt that it was so obvious, after the fact, that a certain investment was going to be a big winner, yet you failed to act on this "knowledge?" The easiest remedy for such a feeling is to buy that investment after the fact, thus relieving the feeling of regret.

What about when you've made an investment decision that at least initially did not work out as planned?

The strong feeling of regret that develops, because in hindsight the now "obvious" factors that made this investment a bad idea, is most easily relieved by selling.

Recognizing the appearance of regret and understanding the likelihood that it has been artificially enhanced by the way you process information can help you combat this poisonous feeling before it causes you to make an actual mistake.

Loss aversion

This second kind of bias, known as loss aversion, causes investors to miss out on profitable investment opportunities because they carry some risk and ultimately reduces one's chances of being a successful investor.

Kahneman's studies have demonstrated that the average investor derives about 21/2 times the amount of emotional pain from a loss than the amount of pleasure they receive from an equal-sized gain.

A common example of this bias is if someone offered to pay you $130 if the coin they toss comes up heads, but you have to pay them $100 if it comes up tails. Most people decline such a bargain because the pain of the potential loss outweighs the potential pleasure of the gain.

Yet, in life we are confronted with a constant stream of such bargains which, when taken together, offer compelling odds of building wealth.

Too many investors decline these bargains, which ends up robbing them of valuable gains.

Kahneman's work demonstrates that the way we process information and human emotion make us susceptible to investment mistakes. Whether it's regret-driven buying high and selling low or fear-driven failure to make winning wagers, we need a plan to overcome these obstacles to investment success.

My advice is to develop a disciplined investing strategy, based on your long-term investment goals and individual risk tolerance level. Once in place, successful investors are the ones who focus on the strategy and ignore screaming market pundits and their own emotions.

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