

INVESTING » THE FEAR FACTOR

Psychology is the key to portfolio happiness

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I'm starting to think that, for most investors, it's impossible to buy low and sell high. People who want to buy socks on sale prefer to buy stocks only after the price has moved up.

During the recent market lows some of my friends told me that they had stopped buying stocks. They were waiting till the market got back up on its feet, the coast was clear and the situation was no longer scary. The market has since risen more than 30 per cent, but I suspect most of them want to see it go still higher before they buy. Then they'll feel better.

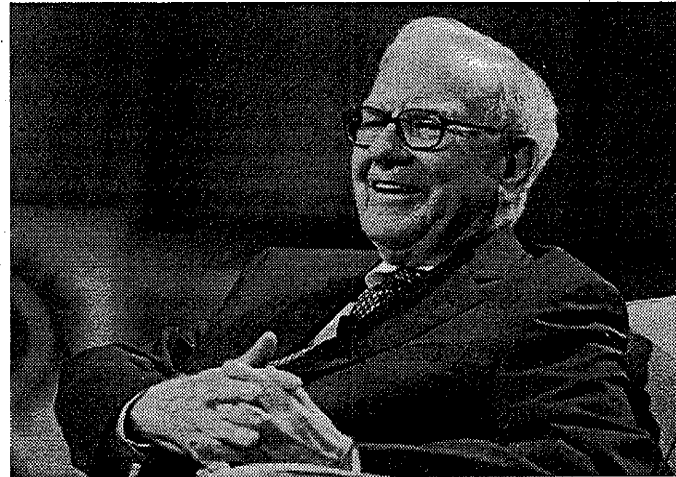
Why exactly do people act irrationally when they invest money? About 40 years ago psychologists began to study this question. The pioneers, who first described how humans display suboptimal economic behaviour, were Nobel laureate Daniel Kahneman and his colleague, Amos Tversky. They and their successors have been able to identify instinctive mental habits that most people fall back on, often to their disadvantage.

For example, most of us have trouble estimating the expected gain or loss from an event. We tend to focus on the imagined impact of the event rather than its likelihood. This leads to expenditures on items such as lottery tickets and accidental death insurance sold in airports.

Research has shown that the negative psychological effect of a financial loss is far greater than the positive effect of a financial gain of the same magnitude. This short-term loss aversion explains, in part, why many people instinctively prefer to invest in bonds rather than stocks, particularly after a year such as we have just experienced. Given the historical after-tax returns from these two asset classes, choosing bonds over stocks is, over time, likely to prove an expensive error.

Our behaviour can be explained by evolution. Our brains are built to allow us to survive in a world far different from the world of today. We have evolved as a separate species over 130,000 years. For more than 98 per cent of that time, we lived as hunter-gatherers. And the way our minds work today reflects that fact.

Hunter gatherers have no



Warren Buffett, chairman and CEO of Berkshire Hathaway, takes the long-term view in his investment strategy. MATT SAYLES/ASSOCIATED PRESS

need to spend a lot of time looking far into the future. Moving around in tribes to find one's next meal (short-term reward) ranks as a high priority. And loss aversion is a highly useful survival instinct.

Given our evolutionary background, it's not surprising to discover that we still naturally focus on the immediate fear of short-term loss, are inclined to follow the crowd, and instinctively believe that activity, in and of itself, is likely to produce returns. For an investor, however, this ap-

proach is highly counterproductive.

Over time, the result of this short-term approach is almost always unhappy. The purchase of popular companies (companies that are expensive relative to their earnings) has proven, over and over, to lead to subpar returns. And the high portfolio turnover that results from short-term thinking increases both trading costs and the average tax rate payable on capital gains.

The prevalence of instinctive thinking clearly presents

an opportunity for investors who can think and act with a long-term perspective. Today, Warren Buffett is the best-known practitioner of this approach.

How does Mr. Buffett approach investing? In his letters to Berkshire Hathaway shareholders, he has laid out his method in a remarkably straightforward manner:

» Confine your investments to predictable businesses having strong economic prospects over the long term.

» Buy shares only when the company is trading for less than the present value of its likely profits over the long run.

» Understand the tax advantages of owning a company for the long run.

If you take a long-term view, buying low and selling high is much easier. But most people simply can't do it. Now I think I'll go and buy some socks.

» Biff Matthews is chairman of Manitou Investment Management Ltd.

» This column ran in the monthly *Trade* by Numbers electronic magazine. To read the rest of the ezine about finding winning stocks for the future go to the new GlobeInvestor.com.