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The Irrational Investor and Behavioral Finance

Investors do crazy things for odd reasons, but experts are getting a grip on investment's human side.

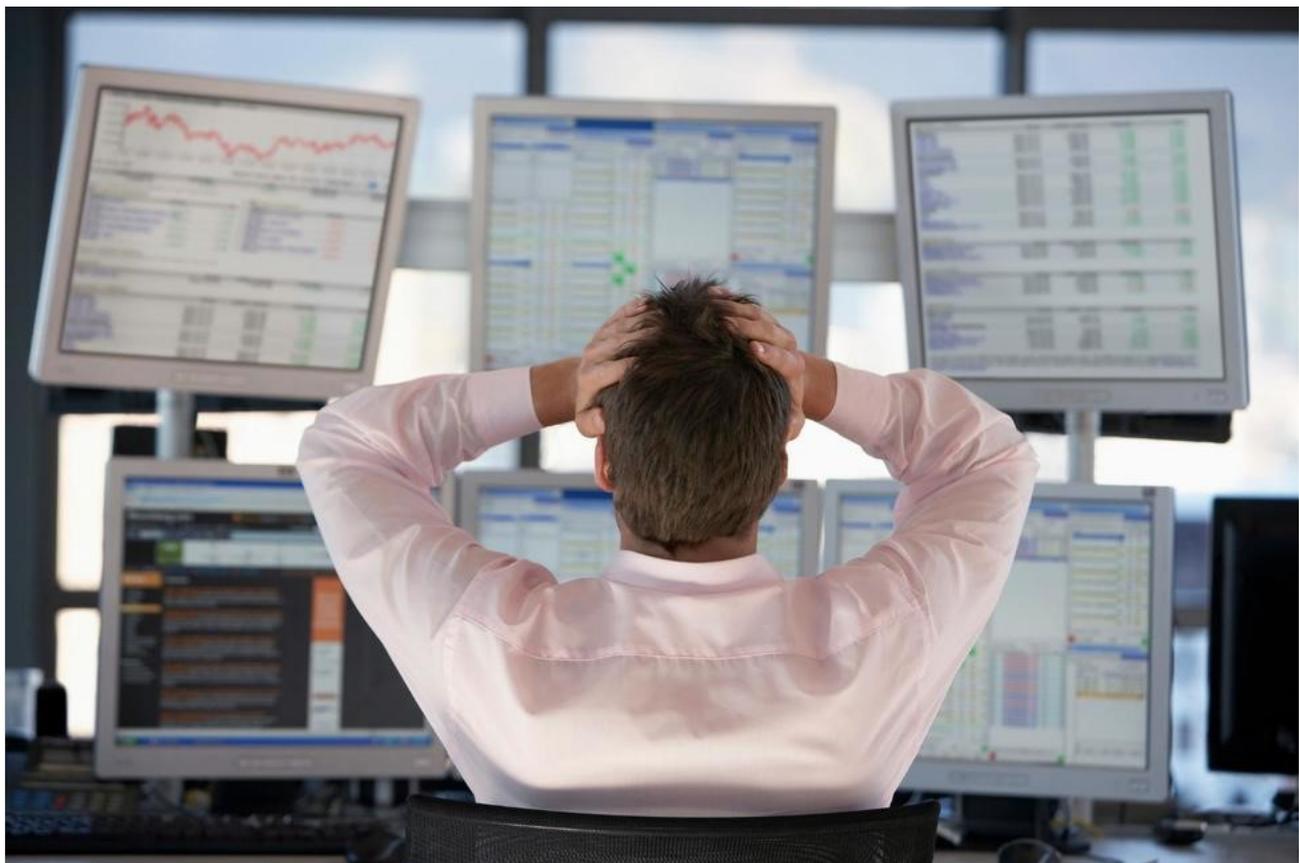
By [Lou Carlozo \(/topics/author/lou-carlozo\)](/topics/author/lou-carlozo) | Contributor July 22, 2016, at 9:00 a.m.

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Just as anyone knows who's come home to the sight of a dusty moose head purchased on eBay (<http://money.usnews.com/money/the-frugal-shopper/2015/08/07/how-to-make-a-living-by-selling-on-ebay>) – and the excited spouse bragging about snagging the Moose Noggin Deal of the Decade – otherwise sane people have the craziest reasons for doing what they do with their money.

And the finance-strange behavior connection certainly doesn't stop with consumers.

The accent on the offbeat climbs all the way up the [investment](http://www.usnews.com/topics/subjects/investing) (<http://www.usnews.com/topics/subjects/investing>) ladder from nervous shareholder, to contrarian advisor, to "Mad Money" pundit, to goldbug – all the way up to CEO.

Welcome to the world of behavioral finance, where academics, researchers and market observers strive to connect how investors behave, the forces that drive that behavior and bottom-line impact. Here irrational exuberance and its just-as-evil twin, irrational anxiety, get their due in the rational, statistical world of [quarterly reports](http://money.usnews.com/money/personal-finance/mutual-funds/articles/2015/05/07/how-to-read-a-corporate-earnings-report) (<http://money.usnews.com/money/personal-finance/mutual-funds/articles/2015/05/07/how-to-read-a-corporate-earnings-report>), earnings per share and market cap.

[See: [10 Ways to Play in the Asia-Pacific Stocks Pool](http://money.usnews.com/investing/slideshows/10-ways-to-play-in-the-asia-pacific-stocks-pool) (<http://money.usnews.com/investing/slideshows/10-ways-to-play-in-the-asia-pacific-stocks-pool>).]

And here the field is growing – and hence, the experts are having a field day.

Two hot topics in behavioral finance include loss aversion and herd mentality. With the former, "The biggest investor behavior by far that is common, but irrational, is selling an investment after it has lost money and/or overall investor sentiment is weak," says Bill Van Sant, senior vice president and managing director at Girard Partners, a Univest Wealth Management firm.

That decision, Van Sant notes, "most often stems from fear and does not factor in rational behavior such as, have the fundamentals of the investment changed, have my goals changed, etc. The same can be said about purchasing investments: Many investors buy high and sell low."

That dovetails into herd mentality. If you don't get in on a hot stock – even if it's at the penthouse as opposed to the ground floor – you must be missing out. And so you take your place in a line that snakes longer than a queue for an overhyped [Black Friday](http://www.usnews.com/news/slideshows/10-black-friday-facts) (<http://www.usnews.com/news/slideshows/10-black-friday-facts>) doorbuster.

Then, there's the frustrating phenomenon known as naming bias. Why does a baseball player with a heroic name like, say, Don Mattingly, always get more respect than someone named, say, Myron Bozolini? Or for that matter, a boy named Sue?

And believe it or not, some investors – otherwise logical – may instead go alphabetical, according to research by Jennifer Itzkowitz, a professor at Seton Hall University's Stillman School of Business, and her husband, Jesse, who teaches at Yeshiva University's Sy Syms School of Business.

"Just like choosing 'AAA Best Plumber' from the Yellow Pages, people when looking at stocks frequently overinvest in companies that have names or tickers that appear early in the alphabet," she says.

Now you know why Google (ticker: [GOOG](http://money.usnews.com/investing/stocks/goog-alphabet-inc) (<http://money.usnews.com/investing/stocks/goog-alphabet-inc>), [GOOGL](http://money.usnews.com/investing/stocks/googl-alphabet-inc) (<http://money.usnews.com/investing/stocks/googl-alphabet-inc>)) changed its name to Alphabet, eh?

Nor does the investment circus stop at the A ring. Itzkowitz also points to a phenomenon known as "stock name fluency" – the ease with which you can say a stock's name or ticker symbol. "That also influences trading," she says. "Additionally, the amount that a company spends on product advertising that helps people remember company names influences stock trading, resulting in irrational decisions."

In terms of how investors approach [portfolios](http://money.usnews.com/investing/articles/2016-05-06/how-to-build-a-stock-portfolio) (<http://money.usnews.com/investing/articles/2016-05-06/how-to-build-a-stock-portfolio>), forms that analyze behavioral biases can help people make smart decisions before they trip themselves up, says Paul Bolster, a finance professor at Northeastern University's D'Amore-McKim School of Business.

"Simple asset allocation models take the form of a questionnaire," Bolster says. "Responses are weighted and aggregated into a score that's in turn translated to an asset allocation. ... Think of these models as having ballast. An investor can pull them toward an extreme position but the model will not encourage them to go all the way to the edge."

[See: [Artificial Intelligence Stocks: 10 Companies Betting on AI](http://money.usnews.com/investing/slideshows/artificial-intelligence-stocks-10-companies-betting-on-ai) (<http://money.usnews.com/investing/slideshows/artificial-intelligence-stocks-10-companies-betting-on-ai>).]

Still, investors will often question the questionnaires and go their own way – even if informed sources and the test results argue against it.

"Our bias toward the familiar is why many people invest in a diversified portfolio," says Benjamin Sullivan, a certified financial planner and based in Austin, Texas. "The known feels safe; the unknown feels risky."

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And as for senseless CEO behavior, few can spot funhouse mirrors in the C-suite better than Ted Prince. Based in Gainesville, Florida, he's written books about how they make or break a bottom line, including "The Three Financial Styles of Very Successful Leaders." He got his ideas from past experiences on company boards: "I was in on a number of CEO hirings and when you get a new CEO, you always think he's Jesus Christ," he says. "But a year later, you're firing the guy – and I began to wonder why that was."

Prince's behavioral finance work has led him to develop something he calls "Cognitive Alpha" – a way of forecasting how CEO department will affect shareholder profit (<http://money.usnews.com/investing/articles/2016-06-20/investor-activists-get-their-share>). For starters, "Behavioral finance has come up with hundreds of terms for bias, but one term that really counts is status quo bias," he says.

Here's what Prince means: "Most people don't want to rock the boat but if you are a disruptor, you break things and produce new things. And if you make a product out of it, you get huge price premiums," he says. "The iPhone is a great example. Status quo bias gives you an idea what the impact on the gross margin will be and we can measure that."

On the other side of the valuation coin, Price sees an "illusion of control bias." "Most leaders tend to think, 'The more money I spend, the more I control the situation' – and very few people feel that way if they spend less. If we can measure illusion of control bias psychometrically, we can get an idea of what the expenses will be," he says.

Subtract expenses from gross margin and, voila: "You've got operating profit. Then I can figure out price-to-earnings and price-to-sales, and can predict the valuation of your company."

So if CEOs, investors and their go-betweens can fall prey to their biases and predilections, what's to be done? Well, they could listen to someone else. But...

[Read: [How to Tell a Company Is In Trouble](http://money.usnews.com/investing/articles/2016-07-21/how-to-tell-a-company-is-in-trouble) (<http://money.usnews.com/investing/articles/2016-07-21/how-to-tell-a-company-is-in-trouble>).]

Sullivan sums up the dilemma nicely: "Investors are constantly barraged by tips from friends, relatives, internet forums, the news or Jim Cramer," he says. "But blindly following advice is detrimental to your wealth."

SLIDESHOW

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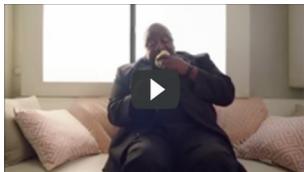


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