

The Psychology of Fiduciary and Investment Decision Making

Lynn Mander, CFA, CFP

Senior Vice President

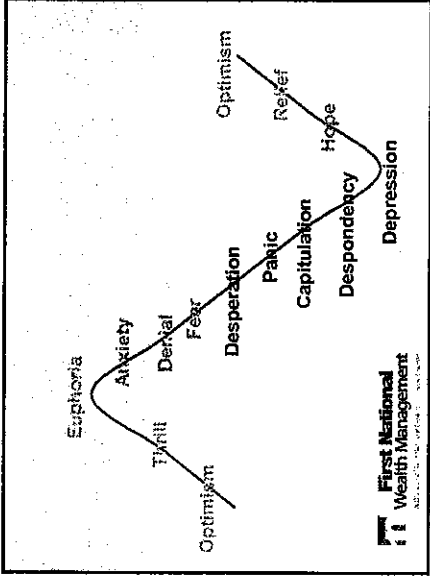
First National Wealth Management

October 23, 2008



First National
Wealth Management

A Division of First National Bank of Chester County



Money Behavior

- Heuristics – Anchoring
- Overconfidence
- Representativeness – Familiarity
- Considering the Past
- Fear of Regret
- Mental Accounting

First National
Wealth Management
10000 W. 10TH AVE. SUITE 1000 DENVER, CO 80202

Optical Illusions (Heuristics)

- Which Line Is longer – AB or BC?

First National
Wealth Management
10000 W. 10TH AVE. SUITE 1000 DENVER, CO 80202


Representativeness

- Mary is quiet, studious, and very concerned with social issues. She majored in English Literature and Environmental Studies. Which is most probable?
 - Mary is a librarian
 - Mary is a librarian and member of the Sierra Club
 - Mary works in the banking industry
- Which of these is most probable?

 **First National**
Wealth Management


Answer = Banking

- The most likely answer is banking. There are many more people employed in banking than in libraries – but this is not representative of what we know about Mary.

 **First National**
Wealth Management

Representativeness

- Judgment based on stereotypes
- “Past performance is not representative of future performance”
 - Tend to revert to mean (average)
- Familiarity
 - Familiarity breeds investment problems
- Creates distorted perception

 **First National**
Wealth Management


Considering the Past

- Consider this wager:
 - Heads you win \$20, tails you lose \$20
 - Would you take this gamble?
- You lost \$20 earlier
 - Now would you take this gamble?
- You won \$100 earlier
 - Now would you take this gamble?

 **First National**
Wealth Management

Answer = all odds are the same

- The odds are the same on all three choices.
- There is no one right answer, but this should get you to think about using the past to evaluate a risky decision.
- Investors tend to take more risk when they have experienced a recent gain – playing with “house money”.

 **First National**
Wealth Management

Considering the Past

- After a gain or profit, people take more risk
 - Gamblers don't view new money as their own
- Risk Aversion (snake bite)
 - After a loss, people are less willing to take risk
- Trying to Breakeven
 - Double or nothing.....
- Memory Effect
- Cognitive Dissonance
 - Brain filters out negative information and fixates on positive.

 **First National**
Wealth Management

Fear of Regret

- You have been selecting the same lottery ticket numbers every week for months and have not won. A friend suggests a different set of numbers.
- Do you change your numbers?

First National
Wealth Management

Answer = both odds are the same

- The odds of winning are the same, but there are two answers here:
 - Stick with the old numbers and the new numbers win (regret of omission)
 - Change to the new numbers and the old numbers win (regret of commission) – much more painful.

First National
Wealth Management

Fear of Regret

- Disposition effect
 - Sell winners too early, hold losses too long
- Wealth
 - Tax implications
- News and regret
 - Regret is strong when your stock falls in a rising market
 - If your stock declines along with market, “act of God” and regret is weak

First National
Wealth Management

Fear of Regret (cont.)

- Reference Points (anchoring)
 - Comparing current price to some other price
- Purchase price
- 52 week high or low
- Recent high or low

First National
Wealth Management

Reference Points (Anchor)

- Retailers use this to get us to purchase items on "sale"
- Manufacturers Suggested Price \$199
- Discount Price \$149
- Today's sale price \$99
- Have you saved \$100 or spent \$99?



First National
Wealth Management

Mental Accounting

- Mr. and Mrs. J have saved \$15,000 toward their dream vacation home which they hope to buy in 5 years. They are earning 3% in a CD.
- They just bought a car for \$11,000 which they financed with a 3 year car loan at 7%.
- What are the ramifications of this decision?

First National
Wealth Management

Mental Accounting Answer

- Wouldn't the J's have been excited to find a safe investment earning 7% for their vacation home funds?
- They could have used some of the vacation home funds to buy the car and paid themselves 7%!

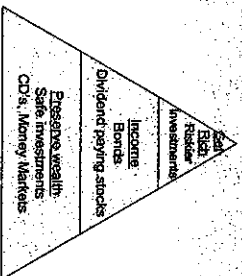


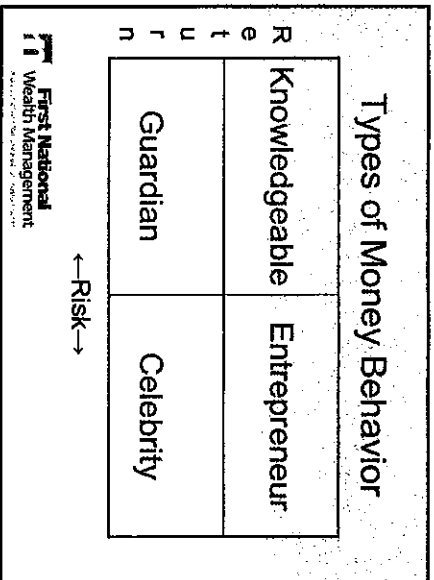
Mental Accounting

- Mental accounting and portfolios
 - Place each investment into separate mental account – discount interaction between accounts
- Perception of Risk
 - Not the risk of each asset, but how they combine to reduce risk



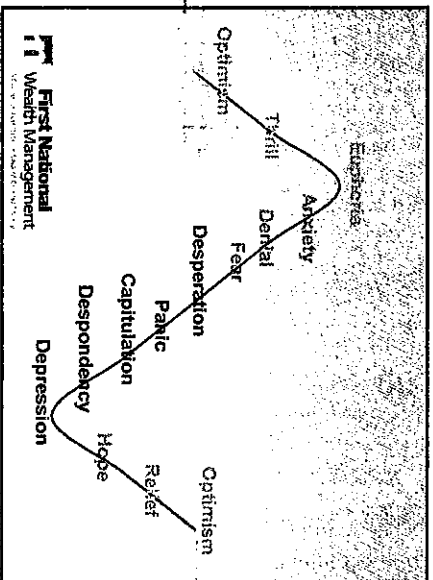
Mental Portfolio Accounting





Beating the Biases

- Understand the bias
 - Helps avoid them
- Know why you are investing
 - Be clear about goals
- Use sound investment criteria
- Diversify
- Control your investing environment



References

- Nofsinger, John R., The Psychology of Investing, Prentice Hall, 2002
- Sherrin, Hersh, Beyond Greed and Fear, Oxford University Press, 2002
- Pring, Martin J., Investment Psychology Explained, John Wiley & Sons, Inc., 1993
- Taleb, Nassim Nicholas, Fooled by Randomness, Thomson Texere, 2004
- Shiller, Robert J., Irrational Exuberance, Broadway Books, 2001
- Mauboussin, Michael, "Contrarian Investing: The Psychology of Going Against the Crowd" The Institute for Psychology and the Markets, "The Journal of Behavioral Finance"
- Peterson, Richard L, MD, "Probing the brain of an investor: How advances in neuroscience are demystifying the markets"
- SFO Magazine, May, 2005, "Is the Trend Really Your Friend?"
- Burnham, Terence C., Mean Markets and Lizard Brains, Wiley, 2005
- Money Magazine, August, 2005 "What Money Type are You?"
- Marketspsychology.com – Take a free test to see what type of investor you are.
- Trahan, Francois, May, 2006, "Approaching an Inflection Point in the Bubble Cycle"
- Baker, Margaret N. C., PhD, Crazy About Money, due to be published in 2007.
- Zweig, Jason, Your Money & Your Brain, Simon & Shuster, 2007

