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## Breaking down bad investors

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Why are we lousy investors? Psychology suggests that, ultimately, there are three sources of error.

The first source has to do with what may be called **investors' financial literacy**: Lack of information and, more importantly, lack of understanding of how our financial markets and the world economy truly work.

The economic reality that we face is complex. Think about it: What is the true relationship, say, between the changing value of the U.S. dollar, the international competitiveness of American industry, and the stock market? This is a tough question, to say the least.

Our mental models, on the other hand -- the stories that motivate our investment decisions -- are quite simple. Too simple, and often misguided. This is not surprising, of course. Even economic and financial experts and portfolio strategists disagree all the time in their analysis of the past or in their predictions for the future.

Second, **there are emotional factors**, such as wishful thinking and overoptimism on the upside (remember the bubble) or excessive fear on the downside (remember the period right before the start of the war with Iraq). Our emotions are very powerful. They frequently overwhelm us. They may interfere with the best plans laid out earlier.

For instance, many people find that investment discipline is difficult to maintain in a bear market. When a stock has dropped in price a great deal, we may rationally accept that the time has come to take our losses, but emotionally we may not be capable to do so, just because we don't like to make the losses definite. So, we postpone, and suffer, and then we postpone more, and suffer more. Of course, hope is also part of the picture. Maybe we can recoup our losses and save face. The net result is procrastination, stubbornness.

The third and **final source of our errors is conformism**, a herd mentality, a

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susceptibility to fashion, to what psychologists call "groupthink." It is difficult, really, not to get caught up in the excitement that accompanies technological, medical or other economic advances even if, personally, we do not understand how the supposed good news translates into value for the company. Nevertheless, we want to be where the action is. We want to be with it. As a result, many unsophisticated investors always arrive late at the party. Through their uninformed trading, they magnify modest news events into euphoria and hysteria.

### **Investor mistakes**

What are some of these predictable errors of judgment?

The most common errors are probably a naïve extrapolation bias -- investors always project recent market movements into the future; in other words, investor sentiment follows the market -- and overconfidence, meaning people are too sure of themselves. Many investors are too cocky. The combination of overconfidence and extrapolation bias can be lethal since investors in this case tend to buy "high" and sell "low." Poor market timing is not a recipe for success.

The overconfidence has many sources. One of them is hindsight bias. After the fact, much of what happened in the recent past may seem logical and indeed inevitable. Consider, e.g., the return of big federal deficits. Now, without 9/11, this could have been very different. But people always try to make intuitive sense of present and past events. They seek order in what may be largely random. The news media play a role in this since a big part of reporting the financial news is interpreting the news. Journalists often overinterpret the news, even as it "breaks." The net result is we don't learn much from our misjudgments, from our mistakes, our false beliefs.

Other common errors include:

- Insufficient diversification. Many people rather put their money in a small, local company that they think "they know" than in 15 blue chips.
- A belief on the part of many individual investors that they will have the trading skill "to quickly sell out" when the market turns against them. Of course, some investors will be able to sell out but not all. That's an illusion.
- A completely superstitious belief in their own good luck. Let's call it the gambling instinct.

### **Taking advantage**

How do we exploit these predictable errors and make money in the market? The answer is, first, to be consciously aware of the mistakes in judgment that I

have mentioned as well as many others. This requires further reading in behavioral finance, an effort to self-educate, and some humility.

Second, I think that a willingness to go against the crowd, to be contrarian, to be non-conformist can help. You're are not going to beat the crowd by imitating it.

People should try to distinguish a good investment from a good company. Remember: These are not the same. Some glamorous companies with strong market positions and fantastic prospects for earnings growth are too expensively priced in the market and become, in fact, terrible investments. Everybody loves them. As they say, sometimes, the market not only discounts the future but also the hereafter.

On the other hand, the prices of some bad companies, with poor prospects, are beaten down so much that they are great investments. So, to sum up, the fact that the market overreacts, that there is a lot of volatility in prices, presents opportunities for the smart trader.

Third, most of the scientific studies that I have seen -- the globality of the evidence, in other words -- suggest to me that the most successful investors are those who follow a structured, disciplined investment framework. A structured framework, with limited trading and sufficient diversification, is the best way to reach financial success and inner peace.

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