

April 8, 2001

Strategies: The Blinding Power of Data

By MARK HULBERT

Throw away the performance tables in this week's quarterly mutual funds report!

I realize that this advice is unlikely to ingratiate me with people who calculate such data. Yet psychological research suggests that these performance tables are dangerous to your wealth. There is a good possibility that you will react to them in self-destructive ways.

The problem is not that the data are inaccurate. The danger derives from a combination of two other features. For a start, the tables report short-term performance — periods as short as the last 90 days. Second, given the recent stock market decline, the majority of these short-term performances are losses.

That is a pernicious combination because, if you are a typical investor, your response to seeing that data will be to reduce your equity exposure. And that will affect your investment results not only for the next quarter or two but also over your lifetime. And that might well prove very expensive.

I am so confident predicting your likely reaction because this aspect of human behavior has been studied extensively in recent years. Two leading experts on this pattern are Shlomo Benartzi, an accounting professor at the University of California at Los Angeles, and Richard Thaler, a behavioral economist at the University of Chicago. They have called the behavior "myopic risk aversion."

This aversion is actually a combination of two behaviors. The first is a greater sensitivity to losses than to gains — a sensitivity that, believe it or not, exists even when the stock market is

at its most speculative. Put another way, the typical investor is more afraid of losses than excited about profits.

The second behavior is the tendency of investors to continually re-evaluate their performance. A related tendency is to focus on investment holdings individually instead of treating one's portfolio as an integrated whole.

These myopic behaviors greatly multiply the frequency with which investors experience loss, at least on paper.

To gauge whether you suffer from myopic risk aversion, consider whether you would be willing to play a game in which you win \$200 if a coin flip comes up heads and lose \$100 if it comes up tails. If you are like most everyone else, you would decline because you would feel the \$100 loss more than the \$200 gain. (The author of this famous example is Paul Samuelson, the 1970 Nobel laureate in economics.)

But imagine that you are given 100 chances to play the game. Now you are probably willing, because the odds are excellent that you will come out a winner after so many flips. The key to being willing to play is focusing on all the flips as one game rather than as 100 individual games.

The coin-flip game is not unlike investing in stocks. Though stocks promise a superior long-term return, their short-term volatility is high. It is the rare portfolio that never holds stocks at a paper loss. The key to stock investing is to focus on your entire portfolio over the long term. If you focus on your individual holdings too often, you will not want to play the game.

That is the theory. To test whether it is an accurate description of investor behavior, Professor Thaler teamed up with three psychologists — Amos Tversky of Stanford (who died in 1996), Daniel Kahneman of Princeton and Alan Schwartz of the University of Illinois at Chicago. They constructed an elaborate simulation of the decisions that one

must make over a lifetime about one's relative allocation to stocks and cash. One set of subjects in their simulation could check how they were doing every month. Another group did so every year, and a third group only once every five years.

Just as the theory predicted, investors who looked at their performance most often had the lowest average equity exposure. Particularly noteworthy was the fact that these frequent checkers not only reduced their stock exposure immediately after a loss, but also had lower average equity exposures during all subsequent months, Professor Thaler and his colleagues found.

Unfortunately, because of the Internet, myopic risk aversion is likely to become even more common. The Internet lets investors check on their holdings effortlessly, as often as they want — and investors are availing themselves of the opportunity. A survey conducted in January by Intuit/ Quicken.com found that 91 percent of online investors checked their portfolios' worth more than once a month. In fact, 13 percent checked it more than once a day.

What an odd situation. By making the process as easy as clicking a mouse, the Internet was supposed to make the stock market accessible to the masses. But to the extent that investors have myopic risk aversion, the Internet will reduce their exposure to equities.

How can you immunize yourself from myopic risk aversion? Keeping your eyes off the data is not very realistic. I can tell my daughter to sit in a corner and not think about pink elephants, but that is exactly what she will think about. The fact that investors can check their performance daily leads, almost inevitably, to their doing so.

RECOMMEND to clients a technique from Harry Browne, who used to write an investment newsletter called Harry Browne's Special Reports and who was the Libertarian Party candidate for president last fall. His

advice is to divide your portfolio in two. The first part, containing the bulk of your assets, would be a so-called permanent portfolio whose composition would not change very often. The second would be a lesser portfolio in which you could speculate and trade to your heart's — and psyche's — content.

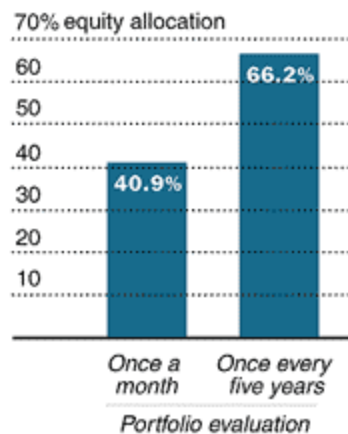
This approach has several virtues. Assuming that you allocate a relatively high portion of your permanent portfolio to equities and other risky assets, you will be largely protected from the effects of myopic risk aversion in your smaller, more actively traded portfolio. And it is psychologically realistic, because it recognizes that you want to check your results constantly, and to make frequent changes.

Finally, here is another helpful psychological trick: View the two parts of your portfolio as a competition. Your challenge is to do better over many years in your repeatedly checked and changeable portfolio than in your permanent one.

Good luck. The odds are against you.

Minding the Store

Investors who check how their portfolios are doing on a monthly basis have lower average exposure to stocks than those who check only once every five years.



Source: "The Effect of Myopia and Loss Aversion on Risk Taking: An Experimental Test," by Richard Thaler, Amos Tversky, Daniel Kahneman, and Alan Schwartz, *Quarterly Journal of Economics*, May 1997.