Index Returns

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Kahneman: “Financial advisors ought to help the investors they counsel take a broad view. They should encourage their clients to think in terms of total wealth and not in terms of separate investments. That’s what I see as their primary role. Taking a broad view of problems makes you better able to tolerate risk and be closer to risk-neutral.”

Active Management

Kahneman: “People see skill in performance where there is no skill. Somebody tosses a coin and hits four heads in a row. He either is very lucky, or maybe he knows something you don’t, or maybe he has a trick about tossing coins. But it’s not such a rare event that you should be very impressed by it. People are overly impressed by the performance of money managers, who sell what they’ve been doing for the past few years. It is difficult to realize that you would get very similar patterns if there was no skill at all in picking stocks or in running funds. The results would look remarkably similar to what they actually do look like.

What’s really quite remarkable in the investment world is that people are playing a game which, in some sense, cannot be played. There are so many people out there in the market; the idea that any single individual without extra information or extra market power can beat the market is extraordinarily unlikely. Yet the market is full of people who think they can do it and full of other people who believe them. This is one of the great mysteries of finance: Why do people believe they can do the impossible? And why do other people believe them?”

Overconfidence

Kahneman: “In a world where most people are overconfident, you’re going to see a lot of trading. People are trading who have no business trading. They have an idea, and they act on it. But they’re acting on noise. Trying to tone that down and have people make global decisions rather than a lot of small responses to noisy events is probably the counsel of wisdom.

A former student of mine, Terrence Odean, looked at the prices of stocks one year after individual investors bought and sold them through a retail brokerage firm. Less the transaction costs, the stocks that were sold did better on average by 3.4%, which means that people are making decisions, on average, quite badly. They are throwing away, on average, close to 5% of their investment—3.4% plus the transaction costs. This is solid evidence that people are optimistic and overconfident. They think they can improve their portfolio when in fact they would be better off just hanging on to it.

Thinking in Broader Terms

Kahneman: “You want to have the attitude that life is a series of repeated gambles. You make a lot of risky decisions; some work and others don’t. If you don’t evaluate each decision separately, but occasionally you take stock of how well you’re doing, then you tend to be both more rational because you take a broader frame and more comfortable because you experience losses with less emotion. That was Bernoulli’s [the 18th century mathematician] error—implying that people think in broader terms than they do. It’s the responsibility of financial advisors to make their clients look not at one investment at a time, but to take a global view. It feels very unnatural to do it the Bernoulli way, but, at least occasionally, people should do it because they will make better decisions.

The disposition of people to hang on to their losers and sell their winners shows how narrow mental accounts are. People keep track of gains and losses separately. Thinking globally, that cannot be right. Terrence Odean also studied 10,000 individual accounts at a brokerage firm. First, he found that when people have a portfolio that contains winners and losers, they are twice as likely to sell the winner than the loser. They don’t like to realize losses. As long as they are hanging on to their losers, they haven’t lost. The moment they sell, they have to admit that they lost money. People are very reluctant to make that admission.

That fits the psychological tendency that Tversky and I call “loss aversion,” which is the belief that people are much more psychologically sensitive to loss than to gain.

Regret

Kahneman: “People’s anticipation of regret and their fear of making fools of themselves are important forces that control investor behavior. They have a great fear, for example, of investing money in a stock and then the stock immediately taking a dive. That mechanism is sure to increase regret and unhappiness. When you consider selling, you’re setting yourself up for regret. Suppose you decide against it and the market moves down. You feel you should have sold, and you feel even worse because you almost sold. The closer you came to doing something, the more likely you are to regret not having done it. One way people avoid regret is to spread investments over time and not invest the whole amount at once. By and large, those tactics are not optimal. They don’t make you rich, but they do give some protection against regret.”

Experienced Investors

Kahneman: “Professional and experienced investors... take a more global view. They have the sense that you win a few and lose a few. They feel the regret associated with losses less acutely than do people with less experience.

It’s harder for [investment advisors]. Their clients are retail. To have a wholesale attitude when you’re dealing with people who think retail is not that easy, and the basic psychological phenomena are not going to be overcome. There could be a change in the culture among advisors, however. If advisors did see their responsibility as not dealing with each investment as it comes but with the broad picture, that could change things.”