



Behavioral Finance Update: Managing Irrational Investment Decisions

Behavioral finance has become a popular investment topic in the past decade. From the technology bubble of 2000, to the recent recession, the emotional aspect of financial decision making has taken its toll on investors. Behavioral economists ask: ***“Are there efficient markets and rational investors?”***

ARE THE FINANCIAL MARKETS EFFICIENT?

For over 30 years, (the field of behavioral finance started developing in the late 1970s), behavioral economists have studied the patterns of investors. Their conclusion is simple: while the efficient market theory develops a strategy for the rational investor, investors are not rational. “Traditional finance assumes that people are rational and tells us how people should behave in order to maximize their wealth,” wrote John Nofsinger in his book, *Investment Madness: How Psychology Affects your Investing...and What to Do About It*. “Alternatively, behavioral finance studies how people **actually** behave in a financial setting.”

If a financial market is efficient, then no amount of research or information can be expected to result in outperformance of a benchmark. A key assumption is that all information is readily available to everyone, at the same time. This market efficiency debate has inspired thousands of studies to determine whether markets are “efficient.” While many studies found evidence that supports the efficient market theory, others have documented numerous anomalies that contradict the efficient market hypothesis.

Behavioral economists believe that the rise and fall of the housing bubble is proof that financial decisions cannot be explained by theory where investors are rational and the market remains efficient. Instead, they argue that since asset prices are not a reflection of the actual value, investors should understand what drives people to buy and sell. This knowledge could help avoid purchasing overvalued assets in an overpriced market, understand the motivations behind the behavior, and differentiate the useful and non-useful (noise) information.

Can the financial markets be efficient? At Next Generation Wealth Management, we argue that you can strive to invest towards an efficient market with what you can control; however



there are measures outside of your control that may cause inefficiencies to exist.

ARE INVESTORS RATIONAL?

Behavioral economists have recognized that emotions may impact an investor's financial decision making. They acknowledge what the efficient market theory does not: that people don't buy numbers, they buy feelings. Studies have shown that investors feel more than double the pain when their portfolio loses value, versus the joy they feel when the portfolio increases by that same amount. Investors anchor their expectations on great returns that come once every six years; they are disappointed in four of the six years because they achieved "typical" returns; and despondent when markets suffer that one in every six years fallout. Irrational behavior occurs throughout these phases. Typically, investors increase their appetite for risk in up markets, taking on more risk than they should as investors feel the existing market conditions are permanent. In down markets, irrational behavior takes over and investors sell because that market is again permanent, where in most cases they should actually be buying.

Irrational behavior was evident over the last 12 years. From 1988 - 2008, the average annual return for an equity investor was 1.87%. In the same time period, the S&P 500 index had an average annual return of 8.35%. Irrational behavior and emotions took control of investors at the wrong times.

WHAT CAN YOU DO TO GUARD AGAINST IRRATIONAL BEHAVIOR?

- **FORMULATE FINANCIAL GOALS:** Defining financial goals is critical to creating an investment program. Understanding and identifying your goals will help create a foundation for your portfolio's asset allocation.
- **UNDERSTAND YOUR RISK TOLERANCE:** Once you determine your tolerance for risk, allocate your assets to that risk and do not stray from your course. Beware that irrational behavior (emotions) may want to take you outside your tolerance for risk.



- **MAINTAIN A CONSISTENT APPROACH:** Once you have formulated your asset allocation, stick with it. You allocate your assets for a reason: to optimize your return for the amount of risk you are willing to take. This is not to say you should not review your allocations. That should be done periodically. Do not allow irrational behaviors dictate your allocations.

Another way to protect yourself against irrational behavior is to partner with an **INVESTMENT ADVISER**. Investment advisers have a powerful advantage over most investors: they can review your portfolio in a more objective manner.

At Next Generation Wealth Management, we do not let emotions dictate our asset allocation decisions. We utilize a time tested investment approach by constructing investment strategies unique to each of our client's needs. We follow a disciplined, objective approach so that we may resist any "impulse" to act on irrational behavior.

If you would like to learn more about behavioral finance, or if you would like to discuss our institutional investment strategies, please contact us directly at (414) 257-4248. Our brand is our passion and we are committed to never making a short-term decision that might tarnish it.

Sincerely,

The Next Generation Wealth Management Team

This material has been created for informational purposes only and does not constitute investment advice and it should not be relied upon as such. It should not be considered a solicitation to buy or an offer to sell a security. It does not take into account any investor's particular investment objectives, strategies, tax status or investment horizon. There is no representation or warranty as to the current accuracy of, or liability for, decisions made based on this material.

Next Generation Wealth Management, Inc. is an independent, SEC registered investment adviser providing investment management and advisory services to a variety of clients including individuals, families, family businesses, trusts and foundations.

Next Generation Wealth Management, Inc.
10700 Research Drive Suite 150
Milwaukee, WI 53226
(414) 257-4248
www.ngwealth.com