12 rules that govern all investor behavior

Deciphering investors' behavior

***By Daniel Crosby**, a behavioral finance expert who works with organizations to develop products and messaging to maximize positive investment outcomes.*

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As I have traveled around the country meeting with advisers and their clients, I've noticed a palpable "antsiness" among investors of all stripes. Most have the sense that valuations are steep, that things have been too good for too long and that the other shoe is set to drop. So, what is the best use of a financial adviser during uncertain times such as these?

An Aon Hewitt study found that investors who worked with advisers during the Great Recession did 2.92% better net of fees than those who did not. Interestingly, what differentiated the DIY crowd from those who received help had less to do with financial acumen and more to do with behavioral coaching. In all markets, but especially in times of elevated emotion, the primary good an adviser can do is to keep their clients from making impulsive decisions. To aid you in your efforts to provide this service, I've constructed a list of 12 rules that account for the bulk of investor (mis)behavior.

1. In every market, you control what matters most

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Over the last 20 years, the market has returned an average of 8.25% per annum, but the average investor has gotten just over 4% of that. The highs and lows of the market may be out of your hands, but how you choose to behave is within your power, and is just as important a driver of returns.

2. Risk is a permanent loss of capital

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Risk is not a paper loss. Risk is not underperforming your golf buddy. Risk is not even underperforming the benchmark. Real risk is the probability of you permanently losing your money. Viewed thusly, those with a long time horizon and diversified portfolios are taking on very little risk indeed.

3. Start now. Start again tomorrow

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Compound interest is the secret to getting rich slowly. The way to maximize the power of compounding is to start today and stay consistent. If you hope to reach $2 million in retirement savings and start investing at age 22, you can hit your target by saving less than $6,000 a year. Wait until you turn 40 and things have gotten much tougher, requiring roughly $26,500 in savings per year.*

**Assumes an investment return of 8% and retirement at age 65.*

4. Trouble equals opportunity

Bloomberg News

We are all familiar with the Oracle of Omaha's admonition to be "greedy when others are fearful and fearful when others are greedy," yet so few of us manage to successfully view a downturn as the opportunity it truly is. There is true joy (and riches) to be had in financial schadenfreude, so commit yourself to continue investing and even upping your savings when times are bad.

6. Do less than you think you should

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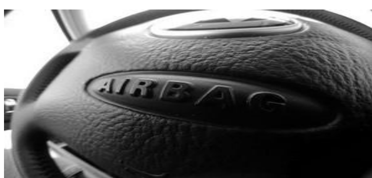
In most endeavors, when you work harder and do more, you are better off. Investment management is just the opposite! The more you trade, the more financial news you watch and the more active you are, the more likely you are to underperform (and get eaten alive by fees in the process). Take heart – laziness pays!

5. “Diversified” doesn't mean “never going down"



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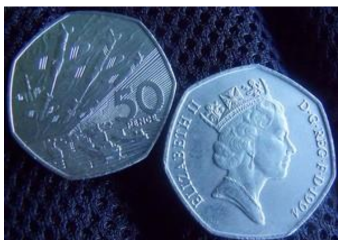
Diversification is not a panacea nor does it prevent your portfolio from falling, even dramatically at times. What it does is protect you from idiosyncratic risk and losing your shirt on a concentrated bet. Buying a car with an airbag is not a bad idea, even if you never get in a wreck. Diversifying your portfolio is similarly wise, even if the benefits may not always be apparent.

7. Get rich quick and get poor quick are sides of the same coin



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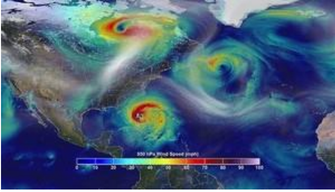
Though it’s not perfect or linear (sorry Modern Portfolio Theory!), there is a strong relationship between risk and reward. It’s true that marijuana sector penny stocks could quadruple your net worth over night, but it’s just as true that they could break your back. Defense wins championships in investing, as in football.

8. Forecasting is for weathermen



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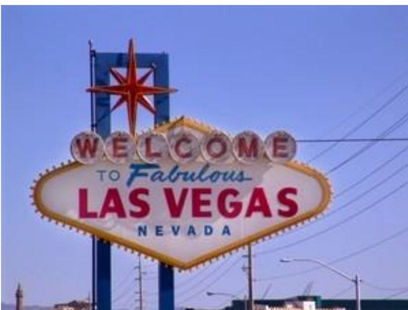
Famed contrarian David Dreman found that from 1973 to 1993, of the 78,695 estimates he looked at, there was a 1 in 170 chance that analyst projections would fall within plus or minus 5% of the actual number. The smartest people in the world don't bother with the crystal ball. Said JP Morgan of the market's future trajectory, "It will fluctuate."

9. If it's exciting, it's probably a bad idea

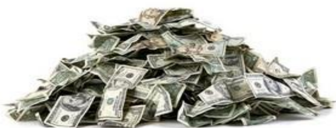


Nobel laureate Paul Samuelson said it best, "Investing should be more like watching paint dry or watching grass grow. If you want excitement, take $800 and go to Las Vegas."

10. This time isn't different (and neither are you)

Robert Shiller is fond of saying that "This time it's different" is the most dangerous phrase in investing. While mania can carry a market for a time, the truth about what works long-term on Wall Street is pretty boring (think paying a fair price for a profitable company) and is unlikely to fundamentally change.

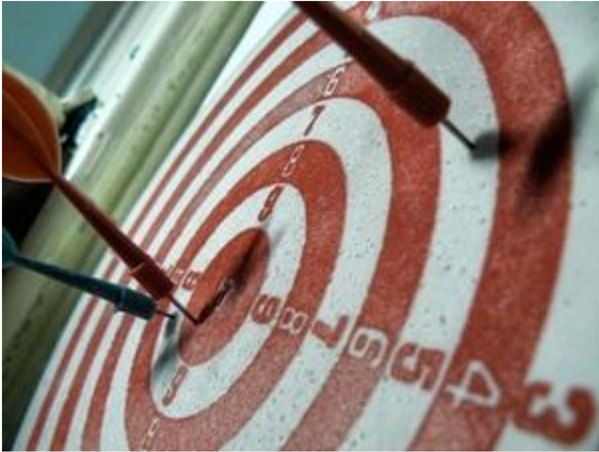
11. Excess is never permanent



John Neff astutely noted that, "Every trend goes on forever, until it ends." It has been said that nature abhors a vacuum and an investment corollary is that markets abhor excess. While short term trends and emotionally fueled investors can push a stock up or down for a

time, things tend to come back to Earth eventually. Betting that something will rise or fall in perpetuity is a risky bet.

12. Your life is the best benchmark



Benchmarking to your own goals instead of a arbitrary external ones has myriad benefits. First off, it personalizes the whole endeavor and makes investing about doing what you love instead of outperforming others. Research also shows that goals-based investors are more likely to stay the course during tough times and even save at higher rates, since what they are chasing is so personally meaningful.