American Association of Individual Investors

Driving Emotions From Your Investment Process: A 12-Step Program

by Thomas Howard

This article is based on Chapter 7 of Tom Howard's book "Behavioral Portfolio Management: How Successful Investors Master Their Emotions and Build Superior Portfolios" (Harriman House, 2014).

For many years, I conducted an AAII Stock Analysis seminar in which I presented a variety of techniques for analyzing and valuing stocks.

Beyond presenting specific techniques, I also discussed ways to remove emotions from a decision process. Now that I manage money professionally and have delved into the ever-growing body of behavioral science research, I am more convinced than ever that ruthlessly driving emotions from stock-picking decisions is essential to generating superior returns. In fact, if you don't, you cannot outperform.

There is now a large body of research showing that investors depend on emotions and anecdotal information when making decisions. You are no doubt aware of this and are familiar with the resulting cognitive investment errors. There have been numerous articles dealing with how investors can avoid such errors and, as a result, do a better job of managing investment portfolios.

Unfortunately, industry professionals apply techniques and put policies in place that encourage investors to continue making emotional decisions. So even if the investor wants to drive emotions out of the investment process, the industry is set up to encourage them to do otherwise.

To help you make this transition, I present a 12-step program to show how to ruthlessly drive out emotions and thus make it possible for you to make superior investment decisions.

The 12 Steps

Step 1: Hello my name is __________ and I am an emotional investor.

Like any self-help program, this one starts with admitting there is a problem. That is, you recognize that you make emotional investment decisions and you would like to avoid this going forward.

Step 2: It is OK to be wealthy.

This may seem like an unusual step, but I'm amazed at the number of people I run into who don't believe they can be wealthy. Not only is it OK to be wealthy, but for many of us, it is also possible to be wealthy.

Time, discipline and a narrowly defined equity strategy are the keys to successfully building wealth. If it is possible for you to be wealthy, then don't apply emotional brakes that will prevent you from becoming so.

Step 3: I will strive to eliminate my myopic loss aversion and reduce my need for social validation.

The two most important emotional brakes are myopic loss aversion (MLA) and social validation, which are the result of millions of years of evolution. The fight or flight reaction triggered when a saber-toothed tiger showed up was critical to our survival as humans. However, a sudden drop in portfolio value can trigger the same MLA emotions as did that predator thousands of years ago, but without the same life-or-death consequences. So being governed by an ancient set of emotions often leads to poor financial decisions.

Doing the same thing as everybody else, the definition of social validation, also made sense thousands of years ago when life was full of danger. Since we lived in small groups then, we depended on others to sense danger and react instinctively. You didn't want to be the slowest member of the group when fleeing the tiger. In contrast, today we frequently want to take positions different from the emotional crowd as a way to harness the price distortions resulting from collective behavior.

Many argue that overcoming such powerful evolutionary emotions is extremely difficult. Nobel Prize Laureate Daniel Kahneman himself expressed pessimism about the chances of making such a change in his book, "Thinking, Fast and Slow" (Farrar, Straus and Giroux, 2011). I am familiar with advisers and asset managers who have successfully dealt with these two emotions in themselves as well as in their clients, so I am more hopeful that it is possible to make progress in this regard. For example, Don Novick, an extremely talented trader, explained his success in "The Wisdom of Psychopaths" by Kevin Dutton (Scientific American/Farrar, Straus and Giroux, 2012) as follows:

"When you are trading, you cannot allow any member of your brain's emotional executive committee to knock on the door of the decision-making boardroom, let alone take a seat at the table. Ruthlessly, remorselessly, relentlessly, you have to stay in the present. You can't let what happened yesterday affect what happens today."

Step 4: I believe that volatility and its close cousins the Sharpe ratio, maximum drawdown and tracking error are largely measures of emotion and should not be used in constructing and evaluating portfolios.

Volatility is driven by the emotional reactions to current events. Consequently, very little of stock market volatility can be explained by changes in underlying fundamentals. On the other side of the coin, investors react emotionally to volatility, meaning that emotions both cause and are caused by volatility. Volatility should be taken out of the portfolio management process to the greatest extent possible.

A particularly pernicious impact of volatility is the widespread use of the Sharpe ratio, which is return divided by standard deviation. It suffers from three serious problems. First, returns are historical and, as we know, past performance is not predictive of future performance. Second, standard deviation is largely emotionally driven. So rather than being a return-to-risk measure, the Sharpe ratio is a return-to-emotion ratio. Third, the returns are long-term, while the standard deviation is annual. This further exacerbates the emotional problems with this ratio.

Tracking error is a bane within the industry, second only to the Sharpe ratio. The first step in calculating tracking error is to assign the equity fund to an arbitrary peer group, for example, small-cap value. It is arbitrary because the assignment has little to do with the strategy of the fund. But it gets stranger. Even though the fund is expected to generate alpha (risk-adjusted excess return over the market's return), it is also expected to closely track its benchmark. How bizarre is this: As a portfolio manager, I am expected to track the index that I am expected to outperform! Finally, in the strangest twist of all, tracking error is considered to be risk..

Investors can't get rid of these volatility-based measures soon enough.

Step 5: I believe that volatility and risk are not synonymous and that most references to risk are really references to emotion.

Risk is the chance of underperformance, while volatility is a measure of emotion. For short-horizon portfolios, volatility does contribute to risk. For long-horizon portfolios, volatility plays a much-reduced role. Since portfolios are often built based on short-term volatility, the paradoxical result is that risk is actually increased. This happens because reducing short-term volatility often reduces long-term expected return, which means the chance of underperformance has increased.

A classic example of this is investing in both stocks and bonds in a long-horizon portfolio in an effort to reduce short-term volatility, with the result that it is virtually guaranteed you will underperform a 100% stock portfolio over the long term.

Risk is mentioned frequently in market commentaries and portfolio analysis, but most of the time emotion is what is being referenced, not risk. So when I hear the word "risk," I mentally cross it out and substitute "emotion."

Step 6: I believe that increased stock market volatility represents an opportunity for, rather than a risk to, my portfolio.

Stock market volatility is particularly problematic when making investment decisions. As market volatility increases, the reaction hardwired by evolution is to exit. Since so many investors do exactly this, a behavioral price distortion results.

Research shows that following a period of heightened market volatility, above-average market returns are common. The historical average market return is 10%, which means expected returns exceed 10% after a period of excess market volatility. The typical investor switches into fight-or-flight mode, exits the market and misses the above-average returns. Studies confirm that the typical equity mutual fund investor underperforms the return of the fund, since fund purchases and liquidations are poorly timed.

Step 7: I will divide my portfolio into buckets as a way to reduce emotional sensitivity to volatility.

Dividing up a portfolio into buckets, each meeting a different set of investor needs, is an important step for reducing the emotional impact of volatility. The bucket approach is also referred to as the endowment model, as endowments construct their portfolios in a similar manner. Typically the portfolio is broken into three buckets.

The first bucket meets liquidity and short-term income needs and is funded using liquid, short-term, low-to-no- volatility instruments. The goal is to eliminate concerns regarding volatility, and the result is confidence that short-term needs are being met. The issue of volatility has been removed from this portion of the portfolio.

The second is the capital growth bucket for building long-horizon wealth. It is important to structure your analysis to spend as little time as possible on the short-term performance of this bucket in an attempt to maintain a long-term focus. If this can be done successfully, it is more likely that long-term expected and excess returns will be the focus for building the capital growth portfolio and, in turn, there will be little focus on short-term volatility and correlations.

The third bucket is composed of unique investments requiring special management. Such investments include real estate, farms, art, a stock held for non-performance reasons, and other non-traditional assets. These are managed in a unique way based on your personal preferences.

Breaking a portfolio into buckets is an alternative to the traditional 60/40 portfolio approach. Each bucket meets a specific need, as opposed to constructing a single portfolio to meet overall needs. This divide-and-conquer approach can have a positive impact on performance while reducing the emotional impact of portfolio volatility. It is one of the most effective ways for driving out emotions.

A number of years ago, an AAII seminar participant in Dallas suggested a creative way to fund short-term income needs without having to devote a large portion of a portfolio to low-yield bonds.

Let’s say that you wish to have the next four years of $75,000 annual income needs funded with virtual certainty. To meet this need, one-, two- and three-year Treasury STRIPS (bonds with the coupons—interest payments—removed, or “stripped”), each with a $75,000 maturity value, are purchased. When the one-year bond matures, a new $75,000, three-year Treasury STRIPS is purchased. With this rolling investment strategy, four years of income is guaranteed without having to commit an inordinate portion of the portfolio to low-yielding bonds.

Step 8: I will focus on expected and excess returns, while largely ignoring correlation and volatility, when building long-horizon portfolios.

If a portfolio is divided into buckets, it is easier to focus the capital growth bucket on long-term expected and excess returns. This also provides an opportunity to largely ignore correlation and volatility, which help in dealing with myopic loss aversion, mentioned earlier, but have little or no positive impact on long-term performance.

Investors who successfully implement the bucket approach generally hold little or no fixed income in the capital growth bucket, thus avoiding the negative impact of low expected bond returns. Instead, fixed-income investments are limited for use in the liquidity and short-term income bucket. This is the power of the bucket approach and allows for constructing separate parts of the portfolio very differently. Being able to ignore volatility in the capital growth portfolio is highly favorable for building long-term wealth.

Step 9: I will forget the price I paid for an investment, as well as its name, to mitigate these emotional anchors.

Many will find this suggestion shocking and even irresponsible coming from a professional portfolio manager. Isn’t it my responsibility to know as much as possible about the investments I am making? In particular, the price paid and the name of the investment represent among the most common information gathered. So why would I make an effort to forget both after making an investment?

It is easy for individuals to anchor on a piece of information, even an arbitrary piece of information that has little to do with the investment itself. The price paid is an anchor that impacts subsequent decisions. It is the starting point of many an investment rule, such as stop-loss orders, profit harvesting based on X% price increase, and holding a stock until it gets back up to the price paid. This latter rule is obviously emotional, as are the other two, which is a consequence of myopic loss aversion.

Hersh Shefrin and Meir Statman of Santa Clara University believe purchase price rules are used by so many investors that it produces market-wide price distortions, something they referred to as the disposition effect in a July 1985 Journal of Finance article entitled, “The Disposition to Sell Winners Too Early and Ride Losers Too Long: Theory and Evidence.” This effect posits that investors sell winners too soon because of the emotional validation arising from earning a positive return, while hanging on to losers too long, due to loss regret. A straightforward way to avoid the pitfalls of the disposition effect is to forget the price paid.

Reinforcing the disposition effect is the observation that investors fool themselves into thinking that if the stock is not sold it really isn't a loss. The tax code, which does not recognize gains or losses until realized, supports this too, which is an example of even the IRS encouraging emotional investing. The simplest way to avoid this emotional decision is to forget the price paid and thus have no idea whether you have made or lost money.

As Kenny Rogers once wisely advised, "You never count your money when you're sittin' at the table."

The investment's name is another anchor that attracts information, whether useful or not. As I firmly believe, the key to successful investing is consistent pursuit of a narrowly defined strategy, which translates into making investment decisions based on a limited information set. This means ignoring everything else about the investment other than what is important in executing the strategy. An investment's name attracts a full range of information that you may have a hard time ignoring, particularly if it comes from what you believe is a credible source. It is only human nature to begin doubting your analysis. One way to avoid experiencing these doubts is to forget the name of your investments.

It's only natural that you enjoy talking about your investments. So when asked, you describe them with a sense of pride, since they were selected based on your careful and insightful analysis. The names you mention will trigger in your listener their own emotions and thoughts regarding the company. Often the person will not agree with you and explain why they feel the way they do, and you might begin doubting your decision. Frankly, I could care less what others think of my investment decisions, and so should you. A simple way to avoid this problem is to tell people you cannot remember what you've invested in.

As an example of this concept, for some time I held Deluxe Corp. DLX in our Athena Pure portfolio. Deluxe manufactures and sells checkbooks, and the usage of checks has fallen dramatically in recent years. The conventional wisdom among analysts was that nobody in their right mind would own the stock. However, my strategy surfaced it as a good investment, so it was purchased.

The father of an adviser for which AthenaInvest manages money worked for Deluxe. A couple of years earlier he had some co-workers over for a party and the adviser happened to mention that his investment clients held Deluxe in their portfolio. The Deluxe employees were incredulous, stating in no uncertain terms that Deluxe represented a terrible investment as check usage was tanking.

Deluxe did very well in spite of what everyone else thought and, paradoxically, even those working at Deluxe did not realize their own company's stock represented a good investment. I sold Deluxe early in 2013, not because check usage was declining, but because the company began paying down debt, a no-no in my strategy. The lesson here is to stick with your strategy and don't be unduly influenced by others, even those who know a great deal about the company in which you are investing.

I generally do not remember the stocks I purchase and I do not remember the price paid, because neither is part of my investment strategy. I only learn about gains and losses on individual stocks after the fact, if ever. This does cause problems when current and potential clients ask what is being held in our portfolios and I'm unable to answer.

Even if I happen to remember the name of the stock, I am unable to provide a story suitable for their consumption, as I only remember those few things that I believe are important in making the investment decision. This is disconcerting to clients because I don't know the name of the stocks held and I can't tell a feel-good story. What I can do is explain my investment strategy simply and clearly, and strategy is all that matters.

Not only do I make no effort to remember the stocks I currently own, once I sell, I never look back. I don't know how the stock has performed while I hold it and I don't know how it performs after I sell it. It doesn't take much to imagine a bevy of cognitive errors arising as a result of keeping track of previously sold stocks. Monday morning quarterbacking doesn't improve portfolio returns.

As I reminded my AAII audiences, there is only one reason to buy stocks: to make money. They are not part of your family. If you conclude that a stock is no longer a good investment, sell it, forget it and move on. Do not fall in love with your stocks and don't think twice when you sell them. Investment management is a cold-blooded, return-maximizing endeavor.

Step 10: I believe past performance is a poor predictor of future performance, so I will not use it when evaluating an investment manager.

Past performance is not predictive of future performance. It is not like there is controversy surrounding this conclusion, as it has been confirmed by numerous academic studies. In spite of overwhelming evidence, virtually everyone, individuals and professionals alike, uses past performance in selecting managers. In fact, it is frequently the most important criterion when selecting a manager.

This is a dramatic example of the emotional power of the representativeness bias. If you release this emotion, you will be acting differently than virtually everyone else in the industry. Are you strong enough to do this? If you are, your portfolio performance will improve.

Step 11: I believe unreasonably constraining a portfolio, such as keeping a manager in a style box, hurts performance and thus will be avoided.

Consistent pursuit of a self-declared investment strategy is key to superior performance. Anything that gets in the way of doing this, such as emotions applied by an investor or constraints imposed by the industry, hurts investment performance.

One of the major offenders in this regard is the style grid used for active equity fund evaluation and distribution. One way to improve portfolio performance is to remove any requirement for a fund to stay in a style box.

Step 12: I will consistently pursue a narrowly focused investment strategy while taking only high-conviction positions when managing a portfolio.

Now that 11 of the 12 steps for removing emotions have been completed, you are ready to begin building an investment strategy. Successful strategies are narrowly focused on harnessing emotional crowd-driven price distortions by consistently pursuing the strategy over time and by taking high-conviction positions. These are important for building a superior portfolio.

Conclusion

There you have it: a simple approach for mastering your emotions! But of course, behavior modification is no easy task, so I am being facetious when I say it is simple. It is indeed quite difficult. But the reward is the ability to build superior portfolios. In fact, I believe removing emotions is the key to becoming a successful stockpicker. As I speak with advisers, other professional portfolio managers and individuals around the country, I become ever more convinced of the truth of this statement. I hope my 12-step program allows you to make progress on your road to emotional mastery.

And I leave with the Athena mantra: May you be wealthy and do good!