Behavioral Finance: Taking the Emotion Out of Investing

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August 2017

Discussing finance is generally something most people like to avoid. Are we saving enough? Can we pay for the kids to go to college? When can we retire? All of these questions and countless others have emotions tied to them. Some investment theories suggest investors are rational and that they do not make financial decisions based on emotion. However, the reality is that your emotions come into play with most, if not all, of your financial decisions.

Behavioral finance is an area of study that attempts to explain why investors act as they do. There are anomalies at both the investor level and in market activity overall that are not explained by objective technical market analysis. This is where behavioral finance concepts provide answers. Two of the concepts clients fall victim to include the Gambler's Fallacy and Herd Behavior.

Gambler's Fallacy

The easiest way to explain this theory is flipping a coin. The past ten times you flipped it, the coin landed on heads. You think the next flip will be tails because the previous ten flips were heads. Or, you think it will be heads because the previous ten flips were also heads. This phenomenon is called the Gambler's Fallacy. The fact is, each time you flip the coin, it has the same probability of landing on heads or tails, and the previous flips have nothing to do with the outcome of the next flip.

This theory also applies to investing. Often investors will see a streak and think the pattern will continue–only because it has continued thus far. For example, an asset one holds has been going up in value for six months. One investor puts more of their money in the investment because they are sure the rise will continue (only because it has so far). Another investor spots this pattern and sells out of the asset completely, convinced that it couldn't continue (only because it has). Both fall victim to Gambler's Fallacy, not taking into account investment fundamentals.

To guard against Gambler's Fallacy, be sure to research and make investment decisions based on facts and fundamentals of the asset and not on the emotion of how it may have performed.

Herd Behavior

Herd Behavior is another concept that can harm an investor. The term "herd" comes from the observation of the animal kingdom and how different species move about based on instinct; think of the Buffalo hunt stories we have all heard of, or the vision of Penguins jumping off of an ice shelf. Herd behavior is the idea that one is doing something just because everyone else is doing it. Herd Behavior occurs in all types of situations, but how does it apply to financial decisions? An example of how Herd Behavior can become catastrophic is the dot-com bubble in the late 90's. Investors unloaded their money into any internet-related business they could find. Not because these companies had solid financials, but because of the optimism of the continued positive performance. The problem with Herd Behavior is that by the time most investors hear of the next big investment, it is too late. They are not going to realize the same appreciation as the investor who was an early adopter. This leads to investors constantly changing their portfolios to have what they believe to be the best investments in their portfolio.

To avoid joining the herd, always make investment decisions based on research and do not follow market fads.

If you manage your own portfolio, it is easy for your emotions to take over and make an irrational investment decision. One proven way to help remove emotion from financial decisions is to work with a professional financial advisor. Not only can they remove subjectivity from your portfolio decision, but they can answer questions such as: how much to start saving, what investment vehicles may be best for you, what you need to do to prepare for retirement, and how to protect yourself from unforeseen setbacks. Your financial planner will know your financial situation and answer any questions you may have, thereby relieving some of the emotion and helping you reach your current and future financial goals.

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