THE WALL STREET JOURNAL.

http://www.wsj.com/articles/this-is-your-brain-on-money-how-investors-trip-themselves-up-1429274625

WEEKEND INVESTOR

This Is Your Brain on Money: How Investors Trip Themselves Up

Three recent studies of behavioral finance show how biases and other foibles can hurt performance

Researchers have detailed numerous ways in which investors can inadvertently hobble their portfolio returns.
PHOTO: SPENCER PLATT/GETTY IMAGES

By LIAM PLEVEN
April 17, 2015 8:43 a.m. ET

Making off-the-cuff decisions, being prone to bias, and getting swayed by market moves. Is that any way to make money in the stock market?

Researchers have found signs of all three behavioral traits in new studies that offer fresh evidence that investors can be their own worst enemies.

Such foibles can be costly, experts in behavioral finance have shown. Work by academics such as Princeton University's Burton Malkiel and endorsements from Warren Buffett and others have boosted the popularity of passive index funds, which can help protect investors from mental mistakes by putting important decisions on autopilot.

Whether they favor index funds or not, investors should use the latest disclosures to examine their own behavior—and try to better understand what motivates it.

"Being aware of the biases may lead you to consider asking questions that you otherwise might not ask," says Jay Ritter, a finance professor at the University of Florida who has written about behavioral finance.

Sell side. One of the new studies found that both individual investors and mutual-fund managers are more likely to sell stocks that are either among the biggest winners or the biggest losers in their portfolios. The study appears in the current month's edition of the Review of Financial Studies, a peer-reviewed journal.

The author, Samuel Hartzmark of the University of Chicago, dubs the phenomenon the "rank effect," and says that it shows up even if you look at two different investors who hold the same stock. The one for whom the stock is an extreme winner or loser is more likely to sell, the study found.

The rank effect also shows up in investors' tax-deferred accounts, suggesting that the sales of extreme losers can't be explained away by investors realizing losses to offset gains for tax purposes, according to the study.

The research indicates that investors poring over their account summaries use the rank effect as "a quick and dirty rule" in deciding which stocks to sell, Mr. Hartzmark says.

The risk is that an investor who unconsciously narrows the pool of candidates of stocks to dump may overlook another that should be sold off instead, he says.

"You really need to be aware you're doing this, so you don't miss something," Mr. Hartzmark says. "If you're aware of it, it's much easier to overcome."

Foreign policy. A second study found that investors put less money into mutual funds run by managers with "foreign-sounding names" than into similar funds run by managers with "typical American names." To draw the distinction, the researchers collected the names of all managers of U.S. diversified stock funds from 1993 to 2011 and asked U.S. survey respondents to decide which names sounded foreign.

The researchers also asked another group to allocate $100 between two similar S&P 500 index funds, one run by a manager with a name that was deemed "foreign" and one run by a manager with an "American" name. Sometimes the fund run by the manager with a foreign name had slightly lower fees, and sometimes the fund run by the manager with an American name had slightly lower fees.

Two funds that track the same index are likely to have nearly identical returns before fees. As a result, "a rational investor should always pick the cheaper fund," Alexandra Niessen-Ruenzi, a finance professor at the University of Mannheim in Germany, one of three co-authors, said in an email.

But in the experiment, investors allocated nearly $11 more on average to the fund run by the manager with the American name regardless of the fees charged, says Alok Kumar, a finance professor at the University of Miami and a co-author of the study.

The study is forthcoming in the Review of Financial Studies.

Parent trap. A third study found that investors put more money into mutual funds when the share price of the fund's parent company is outperforming the market than they put into mutual funds run by companies whose share prices are lagging behind.

For most of the companies in the study, running mutual funds was a relatively minor source of revenue. That suggests that the inflow of investor money wasn't driving the parent company's share price, according to Clemens Sialm, a professor at the University of Texas at Austin who co-wrote the study—which also included fund firms such as T. Rowe Price Group and Janus Capital Group.

The study, which didn't include companies whose shares aren't publicly traded, such as Vanguard Group and Fidelity Investments, is due to be published in Management Science, another peer-reviewed journal.

Investors might have an "economically plausible" rationale for investing in mutual funds run by companies that are perceived to be doing well, Mr. Sialm says. A thriving company might invest more in its products and employees, while a struggling firm might invest less, he says.

MORE WEEKEND INVESTOR

- How to Cut the Tax on Your Investments (http://blogs.wsj.com/totalreturn/2015/04/16/how-to-cut-the-tax-on-your-investments/)
- How to Play the College Financial-Aid Game (http://www.wsj.com/articles/how-to-play-the-college-financial-aid-game-1429280048?tesla=y)
- Are You Hot or Not? For Investors, It's Hard to Tell (http://blogs.wsj.com/moneybeat/2015/04/17/are-you-hot-or-not-for-investors-its-hard-to-tell/)

But the study found no pattern of outperformance by mutual funds run by a parent company whose share price has been faring relatively well. "There are many instances where the management company is doing well compared to its peers, but the mutual funds are not," Mr. Sialm says.

Investors "can improve their financial outcome by behaving more rationally," he says.

The notion that investors can harm themselves with behavioral errors isn't new, of course. Benjamin Graham, who was Mr. Buffett's mentor, helped popularize the notion decades ago.

But the recent research serves as a reminder to stop and reflect before you act.

In his classic book "The Intelligent Investor," Graham wrote, "We have seen much more money made and kept by 'ordinary people' who were temperamentally well suited for the investment process than by those who lacked this quality, even though they had an extensive knowledge of finance, accounting, and stock-market lore."

—Email: liam.pleven@wsj.com