KEYSTONE FINANCIAL PLANNING
ELECTRONIC NEWSLETTER
June 30, 2008

Doing investment research? You are probably wasting your time

Are you the type of investor who diligently researches an investment or the markets before making your decisions? If so, you might be making a lot of mistakes: innate biases make it very difficult for any investor—even professionals—to make good decisions based on detailed research. Here are some of the problems:

- More information often just confirms a decision already made.
- We tend to look only for information that confirms our bias and interpret all information as supportive, even if it isn't.
- We tend to obey and follow figures of authority, even without good reason.

Many studies have shown that increased information merely leads to increased confidence in a decision, rather than to a better and more accurate decision. In one study, racing bookmakers were given information on a race and asked for their predictions. They were then given additional information and again asked to compute the odds. Each time this process was carried out, the bookmakers became more confident in their predictions as the information increased. However, their accuracy did not increase from their first predictions.

In another study published in the *Journal of Economic Psychology*, stock analysts were asked to forecast fourth quarter earnings for several firms. They were presented with the data in three formats, with the second format adding redundant information and the third format adding non-redundant information. The additional information—whether redundant or non-redundant—reduced, rather than increased, the accuracy of their forecasts.

Once we get information we don't handle it very well. Many studies have shown that we not only seek out information that confirms our biases, but that we tend to see all information as consistent with our beliefs, even when it clearly is not. In one such study, two groups—one opposed to capital punishment and one in favor—were given randomly selected studies on whether capital punishment deters crime. They were then asked to rate the studies. Those who supported capital punishment rated highly those studies that found it effective, and rated poorly those studies that found it ineffective. A similar result was obtained from the other group.

Doing research that involves reading the opinions of top investors also can hurt. Many studies have shown that we are deeply obedient to authority, even when our own experience or beliefs are contradicted by an authority figure. In one classic study, subjects were asked to give electric shocks to other subjects who screamed and begged for mercy. Even though those giving the shocks thought they were real, they continued merely on the authority of a "teacher" conducting the test.

The best way to counteract these biases is to put your investing on autopilot by using indexed and asset class portfolios that buy large swaths of the stock and bond markets.

Male hormones and irrational trading

And you thought financial market trading success was all about smarts and experience: a new study indicates that male hormones may play a major role in decision making by successful traders. John M. Coates and Joe Herbert of Cambridge University in England sampled the levels of two hormones—cortisol and testosterone—in male floor traders in London's financial district. They correlated levels of the two hormones at 11 a.m. and 4 p.m. each day with each trader's hits and misses.

They found a correlation between high testosterone levels at 11 a.m. on particular days and higher profits on those days. "Testosterone increases competitiveness, aggressiveness, and risk taking. That's what testosterone does. For males to achieve reproductive success, you need to take these risks. Now, an ancient biological system is working in a new, man-made environment," said Herbert, a neuroscientist who studies how hormones affect the brain's function.

By contrast, on days when the markets were falling, samples of traders showed higher levels of cortisol, a hormone associated with stress. "Cortisol has massive effects on brain function, it makes you anxious, sometimes depressed, causes you to react more strongly to adversity, to remember adversity," Herbert said. "It's a rather depressing hormone."

Although there seems to be a short-term correlation with testosterone, risk taking, and trading success, the researchers cautioned that repeated testosterone boosts may lead to irrational risk taking. Repeated wins and increased hormone levels can make an individual overreach and make rash decisions. Coates theorizes that this happens during market manias, helping to boost financial bubbles. He observed this type of behavior as a Wall Street trader during the 1990s boom. Alternatively, during market downturns increases in cortisol can provoke excessive caution, exacerbating the decline.

A more stable financial system might come about if more women and older men with less testosterone were trading, Coates said.