KEEN ON
RETIREMENT

Are You Losing Thousands of Dollars by Making These Behavioral Investing Mistakes?

Welcome to Keen on Retirement
With Bill Keen and Steve Sanduski

Steve Sanduski: Hey, we've got a great show lined up today. We have another special guest and we're just really excited to have with us today Dr. Daniel Crosby. Dr. Crosby is a psychologist. He's a behavioral finance expert. He's a best-selling author, and he's also the president of Nocturne Capital.

Daniel has a new book called The Laws of Wealth: Psychology and the Secret to Investing Success, and we're going to explore that today, Bill.

Bill Keen: Yes.

Steve Sanduski: Daniel, welcome to the show.

Daniel Crosby: Great to be here.

Bill Keen: One of the most important things about what we're doing here at Keen Wealth is educating and helping our clients and listeners to be engaged in the process. I've always said, Daniel and Steve, that. I believe in lifetime learning, and that's why we reached out and we asked Dr. Crosby to be on our show today because just kind of going to the Barron's conferences and the other think tank groups that we attend every year, we like to collaborate and find out just what's working and bring those things, the core, the fundamental things that are working for investors out there long-term and bring those to our podcast.

Daniel, thank you so much for taking the time to be on here with us today. I know you've got a busy schedule and you are in demand.

Daniel Crosby: Yeah, my pleasure.

Steve Sanduski: What we want to talk about today is this idea of behavioral investing, and I know we've chatted about this a little bit in the past, Bill, but this is a topic that really gets to the heart of investing. When we think about investing, there's a couple of ways to look at it. One is more the mathematical part of investing, the research-based part of investing, the rules-based part of investing, and that's how do we make specific investment decisions, buy-and-sell decisions, that sort of thing, and that's all well and good.

Then there's the other part, which is the emotional aspect of investing, the behavioral aspect of investing, where as the markets fluctuate and things go up and down, sometimes our mental faculties can play some tricks on us and cause us to make some investing decisions that may not be optimal. Daniel, Dr. Crosby, is one of the country's leading authorities on behavioral investing. Your new book talks all about that. We want to go through, Daniel, some of these rules of behavioral self-management that you talked about in your book and what are the things that investors need to keep in mind in order to continue to make good investment decisions.

Why don't we start with, maybe just give us a definition of behavioral investing, behavioral finance.

Daniel Crosby: Behavioral finance tries to sort of reintegrate messy humanity into the process. For so long, our economic and financial models were based around rational actors. We all know, especially those of us with kids, that human beings are not rational actors. Behavioral finance just tries to account for the messiness of imperfect human decision-making and amend it to make it a little bit closer to perfect.

Steve Sanduski: This is really an area of study that academics have been pursuing in, I would call it recent times. Are we talking maybe in the last 20 years or so that this has really become an area of focus for academics to study and research?

Daniel Crosby: It's certainly very topical. It's certainly very hot right now. It's been around in some form more or less forever. It's been its own discipline, probably named discipline for the last 40 or 50 years but really came of age in the last 10 years, even 5 years perhaps, with Daniel Kahneman winning Nobel Prize for his work. That's really, I think, what put behavioral economics and behavioral finance on the map.

Bill Keen: He's the Thinking, Fast and Slow. Is that his book, right, Daniel?

Daniel Crosby: That's his book. It's an excellent book.

Bill Keen: Yes. It's a little bit of a long read, but it's pretty valuable, isn't it?

Daniel Crosby: Absolutely. It's a good book for life. It is a thick read, but he has an incredible volume of work, and it's all presented very nicely there.

Bill Keen: Yes.

Steve Sanduski: Good. Why don't we go through a few of these rules of behavioral self-management, Daniel. What would be a good first one to start with?

Daniel Crosby: Yeah. We'll start at the very beginning. This is the one that if listeners hear nothing else, I hope that they learn and adopt this one, which is that in every market, you control what matters most. Again, in every market, up, down, sideways, you control what matters most. There was a Natixis study that came out recently that I thought was so telling about the state of the financial services industry, because they surveyed financial services professionals like our esteemed hosts here today and said, "Hey, what is the most important thing? What's the biggest determinant of whether or not your clients will reach their financial goals?" and 83% of the professionals said it's behavior, are they managing their emotions, are they managing their behavior. They turned around and asked the clients of these 700-and-something advisors, "Does behavior matter?" and only 6% said yes.

Over the last 20 years, the market has returned an average of 8-1/4%, but the average investor has kept just about half of that, just about 4%, which barely keeps up with inflation. We give a lot of this back by making fearful, greedy, panicked decisions. I think what the industry is coming around to but needs to now disseminate to the investing public is that the choices you make have just as much or more to do with your ability to reach your goals as do things like the returns you get.

Bill Keen: Don’t you believe that so many times we have this instinct to think we need to be doing something, that we need to be reacting or taking action? I think it speaks to maybe one or 2 of your other commandments, if you will, or rules, but it's just such human nature, isn't it, to feel like we need to be doing something?

Daniel Crosby: Yeah, it is. In the book The Laws of Wealth I talk about ... The psychological term for it is action bias, but I talk about what I call in the book Wall Street Bizzaro World, which is the ways in which the rules of investing are run contrary to the rules of everyday life. If you think about wanting to get more fit, you spend more time in the gym. If you want to become more knowledgeable, you read more books. Then when you bring that and extrapolate it to the investing world, research shows that people who watch more financial television and consume more sort of daily financial news have worse performance than those who ignore it altogether.

One of my favorite studies in the book, in the chapter titled Do Less Than You Think You Should, which is, indeed, one of the commandments in the book, Fidelity did this great study where they looked at their retail accounts and they said, "We want to talk to these retail investors who've done exceedingly well, and we're going to drill down and figure out what are the behavioral characteristics that are common to all of our best investors." What they found was, the unifying theme was that the people who had experienced the best returns had forgotten that they had accounts at Fidelity. They didn’t even remember when they get this call that they had an account. It's a strange thing to think that doing less gets you more, but, indeed, that is the case in the world of investing.

Bill Keen: Let me restate what Daniel said and confirm this for our listeners here. Over the last 20 years or so, the overall market return has been somewhere slightly north of 8%, but the average investor has only captured 4% of that return. I wanted to make sure we said that again so folks could really grasp the vastness of that. It would be our belief and actually the fact that that's all behavioral. Right, Daniel? People unable to manage emotions and jumping in and out at the wrong time. That's what we're seeing there, that gap, isn't it?

Daniel Crosby: Yeah, it is. When you think that the market's given you 8%, you've given up 4% to being fearful or greedy, and then inflation's taken 3%, that's like 1% real for the average investor.

Bill Keen: Yes.

Daniel Crosby: It's brutal. If you're not working with someone ... That, again, I guess leads us to our next rule. One of the rules that I have is that you cannot do this alone. The reasons for that I think are a little counterintuitive. Again, going back to that Natixis study, when most people hire a financial advisor, they think they're getting some sort of great stock-picker, someone with financial acumen that exceeds their own, and that is hopefully the case, but the research is pretty unequivocal that the greatest value that an advisor has is that he or she keeps you from making a handful of bad decisions over the course of your investment lifetime and keeps you in your seat.

I cite research in The Laws of Wealth from Vanguard, Aon Hewitt, Morningstar, Envestnet, Brinker Capital, all of which found that people who work with advisors do 2% to 3% better per year than those who go it alone, which is incredible, over a lifetime could nearly double your terminal wealth. That 2% to 3% per year comes not from genius stock-picking typically but from just keeping you from being your own worst enemy. I like to say you need a financial advisor, but not for the reason you think.

Bill Keen: Right. It's about consistency. It's about planning and being able to stay the course, one of the best investments, or the best investment process or program you can be involved in is one you can stick to.

Daniel Crosby: Mm-hmm (affirmative). Yeah, absolutely.

Bill Keen: I've seen so many people over the years that have been referred into the firm who have been jumping around from investment to investment. To our points here, you find the very best one and you still underperform the market by, call it half because of behavioral mistakes.

Daniel Crosby: I'm going to give away the whole book on this podcast, but one of my favorite, another favorite anecdote from the book is I talked about ... I'm forgetting the name of it now, but it was the best mutual fund of the 2000s, so from 2000 to 2010, it was the best mutual fund, and that mutual fund outperformed its nearest competitor by 3% a year. It ended up getting ridiculous 18% a year returns over 10-

Bill Keen: Yes.

Daniel Crosby: ... which is incredible. The average investor in the fund had negative returns, because what people did is that when this mutual fund did well, people piled in. Then it did poorly because mean reversion is a thing. It did poorly, everyone jumped out. It took off again, people jumped back in. You're looking at ... You picked a skillful manager. They were getting 18% a year and no one could handle the ride. Yeah, it really is a lot more about your behavior and choosing a roller coaster that you can ride.

Bill Keen: That’s right.

Steve Sanduski: Daniel, I'm looking at your list here. I got a copy of your book, and rule number 3 I think is another good one here.

Daniel Crosby: Trouble is opportunity. Trouble is opportunity is something that everyone knows and no one does, because the way that we evaluate risk has a lot to do with our mood. If you ask someone who's having a bad day to tell you a story about their childhood, they're going to tell you about getting stuffed in a locker and beat up at PE or what. If you ask someone who's having a good day, they’ll tell you about trips to the shore with the family.

We do this very same thing when we're evaluating market risk. When you look at something like a March of 2009, one of the things that I do is I've come up with systems for giving zero to 100 scores of market sentiment. My sentiment measure has been tested back 50 years, 55 years, and March of 2009 was the absolute low point ever. It was a 5 out of 100 in terms of investor sentiment.

Bill Keen: Yes.

Daniel Crosby: Yet you look at what would have happened if you’ve ... What's happened to the market, it's up 300-something percent since March of 2009. If you are able to develop this sort of contrarian mindset, this sort of schadenfreude approach to investing, I think you're onto something powerful. Now, again, this is something that everyone knows and no one does, right? There's a huge, huge gap between what we know and what we do, and, again, that’s where I think the advisor comes in. They're able to objectively give you a sense of where we are and what you ought to be doing.

I liken it in the book and in my talks to eating. I travel a lot, and if I am ever beaten down by a long travel week and I'm in the airport and I'm eating a cinnabun, it's not because I think it's good for me. It's just because I'm broken. Right?

Bill Keen: Right.

Daniel Crosby: I'm just defeated. The same thing is true of investors. We know what we ought to do, but doing it is an entirely different thing and is where an advisor adds so much value.

Bill Keen: Daniel, I was reading one of your blogs here, and I've also read your book and thoroughly enjoyed it. Would you share the story about how you typically kind of monotonously drive home every day, which we all do, and that you accidentally drove by a hospital one day and what you saw out in the parking lot? Do you remember what I'm talking about?

Daniel Crosby: I do. I do, yeah. This is a blog post about the knowing-doing gap. We usually kind of go into a hypnotic autopilot when driving home, but there was a wreck or something one day and I got rerouted, and I drove by a hospital and there were 13 doctors and nurses out in front of the hospital smoking. It just brought me in mind of what psychologists call the knowing-doing gap. We see this time and time again. We do things that we know we ought not to, and it's sad to say, education in terms of managing tough behaviors is very, very limited in its efficacy. We really need real-time interventions. You need someone to slap the cinnabun out of your mouth-

Bill Keen: Right.

Daniel Crosby: ... while you're eating it, and you need that advisor in the moment to tell you, "Hey, you cannot mortgage your future by doing this. It's not enough to read books on investing."

Bill Keen: That’s right.

Steve Sanduski: Yeah. I think your rule number 4 here is similarly related to number 3, the trouble is opportunity, and your number 4 is if you're excited, it's a bad idea. Tell us about that one.

Daniel Crosby: Yeah. There's a great quote. Let me see if I can remember the exact quote. Oh, here it is. Paul Samuelson, Nobel Prize winner Paul Samuelson said it best. He says, "Investing should be more like watching paint dry or watching grass grow. If you want excitement, take 500 bucks and go to Las Vegas." That’s absolutely right. The best investing, the best investment paradigms are easily described, they're highly intuitive, they make a lot of sense.

Again, some of the sexier parts of investing, things like IPOs I talk about in the book and how IPOs have underperformed the S&P 500 by 21% 3 years on. Again, everyone's got a story about, "Hey, if I had just put $10,000 in Apple on day one, I'd be a gajillionaire now," but these stories tend to override probability, which is a far better predictor of how you're going to do, and you're probably going to do very poorly if you're investing at a time of extreme emotion, either good or bad.

Bill Keen: I was going to make sure we said that. It's not just good, but it's on the bad side, too, or on the maybe fear or panic or what have you.

Daniel Crosby: Yeah, absolutely.

Steve Sanduski: Yeah. I think Warren Buffett said one time that his performance would have been even better if he went to more movies, the implication being that he spent too much time in the office, which caused him to want to do something and make a trade that didn't turn out as well as he hoped, and if he'd have just spent more time at the movies and not thinking about his investing, he probably would have made fewer decisions and it would have gotten some better results. Even the best of them, guys like Warren Buffett, succumb to some of these behavioral biases as well.

Daniel Crosby: I say in the book with no irony that we would be better served if fund managers worked 4 days a year, and I'm totally not kidding. I really think people should make fewer decisions. I live in Atlanta, and I presented to the Southeastern Hedge Fund Association earlier this week, and that didn't go over.

Bill Keen: Right.

Steve Sanduski: All right, what's number 5?

Daniel Crosby: Number 5 is you are not special. This has a lot to do with over-confidence. We as a human species are over-confident by and large, and if you're not, you're probably depressed. There's not much middle ground, it turns out. Over-confidence is damaging in a couple of ways, but mostly because it makes us a stranger to our rules. If you look at research on this, men are especially prone to be over-confident.

There is research in the book that said that 94% of men think they have a better than average sense of humor, and 100% of men surveyed thought that they were more interpersonally skilled than average. If you think about that, that's not how averages work and some of those guys are incorrect. Everyone thinks they're better looking, better driver, funnier, whatever, and this carries over to our investing lives.

Now it's funny to laugh about this stuff in the context of driving or looks or whatever, but when it comes to investing, this causes us to under-diversify. It causes us to hang on sometimes to concentrated holdings maybe that we inherited and have some sort of emotional connection to, but it leads us to make decisions that we wouldn't recommend to other people because our human tendency is to delegate the dangerous and to own the optimistic. We tend to under-represent the likelihood of something bad or tragic happening to us and over-represent the likelihood of good things happening to us. It leads us to make low probability, overly high conviction decisions, and it can be very dangerous.

Bill Keen: I've seen, interestingly, advisors that manage money for their clients one way and completely differently for themselves, based on exactly what you just said.

Daniel Crosby: Absolutely.

Bill Keen: We try to practice what we preach around here, one because I've seen how it works over time. Have you seen any of that type of thing, Daniel?

Daniel Crosby: You mentioned at the outset that I'm an advisor. I have an RIA myself, right?

Bill Keen: Yes.

Daniel Crosby: A lot of times people ask me if I manage my own money, and I do not. I write books on this stuff. I'm licensed myself. I do this for a living, and I do not manage my own money, because I know I am just as stupid and irrational as the next person when things get ugly, and I know I'm going to make poor choices. I pay someone to manage my money, even though from just a knowledge basis, I could easily do it myself. I know that behavior matters more than just that basic content knowledge, and I act accordingly.

Bill Keen: That's right. I'm fortunate enough to have a great team of credentialed folks here at the firm, and when I'm giving talks or talking to folks personally, I say, "I'm an advocate and I'm biased. I'm biased in one way, at least. I believe folks should have an advisor." Now we are advisors, but I believe people should have an advisor, and I say, "I have a financial advisor or a team of advisors," and people look at me kind of funny.

I say my wife and I sit down with the advisors here at my own firm and we walk through all the financial planning process, the checklist and the investments, what we're trying to accomplish, the "why" every year with them and commit to them and are held accountable by them to what we said we wanted. It's powerful. It's just powerful. We could go on about that for a while, but, Steve, I'll let you continue us through the list here.

Steve Sanduski: Yeah. No, I think rule number 6 here is also really important. A lot of times we talk about the benchmarks, investment benchmarks, whether it's the S&P 500 index or the Dow Jones industrial average, but, Daniel, I think you've got a different idea on what the best benchmark is.

Daniel Crosby: Yeah. Rule number 6 is that your life is the best benchmark, and there's 2 big reasons for this. First, we talk about what I call anxiety adjusted returns. You want to maximize your anxiety adjusted returns, which is good, all the return you can that you can actually handle the ride for. Get all the return you can and still sleep well at night, and that looks different for every person. That's where the advisor has to dig in, understand the risk tolerance, risk capacity of an individual and make choices accordingly.

The problem is most people's de facto benchmark is the S&P 500, but that's not the ride that the average investor wants. People want the kind of returns they've gotten from the S&P 500 over the last 7-8 years, but they don't want what the S&P 500 gave you in 2008-2009, and most people don't look at that fairly. One reason is you have to understand what you're going for and measure your risk accordingly. The second reason I talk about having a personalized benchmark is ... You talked earlier about reviewing that "why" every year.

Bill Keen: Yes.

Daniel Crosby: That process of reviewing why actually has some behavioral magic in it. I cite a study in the book that talks about the power of purpose and the power of keeping that "why" front and center in the planning process. In the book I talk about a study that was done with low-income savers where individuals who are subsistence level poor, they're just getting by, they're having, clearly, a hard time saving money, and they try carrots, they try sticks or rewards and punishments, nothing's working. Until finally, they say, "Okay, we're going to prime you with your 'why.' We're going to prime you with a picture of your children before you make important financial decisions."

When they kept that "why" front and center, these low-income savers were able to put aside 250% more than they had previously. Having that personal benchmark from a practical standpoint gets us invested wisely and in a way that we can tolerate, but there's a behavioral component to it, too, that can really animate our saving and our ability to stay the course.

Bill Keen: It creates leverage, doesn’t it, Daniel?

Daniel Crosby: Sure, yeah, behavioral leverage.

Steve Sanduski: Bill and Daniel, I think we're going to tease the audience here, in that, Daniel, you've got 10 rules here and we've gone through 6. We're going to go through one more rule, and then we're going to leave 3 of them for our listeners to check out from your new book. I think that would be fun. Let's take a look at number 9, rule number 9. I think that’s another good one here to chat about for a minute.

Daniel Crosby: Right. Diversification means always having to say you're sorry. The corollary to this, an easier way to say this is that if everything in your portfolio is up at the same time, you're probably not appropriately diversified. Diversification is, again, one of those things that’s widely understood to be important and very seldom done appropriately, I think. I cite research in the book.

We often talk about the lost decade in the U.S. The early 2000s, we had this 10-year period where the return for the S&P was negative over a decade, which had never been the case in U.S. history to that point. If you look at someone who was equally invested among American stocks, international stocks, real estate, fixed income, et cetera, commodities, this person would have gotten, I believe it was about 7-1/2% annualized over that "lost decade." The lost decade and, in fact, times like that are really only lost to people who aren't properly diversified. The bad news is something's always going to be underperforming, and that’s just a fact of life. The good news is over long periods of time, something's always going to be outperforming as well, and the results are far, far more palatable.

Bill Keen: Daniel, don't you also believe that, without getting too technical today, the concept of rebalancing among the asset classes ... I'm assuming that someone has a technically competent portfolio that's being paid attention to, that's rational and diversified appropriately. The concept of harnessing some of the gains and maybe taking advantage of some of the downturns and asset classes that haven't done as well by the rebalancing process actually can turn volatility into your friend if it's done just correctly and with discipline over time.

Daniel Crosby: Oh, yeah. again, another piece of value that advisors add.

Bill Keen: That's right.

Steve Sanduski: I think we are going to wrap it up there. We've gone through 7. There's 3 more. There's, of course, a lot more great ideas and information in Daniel's book and we will definitely link to that in the show notes at keenonretirement.com, so all the listeners, please make sure you go to the website and check out the additional information that we have for the show notes page.

Bill, how would you like to wrap up today's show?

Bill Keen: I think it's so important that folks keep, number one, keep the "why" front and center and not be concerned about what everybody else is doing, but be concerned about your own situation. I always say the fiscal cliff is looming. I guess it's always looming enough for the U.S., but I'm worried more about the client's personal fiscal cliff and their personal situation and how we're going to make decisions on the ground, in the trenches, for that family, and thinking about those things the way Daniel put it today for us so nicely and just keeping that focus on the long term makes a huge difference.

Daniel, thank you for taking the time to be with us today. Again, very, very interesting, and we're going to link to your book in the show notes. I'd recommend everybody pick up a copy of Daniel's book and check it out because as I study his material, it's just right up our alley. I agree with nearly everything that Daniel talks about in his works, and I'm grateful to have been able to talk to him today.

Daniel Crosby: Thank you both.

Steve Sanduski: Thank you. All right, it's a wrap for today. Thanks, everybody, for listening. Again, check out keenonretirement.com, and we'll talk to you on the next show.