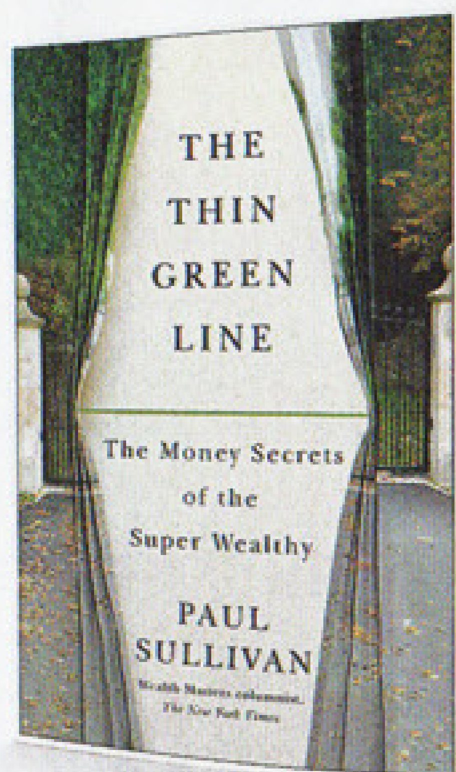
WHEN IT COMES TO BUYING AND SELLING INVESTMENTS, IT TURNS OUT THE ONE PERCENT MAKE THE SAME MISTAKES THE REST OF US DO. FIX THOSE ERRORS, AND YOU GREATLY INCREASE YOUR CHANCES OF ACHIEVING REAL WEALTH.

# 3 HABITS OF THE RICH TO AVOID

BY PAUL SULLIVAN / ILLUSTRATIONS BY OLIVER MUNDAY

**WHAT SEPARATES THE TRULY WEALTHY** from the rich and everyone else in investing? Brad Klontz, a financial psychologist who has an appointment to Kansas State University's personal-financial-planning department, and I undertook a survey in the winter of 2013 to find out what was different about the One Percent. When it came to investing, almost all of them had a financial adviser, over 80% had an accountant, and two-thirds of them had a lawyer they consulted regularly. They would seem to be set. Yet those advisers could not protect them completely from the tendencies and biases that can derail anyone's investment strategy. Drawing the thin green line between the wealthy and the rich was not as simple

as tallying up how much money someone had to invest. It isn't that easy. People with a lot of money to invest make the same dumb mistakes as everyone else. Just because they successfully managed businesses that sold cars or vinyl siding or computer software didn't mean they understood how to manage the money made from those decisions.




In our survey, with representative samples of people in the top 1%, 5%, and 20% for earnings, Klontz and I found that the 1% were actually more likely than the top 5% to make common investing mistakes. They were overconfident in their investing ability. They made more trades. They took pride in selling winners, and they were more likely to hold on to investments that had lost value instead of selling them, taking the loss, and moving on to something else. They also invested in businesses run by friends—even though they said they knew that was a bad idea—and took friends' advice over that of a financial adviser on investments. While these findings make the One Percent similar to less rich people, it also shows how ingrained destructive investing behavior is. It seems hardwired.

What people and their advisers need to do to get on the right side of the thin green line—by which I mean a sense of wealth that lets you make the choices you want, whether you are a nurse, an executive, or a hedge fund manager—is to avoid the three things that can ruin any investment plan: optimism, trust, and self-confidence. When it comes to investing my own money, I shed these feelings, laudable in other areas of life, years ago. I owe my skeptical view to three people: Gregg Fisher, Daylian Cain, and Terrance Odean.

## BE WARY OF THE PAST

**FISHER, PRESIDENT** of Gerstein Fisher, a wealth-management firm in New York, has found a way to get clients to be less optimistic without making them so pessimistic that they bury their money in the backyard. When I sit down in his office, amid the high-rises of Midtown Manhattan, he extends to me a bowl filled with marbles.

"Without looking, pull one out," he tells me.

I do. Black.

"Now put it back and take out another."

Black again.

"One more time."

White.

"You made money," he says with a smile.

In the bowl there are six white marbles and two black ones. The white marbles stand for a rising stock market, the black ones for a declining one. Historically the stock market has gone up 75% of the time, but it doesn't go up three years in a row and down the next one. I had two declining years before I picked the white marble.

Fisher, who manages $2 billion for about 600 clients, says that what his clients struggle with the most is being fixated on events that have already happened. That's the point of picking marbles out of the bowl: The color you just picked has no bearing on what color you're going to get next. "Most people cannot turn off yesterday," he says. "And if the past 10 years are influencing your decisions around investing, it's going to hurt you."

In 2010, after 17 years in business, Fisher thought he had seen a lot of bad investing behavior. He wanted to know if his rich clients were any better than other people at resisting the urge to buy and sell at the wrong times. So he decided to team up with Philip Z. Maymin, a former hedge fund manager and professor of finance and risk engineering at the NYU Polytechnic School of Engineering, to analyze his firm's clients.

The two men focused on 1.5 million client calls to Fisher's firm starting with its founding in 1993. After they weeded out the routine calls—happy holidays, here's my new address—they found that the number of calls to sell securities increased after down days in the stock market, while calls to buy securities increased after days

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when the stock market did well. If this behavior seems logical to you, then you're destined to lose money when you invest.

A better strategy is to buy or sell a stock based on information about the future—a new product or a new market, a loss of competitiveness, or an ineffective strategy—that could influence its future price. A savvier investor would take that information and decide what he thought the value of a stock should be and buy or sell it accordingly. While he would not panic because it went down one day—he might buy more because the lower price made it a deal—he would, just as important, sell the stock when it reached the value he thought it should have. Alas, the average investor acting on his own does not seem to exhibit this kind of patience.

The Maymin-Fisher study, which was published in the *Journal of Wealth Management* in 2011, found that the kind of knee-jerk reactions to what happened the day before cost an investor four percentage points of return each year. That's not only a drag on the portfolio but difficult to recover from over time. What's more, there seemed to be no logical reason for people to call when they did. "It's more about the randomness of what they ate for lunch yesterday," Fisher says. "Or if they bought Google at the IPO, they're more likely to want to buy Facebook. That explains their risk behavior more." And people with more money called with the same frequency as people with less.

The study argued that the annual loss people suffered from their

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> —GREGG FISHER, *money manager*

own folly was greater than the 1% an adviser charged to manage their money. That would sound like an argument for using an adviser, but the result presumed that advisers could hold themselves above the same urges that affected their clients. Don Phillips, a managing director and former president of research at Morningstar, which monitors mutual fund performance, has questioned whether advisers can keep clients from making bad decisions. "If most investors use advisers and most investors continue to do the wrong thing, then there must be a tremendous amount of bad advice being given," Phillips wrote in a Morningstar report in October 2010. This was an argument for boring index funds that would be rebalanced without any input from the investors—a rational option that would help put you on the right side of the thin green line, but one that most investors struggle with because they think they can pick winners.

What I find equally interesting in the Maymin-Fisher study is the research that provided its hypothesis: a 1978 psychological study of a man who could not control his urges to binge-eat in the middle of the night. He went so far as to put a lock on his refrigerator and give the key to a friend. But he still woke up wanting to eat, unable to control the urge on his own. At some point the refrigerator would not be locked and he would binge again.

Maymin made a similar observation about Fisher's clients—and investors in general: Some cannot help themselves in buying high and selling low. "The urge never goes to zero," he says. "People who want to trade aggressively, it will never go away. If the market is volatile, it increases."

An average investor might be better off thinking of that refrigerator as a fictional bucket called "retirement" or "college savings" or "winter vacation." He could mentally lock his money there and not touch it. It would be set aside for a goal and be as unretrievable as the money he spent on lunch. This strategy could keep him from caring about the price of the stocks day to day. Those movements would be irrelevant, and his chance of obtaining real wealth greater. It would make him less optimistic and in the long run wealthier.

## *TAKE ADVICE WITH A LARGE GRAIN OF SALT*

**DAYLIAN CAIN**, an associate professor at the Yale School of Management, has focused on what advisers like Fisher tell clients when they call for all of their irrational reasons. His

research has found that they are too trusting, particularly when their adviser tells them he has a conflict of interest. "Disclosure doesn't work because people don't understand that conflicts of interest are dangerous," Cain says. "Even very clear disclosures don't actually have the intended warning effect. People stick to bad advice. They adjust, but they don't adjust enough."

In the case of the adviser's disclosing a conflict, be it putting you into an investment run by his brother or one that pays him a higher commission, investors may buy less of what is being sold, but they will still buy some of it. They don't want their adviser to think they don't trust him or consider him dishonest. Simply put: Investors do not understand the difference between what is being disclosed and what the risk is. "Warning that you're sitting on a plant is different from warning that you're sitting on poison ivy," Cain says. A willingness to trust is good in other areas of life, such as marriage, but it may not be beneficial in investing.

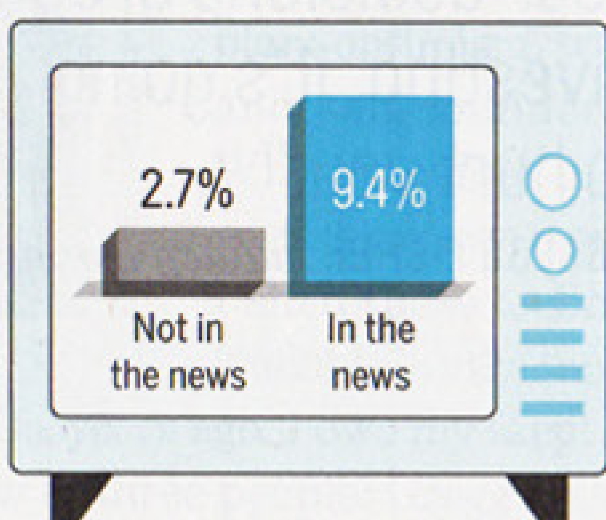
"We asked people how unethical it is to give potentially misleading advice to line your own pockets," Cain says. "Most people thought that was bad no matter what it was for." That's understandable. But then he adds, "We asked another group that same question and said, 'But what if you disclosed your financial incentive in giving bad advice?' People thought it was okay."

This is what psychologists call moral licensing. Once you've disclosed your conflict of interest, the burden shifts, in this case to the client who has been told and should be able to act prudently. But the research shows this will not be the case. The investor may make adjustments, but he will not adjust enough to account for the conflict.

**WHEN STOCKS STAR ON TV**

***Retail investors tend to jump in or out of stocks in the news.***

IMBALANCE OF BUY AND SELL ORDERS




***NOTE:*** *At discount brokers.* ***SOURCE:*** *Terrance Odean*

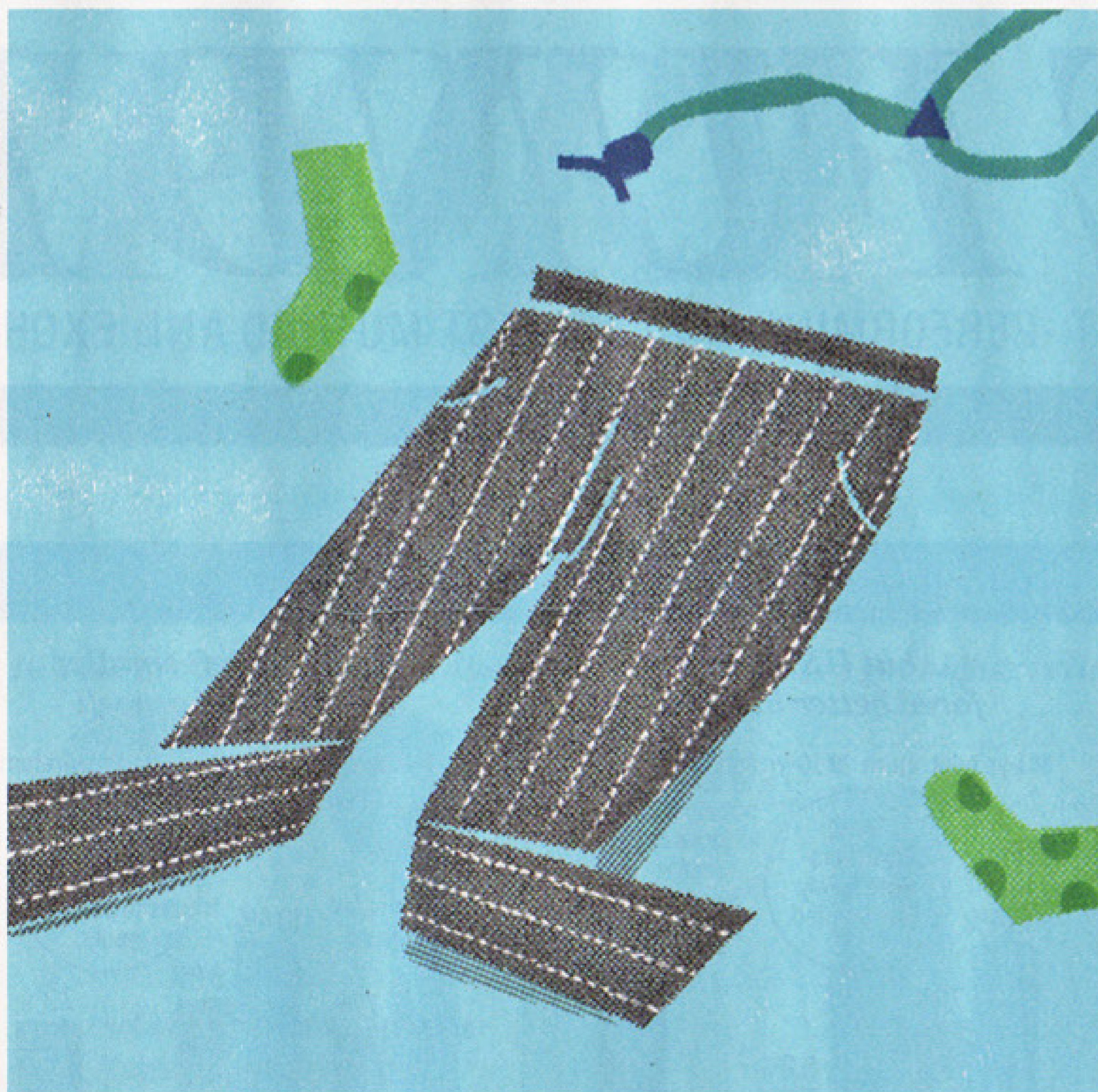
The solution would seem to be a second opinion from an adviser who has nothing to gain. But that fails too. People demonstrate an anchoring bias, which means they use the first set of recommendations as the starting point. What they should do is collect many types of advice and weigh them against one another.

## *DON'T THINK YOU'RE SO SMART*

**MAKING AN INVESTMENT** after a conflict is disclosed is not a great idea, but other problems in buying are worse—like hearing about a company on TV while you're having lunch and buying the stock.

Terrance Odean, a professor of finance at the Haas School of Business at the University of California at Berkeley, has done a series of experiments showing people are blithely and irrationally overconfident when it comes to investing. He had a hunch in the years between the tech stock bust and the Great Recession that people overvalued their investment knowledge. His hypothesis was that stocks talked about on television would have a spike in trading on the day they were mentioned, regardless of the show or channel or person talking about the stock. He was right.

In a 2008 paper, "All That Glitters: The Effect of Attention and News on the Buying Behavior of Individual and Institutional Investors," he labeled the television-driven stock picking "attention-driven buying." With too many stocks to choose from, investing in what flashed on the television screen narrowed the list of choices. "Buying is this daunting task," Odean says. "Investors informally, if not consciously, limit their attention. A stock catches their attention and they make the decision based on that. Instead of choosing from 5,000 stocks, they consider 15." But the extent to which a television appearance of a stock sways investors' buying and selling habits is extreme. On any given day at discount brokerages, the imbalance between buy and sell orders for stocks out of the news is 2.7%, meaning just about the same number of people are selling as buying. But the imbalance is 9.4% for stocks in the news. At large retail brokerages the difference is even more extreme, with a 16% imbalance for stocks in the news.



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—TERRANCE ODEAN, *finance professor*

What a ludicrous way this is to spend your money. Without real research, how would you know the quality of those 15 stocks? They could be 15 great stocks, 15 awful stocks, or a mix. And since you were probably eating lunch or otherwise taking a break from work when you caught the news, were you properly evaluating the tip or just reacting like Fisher's clients? Is that person on television knowledgeable, or is he trying to profit from what he is telling you without even the weak disclosures that Cain found do not work?

In his paper, Odean compared an individual's strategy with that of professionals, who still pick losers but at least have a method. "With more time and resources, professionals are able to continuously monitor a wider range of stocks," Odean wrote. They "are likely to employ explicit purchase criteria—perhaps implemented with computer algorithms—that circumvent attention-driven buying."

Of course, for an individual the alternative to choosing from a small set of stocks is to be totally overwhelmed by thousands of them and do nothing. Odean's research has shown that it was unlikely people would take the time to pore through all the stocks; instead, people prefer to divine patterns where none exist. "We're like pattern-finding machines," he says. "If lightning strikes and something falls off the table, we think the lightning caused it. Or worse, the book falls and lightning strikes and you think the book caused the lightning."

Looking for patterns certainly has an evolutionary place: If you noticed family members being eaten by lions when they went out alone, you might not go out alone. But trying to divine patterns in stocks based on theories more akin to racetrack hunches is less likely to yield lifesaving benefits. "The investor who is in the market and constantly seeing patterns better have a good day job," Odean says.

So what about Odean? Is he immune to human frailty? "I buy index funds so that when you ask me I can say that," he quips. "People are overconfident about their ability to be an active manager."

Coming to that conclusion was hard-won. Before becoming an academic, Odean traded stocks between working at various day jobs. How did he do? "The thought that you can do part-time what professionals struggle to do full-time and with teams," he says, "that's hubris." M