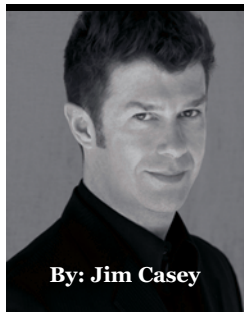


## INTEGRATED WEALTH MANAGEMENT

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# Behavioral Finance



By: Jim Casey

**05.10.2009** | The concept of expecting higher returns following a period of increased risk sounds great in an academic setting. When we introduce the emotional equation to the concept, it becomes an extremely difficult strategy to execute. Sanity, or lack thereof, takes center stage in periods of heightened risk and volatility.

According to Lawrence Raifman, a psychology professor at Johns Hopkins University, market valuations are like Goldilocks' porridge: They're either too hot or too cold and seldom "just right." It is common for investors to overreact to volatile swings in the market. Investors have always experienced upside moves and downturns in the market and the subsequent actions they

have taken have been extreme as well. As a result, markets tend to oversell on the downside.

Investors rely upon trial and error strategies known as heuristics when making decisions in these reactionary periods. Decisions based upon heuristics are often arrived at with little or no assessment of facts or the most likely outcomes. As a result, present circumstances completely outweigh historical, more empirical evidence. In this case, we believe that optimal, better thought out decisions take a back seat to the present psychological emotions of fear and greed. Investors may abandon a long-term perspective and cause themselves to become more susceptible to selling into weakness or become too scared to buying and/or rebalancing. Either practice can exacerbate the negatives of their current situation.

Behavioral finance is complex. Investors need to acknowledge that forces in their brain are in conflict with one another. The forces can be divided along many lines. Perhaps the easiest to understand is: "Do I make the rational, well thought-out and supported decision or do I go for immediate gratification so that the pressure of arriving at a decision can be over and I can feel immediately better?"

Researchers Amos Tversky and Daniel Kahneman defined this as the Prospect Theory in their paper, "The Framing of Decisions and the Psychology of Choice." Losses are more painful than gains can be pleasurable and as a result, investors become risk averse at precisely the wrong time.

One could conclude that investors should be well positioned once they have established their own asset allocation, selected appropriate risk/reward parameters, identified and come to grips with their emotional stance towards investing, and confirmed their time frame. However, as the recent debate between Jon Stewart, host of The Daily Show on Comedy Central, and Jim Cramer, CNBC host of Mad Money, highlighted, there is still one more critical component of investing to identify for success. During the debate Stewart said, "My mother is 75 and she bought into the whole idea that long-term investing is the way to go. And guess what?" Cramer then responded, "It didn't work."

Setting out on the road to financial recovery requires introspection. As Stewart alluded, everyone has been affected by the financial crisis in some form. Now the question ubiquitously asked is: "Where do we go from here?" How should we view the world and approach an investment strategy, considering all that has transpired?