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Is your brain wired for wealth? An owner's manual for the investor's brain: From hunting sloths to picking stocks.

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NEW YORK (MONEY Magazine) - Suddenly, stunning investment insights are coming from the frontiers of one of the least likely fields you could imagine: neuroscience. In university and hospital laboratories around the world, researchers are using the latest breakthroughs in technology to trace the exact circuitry your brain uses to make the kinds of decisions you rely on as an investor.

For the first time in any nonscientific publication, this article will take you deep inside your own brain to help you understand why you invest the way you do -- and, more important, how to enhance the workings of your brain to get better results.

You'll see that the neuroscience of investing helps explain one puzzle after another: why we chronically buy high and sell low, why "predictable" growth stocks sell at such high prices, why it's so hard to understand our own risk tolerance until we lose money, why we keep buying IPOs and "hot funds" despite all the evidence that we shouldn't, why stocks that miss earnings forecasts by a penny can lose billions of dollars of market value in seconds.

Fortunately, the latest discoveries also point the way toward cures for bad investing behavior. "Investors are human," says Andrew Lo, a finance professor at the Massachusetts Institute of Technology. "Therefore, how the human brain works and why we react the way we do to various situations are critical for developing a better understanding of the common mistakes that typical investors make."

How we got our brains

For nearly our entire history as a species, humans were hunter-gatherers, living in small nomadic bands, pursuing wild animals, foraging for edible plants, finding mates, avoiding predators, seeking shelter in bad weather. Those are the tasks our brains evolved to perform.

The human brain is a superb machine -- "a Maserati," says Baylor College of Medicine neuroscientist Read Montague -- when it comes to solving ancient problems like recognizing short-term trends or generating emotional responses with lightning speed. But it's not so good at discerning long-term patterns or focusing on many factors at once -- challenges that our early ancestors rarely faced but that we investors confront every day.

Rein in your brain

Now, how you can use these new insights into the brain to make yourself a better investor?

Whenever possible, you need to develop automated, irreversible investing habits that are tailor-made for neutralizing your brain's worst liabilities while optimizing its greatest assets. Here's how neuroscience leads to a new science of investing.

Strap yourself in -- Because the amygdala -- the part of your brain that initiates feelings of fear -- is an almost irresistible force, you must reduce your exposure to images that can provoke panic. Turn away from stock tickers; turn off the televised images of closing bells and yelling traders. And promise aloud or in writing, before a friend or family member who can hold you to it, that you won't check the value of your accounts more than once a month. If you haven't already, sign yourself up to dollar-cost average through an automatic investment plan that will electronically purchase shares in a mutual fund every month. That way, your investing commitment can never flag, even when you are full of fear.

Stay in balance -- The human brain is wired to try to make predictions from past patterns and take risks in the search for a big reward. That make sense if you're following the footprints of a tasty water buffalo or looking for flowers that indicate an edible root plant. With stocks, that habit can lead you quickly astray as you invest in a few stocks based on past performance.

Geniuses like Warren Buffett can get away with putting all their money in a handful of holdings. The rest of us need to set limits on our prediction addiction. Give your broker a limit order that will automatically sell any stock that grows to more than 10 percent of your total. And if your long-term goal is to have, say, 75 percent of your assets in stocks, but they've shriveled to 49 percent, buy enough to get them back up to 75 percent. Make that kind of asset reallocation twice a year, every year -- no more, no less -- on equidistant, easily memorable dates like New Year's Eve and July 4.

Redouble your research -- If a stock or fund goes straight up, don't just enjoy the ride. The better an investment does for you, the more powerfully your brain will believe nothing can ever go wrong with it. Each time it rises, say, 50 percent, study it again more closely; ask what could go wrong; seek out negative opinions. The time to do the most homework is before bad news can catch your brain by surprise. There are no guarantees, but doing extra research just when things are going well is the best way to prepare yourself in case something later goes wrong -- or seems to. You'll then have a better sense of whether it's a false alarm or a real one.

Use different wallets -- If you can't stop chasing "the next Microsoft," at least chase it with only part of your money. Just as prudent gamblers lock most of their cash in the hotel-room safe and go onto the casino floor with no more than they're willing to lose, you should set up a "mad money" account. You can't control your prediction addiction, but you can at least contain it -- by putting into your mad-money account only what you can afford to lose. That way, you speculate with a fraction of your money, not with all of it.

Build an emotional registry -- Remembering what you did is only one way to learn from your own experience. Emotions can be an excellent guide to what you should and shouldn't do. But to use them as an accurate guide, you need to remind yourself of how you felt after your decisions (and their results). "Regularly evaluating whether an outcome made you feel good or

bad," says University of Iowa's Antoine Bechara, "will help you learn from your behavior." Keeping a written record of your feelings -- what Bechara calls an emotional registry -- is a good idea, particularly if you are a younger investor. Store these "feeling records" alongside your trading records.

Look at the long run -- Remember that your brain perceives anything that repeats a couple of times as a trend -- so never buy a stock or a fund because its short-term returns look hot. Check out the long run, and never assess performance in isolation; always compare a stock or fund to other similar choices.

Flex your cortex -- Because your prefrontal cortex is responsible for evaluating the consequences of your actions, and because advancing age impairs that part of your brain, be on guard. If you (or members of your family) are elderly, simple reminders can help -- like a note next to the phone that says, "No thanks to telemarketers" or a Post-It note on your PC that reads, "Never open unsolicited investing e-mail."

Diversify, diversify, diversify -- This grim bear market has revealed the biggest risk of all: underestimating your own tolerance for risk. Thinking you can tough it out then suddenly finding you can't is a recipe for financial disaster. Diversification -- making sure that you never keep all your money in one kind of investment -- is the single most powerful way to prevent your brain from working against you. By always holding some cash, some bonds, some real estate, some U.S. and foreign stocks, you ensure that your prediction addiction can never force you into a single, sweeping bet on a "trend" that disappears. And by keeping your money in a broad basket of assets, you lower the odds that a meltdown in one investment will send your amygdala into overdrive.

Putting yourself on investing autopilot minimizes the opportunities for your brain to perceive trends that aren't there, to overreact when apparent trends turn out to be illusions or to panic when fear is in the air. That frees up your brain to focus on the harder work of long-term financial planning. Above all, you should take enormous comfort from knowing that the latest scientific findings show just how newly valid the oldest truths of investing really are. ■

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