

# ASPERA BULLETIN

Intelligent, Independent Investment Management

## I'm Alright, You're Alright or A Skeptical Realist's Guide To Investment Psychology

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There are a number of ingredients that go into being a successful investor. Understanding your own psychology is one of the most critical components. The more you understand what makes you tick, the better able you'll be to choose an investment style that suits your personality and to take advantage of your strengths while minimizing the mistakes that come from your weaknesses.

In the interest of full disclosure, I am not a trained psychologist. I did, however, take a Psychology 101 course about 20 years ago and found the class schedule and my nap schedule correlated perfectly with an  $R^2$  of 1.0 (I was also taking a statistics class that did not correlate with my nap schedule). Also, I've seen most episodes of the Dog Whisperer and once walked through the self-help section at Borders on my way to the coffee bar. Finally, I've been privy to and have been the subject of the psychoanalytical skills of not one, but two wives. In sum, I feel that I'm at least as qualified to opine on the topic as your average practicing psychologist.

*Freud: If it's not one thing. It's your mother.*  
Robin Williams

When asked how to get started with investing or how to select an investment adviser, I often begin by explaining that there are many different investment styles. If you plan to do your own investing and want any chance of success, you need to explore the various investment styles and find one that makes sense to you and is consistent with your personality. For example, a very frugal person probably won't make a successful momentum investor, and a trend follower won't make a good contrarian. Practicing an investment style that conflicts with who you are ultimately dooms you to failure.

*Knowing yourself is the beginning of all wisdom.*  
Aristotle

Similarly, when hiring an investment adviser, it's important to have some sense for his or her investment personality. This doesn't mean that you should seek out someone who mirrors your own traits. It means that you should feel confident that your adviser's investment philosophy is consistent with his personality. Furthermore, the investment psychology and style of your adviser will have a strong bearing on the risk-return profile of his portfolios. This will dictate how your portfolio performs in various markets and over the course of the business cycle.

Over the years, I've worked with many investment professionals and clients. I've seen firsthand a number of investment personas. Each has its pros and cons, but the biggest problems occur when people pursue an investment style or strategy that is inconsistent with their personality. Below, I've listed a number of the investor types that I've encountered. The following list is much more anecdotal than scientific and is by no means comprehensive.

## The Optimist

### **Traits**

- Focuses on the positives. Unable or unwilling to see the negatives and warning signs.
- Understands that real estate prices have fallen sharply...but not for his house.
- Bad news is good news. If nothing else, the shorts will eventually have to cover!
- 9 years later, views the collapse of the internet bubble as a temporary dip
- Still owns shares of Enron for their inevitable rebound

### **Strengths**

- Doesn't act out of fear
- Can sleep well while portfolio implodes

### **Weaknesses**

- Can't cut the losers. Keeps averaging down.
- Does well in long-term bull markets but gets slaughtered in the bears
- The mortgage company doesn't accept hope as a payment

## The Armageddonist

### **Traits**

- Finds fault in virtually all investments
- Invests only in cash, gold bullion, and ammunition
- Has been warning about the next Great Depression for the last 50 years
- Owns a pantry full of freeze-dried foods and a hand-crank flashlight
- Disappointed with gains because it means having to pay taxes

### **Strengths**

- Never suffers big losses
- Will have cornered the market in penicillin when the End Times arrives

### **Weaknesses**

- Spends 20-year bull markets waiting for a pullback
- Dies alone in his bomb shelter from an overdose of rubbing alcohol surrounded by his collection of mail-order bride catalogs

## The Egoist

### **Traits**

- Must personally "discover" each investment idea himself
- If stock goes up, he's a genius. If it falls, he never owned it.
- Very intelligent and seldom wrong. Just ask him.
- Spends free time on Yahoo Bulletin Board trying to convince some truck driver to "invest" his \$500 life savings in a dog grooming penny stock
- Currently thinking, "I could have written this article better."

### **Strengths**

- Quickly gets over bad investment decisions
- Gets to spend every day with his favorite person

### **Weaknesses**

- Doesn't learn from his mistakes
- Gets lucky a few times, confidence builds, makes bigger bets, and eventually blows himself up
- There's a fine line between confidence and violence-inducing obnoxiousness

### **The Masochist**

#### ***Traits***

- Secretly enjoys being wrong and making bad investments
- Prefers buying stocks in companies currently being investigated by the SEC
- Tried to invest with Madoff after he was arrested
- If you know these people, pass their names along. I have a monthly poker game.

#### ***Strengths***

- Never has a capital gains tax to pay
- Won't lose much in divorce settlement

#### ***Weaknesses***

- Never has a capital gain
- Likely to end up a ward of the state

### **The Manic**

#### ***Traits***

- Enamored by the latest investment fad
- Changes investment style frequently. Always doing what's just about to stop working.
- Buys all the new investment books
- Can't read this far into the article – has to keep checking on his latest trade

#### ***Strengths***

- Never bored
- Doesn't sit still long enough to take debilitating losses
- Has the safety net of a fallback career as a circus clown, congressman, or stock broker

#### ***Weaknesses***

- Death by a thousand cuts
- Attention span of a moth
- Trading activity funds a Goldman Sachs trader's new vacation home in the Hamptons each year

### **The Waffler**

#### ***Traits***

- Can't pull the trigger. Sees the bull and bear case as equally valid
- Tormented by decision to move money from checking account to savings account
- Bought life insurance but named himself as the beneficiary
- May still be living with Mom

#### ***Strengths***

- Can't be wrong if you never take action
- Mom's home cooking

#### ***Weaknesses***

- Always misses great opportunities
- Only invested when mistypes the ticker symbol of a money market fund

## **The Conspiracy Theorist**

### ***Traits***

- Believes the market is controlled by the Reptilians
- Thinks the “X-Files” was a documentary
- Certain that this article is bugged
- Prefers to put investment funds into his home security system
- Note: Should not breed with Armageddonists or other Conspiracy Theorists
- Check that. Should not breed.

### ***Strengths***

- Not personally responsible for any losses
- Few friends means plenty of time for investing

### ***Weaknesses***

- Never takes any investment risk
- Spends too much time trying to prove that Bernanke, Obama, and Pelosi are all the same person

## **The Skeptical Realist**

### ***Traits***

- Objectively weighs the pros and cons of an investment
- Thinks and acts independently. Valuation matters.
- Takes nothing at face value. Reads SEC filings.
- Extremely attractive and intelligent
- I’m talking off-the-charts hot and smart
- Note: Think of a Conspiracy Theorist as a Skeptical Realist with schizophrenia and a cocaine addiction

### ***Strengths***

- Learns from mistakes and catches big secular moves
- Unlikely to get blown up
- Can perform discounted cash flow analysis as a party trick

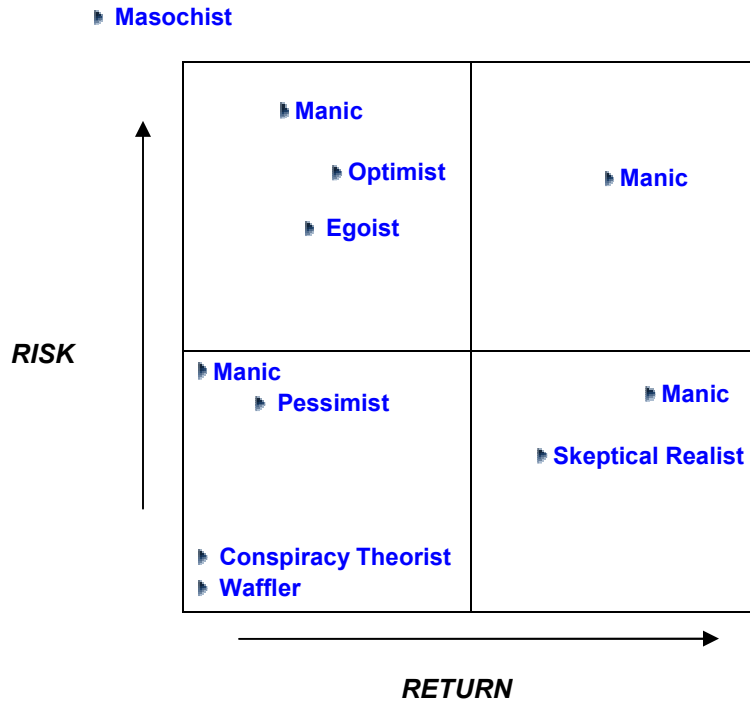
### ***Weaknesses***

- Perpetually early
- Has to read SEC filings. Have you ever read SEC filings?

Most of us don’t fit neatly into just one of these categories, and they aren’t intended to be mutually exclusive. I’m probably 80% Skeptical Realist, 5% Armageddonist, 5% Egoist, 5% Optimist, and 5% Conspiracy Theorist. The critical issue is to be sure that you understand the strengths and weaknesses of your investment psychology as well as the investment style that complements it. For example, given my investment psychology, I’m not well suited for momentum investing, buying high-growth stocks regardless of valuation, astrology, or reading squirrel entrails. That doesn’t mean they aren’t valid strategies (but they’re not). It just means they won’t work for me. Instead, my personality lends itself to fundamental long-term investing with a value and contrarian bias.

Once you’re clear about your investment psychology and the investment style that complements it, you can better understand the investment and performance implications that accompany it. Figure 1 illustrates where each investment persona is likely to fall over time in regards to risk and return.

Figure 1. Risk/Reward Profile of Various Psychological Styles



Understanding your investment psychology and your strengths and weaknesses won't guarantee investment success, but it will improve your chances. Still, it's important to be vigilant, disciplined, and objective. Since few of us fit neatly into any one category, there's bound to be internal conflict. The Optimist in me thinks there's plenty of room for all of us to get along and to leverage all of our strengths. The Armageddonist is sure this article was a waste of time since we'll all soon be on a barter system and the U.S. dollar will be replaced by seashells. The Egoist thinks we could've written this better. The Skeptical Realist is wondering if it's time to short the Yen. The Conspiracy Theorist thinks the other 95% are out to get him.

Best,

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10/28/09