

Making Money: When You Are Your Worst Enemy

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IN THE EARLY 1990S A REVOLUTIONARY TREATMENT FOR AUTISM WAS DISCOVERED: FACILITATED COMMUNICATION. FACILITATED COMMUNICATION IS A TECHNIQUE THAT ALLOWS THOSE PREVIOUSLY UNABLE TO COMMUNICATE BY SPEECH TO TYPE WORDS ON A BOARD OR KEYBOARD. MANY PARENTS WERE DELIGHTED TO BE ABLE TO COMMUNICATE WITH THEIR CHILDREN WHO STRUGGLED WITH AUTISM. THE ONLY HITCH WAS THAT THE CHILDREN NEEDED A FACILITATOR—SOMEONE WHO GUIDED THEIR FINGERS ON THE KEYBOARD WHEN THEY TYPED. OVER TIME, THIS APPARENTLY HARMLESS TREATMENT TOOK A NASTY TURN AND OPENED UP A CAN OF CONTROVERSY. THE "PRISONERS OF SILENCE," AS THE CHILDREN WITH AUTISM WERE CALLED, STARTED ACCUSING THEIR PARENTS OF SEXUAL ABUSE.

One enterprising lawyer devised an ingenious plan to determine the truth. He suggested presenting two different sets of information to the participants that were "responsible" for the words typed on the keyboard. The child was shown one set, and the facilitator was shown another set. The team was then asked to describe what they saw. The outcome of the experiment resulted in a description of what the facilitator observed, never what the autistic child was shown. Facilitated communication was bogus in a majority of the situations. Looking back, the flaw of the system was obvious, so why did so many intelligent people believe something that wasn't true for so long? The advocates included professors and clinicians with medical degrees and PhDs, plus social workers and parents. It seems the only explanation was that the interested parties wanted to trust the flawed information. The treatment gave them hope for children with autism, and they were willing to overlook obvious design problems for the privilege of that positive feeling. Their brain hardwiring allowed them to deceive themselves.

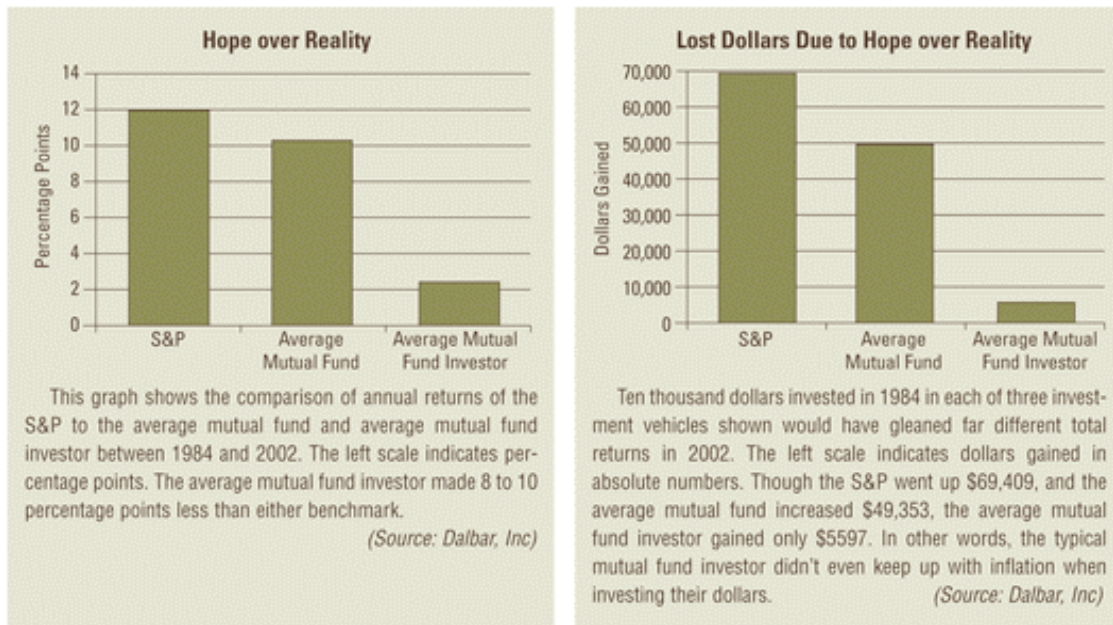
Emotions Blur Decisions

Though self-deception is just beginning to be studied in relationship to the stock market, it is an important part of investor behavior today and always has been. It is human nature to hope for the best, and the average shareholder relies on hope more than critically-examined data and historical results. This can result in an enormous impact on returns for the average investor.

For example, between 1984 and 2002 the average mutual fund appreciated 10.4% annually, while the S&P 500 went up an average of 12.2%. According to data from Dalbar, Inc, the average mutual fund investor simultaneously gained only 2.5% annually. This was primarily due to the fact that they moved in and out of funds, jumping from one hope to the next.

Because no intelligent person would knowingly or intentionally hurt themselves monetarily, the average mutual fund investor must be influenced by factors other

than objective. Similar to those who held a strong belief in facilitated communication, the average investor hopes for a good result. That hope, not necessarily based on reason, carries them forward mentally, so that they are able to ignore what they don't know and diminish negative information that doesn't fit into their anticipated good result. The problem is that it can come at a significant—and oftentimes avoidable—cost.



Behavioral Economics

This tendency for investors to perform poorly in the market is the subject of a new field of study called behavioral economics. It seeks to understand the origin of investor behavior that is counterproductive, applying scientific research on human and social cognitive and emotional biases. The field may provide a better understanding of economic decisions that affect the market. In other words, why do shareholders and even money managers act in ways that do not benefit them? The following are some of the principles that the study reveals:

- **Herding.** When investors copy the behavior of others to the detriment of their investments.
- **Media reaction.** The tendency to respond to news as though it's gospel without examining the underlying information, which can make it less credible or applicable to each investor.
- **Narrow framing.** Decision-making that occurs without considering all the implications; investors hurt themselves by not making the most advantageous choice.

The advocates of facilitated communication ignored all the principles above and unknowingly fell victim to each. They believed what the general majority of

supporters were saying and failed to consider other possibilities that could have played a part in the discovery. The average mutual fund investor between 1984 and 2002 followed a similar pattern. They changed mutual funds when reports of better short-term results were publicized across the media in newspapers and on televisions and radios. Basic knowledge about the advantages of long-term investing was shed and forgotten in an effort to make a short-term gain that was hailed by the masses. In doing so, they lost long-term results—possible profits—in the funds they had, and the new funds often didn't line up with the high expectations.

Recent investment results, however, suggest that investors may be learning something from the new discipline of behavioral economics. In 2004, the average equity mutual fund investor actually earned more than the S&P 500 because they continued investing through the ups and downs of the market, ignoring the impulse to jump at seemingly great opportunities. Time will only tell if this is an aberration or a trend that will continue in the future. In the meantime, we can hope that it lasts, and that this expectation is not just another symptom of self-deception, making us again prisoners of our own wishes.

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