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STRATEGY

Your Own Worst Enemy

Terry Odean's research into investor behavior shows how people sabotage themselves.

By David K. Randall

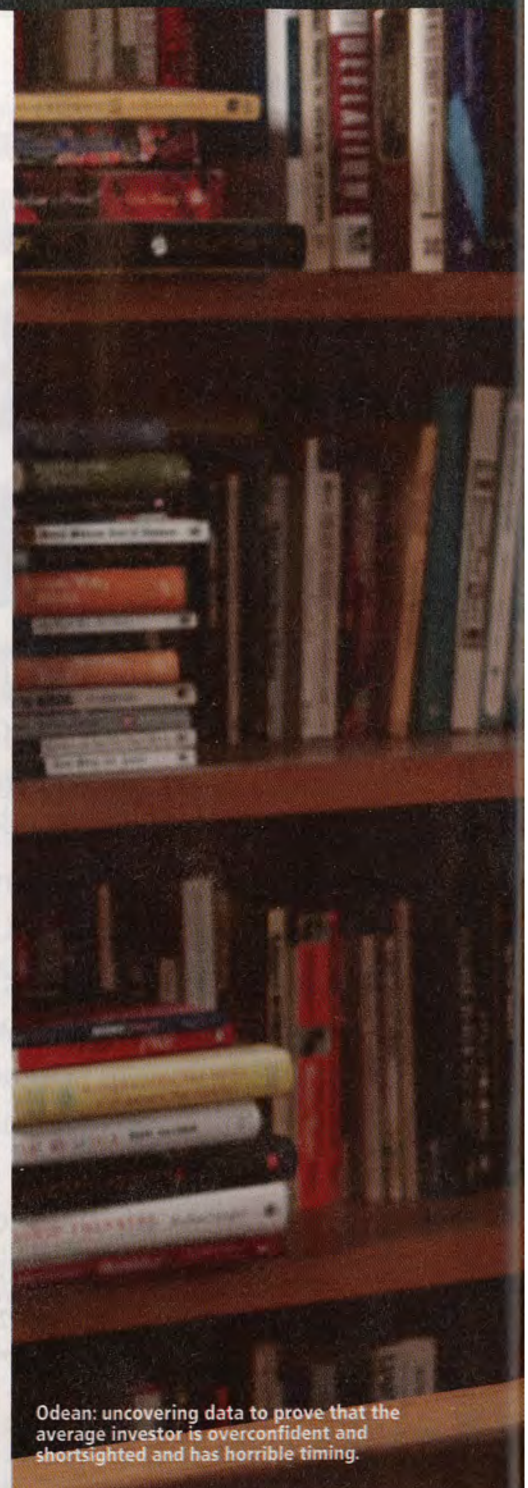
TERRANCE ODEAN, A FINANCE professor at the University of California, Berkeley's Haas School of Business, has spent his career studying a very specific type of investor: the one who is overconfident, shortsighted and far more likely to snap up a stock at the worst possible moment than to make the kind of contrarian bet that pays off in the long run. Odean's specialty, in other words, is the average investor.

"Many of the mistakes investors make come from a lack of any understanding of the innate disadvantages they face," Odean says.

As a student of how investors act in the real world, Odean is part of the burgeoning field of behavioral finance, which, over the past three decades, has blended elements of neurology, psychology and economics. It has revealed that, contrary to the preachings of classical economics, individual investors tend to be anything but rational, self-interested profit maximizers. Their own worst enemies would be a more apt description.

Odean, a young-looking 60-year-old with a hint of an accent of his native Minnesota, is a bit of a behavioral oddity himself. A hippie back in the early 1970s, he dropped out of Carleton College a half-year short of earning a creative writing degree and spent the next 15 years bouncing between jobs that ranged from driving cabs to programming computers.

Married with mortgage payments, he applied to return to school at UC, Berkeley at the age of 37. Odean was told that his favored major, psychology, was unavailable but that he'd be admitted if he agreed to take up statistics. Near the end of his studies Odean considered



Odean: uncovering data to prove that the average investor is overconfident and shortsighted and has horrible timing.

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The WORST HARD TIME
YOGA

pursuing psych in grad school, but professor Daniel Kahneman, a future Nobel economics laureate, convinced him instead to go for a Ph.D. in finance, studying investor behavior in the process.

Odean, whose website boasts a photo of himself that turns into a winking hippie, says he needed to look no further than himself to find his first example of a wrongheaded investor. Before studying finance, he says, he'd used his modest brokerage account to trade individual stocks—typically on a tip from his broker and two seconds of research. When many of his buys crashed, Odean held on anyway to avoid admitting defeat.

"In hindsight I'm glad I did all that stuff because it was like a lab experiment for my future research," says Odean, who recently returned from a nine-day silent meditation retreat in the California desert. "When I decided to study investors, I would continually ask myself, 'What would I have done?'"

Here's what Odean's years of research around the world tells him are investors' greatest sins:

Overconfidence. Humans seem to be hardwired to expect success and to regard themselves as above average. Odean likes to hammer this point home to his M.B.A. students by asking them to rate their driving abilities. "Above average" is the virtually unanimous response. One of the few students who rated herself merely an average driver was, in fact, about to lose her license for having had three accidents in the past year.

Overconfidence permeates the ranks of investors, especially men, Odean concluded in a study with finance professor Brad M. Barber from UC, Davis. Looking at the trading patterns of 35,000 households over five years, they found that single men's confidence in their ability to outperform the market prompted them to trade 67% more frequently than did unmarried women. The payoff for all this activity was negative; the men's portfolios underperformed those of the less-frenetic women by 1.4 percentage points per year, Odean and Barber found.

Excessive trading. Princeton finance professor Burton Malkiel has argued that investors are on a fool's errand in trying to outperform an efficient market in which all relevant information is reflected in equity prices. Odean agrees that trying to beat the market is a loser's game for small investors but for a somewhat different reason. He thinks the casino is rigged in favor of large institutions.

"Many of the mistakes investors make come from a lack of any understanding of the innate disadvantages they face," says Odean.

Looking at every trade made on the Taiwan Stock Exchange over four years, Odean found that commissions, taxes and poor timing of buy and sell decisions sucked a collective $32 billion out of the pockets of individual investors over the period studied. (The exchange's listings have a combined market value of $660 billion.) The winners in this game: middlemen and institutions.

Even when the little guy thinks he's in the know, he is often clueless about what's going on behind the scenes. Not so the big guys, Odean argues.

"For an individual to not believe that he's at an informational disadvantage when he's trading against guys from Goldman Sachs is naive," he says. "It's like deciding to play one-on-one with a professional basketball player. You're going to lose."

Going with the crowd. Like children fighting over the same toy, investors are often attracted to stocks because others want them. In fact, individuals are much more likely to buy and sell the 10% of stocks mentioned in the news and ignore the other 90%, he found.

The problem with buying stocks when they're popular rather than on the basis of fundamental value is that they tend to be expensive and susceptible to changes in investor sentiment.

The day after a stock ranks among top performers, two-thirds of all trades by individual investors are buys (institutions, by contrast, tend to wait for dips in prices and trading volume). Over the following month these hot issues underperform the overall market by an average 1.6 percentage points, Odean found in a 2006 study. Adding salt to the wound, Odean tells us that more often than not the stocks that investors sell outperform the ones they buy.

Stubbornness. Savvy investors sell losers to book tax losses, offset gains and stiff Uncle Sam. Logical as this is, few investors are willing to admit defeat. That was Odean's conclusion after analyzing 10,000 discount brokerage accounts over three years. The exercise revealed that investors are more likely to sell winners and trigger capital gains taxes than to sell their losers and avoid them.

The damage doesn't stop there. In addition to the tax drag such behavior entailed, Odean found that in the year after they were sold winning stocks went on to gain 3.4 percentage points more than the losers to which investors clung.

If you're sure you're an above-average investor, go ahead and trade like a fiend. But keep in mind the possibility that you are fooling yourself and would do better buying index funds and focusing on becoming a better driver. F