the early 1980's. In each case, investors thought: "This time is different, it's a new economy." When the next investment mania occurs, keep things in perspective and ask yourself, "Is history repeating itself?"

2. **Establish an investment policy statement.** An investment policy statement determines what percentage you will invest in each asset class such as stocks, bonds, and cash. For example, based on your risk tolerance, you may determine that 60% of your assets should be in stocks, 30% in bonds and 10% in cash. Assuming each category is diversified, studies have demonstrated that you can expect a certain range of returns and volatility over the long-term based upon your allocation. Establishing and monitoring the above parameters can help you limit your emotional involvement and avoid the overconfidence bias. When the market surges ahead, and your confidence increases, check your investment policy statement to make sure you stay on course.

Availability Bias

Availability bias causes people to base their decisions on the most recent and meaningful events. The brain views ancient history as anything that happened more than a couple of years ago. For example, if you were in a car accident within the last week, it would be a natural tendency for you to drive extra cautiously for the next month. However, as time passes, your driving will likely return to its original state. Availability bias causes investors to over-react to market conditions whether it be "positive" or "negative". As illustrated earlier, in the late 1990's, investors got caught up in tech mania, which caused them to disregard the risks. This was followed more recently by troubling events in the economy, which caused investors to lose confidence and over-focus on the short term, negative results. It is natural for people to get lost in the moment.

Availability bias also causes people to think that events that receive heavy media attention are more important and pertinent than they are in actuality. Unfortunately, much of the financial information received on a daily basis is mostly noise and not particularly important. In fact, the information is often inaccurate, based on multiple opinions, outdated or downright confusing. Coupled with too much information, many investors overlook the fact that they often lack the training, experience and objectivity to interpret the massive amount of information available. This causes many investors to get a false sense of security in thinking they are well-informed investors. James J. Cramer, analyst for CNBC Network's morning show "Squawk Box" and co-founder of the magazine *Smart Money*, loosely advised audiences not to watch too much CNBC or read too much of the popular financial press because many people who appear are scripted and don't give enough information to form
a basis for real analysis. "It is ironic that the greatest stock bubble coincided with the greatest amount of information available. I always thought this would be a good thing, but maybe it was not so good" notes Cramer.

Avoiding Availability Bias

1. Focus on long-term results and avoid getting swept away by your emotions and the latest mania whether it be positive or negative.
2. Recognize that it is a human tendency to overemphasize the most recent financial events proliferated by the news media. Simply refuse to let those events overly influence you. The old axiom, "nothing is as good or as bad as it seems" is important for the investor to keep in mind.

Mental Accounting

What behavioral finance professionals have called

The Bull & Bear FINANCIAL REPORT

"mental accounting" is where investors mentally compartmentalize money such as individual stocks, bonds, real estate or cash. This causes investors to lose sight of the big picture and instead focus on each specific investment and feel pleasure or pain depending on a particular investment's performance. For example, an investor may purchase a specific stock, which declines in value 10% over 12 months. Because of the tendency to think myopically (mental accounting), the investor tends to feel a disproportionate amount of pain from the loss. The investor may overlook the fact that his overall wealth (stocks, bonds, real estate and cash) has actually increased over the same period. While investors recognize that certain asset classes will
outperform others during any given period, due to mental accounting, an investor will typically hyper-focus on the investments that are down. Furthermore, the results of psychological studies indicate that investors feel the pain of loss 3 times greater than the pleasure of gain. This pain can cause an investor to make highly irrational decisions such as selling their stocks during a down market. This investor not only suffers the loss of selling at a low, but may also miss a substantial upturn.

How to Avoid Mental Accounting

1. Measure your investment success by the performance of your overall assets versus measuring success by a particular asset category such as stocks, bonds, or real estate. Remember, it is your overall financial picture that matters at the end of the day, not how one asset category has done.
2. Establish long-term financial goals. Acknowledge to yourself that the fluctuation of your investments along the way does not determine your ultimate success or failure. It is the eventual safe arrival at your destination that is most important.

Conclusion

It is increasingly more apparent, if investors are to achieve significant returns, they can not afford to overlook the role that psychology plays in the decision-making process. Recognizing that psychological biases exist and taking proactive steps to overcome them may potentially increase the investor's ability to achieve their long-term financial goals.

Editor's note: *John P. Ciccone, ChFC, CFS Financial Consultant and founder of* ***The Capital Navigation Plan***,™ *has specialized in comprehensive financial consulting for over 20 years. Working exclusively with closely held business owners and high net worth individuals, John Ciccone found that these individuals confront unique dangers and opportunities and therefore require customized planning to help achieve their goals. In response to this need, he developed The Capital Navigation Plan.™*

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Recent Publications

Achieving Investment Goals

- The Bull and Bear
- New England Real Estate Journal
- Physician's Money Digest

Proper Decision Making Tools in a Difficult Market

- Banker and Tradesman

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ARTICLE REPRINT • VOL. 17 NO. 12 • APRIL/MAY 2002 • FROM WWW.BULLANDBEAR.COM

Achieving Investment Goals

by John P. Ciccone, ChFC, CFS

"The investor's worst enemy is likely to be himself."
– Benjamin Graham, a legendary value investor and one of the fathers of modern security analysis.

An expanding field known as behavioral finance is beginning to take hold which demonstrates that psychology plays a significant role in how investors make decisions. Historically, the impact of psychology and how it relates to decision-making has been mostly ignored. Studies by Richard Thaler of The University of Chicago and Daniel Kahneman of Princeton clearly demonstrate that investors behave highly irrationally and make predictable errors. These investment errors can wreck havoc on an investment portfolio and upon the investor's ability to achieve long-term financial goals.

Outlined below are three of the key "psychological biases", including overconfidence, availability bias and mental accounting; which affect the investment decision-making process along with practical strategies to help you avoid making decisions based upon a "psychological bias" so that you may achieve greater investment success.

Overconfidence

Psychologists have found that people become overconfident when they experience success. There are two main sources of overconfidence bias. The first relates to the fact that most people consider themselves to be better than average in most things they do. For example, 80% of drivers contend that they are better than average drivers. Is that really possible?

The second source of overconfidence is due to people's tendency to underestimate the role of chance in events and erroneously attribute their skill as the defining factor for achieving success. This overconfidence was clearly illustrated in the late 1990's where even novice investors experienced exceptional growth in technology stocks. As the technology stocks continued to soar, investors began to attribute much of their success to their ability to make wise investment decisions rather than attributing their success to the unsustainable growth in one sector of the economy. Unfortunately, for many investors, this overconfidence lead to significant financial loss.

Avoiding Overconfidence

1. **Let history be your guide and keep things in perspective.** The late 1990's wasn't the first time that people got caught up in investment mania, only to watch the speculative bubble burst and suffer significant losses. It also happened with the railroads in the early 1900's, radio broadcasting in the 1920's, as well as oil and gold stocks in