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## BEHAVIORAL FINANCE

The predominant investment practice of the late 20th century, Modern Portfolio Theory, described investors as rational beings who unemotionally calculated risk and return before making their selections. As anyone who ever made an investment based on a hot tip knows, humans are not always so rational.

The science of Behavioral Finance takes a different tack: Rather than explaining how investors should act, it concerns itself with how investors really *do* act. Since the first research on what was called Prospect Theory appeared in 1979, scientists have found a number of ways in which people's attitudes toward risk diverge from the purely rational.

**Our attitudes toward risk are not always purely rational.**

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## IT'S HUMAN NATURE

See how many of these axioms, all scientifically demonstrated by researchers looking at behavioral finance, apply to your own risk tolerance:

- We have an inclination to get greedy and buy more when the markets are rising, shoving the adage of "buy low, sell high" out the window. By the same token, when the market is in a downturn, we panic and sell too quickly when prices are low.
- When the price of an item rises, such as a can of tuna, we start shopping for an alternative. But we treat financial assets differently from consumer goods: When the price of a stock rises, we can't buy enough of it.
- We are more interested in reducing our losses than in taking a chance on a large gain. One Behavioral Finance experiment offered people the choice between an 80 percent chance of losing \$4,000 and a 20 percent chance of breaking even, versus a 100 percent chance of losing \$3,000. Not surprisingly, 92 percent of the respondents took the gamble, even though the loss averaged \$3,200, against the guaranteed \$3,000 loss. On the other side of the coin, when people had to choose between an 80 percent chance of winning \$4,000 versus a 100 percent chance of winning \$3,000, some 80 percent took the guaranteed money.

**Analyze your own risk tolerance behaviors.**

- The first major loss we suffer is more painful than a subsequent loss of the same amount. In other words, it's very trying to lose \$1,000 in the market, but once you've done that, it's not nearly as bad to lose the next \$1,000.
- In another experiment, people changed their risk tolerance based solely on whether the question was worded positively. If you ask people if they want to invest in a stock that has a 35 percent chance of declining, they'll react differently than if you tell them about a stock with a 65 percent chance of appreciating.
- Finally, many investors have a great deal more confidence in their abilities to pick stocks than is warranted by the results.

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## LEAD WITH YOUR HEAD

The science behind Behavioral Finance holds that these traits are common, if not universal. So if you find yourself wanting to make changes to your portfolio that have more to do with emotions than with careful analysis, you're not alone.

**A good wealth strategist can help you think clearly.**

That's where a good wealth strategist can help, reviewing your financial and investment plans with a calm and well-informed head to ensure they remain in sync with your overall financial goals. That's one of the key ways The Ferrucci Company can help keep you on the right track.

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If you'd like to know more about how we can help you make decisions based on rational, forward-thinking analysis, please take a look at our Web site at [www.ferruccicompany.com](http://www.ferruccicompany.com). You can also send an e-mail to [david@ferruccicompany.com](mailto:david@ferruccicompany.com) or [paul@ferruccicompany.com](mailto:paul@ferruccicompany.com), or simply give us a call at 800.633.3051.

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