How to Make Your Peace with the Financial Markets

If you're a robot, investing is easy. What if you're human? Not so much. When you strip away all the nonsense, investing doesn't have to be complicated: You settle on your goals. You choose an appropriate stock-bond mix. You buy some low-cost mutual funds. You rebalance regularly.

Yet, as simple as this sounds, we manage to mess up regularly. Here's a look at some of the more common pitfalls – and how we might avoid them.

LOSING BATTLE

Pitfalls? For starters, we read too much into the markets' short-term performance. We scour market data, desperately hunting for patterns, and end up making big portfolio changes based on a few days' or weeks' trading.

A classic scenario: We extrapolate recent stock returns, prompting us to flock to popular investments that could be overvalued, while shunning those that are despised and could be at bargain prices.

To make matters worse, our self-confidence climbs along with the broad stock market, because we tend to attribute our portfolio's gains to our own intelligence. This may lead us to trade too much and to take more risk, just as valuations are becoming less attractive.

Indeed, our tolerance for risk is far from stable. The portfolio we're comfortable with at a market peak may be far more aggressive than the investment mix we can stomach at the depth of a bear market. That, however, doesn't necessarily mean we will panic and sell during a market decline. To be sure, some people bail out.

But many of us hang on, hoping to get even before we get out. We're anchored on a particular price, such as the price we originally paid or the highest price our stocks got to. We hate the idea of selling for less, partly because it means giving up all chance of recouping our losses and partly because it means admitting we're wrong, with all the associated pangs of regret.

Often, the best time to buy is when the markets are making us most antsy. Yet our preference is to invest when we're feeling comfortable. That explains not only our increasing exuberance as markets rise, but also our fondness for blue-chip stocks, local companies and our own employer's stock.

At the same time, we shun investments that make us uncomfortable, such as foreign stocks. Yet studies suggest that adding a small dose of foreign exposure to a U.S. stock portfolio may actually lower the portfolio's overall volatility.

Sound grim? On top of all this, we likely engage in mental accounting, looking at each part of our financial life in isolation, rather than focusing on the big picture. For instance, we fret over investments that are struggling, even if our overall portfolio is faring just fine.

MAKING PEACE

These mental mistakes can wreak havoc with our investment results – if we don't find some way to limit the damage. To that end, consider four strategies:

1. Narrow your choice. Today, we can pick from a vast array of stocks, bonds, mutual funds and other investment possibilities.

For many, the choice is so utterly befuddling that they give up in despair. Meanwhile, for the active minority, the choice often proves lethal, providing them with all the ammunition they need for self-inflicted investment wounds.

Many employers, aware that too much choice creates problems, are moving to limit the number of investment options in their 401(k) plans. When investing outside your 401(k), you might try the same strategy by, say, limiting yourself to the funds offered by a single mutual fund company.

2. Consider target-date funds. Many employers have also introduced target-date retirement funds into their 401(k) plan and even designated these funds as the plan's default investment option.

Target-date funds seek to provide one-stop investment shopping, typically offering a broad mix of stocks and bonds in a single mutual fund. You simply pick a fund with a target date close to your expected retirement date. As the fund approaches this target date, it becomes increasingly conservative, buying more bonds and lightening up on stocks.

This keeps investing simpler – and it should also reduce some of the emotional whiplash. Thanks to their broad diversification, target-date funds could be a better option if you're a nervous investor, because you don't see the carnage that may afflict each individual sector.

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3. Divvy up your money. Try mentally dividing your portfolio into two parts: growth money and safe money. This can be a smart move if you want to build your own investment mix.

Count your stocks and riskier bonds, such as emerging market debt and high-yield junk bonds, as part of your growth money. This portion of your portfolio may generate the highest long-run return, but it will also give you the roughest ride.

Meanwhile, for downside protection, you may consider high-quality bonds, certificates of deposit, your savings account and other conservative investments. This part of your portfolio won't deliver dazzling returns and bonds can lose money in bad markets, but this portion of your portfolio may provide comfort at times of market turmoil.

4. Get a second opinion. It is hard to stay calm during market declines, when your wealth seems to shrink every time the stock market opens for business.

What to do? Before you make a big trade that you may later regret, get a second opinion. That might mean talking to your spouse, a colleague or your Financial Advisor.

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Sourcing: For a review of the extensive academic literature on behavioral mistakes, see *Nudge: Improving Decisions About Health, Wealth, and Happiness* (Yale University Press, 2008) by Richard H. Thaler and Cass R. Sunstein. For a discussion of the benefits of adding foreign stocks to a U.S. portfolio, see *Stocks for the Long Run* (McGraw-Hill, third edition, 2002) by Jeremy J. Siegel.

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Diversification does not ensure against loss.

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