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Trust your instincts. Except in investing.
How human nature can derail investment results
Bud Shore

When it comes to investing, your instincts can lead you astray. In this unfamiliar terrain, many of our otherwise-essential instincts turn against us, leading to poor decisions at all the wrong times.

These six misleading instincts can take you down the wrong financial path.

Misleading Instinct No. 1: Bet on proven winners. People like to be associated with winners. We gravitate toward winning sports teams, people and restaurants. A good example would be the Miami Heat basketball team. Even when this reigning NBA champion goes on the road, Heat fans show up to help fill opposing teams' arenas.

For the most part, backing a winner is harmless fun. But in investing, buying into past winners can readily turn against you. It turns out that the familiar disclaimer is right: Past performance is no guarantee of future results. It's not even a good general guide.

This concept can be tough to accept. But the prospects of a company are quickly identified and priced into its stock — long before you see the trend and decide to join in.

Misleading Instinct No. 2: Ditch the losers. This is the flip side of betting on past winners. Human nature tells us to learn from our mistakes and punt away our poorly performing investments. Market efficiency, however, tells us that the weakness of a laggard is discounted into its price, and therefore, a recent loser is no more likely to fall in price in the future than a recent winner.

Misleading Instinct No. 3: Stretch to be the best. In investing, this instinct to outperform can drive all sorts of bad decisions: accepting too much risk, jumping from horse to horse, ignoring costs and taxes in pursuit of short-term gains, overpaying so-called gurus, chasing fads, trading on rumors … the list goes on. The restlessness not only preys on general peace of mind, it tempts investors to buy high and sell low — exactly the opposite of what their instincts should be telling them to do.

Misleading Instinct No. 4: Insist on being different. In an attempt to outperform, instinct may tell us to invest outside the box, to go where lesser investors are too timid or unsophisticated to venture. The result can be a portfolio packed with risky, illiquid and complicated positions. Many specialized investment vehicles (such as "2 + 20" hedge funds), playing on their exclusivity, exact heavy sales loads (a 2 percent, or higher, upfront fee) and siphon a significant share of returns (20 percent of profits) back to the manager. These built-in disadvantages make outperformance for the individual investor that much less likely.

Misleading Instinct No. 5: Trust the names you know. When in doubt, investors may be drawn to the best-known financial names — major Wall Street brokerages, brand-name mutual fund families, and iconic analyst firms and rating organizations. It is natural to find comfort in the names we know, but blind faith is unjustified.

In many cases, name recognition is driven by the size of advertising budgets, not necessarily the quality of investments offered or guidance delivered. The high overhead that is inherent in the largest, most heavily marketed organizations can be a drain on the results ultimately realized by investors.

With your financial well-being hanging in the balance, no firm or advisor should be considered exempt from your rigorous due diligence. You need to know what you are paying for and what they will receive. For instance, the major brokerage firms may pledge to protect the interests of their clients, but they are free to act in ways that serve their own interests at the expense of clients because they are not bound by a legal fiduciary duty (as Registered Investment Advisor firms are).

Big brand names can deliver excellent service and good investment results. But size and familiarity are not, in themselves, a basis for trust. Every vendor, agent or advisor deserves scrutiny. After all, it's not their money at stake.

Misleading Instinct No. 6: React to the crisis du jour. Hand in hand with craving the familiar, we fear the unknown, especially in the form of crises. For example, there have been ongoing economic crises such as the European debt crisis or, for that matter, the increasing debt in the United States. Global and domestic political events or natural disasters can also cause stock prices to drop unexpectedly.

Fear can cause unhealthy financial choices. Our "flight" instincts kick in, and we react in panic before we have time to reflect or seek sage counsel.

If not instinct, then what?

Following our instincts can betray us as we invest toward long-term financial goals. But what is the alternative? For starters:

- **Heed the evidence.** Put the odds in your favor by using an evidenced-based approach to investing. Decades of robust academic inquiry can guide you on which factors are beyond your control (such as predicting the movements of the future market or of particular stocks) and which you can expect to effectively manage (such as minimizing costs and exposing your overall portfolio to appropriate levels of risk and expected reward).

- **Take appropriate risks, but spread them around.** Build a diversified portfolio that represents the breadth and depth of the market. Own a mix of distinct asset classes: domestic and international securities, large and small, growth and value.

- **Stay the course.** Buy and hold for the long term, with the goal of consistently earning market-level returns. Rebalance your portfolio as needed to remain true to your plans in the face of market movements.

- **Control costs.** Minimize hyperactive trading or expensive products that can drive up expenses and tax liabilities.

- **Form a plan.** Invest according to a written plan that reflects your personal financial goals. Adjust your underlying plan only when your own goals or personal circumstances change. Otherwise, leave it be.

- **Don't go it alone.** Team up with an objective advisor who will help you build on all of the above, and who will let you know when your misleading instincts may be getting the better of you.

Enjoy all that instinct can add to life. But beware of what it also can take away, especially when it comes to investing.

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Marion "Bud" Shore founded Shoreline Asset Management in 1998 as a Registered Investment Advisor and wealth management firm. Bud was among the first 1,200 accountants in the country to achieve a combined CPA/PFS (Personal Financial Specialist) designation and was an early advocate of combining best practices in finance and accounting to help individuals reach their important personal and professional goals.

In his community and his career, Bud is an avid regional leader and benefactor. He currently serves or has served on numerous local and regional boards and committees for organizations including Citizen State Bank, Earlham College (trustees and foundation boards), Henry County Foundation, Henry County Hospital, New Castle Henry County Public Library (during its building campaign), United Way, the YMCA and his church. He is a member of the Indiana CPA Society and the American Institute of Certified Public Accountants.

Bud holds an MBA and a bachelor's degree in accounting and finance from Ball State University, and he has held his CPA designation since 1979.