Overconfidence, loss aversion are key predictors for investment mistakes

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The recent stock market decline from its high point has caused concerns for many investors who are affected by short-term market trends. However, experts say now is an important time for investors to remember that many mistakes can be made in this economic environment. In a new study, a personal financial planning expert from the University of Missouri has identified several risk factors for people who are more likely to make investment mistakes during a down market. Rui Yao, an associate professor of personal financial planning in the MU College of Human Environmental Sciences, has identified overconfidence as a key factor causing people to make common investment mistakes.

For her study, Yao analyzed data from the 2008 FPA-Ameriprise Financial Value of Financial Planning Research Study. That study included data about people who made a common investment mistake: moving their financial assets into a cash position during a down market without income interruptions or increased spending needs. This is done primarily by selling off stocks and placing the cash into bank accounts until the market bounces back. Yao found that males, Asian Americans, those who are wealthy, those who are overconfident in their investment abilities and those who are loss averse are more likely to commit this common mistake.

"Asian Americans often move to cash positions during down markets because, culturally, they are much more likely to trade on the stock market more frequently and take a short-term investment approach as

opposed to a more rational long-term approach; however, market-timing and frequent trading rarely pay off," Yao said. "Overconfidence is another key indicator for investment mistakes. If a person has too much confidence in the market or in their own abilities as an investor, they are much more likely to sell low, which is illogical, but common."

Yao says these findings can provide financial planners with some important indicators that their clients may be at risk for making investment mistakes. She suggests that financial planners observe how their clients react during a down market, including whether they appear overconfident or fearful of losing money. Advisers can then help clients better understand the challenges they face and overcome mental biases in order to reduce the likelihood of making investment mistakes. Also, once the market bounces back and the clients view their portfolios in a more positive light, financial planners should work to create some guidelines for their clients concerning what they will do if and when the market takes another dive.

"During a down market, every mistake an investor makes is magnified," Yao said. "If financial planners can identify those who are more at risk to make these mistakes, they can more effectively work with the investors beforehand to help prevent them from making such mistakes."

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