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The Mistakes We Make—and Why we make them - Excerpts from Meir Statman, Professor of Finance, Santa Clara University. - What was I thinking? If there's one question that investors have asked themselves over the past year and a half, it's that one. If only I had acted differently, they say. If only, if only, if only. Most investors are intelligent people, neither irrational nor insane. But behavioral finance tells us we are also normal, with brains that are often full and emotions that are often overflowing. And that means we are normal smart at times, and normal stupid at others.

What are the lessons we should learn, once we recognize those cognitive and emotional errors? Here are eight of them.

1. Goldman Sachs is faster than you. There is an old story about two hikers who encounter a tiger. One says" There is no point in running because the tiger is faster than either of us. The other says" It is not about whether the tiger is faster than either of us. It is about whether I'm faster than you. And the Goldman Sachses of the world has been boosted most recently by computerized high-frequency trading. Can you really outrun them?

So what does this mean in practical terms? The most obvious lesson is that individual investors should never enter a race against faster runners by trading frequently on every little bit of news (or rumors).

Instead, simply buy and hold a diversified portfolio. Banal? Yes. Obvious? Yes. Typically followed? Sadly, no. Too often cognitive errors and emotions get in our way.

2. The Future is not the past, and hindsight is not foresight. Wasn't it obvious in 2007 that financial institutions and financial markets were about to collapse? Well, it was not obvious to me, and it was probably not obvious to you, either. Hindsight error leads us to think that we could have seen in foresight what we see only in hindsight.

Some prognosticators say that we are now in a new bull market and others say that this is only a bull bounce in a bear market. We will know in hindsight which prognostication was right, but we don't know it in foresight.

3. Take the pain of regret today and feel the joy of pride tomorrow. Stop focusing on blame and regret and yesterday and start thinking about today and tomorrow.
4. Investment success stories are as misleading as lottery success stories. Have you ever seen a lottery commercial showing a man muttering "lost again" as he tears his ticket in disgust? Of course not. What you see instead are smiling winners holding giant checks What is true for lottery tickets is true for investments as well. Investment companies tilt the scales by touting how well they have done over a pre-selected period. A diversified portfolio of many investments might make you a loser during a year or even a decade, but a concentrated portfolio of few investments might ruin you forever.
5. Neither fear nor exuberance are good investment guides. A Gallup Poll asked: "do you think that now is a good time to invest in the financial markets?" February 2000 was a time of exuberance, and 78% of investors agreed that "now is a good time to invest." It turned out to be a bad time to invest. It is good to learn the lesson of fear and exuberance, and use reason to resist their pull.

Interesting Facts:

SPEND, SPEND, SPEND - 4 of the 5 largest monthly deficits ever in the history of the United States have occurred since February of this year, including July's $181 billion deficit, which ranks # 5 all-time (Source: Treasury Department).

A LOT MORE - With 1 month remaining in fiscal year 2009 (i.e., 10/01/2008 to 9/30/2009). The government is projecting spending of $4.0 trillion for the 12 month-period. During fiscal year 2001 (i.e., the first fiscal year during the presidency of George Bush # 43), total government spending was 1.9 trillion (Source: Treasury Department).

2037 OR 2043? Social Security announced on 5/12/09 that the trust fund backing the payment of Social Security benefits would be zero in 2037 and that the payment of benefits would drop to 76% of their originally promised levels. On 8/07/09, the Congressional Budget Office calculated that the trust fund would be zero in 2043 and that the payment of benefits would drop to 83% of their originally promised levels (Source: SSA,CBO).

BEST AND THE WORST– The nation's unemployment rate was 9.4% as of the end of July 2009. The highest unemployment rate in the USA since 1947 was 10.8% in November and December 1982. The lowest unemployment rate since 1947 was 2.5% in May and June 1953 (Source: Department of Labor).

TOP ONE PERCENT - To rank in the top 1% of all US taxpayers required an adjusted gross income (AGI) level of at least $410,000 based upon calendar year 2007 tax data. This group earned 23% of all AGI nationwide and paid 40% of all federal income tax in the country (Source: Internal Revenue Service, Tax Foundation).

OFF TO COLLEGE - The average American family borrows 39% of the total cost of their children's college education, either through student loans or loans taken out by Mom & Dad (Source: Sallie Mae).

Interesting Facts:

BURNED BY DEBT - 22% OF American households headed by a retired person are still making a monthly mortgage payment or they have outstanding debt as a result of a home equity loan. 20 years ago (1989), only 16% of these families had mortgage debt or home equity debt (Source: Federal Reserve).

THE NEXT BIG PROBLEM? - The commercial real estate industry (i.e., office buildings, hotels, retail stores, shopping centers) includes $3.4 trillion of real estate. $700 billion of loans connected to the commercial real estate industry have been packaged together into bonds and sold to investors, i.e., they were securitized. Commercial mortgage defaults are occurring at the rate of $2 billion a month as of today and could reach nearly $3 billion a month by the end of this year (Source Fitch Ratings, Financial Times).

STILL COVERED - 21 states allow young adults to qualify for health insurance coverage under their parents' insurance plans through at least age 25 (Source: Commonwealth Fund).

A TRILLION DOLLARS– The S & P 500 stock index had a total market capitalization of $7.87 trillion as of 12/31/08. The stock index reached a peak closing value for this year of $8.88 trillion as of 8/07/09, an increase of $1 trillion YTD (Source: S & P)

JUST TWO STATES - 43% of the foreclosure filings reported on properties nationwide in the first half of 2009 occurred in California and Florida (Source: Realty Trac).

SAVING MORE - The personal savings rate in the USA at the end of June 2009 was 4.6%. The nation's personal savings rate was 0.2% as of 3/31/08 (Source: Commerce Department).

LONG HOURS - 7.4% of Americans work at least 60 hours a week. 17.7% of workers put in at least 49 hours of work each week (Source: Statistical Abstract of the United States, Table 582)

TOP FIVE PERCENT - To rank in the top 5% of all US taxpayers required an adjusted gross income (AGI) level of at least $160,000 based upon calendar year 2007 tax data. This group earned 37% of all AGI nationwide and paid 61% of all federal income tax in the country (Source: Internal Revenue Service, Tax Foundation).

NOT MUCH - The bottom 50% of US taxpayers pays 3% of all federal income tax (Source: IRS, Tax Foundation)

6. Wealth makes us happy, but wealth increases make us even happier. Happiness from wealth comes from gains or wealth more than it comes from levels of wealth. While gains of wealth bring happiness, losses of wealth bring misery. This is misery we feel today, whether our wealth declined from $5 million to $3 million or $50,000 to $30,000. Standing next to people who have lost more than you and counting your blessings would not add a penny to your portfolio, but it would remind you that you are not a loser.
7. I've only lost my children's inheritance. Another lesson here in happiness. Mental accounting-the adding and subtracting you do in your head about your gains and losses– is a cognitive operation that regularly misleads us. But you can also use your mental accounting in a way that steers you right. Say your portfolio is down 30% from its 2007 high, even after the recent stock-market bounce. You feel like a loser. But money is worth nothing when it is not attached to a goal, whether buying a new TV, funding retirement, or leaving an inheritance to your children or favorite charity. Suppose that you divide your portfolio into mental accounts: one for your retirement income, one for college education of your grandchildren, and one for bequests to your children. Now you can see that the terrible market has wrecked your bequest mental account and dented your education mental account, but left your retirement mental account without a scratch. You still have all the money you need for food and shelter, and you even have the money for a trip around the country in a new RV. You might want to affix to it a new version of the old bumper sticker" I've only lost my children's inheritance." So here's my advice: Ask yourself whether the market damaged your retirement prospects or only deflated your ego. If the market has damaged your retirement prospects, then you'll have to save more, spend less or retire later. But don't worry about your ego. In time it will inflate to its former size.
8. Dollar-cost averaging is not rational, but it is pretty smart. ("Dollar cost averaging does not assure a profit nor protect against a loss in declining markets. An investor should be prepared to continue the program of investing at regular intervals. An investor should also consider his financial ability to continue his purchases through periods of lower price levels in order to fully utilize a dollar cost averaging program.") Suppose that you were wise or lucky enough to sell all your stocks at the top of the market in October 2007. Now what? Dollar-cost averaging is a good way to reduce regret-and make your head clearer for investing. Say you have $100,000 that you want to put back into stocks. Divide it into 10 pieces of $10,000 each and invest each on the first Monday of each of the next 10 months. You'll minimize regret. If the stock market declined as soon as you have invested the first $10,000 you'll take comfort in the $90,000 you have not invested yet. If the market increases you'll take comfort in the $10,000 you have invested. Moreover, the strict "first Monday" rule removes responsibility, mitigating further the pain of regret. You did not make the decision to invest $10,000 in the sixth month, just before the big crash. You only followed a rule. The money is lost, but your mind is almost intact. Things could be a lot worse.