BEHAVIORAL FINANCE

May 2024

As always, we aim to deliver all the information you need so that we can create the right strategies for your holistic financial goals.

Understanding behavioral finance is just a supplement to having a robust financial plan built to weather all market conditions.

Please do not hesitate to reach out to discuss how we can support you in achieving your financial goals.

Beverly Hills
PRIVATE WEALTH

ARE WE PREDICTABLY IRRATIONAL?

Mainstream economic theory relies on the idea that all investors are rational—but reality often demonstrates it's the opposite. Humans are complex beings. We carry biases through life, and subconscious beliefs often drive our decision-making. Friends and family, news headlines, social media—these forces all shape our thinking and actions. And much of this can happen beneath our level of awareness.

It's important for us to think about how the irrational investor will respond to changes in the stock market and assess those reactions through a neutral and unbiased lens. Behavioral finance can help us do just that—empowering us to better understand our patterns of decision-making when addressing our finances so that we make smarter and more strategic decisions that align with our long-term plan.

Understanding behavioral finance, however, is just a supplement to having a robust financial plan built to weather all market conditions, so it's important to understand what it is and how it can empower us.

THE INTERCONNECTION BETWEEN EMOTIONS & MONEY

Fear, panic, and uncertainty can all shape our decisions and decision-making abilities. For this reason, it is critical to cultivate skills to avoid an emotion-driven impulse that leads you away from your financial plan. For example:

- **Be wary of "loss aversion."** We are prone to have greater concerns over losses (and take drastic steps to avoid them) than happiness with market gains. This plays out when an investor holds onto a "losing" stock, because they would rather cling on in hopes of a rebound than accept a low sales price.

- **Watch out for news headlines** —about market volatility, recession fears, and geopolitical instability, just to name a few. Remember that headlines are meant to grab your attention rather than provide a full picture of what's at play. While the emotional investor hates uncertainty, the rational investor avoids making investment decisions based off a knee-jerk, anxious, or fearful reaction. Instead, stay grounded in long-term views.

- **Avoid "herd mentality," as we saw with the meme stock frenzy**. When we follow the herd, we are basically saying, "Well, it works for everyone else, so it should work for me." Of course, when it comes to investing, one-size never fits all. In the 2021 meme stock frenzy, we saw investors making risky decisions to "get in" on the action. While some people made lucky returns, others drained their savings, took out loans to buy stock, or even invested (and lost) their retirement money. This is an example of highly irrational behavior quite literally costing people their life savings. Herd mentality is thus often responsible for major market swings.

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This begs the question—amid all the chaos in our world, how can investors be more rational?

KNOWING WHEN ACTION IS NECESSARY

Investing without a clear plan is like getting on a train with no destination. Your plan guides your investment objectives and time horizons, and a good plan will have market volatility built into consideration. When investing in the stock market, remember that this is a long-term commitment. If your end goal has not changed, a volatile environment should not drastically change your investments. History has shown that cyclical markets rebound, and the best market days often follow the worst.

A 2023 J.P. Morgan study illustrated what pulling your money out of the market can do to your portfolio. The study found that from January 1, 2004 to December 31, 2023, missing only the 10 best market days over 20 years cut your overall return in half. Additionally, seven of the 10 best days during that period occurred within two weeks of the worst days.

While it's important to steer clear of making irrational, emotion-driven decisions, in some cases, making a long-term change to your financial plan *is* warranted. When you work with our team at Beverly Hills Private Wealth, we offer questions that you can ask yourself to consider whether a change is appropriate. For example:

- How have my priorities, both financially and in life, shifted?
- Does my investment strategy still support my financial goals?
- Are there any upcoming milestones that will impact my investments?
- Should I be making any changes to my estate plan based on the legacy I want to leave?

We will then work with you to determine what kind of change might be appropriate, especially considering significant life events (e.g., getting married, having kids, inheriting a windfall, deciding to purchase a home, etc.).

Please do not hesitate to reach out to discuss how we can support you in knowing when—and how—to make a change to ultimately achieve your financial goals.

Sincerely,

Your Team at Beverly Hills Private Wealth