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When to Buy or Sell? Don't Trust Your Instincts

By PAUL SULLIVAN

ANYONE watching television commercials could easily conclude that trading stocks is something a baby can do from a crib. But new research into 17 years of call records at a boutique investment adviser shows that the baby in all of us is likely to buy or sell at the worst possible time.

Philip Z. Maymin, an assistant professor of finance and risk engineering at Polytechnic Institute of New York University, studied comprehensive records kept by the investment firm Gerstein Fisher from the firm's founding in 1993 to mid-2010. The firm has over $1 billion in assets.

Gregg S. Fisher, the firm's president and chief investment officer, said the database began out of practicality. "In the first few months early in my career, I was using index cards to keep track of clients," Mr. Fisher said. "I decided that wouldn't be scalable."

He gave Mr. Maymin access to every contact between clients and all the firm's advisers, 1.5 million interactions by phone, e-mail or letter — or what the study calls "touches."

"It turns out we could do an awful lot by counting the sheer number of touches," Mr. Maymin said. Nonessential communications, like mass e-mails and New Year's greetings, were removed from the study, he said.

The study, which will be published in the spring edition of The Journal of Wealth Management, found that the value of investment advisers was not in the stocks or mutual funds they recommended but in their ability to restrain investors from impulsively trading at the wrong time. It cites data showing that aggressive orders by individuals can cost them about four percentage points a year.

"Enlightened behavioral investors ought to be more willing to pay on the order of one percentage point to an investment manager who will prohibit or at least impede aggressive orders than to pay nearly four times as much for the privilege of excessively and detrimentally trading their own account," the authors, Mr. Maymin and Mr. Fisher, wrote.

Mr. Maymin and Mr. Fisher looked at when clients called the most after the initial period of setting up their accounts. It turned out that it was right after the most volatile periods.

The spark for the study was not previous economic research but research into a college student's attempts to keep himself from binge eating in the middle of the night. That study, published in a psychiatric journal in 1978, aimed to find a way to control uncontrollable appetites. What it found was that even when the student found a way to stop eating in the middle of the night — he put a lock on the refrigerator and gave the key to a roommate — the desire to eat never fully went away.

"The urge never goes to zero," Mr. Maymin said. "People who want to trade aggressively, it will never go away. If the market is volatile, it increases."

More than that urge not going away, the Maymin-Fisher study found, it reappears just after a sudden rise or fall in the market. In other words, investors did not trade in expectation of intense volatility or even during it, which might be rational. They waited until the period of greatest volatility had passed and then looked to do what any adviser would tell them not to do: sell at the bottom or buy at the top.

"The interesting question here for me is, does your urgency increase in some rational way if you expect the volatility to go up in the future?" Mr. Maymin asked. "Or does it go up because of recent actual volatility? The recent volatility shouldn't matter so much — who cares what just happened?"

But to too many investors, yesterday matters a lot and threatens to ruin tomorrow.

There is one obvious limitation to the Maymin-Fisher study: the data is from one firm in New York with 600 clients. It could be argued that the firm's clients were not representative of investors in general.

Still, the study adds to research into the so-called behavior gap, a term used by Carl Richards, a contributor to The New York Times's Bucks blog, to explain the difference in investment and investor returns. It is the percentage difference, for example, between a mutual fund's stated returns and the returns individual investors actually get.

Dalbar Inc. of Boston tracks the difference between stated and actual returns and publishes an annual report on it. Data from its 2010 Quantitative Analysis of Investor Behavior showed that the spread between investor and investment returns was narrowing but persisted. In 1998, it was 10.65 percentage points; in 2009, it was 5.03 percentage points. "While investors seem to be learning hard lessons from the past 15 years, the original Q.A.I.B. findings still hold true: Mutual fund investors do not achieve the returns cited by fund firms due to their irrational behavior," Lou Harvey, president of Dalbar, said.

The recognition of this phenomenon has reached the point where Morningstar, which tracks fund returns, has started reporting two sets of returns. In addition to the buy-and-hold returns the funds themselves release, Morningstar now reports investor returns on open-ended mutual funds and exchange-traded funds. It explained the change as an attempt to capture the returns of average investors, who move their money in and out of funds. "Investors often suffer from poor timing and poor planning," it noted.

This is what Mr. Fisher is up against in advising his clients. Using the results of the study to persuade clients not to act against their economic interest is not going to be easy, he said. There is also little correlation between wealth levels and the desire to trade on impulse.

"It's more about the randomness of what they ate for lunch yesterday," he said. "Or if they bought Google at the I.P.O., they're more likely to want to buy Facebook. That explains their risk behavior more."

One caveat here is that advisers can be subject to the same myopia as the investors they advise. Don Phillips, managing director of corporate strategy, research and communications at Morningstar, wrote an article called "The Third Rail" in Morningstar Advisor in October that questioned the whole notion of advisers being the rational counterweight to investors' more irrational behavioral tendencies.

"If most investors use advisers and most investors continue to do the wrong thing, then there must be a tremendous amount of bad advice being given," Mr. Phillips wrote. "Or, said more charitably, the current state of financial advice cannot counteract the self-defeating inclinations most investors have."

The other side of this argument is that advisers may not be forceful enough in their advice or that it may go unheeded. It is the clients' money, after all.

Still, Mr. Fisher is ultimately optimistic that having the data on client calls will allow his firm to better understand client behavior. "This has helped us and our clients make healthy decisions," he said. "We know what happens to us yesterday does affect us today. We want to understand what everyone does and take advantage of it."

In that sense, knowing that most people trade like babies can be an advantage to those who control their inner toddler.