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You're Not as Good an Investor as You Think You Are

By

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Feb. 22, 2013 5:40 pm ET

Are those who can't remember the crash condemned to repeat it?

Markets have been rising and investors returning to stocks, thanks to cheap money from central banks, a rash of takeover deals, the glimmers of economic recovery—and an epidemic of amnesia.

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CHRISTOPHE VORLET

Many investors have been behaving as if the bloodbath between October 2007 and March 2009, when the U.S. and global stock markets lost at least 50%, had never happened. More worrisome, investors are forgetting the agonizingly real fear they felt during the financial crisis.

That could lead some to take more risk than they should and incur losses they can't withstand. So it is vital to evaluate whether you suffer from investing amnesia and, if you are, to counteract it before it is too late.

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There isn't any doubt that individual investors have been getting more aggressive. Leading discount brokerages TD Ameritrade Holding, E*Trade Financial, Charles Schwab, Fidelity Investments and Scottrade added $170 billion in retail assets in the first three quarters of last year, according to Ana Avramovic, a trading strategist at Credit Suisse Group. Margin debt—borrowing that individual investors use to juice up returns on their brokerage accounts—exceeds $330 billion, up 24% in 12 months.

People are revising their memory of the financial crisis, as if they were looking into a rearview mirror made of rose-colored glass. Financial planners report that clients are increasingly saying 2008 and 2009 were no big deal.

Derek Tharp, an adviser at Mote Wealth Management in Cedar Rapids, Iowa, says he has several clients who are "rewriting history." In late 2008 and early 2009, he says, these people often sent long, panicky emails past 10 in the evening "to explain exactly why this was the end of the financial markets and they needed to get out now."

Today, Mr. Tharp says, "they've put it out of their memory" and are eager to increase their return by adding more stocks. "It just feels better for a lot of people" to forget their losses, he says.

You might think memory works like an engraving plate onto which events are carved in stone and preserved for decades until they fade with age. In reality, psychologists have shown, memory works more like an Etch A Sketch, on which events are traced but then often altered or erased entirely.

Elizabeth Loftus, a psychologist at the University of California, Irvine, says people are prone to "spontaneous distortions of memory that make us feel better about ourselves." Studies have shown, for example, that people remember voting regularly in national elections even when they haven't cast a ballot in at least six years and that 71% of students who earned D grades in high school later recall getting higher marks.

"One thing that might make some investors feel better about themselves," Ms. Loftus says, "is remembering that their losses were smaller or their gains were bigger than they actually were."

That's exactly the kind of polishing of the past that seems to be going on in many investors' minds right now.

Memory whitewashes mistakes, too. Mark Armbruster of Armbruster Capital Management in Pittsford, N.Y., says one client insisted on putting 40% of a $5 million portfolio into a single hedge fund. Alarmed by the fund's risk, Mr. Armbruster badgered the client into selling. Shortly thereafter, the fund collapsed. The client narrowly missed losing $2 million.

In a subsequent conversation, Mr. Armbruster says, the investor had no recollection of what had happened. "The whole episode had been blotted out from memory," Mr. Armbruster says.

Because memory is so malleable, Joachim Klement, chief investment officer at Wellershoff & Partners, a consulting firm in Zurich, urges his clients to keep an investment diary, creating a record of their buying and selling decisions and the reasons behind them. "You can mitigate the flaws of memory by writing events down as they happen," he says.

You shouldn't trust your recollections of how you felt in 2008 and 2009. Instead, ask your spouse or a close friend how afraid you were, and look at your old account statements to see whether you sold at the bottom. The best guide to how you will act in the next market downturn is how you did act in the last one.

The great financial analyst Benjamin Graham wrote in his book "The Intelligent Investor," after which this column is named, that "the investor's chief problem—and even his worst enemy—is likely to be himself."

If you can't remember the pain you felt in the past when you lost money, you will have no one to blame but yourself if you end up feeling the same anguish all over again.

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