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Investor Psychology Series ***Individual Investors: Get-evenitis Flaws***

Well, we've started each of our Investor Psychology articles with a quiz, let's keep this trend alive with another real-life story and a series of questions along the way. Give your answers to each question before you continue with the remainder of the story.

Property Woes

Bill and his wife are in their early thirties and have just had their first child. A good friend of theirs named James has been actively investing in real estate for the last several years. James has displayed a knack for finding undeveloped property that looks like a mess but has great potential. After purchasing a property, James's formula has been to clean it up, divide it into parcels, and resell it at a substantial profit (without adding any structures to the land). In the last three years, James has been able to resell most of his properties for between one and two times what he paid for them. Since his initial purchases were made with borrowed funds, a common practice in real estate investment, James has been earning extremely high rate of return.

Several years ago James had encountered some personal problems, and Bill was very helpful and supportive during that time. Since then, James had always tried to repay Bill for his kindness in whatever way he could. Last year James recommended that Bill join James by investing in a small rural tract, which Bill did. This year James had been able to sell the tract for 75% more than their initial investment. Bill and his wife bumped into James one evening, and James was quite enthusiastic about another deal, predicting: You'll want to go in with us on this.

With the birth of their child, Bill and his wife have begun to think about setting aside more money for the future, particularly in respect to funding their child's college education. They know that even when the returns on an investment look attractive, those returns can turn out to be quite modest once inflation and taxes

are taken into account. They are wondering whether the deal mentioned by James might be suitable investment for funding their child's future college education.

Later when they meet with James, he tells them the details. A development company that has just declared bankruptcy purchased Clear Lake Development and is eager to sell. James believes that the property has great potential for retirees. It lies in a rural area, on the shore of a lovely lake.

The price tag for Clear Lake would be \$205,000, and James suggests they go in as equal partners. That is, James would invest \$102,500, and so would Bill and his wife. James plans to follow his usual formula. After subdivision, he would sell all the lots within a year or so, for a total of \$459,000. Bill and his wife currently have \$17,500 in savings, and James assures them that he can arrange for them to borrow the remaining \$85,000 at an attractive interest rate. James says that he is a great believer in leverage because it can offset inflation and taxes that really eat into initial returns.

Question #1: On a scale of 1 to 10, how would you rank Clear Lake as an investment whose purpose is to fund college education in 15 years? A 1 is most suitable, 10 entirely unsuitable.

During the first few months, Bill has been making payments on his \$85,000 loan. In addition, he is no longer earning a return on the \$17,500 of his own money that he invested. When he sees James a few months later, Bill asks him how Clear Lake is doing. James replies that a small glitch has come up.

Apparently, the property had never been surveyed properly, and he has now commissioned a survey. However, no lots can be sold until the survey is complete, and the survey is taking more time than he anticipated. Moreover, the original \$85,000 loan has come due and must be renewed. Renewal is not a problem, but the bank only wants to renew the loan for \$75,000. Consequently, Bill will have to come up with the additional \$10,000 himself. James is clearly embarrassed, but he also remains upbeat about the ultimate success of the project. Fortunately, Bill and his wife have been able to save exactly \$10,000 in recent months, and so have the necessary funds.

Question #2: If you were in Bill's situation at this point, how would you react emotionally? Would you be worried? or anxious? Or would you be patient, believing that most investments incur some glitches here and there and that you are better off having minor problems than major ones? How might you feel, if you found yourself in this situation: worried, anxious, or patient?

Question #3: If you were Bill or his wife, would you begin to experience any feelings of regret? Specifically, would you feel that anyone should be blamed?

Question #4: If you answered yes, who would you blame most: yourself, James, or the situation?

Question #5: Think about how the scenario has unfolded so far. At the outset, how obvious does it seem to you that it would have gone this way? That is, were any telltale indications present? How would you answer this question on a scale of 1 to 10, where 10 is very obvious, and 1 is impossible to predict?

Time passes. In fact, a full year has passed since Bill made his initial investment in Clear Lake. In a conversation, James apologizes that it has taken a year for things to get moving, but says that they now are on the move. He realizes that this has been a period of negative cash flow for Bill, but James says he can work things out so that Bill and his wife won't have to make any more payments on their loan. He, James, will handle the financing details. Moreover, to speed up sales, he will put up a model home on one of the lots. However, he thinks he can take care of the associated costs without asking Bill to contribute additional funds.

The next time Bill sees James, James tells Bill that he has good news and bad news. The good news is that the model home has been built and sold. The bad news is that the sale has not stimulated additional interest in Clear Lake. James says that he feels just terrible that he brought Bill into this venture, and is concerned that it will turn into a cash drain for Bill before too long. Therefore, he

proposes taking over Bills interest in Clear Lake, including all further interest payments, and asks Bill if he would like to sign his interest over to James.

Question #6: Put yourself in Bill's shoes. How would you react to James proposal? You are aware that James is more knowledgeable about the real estate market than you are, but you don't think that he would take advantage of you. He is too good a friend. However, you have now invested \$27,500 in Clear Lake. Would you accept his buyout offer? Or, would you remind James this investment is to pay for your child's education, and you still expect it to do that, thus continuing to hold your stake?

Question #7: Imagine that six years has passed since your original investment! As in question #6, James proposes that you sign your interest over to him. This time James tells you that a real estate agent selling Clear Lake has offered to buy all lots for \$35,000. Together with the \$8,900 received from the sale of the lot with the model home, the total is \$43,900. James has decided to accept the offer, and offers you the chance to assign your interest over for the same offer. Would this change your answer to #6? Would you now tell James you understand he is trying to help you and sign the deal? Or, would you remind James of your child's education funding requirements and keep your interest?

People's Common Answers

Typically, people don't think this real estate deal is particularly good for college savings by Bill and his Wife. However, once committed financially, most people become very reluctant to pull out at any point, even though they admit to feeling a little anxious at the beginning. They typically regret their initial investment and blame themselves. Yet, they never decide to sell, reluctant to realize the loss.

By the way, the child in this story did eventually get a fine education at Stanford University. Her name was Chelsea Clinton. Bill was former President Bill Clinton and his wife Hillary Rodham Clinton. Clear Lake is Whitewater, and James is the late Jim McDougal. The dollar sums are close to the actual amounts of this controversial investment scheme.

It appears that President Bill Clinton suffered from a particularly bad case of *get-evenitis*. Their failed Whitewater investment eventually became the responsibility of

Vincent Foster, a White House aide who committed suicide. The subsequent uproar led the White House chief counsel at the time, Bernard Nussbaum, to explain to President Clinton that he had a choice: Either take his financial records from Whitewater and appear before a Congressional panel, which would involve a personal and political cost to be borne immediately, or take his chances with the appointment of an independent counsel who would most likely cast an extremely wide investigation net.

As we all know, President Clinton took his chances with an independent counsel, and eventually ended up having Kenneth Starr investigate his Whitewater deal and much more. Clinton moved on to similar choices about the cases with Paula Jones and Monica Lewinsky, each time choosing to delay immediate embarrassment in favor of denial and postponement of loss. He was very loss averse which led him to accept dangerous gambles.

Sell Winners, Hold Losers

People generally sell their winners too early and hold their losers too long. Realizing a loss is painful. In studies of 163,000 day-traders, Terrance Odean (1998) found that investors who are loss averse realize more of their paper gains than they do their paper losses. It turns out that from January through November, investors realize gains 1.68 times more frequently than they realize losses. This means that a stock that is up in value is almost 70% more likely to be sold than a stock that is down. Only in December do investors realize losses more than gains, though only by 2% (probably for tax benefits).

Odean also found that investors tend to trade stocks that have outperformed the market over the last 2 years. While they sometimes divest of small losers, they almost never part with big losers. Oddly enough, they also tend to sell the wrong stocks, as their big losers continue to underperform while their small losers perform well after being sold.

Another interesting aspect of behavioral finance for fund managers points to their inclination to take additional risk once they are behind. If a fund manager finds himself in the middle of the comparison pack at midyear, they show a strong tendency to take on more risk than they normally would in order to try to catch up.

But, that's enough for today. Tomorrow, we will explore why analyst projections are consistently overly optimistic, often leading to poor recommendations--or, why great businesses don't always make great stock investments.

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The author, Curtis J Montgomery, is no psychologist, and thus has committed most of the illogical mistakes we will discuss this week. These ideas are gleaned from a book by Hersh Shefrin, Beyond Greed and Fear, published in 2000 by Harvard Business Press.