Behavioral Portfolio Management

By C. Thomas Howard, PhD

Capital market theory has passed through two distinctly different paradigms in the past 80 years and is experiencing the rise of a third. Each paradigm has attempted to better explain the movement of market prices. The currently ascendant paradigm, based on new research in the field of behavioral finance, promises to offer superior guidance to investors and advisors who hope to harness the pricing distortions created by widespread cognitive errors.

The first paradigm in this progression was launched by Graham and Dodd (1934) in their seminal book, Securities Analysis, which provided the first systematic approach to analyzing and investing in stocks. Graham and Dodd argued that it was possible to build superior stock portfolios using careful fundamental analysis and a set of simple decision rules. These rules were based on the emotional mistakes made by investors that could be identified via fundamental analysis. The success of Graham and Dodd is all the more impressive because their book appeared in the depths of the Great Depression, when stocks were crashing and market volatility was reaching levels unseen before or since.

Graham and Dodd’s dominance lasted 40 years, until the ascendency of modern portfolio theory (MPT) in the mid-1970s. MPT proponents agreed that many investors are emotional but posited that there are enough rational investors to arbitrage away pricing mistakes, so market prices are “informationally efficient.” As a consequence, it was no longer worth it to conduct a Graham-and-Dodd-type analysis, or any analysis for that matter. Instead, an investor should simply buy and hold an index portfolio.

MPT immediately ran into problems with the publication of two studies. Basu (1977) demonstrated that stocks with low price-to-earnings (PE) ratios outperformed high PE stocks, and Banz (1981) showed that small stocks outperformed large stocks. MPT had no answer for these anomalies. In order to save the model, these two anomalies were sucked into MPT as return factors. It has been downhill for MPT ever since, with study after study uncovering one anomaly after another.

As MPT proponents soldiered on, a parallel research stream in behavioral science explored how individuals make decisions, concluding that emotions and heuristics dominate decision-making.

Because of the many problems facing MPT and the growing awareness of the provocative behavioral science results, we now see the decline of MPT and the rise of behavioral finance. Among other things, this transition brings back Graham and Dodd as an important way to analyze the market’s emotional—and thus faulty—pricing mechanism.

Introducing Behavioral Portfolio Management

Successful investing is emotionally difficult. It often requires waiting for long-term results when a portfolio has been recently pummeled, recommending an investment when others think it is a dog, investing when volatility is high, and, in general, looking and acting differently from the crowd. To be a successful investor, you must make conscious decisions to redirect your natural impulses and focus on careful and thoughtful analysis. Staying disciplined in an emotionally charged world of round-the-clock news is a challenge.

Behavioral portfolio management (BPM), a concept within the broader paradigm of behavioral finance, assumes most investors make decisions based on emotions and shortcut heuristics. It posits two categories of financial market participants: emotional crowds and behavioral-data investors (BDIs). Emotional crowds are made up of investors who base decisions on anecdotal evidence and emotional reactions to unfolding events. Human evolution wired us for short-term loss aversion and social validation, which are the underlying drivers of today’s emotional crowds.

Emotional investors make decisions based on what Kahneman (2011) refers to as System 1 thinking: automatic, loss-avoiding, and quick, with little or no effort and no sense of voluntary control. On the other hand, BDIs make decisions using thorough and extensive analysis of available data. BDIs use what Kahneman refers to as System 2 thinking: effortful, high-concentration, and complex. BPM is built on the dynamic interplay between these two investor groups.

BPM—An Alternative to MPT

MPT posits that even though emotional investors are numerous, rational investors quickly arbitrage away any price distortions. This implies that prices fully reflect
all relevant information, that active investing lacks excess returns, and that indexed portfolios are superior to their actively managed counterparts. In short, MPT contends that rational investors dominate the financial pricing process.

But what if it is the other way around? That is, what if emotional investors dominate? If this were the case, then price distortions would be common and could be used to build portfolios that are superior to the corresponding index. Active management could generate superior returns. We would see the impacts of emotions in every corner of the market, and these impacts would have to be taken into account when managing investment portfolios.

Ample evidence, reviewed below, supports the argument that emotional crowds dominate market pricing and volatility. Emotional crowds drive prices based on the latest pessimistic or optimistic scenarios. Because stock trading is virtually free, stocks move dramatically in one direction or the other, amplifying these price movements. The market’s mantra seems to be: “If anything is worth doing, it is worth overdoing.”

Rational investors—BDIs—react to the resulting distortions by taking positions opposite the emotional crowd. But BDIs don’t have enough heft to keep prices in line. As a consequence, the resulting distortions are measurable and persistent. BDIs are able to build portfolios that take advantage of these distortions as the market eventually corrects them, either rationally or because the crowd is now moving in another direction.

The events that trigger crowd responses may be short-lived, but the subsequent emotions are long-lasting. As a result, price distortions are measurable and persistent. This provides BDIs an opportunity to identify distortions and build portfolios benefiting from them. Even though a BDI portfolio will outperform, building such a portfolio is emotionally difficult, because the BDI is forever going against the crowd. The need for social validation acts as a powerful deterrent for most investors. Given the difficulty of behavior modification, this situation won’t change any time soon, so BPM contends that BDIs will continue to have a return advantage relative to the crowd.

Viewing the world through the lens of BPM reveals that the decisions made by market professionals often are based on faulty emotional analysis. It appears that much of what passes as MPT-based professional analytics and due diligence is a way to rationalize emotional decision-making.

Basic Principle 1: Emotional Crowds Dominate Pricing

BPM posits that the emotional crowd usually dominates the price-discovery process. This means that prices infrequently reflect true underlying value. Even at the overall market level, price distortions are the rule rather than the exception.¹

For many market participants, this principle is uncontroversial. The chaotic nature of the stock market shows few outward signs of rationality. Prices swing wildly based on the latest events or rumors. For many investors, the contention that prices are emotionally determined is consistent with their own market experiences. But it is necessary to examine stock-price data to grasp the importance of emotions in the price-discovery process.

Considerable evidence shows that stock prices are not driven by fundamentals and that emotions play a major role. Shiller (1981) highlighted emotionally driven excess market volatility, which has been hotly debated ever since. But after 20 years of empirical efforts to explain excess volatility and prove the efficiency of markets, Shiller (2003) stood by his initial assertion:

The fact that noise, rather than fundamentals, dominates market price movements is clear evidence that crowds dominate stock pricing.

Research on the so-called equity premium puzzle provides additional evidence that emotions play a prominent role. The long-term equity risk premium should be associated with the long-term fundamental risks. Mehra and Prescott (1985; 2003) report that the U.S. stock market has generated a risk premium averaging around 7 percent annually from the 1870s to the present. They argue that this premium is too large, by a factor of two or three, relative to fundamental market risk, so they coined the term “equity premium puzzle.” Over the past 25 years, numerous attempts to find a fundamental explanation of this puzzle have met little success.

Benartzi and Thaler (1995), however, provide an emotional explanation.

The equity premium puzzle refers to the empirical fact that stocks have outperformed bonds over the last century by a surprisingly large margin. We offer a new explanation based on two behavioral concepts. First, investors are assumed to be “loss averse,” meaning that they are distinctly more sensitive to losses than to gains. Second, even long-term investors are assumed to evaluate their portfolios frequently. We dub this combination

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“myopic loss aversion.” Using simulations, we find that the size of the equity premium is consistent with the previously estimated parameters of prospect theory if investors evaluate their portfolios annually.

The observed 7-percent equity premium is thus the result of short-term loss aversion and the investor ritual of evaluating portfolio performance annually, rather than the result of fundamental risk. Putting Shiller’s research together with Benartzi and Thaler’s analysis, it is reasonable to conclude that both stock market volatility and long-term returns are largely determined by investor emotions.

Numerous other stock market pricing distortions have been uncovered. Many have been linked to cognitive errors documented in the behavioral science literature. Shefrin (2010) provides an excellent aggregation of four behavioral finance summaries including Hirshleifer (2008), Barberis and Thaler (2003), Baker et al. (2007), and Subrahmanyan (2007). Shefrin (2010) also presents a comprehensive behavioral finance bibliography.

The Ineffectiveness of Arbitrage
A key difference between BPM and MPT is the extent to which arbitrage is effective in eliminating stock price distortions. Research over the past 40 years has shown that arbitrage has not been able to eliminate price distortions. Possible reasons for this lack of effectiveness include the difficulty in identifying arbitrage opportunities, the costliness and riskiness of arbitrage, and the limited number of market participants willing to engage in arbitrage.

Clearly stocks are difficult to value and so the first reason is valid. But even when the price distortion can be estimated accurately, such as with closed-end funds, the distortions persist. Cost and risk clearly make arbitrage difficult. Regardless, one would think that a large number of arbitrageurs still would be attracted to the stock market.

Recent results from Cornell et al. (2011) are discouraging in this regard. Cornell et al. (2011) find a tendency for both mutual funds and sell-side analysts to exacerbate sentiment-driven price movements rather than dampen them, as one would expect of supposedly rational investors. In other words, institutional professionals tend to join the emotional crowds rather than act as BDIs. It appears that arbitrage plays a small role in stock pricing. Indeed, emotion overpowers arbitrage.

Consider this insight from Shefrin (2010):

Finance is in the midst of a paradigm shift, from a neoclassical based framework to a psychologically based framework. Behavioral finance is the application of psychology to financial decision making and financial markets. Behaviorizing finance is the process of replacing neoclassical assumptions with behavioral counterparts. … [T]he future of finance will combine realistic assumptions from behavioral finance and rigorous analysis from neoclassical finance.

Thus Basic Principle 1—that emotional crowds dominate pricing—is a logical first step in building an effective decision process for investing.

Basic Principle 2: Behavioral Data Investors Earn Superior Returns
Emotional crowds dominate pricing, as discussed above. This would seem to indicate that BDIs earn superior returns by taking positions different from the crowds. But this is not necessarily the case. No doubt emotions increase market volatility, but the resulting distortions might be random and unpredictable, making it difficult if not impossible to take advantage of them. So beyond proving that emotions drive prices, it is necessary to show that the resulting distortions are measurable and persistent.

The behavioral finance literature is full of examples of measurable stock price distortions (see Shefrin 2010; Hirshleifer 2008; Barberis and Thaler 2003; Baker et al. 2007; Subrahmanyan 2007). It would seem easy to build superior-performing portfolios, but doing so would mean taking positions opposite the crowd. The powerful need for social validation acts as a strong deterrent for many investors, discouraging them from pursuing such an approach. It is tough to leave the emotional crowd and become a BDI. Though we find price distortions to be measurable and persistent, building a portfolio that benefits from them is emotionally challenging.

To demonstrate that it is possible to earn superior returns, consider the active equity mutual fund research. This group of investors is one of the most-studied in finance because of the availability of extensive data over long time periods. One stream within this large body of research reveals that active equity funds are managed by successful stock pickers (Alexander et al. 2007; Baker et al. 2004; Chen et al. 2000; Cohen et al. 2010; Collins and Fabozzi 2000; Frey and Herbst 2013; Kacperczyk and Seru 2007; Keswani and Stolin 2008; Kosowski et al. 2006; Pomorski 2009; Kacperczyk et al. 2008; Shumway et al. 2009; Wermers 2000). These studies examined individual fund characteristics and holdings and confirmed that a significant number of funds outperformed, as did their top stock picks. Another research stream shows that truly active managers are able to earn superior returns (Amihud and Goyenko 2013; Brands et al. 2006; Cremers and Petajisto 2009; Kacperczyk et al. 2005; Wermers 2012).

Cohen et al. (2010) reported the most compelling results. Figure 1 illustrates that a fund’s best-idea stock, as measured by the largest relative portfolio weight, generated an average risk-adjusted after-the-fact alpha of 6 percent. The next best-idea stocks also generated positive alphas. This demonstrates that it is possible to build a superior stock portfolio.

Cohen et al. (2010) explore the source of these returns, but it is reasonable to conjecture that much of the return is the result of BDIs (i.e., buy-side analysts and portfolio managers) taking positions different from the crowd. This conjecture could indicate that the investment team’s ability to accumulate superior information about the stocks in which they invest is less important. It is difficult to untangle these two return drivers. For now, we are left with the
Reconciling Two Stock-Picking Skill Research Streams

A better-known conclusion from this line of research is that the average active equity mutual fund earns a return that is less than or, at best, equal to the index return (Bollen 2005; Brown and Goetzmann 1995; Elton et al. 1996; Hendricks et al. 1993; Jensen 1968; Fama and French 2010; Jones and Wermers 2011). That is, the average fund earns a zero or negative alpha. This leads to the oft-stated conclusion that equity fund managers lack stock-picking skill, just the opposite of the evidence presented above.

One would think that professional investors such as mutual funds, hedge funds, and institutional managers would be BDIs; indeed, the analysts within such organizations are most often BDIs. But the further up one goes in the organization and the larger the fund, the more like the crowd it becomes. This is because to grow assets under management, funds must attract emotional investors, which means catering to client emotions and taking on the features of the crowd. As a fund grows in size, it increasingly invests in those stocks favored by the crowd, because it is easier to attract and retain clients by investing in stocks to which clients are emotionally attached. A fund also might mimic the index to lock in a past alpha or become a closet indexer to avoid style drift and tracking error. Each of these represents a different way of catering to investor emotions.

So, what starts as a fund managed by BDIs often morphs into something that is acceptable to the crowd. Berk and Green (2004) argue that such behavior is rational on the part of the fund because revenues are based on assets under management. Consistent with this argument, others have found that returns decline as funds grow large (Chen et al. 2004; Han et al. 2008; Pollet and Wilson 2008).

Basic Principle 2, that BDIs have superior performance, is supported by the combination of documented price distortions and excess returns earned by active equity mutual funds on best-idea stocks. Many investors find principle 2 more difficult to assimilate than principle 1, however, because the emotional barrier of social validation must be overcome to build successful BDI portfolios.

Basic Principle 3: Investment Risk Is the Chance of Underperformance

The measures that the investment industry uses to capture investment risk are mostly measures of emotion. To deal with what is really important, let’s redefine investment risk as the chance of underperformance. Measuring investment risk as the chance of underperformance has an intuitive appeal. This measure of risk is used in a number of industries: e.g., the risk of underperformance is the probability that a component, unit, or service will fail. Natural and man-made disasters are described using this type of risk measure. In each situation, the focus is on the chances that various final outcomes might occur. In general, the path to the outcome is less important and has little influence on the measure of risk.

Recall the discussion above about stock market volatility and the argument that most volatility stems from crowds overreacting to information. Recall also that almost none of the volatility can be explained by changes in underlying economic fundamentals at the market and individual stock levels. Volatility measures emotions, not necessarily investment risk. This is also true of other measures of risk, such as downside standard deviation, maximum drawdown, and downside capture.

But unfortunately the investment industry has adopted volatility as a risk measure. Volatility, however, focuses on the bumpiness of the ride, not the final outcome. Focusing on volatility leads us to consider a smoother ride as less risky, regardless of the final outcome. This leads to the unintended consequence of building portfolios that result in lower terminal wealth and, surprisingly, higher risk. This happens because the industry mistakenly builds portfolios that minimize short-term volatility relative to long-term returns, placing emotion at the heart of the long-horizon portfolio construction process. This approach is popular because it legitimizes the emotional reaction of investors to short-term volatility.

Thus risk and volatility are frequently thought of as interchangeable. However, focusing on short-term volatility when building long-horizon portfolios can have the unintended consequence of actually increasing investment risk. Because risk is the chance of underperformance, focusing...
on short-term volatility often will lead to investing in markets with lower expected-return, with little impact on long-term volatility. Lowering expected portfolio return in an effort to reduce short-term volatility actually increases the chance of underperformance, which means increasing risk.

Consider, e.g., the comparison of long-term stock and bond returns. Stocks dramatically outperform bonds over the long run. By investing in bonds rather than stocks, short-term volatility is reduced at the expense of long-term wealth. Equating short-term volatility with risk leads to inferior long-horizon portfolios.

Assimilating Basic Principle 3
This principle that risk is the chance of underperformance rather than volatility is the most difficult for investors to assimilate. It involves redirecting the powerful emotion of short-term loss aversion and acting contrary to the hard-wired need for social validation. For a number of investors, this may be too much to ask. But for others, progress may be possible.

A first step is calling things as they are. Rather than labeling everything risk, be careful to identify and separate the portion that is really emotion. There are risks that must be taken into account when making investment decisions. But don’t muddy the water by carelessly lumping emotions and investment risk together into a single number, as is the case for many popular risk measures.

A flying analogy illustrates this separation process. Anyone who has flown has experienced turbulence, which can range from unnerving to terrifying. When asked about their flights, many travelers will comment on the turbulence. But we know from years of Federal Aviation Administration (FAA) research that turbulence rarely causes injury or death. Instead, pilot error and other human errors are the leading causes of plane crashes.

What if the FAA had listened to passengers to determine the risk of flying? Rather than meticulously studying each accident and uncovering the true causes, the FAA would have spent considerable time trying to reduce turbulence, as requested by passengers, thus missing the critical role of human error in accidents. By focusing on short-term turbulence, the FAA would have made flying more dangerous. But that’s not what has happened, and as a result we have just experienced the safest year ever in commercial flight.

We are not so fortunate in the investment industry. Rather than carefully separating risk from emotions, the industry provides a mixed bag of risk measures that intensifies the emotional aspects of investing. So advisors, to allay client fears, find it necessary to disregard conventional wisdom. They must confront clients and the investment establishment to overcome the emotional challenges to successful investing.

Volatility and Advisor/Fund Business Risk
Short-term emotional volatility is potentially more of a problem than investment risk for the advisor/fund. Advisors and funds see revenues decline when client short-term investment performance is poor, and in the extreme case, investors may leave to invest elsewhere. This is an important reason why the industry lumps emotional risk into popular risk measures.

So when advisors or funds state that an investment is risky based on popular measures, they are actually saying three distinctly different things:

1. There is considerable emotionally charged volatility with this investment.
2. Because of this, there is substantial business risk for my firm.
3. Oh, by the way, there is some amount of investment risk.

Only investment risk matters for making decisions, particularly for long-horizon portfolios. But these three types of risk are emotionally interconnected and it requires considerable effort to pull them apart. The first step is to correctly label each component: (1) client emotional reaction to volatility, (2) advisor/fund business risk, and (3) investment risk.

Implementing Behavioral Portfolio Management
Implementation of BPM has three steps: (1) redirecting your emotions, (2) harnessing market emotions, and (3) mitigating the damage of client emotions on their portfolios. The first and third steps must be accomplished to successfully implement the second step. Many investment firms provide excellent materials to help advisors help clients avoid emotional errors and improve the investment decision process. But beyond an inventory of common emotional mistakes and antidotes, not much is available regarding how to harness market emotions. This is an important omission. Emotion-harnessing portfolios are key to earning superior returns. How to create these return enhancements is discussed below.

BPM-Based Asset Allocation and Portfolio Construction
The standard approach to portfolio construction, as proposed by Markowitz (1952), is to maximize return for a given level of volatility. This is often referred to as a risk-return analysis. But as argued above, the typical measure of risk—volatility—is really a measure of emotion. So risk-return analyses are really emotion-return analyses. To avoid placing emotionally charged volatility at the center of asset allocation, we need to sideline it to the greatest extent possible.

BPM-based asset allocation uses a personal endowment approach to portfolio construction. Endowments are faced with the dual charge of providing an annual income stream to a university or other institution as well as growing the portfolio over a long-term horizon. To a large extent, endowment managers are insulated from the short-term performance pressures facing many other investment managers. For this reason, they are able to construct the best portfolios for meeting the dual charge of regular income and long-term growth. Endowment fund behavior provides the basis for BPM-based asset allocation.

The first step is to divide the client portfolio into three buckets: short-term income and liquidity, capital growth, and alternatives. The short-term bucket is invested in low-
or no-volatility securities that are sufficient to meet the client’s short-term needs with virtual certainty. This removes volatility from conversations regarding this bucket.

The capital-growth bucket is built to maximize long-term wealth. Because the investment horizon is long for this bucket, the focus should be on expected and excess returns. Endowment funds do exactly this by overweighting the asset classes that have the highest expected returns. Endowments heavily weight equities and invest very little in bonds.

Because investors are hardwired for short-term loss aversion, they are significantly challenged to think long-term. Instead of a 30-year horizon, for example, they see a series of 30 one-year time frames or a series of 120 one-quarter time frames. In each period, they apply short-term loss-aversion criteria. Investors have difficulty staying the course with high-return, volatile investments such as stocks. Short-term loss aversion can undermine capital-growth-portfolio performance because it can lead to decisions based on short-term market volatility.

The major benefits of breaking the portfolio into three buckets are sideling volatility as an issue and being able to construct each bucket to meet specific needs. Volatility, correlations, and other commonly used statistical measures, such as downside risk, play a diminished role in BPM-based asset allocation and portfolio construction. Instead, expected and excess returns are most important.

BPM-Based Fund Selection: Strategy, Consistency, and Conviction

Once asset allocation decisions have been made, the next step is to select the funds in which to invest. The most common criterion for selecting equity funds is past performance. Funds that have performed well in the past feed on the emotional belief that they will perform well in the future. In fact, the most popular fund-rating system, Morningstar’s star system, is based on three-, five-, and 10-year past performance. There is a big problem, however: Past performance is not predictive of future performance. This has been confirmed by numerous statistical studies (Bollen 2005; Brown and Goetzmann 1995; Elton et al. 1996; Hendricks et al. 1993; Jensen 1968; Fama and French 2010; Jones and Wermers 2011). The fact that everyone in the industry continues to use past performance, in the face of overwhelming evidence against its usefulness, is a testament to its powerful emotional appeal. Counterproductive emotional habits are nearly impossible to break.

Rather than using past performance, BPM focuses on important manager behaviors: strategy, consistency, and conviction. Strategy is the way a fund goes about earning superior returns through analysis, buying, and selling. The strategy must be pursued consistently through time. The fund will move about the investment universe (based on its asset-class mandate) to identify the most attractive securities in response to ever-changing economic and market conditions. Finally, the fund should take high-conviction positions in its best investment ideas. These fund behaviors can be objectively measured and used to identify best-performing funds going forward, with top funds outperforming closet indexers by 5 percent annually.

BPM-Based Stock Selection: Best Ideas of the Best Managers

One of the reasons fund managers (i.e., BDIs) outperform is that they take high-conviction positions in stocks that were mispriced due to emotion-driven price distortions. The direct way to tap into these behaviorally driven returns is to develop an investment strategy and manage a portfolio based on it, as active equity managers do. The evidence regarding individual investing success is mixed, but it is compelling for a mutual fund’s best-idea stocks.

Stock-selection skill can be captured by investing in the best ideas, as measured by relative portfolio weights, of the best funds. The best funds are those that are most strategy-consistent and take high-conviction positions. The high-conviction stocks held by these top funds are designated the best ideas of the best managers. It turns out that the best-idea stocks do even better than the best funds, with high-conviction stocks enjoying a nearly 8-percent annual return advantage over low-conviction stocks based on my own research.

BPM-Based Market Selection: Which Strategies Are Investors Rewarding?

When investors make cognitive errors that impact the market as a whole, the resulting market price distortions are often measurable and persistent. A key is to identify objective measures of these distortions rather than relying on survey data, which is notoriously unreliable. One must understand what investors are doing, rather than what they are saying. One of the first such measures is the sentiment index of Baker and Wurgler (2006, 2007). The index is predictive of when small-capitalization stocks will outperform large-capitalization stocks and vice versa. Baker and Wurgler find that the more pessimistic investors are, the better it is for small stocks and the market as a whole. Investor optimism is a stock market return killer.

By combining the sentiment index with U.S. and international strategy market barometers, it is possible to implement a global tactical model that trades among U.S. large-cap, U.S. small-cap, and international stocks, as well as cash. The resulting after-the-fact-return advantage of this tactical strategy, based on my research and actual implementation, is even larger than those reported earlier for funds and stocks.
Each of the four return enhancements discussed above is based on currently available data that allow for the measurement of persistent behavioral price distortions. This data can in turn be used to build superior portfolios. The reward for harnessing these factors is worth the effort of redirecting your emotions and mitigating the impact of client emotions on their portfolios. This is the ultimate promise of behavioral portfolio management.

**Conclusions**

BPM is a proposed model that focuses on the behavioral aspects of financial markets in an attempt to improve investment decision-making. The first basic principle of BPM is that emotional crowds dominate the determination of prices and volatility, and fundamentals play only a small role. This means that more often than not prices reflect emotions rather than underlying value, a conclusion of arbitrage failing to keep prices in line with fundamentals. As a result, price distortions are the rule rather than the exception, making it possible for rational investors, also known as behavioral-data investors, to build superior portfolios; this is the second basic principle of BPM. The third basic principle of BPM is that risk is defined as the chance of underperformance, and for a long-horizon portfolio risk and volatility are not synonymous. In meeting short-term financial goals, volatility is an important contributor to investment risk. However, volatility plays a much less important role when building long-horizon portfolios. By focusing on short-term volatility when building long-horizon portfolios, the investor injects emotions into the portfolio construction process. It is important to distinguish between emotions and investment risk so that the best decisions can be made. The bottom line is that building successful investment portfolios is straightforward but emotionally difficult. Making decisions based on crowd-created emotional price distortions and ignoring short-term volatility when building long-horizon portfolios presents significant challenges for investment professionals. This is because such a strategy is forever going against the crowd, thus depriving clients of social validation, and in turn asking them to set aside the strong emotions associated with volatile prices. Consequently, it is necessary to mitigate the impact of client emotions. Emotion mitigation is a fact of life in the investment industry, and advisors and investment managers should develop such skills. The goal is to be sensitive to clients’ emotional reactions while minimizing damage to their portfolios. Developing an approach that keeps clients in their seats while building superior portfolios is important for clients, advisors, and investment managers alike.

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**Endnotes**

1. See Shefrin (2008), which introduces the concept of “knife edge” market efficiency, which exists only with the occurrence of a rare combination of wealth and investor emotions. Thus Shefrin (2008) argues that stock prices rarely reflect underlying fundamentals.

2. Higher return variance lowers an investor’s long-term compound return, but this impact is small compared to the impact of investing in markets with lower expected returns.

**References**


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