BOOK REVIEW

The Behavioral Investor

BY DANIEL CROSBY

Reviewed by Judy Benson
Daniel Crosby, PhD, who is described as “a psychologist, behavioral finance expert and asset manager who applies his study of market psychology to everything from financial product design to security selection,” has hit a home run with *The Behavioral Investor*.

Let me preface this review with a strong recommendation. Read this book from two vantage points—you as the investment advisor and you as the individual investor. That latter vantage point strongly informs the former and helps the advisor better relate to the client, understand a client’s biases, and effectively articulate investment strategies to help the client overcome those proclivities—in short, helping clients avoid being “their greatest enemy: themselves.”

This book is well-researched and very digestible. It thoughtfully lays out the case for the behavioral investor and rules-based investing. Crosby liberally cites other experts in the field to reinforce his thesis; easily recognizable names include Daniel Kahneman, Amos Tversky, Meir Statman, Cliff Asness, and other subject matter experts such as Antii Petajisto (known for work in active share and closet indexing).

The book is divided into four main sections: The Behavioral Investor, Investor Psychology, Becoming a Behavioral Investor, and Building Behavioral Portfolios. Crosby’s goal is to help the reader understand why humans make the decisions we do—because only then do we gain insights into more effective investing.

*The Behavioral Investor* elaborates on the physiological, sociological, and neurological impediments to sound decision-making. Here are several of the many telling paraphrases from the book:

- Investors profit most when they do the least. The corollary—we are primed to action—damages investment returns. We are wired for immediacy.
- Emotional satisfaction wins out over what is economically best.
- We suffer from an irrational primacy effect. Translation: We have a tendency to give more weight to information that comes earlier in a sentence or list and what we learn first sticks with us the longest. Let’s not forget a loyal companion, the recency effect. Taken together, early and recent investment experiences take on disproportionate influence.
- Our mental processes in life are less appropriate (if at all) for investing.
- Belief in yourself is “really bad advice for investors.”

A few additional traits I didn’t know I was guilty of: hedonic treadmill,1 predisposition to greater risk-seeking in bull markets and more conservative approaches in bear markets, and the contrary behavior of buying low and selling high. The list of my investing handicaps goes on.

The author describes various types of risks, but considers the pre-eminent risk to be behavioral risk, which cannot be managed successfully unless we understand it. Behavioral risk comes in four buckets: ego, conservatism, attention, and emotion. We humans are described as self-centric, constantly seeking confirmation bias, exhibiting the backfire effect, and holding onto our beliefs more tightly when those beliefs are challenged. Change my mind—never. Adding to this mélange is that we have a difficult time with uncertainty and admissions of wrongdoing, and overwhelmingly default to the status quo. From an investment perspective we tend to hold losses too long, fail to rebalance, and underallocate to riskier assets.

Yet another eye-opener for this reviewer was that we feel stronger regret for bad outcomes that result from new actions rather than for similar bad consequences from status quo ante. Let me layer on the endowment effect and regret aversion. I feel like Sisyphus2

Coincident with reading this book, there was a column in the *Wall Street Journal* (Saturday/Sunday, July 13-14, 2019, page B5) by Jason Zweig entitled, “The Smart Money … It’s Just Like Us!” that concurred with the book’s tenets.
Several new studies show that the so-called smart money is prone to many of the same errors as amateurs... Professional investors hold stocks too long. They react erratically to stock splits. They may even buy one stock when they intended to purchase a different one—almost as often as supposedly clueless individual investors make the same kind of blunder... The problem... is what psychologists call the “endowment effect.” This is the automatic tendency to put a higher value on what you own than what you don’t—and to become reluctant to part with something merely because it is yours.

By now you may be wondering if there is a lighthouse flashing its welcoming beacon. The short answer is yes, and it’s why the how-to chapters and the epilogue are so vitally important.

Without spoiling these chapters, I’ll just say that Crosby compares three different investment approaches—passive, active, and rules-based—and the specific investment styles that can best be described as all-weather approaches to successful investing.

In the epilogue, Nassim Taleb imparts some invaluable advice:

Even once we are aware of our biases, we must recognize that knowledge does not equal behavior. The solution lies in designing an investment process that is at least partially robust to behavioral decision-making errors.

Crosby’s book made me cognizant of my hardwired biases in an understandable and non-threatening way. The book provided a platform by which those biases could be surmounted in my investing life as well as those of an advisor’s clients. This book is an eye-opening read because it provides an excellent understanding of our own biases and effective ways to surmount them, and it helps inform more effective client interactions.

---

**ENDNOTES**

1. Wikipedia defines hedonic treadmill as “the observed tendency of humans to quickly return to a relatively stable level of happiness despite major positive or negative events or life changes.” Crosby describes it more colorfully: “… anticipating a reward is deeply satisfying whereas literally receiving the reward is far less gratifying ... we take great pleasure in building castles in the sky and discussing what we would do with, say, our lottery winnings.” As Jason Zweig says of this concept: “By the time you pocket the money the thrill of greed has faded into something that resembles a neurological yawn—even though you got the gains you wanted. Making money feels good, all right; it just doesn’t feel as good as expecting to make money.”

2. From Wikipedia: In Greek mythology, Sisyphus was the king of Ephyra (now known as Corinth). He was punished for his self-aggrandizing craftiness and deceitfulness by being forced to roll an immense boulder up a hill only for it to roll down when it nears the top, repeating this action for eternity. Through the classical influence on modern culture, tasks that are both laborious and futile are therefore described as Sisyphean.