Using the Power of the Written Word to Improve Your Returns

By Charles Rotblut, CFA

Article Highlights

- Journals, checklists, rules and mistake books can help you to become more disciplined and avoid making decisions based on emotional reactions.
- Writing down what has previously triggered you to act based on emotion can give you a starting point to develop a plan for handling similar situations in the future.
- Written sell rules provide much needed clarity and can reframe how you assess the investment by prompting you to evaluate it based on specific criteria.

"As in driving, the secret to success is not making big mistakes."

—Charles Ellis, "My Investment Letter: Words of Advice for My Grandchildren," AAII Journal*, October 2013.*

I start most of my presentations with this quote from Ellis, who authored the best-selling book, "Winning the Loser's Game" (McGraw-Hill Education, 7th Edition, 2017).

The quote focuses on the biggest key to successful investing: not screwing up. As long as a person avoids making the big mistakes, they will have returns far in excess of the average investor.

The biggest mistakes are typically due to behavior. Investors allow a combination of emotions and mental shortcuts (heuristics) to significantly influence the decisions they make and the actions they take. Any step taken to interrupt the System 1 (quick and intuitive) mode of thought we humans often operate in can be beneficial. I believe the written word is a powerful tool for disengaging from System 1.

This article discusses common biases and behavioral mistakes along with pragmatic solutions based on using the power of the written word to your advantage. In some cases, there is more than one solution. As you read through the article, realize there is no one universal set of solutions that will work for every person. Use the suggestions as a starting to point to create a customized approach based on what you think will work best for you.

Halting Reactive Responses

The human mind evolved to cope with a very different environment than what we currently face when engaging with the financial markets. The first financial bubble in recorded history—the tulip mania—started in 1636. The earliest settlements in Mesopotamia date back to approximately 10,000 B.C. according to History.com. Our ancestors' survival depended on the ability to think and react quickly. If there was a rustling in the savannah, early humans had to quickly assess whether it was a dangerous predator or something harmless. It was better to flee first and ask questions later than it was to analyze the situation and then react accordingly. Pausing to think things through could get a person killed.

This survival-based reactionary thinking resulted in modern humans having two types of processes guiding cognitive reactions: System 1 and System 2. System 1 is intuitive thinking; it relies on heuristics (mental shortcuts) to form quick assessments and guide our initial reactions. System 2 is reflective, deliberate and slower. It uses up more energy and requires more effort. As such, most of the time, humans act on the decisions made by System 1. Meanwhile, much of System 2 thinking is spent creating rationales supporting those actions called for by System 1. Put another way, we're programmed to act first and think second.

One way to interrupt the tendency to act upon snap

decisions is to create and use a checklist. A checklist will slow you down and make you think through the decision process. It will force you to work through a specified set of steps before action can be taken. Designed correctly, a checklist will bring forth the objective information needed to make a decision.

What should be on a checklist? It should prompt you to do whatever is necessary to make an informed and well-thought-out decision. An investment checklist could include prompts to look at valuation metrics, financial statement ratios, revenue and earnings growth, credit quality, performance, allocation relative to your overall portfolio (position size) and/or known risks specific to the investment. Whatever you think is important to consider when analyzing an investment should go on your checklist.

However, merely creating a checklist is not enough. You must use it consistently and regularly. The more you do, the more it will become part of your routine and the less reliant you will be on snap judgments.

A Simple Checklist for Analyzing Stocks

Checklists don't have to be overly complex to be effective. In fact, they should be easy to read and follow. Bullet points, phrases and simple sentences work better than long prose. Checklists also don't initially need to cover every conceivable step. Rather, plan on evolving the checklist once it's put into use. Make changes based both on what is needed to avoid future mistakes and on tasks that need to be redefined, altered or split into more steps.

An example is the checklist below for analyzing stocks. It does not cover every aspect of analysis, but it will give you enough feedback to determine whether or not a specific stock is a worthy investment candidate.

- ☑ **Valuation Ratios:** Are the valuation ratios (price-earnings, price-to-book, price-to-sales, price-to-cash-flow, etc.) low or high?
- ☑ **Earnings Estimates:** Are analysts raising their forecasts (good) or cutting them (bad)?
- ☑ **Income Statement:** Is the company profitable? Are revenues and earnings growing?
- ☑ **Cash Flow Statement:** Is cash flow from operations consistently positive? Is free cash flow (cash from operations less capital expenditures) positive?
- ☑ **Profit Margins:** Are gross and operating margins relatively steady, rising or falling?
- ☑ **Dividends:** Does the company pay a dividend? Is it growing? What's the yield?
- ☑ **10-K:** Scan through this annual filing required by the U.S. Securities and Exchange Commission (SEC) to see if there is anything that would cause you to be cautious about investing in the company. (It can be found in the EDGAR database at www.sec.gov/edgar/searchedgar/companysearch.html.)
- ☑ **Earnings Releases:** What were the most recently reported results and what impacted them? Was guidance given? If so, what was it?
- ☑ **Company Presentations:** Review to identify business trends and plans. (They are available on a company's investor relations website.)

Focus on the Process, Not the Outcome

Another advantage of checklists is their ability to get you to focus on the process. Across fields, good processes improve the odds of achieving the best possible outcome. Another reason for focusing on the process and not the outcome is that humans, in aggregate, are bad when it comes to self-assessment.

One oft-cited study about self-assessment found that 80% of people rated their own driving abilities as being above average ("Comparative Perceptions of Driver Ability—A Confirmation and Expansion," by Iain McCormick, Frank Walkey and Dianne Green; Accident Analysis & Prevention, June 1986). It's not unreasonable to assume that most people would take issue with a statistic designating four out of five other drivers as having above-average driving skills.

Clifford Asness, the head of hedge fund company AQR Capital Management, has pointed out in conferences that if most investors are above average, then a small group must really be awful. His statement is based on simple math: If the overwhelming majority of the data points are higher than average, then a small subset has to be low enough to bring the average down below that of the majority.

What happens in driving, investing and other activities is that less skilled people tend not to recognize their weaknesses, while skilled people tend to underestimate their abilities. At the same time, we're bad at attributing outcomes. This leads to behavioral errors, as Nobel laureate Daniel Kahneman explained in the July 2012 *AAII Journal* ("Behavioral

Errors Hurt Your Returns"): "In a rising market, individual investors tend to feel that they're geniuses because the results are good. They blame the market when things collapse, but they take credit when things go well. This bias tends to make them overconfident and hyperactive."

Objective feedback on your process will shed light on how you are actually doing. Compare your performance against the returns of appropriate benchmarks, taking a long-term view. Returns over a few weeks or a few months can be above or below that of the relevant benchmarks for reasons other than skill or lack thereof.

In addition, conduct a postmortem when selling an investment. Think about what part of your process worked right, what part of your process you didn't follow and what you could have done differently based on the information known or that should have been known at a past point in time.

Some people find it helpful to keep a mistake book. As the name implies, this is a journal of past mistakes. It is intended to highlight errors so that they won't be made again. As you identify the errors made, adjust your checklist or set of buy and sell rules to prevent the same errors from recurring.

Taking things a step further, combine a trading journal (a diary of the decisions you are making and the rationale for them) with postmortem analysis and a mistake book. The three will give you documented information about your process. This will allow you to discuss your process with someone you trust who is in a position to give you objective feedback, such as a financial planner or adviser.

A System for Reacting to Turbulent Markets

If you haven't previously documented your investing decisions, your brokerage statements can shed light on how you've reacted in the past. Pay particular attention to past periods of downward volatility, such as previous corrections and bear markets.

The reason why is that recency bias and availability bias collide with loss aversion to create harmful outcomes for many investors. This can be seen in the 10-year annualized investor returns for the Vanguard 500 Index fund (VFINX). Morningstar calculates shareholders of this fund realizing a 5.06% annualized return for the 10-year period ended April 30, 2018. This compares to an 8.89% annualized return for the fund itself.

This 3.83 percentage-point difference is known as the return gap or behavior gap. It is the difference in returns that investors actually realize from their buy and sell decisions. In the case of the Vanguard 500 Index fund, had the average shareholder in the fund simply held onto their shares for the full 10-year period, they would have realized the same return as the fund itself (and very close to that of the S&P 500 index). Rather, by allowing their emotions to take over, they forfeited a large amount of wealth.

The gap occurred during the 2007–2009 financial crisis and the period afterward. The period's negative headlines were front and center in investors' minds and easy to access by System 1 thinking (availability bias). At the same time, investors were expecting the then-bear market to last for a prolonged period of time (recency bias). The falling markets created emotional discomfort, prompting a desire by System 1 to sell in order to limit the pain and avoid any further declines in portfolio value (loss aversion). It was a classic behavioral response to do what felt good at the time without considering the potential long-term implications.

If you've previously sold during down markets or otherwise stayed away from riskier investments out of concern about what could happen to your portfolio, think about what triggered your decisions at the time. Was it a certain decline in portfolio value? Was it the headlines? Was it fear about not achieving a financial goal? Whatever the reason(s), write it (them) down. Doing so will give you a starting point for developing a plan to handle similar situations in the future.

Then start developing systems to alter what you do when such triggers re-emerge. One example would be a simple ritual of getting up, walking to a different room, breathing slowly 10 times before taking any investment action. As silly as this may seem, it interrupts the flow of System 1 thinking. A study published in the Journal of Personality and Social Psychology found "that when people already have a goal that matters to them … rituals may enhance self-discipline to improve self-control," (Allen Ding Tian, Juliana Schroeder, Gerald Häubl, Jane L. Risen, Michael Norton and Francesca Gino, 2018).

A ritual could include reviewing notes you've written in advance about how to react to such situations. These are guidelines you write while in a calm state about what to do during the periods when you are worried. Because they are your notes, you may be more likely to follow them—especially if you put thought into them.

What should these notes include? It depends on what triggers you to act and what prompts you not to act.

Some investors may simply need a reminder of what is normal and what is rare. For example, corrections and bear markets are not unusual. Between 1945 and 2016, 21 corrections and 12 bear markets occurred, according to Sam Stovall, the chief equity strategist for CFRA Research. While these drops have resulted in average declines of 14% and 33%, the S&P 500 fully recovered its losses within four months following the bottom of a correction and within about two years (25 months) following a bear market's trough on average ("Stock Market Retreats and Recoveries," *AAII Journal*, October 2017). Having this data written down in an accessible spot can provide much needed perspective.

Other investors may need a reminder of how their portfolio is structured, along with the safeguards built into it. Cash and cash-equivalent savings of six to 12 months' worth of living expenses is suggested for workers; an amount equal to two to four years of living expenses are suggested for retirees. Being reminded of these buffers may reduce the urge to pull out of the market.

You could also write down the various financial goals you hope to achieve and how you've oriented your portfolio to achieve them. This is a version of the bucket strategy, which splits a portfolio's allocation based on the timing of when the money will be needed. For each goal, list the rationale for your allocation to it and why you are willing to tolerate X% of downside volatility to achieve the goal. This may ground your emotions by reminding you of your well-thought-out plan.

Another alternative is to establish a system for channeling your emotions. If you expect that the urge to act is going to be strong once your emotions are triggered, write down instructions for how to act. Perhaps you allow yourself to sell a small percentage of your stock holdings—say, 5%, for every 10% drop in the S&P 500. Is this ideal from a long-term investing standpoint? No. Is it better than selling a much larger stake of your portfolio out of panic because you didn't have this safety valve? Yes.

An even better strategy is to have a system that is designed to prompt you to buy when prices fall. Stovall has found that allocating money to stocks every time the S&P 500 falls by a 7% increment has historically been a profitable strategy. Alternatively, you could use rebalancing. Rebalancing means adjusting your allocations back to target when the major asset classes in your portfolio have strayed too far off target (e.g., by five or 10 percentage points). Write instructions to do this or have a checklist created for this purpose.

In all cases, the power of the written word comes into play by reminding you of what you need to do. Without written guidelines, you may forget the pact you made with yourself—especially when you are in an emotional state. None of this has to be in long prose; in fact, it's better if it is written in bullet-point format. Even an "I'm Nervous" checklist can do wonders for limiting the impact that your emotions will have.

Useful Tools for Keeping Portfolio Notes

Various products work well for keeping investing notes, rules and checklists. The right one depends on personal preference. Listed below are some options, along with observations about them.

Paper Notebooks: Spiral notebooks are one of the best portfolio tools, in my opinion. They are cheap, portable and easy to use. I've personally switched to using the lined Moleskine classic notebooks, however, because their hard cover makes writing easier when I'm not sitting at a desk.

Sticky Notes: These work great for putting reminders by a computer. A downside is the potential clutter if you use several of them. I've found it helpful to tape any sticky notes I want to keep for more than a few days to my computer screen's bezel.

Whiteboard: A whiteboard can keep notes and checklists right in front of you. It's also easy to make changes. The decision to use one really comes down to space and decorative preferences.

Different Colored Pens: I alternate between pens of a few different colors when using my notebooks. Doing so makes it easier to identify when I've taken notes on different days or about different topics. Each new entry is written in a different color than the one before, on a rotating basis. I might rotate by using black, then blue, then purple, then back to black ink, for instance. The whiteboard I use in my office for planning future issues of the *AAII Journal* also has notes written in different colors.

Digital Documents: There are a range of applications that could work well. Spreadsheets (e.g., Microsoft Excel) are good for keeping chronological notes, maintaining checklists and tracking performance. The ability to use tabs can be helpful for following multiple investments. Google Docs is an alternative and offers the advantage of being accessible by any browser-enabled device. Smartphone and tablet apps such as Simplenote and Evernote are viable options as well.

Become Better at Selling

The return gap is emblematic of a bigger challenge many investors face: knowing when to sell. A preset list of rules to follow makes the process of deciding when to sell more disciplined and reduces the uncertainty associated with it.

At the most basic level, your sell rules should be the opposite of your buy rules. Value investors should sell when an asset's valuation becomes high. Growth investors should sell when revenues or earnings stop rising. Dividend investors should sell when the quarterly payments are cut or when the yield falls to too low of a level.

The precise reasons for selling will depend on your strategy. Stock investors can include maximum limits for the valuation ratios (e.g., the price-earnings ratio, the price-to-book-value ratio, yield etc.); a decline or elimination of revenue, earnings or dividend growth; a loss of profitability; or a deterioration in a price momentum-based metric in their sell rules. Bond investors can act on deteriorations in the issuer's underlying fundamental strength and ability to pay. Fund investors may act on changes in a fund's objective, underperformance relative to a fund's peers, a change in the manager or a significant increase in turnover. These are not comprehensive

suggestions, but they should give you an idea of the types of things to build sell rules around.

Whatever rules you decide on, write them down before the decision to sell needs to be made.

Written sell rules are effective for two reasons. First, they provide much needed clarity about when to sell and when to hold. Secondly, they counteract the endowment effect. The endowment effect is the premium value we assign to something we own. It can cause us to succumb to other behavioral errors, including confirmation bias (only paying attention to information that supports our decision to own an investment and downplaying information that is counter to our opinions). Your sell rules counteract the endowment effect by reframing how you view the investment. The rules lead you to evaluate the investment based on the criteria you've specified.

Refer Back to What You Write

Journals, checklists, guidelines and rules only work if you refer back to them regularly. It does little good to keep notes, establish rules and create checklists if you never look at them. On the other hand, the more you use these tools, the more they will become part of your investing routine. A well-thought-out checklist, for instance, can become so effective that you may find not relying on it is more time-consuming than using it is.

When starting the process of using the power of the written word, don't try to get things perfect. Your strategy and knowledge will evolve over time; as should your rules, guidelines, systems and checklists.

If you find yourself making new mistakes or falling for the same behavioral mistakes, keep adjusting your approach as necessary. Over time, you'll find that the incremental changes you make will end up having a big positive impact. ▲

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TipRanks www.tipranks.com
$49.95/month (AAII discount)
- Stocks, ETFs and mutual funds
- Link to select brokerages or enter holdings manually
- Email notifications and alerts
- Compare and share portfolios
- Separates news into "bullish" and "bearish" categories
- Portfolio earnings calendar
- Portfolio analytics page: portfolio beta, dividends and price-earnings ratio
- Management fees tool finds similar funds to your current holdings that have lower fees

Honorable mentions: Stock Rover, Next Capital and FeeX

FINANCIAL PLANNING

Highlighted here are retirement planning sites. Go to AAII.com for estate planning, personal finance and tax sites. I looked for sites with frequently updated information, tools and/or calculators and meaningful, useful content.

Retirement Planning

BankRate Retirement Planning Resources www.bankrate.com
Free
- Basic retirement planning calculators
- Articles on retirement planning
- Retirement planning blog

MarketWatch www.marketwatch.com
Free
- Interactive high-quality retirement planning tools and calculators
- How-to guides like "how to invest for retirement" and "how to write a will"
- Wide range of video and up-to-date article content on retirement

NewRetirement www.newretirement.com
Free – $210/month (AAII discount)
- Helpful basic calculators and tools
- More-involved planning tools with PlannerPlus: personal retirement plan
- Easy-to-understand content
- Analysis charts with suggestions on optimizing your retirement plan
- Adds new tools often and receptive to user feedback

Social Security Administration
www.ssa.gov
Free
- Apply for and manage benefits online
- "Retirement toolkit" PDF
- Educational content available as PDF or audio and in different languages
- Tool for estimating retirement benefits

ThinkAdvisor www.thinkadvisor.com
Free
- Geared to financial advisers, but offers a section on retirement planning

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