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Risk Within the Context of Behavioral Finance

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As part of the Risk Gap, Eleanor Kreitler explores how behavioral finance can help investors better understand the role of emotions and confidence in financial decision-making. From loss aversion and overconfidence to recency bias and herd behavior, these common tendencies can influence how investors approach risk, respond to market volatility, and make long-term investment decisions.

Through practical insights, this discussion highlights how traits often associated with women investors, such as patience, caution, and deliberation, can be valuable strengths while also presenting potential challenges. By recognizing these behavioral patterns and aligning investment decisions with financial goals, investors can build greater confidence and take a more disciplined approach to managing risk.

VIDEO TRANSCRIPT

Hi, I'm Eleanor Kreitler, a financial advisor here at Grimes and Company, and today I'm going to talk about risk within the context of behavioral finance.

When we think about investing, we tend to think about numbers: market returns, interest rates, stock prices. But there's another factor influencing every investment decision we make, and that's ourselves: our emotions, our experiences, our confidence level.

Even what happened in the market last week can shape how we feel about what might happen next. That's really the idea behind behavioral finance.

Behavioral finance looks at the ways real people make financial decisions, not just the way we would make them in a perfectly rational world. And that matters because when it comes to investing, being aware of your own behavior can be just as important as understanding your portfolio.

There are a few common behavioral tendencies that are especially helpful to recognize. One tendency is something

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called loss aversion. Put simply, losses tend to feel more painful than equivalent gains feel rewarding.

For example, if your portfolio goes up 10%, you'll probably feel good about that. But if it falls 10%, that decline may feel more significant emotionally.

The negative feeling from the loss outweighs the positive feeling from the gain, even though they were both 10% movements. This can make market volatility difficult to psychologically see and go through, even when the ups and downs are perfectly normal for a long-term investor.

On average, women have historically reported a lower willingness to take financial risks compared to men. But it's important to not automatically think of that as a weakness. A healthy respect for risk can be very valuable.

It can encourage you to ask more questions. It can make you less likely to jump into an investment you don't understand. And it can help you think carefully before making a decision.

But there can also be a downside. If concern about losing money turns into avoiding investment risk altogether, you may end up holding too much cash or investing too conservatively for a goal that is still 10, 20, or 30 years away.

So, the goal isn't necessarily to take more risk. The goal is to take the right amount of risk for your goals, your time horizon, and your overall financial situation.

Another important behavioral concept is overconfidence. Overconfidence can show up when investors believe too strongly in their ability to pick winning investments, time the market, or know what's going to happen next.

In one of the classic studies in behavioral finance, found an interesting gender difference here. Researchers Brad Barber and Terrence Odean look at more than 35,000 brokerage households and found that men traded about 45% more frequently than women. The extra trading in this instance did nothing but reduce the men's investment returns compared to the women's.

Now, that study is older and uses a relatively small sample size, so that's not proof that every man invests one way and every woman invests another. But the broader lesson is still very useful. More activity does not necessarily mean better investing. Sometimes being more deliberate can be an advantage.

Women have often been described as less confident investors, but in certain situations, that caution may help reduce unnecessary trading or impulsive decisions. But at the same time, there's another side to that. Lower confidence can become underconfidence.

How can this show up in investing? You might wait too long to invest, you might avoid making a decision because you're worried you won't make the correct one, you might be afraid of asking questions, or you might assume someone else understands the situation better simply because they sound more certain about it. So confidence matters, but there's a middle ground. Too much confidence can lead to overtrading or switching strategies too often. Too little confidence can lead to inaction.

A third behavioral tendency is recency bias. That's our tendency to give recent events too much weight.

When markets have been rising for a while, it can feel as though they're going to keep rising forever. When markets fall sharply, it can feel as though things may never recover. In both cases, what just happened starts to shape what we expect will happen next.

Closely related to recency bias is herd behavior, the instinct to follow what everyone else seems to be doing. You see people getting excited about a certain stock, sector, or investment trend, and suddenly you feel like you're missing out. Or you see everyone getting nervous during a market decline and you start wondering whether you should be selling too.

Again, a naturally cautious investor may actually have an advantage here. A little skepticism can help you resist the urge to chase whatever is popular at the moment. But there's an important distinction between being skeptical and being permanently hesitant.

You don't want the fear of making the wrong decision to keep you from making any decision at all. And that gets to what I think is one of the most useful lessons in behavioral finance. The goal isn't to eliminate emotion from investing, that's impossible. The goal is to build a process that makes it harder for emotion to control the decision. There are a few simple ways to do that.

First, know why you own what you own. Your investment should connect back to a goal, like retirement, education, buying a home, financial independence, rather than simply what the market happens to be doing today. Second, decide in advance how you plan to respond to volatility. If markets fall, what would actually cause you to change your investment strategy? Having that answer before the stressful moment arrives can make a big difference. And third, create a little space between feeling something and acting on it.

When markets move sharply, ask yourself, has something changed about my financial plan or has only the market changed?

That simple question can help separate a real reason to make change from an emotional impulse. And that brings us back to women and risk.

Some of the traits traditionally associated with women investors, patience, deliberation, and a healthy respect for risk, can absolutely be strengths.

The opportunity is to recognize when those instincts are protecting you and when they may be holding you back. The goal isn't to become fearless. It's to understand the risks you're taking, why you're taking them, and to build enough confidence in your plan that you can stay with it when emotions inevitably show up. One useful place to start is simply noticing your own pattern.

When markets become uncomfortable, are you more likely to act quickly, avoid making a decision, or stick with your plan? There's no judgment in that answer. But the more aware you are of your own investing behavior, the better equipped you may be to make an intentional decision instead of a reactive one.

Thank you for watching. For more information, please visit grimesco.com.

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