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Colorado advisors to investors: 'Control your emotions'

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Tom Howard founder of AthenaInvest and author of Behavioral Portfolio Management, meets with his team. He said, "I tell people, you can be wealthy, but you have to control your emotions."

The CEO and director of research at a Greenwood Village investment services firm is convinced financial advisers should have psychology degrees.

Tom Howard, founder of AthenaInvest and author of Behavioral Portfolio Management, is among a small tribe of investment advisers who are tossing out the age-old "Modern Portfolio Theory" — which essentially says markets are efficient and people make rational decisions — in favor of a new theory that advances a behavioral-driven investment philosophy in picking stocks.

The basic premise of behavioral-driven investment strategies is that investors make mistakes based on their emotions. But the mistakes are persistent, Howard said. And that is what he studies.

"I tell people, you can be wealthy, but you have to control your emotions," Howard said.

The term "behavioral finance" may be relatively new in industry circles, but long-time investment advisers say there has never been a doubt that investing is emotional, and they've often had to talk clients off the ledge when it comes to reacting to market news.

"When the market is going down, and fast, human nature is that people panic and sell. And they never get back into the market because they are scared," said Fred Taylor, president and co-founder of Denver-based Northstar Investment Advisors.

Certainly, he said, advisers are life coaches who help investors get over their emotional bias.

“You can’t time the market,” Taylor said. “You can look at technical analysis; the reality is you never feel good about investing. You have to choose a strategy and stick with it. If you were rational and moved based on headlines, you would never be in the stock market.”

Howard, who has patented an investment process he calls Behavioral Portfolio Management, admits the financial advising industry is reluctant to come around to the behavioral investment theory. The hesitancy, he believes, is because the advent of the so-called Modern Portfolio Theory, which was advanced in the late 1950s, and added science to the craft of investing. It gave advisers legitimacy, he said.

It’s a tough sell to get advisers to give up the science, he said. But he argues that studying behavior is a science. He founded his firm to study the behavior of successful active equity managers.

In his strategy, he studies emotional investors and those on the opposite side of the spectrum who go through extensive analysis and he measures where they converge. Emotional crowds dominate the determination of prices and that means, he said, that prices reflect emotions rather than underlying value. He studies those price distortions to build the portfolio.

It’s the long game and he must convince investors to let go of their impulses and focus on thoughtful analysis, he said.

“I’ll base our investment management on emotions and behavioral currents – the reason those are so strong, is people don’t change behaviors,” he said. “We identify the behavioral price distortions that are measurable and persistent and we build [the] portfolio on that.”

John Riddle, co-chief investment officer at Denver-based 361 Capital, says there absolutely is science in the behavioral investing model. His firm uses an algorithm to study the behavior or analysts.

Riddle has been a believer in behavioral investment strategies since college.

“Prices move far more than they should based on fear and greed,” he said.

The way Riddle figures it, he cannot predict how the market will act. But, he can predict how people act, he said.

“Predicting human behavior is much easier than predicting the complex movement of the thousands of variables,” he said.

He watches the moves and studies the behavior of analysts. Riddle uses mathematical formulas, he calls a behavioral forecasting model, that collects data on analysts’ forecasts for the companies his firm follows.

The program studies analysts’ upgrades and downgrades and finds patterns that help in choosing stocks for institutional portfolios.

“I wish we had coined the word behavioral finance,” Riddle said. “It’s a little hard to implement. You hear people talking about it. You don’t hear managers focusing on it. You see it’s hard to believe what we believe about the market and fit it into a traditional structure of how money is managed.”

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