The guy factor: Overconfidence make for risky investments

by Lynn O'Shaughnessy

Do you know how to invest? Do you enjoy the kind of financial success that would make you an obvious candidate to write a book about it? Do you sometimes wonder why you're even spending five minutes reading this Sunday column when you already know what I'm going to say?

If you've answered yes to these questions, you may or may not be an investing Hercules. Actually, your financial prowess might not exceed the abilities of us mere mortals. Your Achilles heel could be your own overconfidence.

That's the conclusion you can draw from a new study conducted by researchers at the Vanguard Group, who examined the trading habits of more than 1 million 401(k) participants from 2003 to 2004. The investors who traded the most in their workplace accounts exposed their nest eggs to far greater whiplash, but their high-wire portfolios didn't fare any better than the folks who may glance at their portfolios once a year. What's more, the 401(k) investors who rearranged their portfolios the most lost nearly 1 percentage point a year in performance versus the least active traders.

Who are these risk-takers? Most are older male professionals, who have held their jobs for a long time. These men are also far more affluent than the average 401(k) participant. In fact, these fellows are more likely to have higher household incomes and enjoy substantial wealth outside their 401(k)s. Their account balances are nearly 90 percent higher than the folks who rarely tinker with their portfolios.

Stephen P. Utkus, who heads the Vanguard Center for Retirement Research, calls these traders "men on the job on the Net." With online access to their accounts, moving their money is as easy as devouring a plate of buffalo wings.

The guy factor has been documented before in a famous study of brokerage account activity in the late 1990s. Men fared worse than women in this landmark research, which was called, appropriately enough, "Boys Will Be Boys: Gender, Overconfidence, and Common Stock Investment."

According to those researchers, men traded 45 percent more frequently than women and their returns were worse than the female accounts. The increasing popularity of the Web only fueled the phenomenon of male investors gone wild.

A few years ago, researchers from the University of California documented that the investment performance of a group of brokerage clients dropped dramatically when they stopped investing by telephone and started making their own trades online.

When they faced the hassle of reaching someone by phone, their dialing finger wasn't as itchy and their returns beat the market by more than 2 percent. But when they switched online and could easily make trades during ESPN SportsCenter commercials, they ended up badly lagging the market by more than 3 percent a year.

Knowing this, it's easy to assume that the television ads for online brokerage firms that show wise dads calmly trading stocks while their kids are yammering in the background isn't worthy of a Rockwell portrait. The kids would probably end up with more cash in their college funds if Dad unplugged the computer and spent his free time changing a diaper or playing catch in the backyard.

It doesn't matter if you think the villain is high-speed Internet connections or testosterone. Whether or not you've got the Y chromosome, what's important is knowing how to avoid letting a swelled head suffocate your portfolio. If that's your goal, here's an excellent strategy: Do nothing. (Or, actually, nearly nothing.)

A 401(k) should be nearly as low-maintenance as an Alaskan rose garden in February. While you should continue feeding new money into your accounts, you should otherwise forget about them. Once a year, you'll want to check your accounts to see if the investments have gotten out of whack. Suppose, for instance, that you started the year with a classic balanced portfolio. You had 60 percent of your money devoted to stock funds and 40 percent to bond funds.

If stocks soared during the next 12 months and bonds faltered, you might end the year with a lopsided portfolio that now contains 80 percent stocks and 20 percent bonds. To rebalance, you'd peel off 20 percent of the stock shares and use the cash to buy more bonds. By focusing on maintaining your account's equilibrium, you should improve your long-term chances of investment success.

For those who consider even this rote work too much of a hassle, there is another option. Invest in a balanced mutual fund, which generally maintains a 60/40 split of stocks and bonds, or choose a life cycle fund, which rebalances automatically. Life cycle funds, which typically contain several underlying mutual funds, will become more conservative as you age, so over time your exposure to stocks will decrease and your bond holdings will grow.

Other variations of these funds are labeled as appropriate for conservative, moderate or aggressive investors. These funds also contain a variety of underlying mutual funds, but their investment mix remains static.

In the Vanguard study, the workers who invested in a balanced or a life cycle fund earned the highest risk-adjusted returns. About 95 percent of 401(k) plans offer a balanced fund, life cycle funds or both.

Keeping a hands-off approach is also recommended for your other investment accounts as well. But to pull this off, it's best to invest only in mutual funds, which provide a diversified assortment of investments, rather than individual stocks, which are far more volatile and hazardous to your financial health. And remember, as Utkus says, "The more frequently you trade, the less successful you will be."

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