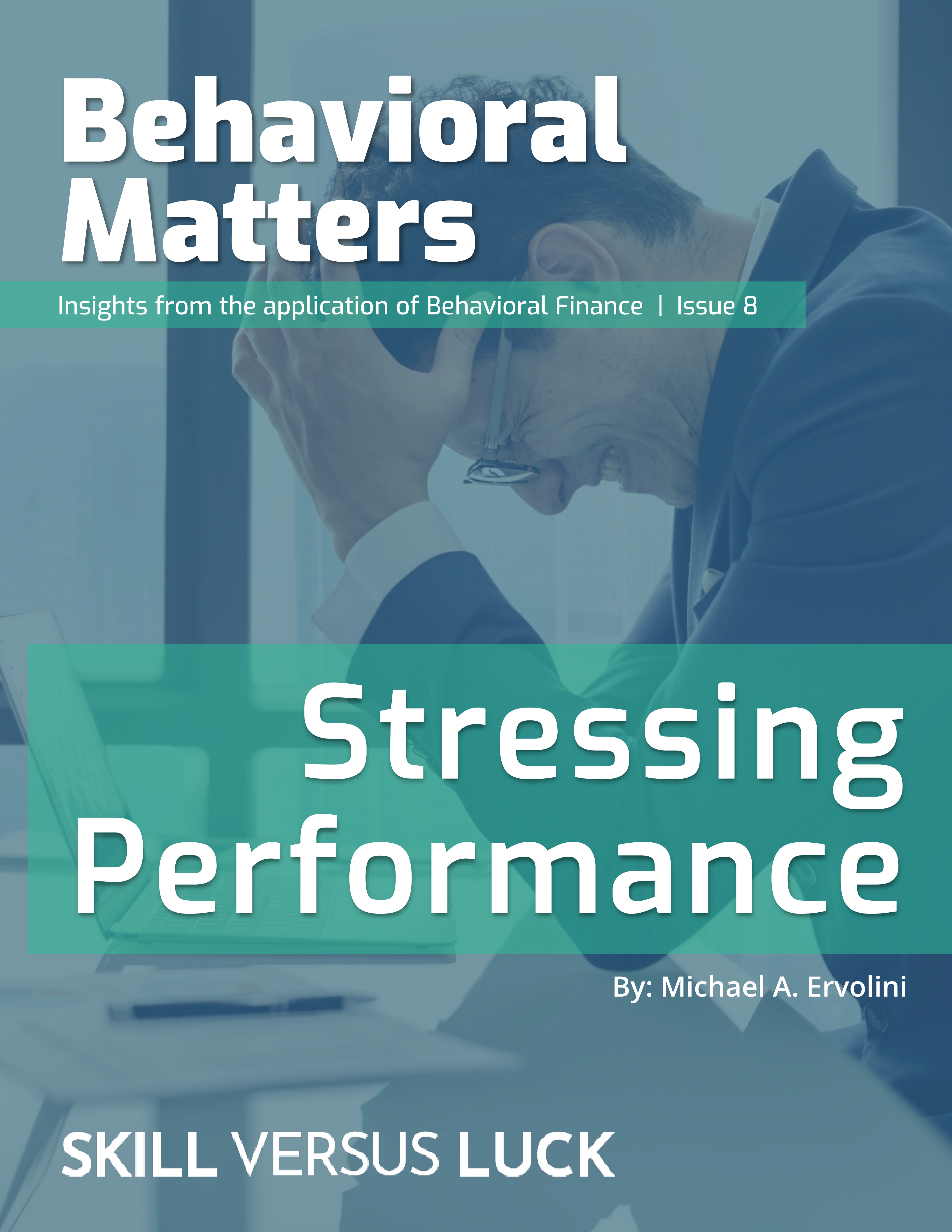

Behavioral Matters

Insights from the application of Behavioral Finance | Issue 8

Stressing Performance

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SKILL VERSUS LUCK

INTRODUCTION

Behavioral Matters is a series of essays on the application of Behavioral Finance written specifically for professional investors and portfolio managers.

> "Nothing is more difficult, and therefore more precious, than to be able to decide."
>
> \- Napoleon Bonaparte

No one has to tell you what stress feels like. It is your job to make the tough decisions about which names stay in the portfolio and which go. A burdensome responsibility, even in the best of times. But these are not the best of times. Your normal processes are being wracked by a market slump well outside your career experience combined with outflows that can be unnerving. If you are sensing in yourself a few raw nerve endings, that is only natural. It is one thing to survive stressful times – quite another to excel during them – ask any jet fighter pilot. In this essay we examine the nature of stress, its impact on critical thinking and what top professionals are doing to harness its effects rather than be overwhelmed by them.

FEELING IS BELIEVING

> “Stress isn’t always a bad thing.”

Stress isn’t always a bad thing. After all it is simply a state of heightened emotional and physiological awareness. Athletes, actors, public speakers and others use positive stress to strengthen their performance. Eustress, a term coined by researcher Richard Lazarus, is felt when the demands being placed upon us seem within our ability to handle. Coping with these stresses is exciting and actually heightens our abilities. In other words "getting pumped up" to perform involves harnessing positive stress.

Negative stress or distress, on the other hand, is felt when we are overwhelmed. Fears of failure or feeling out of control are powerful stressors that can severely limit our thinking and actions. During such experiences we are heavily driven by emotions that, while instinctive, are not the instincts that propel us to do our best. Learning what stresses you, and how to better manage these stressors, is all part of professional self awareness.

DR. JEKYLL, MR. HYDE

Stress can change who you are ... or at least how you think. A diminished ability to consciously make good decisions is a common reaction to stress. Stress elicits our brain's primitive protective responses, that old "fight or flight" feeling. These ancient instincts worked well when we needed protection from a marauding Woolly Mammoth, but are generally less helpful when managing modern sources of stress like market volatility or unhappy investors. This instinctive over-ride of conscious decision making limits us to only part of our brain, the part that doesn't want to think. It prefers action.

Here are a few ways that stress can impede your decision-making.

Narrow framing: Distress causes us to curtail research and investigation prematurely. This rush to be done results in limiting the number of options we consider; emphasizing simplicity and expediency.

Shortened time horizon: Negative stress can push us towards a quick fix, even when that fix may cost us in the future. We just want the pain to stop.

Heuristics: Stress can result in an over reliance on simple rules-ofthumb. When succumbing to the desire to "do something" we might repeatedly apply ineffective solutions rather than reassess.

Negativity: Stressors can weaken our self confidence, lower our creativity and tilt our viewpoint so that more alternatives seem to possess negative outcomes. This "glass mostly empty" approach to decision making often becomes self fulfilling.

"The instinctive over-ride of conscious decision making limits us to only part of our brain, the part that doesn't want to think."

STRESS THIS

So how can you benefit from the current market chaos? We recommend building upon your self awareness, discipline and process.

In general, good coping skills help us negotiate stressful times. They enable us to increase our sense of self-efficacy and perception of control. According to Dr. Albert Bandura self-efficacy is our sense of competence, our belief in our own abilities. The more capable we feel in any given situation, the less distress. Our sense of control also helps determine if we experience eustress or distress. According to Harry Mills, Ph.D "The perception of being in control (rather than the reality of being in or out of control) is an important buffer of negative stress". Our sense of competency and control, therefore, act together in determining our personal reactions to stressors.

Self awareness, discipline and process are the tools you possess to strengthen your feelings of self-efficacy and control. The more you understand and believe in what you do at each decision point, the better you can manage stressors. As you learn to harness stress the more your portfolio decisions will reflect your strategy and analytic thinking rather than those unexamined rules-of-thumb hiding in your unconscious.

> "The perception of being in control is an important buffer of negative stress."

CONCLUSION

Stress is part of life. Minimizing negative stress is a skill that can be developed. The further you develop self awareness, discipline and process the better you will handle stress and the better the decisions you will be placing in your portfolio.

Managing stress and thinking clearly as markets gyrate around you can have an obvious impact on return. They can also mean the difference between having your portfolio, strategy and processes well positioned for the eventual market rebound or being caught flat-footed while others garner assets.

ENDNOTES

1. *"Judgment and Decision Making Under Stress: An Overview For Emergency Managers", Journal of Emergency Management, 2008, by Kathleen M. Kowalski-Trakofler.*
2. *Making Decisions Under Stress: Implications for Individual and Team Training, American Psychological Association, 2000, edited By Janis A. Cannon-Bowers and Eduardo Salas.*
3. *Sitting in the Hot Seat: Leaders and teams for Critical Incident Management, John Wiley & Sons, 1997, by Rhona Flin.*
4. *Sources of Power: How People Make Decisions, MIT Press, 1998, by Gary Klein.*