Investor, Know Thyself

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[Note: This article was adapted from Meir's article in the Wall Street Journal.]

Want to be a smarter investor? Get in touch with your feelings.

If we better understand how we feel, how we think and what kind of personality we have, we get more insight into the forces that affect our investing behavior. And that might make us smarter investors — or at least invest in ways that don't give us heartache.

What are you prepared to lose?

Suppose that you could replace your current investment portfolio. The new portfolio has a 50-50 chance to increase by 50% your standard of living during your lifetime. However, the new portfolio also has a 50-50 chance to reduce by X% your standard of living during your lifetime.

What is the maximum X% reduction in standard of living you are willing to accept?

The lower the number you chose, the more you think the pain of a decline outweighs the joy of an increase. For instance, people who are willing to accept a maximum 25% reduction are saying, in effect, that the potential pain is twice as important as the potential joy.

Surveys show that, on average, Americans are willing to accept a maximum reduction of approximately 12.5% — meaning pain outweighs joy by 4 to 1. Fear of loss magnifies risk, driving us out of stocks, as at the peak of the financial crisis in 2008. Exuberance blinds us to risk, rushing us into stocks, as at the peak of the technology boom in 1999.

If you're very reluctant to take risks, you might want to consider a bigger position in stocks to make up for your cautious tendencies. If you're more aggressive, perhaps think more closely about bonds or other more conservative investments.

Do Bad Choices Bug You?

If you tend to feel bad about decisions you've made, remember one important fact: Regret is a powerful teacher, but sometimes it teaches the wrong lesson.

All too often, highly regretful people shy away from everything that didn't work out for them, for whatever reason. Regret stupid choices and learn not to repeat them. But don't regret wise choices that turned out poorly, or else you could end up missing out on valuable opportunities.

Think You Can Beat the World?

Overconfidence can be handy in some situations, but it can lead you to make poor choices when you're investing.

If you have confidence that you can beat the market, remember one simple fact: A consistent ability to earn higher-than-average returns is rare, and most investors who try to beat the market end up beaten by it. Find ways to tamp down your eagerness and make fewer trades. Look for stocks that you'll buy and hold for the long term, or buy a portfolio of mutual funds that take care of the trading for you.

Attention to Details

Those who describe themselves as organized, responsible and thorough are considered conscientious. When it comes to managing money, conscientious people are good at saving, accumulating fatter portfolios than people with equal income but lower conscientiousness.

But be sure to avoid going overboard. Don't let conscientiousness turn you into a miser, injuring your family and you.

The Life of the Party

Extroverts, as psychologists call them, are overconfident, willing to tolerate risk and largely immune to regret. This combination of traits makes them good salespeople, whether selling products or themselves. But extroversion detracts from introspection and gets in the way of listening.

If you're extroverted, recognize that some of your willingness to take risks in investing is probably rooted in your psychology — and not in a thoughtful assessment of risks and returns. Be sure to think twice about any move you make.

A Generous Spirit

Agreeableness is a mixed blessing when it comes to investing. If you're agreeable, consider buying riskier issues that may generate big returns, but don't make a lot of moves with your holdings once you've got them.

A Vivid Imagination

"Open" intellectuals are more interested in ideas and inventions than in money, and are easily bored by routine. Many spend their careers without thinking much about what they're accumulating in their pensions and defined-contribution savings plans. Many often find, too late, that they still don't have enough, because they never paid attention to their investments and didn't build up enough wealth.

It may help to try thinking of investing as a puzzle or a machine, something whose mysteries you can examine and try to make sense of. (Just don't imagine you can beat the market consistently; there's no system that will get you great returns every time.)

A Worrywart?

Worriers may think they're objectively assessing risk when they make moves, or resist making moves. But more likely, those actions are due to fear and pessimism.

Regardless of your personality, a good strategy is to turn to a financial advisor to design and enforce a portfolio for you. An advisor can calm you down when the market tanks and you feel compelled to dump your stocks. He or she can also impose rules to make sure you're making wise moves that will help you meet your long-term goals.