

Net Gains

How Watching Basketball Can Improve Your Approach to Investing

By JONATHAN CLEMENTS

Staff Reporter of The Wall Street Journal

If you want to improve your investing, settle into an armchair, grab the remote—and spend the next two weeks watching the NCAA basketball tournaments.

True, this might not endear you to your family. But the fact is, there are intriguing parallels between the foibles of basketball and the behavioral mistakes investors make.

As you cruise the channels, what should you look for? Academic and financial experts offer up these three basketball-inspired investment insights.

Keeping your cool

Both the men's and women's NCAA tournaments began last week. If you think stock jockeys are obsessed with finding the next hot thing, just listen to the basketball commentators.

You will probably hear the television announcers declare that one or two of the players have the “hot hand” because they have scored on, say, their last three shots. The implication: Their teammates should feed them the ball, because there's a good chance they will keep knocking down the jump shots.

Academics, however, would beg to disagree. A study that appeared in *Cognitive Psychology* in 1985 looked at the shooting record of the Philadelphia 76ers during the 1980-81 season, a squad that included the great Julius Erving. The study found that, contrary to popular belief, the probability that the players would score on their next shot was, on average, slightly lower following a successful shot.

But what about those unusual hot streaks? Statistically, hitting three or four shots in a row—or beating the market in consecutive years—just isn't that unusual. Indeed, if you and a bunch of friends each flipped a coin 20 times, half of you would likely get four heads in a row.

“Fund managers can look like they're hot or like they're a market beater,” says Thomas Gilovich, co-author of the “hot hand” study and a psychology professor at Cornell University. “But you swap out of your underperforming fund and into the hot fund at your peril. Given that the market is pretty efficient, past performance just isn't a good guide.”

Why do people reach grand conclusions based on skimpy data? Part of the blame lies with so-called confirmation bias. If you are convinced you're a great stock picker or that basketball players can “get hot,” you will likely find the necessary proof.

“The brain looks for patterns,” says Meir Statman, a finance professor at Santa Clara University in California. “And once you decide there is a pattern, you will look for confirming evidence and you will dismiss contradictory evidence as a fluke.”

Expecting less

While it's hard to say definitively that some fund managers are

superior to others, some basketball teams clearly are more skillful. Yet fans of weaker teams are forever hopeful.

How often does a college basketball team that's trailing at halftime come back to win? Allan Roth, a financial planner with Wealth Logic in Colorado Springs, Colo., often puts this question to audiences. He says people typically guess that between 30% and 60% of teams make a comeback.

In fact, Mr. Roth looked at over 3,300 college games played in November, December and January and found that, among teams trailing at the half, less than 20% came back to win. Why do folks think the number is so much higher? Mr. Roth figures there are two reasons.

First, we tend to be overly optimistic. “It's America,” Mr. Roth says. “We believe in the underdog—and we believe in the small investor.” Even though studies suggest that most investors lag far behind the market, we like to think we can beat the odds and come out on top—which helps explain why market-tracking index funds still aren't that popular.

Second, comeback victories tend to get the most media attention, so they stick in our minds. “It's the same thing with hot mutual funds and hot money managers,” Mr. Roth says. “Because investors only hear about the winners, they think it's easy to beat the market.”

Playing the odds

Investors hate the idea of losing. So, too, do basketball coaches—and it can lead both groups to be a little irrational.

Suppose a team is down by two points and it has time for one last shot. What play should the coach call? Let's say there's a 50% chance of scoring on a two-point shot and pushing the game into overtime, but only a 33% chance of making a three-point shot and getting the immediate win.

Nonetheless, the three-point shot is the rational choice. The reason: If the team makes the two-point shot, it still has to play overtime, where its chances of winning are 50%. In other words, by opting for the two-point shot, the team is looking at having to win on two 50% gambles, which means its overall odds of winning are just 25%.

Yet coaches usually go for the two, notes Richard Thaler, an economics professor at the University of Chicago. Chalk it up to our aversion to regret. If the coach goes for the three and misses, not only will the team suffer an immediate stinging loss, but also critics will vilify the coach as “greedy” and “reckless.”

Similarly, investors are often too worried about looking foolish in the short term. Stocks, like the three-point shot at the buzzer, may be the best bet. But many investors shy away from stocks, because they worry about stinging short-term losses and the pangs of regret that accompany them.

“If you believe there's a premium to owning stocks, you're crazy not to own them if you're a long-term investor,” Prof. Thaler argues. “You shouldn't be so bothered by day-to-day or month-to-month volatility.”