Why personality matters

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Who are you? This question matters more for your investment choices and performance than is generally realized.

In conventional economics, people are just equation-solving machines, who maximize utility subject to a budget constraint. Personality matters only insofar as it affects our tastes. And in the box-ticking mentality of the cruder financial advisor, these tastes consist merely in differences in appetite for risk*.

This view isn't entirely stupid. After all, share prices rise and fall the same for all of us, regardless of differences in personality. But it is far from the whole story, as new research shows. In an important recent book, George Akerlof and Rachel Kranton show how differences in ethnic and gender identities affect people's choices in education and work. A similar thing is true in investing: personality matters.

One clue that this is the case lies in a recent discovery by Karl Taylor and Sarah Brown at the University of Sheffield. They found that among the richest quarter of 50-year-olds in the UK, people are more likely to own shares if they regularly attend church than if they don't.

This isn't a pure religious effect. People who spend lots of time with their friends, or who are active members of sports clubs are also more likely to own shares; this is true even controlling for lots of things that influence shareholding, such as income, intelligence, home-ownership and gender. "Individuals who are more socially active have a higher probability of participating in the stock market" they conclude.

This could be because people with wider social networks get more share tips. Or maybe their greater concern to keep up appearances leads them to prefer higher-returning assets.

However, something else might be going on. Researchers at VU University in Amsterdam give us a clue here. They estimate that people who score highly on agreeableness in "big five" personality tests - that is, get on well with others - can adapt more easily to financial losses. This, they say, is because such people have lots of friends and so can take solace in these when disaster strikes, whereas the more solitary person tends to brood on their loss. In this sense, friends are a form of insurance. So too for that matter is religious belief. Andrew Clark at Paris School of Economics has found that believers suffer less unhappiness when financial disaster strikes than do non-believers. Religion, he says, is a form of insurance in this life.

Naturally, people who are well-insured - by friends or faith - can afford to take more risks than others.

Our personality doesn't just shape our investment choices, though. It also affects our performance.

You might think this is trivial in one respect. Surely, intelligent people are better stock-pickers than others. Yes - but only slightly so. Mark Grinblatt of the UCLA Anderson School of Management has found that intelligent investors do out-perform stupider ones, but not by much and not for long.

Instead, other attributes seem to matter. Robert Durand and colleagues at the University of Western Australia show that extravert investors earn higher risk-adjusted returns than others, perhaps because they churn their shareholdings less often. They have also found that investors who are open to new experiences do better, perhaps because such people are better able to cope with uncertainty.

However, conscientious investors did worse. Which sounds weird. Surely, self-discipline, attention to detail and a sense of duty help people work better, which should improve their investment performance.

But there's an offsetting tendency, uncovered by that Dutch research. Conscientious investors find it hard to adapt to losses. They regard them as personal failings, errors of judgment, rather than mere accidents. This makes them more prone to the disposition effect; they can cling onto losing stocks because they feel that crystallizing a loss would be an admission of failure**.

It's not just aspects of the "big five" personality tests that affect our performance, though. So too do the years on our clock. "Investment skill deteriorates with age" conclude George Korniotis and Alok Kumar, two US economists.

Sumit Agarwal of the Federal Reserve Bank of Chicago explains why. Our intellectual ability, he says, comprises two parts: fluid intelligence, our ability to tackle new unfamiliar tasks; and crystallized intelligence, our accumulated wisdom and experience. The former deteriorates with age, but the latter improves. On balance and on average, says Mr Agarwal, these trends produce a hump-shaped relationship between age and investment skill; it improves up to our middle years and then falls off. He and colleagues studied Americans' choices in credit card transfers, mortgages and car loans, and found that the best interest rates were paid by people with an average age of 53. "Middle aged adults may be at a decision-making sweet spot" they concluded.

There are two messages in all this. One is for the orthodox economics which regards people as mere calculating machines - what the University of Chicago's Dierdre McCloskey has called the "max U" view. People differ not just in their tastes, but in their ability to "max U". And these differences aren't mere random differences, but are systematically correlated with aspects of our personalities.

The other message is for investors. We shouldn't think only about shares' risks and expected returns. We should also look inward, and ask: do I have the psychological and social resources that cushion risks? Do I have the characteristics that facilitate good judgments under uncertainty? The problem is that answers to these questions are quite likely to be distorted by over-confidence and the Dunning-Kruger effect. But that's another story.

* Many of them compound this error by assuming that "risk" is a single thing. It's not. It comes in many varieties: volatility, tail risk, liquidity risk and so on.

** This isn't a universal failing of conscientiousness, though. An investor who was rigorous in sticking to rules might be well able to avoid the disposition effect, as long as he had a rule in place to sell losers.