Science proves Jack Bogle's advice on stocks is right

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MarketWatch
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A new study of our innate human biases reinforces the value of diversification when it comes to stock investing.

Short version: We just can't help ourselves when we think we know something.

Scientists call this confirmation bias, the unconscious way we seek out information that proves we are "right" about closely held ideas.

The problem is that once we are confronted with facts that show we are wrong, our brains nevertheless double down on the clearly bad information.

In the study, researchers gave volunteers a game that associated abstract symbols with a financial value.

Participants were presented with two symbols but learned the value of just one, whichever one they had chosen. The subjects could repeat the process, though, and in time learn the values of several symbols in a set.

In a later game, the volunteers were given a choice between two symbols. In this game, they were told in advance the financial values of each symbol.

Bizarrely, participants stuck to previous choices, despite making less money from them. "It's as if you don't hear the voices in your head telling you that you're wrong, even if you lose money," said Stefano Palminteri, one of the researchers.

This problem is largely resolved by diversification, the investment practice of owning large numbers of securities.

We know from investment history that stocks grow and compound over time. Where we get into trouble, often, is in trying to guess which stocks might do better than others.

And it's true that some stocks do better than others. Some do far, far better.

Yet nobody knows in advance which stocks will be winners. Meanwhile, hidden biases conspire to keep us invested in losing stocks for long periods. We sell beloved names only under great duress, such as a market crash — locking in permanent, unrecoverable losses.

The solution, oddly enough, is to know less about your investments, not more. Diversification via a low-cost index fund, a strategy pioneered by the great Jack Bogle of Vanguard Group, automatically cuts the risk from confirmation bias.

By owning all of the stocks in an index (SPX) you don't need to have any strong feelings about any of them. You just need to have faith in the stock market itself, a proven investment over the long run.

Even when things look dark — and that happens to stocks from time to time — the key is to diversify and to stay invested, Bogle explains.

"My rule — and it's good only about 99% of the time, so I have to be careful here — when these crises come along, the best rule you can possible follow is not 'Don't stand there, do something,' but 'Don't do something, stand there!'" Bogle said in 2011.

He spoke on a day that Standard & Poor's, the ratings agency, had cut the investment rating of the United States. Stocks fell sharply, below 11,000 on the Dow Jones Industrial Average (DJIA)

Nevertheless, to Bogle's point, stocks were above 22,000 in recent trading. If you had bailed on stocks back in 2011, you would have missed a doubling of the value of the stock market since then.

Keep the faith

As usual, the risk is not from owning stocks but from knowing too much about the stocks you own. A lot of diversified investors look at the bottom in 2009, for instance, and threw their hands up. Nothing to do about it now! So they stayed invested.

That's exactly Bogle's advice. When things look awful, you're much better off doing nothing at all. Don't do something, just stand there.

It's when we think we know something about stocks — easier to do when you own only a few of them — that we can be prompted to take action and sell at difficult moments.

Diversify and keep the faith, and your tricky brain will get over its attachments in time. The less you know the easier it gets, as Bogle says, to "just stand there."