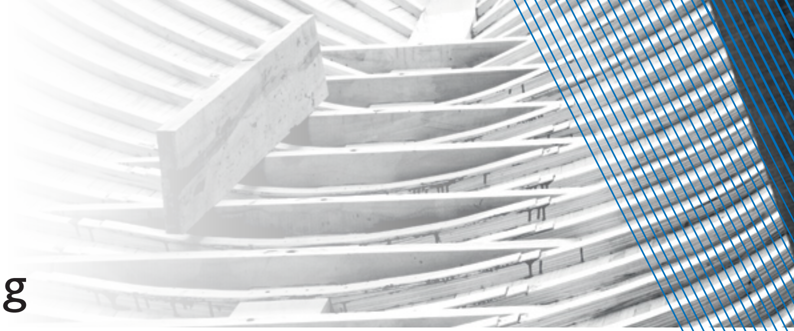


STANLIB Multi-Manager

The Educator

The pitfalls of emotional investing

In The Educator, we address a number of topics with the ultimate goal of providing a better understanding of investing clients' money.

Time in the market, rather than timing the market is far more valuable to investors.

Emotional potholes

Since investors rarely behave according to financial and economic theory, behavioural finance has grown over the past twenty years. Most investors know that emotion affects the way in which investment decisions are made – and that greed and fear play a large role in driving investment markets.

The actions of many investors are based on feelings rather than facts. They may make decisions based on a host of emotional biases that, unfortunately, undermine the chance of meeting the desired investment outcomes. Admittedly, it is difficult to escape the influence of emotions on investment decision-making and that influence, is more than likely the main reason many investors do not achieve the results they want.

Our brains regularly set little traps for us – and these 'emotional potholes' may have very real costs associated with them. Crucial in overcoming this risk is awareness of how emotions can affect decisions, which may make you a better investor in the process. In order to improve decision-making and investment results, it certainly helps to be aware of:

1. Some of the most common biases

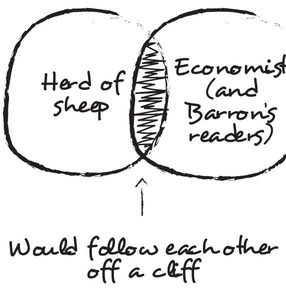
2. How to avoid/mitigate these costly investment mistakes; and

3. Focusing on your goals

Some of the most common biases

Herd mentality

Our emotions may be influenced by the prevailing investment climate – such as a fear of standing out from the crowd or missing out on a trend. Herd behavior/mentality can amplify the market upswings and down turns and a prominent example was the dotcom bubble in the late 1990s. Venture capitalists and private investors made frantic moves to invest huge amounts of money into internet companies, despite the fact that many of those dotcoms not having financially sound business models. Many investors more than likely moved their money in this way, on the reassurance they received from seeing so many other investors do the same thing. They did not want to miss out and followed the 'herd of sheep' rather than their logic.



*Carl Richards

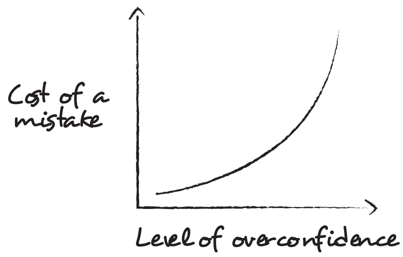
Greed and fear

This relates to an old Wall Street saying that financial markets are driven by two powerful emotions – greed and fear. Succumbing to these emotions can have a profound and detrimental effect on investment outcomes, as too often, investors enter (on greed) or exit (on fear) the market at precisely the wrong time.

Overconfidence

Overconfidence may cause investors to overestimate the quality of their judgment or information. Some investors believe they can successfully predict market downturns and rallies. Others perceive themselves to have a knowledge advantage when they get a tip from someone in finance or read information from a publication or research report. In reality, several studies have shown that overconfidence bias leads investors to trade more frequently in effort to align their positions with current market conditions.

The cost of frequent trading erodes returns and returns earned are rarely sufficient to make up the difference. Investors are very susceptible to forgetting the times they were incorrect or recognizing the role that luck played in positive outcomes.



*Carl Richards

If you ever find yourself saying things such as 'nothing could ever go wrong,' 'I believe it will go forever,' or 'I know the risks,' it may be time to check yourself. It is important to remember that every investment carries some risk and the potential for loss.

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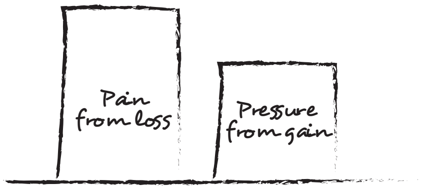
Loss aversion

The basic concept behind loss aversion is that investors feel losses much more than they feel gains. Investors would rather avoid losses than reap rewards. Loss aversion is often seen in financial markets – stock market investors hold their positions with paper losses too long and sell their investment holding paper gains too early.



*Carl Richards

Consider an investment bought for R1 000 that rises quickly to R1 500. Investors would be tempted to sell it in order to lock-in the profit. In contrast, if the investment dropped to R500, investors would tend to hold it, in order to avoid locking in the loss. The idea of a loss is so painful that investors tend to delay recognizing it. More generally, investors with losing positions show a strong desire to get back to the break-even point. This means that investors generally show highly risk-averse behaviour when facing a profit – selling and locking in the sure gain – and more risk tolerant or risk seeking behaviour when facing a loss – continuing to hold the investment in the hope the price rises again.

Mitigating biases

How does one go about avoiding 'emotional traps?'

Financial markets without volatility would be unnatural, like an ocean without waves. Like the open ocean, the market is constantly churning and the degree of market volatility varies from small ripples, to rolling waves, to a financial crisis sized tsunami. Despite any negative connotations, volatility simply refers to a change in prices. It is normal and happens over time. It is not necessarily a cause for panic and is something that needs to be considered when investing.

By understanding that prices of stocks and bonds will go up and down, there are things that can be achieved with that in mind. Many investors are uncomfortable with the large amplitudes swings inherent in a volatile investment and thus shun this risk – and the associated return – for less-swingy, lower returning investments. Avoiding more volatile investments simply leaves a lot of potential return on the table and may shave thousands and possibly hundreds of thousands off one's wealth at retirement. Paradoxically, avoiding risk in long-term investing typically leads to a smaller pool of wealth, feeling far "less safe" in retirement than if one had assumed more risk along the way.

How to respond to market volatility

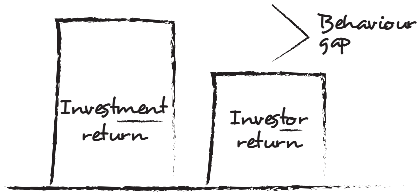
It might sound counterintuitive but during periods of market volatility, the correct course of action might be to take no action. This is difficult to do because volatility can leave investors feeling vulnerable and concerned that they have to react.

That means that investors who jump ship after a 'big wave' may break the cardinal rule of investing by 'selling low.'

Consider this – if you own a home and its value went down this year, would you panic and sell? Most likely, you would not. You bought your house because you knew you would be there a while and so its day-to-day price movement is not as important. The chances are that your home's value will rise over time and that is what you are focused on.

Be disiplined and stay invested

There might be many investors who have made money by seemingly timing the market correctly – in other words, predicting market movements and selling or buying shares accordingly – but it is likely that this was due more to luck than skill. For the average investor it is not only difficult to foresee market upswings and downswings, but also challenging to make decisions that are not marked by emotion.



*Carl Richards

The golden rule that it's about time in the market and not timing the market is valuable to investors. We know that markets do not move up in a straight line and that volatility is inherent in equities as an asset class. Checking a portfolio too frequently can make investors more susceptible to loss aversion, since the probability of seeing a loss in a short time period is much greater than over longer time periods. As a result, investors that frequently check their portfolios tend to take a less than optimal amount of risk. True long-term investors are more willing to allocate towards risky assets because they do not care about the short-term ups and downs. Holding a portfolio for long enough increases the probability of a positive return.

Research from Putnam Investments on investing offshore in the S&P 500, shows that by remaining fully invested over the past 15 years, would have earned investors $20 460 more than those who missed the market's 10 best days – more than double!

A goal without a plan is just a wish

Acting on emotion may lead to irrational decisions — and difficult lessons. If you develop a sound investment game plan and stick to it, you will more than likely be in a better position to pursue financial goals. A game plan can help remove emotions from the equation, enable investors to make the most of potential market opportunities; and help preserve assets during periods of volatility.

Investors who are not saving for a goal and/or do not have the discipline to remain invested during the time saving for a goal, are more likely to realise the waves of volatility that occur over their period of investing. In contrast, investors with clearly defined goals, that are able to shift their focus on the potential of meeting their needs and requirements, have the luxury of realising infrequent negative market returns. There is unfortunately no assurance that an investment strategy will be successful but investing with a clear plan provides a higher probability of meeting your goals/needs.

Conclusion

The industry is learning more and more about emotional biases and the effect on individual investors. But it seems that adhering to a sound investment plan may be one of the best ways to avoid the pitfalls set by our brains.

Images credit: Carl Richards

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