Spotlight on Emotional Investing

Investment decisions have financial and emotional implications. Key to a sound investment plan is ensuring your financial needs are aligned with your emotional needs. In this issue of our Spotlight series, we look at how natural emotional biases often shape how we view our finances and interact with our investments, often subconsciously.

Are You Emotionally Invested?

While the ups and downs of equity markets are largely unpredictable, their effect on investor behaviour very often is. Some investors, as demonstrated during periods of increased volatility, can markedly misjudge their tolerance for risk. After all, it's one thing to acknowledge losses are possible, but it's quite another to live through them.

Investor psychology and the field of behavioural finance goes a long way to help explain the gap between why investors say one thing and often do another.

The Real World: Behavioural Finance 101

Traditional economic theories are rooted in the concept that investors make rational decisions and all existing available information is used in making investment decisions. Behavioural finance counters this notion by suggesting that investors frequently behave irrationally and often against their best interests. **In other words, the former looks at how investors should behave, while the latter looks at how investors actually behave.**

Pioneers in the study of behavioural finance have identified a number of biases that contribute to investors' unpredictable and often detrimental financial decision making behaviour. We examine three common emotional biases that investors are prone to and what you can do to manage them:

1. Mental Accounting

Mental accounting explains why some investors tend to compartmentalize their money into separate accounts based on a variety of subjective criteria, like the source of the money or purpose for each account. It also helps explain why some people will drive across town in order to save $5 on a tank of gas.

Mental accounting can also lead to asset segregation; where risk and value are exclusively assigned at the investment and not the portfolio level. It's also exhibited by investors who sometimes view their retirement accounts too conservatively and run the risk of encountering a shortfall in retirement savings.

What can I do?

- Focus on the long run and the big picture. The flip side of overconfidence, mental accounting and loss aversion can prompt you to be overly conservative.

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- Anxiety over the possibility for short-term losses can cloud your judgment and lead you to handicap the growth potential of your savings over the long run.
- Tune out the noise. Investors who tune out the majority of financial news tend to fare better than those who subject themselves to the constant barrage of information.

2. Prospect Theory

Market volatility is a catalyst of uncertainty. Closely related to the concept of mental accounting, prospect theory contends that losses have more emotional impact than an equivalent amount of gains.* For investors, prospect theory can be exhibited through the disposition effect – the propensity for selling winning investments too early and an unwillingness to part with laggard investments. It's also demonstrated in an innate desire to avoid losses; even if that means choosing not to participate in potential gains.

What can I do?

- Spikes in market volatility, while unsettling for most, can prompt some to abandon their long-term plan for the short-term reprieve that cash and other liquid investments offer. When the temptation to retreat to the sidelines takes hold, ask yourself if the market or economic event fuelling the downturn changes your long-term goals? Odds are it doesn't. Better yet, contact an advisor at Scotiabank and share your concerns.
- Taking on investment risk shouldn't be an all or nothing approach. Consider finding a middle ground with an investment solution that offers a balanced approach to risk and return.
- Instead of fearing a market correction, consider viewing them as an opportunity to purchase an investment, such as mutual funds, at a discount. Investing small amounts in regular increments through a Pre-Authorized Contribution (PAC) plan is a measured approach to taking advantage of market volatility.

3. Over-Confidence/Optimism

It's human nature to be overconfident. One frequently cited study found that 90% of the car drivers in Sweden rated themselves as above-average drivers.** Statistically, you're more likely to be an average driver than an above-average one, even if you live in Sweden.

In the investing world, confidence levels are driven in part by recent market performance. For instance, it's easy to overestimate your risk tolerance, particularly when your immediate frame of reference is a period of equity market gains. Very often investors who perceive their risk tolerance to be high exhibit much less confidence when faced with market downturns. Fear that others are more knowledgeable can drive a herd instinct, with frenzied selling (during market crashes) or buying (during market bubbles) when it is least opportune to do so.

* Source: Daniel Kahneman and Amos Tversky, "Prospect Theory: An Analysis of Decision Making Under Risk," Econometrica, 1979.

** Source: Svenson, O., (1981), Are we all less risky and more skilful than our fellow drivers.

What can I do?

- Although it's practically impossible to forecast when the next upward or downward spike in the market will take place, having a well thought out investment plan can help instill a sense of confidence that you can ride out the volatility.
- Be realistic and measured. When looking at historical rates of returns, don't focus solely on the upside.
- Keep your confidence levels in check. It's easy to get swayed when your immediate frame of reference is strong returns.

Becoming more aware of how your emotional biases can affect your decision making will equip you to make better investment choices, view your portfolio with less unease and ultimately help meet your financial goals. Whether you're feeling more optimistic or cautious about investment opportunities today, an advisor at Scotiabank can help you to stay focused and on track to reaching your long-term goals.

Contact your advisor today

To find out more about long-term investment opportunities or visit us at **scotiafunds.com**

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