

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. Let's take a closer 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 can be observed. 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.
- Anxiety over the possibility for short-term losses can cloud your judgment and lead you to limit 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.
- 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.

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.

**4. Contagion**

Contagion, also known as herd mentality is the investing world's comparable to 'keeping up with the Joneses'. Picture a typical investor, who invests in a diversified portfolio and earns a respectable annual return, but whose friends have invested heavily in a concentrated portfolio of foreign stocks that's earning above-average market returns. At first, the temptation to join in and invest with friends may be easy to resist, as the investor knows that portfolio concentration is risky. However, as they hear more and more about their friends' success, the temptation to join in gets stronger, with the investor eventually giving in. Eventually, a geopolitical event occurs and the investments fall, leaving the investor with substantial losses.

Wanting to maximize returns is a natural human emotion. Since humans are not emotionless beings like Star Trek's Spock, we have to control these emotional tendencies, and try not let them interfere with our decision making.

* 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?

- Maintaining a level head is paramount. Investment decisions should be based on logic and reason, not on what other people are doing.
- Establish a long-term financial plan that meets your individual needs - and stick to it.
- Having a financial advisor to help you keep your emotions in check can help guard against herd mentality.

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.

**Contact your advisor
today**

to find out more
about long-term
investment
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