Spotlight on emotional Investing

Investment decisions have financial and emotional implications. A sound investment plan requires that your financial needs are aligned with your emotional needs. The following article looks at how innate emotional biases often shape how investors view their finances and interact with their investments, often subconsciously.

Are You Emotionally Invested?

One of the key learnings from recent market volatility is that many investors markedly misjudged their tolerance for losses – real or unrealized. That is, the loss they are willing to endure should their portfolio actually decline in value. After all, it's one thing to acknowledge losses are possible, but it's quite another to endure them.

Risk tolerance is the day to day fluctuations that you think you can tolerate when you purchase an investment

Loss tolerance is the loss you are willing to endure should your portfolio actually decline in value

Investor psychology and the field of behavioural finance goes along 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'll look at three common emotional biases that investors are prone to and what you can do to manage them:

1. 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.

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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.

Cycle of Market Emotions

While the ups and downs of equity markets are largely unpredictable, their effect on investor behaviour very often is. **Figure 1** illustrates the typical cycle of market emotions.

Understanding the cycle of market emotions can help manage your reaction to market volatility and keep your long-term financial goals in sight even in times of uncertainty.

What can I do?

- Keep your confidence levels in check. It's easy to get swayed when you're immediate frame of reference is strong returns.
- Be realistic and measured. When looking at historical rates of returns, don't focus solely on the upside.
- 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 instil a sense of confidence that you can ride out the volatility.

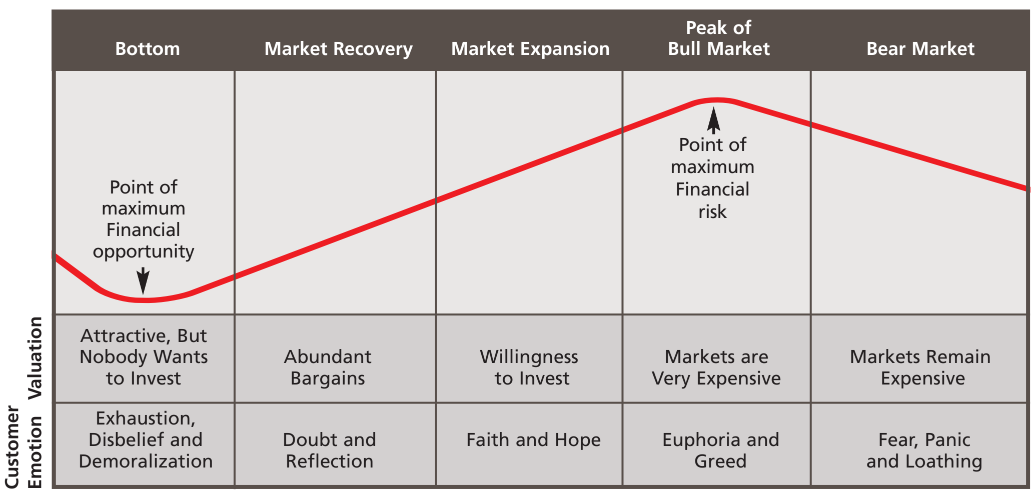
2. Mental Accounting

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 is exclusively assigned at the security level and not the portfolio level. It's also exhibited by investors who view their retirement accounts too conservatively and run the risk of encountering a shortfall in retirement savings.

Figure 1

The Cycle of Market Emotions



Source: Darst, David M. (Morgan Stanley and Companies, Inc.), The Art of Asset Allocation. McGraw Hill, 2003.

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 handicap your long-term performance by avoiding higher-return potential investments.
- Tune out the noise. Studies have shown that investors who tune out the majority of financial news fare better than those who subject themselves to the constant barrage of information.

3. Prospect Theory

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?

- The recent market downturn and "flight to cash" has left many investors paralyzed on the sidelines. Investing small amounts in regular increments through a Pre-Authorized Contribution (PAC) plan is a measured approach to getting back into the markets.
- Taking on investment risk shouldn't be an all or nothing approach. Consider finding a middle ground with a portfolio solution that offers a balanced approach to risk and return.

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, a *Scotia*® advisor can help you to stay focused and on track to reaching your long-term goals.

To learn more about *ScotiaFunds* speak to a *Scotia* advisor or visit www.scotiafunds.com

* Source: Svenson, O., (1981), are we all less risky and more skilful than our fellow drivers? Acta Psychologica, 94, pp 143-148.

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