Don’t Let Emotional Investing Cloud Your Judgement

It’s important to maintain a level head in times of market turbulence. But that is often easier said than done, especially in the heat of market volatility. Even with the best intentions, investors can be challenged by their own bias and emotions when it comes to making investment decisions.

Emotional investing may be amplified during periods of market stress. But by understanding your emotions and biases, you can better avoid common pitfalls and keep yourself on track with your investment goals.

Common investment biases fall into four major categories:

- Overconfidence
- Aversion to Loss
- Anchoring
- Pattern-seeking Behavior

Overconfidence: Overconfidence implies that investors tend to overestimate their ability to generate a return and underestimate the risk associated with a particular investment. For example, imagine you are an investor who has recently had success picking winning shares. You may conclude that the success is due solely to your investment skill. That may be the case, but it's also possible the results were due to market forces outside of your control. The problem is that in either case, recent success may encourage you to take greater risks. While this could lead to greater profits, it's just as likely to result in greater losses.

Herding mentality, which is the tendency for investors to follow and copy what other investors are doing, also tends to distort near-term risks in up markets. Thus, investors can mistakenly discount the volatility and chance for loss as they seek to chase higher returns. Investors are best served by following objective information and building in an expectation that stocks do not move in a straight line.

Aversion to loss: Aversion to loss is innate. It is said that one feels the pain of a loss twice as strongly as the joy of a gain. In an attempt to minimize the pain associated with an investment loss, investors may be more prone to take action that can lead to the derailment of their long-term investment success. In market drawdowns, investors can be quick to react, selling stocks, and over-allocating to bonds or cash to avoid further losses and protect their nest eggs. Many investors sold down their stock funds in favor of bond funds and cash during the 2008/2009 financial crisis. Unfortunately, some of these investors missed out on the subsequent rallies that eventually took place and helped propel stocks to new highs.

While it is tempting to move to the sidelines during times of market stress, investors may want to avoid over-allocating to cash and avoid locking in investment losses that they would not otherwise incorporate into their regular portfolio management activity. Importantly, if people maintain a well-diversified investment mix and own high-quality stocks and bonds, you should be able to stomach near-term investment losses and ride out the eventual market cycles that come and go with time.

Anchoring: Anchoring implies that investors tend to rely too heavily on specific information or lean on recent circumstances to make decisions. Our minds can "anchor" to information, and it's used as a reference point moving forward, regardless of relevancy. For example, investors may hang on to poor investments by waiting for the them to break even at the price at which it was purchased. If you’re trying to decide whether to sell or hold a stock, are you basing your decision on what you know about the company and the state of the market, or are you basing your target price on the purchase price or other measures that may be less relevant to the stock’s future course?

To help combat such biases, it's important that investors accept that market circumstances routinely change and sometimes suddenly. Therefore, your outlook may need to change accordingly. Investors can adjust to new market developments by seeking objective information, leaning on a financial advisor for sound advice, and setting realistic assumptions for potential returns.

Pattern-seeking behavior: Pattern-seeking behavior describes our brain's desire to seek out ways to compartmentalize the flow of information and find patterns that help us make sense of the world quickly. Since our brain is hardwired to do this, investors can mistakenly believe they see patterns in market trends that prove false. Since the future can be unpredictable at times, and patterns are not always present, investors may want to incorporate the following:

- Establish realistic expectations for your portfolio, both from a return and risk perspective.
- Expect markets to move in unpredictable ways, particularly during periods of market stress.
- While the near-term is unpredictable, generally, stocks move up and to the right over the long-term.
- Society is aging, and growth is slower. That means the patterns of the past may be harder to apply to the future, or possibly, not relevant.

Truly understanding your risk tolerance and your threshold for loss can go a long way in helping you maintain a level head during times of market stress.

If you suspect your personal investing bias and emotions are interfering with your investment decisions, defer to the experts. Ask a financial professional to conduct an objective review of your portfolio, with an eye to performance and your financial goals. Together you can look for opportunities to grow your investments through disciplined investing strategies.

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