Don't let your emotions be your enemy

INVESTING SOUNDS STRAIGHTFORWARD. YOU BUY AN INVESTMENT THAT IS CHEAP, HOPING THAT IT GROWS IN VALUE SO YOU CAN SELL IT FOR A PROFIT. HOWEVER, THERE ARE MANY THINGS THAT GET IN THE WAY OF DOING THAT. ONE OF THE MAIN PROBLEMS IS HUMAN NATURE AND, TO MAKE MONEY, YOU MAY NEED TO OVERRIDE YOUR BASIC EMOTIONS.

While experts will find lots of reasons why share prices may go up or down, stock markets comprise of buyers and sellers. Simply put, when there are more buyers than sellers, the price goes up, and when there are fewer buyers than sellers, the price goes down. The difficulty comes in predicting when people will buy and when they will sell.

This creates a fundamental problem. If there are lots of buyers, then the price will probably be high. While that may sound like a good thing, it may mean that the positive feeling about that investment is as high as it can go and the price is about to fall.

> "One of the funny things about the stock market is that every time one person buys, another sells, and both think they are astute."
>
> *William A. Feather*
> *(1889 – 1981, American publisher and author)*

Running with the herd

As humans we are comfortable running with the herd. For our early ancestors there was comfort in numbers – it helped protect them from predators. However, when it comes to the stock market, following the pack can often be a bad idea. It can lead us straight to over-valued stocks.

This herd mentality can also lead us to panic sell when markets start to fall. The stock market often recovers sharply after big losses. If an investor has panicked and sold out, they will miss that recovery. While it is important to remember that past performance is not a guide to future performance, analysis by Fidelity of average annual returns from the UK stock market over the last 15 years found that those who stayed invested throughout enjoyed returns of 9.3% a year[1] to March 2018. Missing the 10 best days reduced the return to 5.0% and missing the 20 best days resulted in investment gains of 2.4%. Investors who withdrew for the best 30 days saw a return of only 0.2% while those who missed the best 40 days of the period suffered losses of 1.7%.

The same thing happens for investors in collective funds. Research from Morningstar[2] showed that private investors often don't receive the published return from a fund because of their tendency to buy in and sell out at the wrong time. In most cases, they would have been better off just staying invested and riding out the volatility.

Natural biases

All sorts of other troublesome cognitive biases influence our ability to invest successfully. For example, we are vulnerable to confirmation bias; this is where we look for lots of information to confirm our existing prejudices. In today's world, there is plenty of information to choose from – from a tweet to the latest economic data – so we can always find a way to 'prove' what we already believe.

Balancing emotional comfort and investment returns

Humans are naturally over-confident in their ability to be able to predict the future. They also tend to remember past successes rather than previous failures. Researchers at Barclays have shown that investors are constantly making the trade–off between 'emotional comfort' and long–term investment returns[3]. When markets rise higher, investor fear evaporates and they start to worry about missing out on potential gains. Very few people would want to invest just after a significant market crash, yet this may be the best time, because it is when markets are at their lowest and cheapest.

Losses are more powerful than gains

Much of the work in investor psychology has its roots in 'prospect theory', set out in 1979 by Daniel Kahneman and Amos Tversky. This examined the idea that decision making is based on the values and costs that investors associate with gains and losses and not on the likelihood of each outcome.

The loss of £100 is felt far more intensely than a similar-sized gain, which means investors tend to be naturally risk-averse, selling their winning investments prematurely and holding onto losing positions too long, in the hope that they won't need to crystallise the loss. This phenomenon is also seen in people's tendency to hold far too much in cash, even though they may be losing money in real terms, because it feels instinctively 'safe'.

Winning the battle with yourself

How can you overcome your instincts? Being aware of the problem is half the battle. It means you think twice before buying that trendy new technology company or selling out as markets are falling. The best advice is to invest regularly, for the long-term and then – apart from regular reviews to check your portfolio is still suitable for your objectives and attitude to risk – leave it alone as far as possible. In that way, you let compounding do its work. ■

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The value of your investments can go down as well as up and you may get back less than you originally invested.

Please remember that past performance is not a guide to future performance.

Sources:

1. *Fidelity, When doing nothing is best.*
2. *Morningstar, Why are investors failing to benefit from fund returns? 17 July 2017.*
3. *Barclays, Behavioural Finance White Paper, Cycle of investor emotions.*