Navigating the emotional pitfalls of investing

What leads investors to act as they do? Although we would like to believe that all of our decisions are based upon sound judgment, it's easy enough to conclude that emotions may play a role in the decision-making process. In fact, an entire academic field, behavioral finance, has emerged in recent years in an attempt to explain how emotions and cognitive errors influence investors and the decisions that they make.

The current roller-coaster ride

Of course, it's not easy for even sophisticated investors to remain in total control of their emotions given the recent volatility in the markets. After all, the Dow Jones Industrial Average took but three months to jump from 13,000 to its all-time high of 14,000.41 on July 19—only to give everything back by three weeks later. It's only natural that some investors bolstered by the upswing have been made uneasy, to say the least, by subsequent events.

But, as Warren Buffett has been quoted as saying: "You have to be able to control yourself; you can't let your emotions get in the way of your mind." Doing that requires recognizing the feelings that lead you to act in a certain manner.

Taking your emotional pulse

What are the most common emotional responses that can lead investors to make mistakes?

Acting rashly. It's easy to panic when you see the value of your portfolio fall precipitously. But all buy and sell decisions should be made calmly, based upon reflection and not upon a knee-jerk reaction. Neither hunches about where the market might be headed nor the casual advice of family or friends should play a role in maintaining your portfolio.

Avoiding action. The converse is true as well. Have you ever made a sell decision in your head, yet failed to act upon it? Procrastination is a fairly common problem for investors—common enough that psychologists who counsel financial advisors have put a name to it—"divestiture anxiety." Some behavioral finance professionals theorize that investors are affected deeply by whether their investments were bought for more or less than the current price. Selling brings on such emotions as pain, regret and even embarrassment—feelings that everyone seeks to avoid.

Giving too much weight to recent market activity. It can be dangerous to draw conclusions based upon current events. Typically, says Robert J. Shiller, a notable figure in behavioral finance, people give too much weight to recent experience and extrapolate recent

trends that are inconsistent with long-term trends and statistical odds. As a result, they tend to become more optimistic when the market rises and more pessimistic when it falls.

Seeking safety in a crowd. The "herding" instinct is a strong one. It may feel wrong in one's mind to deviate from group consensus. That reminder is an important one, and a good way to wrap up this discussion: Your approach to investing has to be *individualized* and must reflect your personal circumstances and goals. Therefore, it is your own knowledge and interpretation of events and conditions, as well as the guidance of professional advisors, that, in the end, will serve you best.

(September 2007)

© 2007 M.A. Co. All rights reserved.