

Investing Without Emotion

By Louis E. Conrad II

- ▶ According to Warren Buffet, the highly regarded investor and chairman of Berkshire Hathaway, "success in investing doesn't correlate with IQ....Once you have ordinary intelligence, what you need is the temperament to control the urges that get other people into trouble in investing....successful investing requires something perhaps even more rare: the ability to identify and overcome one's own psychological weaknesses."

Emotionally-based investment decisions tend to lead an investor away from the old Wall Street adage of buy low, sell high. Instead, during periods of market turmoil and weakness, investors who let their emotions dictate their actions respond by selling their riskier positions after the market has already sold off, thereby missing the inevitable rebound. In addition, selling out of an asset class, while thought to be a means of reducing risk, actually increases a portfolio's risk due to its reduced diversification.

As Warren Buffet suggests, investors are challenged by their own emotions in making good investment decisions. In fact, a study conducted by Dalbar, a provider of financial services industry research, found that the average investor dramatically underperforms broad stock and bond indices, with stock returns lower than the rate of inflation.

A slew of psychological challenges face each investor.

Rearview Mirror

This is my unscientific, but descriptive phrase of what behavioral finance calls "anchoring" and "recency bias." Too many investors expect that what has most recently occurred will continue to occur. For example, in the late 1990's, many investors expected the dot-com and Internet-related stocks would continue their parabolic ascent, though many such companies were likely years away from turning a profit. Investors were, in effect, looking in the "rearview mirror" and optimistically expecting that the past stock appreciation, though consistent with a bubble, would continue indefinitely.

One consequence of investors extrapolating the market's contemporary experience into the future is that they overweight the asset classes, sectors, and individual securities that have performed well recently rather than looking prospectively and making a sound judgment as to what will perform well in the future based upon a rational assessment.

Confirmation Bias

Related to anchoring, confirmation bias is placing greater weight on information that supports what you already believe (or want to believe), as well as discounting information that does not support your view. Many investors were easily taken by the prospects of dot-com stocks, rather than critically evaluating their prospects based on realistic growth and valuation metrics.

Return Asymmetry

One of the more interesting perspectives that some investors have is that they would like to enjoy the upside of stock investing, but are unwilling to accept the downside potential of such investing. Unfortunately, to obtain the greater returns offered by stocks, you need to accept the greater risks that accompany them—stock returns are not asymmetric!

Loss Aversion

No one prefers to lose money and, not surprisingly, investors avoid losses like the plague. Yet losses are part of the normal investing experience, though you obviously expect your gains to occur more frequently and with greater magnitude than your losses. Many investors habitually focus more on their money-losing holdings than on their holdings that have performed well. Certainly you should review underperforming holdings, but many investors are unable to distinguish between a bad decision and a bad outcome. Often a reasoned decision was made initially, but a bad outcome may still result. Such is the life of an investor!

To avoid being overrun by emotions, COMPASS Wealth Management designs portfolios with a structure that incorporates a client's goals, investment time horizon, etc. By consistently following a disciplined process, the chances of creating the wealth necessary to meet a client's financial goals are improved.