Emotions and investing don’t mix

GOLDBLOOM Wealth Management, LLC

- Emotions and investing don’t often mix well.
- Investing is difficult, and being human makes it even more challenging. Even the smartest people can make emotional judgments when it comes to investing.
- This week’s piece addresses some of the common emotional biases we face and some techniques to counter the potential effects.

Mixing emotions with investing

As humans, we are innately emotional beings, and we sometimes react to those emotions irrationally. As such, we are all susceptible to cognitive and emotional biases. These biases may cause us to make choices in situations where we don’t know all the answers, or to make decisions based on our emotions – both of which can lead to errors in judgment. Because we are emotional beings, it is no surprise that we don’t always make the most logical decisions.

Human behavior has become an increasingly important topic in the world of investing. In fact, an entire field of study known as Behavioral Finance has emerged that focuses solely on the impact of human psychology on investing behavior. Although this may sound like fiction, there is convincing science behind it. The research incorporates finance, psychology, and neuroeconomics, which is a relatively new field of study that looks at the impacts of finance on brain chemistry.

How can behavioral bias affect us?

Simply put, behavioral biases can lead us to make poor decisions about our investments. For example, emotional reactions to market volatility could cause an investor to assume too much or too little risk to meet their investment objectives. Being overly sensitive to market movements can also lead to erratic trading activity, such as buying and selling too frequently. Regardless of the form these biases take, they all have the potential to put investors in a position where they end up farther away from achieving their goals.

What are some common biases?

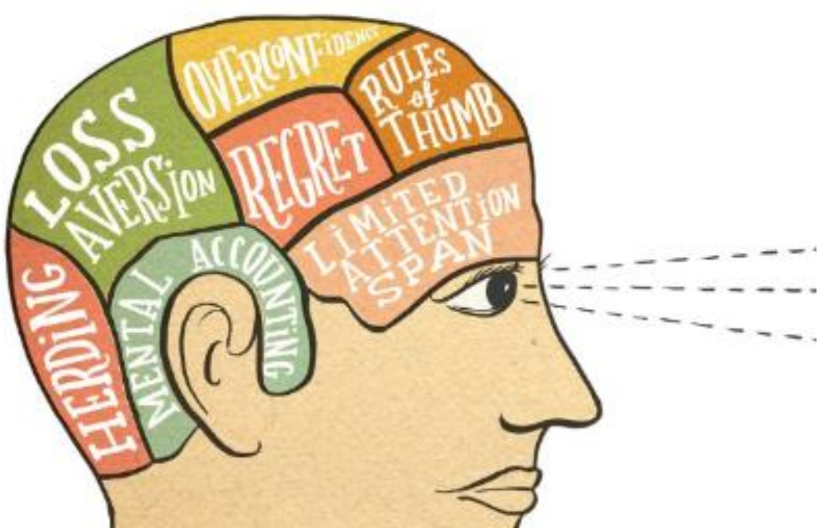
One common trap investors fall into is known as overconfidence bias, which is the overestimation of one’s actual abilities. In investing, this translates into investors’ tendency to overestimate their ability to pick winning investments. With this bias, there may be an illusion of having superior information or mistakenly believing we’re capable of interpreting available information beyond our actual ability. Common traits of overconfidence bias are underestimating risk and overestimating return: If I’m certain a particular stock is going up, why not go all in? This mindset could lead to a lack of diversification and excessive trading, which in turn could result in higher trading costs and lower overall returns.

Another common bias is loss aversion, which causes investors to make irrational decisions solely to avoid losses in their portfolio. At first, this may sound like a perfectly rational thing to do – after all, no one wants to lose money. However, sometimes we must experience short-term pain to achieve our long-term goals. For example, if an investor buys a stock and later realizes that the stock is a loser, he or she may avoid selling it just to avoid coming to terms with a loss. Instead of selling the loser and buying a new potential winner, the goal may then become getting back to even. To speed up the process of getting back to even, the investor may take on more risk – just as a gambler tries to make up for losses by placing larger bets.

Sometimes the opposite happens, too: Investors may sell winning stocks too early just to realize the short-term gain, even though they could have generated additional gains by holding the stock longer.

Regret aversion – the bias that motivates investors to avoid feeling regret – is best illustrated by an investor's decision to do nothing to avoid regretting a decision. For example, an investor debating whether to buy a given stock may avoid the purchase altogether to ensure there is no chance the stock will lose value. In this scenario, the fear associated with possibly making the wrong decision is greater than that of doing nothing at all. One effect of this bias is excessive conservatism, which is remaining invested in less risky assets due to the lower risk of loss, even if more risk is appropriate. This concentration of low-risk, low-return investments can lead to long-term underperformance.

A further extension of regret aversion is known as herding behavior, whereby an investor jumps on the bandwagon and invests in the latest popular trend. If the outcome is unfavorable, the whole group is wrong, and the individual investor is not singled out of the party. Bitcoin is a recent phenomenon that could be defined as herding behavior.



Source: Explara.com

What are potential solutions?

Behavioral biases can be difficult to overcome because they are an inherent part of our psychological makeup. The good news is, there are strategies advisors can employ to help investors keep their emotions in check. Learning to recognize the signs of emotional behavior and cognitive deficits is a crucial step. After all, it's virtually impossible to correct harmful behavior if you are unaware of the signs. Simply having the background knowledge that an investor may be susceptible to these common biases can be extremely helpful when managing investments. It's especially important to understand that each investor is different and some individuals may be more prone to certain biases than others.

Strategies such as goals-based investing and behaviorally modified asset allocation may help. These are frameworks that attempt to provide guidance for the emotionally-biased investor. The process is similar to what golfers may do when they keep slicing the ball to the right: To compensate for the mistake, they start aiming farther left.

Working with a professional investment advisor to create a custom-tailored plan may also help investors avoid irrational decisions based on short-term fears and misperceptions. Of course, financial professionals are also human and subject to biases themselves. However, a knowledgeable professional can help investors organize and define their investment goals, as well as help recognize behavior that can be potentially destructive to building wealth. Additionally, many advisors can provide behavioral coaching to help keep investors' long-term financial plans on track.

The bottom line

Human emotions often have the potential to derail investment plans. Behavioral Finance has helped the investing community identify the challenges presented by common behavioral biases, as well as bring potential solutions to the table. The first step to help avoid falling into these traps is being aware of how our emotions can impact our behavior. Greater awareness can help start us on the path to making more rational investing decisions, which may ultimately help us overcome the potential negative effects of mixing emotions with investing.