

The Emotional Side of Investing

In recent months, volatility in global equity markets have increased, with indices like the Dow swinging more than 200 points in a single day and the Hang Seng moving in the 1000-points per day range. Such market gyrations can cause emotions in investors to run high, and if not properly managed, these emotions can be an investor's worst enemy.

Gary Halbert¹ in his article on "The Science Behind Buying High and Selling Low" notes:

"Many investors bail out of the markets when they are well into a steep decline, often selling at or near their lows. Then they are hesitant to get back in until it seems clear to them that the trend is higher, but that is often after the market has moved up for an extended period of time. Selling low and buying high."

In a similar fashion, Jason Zweig² in his book "Your Money and Your Brain", made this observation:

"... our investing brains often drive us to do things that make no logical sense – but make perfect emotional sense. That does not make us irrational, it makes us human."

It has been established in behavioural finance that emotional decision-making is very much the default option for our brains. However, if emotions go unchecked, it could often lead to decisions that may not be in our best interests. The emotional side of investing is more complex than just fear and greed. Interestingly, neuroscientists have recently uncovered two particular behavioural traits of significance to investors³:

"The first is that we are hard-wired for the short term. We tend to find the chance of short-term gains very attractive. They appear to stimulate the emotional centers of the brain, and release dopamine. This makes us feel confident, stimulated and generally good about ourselves. The second is that we appear to be hard-wired to herd. The pain of social exclusion (i.e. betting against anyone else) is felt in exactly the same parts of the brain that feel real physical pain."

Perhaps now we can begin to understand why we sometimes succumb to our tendencies to focus on the short-term and follow herd instincts. Some pointers that may help in keeping emotions in check when investing, particularly over short-term market turbulence, are:

Know your comfort zone of risk. Risk and return go together. While some investors aim for higher returns, they cannot emotionally handle the higher risks and volatility that come with it. It is important then to define your own comfort zone of risk and invest up to your sleep level.

Think long term. Invest for the long term and focus on the big picture. Studies have shown that bull markets generally last longer than bear markets.⁴ Investors who take a long-term view should be better able to ride out volatile markets.

Avoid the herd mentality. Know yourself, your needs and objectives. Do not blindly follow what the 'crowd' is doing. It may not be suitable for your needs or situation.

Notes:

1. Gary D. Halbert, *Forecasts & Trends E-Letter*, September 25, 2007
2. Jason Zweig (2007), *Your Money and Your Brain: How the New Science of Neuroeconomics Can Help Make You Rich*, Simon & Schuster
3. James Montier (2007), *Behavioural Investing*, John Wiley & Sons, Ltd
4. Jack Schanep, *The Bull & Bear Bell Curves, Schanep Timing Indicator & The Dow Theory.com*