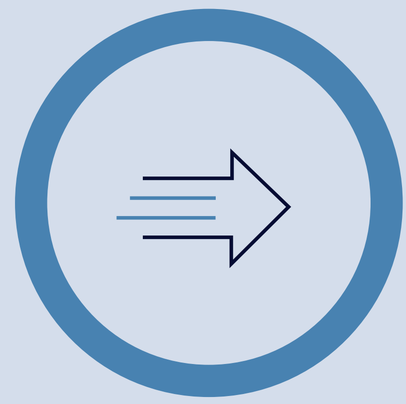
Don't let emotions control your investing



When financial markets experience ups and downs it can be worrying for investors, which can lead to investing mistakes. Having an understanding of the role emotions play when investing can help you avoid making decisions based on feelings.

A difficult year for investing

It's been a difficult year so far for investors, with equity markets falling amid soaring inflation, rising interest rates and the war in Ukraine. The S&P 500 posted its worst first half of the year since 1970, while other major indices have also dropped sharply. With global economic growth slowing, there are now fears we could see major economies slip into recession. The good news is that markets have started to make a tentative recovery, although they are still well below where they were last year and uncertainty remains high.

When markets fall it's easy to act on emotions, especially if money is on the line. For many investors, their portfolio represents their hard-earned savings over many years and/or impacts the lifestyle they might have in retirement, for example. As a result, a lot of emotion tends to be tied to the value of investors' portfolios.

Acting on these emotions, however, can lead to poor investment decisions that could end up backfiring. If you want to capture the best returns over the long term, you need to park your emotions and stick to the plan set out by your financial adviser. Understanding how emotions affect your investment decisions can stop you making mistakes, helping to secure your long-term financial future.

Understand the cycle of investor emotions

While many of us wouldn't like to admit it, emotions can be a driver of investment decisions, especially when markets are volatile. However, allowing emotions to get the better of you can lead to buying high (for example, when markets have already risen) and selling low (when markets have already fallen), making it difficult to stay on track and achieve long-term financial goals.

There's a wave of emotions we experience in response to market conditions, so understanding how they work can help you make better investment decisions in the long run. While going through a cycle of emotions is only natural, the challenge is how you react to the peaks and troughs, especially when the market falls.

Initially as investors we start out as optimistic, with our emotions becoming increasingly positive as markets rise (figure 1). As investments start to significantly increase in price our emotions intensify and we become excited and thrilled about the prospect of even greater returns. However, by the time investors have become optimistic and excited about the markets, most of the big gains have already been made.

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If, however, an investor waits for the point when they feel most assured about markets, they would have missed out on the best long-term gains as they would be buying when prices are high. Instead, it's always best to invest as soon as possible so your money can start working over a longer period of time. When we are at the top of the cycle we experience euphoria, but this is also the point of maximum financial risk. In this stage, investors think they can beat the market and everything they touch will turn to gold – even though the best gains have already passed.

The next phase of the cycle begins when the market fails to meet our expectations and starts to fall. At first, we anxiously watch as our investments lose money, telling ourselves that the dip is just a temporary setback as denial takes over. As the market declines further, reality begins to hit home, and these emotions turn into fear, desperation and panic. As losses continue to build, many investors will eventually reach a point of capitulation and finally exit the market altogether. Those who persevere could become despondent, wondering whether markets will ever recover.

Ironically, it's when you feel most discouraged about your investments that you have the most to gain as this is the point of maximum financial opportunity. Feelings of despondency might make you want to throw in the towel when the market is down, but you should avoid the urge to sell when your portfolio is worth the least.

Instead, this is the time to consider adding to your portfolio if you are able to, as prices are at their lowest. As the market begins to recover you feel hopeful it will continue to climb. Regaining your optimism you once again feel hopeful about your investment opportunities. If you try and let emotions run your investment portfolio, it may be that you end up exiting the market once capitulation kicks in, crystallising the losses you have already made and missing out on the recovery.

Figure 1: The cycle of investor emotions

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Stay vigilant in bear markets

Bear markets are a breeding ground for emotions-based investing. They occur when there is a dip in the price of assets of at least 20% or more from their recent market highs, lasting for at least two months. If you imagine how you'd feel if your retirement 'pot' decreased in value by 20%, it's no surprise that bear markets can transform our decision making. Notable examples of bear markets include the dotcom bubble bursting in 2000 and the financial crisis between 2007 and 2008.

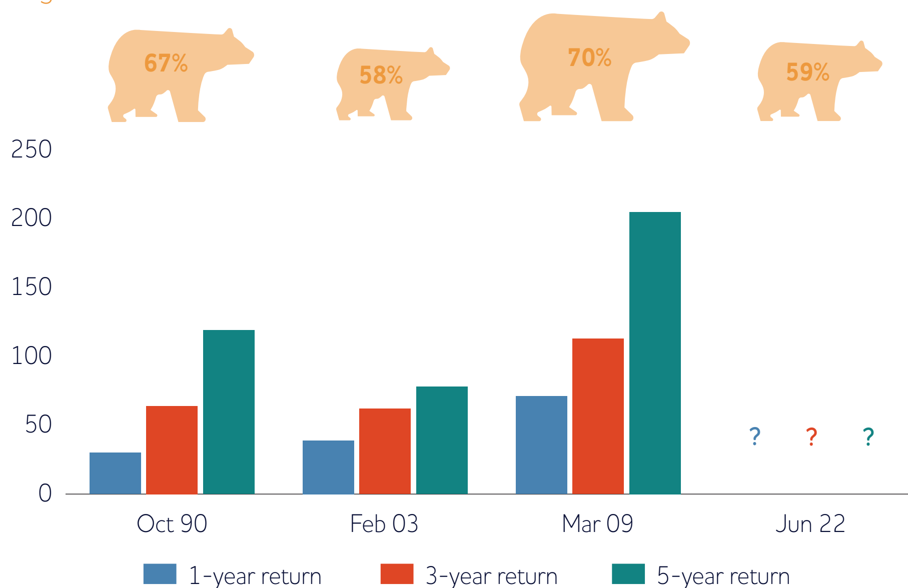
When a bear market hits, our ability to make rational decisions can quickly be overwhelmed by the negative emotions we experience. A bearish market can make investors more risk averse and want to sell. But if investors act on these emotions they could end up missing out on long-term gains.

For example, in March 2009, as the financial crisis was coming to an end, bearish sentiment – the percentage of investors that think the market will trend down – was extremely high at 70% (figure 2). Investors that acted on their emotions and sold would have missed out on an increase in the S&P 500 (the US stock market) of 205% over the following five years, highlighting the importance of staying invested.

Investor sentiment currently remains shaky, with the percentage of investors who are bearish at 59%, although if things get worse this could go even higher. While past performance is no guide to future returns, markets tend to give you strong returns in the years after maximum pessimism.

Figure 2: Increase in returns of S&P 500 after periods of bearishness

Investors that acted on their emotions would have missed out after the financial crisis



Source: American Association of Individual Investors, Bloomberg.

How to avoid the cycle of investor emotions

While there are no easy or failsafe measures to reduce the impact of emotions during difficult market conditions, there are some steps you can take.

1. Temper your optimism

As you start to become more excited as the market picks up after a downswing, it can be easy to think that investing in the stock market is a sure thing. However, as investors have previously learnt to their cost, being overly optimistic during the good times can be just as dangerous as being pessimistic during the bad times. The best approach when markets are riding high is to be realistic and temper your optimism. Make sure you talk to your financial adviser, review your plan on an ongoing basis and find a comfortable balance between risk and return.

2. Stop checking your investments daily
If you stop tracking your investments on a daily basis this will help reduce the emotional impact of market volatility – the normal ups and downs of the market. If you frequently check your portfolio you might feel the need to make adjustments if there is a sharp downswing, which could crystallise your losses that you would have made up over time. It may be tempting to try to second guess the market, but in the long term it's always best to stay invested.

3. Look to history
From wars to global recession, there have been plenty of economic shocks throughout history. But no matter what happens to the global economy, markets always go on to deliver impressive returns in the long term. Understanding the market cycle and historical economic trends can help ease the excitement or fear you feel when the market moves.

4. Block out the noise
There is a consistent stream of news and stories about what's going on in the markets, which can easily influence your investment decisions. When markets fall, the media headlines can be a huge source of stress and anxiety (remember, bad news sells!). It's important to filter out the noise to help keep your emotions under control. While it's good to keep abreast of the news, it shouldn't be the driving force of your decision making. Focusing on your long-term goals – such as saving for retirement or your children's education – can also help ensure you aren't distracted by current events.

5. Speak to an adviser
Speaking to an adviser will give you a better understanding of what's going on. Many advisers have been through multiple market cycles and experienced difficult periods before, so they will be able to help you see the bigger picture. As they are not emotionally involved, they can give you an objective opinion – helping you to navigate choppy waters and avoid making any impulsive decisions.

Base your decisions on facts

Gaining an understanding of how your emotions work is the first step in overcoming their influence on your investment decisions.

The best investors are not emotionally tied to their investments and instead base their decisions on facts rather than their instincts. Remember that markets always recover so keep a cool head and stay invested. An adviser can help guide you through any ups or downs in the market and reassure you if you have any worries.

Our portfolios are diversified to help spread your investments around to limit exposure to any one type of asset and help reduce volatility. As a result, you're not vulnerable to just one market's performance.

Find out more

As always, the best thing to do when you are feeling nervous about your portfolio is to stay calm and speak to your financial adviser, who will be able to assess your portfolio against your long-term objectives.

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