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focus

Investors beware: Self-inflicted pain can hurt the most

If you asked “what’s the biggest driver of an investor’s long-term returns?” we suspect most people would guess it’s which investments they own or how the overall market performs. These obviously do have a significant influence. However, there is another factor that studies conclude is even more important — how an investor behaves, or more accurately, how they manage their emotions.

FORSYTH BARR

...people dislike losses a lot more than they enjoy gains...

Research has identified many human traits and emotions that can hurt investors. An important one is loss aversion — the fact that people dislike losses a lot more than they enjoy gains. Unfortunately, the risk that loss aversion damages our long-term returns becomes heightened during periods of market stress like now, the most inopportune time.

What makes us tick?

> *"The psychological mood of people changes more drastically than anything else in finance. Human nature changes least of all."*

Benjamin Graham, professor, economist, "father of value investing"

Humans are emotional. Not all our behaviour is rational. The field of behavioural economics combines psychology and neuroscience with economics to understand how and why people make the decisions they do. This relatively new school of study contrasts (often sharply) with the concept of a "rational economic man" that underpins much of traditional economic theory — the notion that people always make decisions based on dispassionate rational analysis.

The most famous work in the field was undertaken by two Israeli psychologists Daniel Kahneman and Amos Tversky in the 1970s and 80s. (Their contributions were recognised with Kahneman being awarded the Nobel Prize in Economics in 2002 – unfortunately Amos Tversky passed away in 1996.) The pair explained why people's decision-making is not completely rational and how it's affected by emotions, biases, and heuristics (mental shortcuts that have been hardwired into our brains over hundreds of thousands of years).

"Losses loom larger than gains"

One of Kahneman and Tversky's key early conclusions was that people are loss averse. This means a person's aversion to losing something they already have outweighs the pleasure that they get from gaining something new of equivalent worth. They estimated that the aversion is about 2¼ times greater, meaning the hurt from losing $1000 is about 2¼ times more than the joy we get from winning an equivalent $1000.

The theory why humans are hardwired to be loss averse reflects back to our time as hunter-gatherers — the loss of food or shelter could be fatal, while gaining a bit extra simply provided a little more comfort.

Loss aversion can negatively impact investors. Kahneman and Tversky found that the more a person checks their investment portfolio the worse their portfolio typically performs. Why? Because the more often someone looks the more they experience the pain of down days. Day to day markets are volatile. On any single day it's

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close to a coin flip as to whether you'll see a gain or loss – over the past 20 years 55% of days have been up, while 45% have been down. However, because markets tend to move up over time, the less often you look at your portfolio the more likely it will have gone up. Over that same period if you'd checked your portfolio only once every six months, around 73% of the time it would have been up, with only 27% down.

As a result, investors who look at their portfolio more often tend to take less risk, wanting to avoid those painful down days. Less risk means, over time, lower returns. One of the reasons some people feel more comfortable investing in housing is that they can't check the price daily and don't feel the hurt of regular down days.

Loss aversion compounds during periods of market stress

Unfortunately, loss aversion tends to conspire against us during volatile times. During these periods many investors tend to focus more on their investments. It's hard not to! The media loves dramatic headlines. It can be hard not to feel emotional, especially if you're facing a steep loss. And nowadays it's so easy to instantly check portfolios online. Often, this combination of increased focus on the portfolio, plus the pain from regularly seeing those losses (which, remember, hurts 2¼ times more than the equivalent gain), results in investors overreacting and often selling out at inopportune times.

How do you avoid making rash decisions?

> *"A lot of people with high IQs are terrible investors because they've got terrible temperaments. You need to keep raw, irrational emotion under control."*

Charlie Munger

> *"We don't have to be smarter than the rest. We have to be more disciplined than the rest."*

Warren Buffett

First and foremost the main way of avoiding psychological traps is to follow a long-term investment plan. This plan should reflect your risk tolerance, investment horizon, and long-term goals. Sticking with this plan can help you prevent panic-selling when markets are challenging.

It's important to keep events in perspective. Up until this year markets had had a great run. 2022 has been difficult with the lingering effects of COVID, soaring inflation, and a war in Europe. But it's far from the first time the world has faced challenges. Markets have navigated all sorts of crises through the decades and have always emerged intact on the other side.

Stop looking at your investment portfolio every day, every week, or even every month. We appreciate that isn't easy, but if your long-term objectives haven't changed it's unlikely scrutinising your portfolio will achieve anything except raise your anxiety levels. Short-term market movements are almost never a good reason for deviating from your investment plan.

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If you're still feeling stressed and can't sleep at night it probably means you're carrying too much risk. You should probably reduce the portion of higher risk assets like stocks in your portfolio. It will likely mean lower long-term returns, but it's worth it if it makes you more comfortable with your portfolio.

And remember to lean on your adviser. The evidence is that people who work with an adviser do, on average, earn higher long-term returns. A key reason for this is having someone to talk to before you act reduces the chance you'll do something rash you might later regret.

Further reading

Loss aversion is only one human emotion that can hurt you as an investor. There are others. For those interested in understanding more about Behavioural Finance and the emotional traps that can trip you up, here are a few books you might find of interest.

- *The Little Book of Behavioural Investing: How Not To Be Your Own Worst Enemy*, by James Montier
- *The Psychology of Money*, by Morgan Housel
- *Why Smart People Make Big Money Mistakes*, by Gary Belsky and Thomas Gilovich
- *Thinking, Fast and Slow*, by Daniel Kahneman

Matt Henry
Head of Wealth Management Research

If at any time you want to discuss investment options and opportunities, your Forsyth Barr Investment Adviser is available to provide you advice and assistance.

0800 367 227

forsythbarr.co.nz

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