Coping with investor emotions

Applying discipline is half the battle

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By Kim Inglis

The average investor underperforms virtually all other traditional asset classes, even when inflation increases are included. J.P. Morgan, comparing 20-year annualized returns by asset class, found the average investor rings in at 2.1% compared to the S&P 500 Index at 8.2%. This underperformance is largely attributed to behavioral finance, when emotions influence investment decisions. Fortunately, a disciplined approach to investing can help avoid that effect.

Studies show that investor emotions are both predictable and in sync with market cycles. During a bull market, investor emotions have an upward trajectory from positive to confident, then thrilled with a peak at euphoric. When markets fall, emotions follow. They track downward, running the gamut of surprise, nervousness, worry, and desperation. This descending emotional path ends in panic and defeat. As markets bottom out and start to regain some steam, investors become hopeful and encouraged, cautiously re-entering the market. Then, the cycle repeats.

When emotions rule, investors exit their investments at the bottom. They wait, hoping they can predict the perfect time to buy, but never actually pull the trigger and they miss out on the biggest gains.

That's because it is almost impossible to time the market. Proven research on market timing, by Nobel laureate William Sharpe, found a market timer who switches between 100% stocks and 100% T-bills on an annual basis has to be correct about 74% of the time (on average) to beat the market.

The markets move fast and an investor who reacts to short-term noise invariably loses. Consider an investor who sold their Royal Bank stock during the financial crisis when it dropped to $25. Another investor, who held onto the position, would've been back to $50 within five months. Now the stock is in the mid-nineties, or over 280% higher than it was during the financial crisis.

The first step in keeping emotions in check is to create an Investment Policy Statement (IPS), which establishes rules for making investment decisions and encourages the discipline required to stick to those rules. Clear rules are important, as they facilitate a calm assessment of hard facts and ensure appropriate reactions to new or changing information. Investors remain emotionally neutral, ultimately making them more likely to buy low and sell high.

The next step is to build a portfolio that employs a disciplined strategy. It's half the battle because a clearly defined buying and selling strategy removes emotion and irrational decision-making.

Similarly, factor-based strategies can help maintain portfolio discipline. According to MSCI Inc., long-term equity portfolio performance can be explained by certain key factors. They include value, low size, low volatility, high yield, quality, and momentum. Adding discipline brings transparency to allocations, which ultimately helps alleviate manager 'style drift' and has positive implications for risk management.

The most successful investors do not allow emotion to affect their investment decisions. They

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create rules, document them in a comprehensive IPS, and choose investments based on those criteria.

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