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Emotions a hazard to portfolios

Discipline is the key to success

Investor emotions are a portfolio's worst enemy. Fortunately they are also predictable, following a route in sync with market cycles.

The peak is the middle of a bull market, when investors are most optimistic. The trough is during a bear market, when investor emotions are correspondingly low. The markets and investor emotions both reach their peaks after experiencing increasingly positive indicators, and they both hit bottom after a growing series of negative signs.

However, investors will typically make better decisions if they have their emotions out of phase with market cycles. Ironically it is at the peak of market cycles, when investors are happiest, that they are at maximum risk. Conversely it is at the bottom of the cycles, when investors are most despairing, that they have the greatest opportunities.

An example of this phenomenon began in 2007. Investors had become so accustomed to good returns that they viewed 20% performance as "average". Euphoria reigned. Attracted by increasingly higher returns, investors shifted away from cash and fixed income holdings and into progressively overweight and risky equity positions. They had very little buffer for volatility.

Few investors acknowledged the underlying risks and, in the crescendo of excitement, they ignored signs that typically characterize the top of the markets. Alarm bells started ringing, but contrary opinions were ignored.

As negative news continued, investor anxiety rose. Although nervous about the cooling markets, investors were hesitant to make drastic changes. They still hoped that blue skies were on the horizon, and continued to ignore warnings.

Quickly though, the markets took a turn for the worse and investors entered a period of denial. At this stage, it was clear that the bubble had burst but very few were willing to acknowledge the signs and accept the reality.

As the markets declined further, fear grew. Investors became desperate and started to panic with stronger and quicker emotional responses. The markets experienced 800-point moves as investors capitulated and entered "sell everything" mode.

After the dust settled, investors became despondent. They lost interest in the markets completely and focused their attention elsewhere. They became depressed over their losses and negative about the markets. Sadly, most then missed the ensuing rally.

As the economy started turning around, investors cautiously re-entered the markets. They first opted for conservative blue-chip investments and have slowly started to delve into other areas. Eventually, investors will enter a period of relief and once again feel comfortable with their portfolios. However, they must avoid another cycle of emotional reactions.

Since investor emotions are predictable, they should also be manageable. Managing them requires two

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things: a set of rules to guide investment decisions, and the discipline to stick to the rules.

Rules allow the proper assessment of hard facts and ensure rational reaction to new information, including factors as such as net assets, revenues, profit margins, debt, dividends and cash flow. Along with expectations for each of these factors, rules should include a margin of safety to allow for unpredictable variables like company earnings. Adherence to selection standards should be accompanied by ongoing scrutiny. A company's fundamentals can change negatively which requires stop-loss rules to exit positions.

Then, with rules clearly laid out, the plan needs to be followed. Investors who discipline themselves to remain emotionally neutral and stick with their rules, are more likely to be buying low and selling high in the market cycles.

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