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Keep your emotions in check

Fight impulses and stick to rules when investing

A BMO Psychology of Investing report revealed some worrisome data on investor emotions that included; two-thirds of those polled have not been in total control of their emotions when investing and; a majority of Canadians have invested on impulse at least once.

That’s bad news for portfolios because investor emotions are 180 degrees out of sync with market cycles. At the peak of market cycles, when investors are happiest, they are at maximum risk. Conversely it is at the bottom of the cycles, when investors are most despondent, that they have the greatest opportunities.

According to a Gerstein Fisher Research Center analytical paper, the average investor's performance in an asset class lagged the average performance of the asset class itself by an average of 1% per year over the previous fifteen years, based on net investor mutual fund cash flows. Undoubtedly, some of that poor performance would have been due to irrational extremes of hope and fear.

Warren Buffett said it best: “Only when you combine sound intellect with emotional discipline do you get rational behavior.” In other words, if investors do their research, and don’t let market exuberance rattle them, they are more likely to make sensible investment decisions.

The good news is that investor emotions are quite predictable, which means that managing them should be possible. It requires two things: a set of rules to guide investment decisions, and the discipline to stick to those rules.

Emotions can be removed from the equation by creating an Investment Policy Statement that sets parameters for making investment decisions, and encourages the discipline required to stick to the rules. Clear rules facilitate a calm assessment of hard facts and ensure proper reactions to new or changing information. Investors remain emotionally neutral, ultimately making them more likely to buy low and sell high.

Rules allow the proper assessment of data and ensure rational responses to new information, such as changes in 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. Sticking to to selection standards should be accompanied by continuous scrutiny. A company's fundamentals can change negatively which requires stop-loss rules to exit positions.

Investors who fight their impulses, and stick to their rules, will not be chasing prices upward in bull markets or be afraid to buy when the bear is about. Those who can’t master their emotions are destined to do the opposite and, as a consequence,

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lose money by entering before losses and exiting before gains.

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