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Keeping emotions out of your portfolio

Investor emotions are a portfolio's worst enemy

According to a Gerstein Fisher Research Center analytical paper, investors chase returns and, in doing so, create the conditions of their own demise. The study found that the 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.

Investor emotions are a portfolio's worst enemy because investors will underperform when they allow emotions to dictate their investment approach. Nervous investors are much more active than necessary, ultimately losing money by entering before losses and exiting before gains. Warren Buffett sums it up nicely, "For investors as a whole, returns decrease as motion increases."

Investor emotions follow a predictable route generally in sync with market cycles. The markets and investor emotions both peak after experiencing increasingly positive news. Joyful investors buy late because they believe the trend is predictive. Likewise, markets and emotions both hit bottom after a growing series of negative signs. It is then that nervous investors sell and exit although opportunity is greatest. Fortunately, just as investor emotions are predictable, they can also be managed.

One of the best ways to keep emotions out of the equation is to create an Investment Policy Statement (IPS) that sets parameters for making investment decisions and creates the discipline required to stick to the rules. And, clearly laid-out rules are important as they facilitate a calm assessment of hard facts and ensure proper reactions to new or changing information. Investors remain emotionally neutral which ultimately makes them more likely to buy low and sell high.

Investor emotion can also be removed from the process by setting up a discretionary portfolio with the day-to-day investment decisions delegated to a Portfolio Manager (PM). This differs from traditional, non-discretionary accounts where clients make final trading decisions. Instead, investors give the PM full investment discretion over the portfolio, allowing the PM to act on available information quickly and efficiently, buying or selling positions when he or she sees fit.

This arrangement also helps with profit taking. Many investors find it easy to buy positions, but difficult to sell when the time is right to pull the trigger. Such sentiment is removed from the equation when the PM is making the decisions.

A BMO Psychology of Investing Report found that two-thirds of those polled have not been in total control of their emotions when investing. A majority of Canadians have acted on impulse at least once. Investors like these have to establish rules or get advice that takes emotion out of the

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picture. If they cannot remain rational and focused on the horizon, they will not accumulate sufficient funds to meet their long-term goals.

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