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UNIT TRUST CORPORATION

ADVISORY SERVICES DEPARTMENT

Newsletter

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Q1 2018 | Issue 13

HOW EMOTIONS CAN AFFECT INVESTMENT DECISIONS

Emotions & Investment Decisions

The process of determining which securities should be part of their investment portfolio is usually considered by many people to be an analytical one which is guided by strategic and methodical decisions. However, this is not always the case as emotions can play a significant role in this process and can sometimes be one of the strongest influences on your investment choices. At times, your emotions can even override important factors such as rational reasoning, common-sense and logic. Therefore, an essential trait of any successful investor is the ability to keep their emotions in check.

"Emotional investing" is the term used when investors make drastic decisions about their money and assets based on how they feel the market is currently performing instead of focusing on their long-term performance.

According to a study by *Science Magazine*, during times of financial stress people lose 13% of their IQ points and make rash decisions.

All markets go through cycles which are practically impossible to predict. Studies have shown that there is also a cycle of typical emotions that occur simultaneously. It is known as the Market Cycle of Emotions.

The Market Cycle of Emotions

This cycle illustrates the emotional aspects of investing. It shows the ebb and flow of a typical market cycle: the market rises, peaks, declines, bottoms-out and then begins to rise again.

At each point along the cycle, investors make specific trade-offs between emotional comfort and long-term returns. The typical emotions that investors experience as market conditions vary are explained below:

The Upturn

Your investments grow and so does your confidence. When market returns are favorable, investors usually experience feelings such as excitement and euphoria despite the fact that they don't know exactly where the top of the market is going to be.

Point of Maximum Financial Risk

This is at the peak of the market when prices are highest. This is the point in the cycle when one should be extremely cautious. However, investors typically feel over-confident and believe prices will keep increasing; to their peril, they ignore the reality of the inevitable downturn. Additionally, in an effort to gain higher returns, investors often increase the amount invested and switch to more aggressive strategies. Unfortunately, as history has shown time and time again, no bull run lasts forever.

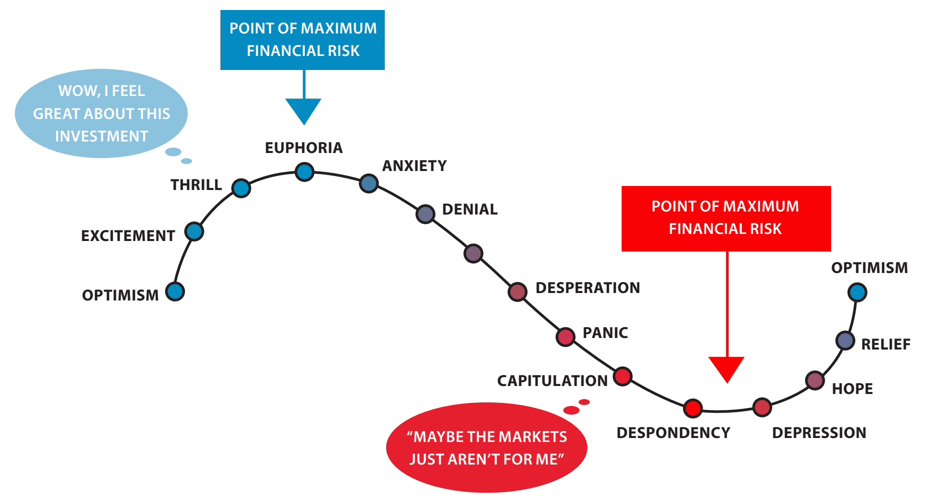
The Downturn

When the market begins to decline, investors usually grow anxious. As the decline continues, they fall into denial and believe what they are experiencing is a momentary setback. When the market slips further, feelings of desperation and panic ensue.

Point of Maximum Financial Opportunity

This is at the bottom of the market when prices are at their lowest. It is also the point when investors tend to be overrun by emotions such as fear and despondency and opt to entirely abandon the market. However, there are three major negatives that occur when decisions are made based on emotions:

The Market Cycle of Emotions



Source: Westcore Funds/Denver Investment Advisors LLC, 1998

1. Losses are usually made and they can be quite significant.
2. Investors are on the sidelines spectating when they should be actively seeking out new investment opportunities.
3. Investors who are waiting to regain the confidence to reinvest generally miss out on the first 1/3 of the next bull market which historically has accounted for 60% of the total performance of that bull trend.

Despite contrary emotions, this is the best time to invest, while buying power is at its highest.

Recovery

As the market shows early signs of recovery, investors are hopeful that the tides have changed and once the uptrend is confirmed relief sets in and they reinvest once their confidence has returned and once they are feeling optimistic that they can make money. This also represents the point at which the cycle has restarted.

As an investor, it is important for you to be aware of this emotional cycle so that you are able to protect yourself from the negative consequences associated with impulsive and irrational reactions to your emotions. It has been shown that investors fail to take full advantage of market opportunities as a result of their emotions.

How to Avoid Emotional Investing

Rather than riding the emotional roller coaster illustrated above, it is more sensible to develop and stick to a wise investment strategy so that in times of uncertainty it can provide perspective and guidance to keep you on track to achieve your long-term financial goals.

The following strategies can help reduce your emotional response to market conditions and thereby reduce poorly timed investment decisions.

- **Dollar Cost Averaging**
  In this strategy equal amounts are invested at a regular, predetermined interval, which is good during all market conditions. During a downward trend, the number of shares you can purchase increases, the prices are cheaper and continue to fall. During an upward trend, despite the fact that you can purchase fewer shares because the price is higher, the shares already in your portfolio are currently producing capital gains. The key to this strategy is to stay the course, even though it can be quite difficult, especially when emotions are threatening to take over. It is essential that you stick to the predetermined strategy and only in drastic circumstances consider revisiting and redefining the established course.

- **Portfolio Diversification**
  This strategy provides downward protection. It can be achieved by investing in different industries, geographical locations, as well as different types of investments such as real estate or private equity. If your portfolio consists of various types of investments, you should be protected across a range of market conditions because the probability of all markets crashing simultaneously is low.

Common Emotional Pitfalls

Your first step to becoming a better investor is to understand how your emotions may have affected previous investment decisions. By becoming aware of not only common, but your personal, emotional and behavioral pitfalls, you can drastically reduce the frequency of these errors and greatly enhance your returns.

The five most common behavioural pitfalls that investors are likely to experience are:

1. **Overconfidence**
   This happens when investors are overly optimistic about their ability to choose the best securities as well as the best times to enter or exit a position.

2. **Loss aversion**
   Loss aversion refers to an investor's preference to avoid incurring losses because the associated pain is more intense than the reward felt from a gain. Investors tend to experience this more intensely during periods of market volatility.

3. **Chasing past performance**
   Many investors fall prey to this pitfall because they select securities that are performing well because they believe that the securities' recent performance will continue to offer robust returns. This, however, is far from the truth as studies have shown that recent performance has almost no correlation to future performance.

4. **Timing the market**
   Investors who use this strategy buy and sell stocks based on expected price fluctuations, i.e., if they can correctly guess when the market will go up and down. However, this is almost impossible to achieve on a regular basis.

5. **Failure to rebalance**
   It is essential for investors to rebalance their portfolios on a regular basis to keep their asset allocation on track and provide the necessary protection from market volatility. Due to prevailing market conditions, some investors stray from their predetermined allocation and can also fail to rebalance on schedule.

Investment Checklist

Emotional investing can sabotage your long-term financial plan. Following your feelings is usually counterproductive as your emotions usually lead you to choose the wrong action at the wrong time. Additionally, it can be costly because there are usually charges associated with carrying out buy/sell transactions and if you respond to every change in the market, it increases your fees.

Studies have shown that successful investors have cultivated the following disciplined investing habits to help them reach their long-term goals:

- Follow a structured long-term investment plan. This is developed by selecting the appropriate investment vehicles that complement your risk attitude and will help guide you to achieve your predetermined goals.
- Track your progress so you can always be aware of how your investments are performing. This will help you to determine if you need to make any adjustments to your portfolio.
- Seek expert advice. Financial advisors can offer you professional expertise as well as insight you may not have and can help you to evaluate the available information to make the best investment decisions.
- Know and understand the value of doing nothing at all. There is a saying that time in the market, rather than timing the market, is what leads to a satisfactory result. Therefore, if you make fewer changes, you will hopefully make fewer mistakes as well. This, in turn, will allow your investments to benefit from sustained compounding, which is one of the best drivers of returns.

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