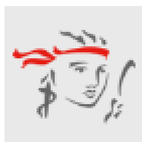

Prudential Investment Managers
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Part 1: Why you should never let emotions cloud your investment strategy

When it comes to investing, we all like to think of ourselves as rational beings who're governed by our heads, not our hearts. But even hardened investors let emotions lead the way from time to time – with potentially dire consequences.

You may think you're able to switch your emotions off when dealing with money matters. But at the end of the day we're all human (Warren Buffett included!), and even seemingly rational decisions can be influenced by powerful emotional biases that operate on a subconscious level.

Two kinds of biases

- **Cognitive biases** are errors which stem from poor information processing, inadequate statistical research techniques and a lack of information. You can overcome these quite easily by getting better information and qualified advice.

- **Emotional biases** are based on impulses, intuition and feelings. They can have a significant impact on your long-term investment return and are far harder to mitigate than cognitive biases. Emotional biases are completely normal – what's important is to know 1) how to recognize them and 2) how to stop them in their tracks when making important decisions.

Know your enemy

Emotional biases result in huge financial losses for personal investors every year. DALBAR, the global financial community's leading independent research expert, has measured the effects of investors switching in and out of unit trust markets and confirms that the actual return personal investors receive tends to underperform the average unit trust market return (also taking fees into account).

The first step in combating emotional biases is to be able to pinpoint the exact nature of the bias. If you don't know who your enemy is, how can you possibly fight him? Let's focus on three of the common emotional biases that can cloud our investment decisions, namely loss aversion, familiarity bias and confirmation bias.

1. Loss aversion

Loss aversion refers to our tendency to strongly prefer avoiding losses over acquiring gains. Much like the Springboks' ultra-defensive strategy, it can be described as a fixation on the risk associated with an asset as opposed to the long-term potential gain it carries.

If you answer yes to one of the following questions, you may be too sensitive to potential losses and your investment returns may be suffering as a result:

- Do you prefer life assurance over an equity-based portfolio as a manner of protecting your future?
- Do you fixate on the one unit trust that has lost money in your diversified portfolio even though the others have outperformed the benchmark?

- Do you keep telling yourself that you haven't lost until you sell, instead of stemming the losses by selling as soon as you realise you've made a bad investment decision?

2. Familiarity bias

Familiarity bias is the ongoing preference for well-known, familiar investments despite the obvious gains to be had from diversification. In the same way we all use the same margarine our moms bought, we all tend to prefer to invest in our own way.

If you find yourself doing any of the following, you may be affected by familiarity bias:

- Purchasing an additional property to rent despite your total wealth portfolio being overexposed to residential property
- Investing only in South African-based companies that you know
- Avoiding purchasing offshore unit trusts because they are invested in "strange" emerging markets
- Buying more and more shares in the company you work for – thus exposing both your assets and your income to risk should the company go off the rails.

3. Confirmation bias

In the modern era of smartphones and Twitter feeds, we're all exposed to an overload of information. Amid the deluge, we have a tendency to manage the overload by focusing on facts and opinions which support our own – at the expense of potentially useful information that doesn't fit in with our preconceived notions.

This helps to partly explain bull and bear markets (apart from the overriding and well-known emotions of fear and greed): when markets rise, everyone buys and the increased demand pushes prices up. Conversely, as markets fall everyone sells, and the increased supply leads to further market losses….

If you've noticed yourself doing any of the following, it's likely a result of confirmation bias.

- You see far more BMWs on the road shortly after buying one for yourself
- You sell your local equity-based unit trusts as they've underperformed for three years (even though you know this is a short time horizon)
- You decide to buy Bitcoin because you think it's cool and everyone is talking about it, without consulting a financial adviser

Know yourself - and use a financial adviser
All three of these biases (the tendency to avoid loss, to stick with the familiar and to see information which confirms our beliefs) impact on us as investors. While we cannot – and should never want to – 'cure' ourselves of the emotional biases that are bred into us through life experience, we can try to mitigate their potentially negative effects on our investments. Working with a financial adviser can assist you in recognizing these emotional traits before they cause any serious damage. They will help you build an investment portfolio with the appropriate asset exposure and risk to meet your investment goals.

In our follow-up article, we'll look into a few more emotional biases that can lead to poor investment decisions, and discuss strategies to overcome them.
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