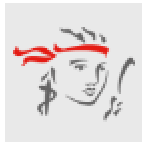

Prudential Investment Managers
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Part 2: Why you should never let emotions cloud your investment strategy

Traditional financial theory assumes that investors know what they're doing and are consistent in their decision making. It suggests that as we experience new information, we update our beliefs accordingly and that our investment decisions take into account the circumstances around us. When it comes to putting this theory into practice, however, we often act emotionally and irrationally. With severe consequences for our hard-earned cash…

As discussed in Part 1 of this article, the first step in successfully combating emotional biases is to pinpoint their exact nature. Once you're able to recognize these biases in yourself, you'll be better equipped to stop them in their tracks when making investment decisions.

This week we're going to look at three more emotional biases that can cause financial loss, namely overconfidence, herding and recency biases.

The hare and the tortoise: Overconfidence bias
Just like the weekend chef who thinks he can make a perfect risotto, overconfidence stems from thinking that you know more than you do or being lulled into believing that you have more control than you do. In an investment context, overconfidence can be:

- A prediction confidence, which refers to having very specific market range estimates and being confident that they're accurate
- A certainty confidence, which describes someone who assigns too high a probability to a specific outcome

If you find yourself doing any of the following, you're probably affected by an overconfidence bias:

- Failing to diversify (because diversifying is only for those who cannot see the future)
- Buying too many assets that professionals would class as risky because you believe they aren't risky
- Trading a lot because you believe you can time the market

Overconfidence can be even more dangerous when combined with a self-attribution bias – the term used to describe investors who take credit for their good investments but who blame external factors when they lose money…With the result that they never learn from their mistakes.

Remember that all overconfident investors are only one trade away from a humbling wake-up call!

The wolf in sheep's clothing: Herding bias
Herding behaviour is our tendency to copy the actions (whether they be rational or irrational) of larger groups. Better put, it's mob mentality and lazy thinking. There are two reasons why herding can occur:

- Most of us have a natural need to be accepted by a group rather than be branded as an outcast
- We tend to believe that group-think can't be wrong (and even if we disagree, we join the group because we fear that they know something we don't)

Investment ideas can be contagious and being part of a group makes us less likely to ask appropriate questions. Following the herd can be fun while it lasts but it's seldom profitable for very long and it's impossible to predict when the group will change its 'emotional mind' and swing markets, or the value of specific, investments in the other direction.

If you've done any of the following, there's a good chance you're affected by the herding bias:

- Going to AfrikaBurn three years in a row, despite your dust allergy
- Investing in Bitcoin even though you don't know how it works
- Buying when markets are high and selling when they fall

The boy who cried wolf: Recency bias

Recency bias is our inclination to believe that something is more likely to happen simply because it occurred in the recent past. The inverse is also true: if it's been a long time since an event last happened we tend not to expect it to happen again. The Springboks' dismal recent record against the All Blacks being a case in point. This bias stems from the fact that that we tend to value recent information more highly than older information.

In investing, the recency bias establishes momentum and convinces us that a rising market will continue to rise and conversely that a declining market will continue to fall.

If you say yes to any of these, you may be influenced by the recency bias:

- Do you review recent returns and use them as an indication of future returns?

- Did you sell unit trusts during the 2009 market crash?
- Do you review your portfolio every day and call your advisor frequently?

Strategies to overcome emotional biases

While you cannot cure the emotional biases that make you a human being, you can certainly try to mitigate their effects. For starters, keep reminding yourself of these tried and tested investment strategies:

- Remain humble and don't try to time the market
- Do your homework before following an investment trend
- Take on a long-term view
- When evaluating a unit trust's performance use 5 to 10-year annualized returns
- Diversify across asset classes as appropriate to your investment strategy
- Don't make snap decisions and always seek professional advice

Once you've taken care of these basics, the best way to keep emotions out of your investment decisions is to commit to learning. Devour information from a wide range of sources and give equal weight to articles or opinions that differ from your point of view.

Even more significantly, learn from the past by keeping thorough investment trade records which also detail your practical and emotional circumstances at the time. Study these records closely and you'll start to see a pattern emerging. Only once this happens will you be able to create the self-awareness which is vital to remaining objective.

Has this got you thinking about your emotions? Speak to your financial adviser or use Prudential's investment tools to assist you to make rational investment decisions.