INVESTING

Inside the Investor's Mind

"Oblivion," the world's first vertical drop rollercoaster, elevates riders 196 feet at its peak, and then plunges them into an underground tunnel. In a matter of seconds, the coaster's riders feel euphoria as they soar over Stratford, England, and then fear, as they take a 68 mph nosedive into a shadowy abyss. Does this sound similar to the emotional highs and lows you experience with your investment portfolio?

More often than not, your investment portfolio's highs, lows, twists, turns and plummets are actually courtesy of your own psychology. Emotions substantially affect rational thinking; when you let certain emotions fuel your investment decisions, your portfolio could be in trouble. Understanding the psychological weaknesses that typically afflict investors will help you prevent them from damaging your own investment portfolio.

What's Your Risk Tolerance?

Before identifying the emotions that typically affect investors, it's first important to understand risk tolerance. Risk tolerance is how much unpredictability a person can financially—and especially "mentally"—handle in his or her investment portfolio.

Those with high risk tolerance—meaning they're comfortable with investing in riskier markets—usually reap the highest long-term gains. But their chances of suffering short-term losses is just as high. Especially for retirement investments, investors in their 20s usually have a higher risk tolerance than investors in their 60s who are nearing retirement. Aging investors usually have a low risk tolerance; a short-term loss could deplete their portfolio and they don't have time on their side to recoup what they've lost.

Risk tolerance and emotions go hand in hand; successful investors know their risk tolerance and how certain emotions can either increase or decrease the amount of risk they take.

The pain of regret can cause investors to enter or exit the stock market too soon or stay in the stock market too long.

Emotions That Affect Investors

Emotions are the part of your psyche that influences your motivation and behavioral tendencies. In any area of our lives, when emotions run high, it causes our rational, commonsense

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brains to shut down and prevents us from making rational decisions.

Euphoria, greed, fear and regret are just a few of the emotions that affect investors and the decisions they make for their portfolios.

Euphoria, optimism and overconfidence

Euphoria—the state of intense happiness and self-confidence—gives an investor that surge of adrenaline, similar to what riders feel at the top of "Oblivion." Euphoria causes investors to be more optimistic about the stock market and certain stock picks. But the elation and pride from a gain can also prevent the investor from detecting risks. As their self-confidence increases, investors tend to view themselves as more competent to choose the right stock picks than they really are. Many times, overconfidence leads to greed.

Greed

Greed is the excessive desire that alters investors' judgment, leading them to poor decisions and irrational actions. Most people want to make as much money as they can, in as little time and with as little effort as possible. Investors have the instinct to always try and get a little bit more; but this "get-rich-quick" mentality can cause a frenzy in their portfolios, not to mention, the overall stock market.

Greed is not an easy emotion to overcome, and it can be the foundation for reoccurring investment errors such as "following the herd" and jumping on the bandwagon of the latest investment fad, or hanging on to stocks too long.

Fear

On the opposite end of the spectrum from greed is fear, an emotion just as debilitating to both investors and potential investors. Fear is an instinctual reaction to what someone perceives as an anticipated or actual threat. It can cause investors to do any of the following:

- Sit on cash that should be invested
- Sell winning stocks too soon or enter and exit the stock market too soon
- Hold on to losing stocks too long or stay in the stock market too long

Some people believe the stock market is too risky. They would be unable to stomach the ups and downs of their investment losing and gaining money. These individuals feel more comfortable protecting their money somewhere with very little risk, such as a savings account. Little do they know that stockpiling their cash in a savings account is a risk, too. While their money is safe in the short term, it's not growing to meet the rate of inflation over time. Preparing for major life events, living expenses in retirement and major purchases, your money must grow to afford the higher price tag of these expenses in the future.

Those who actually do invest are also susceptible to fear. Paralyzed by the fear of making errors, some investors either sell winning stocks too soon or hold on to losing stock positions that should be sold out because they're afraid of losing money. Some studies show that the pain of losing a certain amount of money is actually greater than the pleasure derived from winning the same amount.

Regret

Who likes to admit they're wrong? No one. For investors, it's difficult to admit they're responsible for making poor decisions about stocks. The pain of regret can cause investors to hold on to losing stocks too long or sell winning stocks too soon. A loss of wealth can be so painful to your psyches that you want to make the pain go away quickly. Usually driven by fear, investors will make any decision possible—however irrational it may be—to avoid experiencing regret.

The Stock Market: One Big Emotional Rollercoaster

Did you know that investor emotions affect more than just an individual's portfolio, but also the overall stock market?

The volatility of the stock market is based on a number of factors—from events happening around the world, to the psychological whims of a group of investors in the short term. Especially highly emotional investors—and the "herd mentality" in which may investors jump on a bandwagon and buy a certain stock—can create panic and excitement that causes instability in the market.

Market fluctuations result in part from the collective expression of individual investors' psychological hang-ups. When investors put more and more money into a particular stock, the price rises sharply, creating a bubble. Greed can cause investors to hang on to these stocks for too long. Then fear causes a mass exodus out of the stock market and stock prices plummet. These are just a few of the "mood swings" that affect the market.

Put Your Emotions in Check

It's easier said than done, but keeping your emotions in check will lead to personal investment success. So how can you accomplish this?

Know you're in control. Only you can prevent your emotions from clouding your investment decisions. Understand that once the emotion is released, it's difficult to contain. Identify your emotions before you act on them, and take time to think things through before jumping on an investment decision.

Educate yourself. Understanding how the stock market works will decrease much of the fear and anxiety that comes with investing. Thoroughly research your investment and examine the history of the stocks you're interested in. Don't simply look at how a company is performing now; analyze the history of the stock's performance. When you finally decide to buy, select your investment based on facts, not on speculative forecasts or because everyone else is buying them.

Choose an asset allocation mix that's right for you. This means diversifying your portfolio and finding that balance between riskier and conservative investments. Some investors build their portfolios largely out of stocks in order to have the best chance of providing a high return. Other investors buy mostly bonds and cash equivalents; these are low risk, but the returns are also very small. To combat the risk of huge losses for both those with high and low risk tolerance, investors diversify their portfolios by spreading their assets among different types of investments to minimize loss. Diversification is a reliable method to decrease risk while still getting solid returns.

Think long term. Avoid watching the day-to-day peaks and plummets of your stock. This can stress you out. Instead, concentrate on the long-term performance of your entire portfolio.

Reduce stress. Stress is a symptom of emotion. Letting stress—the body tension and mind clutter—overpower your thinking prevents you from making rational decisions about buying, selling or holding onto an investment. Reduce stress by doing your own homework and talking to an investment expert.

Talk to Heim, Young & Associates, Inc.. We are here to discuss your personal financial goals and educate you on investment strategies to meet those goals.

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