Why Fear Is an Investor's Worst Enemy

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Barry Ritholtz, chairman and CIO of Ritholtz Wealth Management, wrapped up day two at the 2017 Morningstar ETF Conference with a lively presentation on the role that fear plays in investing.

Many people underestimate the power of fear in investing. Ritholtz pointed out how dangerous fear can be, especially because investors tend to fear the wrong things. This is evident in the public's fear of taking on risk. In investing, risk is sometimes seen only as downside, instead of as a necessary part of achieving higher long-term returns.

Throughout his presentation, Ritholtz gave multiple examples of humans being controlled by irrational fears. He mentioned the film "Jaws" that came out in 1975. Since its premiere, sharks have been seen as menacing, man-eating predators. Growing up in Rhode Island, Ritholtz even remembers people staying out of the water that summer, out of fear of a shark attack. Although sharks are great predators they are certainly not deserving of this stigma. In fact, more people are killed by trying to take selfies. In the U.S. deer and cows are much more dangerous than sharks.

Ritholtz discussed a similar irrational fear that developed after the 9/11 terrorist attack--people were afraid of flying. This fear didn't come from a well-reasoned look at data, instead it was born from an intense, emotional response to a national disaster. When something as catastrophic as this happens, our emotions can get the better of us and seep into our decision-making process.

Fear-based or emotional decision making can only lead to bad judgment and outcomes in capital markets according to Ritholtz. In this example, the fear of flying prompted people to take to the road instead, causing 1,500 more travel deaths due to car crashes.

Why does this happen?
According to Ritholtz, emotional decision-making came in handy for our ancestors who had to survive in the wild. But today, it can make us miss out on returns.

In capital markets, these survival instincts turn into behavioral biases, such as availability bias and loss aversion. Availability bias is our tendency to overreact to attention-grabbing events. Ritholtz gave multiple examples of investors and the media shouting doomsday at every bump in the road--such as after the 2003 Bush tax cuts or the swine flu wcare of 2009--only to see the markets soar months later.

What does this fear make investors do?
Our irrational fears prevent us from taking on risk. In behavioral science, this is called risk aversion, or our tendency to put our money on a low risk, low return investment, instead of taking on a riskier, but more promising investment. We prefer to choose the sure and safe option, even

at the cost of higher returns. In the long run, this bias can cost investors dearly. This instinct was great for our ancestors when exploring a new environment, but today, it can lead us to a portfolio that consistently underperforms the market.

According to Ritholtz, this is why it's important to manage our emotions when investing. As we all know, without risk, there is no return. To help manage our emotions, Ritholtz gave a few tips.

Focus on the data. Research on investment risk show that markets always recover. Disciplined investors who hold on through the rough times are rewarded in the long term.

Focus on things that matter and that you can control. The market is bound to fluctuate, and there's nothing investors can do about that. Instead, focus on managing that risk, like diversifying.

Remember that risk is necessary for returns. When it comes to investing, our minds are our own worst enemies. When making investing decisions, try to focus on long-term goals--and not the naysayers on TV.